



## Sophistry

John M. Gustafson – 30 September 2021

*“Among the most formidable of the obstacles which the new Constitution will have to encounter may readily be distinguished the obvious interest of a certain class of men in every State to resist all changes which may hazard a diminution of the power, emolument, and consequence of the offices they hold under the State establishments; and the perverted ambition of another class of men, who will either hope to aggrandize themselves by the confusions of their country, or will flatter themselves with fairer prospects of elevation from the subdivision of the empire into several partial confederacies than from its union under one government.” - Alexander Hamilton, Federalist 1*

My daughter’s English class will be reading the “*Federalist Papers*” this year and when I heard that I thought I would play along – not only for the discussion but also because they are something I had always wanted to read, but never found the time. If you haven’t read these essays, or if it’s been many years since, I highly recommend having a look once again. It is amazing how these missives written more than 230 years ago can feel as if they are describing what we see in the country in the past decade as outlined above.

Why am I outlining old political philosophies in an investment essay? Because as has been the case throughout our history – and especially over the past decade – the political battles in our country continue to directly affect the economic winds on which we ride.

“Yellow” journalism isn’t a new concept either, however the speed at which information (true and biased) is disseminated is far easier to use to create whatever *reality* favors the “perverted ambition of another class of men.” That is also why I chose the title of this quarter’s note.

As you can imagine, I speak with a lot of people from across the country – some on the left and some on the right – and can tell where they sit simply by the types of questions they ask about the markets and our current economic situation. It is quite useful to me as it allows me to check my biases and not remain in an echo chamber driven by media and online algorithms. That’s not to sound pejorative in any way. People have always lived in silos as indicated by the famous quote attributed to Pauline Kael, a New Yorker editor, who exclaimed after a Nixon victory, “I can’t believe he won, I don’t know anyone who voted for him.” (That’s not the actual quote, but it is a fairly accurate summation.)

Technology and media expansion was supposed to make us all better informed and ease access to the “truth.” In reality, it has been manipulated to isolate groups and wall us off from differing opinions. Again, something I try to dig through daily to see the investment forest through the trees.

*“The instability, injustice, and confusion introduced into the public councils, have, in truth, been the mortal diseases under which popular governments have everywhere perished; as they continue to be the favorite and fruitful topics from which the adversaries to liberty derive their most specious declamations.” - James Madison, “Federalist 10”*

In terms of political drivers of our economy and the markets – especially in the short term – what's old is seemingly new again and the teams have once again switched sides of the stadium. All we hear on one side is that the ballooning deficits will crush us all (after significantly increasing it during recent good economic times) while the other couches their program as an “investment” in the future. The issue is that we have come to a point where each side feels that theirs is the only solution to American ills. In reality a little bit of both is likely the proper answer and that does seem to be what will come of this. The bright spot amidst the constant wailing and gnashing of teeth.

This is how I couch my current investment outlook. We are in a position where there is TONS of liquidity still sloshing around from all of the COVID relief bills (not simply the last one), interest rates remain historically low, despite the pearl-clutching about inflation and other than some pockets of residential real estate there really aren't any obvious bubbles in our markets currently.

In fact, I was participating in a professional investors' forum held by Goldman Sachs the other day and one of their chief strategists outlined the fact that consumer debt has fallen, earnings continue to rise and the bits of wage and energy inflation we've seen this year (again, after having come to a complete halt last year) will likely normalize over the next several quarters.

That is not to say there is no risk, specifically in the short term, it's simply to say that nothing is out of the ordinary in terms of the business cycle and other key metrics that are accurate over time but can be misleading in the short term. (Especially when you're a media company that needs a story to tell each day – and as we've outlined, it is all colored by politics and how you want to spin the facts.)

*“It has until lately been a received and uncontradicted opinion that the prosperity of the people of America depended on their continuing firmly united, and the wishes, prayers, and efforts of our best and wisest citizens have been constantly directed to that object. But politicians now appear, who insist that this opinion is erroneous, and that instead of looking for safety and happiness in union, we ought to seek it in a division of the States into distinct confederacies or sovereignties.” -- John Jay, “Federalist 2”*

Here is where the longer term danger lies... As has been stated in multiple essays here over the past 12-ish years, Congress will never take action until they are forced to at the 11<sup>th</sup> hour and we are once again seeing that play out with the debt ceiling. Let's be clear here – despite what Leader McConnell would have everyone believe, the debt ceiling is paying for bills that we have already incurred, regardless of what is being planned. (Like all those COVID relief bills last year as one example.) The last time this vote needed to be taken was in 2017 and nobody made a big stink about it.

Do I think that it will be raised? Yes... But just like the last time there was even a hint of the United States defaulting on our obligations, the market reacted poorly and swiftly. That was

when Tea Party members would gleefully go on TV and opening discuss their desire to default as if it would hurt China more than the U.S. back in the third quarter of 2011.

