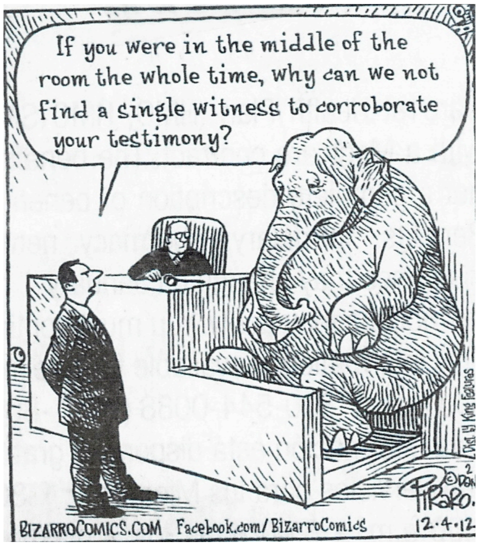
THE BAZAAR



Anxiety, says Kierkegaard, is a natural condition. As emotion it forces our hidden truths on us. More than that, though, anxiety is pure energy we can, if we wish, use. In fact, by his thinking, anxiety proves we have a free will – face the cause and be free of it or bury it and suffer the despair that brings. In short, anxiety defines maturity, defines growth, and defines change. Sartre expressed it even more simply, " . . . man is condemned to be free . . . "

Anxious times, widely felt. Thank you, Internet, Twitter, et al – it is now impossible to avoid global concerns and the anxiety they cause no matter how far you remove yourself. Those of us managing investments also find ourselves, at times, anxious. Charged first with the duty to preserve and then to grow portfolios, we fiduciaries remain exposed to the capital markets. Our freedom – our release from these stresses, is to act. We research, judge, dig for data, steal widely from others, all in an effort to understand, if only a little, our environment. We are practitioners with skin in the game, an ever-shrinking group of people. Our clients, acquiring risk assets beyond our review, further rely on us for background; to my mind the hardest part of the job because we seldom hear all the details.

In prior Quarterlies, I noted some factors that I, and many others, hold as core to understanding the environment of the New Economy and subsequently the markets we must function in:

1) Governments created housing booms and busts in more than a few countries under the guise of providing home ownership to most anyone with a pulse, establishing yet again that social welfare is generally destructive in government hands.
2) A blanket of credit card applications led the weak among us to borrow excessively.
3) Vote buying on both sides of the Congressional aisle rose to new heights with corporate "breaks" and social welfare programs – a race to the bottom of dependency, if you would.
4) Some 5% of the world population, us, reached new levels of arrogance with affinity groups focused on self-created problems here and elsewhere in the world while, for example, inner-city children continued an uneducated poverty cycle. In a classic case of "cause" generation these groups adopted "voiceless constituencies" such as fish, trees or owls and "spoke" for them. (Thanks Mark, again.) [I need to do a paper on this and the groups that form around the voiceless issues – often for the benefit of the founders, first.] The end impact was further regulation, new costs and real human issues ignored.
5) Courts interpreted "bargaining in good faith" as a mandate for unions to coerce benefits.

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6) We became older.
7) We taught our children nonsense, best exemplified with the trophy to all participants on the "everybody is a winner" train.
8) Technology significantly replaced face-to-face human contact, but technology itself has produced no new breakthroughs save variations of applications of existing, old, well-known hardware and software – none – but is worshipped as our future.
9) Wall Street, ever a handy villain, was accused of more wrong than it actually did (see #1), but that was balanced away with trivial numbers of punished malefactors.
10) Being a now-older society, old men and old women brought all the baggage of their long-gone era to the tables of power in religion, economics, politics and, yes, even science, to little constructive avail save to create "affinity groups" around themselves.

And these are some of the problems with this particular 5% of the world. Similar problems exist in Europe save for a significant advantage they have – their citizens are not nearly as in debt as are we American consumers. Their government is also trying to find ways to stimulate economic growth via their consumers. The goal, of course, is the tax revenue from income and sales to pay down their government debt. The irony is they can solve their issues far easier than we can; they need only lower a bit their very high tax rates, ease the laws around employment and, in essence, get out of the way – something you would think the inept could do well. The further irony is they seem to be choosing even higher taxes, more debt and austerity programs. Europe, though, could recover before we do and, as of late, thanks to massive loans from the European Central Bank, is enjoying a quiet economic moment of relief, unlike us. Social angst remains as do strikes and heated debate, but immediate collapse is delayed.

