



The Art of War

(The “New Normal” in America)

John M. Gustafson – 31 December 2017

“The wise warrior avoids the battle.” - Sun Tzu

“When people treat me badly or unfairly or try to take advantage of me, my general attitude, all my life, has been to fight back very hard. The risk is you'll make a bad situation worse, and I certainly don't recommend this approach to everyone. But my experience is that if you're fighting for something you believe in — even if it means alienating some people along the way — things usually work out for the best in the end.” - Donald Trump, “The Art of the Deal”

As a tumultuous year ends inside the D.C. Beltway, the markets continue on their upward, years-long journey, pushing the envelope with an actual legislative victory from the do-nothing Congress that should keep financial momentum rising at the corporate level for years to come. This year has also continued to reveal that there remain two-Americas, and that is the risk to true financial security in the long run. The political Left and Right have changed seats in the stadium, but the cheers and jeers all sound the same as we heard the previous eight years.

The “makers” will certainly be helped by the tax legislation, but there were no corresponding changes in the way the “takers” in the economy will continue to be compensated, thereby preserving a shell game that cannot last forever. Far be it from me to be a deficit hawk - and I roll my eyes every time I see a “study” predicting social security going broke decades from now, when the truth is that Congress can't think past the next election - but we do seem to have lost all concern for such things. A small red flag...

I don't blame the President on this front - ownership lies squarely at the feet of the spineless members of the House and Senate who never have the guts to enact real change to help raise everyone up. They would rather continue the system of bribery and handouts (not a hand-up) keeping the lower echelon docile. It's quite similar to how the Saudi royalty and Chinese Communists remain in power over their downtrodden masses. As Shaw wrote, “A government that robs Peter to pay Paul can always count on the support of Paul.” (The swamp is tough to drain...)

From an investment perspective there has been endless speculation as to how the tax cuts will truly affect corporate behavior in the long term. The one thing lawmakers absolutely got right in the bill is that it is a permanent rate change. The fact that individual rates revert in a decade isn't

as big a deal - not many individuals think in terms of multiple years when it comes to budgeting. However, when it comes to large, job-producing capital expenditures, all good companies absolutely do. And we invest in companies here, not the public at large.

“The general who advances without coveting fame and retreats without fearing disgrace, whose only thought is to protect his country and do good service for his sovereign, is the jewel of the kingdom.” -Sun Tzu

“One thing I’ve learned about the press is that they’re always hungry for a good story, and the more sensational the better. It’s in the nature of the job, and I understand that. The point is that if you are a little different, or a little outrageous, or if you do things that are bold or controversial, the press is going to write about you.” - Donald Trump, “The Art of the Deal”

A key theme to these notes over the past several years, that many of you may recall, is that D.C. has been a dumpster fire of ineptitude for years and the real reason we crawled back from the abyss in '08 was Ben Bernanke and we then continued to rise steadily via the work and philosophy of his successor, Janet Yellen. Both had a keen perspective on the actual working of a capitalist economy within the proper context of history, as well as what was required to keep things chugging along, despite efforts from the Capitol continuously to the contrary. The new sheriff in town, that the President recently appointed, Jay Powell, is cut from the same cloth as Ben & Janet, but is most importantly (to POTUS) *his* guy.

Even though philosophically Powell is aligned with Bernanke and Yellen, there are distinct differences that are important. First, he is not an academically-trained economist, he’s a lawyer. One who has spent his career at financial firms - dealing with legal issues - not directly with the bond markets. Certainly not a disqualifier, but operationally it will make a difference.

Second, he will now lead an organization similar to a third-generation family business. “Grandpa” Bernanke started the business amidst chaos and got things going in the right direction, “Mother” Yellen continued the trend after learning the ropes from her dad, and now the “Grandson” Powell must take the family business in an entirely different direction. Generally a precarious time in many family-run endeavors. Stay tuned...

Unwinding the enormous portfolio Powell inherited, while keeping an eye on the resurgence of inflation that we may finally see once again from the aforementioned tax cuts. A tricky environment we haven’t experienced since the mid-1990’s. The good news is that inflation is somewhat easy to tamp-down with the Fed’s interest-rate hammer. Lighting the “growth fire” solely via monetary policy is alchemy. (Just ask the Japanese) It will also be interesting to see the Tweeter-in-Chief’s reaction if the markets stumble during a quarter where the Fed needs to be aggressive with rates.

