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**Fourth Quarter 2016 Economic Commentary**

***“There is no-one on the world stage who can compete with me.”***

-Silvio Berlusconi

***“I don't need to go into office for the power. I have houses all over the world, stupendous boats... beautiful airplanes, a beautiful wife, a beautiful family... I am making a sacrifice.”***

-Silvio Berlusconi

***“Vladimir (Putin) is the exact opposite of the image portrayed of him in the western media. He is a really sensitive person, a man of profound feelings, always respectful of others. He is very gentle, a man with a delicate sensibility.”***

-Silvio Berlusconi

Happy New Year to you, our clients and friends!

Last quarter, we had expressed some relief the election campaign was just about ending:

*“Aren't you glad it's almost over? This election season has left all of us a little worse for the wear, suffering daily trauma just by being engaged. Someone described it as 'like being banged around like tennis shoes in the dryer.'”*

Now that the inauguration has taken place, divisions in the country are manifest and many Americans feel agitated and irritated because of a surprising, if not shocking election and the massive changes in governmental philosophy that lies ahead.

Populism is a growing global phenomenon that has been evident for some years, well before Trump's victory or the Brexit shock. All forms of populism include some kind of appeal “to the people” and a denunciation of “the elite”. Populist leaders like Donald Trump, Marine Le Pen (France), Norbert Hoffer (Austria), Nigel Farage (UK), Rodrigo Duterte (Philippines) and Geert Wilders (Netherlands) are prominent today in many countries, completely uprooting established patterns of party competition in contemporary Western societies and elsewhere. These parties have gained votes and seats in many countries, and entered government coalitions in several Western democracies, including in Austria, Italy, and Switzerland. Even in countries without many elected populist representatives, these parties can still exert tremendous ‘blackmail’ pressure on mainstream parties, public discourse, and the policy agenda, as is illustrated by the UKIP's role in catalyzing Brexit, with massive consequences. Populism is hardly new, and has taken many shapes ranging from Francisco Franco in the 1930's , Juan Peron in the 1950s to Silvio Berlusconi in the first decade of this century.

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Most political scientists attribute the rise in this movement to economic inequality, arising from profound changes transforming the workforce and society in “postindustrial” economies. The rise of the knowledge economy, the replacement of labor by automation and robotics, the collapse of manufacturing, the weakening of unions and organized labor, and the flow of capital to lower cost regions have contributed to a growing disparity of haves and have-nots, and a sense of being left behind. Immigration and the incursion of refugees have resulted in a backlash against “establishment” and the rise of nativism (protecting the interests of native-born inhabitants) and xenophobia.

But inequality is not the sole driver of populism basis. Work by Ron Inglehart of the University of Michigan and Pippa Norris of Harvard point to cultural reasons, a reaction against progressive cultural change. In a recent paper, they observe:

*“This cultural shift has sometimes been depicted as an inexorable cultural escalator moving post-industrial societies steadily in a more progressive direction, as opportunities for college education have expanded to more and more sectors of the population and as younger cohorts have gradually replaced their parents and grandparents in the population. But it has been clear from the start that reactions to these developments triggered a counterrevolutionary retro backlash, especially among the older generation, white men, and less educated sectors, who sense decline and actively reject the rising tide of progressive values, resent the displacement of familiar traditional norms, and provide a pool of supporters potentially vulnerable to populist appeals. Sectors once culturally predominant in the Western world may react angrily to the erosion of their privileges and status.”*

Even in Canada, Prime Minister Justin Trudeau faces potential opposition from populist candidates in the opposition Conservative party. Among the candidates to lead the Conservative Party is Kevin O’Leary, known in the US as Mr. Wonderful on CNBC’s Shark Tank. The essence of his campaign is that “voters don’t want politicians anymore. They want people that have a track record of executional skills. I’m not a politician and, as a result, I think voters and taxpayers are looking for change makers.” The reality TV star’s end goal is to overturn everything Trudeau has done. “I’m going to unwind everything [Trudeau] did when I get in there,” O’Leary promised. “Canadians won’t remember his name after I’m there for 100 days.” Sounds familiar doesn’t it?

Whatever your political persuasion, for many voters there seems to be hope and promise ahead that long-ignored segments of American society have someone to champion their values and goals. In 1936, John Maynard Keynes, the famous economist coined the phrase “animal spirits” to describe human emotion that drives consumer and investor confidence.