Which brings me to the point of this Economic Outlook. I suspect our now widely distributed anxiety about our future has its roots in our lack of power to address it – we simply do not turn out in hundreds of thousands to strike and protest on a daily basis. Anxiety liberates, it shows us we are capable of addressing hidden fears. We all sense that we individually have the energy, the will to avoid despair and deal with these issues, but can't seem to find the crack, the entry point to significantly begin. Of course not – we gave that up decades ago when we abdicated our vote to our individual interests. When we lost sight of the greatest good for the greatest number, as Bentham put it, we lost our own interests as well. We have to deal with it though, or we will all go mad as do all who fall into hopeless despair. We will, in time, be more "in the streets."

Addressing anxiety in the markets, though, how we invest (not whether, but how) is fairly straightforward. To totally exit capital markets is to yield to an ultimate collapse – to yield to a final despair that "it," whatever that is, is all over now and forever and the entire globe will live like the people of Somalia. Should that be your view, read no further as we participants just aren't lost to that outcome.

No, managing the market place is straightforward: hedge; use that eternal strategy of traders, merchants and dealers since, well, fire. My clients' portfolios have long been pseudo-hedge portfolios, for lack of a better phrase. Each asset was selected for its cyclical and/or counter-cyclical role. This decision was made many years ago when I built my first hedge fund of funds. The strategy is the same today; hold various amounts of various correlated and non-correlated assets. Vary the ratios (tactically) as conditions change. Above all, hold non-traditional assets – go well beyond the traditional stocks-bonds-cash theory, which is, to me at least, a simplistic diversification strategy peddled as an answer by firms with a narrow view of the world. Ignore any idea of seriously weighting any one asset class, for now. Ignore Wall Street and TV. Be prepared to wait. Know your fellow players are human and will never fail to act like it. Ask who benefits – you or the source of the idea. Expect to be wrong at times – and find out why, every time. Know the true cost of the components.

Key to the pseudo-hedge is time – each element of the portfolio works on its own time line. Thus we find ourselves at some points increasing a single asset or perhaps selling out completely – and doing nothing else. Some more risk-oriented clients seek higher returns. This usually begs either very short holding times (not our expertise) or longer holds (our favored approach), but the concept changes only to the size of a given asset in their account. And, in fact, we own a long/short hedge fund. It was bought for its specific ability to go "short" in the market (to sell what it does not own) with all the back office aspects of that tactic that we prefer to let others process.

Hopefully the continuing reader will see how the prior Quarterlies address this portfolio construction. For example, writing about credit abuse gave us long ago the reduced GDP forecasts; about crowd behavior a reminder that facts and truth can be found in crowds if you watch, "*Snap*" spoke to survival instinct and, for me at least, the false run to Treasuries. The Quarterlies around monetary and fiscal histories led us to gold. Europe's problems predicted ours. Europe and Japan are, to me, as buoys marking a shipping channel for America.

So, the capital markets – my job – I can deal with. The problem that remains, though, is separating anxiety in the markets, which is manageable, from overall client (and personal) anxieties about "the world." I have no answers for global anxieties about failed governments or terrorists save for how they momentarily impact my world of markets. What I do know, as do all of you, is that increasingly governments, globally, are proving less and less able to deal with the issues. Widely recognized now by more than just terrorists trying to lever governmental impotence to their advantage, our anxiety rises from our sense of helplessness about that impotence. The hidden truth is not so much the failed leadership, but rather the untapped alternative we always go back to – ourselves.

As each crisis comes, gets minutes of press and goes, we grow what – irritated? Beyond that. Frightened? Yes, I think anxiety has grown into fear. We see it in the sale of guns, in the rise of militias, in increased crime and increased wariness on our daily commutes. We trust fewer, are more surprised than normal when kind acts are given us, we hesitate to "get involved." We are beginning to waken.

It's an easy leap from that climate of fear to a dead-in-the-water economy. Who would venture, broadly speaking, to invest in an undefined future? But the pseudo-hedge portfolio continues to make sense. *Optimism specific – how to be in the markets – to optimism general is the transition I see shaping up.*

What is changing, in my mind, is control. That's the progression of "government knows best for all" to "tea-party think," if I may slander that group. We sit, at the moment, aware that neither works. Oh, issues were surfaced, spun, twisted, "the 1%" vilified and even the media was found, in particular, that they were now far more widely viewed as just tools of the polarized wings.

No, this is about elephants, big elephants. Early signs of elephants in the room are the states telling Washington "no," the employer telling unions, "enough," the cities telling its citizens "we're broke," the banding of civilians to provide basic protection.

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These events are occurring faster than most any period I recall in American history. Add in the rapid education of a middle-class in Asia, South America and even the Middle East (Iran in particular) and the pace of disenchantment with leaders can only accelerate worldwide.

The elephant? The elephant is a massive shift in power from the government to the people. Tea parties were a lead indicator of a desire in you and me to take back control of our lives and our futures. We know our government's losing power – we watch it slip away to fringe thinkers, multinational corporations, minor dictators, mobs and even voting Americans.

