Sansoterra Group LLC

2017

"An occupational hazard at this time of the year is the . . . annual outlook. There is no particular reason why analysts have anything more coherent (or) insightful . . . to say about the 12 months starting with January than with, say, the 12 months starting in mid-May. We all do it, regardless."
Barclay Capital Analyst

The Weekly Outlook has tried to spell out the large issues now in play and awaiting resolution: European debt, our debt, entitlement, the fairness of the 1%, unemployment, the social contracts we signed with unions and government workers and, of course, the social contract we made with the boomers around Medicare. (Social Security is solvable . . . and less a problem than commonly thought.)

The 5-year view – through 2016, where all these issues merge and evolve will give us what I expect will be an era of particularly high growth for this country, widely recognized by 2016 and enjoyed broadly in 2017.

It's the word "widely" that separates a five-year approach to forecasting from the one-year. The New Economics I have written about will come about slowly, with an insightful few growing into a larger group over time. Large groups of people, however, change very slowly. Those with early insight spotted, for example, the myth in housing or the myth that credit was endless. An even smaller group of these people, though, put their homes up for sale and moved to an apartment in 2009, after that first big drop in prices. Fewer still believed it was to last a decade or more because 70 years of widely held intelligence said otherwise.

But by 2010, the great majority of Americans got it – housing was in serious, long-term trouble. Also, many gauged 2007-2008 as just another normal recession, having never experienced a balance sheet recession on a global basis. Oh, a few elderly who remember 1929-1939 did – and were dismissed for their lack of faith. Few still think this is a normal recession and most of them, frankly, have something to sell you – they have to be bullish. We buyers – of all things financial or material – get it even if they don't. Some progress was made here over the last 4 years, mostly for teachers, the unemployed and union members, but at a huge surge in government transfer payments. So large were these payments (and so little the resulting jobs) that a prior widely held belief that the government could do something became a wide belief that they could not.

Progress is significant in corporations, however. Firms are far leaner; expensive debt has been traded in for low-cost debt, human costs have been greatly reduced and management itself is under attack for its benefit packages. This bodes well for future profitability and the coming isolationism, which will cause us all to look here at home for goods we now buy from Asia, in particular.

Progress by the consumer is also widely noticeable; credit card balances are down, filling the lack of a job with going back to school has a modest beginning, home equity draws are nearly non-existent and it's quasi-fashionable to be frugal. Some union members also get it, and this group is moving slowly to the widely shared view that there is no way to see retirement as before.

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Progress is also showing up in the way our children think. Open discussions about wasted college years leading to no employable skills, fairness in pay, even evidence (from those with the least life experience) that you can't kick "the can," however defined, down the road, all seem a bit wider in circulation. Forced to return to their parents' homes probably sped the process. I find the lack of focus in the Occupy crowd a telltale – "we are disenfranchised and nobody cares" – the last gasps of a spoiled generation attracting others like themselves and the ever-hungry media.

Progress in Europe is far less. Here the great discovery is limited to awareness that all of Europe has "some problem" that existing governments somehow created and can't solve in a manner that doesn't disturb the entitled status quo.

Progress around the idea (thanks, Ray) that you can't bail out the boat if you're standing in the bucket is just now being noticed. Simply put, the 1% is discovering their financial assets depend on the 99% and, as the reserves of the 1% continue to erode and their wealthy friends quietly sell homes and jewelry, this message of shared pain grows. Widely viewed? No, but be patient as even the 1% are getting it. High-end home prices and the number of such homes continue to be a good lead indicator of their situation. Students of Russian and French history will see parallels to our 1% and their learning process.

Progress has been made in how we invest. In 2008-2009, not many serious investors took the long defensive view and even less acted on it – most felt it would pass. They gradually discovered constant trading each headline was, as expected, a zero-sum game. We all misjudged how long it would take, but some of us refused to play that "risk on-risk off" game while we waited. I was among the most consistently bearish about the consumer; now it's widely accepted and, accordingly, over with for me.