I’m not in any way saying that I don’t believe the market can continue to rise - it’s done so quietly for eight years, while people endlessly questioned the surrounding environment - something unquestionably better now. However, the old saw from John Templeton always rings true, “Bull markets are born on pessimism, grow on skepticism, mature on optimism (*where I believe we are now*) and die on euphoria.” The only thing that has been truly ridiculous and

euphoric so far is Bitcoin. We can see positive sentiment growing in the U.S. stock market based on recent fund-flows, but we're not crazy yet. Simply another small red flag...

"If you know yourself but not the enemy, for every victory gained you will also suffer a defeat." - Sun Tzu

"I don't hire a lot of number-crunchers, and I don't trust fancy marketing surveys. I do my own surveys and draw my own conclusions." - Donald Trump, "The Art of the Deal"

Unemployment and immigration is going to be a sticky-wicket in 2018 for sure. The argument from both sides is always played as black & white rather than shades of grey - as are all complex issues in our current hyper-political environment. With all that rocket-fueled, capital spending we expect from the massive corporate rate-drop, the issue will now fall to immigration. We are at historically low levels of unemployment and we simply don't have enough properly-skilled people to perform all the jobs. It is also the fallacy of the ultra-loyal, rural Trump voters that will be an interesting story to watch play out - these jobs aren't coming to coal towns in Appalachia.

The right side of the aisle is correct in that we *do* need to stop illegal immigration, stemming the incredible drain on our social-welfare nets and keep those meager dollars for our own citizens and *legal* immigrants who need help. *But*, we also need those with skills to have a streamlined path to immigrate and stoke the fires of our economy.

If this situation isn't addressed the country has almost zero chance of getting growth above 3% for a sustained period. Once big dividends are paid and buybacks of stock are announced, we go back to the planning of large, capital projects that are the true job-creators that everyone wants. It's not simply the permanent rate cuts that make it worthwhile for the corporations, they also need to be able to staff at appropriate levels in order to take advantage of their newly created bandwidth. A slightly larger red flag to watch...

Complicating this argument will once again be D.C. politics. The tax bill was a huge win for the Republicans and my fear is that they want to fall into a prevent defense for the 2018 midterms and go back into their inactive shell. Immigration policy, health insurance and infrastructure are still the big needs after years of inaction, neglect and outright foolish policy on these issues.

The President is going to want to keep the foot on the gas on these items because he's thinking of 2020. Those on the Hill are simply eyeing November. You can clearly see signs of Trump thinking ahead - have you noticed how close he has seemingly become with Orrin Hatch of Utah? All you need to know about this D.C. Bromance is that the party favorite to run in his place, should Sen. Hatch decide to retire, (he's held the seat since 1977) is none other than Willard "Mitt" Romney. Not exactly someone President Trump would like to see building power and connections in D.C. Another small red flag...

"When the enemy is relaxed, make them toil. When full, starve them. When settled, make them move." - Sun Tzu

Please take note of the tone of my final quote above - that statement is a philosophy that both Sun Tzu and the President seem to share. My intent in this report was to illustrate a real issue that has always been around, but seemingly exploded over the past 18-months. We are in the age of speed and the internet, where being first is better than being right. It's more than that, however... We have discussed several times over the years about bias in what you hear on TV regarding investments, the media business model versus the model of someone who actually manages money and has to face clients when things don't go as planned. The last election seems to have taken this to a new level in politics where more mainstream *news* outlets went crazy.

We've clearly slid into an era where nothing is simply reported as plain facts - everyone has an angle and the way they tell the story colors the view. As I did in this missive, simply using historically accurate quotes of my choosing paired to show desired dissonance and tone.

It is a minefield we are used to in the investment world - I'm specifically recalling a note I'd written several years ago explaining "synthetic derivatives" as used in a now infamous Goldman Sachs trade, versus what the screaming media was telling everyone.

So, what is the bottom line for 2018? Our portfolios will remain U.S. centric with a global balance. Fixed income will be a store of value, but structured to survive rising rates. Our continued addition of large, U.S.-based multinationals will be sprinkled in where appropriate. They are the absolute winners of the tax bill, without question..

Our annual calculations regarding rebalancing and updating the portfolios is underway based on the lessons learned over 25 years (next month!) managing assets. Thoughtful strategy, not emotional reaction, has never gone out of favor for the long term - only our metrics of analysis change based on how the public reacts to the current and projected environment.

Two final quotes that I hope are proven to be prophetic in the coming year and we see a turn away from the poisonous dialogue of the past decade.

"There is no instance of a nation benefitting from prolonged warfare." - Sun Tzu

"A kingdom that has once been destroyed can never come again into being; nor can the dead ever be brought back to life." - Sun Tzu

Happy New Year to you all! Thank you for your continued trust and business. Here's to another profitable year in 2018!

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.