The dangers abound. Weapon control, currency issues, financial instability all rise from less powerful national governments. That comes later.

For now, anxiety has brought us to first, an understanding that we need to control our future. Second, it has brought awareness that governments at all levels are frequently inept and corrupt. Third, and very important, anxiety has shown that action helps – it dissipates despair – but also that more and better-focused action is needed. A few of us fear the (remote) chance of the kinds of leaders that can come out of times like these. Fourth, the answer, if you would, is in the middle of the room all along, as it always has been through history – the unformed, unled people. We saw in a small way how they can integrate and cooperate without a formal group. (Civilization: Act 2, April 2011). It is my belief they are on the cusp of that behavior, have picked up the red and green paddles.

The question is whether we wait for leaders or not. For now, most seek others with similar anxieties as we are still tribal in our genes. All kinds of solutions are being offered – by many that see the elephant clearly and would claim it as their own, grab control of the emerging alternative.

This period of transition from deer-in-the-headlights to action is not over. We, the elephant, are beginning to glimpse alternatives. Leadership is lacking and, regretfully, our sheer size requires some. In the meantime, we vent our anxiety on drugs, alcohol, militia groups and an open anger to the world around us. Frustrated, aware of our need to act, we act out . . . and still no leaders emerge. Religion provides solace to many and, sadly, solves nothing in our temporal world. Islam rises in that same climate as it offers leaders and futures clearly defined. There is a lesson there.

So the elephant sits and waits, the markets move on, people come and go. Governments weaken, fail, new ones emerge. Currencies are debased, mobs form, people die, but in point of fact, was it not always so? We have broader, faster information so we see and hear more than ever before but the events – the failure, the flaws, the risks, the pain – was it not always so? The elephant will, in time, act, as always. In some places violently, in others rather methodically and quiet. Note, though, that the markets march on. And so, for 2013? More of the same.

For 2013, I expect an economy growing at 1½% to 2% but, in fact, after inflation, finding real growth at half that or less. I expect anxiety to increase as too many volatile situations still exist – Iran, Egypt, Afghanistan, North Korea, atomic weapon growth – you know them as well as I. Bernanke and the Fed, as I have long suggested, have run out of tools and by its own admission is "experimenting." Unemployment will not be solved in actuality but with games and chicanery.

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To predict events is impossible. I can, however, list the things vulnerable – figuring out what is sensitive is fairly straightforward. In constructing the pseudo-hedge portfolio, one design test is to theorize if a holding can be hurt by the proverbial "Black Swan" – the massive, unforeseen event, or even helped by it. It's my view we benefit from these traumas the same way tearing muscles strengthen them or the way life experiences, as mothers preach, either make you stronger or crush you, but seldom leave you the same. Taleb calls it "traumatic growth," Schumpeter calls it "creative destruction."

Money managers know this. The academic or political figure, though, never has the financial scars (or most any scars for that matter) from bad decisions or forecasts as does the lawyer, the doctor and, yes, the adviser. The value of the academic view in 2012 is, to my mind, not only at an historic low, (joining politicians), but seen as such by the guy in the street – a huge step forward by those who would otherwise remain unaware. Oddly, we now benefit from academic and political ineptness as it forces our anxiety and thus action – or madness. Those who act, win. Their scars define and refine their future actions.

In my view, 2012 was the year of realization. It showed us, 4 years after the recession numerically ended but didn't, that we were in a new place. It showed us history may not repeat, but it sure rhymes as these economic disasters echoed so many from the past. It showed us it was our turn. It showed us economics in particular is truly not quantifiable as physics may be and as academics insist but instead, is the amalgamation of human emotion, experience and genetic construction. It showed us our leaders were adept at can kicking. For me, in particular, it punctured once and for all any tiny faith I had in economic policy. It taught many that change often hardens us deeper into our ideology – look only to the two parties; as they grow harder their relevance diminishes. So I expect no meaningful improvement from them and thus is born, as it always was going to be, the elephant in the room – us. It taught us, finally, how truly cowardly we and our leaders can be – until we can't bear the despair. This will swirl around us for the foreseeable future which will in turn, I believe, strengthen us as a people – and drive a few mad. We will be called upon at some point unseen to act – that's pretty much a given. Until then we fiduciaries have a job to do.

My conclusion, then, is to repeat: All markets, from the first bazaars in the East to the current deliberately blind of Washington and Wall Street, continue to function no matter the interruption. War, peace, anxiety, despair, it matters not. Time and the markets, in one form or another, march on. The only issue is how to participate. Stand by, it's going to get interesting.

Credits: Heavily to Nassim Taleb, Alan Beattie and the Reinhart-Rogoff Team.

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