Progress in the debt and derivatives market ("Wall Street") is a different story. Oh, most see the hype in the TV shows about the stock market, but the stock market size pales in comparison to the size of the bond market and that in turn pales in comparison to the market for derivatives and other "insurance" products on bonds. We are all now well aware of how interwoven European banks and Sovereign debt are. We are also fairly aware of how weak European bank capital is, principally because the majority of their core assets are the very Sovereign bonds that are in the daily headlines enroute to worthless. (John Paulson once told me all bonds in the short run are headed for one of only two prices: par (face value) or zero). In short, both the European and domestic debt markets are of such a size that even solid economic growth will take the respective economies near a decade to work down. And solid economic growth isn't likely in greater Europe, which leaves only inflation.

Inflation will solve their problem – and ours – it will get debt paid off. Once again, society as a whole will pay the price for "saving" the bondholders – you know the axiom – privatize profits, socialize losses. This is about to play out in the largest manner in history as Europe prints euros, inflates her economies and saves her Sovereign debt holders – banks and institutional funds – in spite of German objections.

No progress, though, has been made in what may turn out to be the largest unspoken issue of all – hypothecation. A short sidetrack:

> Hypothecation occurs when a borrower pledges collateral to secure a debt. The borrower has ownership of their collateral, but it is "hypothetically" controlled by whoever lent the money. That lender can take possession and thus ownership if payments are missed. Think home mortgage: You legally own the home, but your bank can take possession if you stop paying.

A brokerage account illustrates the same concept: You borrow money in your portfolio, using your stocks as collateral, and fail to pay it back. The brokerage firm will sell your securities to the level needed to cover your debt. Your securities are the collateral for what is commonly known as a margin account. You own your stocks – until you use them as collateral and hypothecate them.

It is perfectly legal for a broker to lend client assets and it is very common with large hedge funds or large institutional pools (they have little interest in your 200 shares of Apple). Anyhow, suppose you are MF Global and suppose – just suppose – you used client securities to do some hypothecating on, oh, say, European Sovereign debt. Post the clients collateral, get some cash, buy some nice fat Sovereign yields – they'll be bailed out, right? Hedge funds may legally do this. In fact, in the U. K. there are no limits as to how many times a firm may re-re-re-re-hypothecate. (In the U. S. the limit is 140% of principal debt – if you have $200, you may re-hypothecate 140% or $280, maximum.)

So, you say? Well, it's pretty easy to create a U. K. subsidiary as Lehman did and MF Global did. Now $1.2 billion of client assets re-hypothecated a few times becomes $16.5 billion at MF Global – mostly in the debt of Italy, Spain, Belgium, and Portugal – you get the idea. When the Sovereign debt "wavers", to be kind, you can guess what happens to the funds borrowed on client assets. Disclaimer: So far, this is but one possible answer to the MF Global//Corzine fiasco. I used it to make this point, only:

> **. . . we have no idea how much hypothecation and subsequent re-hypothecation is out there . . . and it's legal.**

So, while we wait to see if, in 2012, hypothecation brings yet another balance sheet tsunami, hold this thought: It created a massive amount of liquidity with no assets behind it. Quoting Thompson-Reuters, "It may be the world's largest ever credit bubble."

The second undropped shoe is what Art Laffer calls the tax wedge. It is the simple case that Americans, facing rising taxes, are less and less induced to consume, much less work harder. That wedge – that tax bill, when sharply reduced, was what drove the Reagan boom (1982-1990). That round of tax cuts created 21 million new jobs in that period, over and above the absorption of women and boomers entering the job market. Massive change to the tax structure – rates <u>and</u> deductions – has to occur or what little growth we have will falter by 2013, as taxes are scheduled to rise yet again.

