The Equus Report

—BY BARNABY LEVIN

Seven Surprises

February 21, 2017

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Every year since 1986, Byron Wien has published a list of “Ten Surprises,” offering his views on a number of economic, financial and political events for the coming year, defining a “surprise” as something that the average investor would only assign a one-in-three chance of taking place but which he believes “probable” – that is, having a better than 50% likelihood of happening. So, I thought it might be fun to try my own hand at it for 2017.

To begin with, it only seems fair to see how I did in last year’s article, “Ipso Facto,” in which I not only gave my explanation for the 1st Quarter sell-off, but also what we needed to keep our eyes on over the year ahead. This included what I called the four “C.O.R.E.” fears regarding **C**hina; **O**il; the possibility of a U.S. **R**ecession; and a slowdown in **E**arnings. In the end, despite these very real concerns, I thought we’d make it through okay from that point forward and we did.

Regarding **China**, the markets feared a further slowdown in the face of a property- and shadow-banking bubble and the potential for failure as China continued to transition from an export- to a consumption-driven economy that might result in a hard landing. That didn’t happen because, as I thought, China was once more successful in adapting with the help of a $3 Trillion Balance Sheet. Today, that Balance Sheet is closer to $2 Trillion as they spent aggressively on stimulus and defending the Yuan from too-precipitous a drop versus the $US Dollar and, in the process, shifted their focus to the IMF’s Basket of currencies that includes the euro, Japanese yen and pound sterling, against which the Chinese renminbi has proven less volatile.

Oil – which early in the year reached a multi-year low in the mid-$20s (and, contrary to what Jeff Currie at Goldman Sachs thought would happen at the time) – recovered to the mid-$50s by year-end. This was partly a result of OPEC’s agreement and unexpectedly high level of compliance by member nations to hold production at current levels; and partly because of the old truism that the best cure for low prices is low prices as capacity was aggressively removed in the U.S. through cutbacks and a number of high-profile bankruptcies.

With regard to **Recession** – while we only continued to bump along, just-barely above “stall speed” with an average 1.6% growth in GDP – that growth did pick up in the 4th Quarter to 1.9% possibly due, in part, to optimism over Trump’s campaign promises, including lower taxes; reduced regulation; and a moratorium providing companies like Apple, Microsoft, Cisco and GE an incentive to repatriate trillions of dollars held overseas.

And finally, with regard to **Earnings** – after three quarters of negative results – a blended rate of 5.0% in year-over-year growth in the 4th Quarter seems likely (with more than 71% of U.S. companies reporting through the middle of February) and the S&P, for the first time since Q1 2015, showed an increase in earnings for two quarters in a row and, for the year, eked out a modest gain of +0.9%.

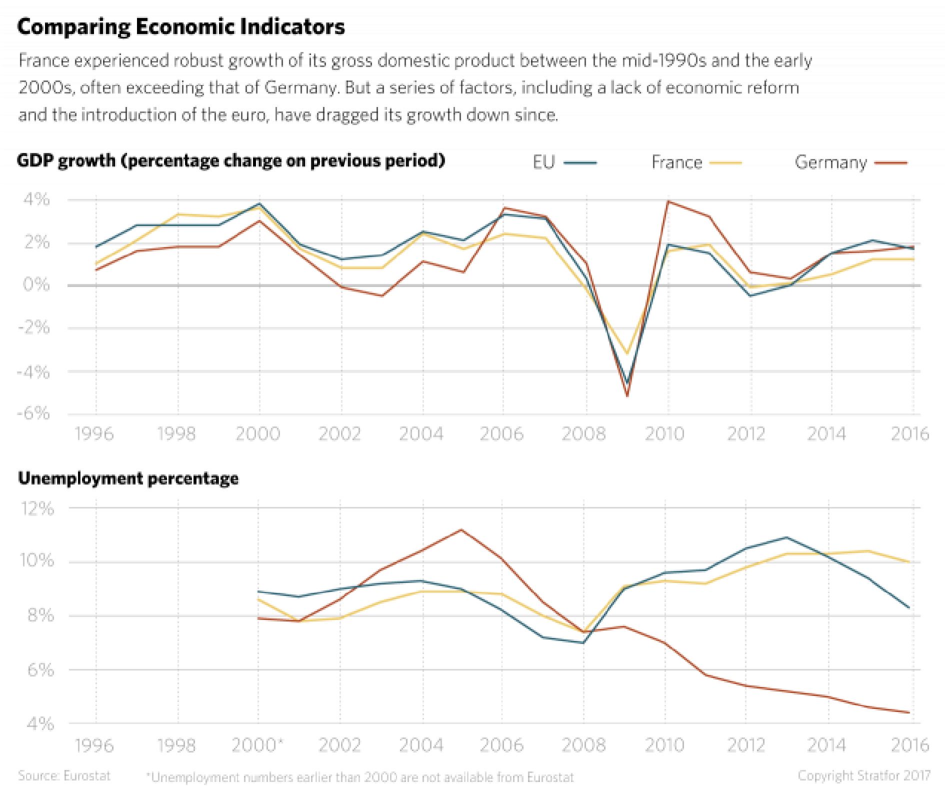
For the first time in many years, I must admit to a bit more optimism (economically speaking) than I have felt for quite some time. While the degree of rancor within our Two-Party system has only gotten worse, it is refreshing to see the constant attacks against our country’s greatest *businesses* beginning to fade, at least – which, I believe, is critical since they are the country's employers and, if we're to be successful going forward, will be responsible for the bulk of capital spending which, we hope, will create new and better-paying jobs for many in America who have long-felt left behind.