The very fact that the U.S. Dollar is THE reserve currency of the globe cannot be understated and nobody would like to see us knocked down a peg more than the Chinese. And of course Vlad Putin would have a chuckle and share plenty of his thoughts about America's failings. Both countries dislike our influence across the globe and are continuously working to grab the affection of our friends and allies.

I don't think we will see a repeat this year, but the way the extremes are acting while posturing in their respective echo chambers (that didn't exist as they do now, back then) we'll have to wait and see. You can't strategically plan for a tactical hit like this other than to be comfortable with the level of cash on hand we have after the last rebalance. It's one of the reasons we take such actions at inflection points during the year.

*"A firm Union will be of the utmost moment to the peace and liberty of the States, as a barrier against domestic faction and insurrection. It is impossible to read the history of the petty republics of Greece and Italy without feeling sensations of horror and disgust at the distractions with which they were continually agitated, and at the rapid succession of revolutions by which they were kept in a state of perpetual vibration between the extremes of tyranny and anarchy. If they exhibit occasional calms, these only serve as short-lived contrast to the furious storms that are to succeed." -- Alexander Hamilton, "Federalist 9"*

Back to our business of looking ahead – always forward, never straight. What is likely in store as summer turns to fall and we roll onward toward winter?

To reiterate an earlier point, there remains a firehose of liquidity coursing through our economic veins and the chance for more when it comes to a bipartisan infrastructure bill. The numbers being thrown around are a bit ridiculous. There is zero chance that \$3.5 Billion will be the final number. The plan that was negotiated by the group of Senators from both parties is a little under \$2 Billion – and the only thing holding that up right now is the Sanders wing on the far left. At some point, that side of the political aisle is going to have to realize that they will likely lose the House next year, simply because of redistricting, but also because they hold the White House and that's the historical pattern. However, if they blow this deal, Katy bar the door - they will get crushed next fall in both chambers.

Another one of those items I believe will pass – only at the last minute, of course. That said, we must remember that there has been plenty of money lost speculating that politicians will do anything other than what they believe will serve their own personal interests. Stay tuned...

Regardless of those political outcomes, the true governor on economic growth at this point in our country is labor mobility and skill. The pandemic issues across the globe is still causing shipping and material movement to be dramatically slower, but all across the country there are currently over 1 million more job openings than there are people out of work looking for employment.

We have discussed this issue over the past several quarters, but it is something that needs to be remedied. The only media story regarding U.S. immigration policy concerns the illegals at the southern border (I think we've been hearing about that issue for most of my 50 years) but the truth is we need to improve our "legal" immigration path as well. Otherwise, no amount of

stimulus or infrastructure money will move the needle in any extended fashion. We simply don't have enough skilled workers in the correct places to drive our economy and utilize its full capacity.

Will making tech schools and community colleges free to those who wish to train for new opportunities be a good solution? It couldn't hurt... Will that solve our problems without letting more immigrants in? Not a chance – at least not in a timely fashion to keep growth from stalling out.

I don't have the answers on this one for sure, but my hope is that those who are tasked with such things will at least stop yelling nonsense and have the conversation. If it isn't solved soon, that will put the brakes on our markets fairly quickly, but if it is... we could be in for another boom like the 1950's.

All-in-all, I'm not overly concerned with any single industry holdings in our portfolios outside of technology. You know that one of the items I always keep an eye on are the industry weightings in the S&P 500. I have found it to be a fairly good indicator as to what industries have become generally over-valued. You could see it in the dot-coms in the late 90's, the housing / financials in 2007 /2008 and the several times that energy (oil) has had large spikes in the past few decades.

Any time a single industry comprises over 30% of the valuation of the entire index, nothing good is likely to come in the near future. We're not there yet with tech, but it is nosing up beyond 27%, so there's clearly not an "undervalued" situation there. Most of the rest are fairly close to their historic weights. Another indicator that without outside circumstances (\*cough\* government default \*cough\*) is not likely to trigger more than a normal, cyclical correction.

And to add a little more color to this conclusion – outside of the largest tech stocks in the S&P 500, almost 80% of the remaining stocks in the index have already experienced a correction of more than 10% from their respective peaks in the past several months. They simply didn't fall all at once to catch everyone's attention.

I'll close this note with another not so subtle reminder from one of our founders that once again rings true today.

*"A dangerous ambition more often lurks behind the specious mask of zeal for the rights of the people, than under the forbidding appearance of zeal for the firmness and efficiency of Government." - Alexander Hamilton "Federalist 1"*

Thank you as always for your business, trust and friendships. If you have any questions or need anything in the interim, please reach out via phone, text or email. Cheers!

A handwritten signature in black ink, appearing to read "J.M. Gustaf". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.