In the short run, a potential new credit bubble is in the 5-year window and, absent tax reform, virtually no real growth. Some candidates are talking the only serious fix – a flat tax. My belief is that the chance of a new, widely held view that the can may no longer be kicked is growing – and for the right reasons. In Europe, they kick the can by changing leaders and very little else. They dither, we twitter. I'm encouraged by our growing awareness of the need for <u>many</u> changes.

So, what of the next five years, given the progress alluded to, the pair of shoes not yet dropped and the thesis of slow change?

- I expect to see far more frequent change in national leadership. Easy prediction, you say? Yes, but for what reasons? Here, for growing fiscal maturity, in Europe for a chance to keep entitlements alive, in Asia, China in particular, for more personal freedom, in the Middle East for a shot at Western wealth and freedom. In South America, my all time favorite: Their 1% crowd chance death from the peasant revolts. Here, fortunately, our 1% slowly sees that if the 99% are economically destitute, their 1% wealth noticeably suffers also. I see a growing alliance here between the 1% and the 99%.
- There is over $1 trillion parked for stock purchases when this crisis works through over the next 5 years.
- "Risk on-risk off" goes away – is likely gone already as we return to investing around fundamentals. "Headline trading," as many have been doing, has been shown a loser.
- Homes are back in line, more or less, with income (house = 4X income) and a bottom is forming in home prices.
- There is no domestic (or global, for that matter) serious excess inventory – and a lot more firms now worship "just in time" production, delivery and inventory. This softens recessions yet to come.
- The emerging markets have emerged with all the attendant problems of wages, unions, slower productivity growth, etc. The new ones in Africa are untouched by near all these issues, for now, and the next 5 years will be significant for them and the producers of the world's goods. Massive natural resources and a new working class with paychecks can buy a lot of tractors and cell phones.
- Lacking wage gains, fearing further layoffs and aware of the benefits accruing to management, employees here will continue to reject overtime (why bother – it goes to taxes), be sick to the max allowed, leave the labor force for welfare and, generally, further reduce all personal effort – lacking wage gains. Personally, I think the talented folks already left . . . to be competitors. Working less on your existing job is easy. Management knows it. Management at all levels has few clues on how to fix it. I see an end by necessity, therefore, of cost cutting for its own sake. There is far too little demand overall to have indifferent employees, especially those with skills, client access and a brain. It's ironic – businesses far and wide chopped weak performing employees and kept the productive core – and now face that, shall we say, smarter group's quiet revolt.
- The biggest drop in GDP in the U. S. was Quarter 2 of 1980 – it fell almost 8%. I see in the 5 years ahead of us numerous small negative quarters – sort of a rolling soft recovery then soft decline. Not massive recessions, but more of them. (I also expect the stock and bond markets will learn to ignore them.) Key to this is the new, aggressive control of inventories and people.
- A tighter fiscal bond among the 17 of Europe will be tried repeatedly and will fail for lack of trust and, as noted in the Weekly, an inability to enforce the existing, much less new, rules.
- Art Laffer often argues that tax cuts spur tax revenue growth – and it's established that revenue increases more than taxes are cut as a byproduct of new, higher levels of growth. A small forecast, then: Dividend growth slows a bit, the 1% complains, but the freed-up funds go to wages, morale improves, profits more so, stocks rise. Okay, only an idea, but it works with taxes, why not with the 1%?