This year, our country will be shifting from Monetary- to Fiscal- initiatives, as Central Banks worldwide finally recede in importance and Government Spending takes center stage, with positive implications for growth and, possibly, more normalized/higher interest rates. There will also, most likely, be a return of volatility in the Markets as we see how many of Trump's promises actually come to fruition. Our world is shifting from global- to domestic- agendas, with strong implications for Trade that could cut either way, both positive and negative. But, if the world can grow overall as the IMF expects, it doesn't *have* to be a Zero-Sum game. As we proceed down this proposed path of DE-Regulation, it could certainly have a positive impact on those industries most-harmed in recent years, including Energy, Financial Services and, possibly, Health Care – though the latter's checkered history of (what some might consider) price "gouging" here in the U.S.; poor public relations; and aging demographics may make those negotiations more difficult than the former two. For its part, China will certainly have a harder time *this* year than they did last as their growth (admittedly, for a change) slows even more and, having just spent more than a third of their Foreign Reserves, they will be hard-pressed to continue stimulus at the same pace as in years past. In general, the most vulnerable Emerging Markets will be China, Brazil, Chile, Indonesia, South Africa and Turkey due to their excess Credit growth and large percentage of Foreign Exchange Reserves that are denominated in U.S. dollars which will be more expensive to repay as those debts mature. And all of these trends could last for many years, during which we'll undoubtedly need to deal with a lot of uncertainty since we aren't the only ones led by "strong" leaders who are outspokenly looking out for their own country's interests. Neither Abe in Japan, Xi Jinping in China, Putin in Russia, Erdogan in Turkey, Duterte in the Philippines or (while maybe a long shot) Le Pen in France are people who mind knocking others around in the process of getting what they want and we are unlikely to see any easy resolutions soon. Let's hope we're pleasantly surprised.

Which brings us back to those "Surprises" I promised (some of which I have already alluded to in my comments above) and where I will limit myself, instead, to **7** (which seems *more* than enough):

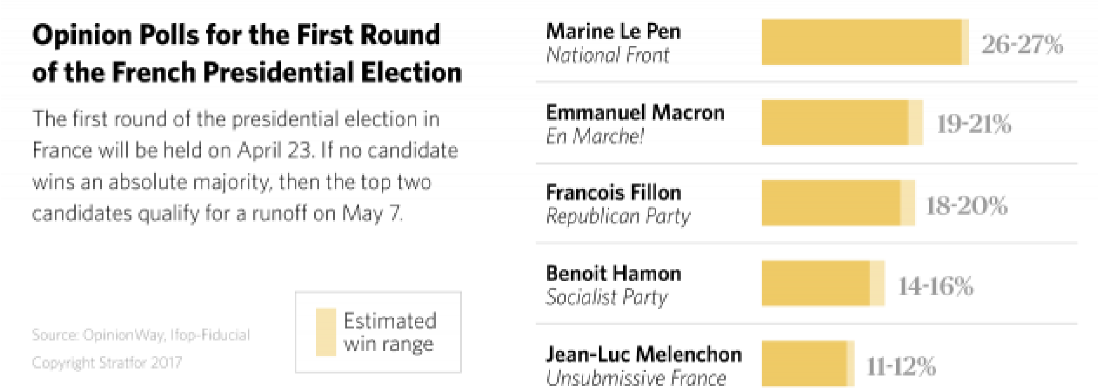
1. **Marine Le Pen is elected President of France**. This is still a long-shot, since France has long practiced a two-round election process designed to prevent extremist candidates from winning. But there's no doubt that the far-right National Front Party has been making strong gains and Le Pen's more conservative, centrist opponent, Francois Fillon, is facing a scandal over jobs he gave to his wife and children. As in so many other countries (including Spain and Italy), there is a growing sense of dissatisfaction with the EU, beginning with a widespread demand across *all* candidates to loosen restrictions on deficit spending while migrants – who now represent nearly 10% of their country's population – are a growing source of concern for many French who believe that the ongoing influx is threatening not only their national identity but, also, their security. Unfortunately, as the graphs show below, persistent Unemployment at 9% has surpassed the EU average every year since 2009 and one in four of the jobs they have is provided by the public sector, leading to high taxes