The stock market psychology has turned from a begrudging preference for shares into a rush of FOMO, or fear of missing out, after the election. Trump’s promises of tax cuts and infrastructure spending put a spring in the step of investors.

Equity markets have climbed with the election outcome anticipating two things: (1) faster growth for the US economy based on stepped up infrastructure spending and (2) a reduction in government regulation. Debt markets on the other hand, have swooned as interest rates have risen since November 7th responding to fears of fiscal stimulus and budding inflationary pressures.

That the incoming Trump administration will be business-friendly is assured, especially given Republicans will control both houses of Congress. This carries short-term opportunities but long-term risks.

For an upbeat take, look no further than a recent article by Ray Dalio, chairman and chief investment officer of the world's biggest hedge fund, Bridgewater Associates.

<https://www.linkedin.com/pulse/reflections-trump-presidency-one-week-after-election-ray-dalio>

He cites that the incoming Trump administration has a combined 83 years of executive business experience, the highest over a period looking back to John F Kennedy in 1961. In contrast, Ronald Reagan's team, with whom Trump is often compared, had only 45 years. President Obama's administration had just five years.

"By and large, deal-maker businessmen will be running the government," Dalio writes. It's a move away from left-leaning government types to "bold" profit-driven, pin-striped types. And if the "ideological shift" from treating businessmen as "heroes" rather than "villains" can ignite the long elusive animal spirits in corporate America, then the stimulus will extend beyond tax cuts and fiscal spending.

"If this administration can spark a virtuous cycle in which people can make money, the move out of cash (that pays [investors] virtually nothing) to risk-on investments could be huge," Dalio says. As to whether Trump's team will be "aggressive and reckless" or "aggressive and thoughtful", he adds: "We are pretty sure that it won't take long to find out".

We worry that President Trump's effectiveness is far from assured. For one thing, Congress, despite being Republican, may provide a check. So, if it turns out that Trump is the new Berlusconi, not the new Thatcher, then financial markets may have jumped the gun. The Berlusconi quotations at the beginning certainly could easily be mistaken for the common perception of Trump's manner of speaking.

The idea of an American Berlusconi should be enough to give most investors pause for thought, at least over the longer run. The former Italian prime minister was premier on and off three times between 1994 and 2009. He also swept into power as a rich businessman prepared to shake up a lethargic system and spark growth. He failed miserably.

Annalisa Merelli, is a writer now based in New York who was born in Italy, who has written about gender inequality, politics, and economics from a global standpoint for some years. She described the parallels between Berlusconi and now President Trump as, "They appeal to what in Italy is referred to as 'the belly' of the electorate—their gut reactions to the issues at hand."

<https://qz.com/624065/a-tip-to-americans-from-an-italian-who-saw-berlusconi-get-elected-again-and-again-and-again/>

Robert Shiller, a Nobel Laureate in economics, recently wrote in [Project Syndicate](#), that, "The closest we can come to Trump among former US presidents might be Calvin Coolidge, an extremely pro-business tax cutter. 'The chief business of the American people is business,' Coolidge famously declared, while his treasury secretary, Andrew Mellon – one of America's wealthiest men – advocated tax cuts for the rich,

which would “trickle down” in benefits to the less fortunate.” During “Silent Cal’s” presidency, the US experienced rapid economic growth in a period that became known as the Roaring Twenties.

The twenties were always something of a gilded and adorned age which became very evident as the Great Depression followed. Even amid the great prosperity and excess of the decade, America’s economy was fundamentally weak. Over 40 percent of Americans got by on less than \$1,500 each year, which economists cited as the minimum family subsistence level. The income of the top 0.1 percent of families equaled the income of the bottom 42 percent. At any given moment in the Roaring Twenties, from 7 to 12 percent of the population was jobless. The country held its strong isolationist sentiment, as the Senate refused several times to join the League of Nations, feeling that joining the league could create greater obligations that essentially transcended American interest and potentially could put the US at the mercy of the European agenda. The League of Nations called for collective security, that when one nation harassed another, all the nations would act. I need not draw the obvious parallels of statements that Trump had made as a candidate about America’s NATO involvement and with the United Nations.

Trump’s cabinet appointments say more about his style than policy substance with his preferences being government outsiders who hate bureaucratic processes and government regulation. But it remains unclear whether they will have the dexterous skills to achieve needed Congressional support to actually get anything done.