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- "Have-have not" winds to a close – but it will need all 5 years. We, as a people, will take on a new "us" versus the world mindset – and it's already begun.
- Far less government expansion – regardless of who is in office, as our citizens vote out the expansionists.
- Protectionism – the big change – occurs widely as we watch labor and other social costs rise sharply in heretofore low labor-cost markets and we thus start bringing production (and consumption) home. Their goods get pricy; we get smart with labor and technology and up goes our drawbridge.
- We are used to dealing with our problems one at a time – even during the wars. Now it's widely seen that global interlinks are for real. We will work very hard at disconnecting where possible – getting as far from other nations issues as we can. It was funny when the teacher smacked the one kid for misbehaving – now we all get detention, like it or not. Up goes the drawbridge-the new fairness is us versus the world – we want to sit as far from the bad kids as possible. This, by the way, is not good in the long run – more on the negatives another time.
- Flat to falling commodity prices will reflect both newly found sources (Africa) and much reduced aggregate global need, moved around primarily by the rolling recessions.
- We are already seeing one trend that I believe has duration – rising consumer discretionary spending. Many think it's falling – it is, in fact, at new highs. Free of a house (or ignoring the default/foreclosure notice) is one element, but again – who is unemployed? Where is consumption disproportionate to the number of people in an income group?
- The rising dollar will further distort global prices. Too high a dollar will hurt our exports of some goods, but best of all some of our goods are 1) hard to duplicate and 2) have very high entry costs to make and distribute and are 3) globally desired. These firms can hold onto higher margins. Here, our comparative advantage in technology across virtually every industry plus our collective skill and education levels increases the number of high value products and firms, further raising entry barriers.
- Last, the banks. (Thanks to Mike Aronstein, easily one of the best long-term thinkers I have the privilege to know.) Banks will break up into their component parts – just as the conglomerates finally did in the 70s. Banks are flat-out worth more disassembled. Their business models and management are worse than the auto companies – inbred, limited creativity, unable to separate risk management of the bank from its non-banking divisions, outmoded banking service, over regulated and most importantly, widely disliked. Yet within there are some attractive, profitable businesses lacking entrepreneurial leadership or drowning in the new risk-avoidance culture of the banking floor. Anybody want to guess the profit margins in Retail brokerage? Trust? Estate settlement? Custody services? Check imaging? Mortgage servicing? I await the leveraged buy-out guys discovering this fertile field to disassemble. If it fails to disassemble, I expect to see many more competitors to the banks' high margin businesses. I like to think of myself and other private advisors as just such competitors, along with credit unions, online brokers and attorneys providing trust services.

My clients will continue to see the firms that are in tough-to-enter industries that have pricing power. We are already in Africa in a small but growing way. Further, the lack of interest in venture capital investing is backwards – what better way to wait out the next 5 years than by incubating a few dozen startups?

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And last, Europe. I expect the European Central Bank will follow Bernanke and print and print and print – German objections notwithstanding. Germany may even come to see it as a way out, down the road. The ensuing inflation will bring the Euro to parity with the dollar (if they're lucky and it doesn't go to zero – the Euro that is). This massive printing, far in excess of Bernanke's, will allow the flight from Sovereign debt risk to wind down, will fund budget imbalances, will cause massive inflation ("better a weak currency than a defaulted one") and will temporarily hurt the fiscally prudent the most. It will do nothing to bring about fiscal common sense or to kill the entitlement mind set. The end result, a few years out, will be a more liquid Europe, less volatile debt, and less fear of wide spread defaults. That will be the moment the EuroUnion can quietly, and with little or no impact, end or divide in two and throw out the Club Med countries. Ideally, all reverting to their individual currencies would be best. I think the U. K. is our "early adaptor" – they simply refused to join then or to help now.

Funny, looking at it today, is why we ever thought this would work. If you want a small taste of the peoples involved, find a copy of Michael Lewis' *Boomerang: Travels in the New Third World*, a current best seller. It's a very easy read, short, a bit flip, a lot irreverent and simplistic but it does capture some of the differences in these peoples. After reading it you will wonder who in hell thought any of this would work.

By comparison, we are organized. Rotate a few Senate seats, publicly embarrass a few Presidents and a lot of government agencies, inflate the currency one more time and we might just make it. Europe, though, will rotate whole governments from extreme conservative to extreme socialist and back, for the next decade, seeking to avoid their greatest fear, as yet unspoken, the loss of all freedoms to the new fascists currently labeled "technocrats." Up goes our drawbridge.

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