and public debt at a time when growth has slowed to a meager 1.2%. Being a Eurozone member, fortunately or unfortunately, prevents Paris from manipulating its currency or imposing tariffs to boost competitiveness and, especially when times are tough (as I predicted just prior to Brexit), people resist the idea of an outsider – especially an *un-elected*[1] group of (primarily) politicians and lawyers in Brussels[2] – telling a Sovereign Nation like France what they can and cannot do.

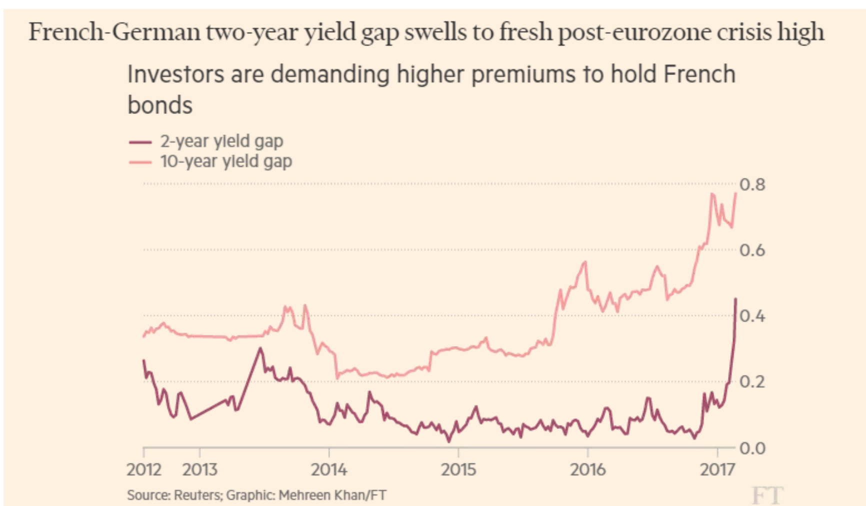


[1] This can be quite confusing, but the European ***Parliament*** is the only directly-elected institution of the European **Union**, composed of 751 members, elected every five years by universal suffrage, in which voter turnout has been steadily declining to 42.54% in 2014. The European **Commission**, on the other hand – which was formally established in 2009 under the Treaty of Lisbon – is composed of 28 members (one member per state) ***appointed by the Parliament***, and led by Jean-Claude Juncker, the former Prime Minister of Luxembourg who, in an interview with the French newspaper "Le Monde" just prior to Britain's vote, famously said "Deserters will not be welcomed back." Through Article 17, it is ***this Commission*** that is responsible for developing strategies for the benefit of all member states; drafting legislation; implementing decisions; upholding EU treaties; representing the EU in trade negotiations; and drawing up the budget for the European Union. Finally, the European ***Council*** is comprised of the heads of state of the member nations and is simply charged with defining the EU's overall political direction and priorities. *Wikipedia.org*

[2] The Juncker Commission, Wikipedia.org



The ***problem***, if I'm right, is that several senior-ranking members in Le Pen's FN Party have already said that, if they win, they will, first, schedule a referendum regarding EU membership (because *they* want to *leave*) and, then, exercise their Sovereign "right" to convert nearly 80% (or 2.1 Trillion euros) in Public Debt to a new, national currency on a 1:1 basis with the euro. This, unfortunately, would cause what Moritz Kraemer, S&P's head of sovereign ratings, says would be "the largest sovereign default on record, 10 times larger than Greece. If an issuer," he says, "does not adhere to the contractual obligations to its creditors – including payment in the currency stipulated – we would declare a default," the impact of which on global markets would, undoubtedly, be severe. So, to be clear: while it is not my *hope* that Le Pen wins, it *is* more than a "mere" possibility.



The Franco-German divergence continues apace.

France's short-term yield spread with Germany has hit a new post-eurozone crisis high today as the country's bonds come under politically-induced pressure while Germany's two-year bond prices hit record highs.