Our comments about policy substance are of necessity conjectural and tentative. Someone once said that political campaigns are designed by the same people who sell toothpaste and cars; consequently, enacted policy rarely conforms with campaign promises.

Tax reforms have been identified as an immediate priority, a premise with which we largely agree. But we take issue with the structure of some of these “reforms” remaining largely unresolved and potentially quite harmful. In addition to the major reduction of the overall rate, to align itself with other countries, the new system would change in three fundamental ways. First, all investment outlays can be written off in the year they occur rather than over time. Second, interest payments to bondholders, banks and other creditors will no longer be deductible. Third, companies will be able to exclude receipts from exports in calculating their taxable income and will not be permitted to deduct payments to foreign suppliers or affiliates from income.

Retailers that import goods from abroad would have no ability to deduct import or interest costs and given their low profit margins at this point, taxes would become very onerous. Capital intensive industries that invest heavily and are export oriented would have perpetual negative taxable income and potentially receive annual tax refunds. An income tax system that discriminates to favor exports would no doubt elicit protectionist moves by many countries. Tax policy is still being formulated and is famously complex and time-consuming and predictions and comments are likely premature and speculative if not perilous.

Proposed policies that hinder trade will shift US geopolitical strategy toward isolationism, pursuing a nationalistic, “Make America Great Again”. As Nouriel Roubini, a former Senior Economist with the Clinton Administration’s Council of Economic Advisers has observed:

*“Trump, however, may pursue populist, anti-globalization, and protectionist policies that hinder trade and restrict the movement of labor and capital. And he has cast doubt on existing US security guarantees by suggesting that he will force America’s allies to pay for more of their own defense. If Trump is serious about*

*putting “America first,” his administration will shift US geopolitical strategy toward isolationism and unilateralism, pursuing only the national interests of the homeland.”*

*“When the US pursued similar policies in the 1920s and 1930s, it helped sow the seeds of World War II. Protectionism – starting with the Smoot-Hawley Tariff, which affected thousands of imported goods – triggered retaliatory trade and currency wars that worsened the Great Depression.”*

So the economic road ahead is quite obscure. The era of the “central Bank” whose policy dominated trading in bonds and stocks since 2008, is drawing to a close. The Fed will have less ability to tilt “dovish” if fiscal stimulus and deregulation help stimulate already recovering economies such as the US. The Fed finally budged rates slightly higher in December and has hinted at a series of additional increases for 2017 and 2018,

The US is in its eighth year of economic expansion, the fourth longest expansion since 1900 but the pace of growth has been the slowest of all post WW-II expansions. At the moment, it appears that Trump’s campaign promises should boost after-tax corporate earnings and have already raised consumer and business confidence. For example, the National Federation of Small Business, which represents six million employer firms, showed a tremendous rise post-election. Small business optimism rocketed to its highest level since 2004, with a stratospheric 38-point jump in the number of owners who expect better business conditions. The percent of owners planning capital outlays in the next 3 to 6 months jumped 5 points to 29 percent, the highest reading since December 2007, the peak of the last expansion but well below the high readings in the mid-90s of 40 percent. Here is a look at the aggregate index:



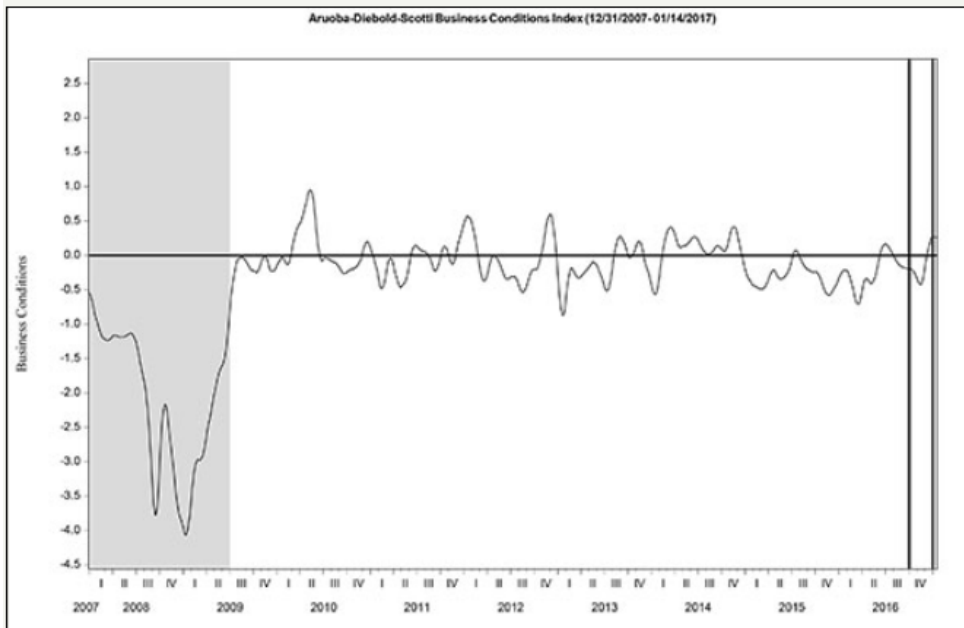
Source: <http://www.nfib.com/surveys/small-business-economic-trends/>