2. In the meantime, **Europe will continue to accelerate their move toward eliminating paper money**, perhaps altogether, under the guise of "cracking down on money laundering and the financing of terrorism." Perhaps you didn't know but, on the heels of India eliminating 80% of their currency last December by recalling all denominations greater than a measly $*8* (500 rupees!), these sorts of actions have been defended by the likes of Ken Rogoff and Larry Summers. Rogoff said "there is little debate among law-enforcement agencies that paper currency, especially large notes such as the U.S. $100 bill, facilitates crime," while Larry Summers wrote that "a moratorium on printing new high denomination notes would make the world a better place" (?!) The bottom line is that the European Union has already discontinued the 500 euro note and England's "Brexit" has only incentivized governments throughout Europe to hunker down and begin criminalizing cash transactions over certain limits so it only seems a matter of time – should the EU truly begin to unravel – before they seize further control of their respective banking systems in an effort to prevent physical money from flowing out of the EU to safer havens before it's too late and their own currencies collapse.

3. **Gold will make its comeback as "Money."**

   No, no, I'm not going off the 'deep end' and worrying that the world is about to end (*yet* ;-). But one of my "heroes," Stan Druckenmiller – after being heavily invested in gold and short the S&P up through the election last November – sold all his gold so he could go "long" the S&P the night before the market rallied and, only three months later, bought it back again: "I wanted to own some currency and no country wants its currency to strengthen so, when gold was down, I bought it." It was, of course, a brilliant trade. But why does he *ever* hold gold? To begin with, comments from Fed Chair Janet Yellen and EU Central Bank Chair Mario Draghi that "economic growth could be derailed" have led to speculation that the Fed may be more cautious about raising U.S. interest rates. There's uncertainty over whether Trump will back (among other things) the House Republican tax plan. There's uncertainty in the wake of Brexit and the more recent "No" vote in Italy that would have increased the power of their Senate to make changes affecting economic policy (which they *need* to do). There are the often-conflicting aims of globalization and open borders versus the security of one's own citizens and how best to protect them. The list goes on but – while gold may *occasionally* be thought of as an "inflation" hedge; a "deflation" hedge; a "fear" trade; or, even, a "store of value" – none of these, often contradictory explanations, ever seems to hold true on any sort of ongoing basis. Instead, like Druckenmiller, I have simply come to consider gold (and silver) another form of "money" like it has been for 5,000 years in most parts of the world. And the fact that a Western power like Germany recently completed its four-year plan to repatriate nearly a third of the 1,500 tons of gold held here in the U.S. "ahead of schedule" (and all 374 tons from France) so that *at least half* of its 3,378 tons in gold Reserves would always be held at home makes me feel it's a good idea to have *some*, at least, on hand. The fact is that, in the aftermath of the financial meltdown in 2008, most central banks have once more come to realize the importance of gold as an anchor for their monetary system and, if the euro were to ever collapse, it would behoove Germany to back its new deutsche mark to prevent what happened to them in 1923 when, after World War I, a wheelbarrow of money couldn't buy a loaf of bread and millions lost their life savings. The simple question, then, as I have asked before is: "Why shouldn't *we*?

4. **The European Union is rocked by another exit from either France or Italy (or both) and is forced to restructure its charter.**

This is why the EU so vehemently opposed England's exit: because they fear it might be the beginning of the end. In recent polls, European citizens have been giving widely mixed reviews on whether they have a "favorable" or "unfavorable" view of the EU – but in some countries, like France, it has definitely been growing more "***un***favorable" due, in part, to that country's handling of refugees and, in part, the sense of Populism that seems to be spreading worldwide. Until recently, people have enjoyed the many benefits of a common currency and free trade between countries. However, Greece and, now Italy, have made it clear that the failure to create and enforce a *financial* union as well has allowed certain countries to ride on the coattails of more disciplined ones like Germany without taking steps to rein in their own spending which, of course, would make life more difficult for those dependent upon the support and, therefore, politically untenable. Unemployment, for example – while having fallen from 11% to 8.3% since the start of 2013 – is still high and is higher than it is here in the U.S. and cutting back on government bloat would only add to the numbers of those already out of work. In addition, underlying the economic risks within the EU bloc, is their inability to sever the link between their banks and their countries' government debt, which still comprises the bulk of bank Reserves and which creates the potential for what is known as a "doom loop": should markets lose faith in a government's ability to repay its debt, that would precipitate a sell-off of their bonds which, in turn, would harm the balance sheets of the banks *holding* those bonds, making them more likely to need another bailout, which would further erode confidence, leading to more sell-offs and so on.[3] So, as I said in "Essential Context," as this unelected group of "elites" in Brussels (or, many believe, Germany, which has been the EU's primary Banker) begins to exercise more control in other areas of their lives – especially if and when it causes financial pain – these Sovereign Nations are going to push back and say "Nobody tells ***us*** what to do." It's fine to tell *Greece* to get *its* act together – but not *France*, whose people fiercely believe they should be the master of their own destiny. The bottom line, therefore, is that the EU is in the grip of a "Catch-22": if they *don't* increasingly exercise control and move in a more heavy-handed manner to enforce *financial* union so that *all* countries are required to operate by the same set of rules, **the EU will fail**; and, as they enforce rules that cause pain in each of their member nations who, like countries the world over, are laser-focused on *added* stimulus and protectionism to advance their own interests, the more those targeted nations will push back

[3] At this time, Italy – the Eurozone's third-largest economy – "has the second-largest ratio of debt to gross domestic product at 132.4%, while its banking sector, saddled with 276 billion euros in bad loans, is the most vulnerable, being the bloc's biggest holder of their own government debt at just under 12% of total assets." Stratfor.com, "The Eurozone: On the Edge of Crisis," January 17, 2017

and the odds, again, will increase that – in the face of elections in Italy or France – one or both of them are at risk of voting (as we did here in the U.S.) "No" (or "***Non***").

5. **Trump's efforts to unravel the Iran deal succeed.** The challenge, of course, will be how many of the five other countries (Russia, China, Britain, France and Germany) that signed the deal would go along with such an action. Britain might; and, depending on which way upcoming elections go, France – and, ultimately perhaps, Germany as well. China and Russia, on the other hand, whose economies are far more intertwined with that of Iran are highly unlikely. But, if *any* of the others go along, it would provide cover for our new Administration to increase sanctions, at which point Iran would most likely declare the agreement null and void in defiance. I think it's safe to say that few countries *truly* believe that Iran's weapons-grade nuclear program has been restrained or degraded, or that the several missile-launches staged by Iran in the months since the Agreement was signed did not violate the spirit, if not the letter, of the law. Yet, in signing the Agreement and releasing millions, if not billions, of dollars held in frozen accounts, we and others have endangered long-held relationships with other Middle-Eastern countries – including the Gulf Cooperation Council composed of Saudi Arabia, Kuwait, the UAE, Qatar, Bahrain and Oman – not to mention Israel, who have long been our strongest allies in the region. It appears that the new Administration is moving to rebuild ties with Jordan and Egypt in the hopes that finding fresh ideas and a new solution for the Israeli-Palestinian conflict might finally restore peace to the region – and only time will tell if they're successful when so many others have failed. But one must try and, in the process perhaps, address other shared interests, like putting an end to the spread of ISIS, al Qaeda, the Taliban and other forms of *militant* Islam, which is a threat to *everyone's* interests – and we can only hope this will include a more-enlightened education system in those countries that doesn't demonize Israel and the U.S. from an early age.

6. **The U.S. avoids punitive tariffs against Mexico *and* China.** When it comes to tariffs, Wilbur Ross, Trump's nominee for Commerce Secretary – whose sway extends from the Census Bureau and Bureau of Economic Analysis, to the Patent and Trademark Office, to the International Trade Administration – has repeatedly stressed the need for "reciprocity." "If the U.S. is going to open up its market to foreign goods," he says, "our trading partners should be expected to do the same." And according to him, the best way to narrow our trade deficits with other countries is to increase ***ex***ports, not limit ***im***ports. "Tariffs," he says, are simply a "way of giving the U.S. leverage as a negotiating tool and, where necessary, to punish those who don't play by the rules."[4] Positioning himself as an advocate of data ("Anything you can't measure you can't manage"), the idea is to work with each partner on a one-on-one basis – from the UK to China, Japan, Canada *and* Mexico – so that trade with <u>each</u> nation is based on policies reflective of the actual flow of goods and services with <u>that</u> nation and is reviewed on a periodic basis as things change which, over the 23 years since the adoption of NAFTA in 1994, they most certainly have. I believe that, with

[4] "Commerce nominee Ross says top priority is renegotiating NAFTA," The Washington Post, January 18, 2017