We have sought a way to visualize and summarize how our clients can look at US economic trends without burying them with statistics and excessive verbiage. We have modelled this after some economics blogs that we have referenced in the past:

<b>Economic Indicator Status and Trend</b>					
<b>Strong Signs</b>	<b>Trend</b>	<b>Weak Signs</b>	<b>Trend</b>	<b>Neutral Signs</b>	<b>Trend</b>
Unemployment Rate	Strengthening	GDP	Neutral	Non-Farm Payrolls	Neutral
Unemployment Claims	Neutral	CPI	Strengthening	Pending Home Sales	Weakening
Housing Starts	Strengthening	PPI	Strengthening	Retail Sales	Neutral
Housing Permits	Strengthening	ISM Manufacturing	Strengthening		
New Home Sales	Strengthening	ISM Services	Neutral		
Consumer Confidence	Strengthening	NY, Richmond and Philly Fed	Strengthening		
Personal Income	Neutral	Durable Goods Orders	Neutral		
Personal Spending	Neutral	Labor Force Participation	Weakening		

We think that recession risk is low. The Federal Reserve Board of Philadelphia publishes an ADS Business conditions index which tracks current conditions. The average value for the ADS index is zero and progressively higher values indicate progressively better-than -average conditions. The ABS Index is trending up after drifting down slightly for most of 2016.

## Aruoba-Diebold-Scotti Business Conditions Index

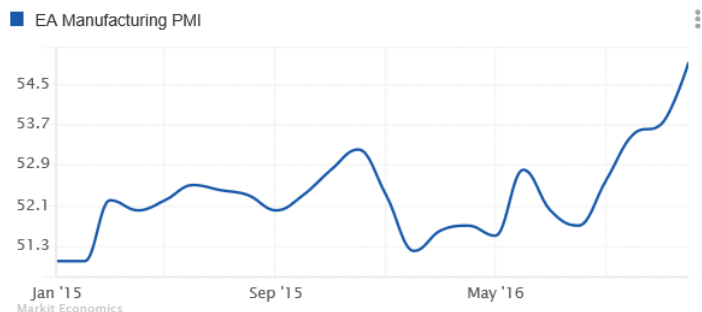


Source: <https://www.philadelphiafed.org/research-and-data/real-time-center/business-conditions-index>

We expect that GDP this year will pace higher this year, somewhere around a 2.3-2.5% growth rate versus the 1.9% estimated for 2016. This is taking into account our best guess of the impact of President Trump's possible policies.

Manufacturing is strengthening across the planet. PMI, or Purchasing Manager Index represents what's called a diffusion index, a number greater than 50 indicates expansion of the index and a number less than 50 indicates contraction. Let's have a look at some of these indicators:

- Global PMI rose to 53.1 the highest since Feb 2014
- Japan Manufacturing PMI rose to 52.9, the highest since Dec 2015. Employment grew at the fastest pace in 32 months.
- China's PMI rose to 51.9- the highest since Jan 2013-sixth straight month of growth. Output rose the most in 71 months!
- European PMI rose to 54.9- highest since April 2011.