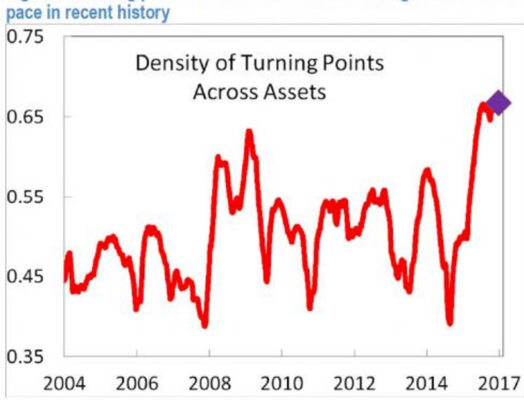
the offsetting influence of Ross and Peter Navarro in the more "protectionist" camp on one side – and Treasury Secretary Steve Mnuchin and Economic Advisor Gary Cohn as advocates of free-trade on the other – they have a decent chance of finding some sort of balance according to a policy of "Fair" Trade. Plus, I really do think Trump understands that – if he truly hopes to increase the Nation's anemic growth from an economy that barely grew 1.6% in 2016 to 3% (plus) this year or next – a Trade War would be the *last* thing he wants *unless we have no choice* and, in the case of China (with whom we have a $350 billion deficit), it seems we have plenty of room to maneuver. Clearly there will be "winners" and "losers," insofar as those who benefit from current policies will pay more or make less and those who gain increased access as a result will see greater growth – which is why, as I often say, "Where You Sit Depends On Where You Stand"[5] and why we're bound to get all kinds of resistance from the status quo. But as Jean Monnet, one of the Founding Fathers of the European Union said before retiring from public service in 1955: "People only accept change in necessity and see necessity only in crisis." One thing Trump's Team *does* seem united on is the need to generate *substantial* capital investment and everything they do – from radically lowering the corporate tax rate from its current 35% (the highest of any major developed nation), to regulatory reduction and increased infrastructure spending – is targeted at stimulating private, non-residential, fixed investment which has been stalled since the third quarter of 2014.[6] If his tax plan is successful in allowing companies, large and small, to increase profits and compete more effectively in international markets, they will have the ability and *incentive* to invest in new plants, labs and research facilities, creating more jobs and generating new revenues which we can *tax* to help offset the initial cut in rates without monkeying with unpredictable exchange ratios or border taxation. Also, by possibly allowing companies to write off 100% of all capital investments in the first year instead of expensing them gradually, that substantially raises the future returns on those new plants and equipment – while lowering the rate on the $2.5 trillion in un-repatriated profits our companies are holding offshore, Congress could, as yet another avenue, require that (even at 15%) all $375 billion of it be applied toward the proposed $1 trillion Infrastructure program and remove altogether any incentive for U.S. companies to seek out low-tax nations for their subsidiaries on a go-forward basis for anything other than strategic investments. Finally, by granting tax breaks up to some reasonable limit for private companies willing to invest directly in those infrastructure projects, we will be encouraging partnerships between government and the private sector, which could leverage the latter's equity and, once more, allow us to generate additional taxes on the new jobs and profits created by those projects. **The bottom line** in all of this is that I am not seeing Tariffs as a *first* but, instead, as a *last* Resort and, when dealing with a new Administration at the *start* of its *four-year* term, a spirit of cooperation and compromise seems more likely than not in our negotiations with other Nations.

[5] EQUUS Report, January 26, 2011
[6] "The Promise and Peril of the Trump Economy," Shawn Tully, Fortune, February 16, 2017

7. **From a Market perspective, expect markets to keep getting "faster" and more volatile, even if "Buy The Dip" continues.** A recent analysis from JPMorgan proves what I remarked on in my article last May titled "Essential Context." That is, the volatility – with violent swings in either direction – we have been experiencing in recent years has been getting more prominent and should be expected to continue *forever*, if not just the *foreseeable* future. "We live," they say, "in a world in which everyone is a momentum chaser and, as a result, the increased popularity of trend-following strategies is likely to contribute to shorter and faster trends as strategies react quicker and lead to potential over/undershooting of fundamentally justified levels."[7] As shown in the following series of charts, the implications of this are as follows:

- "Macro investors cannot ignore these developments, as they will need to react faster, compete with machines, and will be left with more risk in the form of market turning points"

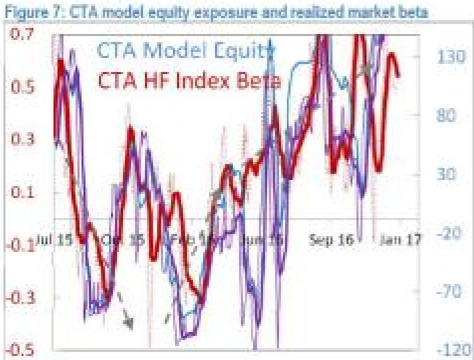
Figure 6: Turning points in asset trends are occurring at the fastest pace in recent history



Source: J.P. Morgan Quantitative & Derivatives Strategy.

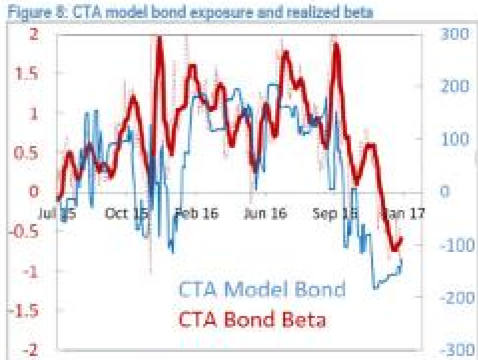
- "Stocks and bonds are increasingly driven by (market neutral) exposures at the expense of fundamental drivers"

Figure 7: CTA model equity exposure and realized market beta



Source: J.P. Morgan Quantitative & Derivatives Strategy.

Figure 8: CTA model bond exposure and realized beta

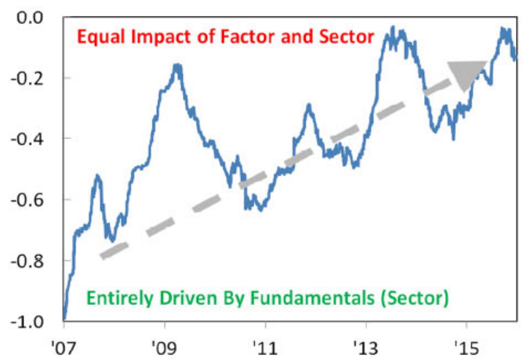


Source: J.P. Morgan Quantitative & Derivatives Strategy.

[7] "Turning Points in Market Trends Are Occurring at The Fastest Pace in History," JPMorgan, February 4, 2017

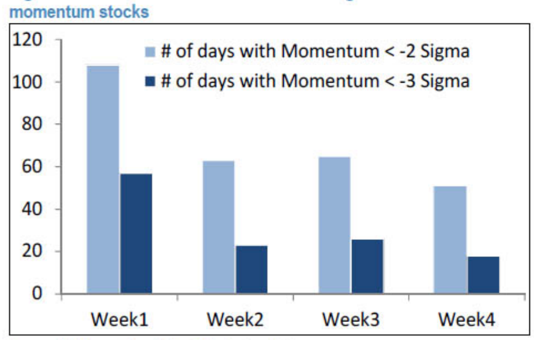
- “We noticed an outsized impact of stock returns around quant rebalances that typically occur at the end and first week of the month,” using Johnson & Johnson as just one example

Figure 9: Difference between correlation of JNJ to Low Vol factor vs. correlation to sector



Source: J.P. Morgan Quantitative & Derivatives Strategy.

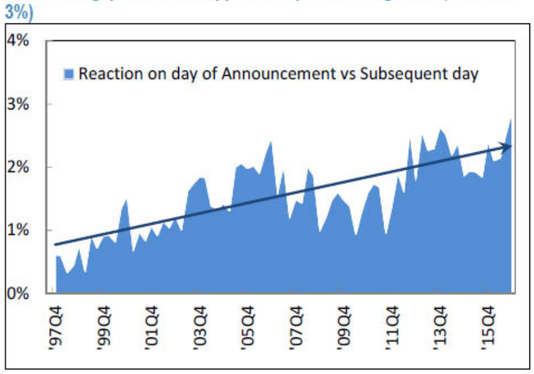
Figure 10: End of month rebalances drive larger moves for momentum stocks



Source: J.P. Morgan Quantitative & Derivatives Strategy.

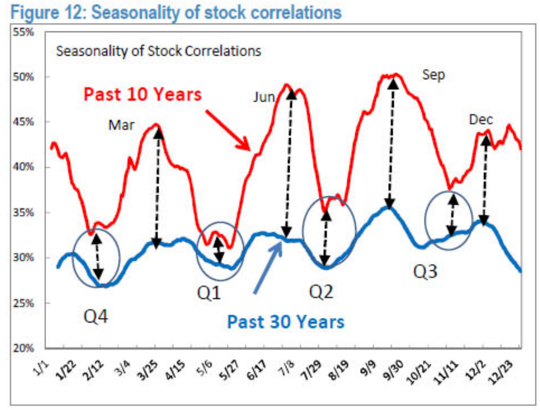
- Stocks are reacting far more quickly to news, leaving human investors less time to act, for example, when earnings are announced and stocks immediately adjust to a new price level, thereby distorting any “efficient market” theories

Figure 11: Portion of stock reaction on earnings announcements realized as gap moves, as opposed to post-earnings drift (scaled to 3%)



Source: J.P. Morgan Quantitative & Derivatives Strategy.

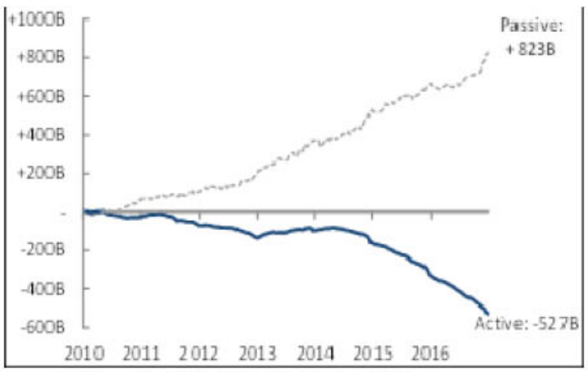
Figure 12: Seasonality of stock correlations



Source: J.P. Morgan Quantitative & Derivatives Strategy.

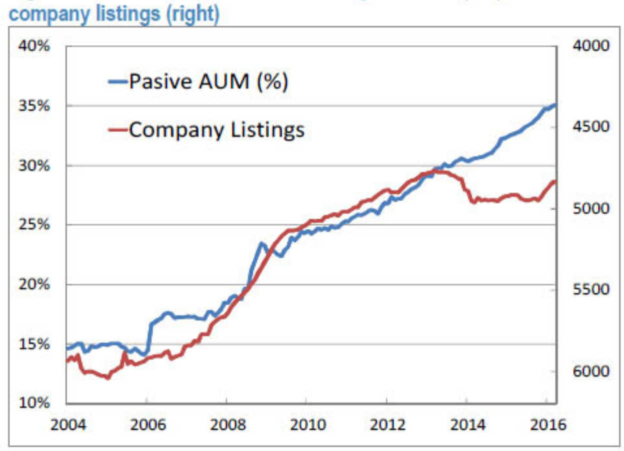
- Finally, as the level of passive indexation reaches new highs, with an estimated 35% of equities invested in capitalization-weighted indices versus 15% just 10 years ago (when active management was dominant), this may lead to a misallocation of capital in that large companies get larger and smaller ones – regardless of fundamentals and with fewer listings due to ongoing mergers – are starved of capital altogether

Figure 13: Passive vs. active fund flows



Source: J.P. Morgan Quantitative & Derivatives Strategy, EPFR.

Figure 14: Passive AUM as % of total capitalization (left) and # of company listings (right)



Source: J.P. Morgan Quantitative & Derivatives Strategy.

The conclusion, as JPMorgan says in its note, is that "carbon-based investors will find themselves increasingly at a disadvantage, even as the market drift from "fair value" continues to grow and, in turn, makes a major market "repricing" increasingly more likely." In other words, we must continue to make sure we only own things we want to own for the long-term because 1) we won't be able to get out in time and 2) we want, without a moment's hesitation, to be buyers of them on any sort of substantial pullback(s) that is (are) bound to happen in the future.

This is *precisely* what we have been doing our best to prepare for as we have decreased our allocation to individual securities that, at the same time, are limited only to best-in-breed, Global Gorillas; increased our allocation to several, broad-based and certain sector-specific index shares ourselves; and have made an even-*more* substantial allocation to an array of liquid alternatives that are either quantitatively-based; counter-trend; and/or can be long or short themselves, whether as a hedge or to create an opportunity, for that part of our portfolio at least, to take *advantage* of any fall by moving *inverse* to the market.

In the end, as I said in the beginning, I actually find myself feeling more optimistic than I have in quite a while in the hope and belief that at least *some* of the above-mentioned policies might actually come to fruition and justify the recent rise in optimism among business owners large and small whose expectations of better conditions going forward has risen from 12% to 50%.[8]

[8] The National Federation of Independent Business Survey, "The Promise and Peril of the Trump Economy," Fortune, February 16, 2017

Source: Financial Times, February 21, 2017.

This is why the market has risen since last November's election and, if these new policies *are* successful then, *maybe*, we'll have a chance to begin bending the Entitlement curve which, by 2027, threatens to triple the interest to $768 billion a year on our debt alone (or one in every eight dollars the U.S. spends). We can do this, but we need to get going – and the only way to do so, economically-speaking, is to embrace change in a spirit of cooperation with the best and brightest of our country's most successful companies – with people who understand an Income Statement; the difference between a Profit and a *Loss* (which, contrary to what one politician said in Bill Clinton's first term, can't *ever* be made up "by volume"); and a Balance Sheet. We need to understand that "Less is More" and, with regard to regulations, "Keeping It Simple" should be our mandate so the objective is focused, clear and, therefore, easy to enforce. Bi-Partisan would be nice – but maybe it's up to the Republicans first to prove that at least *some* of their ideas actually work before the centrists on both sides can begin finding common ground and once more act on what Americans (that is, the middle two-thirds versus either extreme) truly want in a country that is, for now, divided down the middle.

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