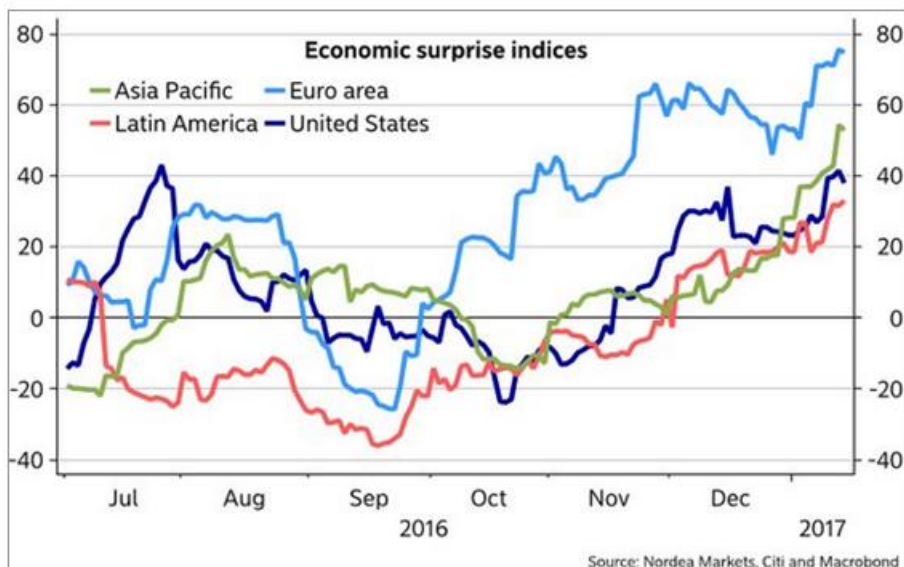
But the real standout was Prices Paid which surged 11 points to 65.5. That component hasn't been this high since June 2011 and is tied for the 23rd highest monthly increase since 1948. Inflation has not been a concern among investors for some time now, but a couple of more moves like that in this report or a similar surge in the Prices Paid component of the ISM Services report, and it will quickly show up on the radar again.

Bottom line- global manufacturing is alive and kicking and inflation is starting to raise its ugly head.

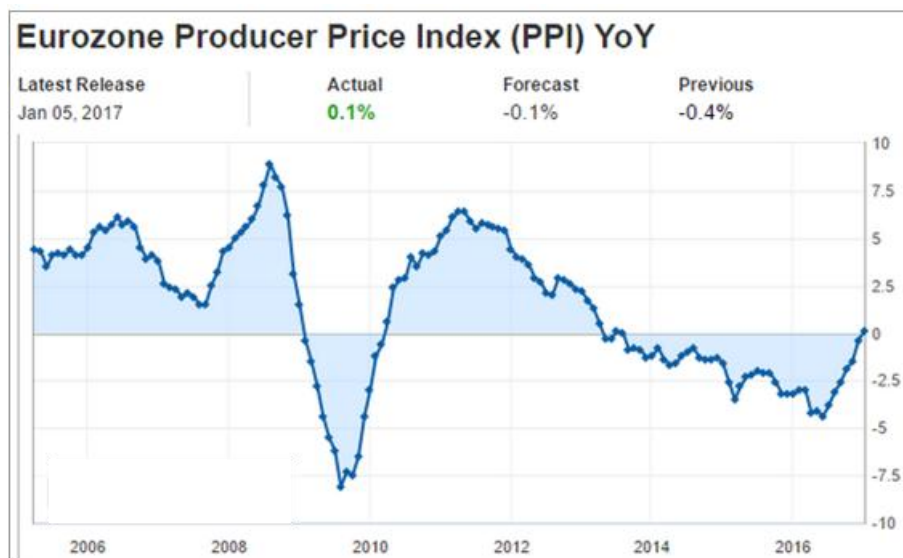


Looking at broader indicators globally, economies are making steady progress toward improved growth:

**Global Developments:** Global economic surprise indices have all moved higher.



One other hopeful sign is that the producer price deflation that has persisted in Europe since 2013 has finally flattened, but just barely.





A friend of ours, David Kotok, recently described reading Trump was like “sculpting fog”. The inauguration speech focused on America first and was very critical of both parties for favoring “elites”. Recent comments were also at odds with Republican orthodoxy on spending and deficits.

An economic commentary would be confined if we were not to elaborate on trade. Recent invitations to the prime ministers of the UK and of Canada and the President of Mexico may represent some fresh thinking on trade, in my opinion. I think this bears watching. Some of the viewpoints expressed here come from recent discussions I have had with former senior management of the Bank of Canada, so it is not idle speculation.

Canada has an existing deal with the US and Mexico under NAFTA. That matters in terms of understanding where Trump is headed on trade. Canada is also the second largest trading partner for the US behind the European Union. Finally, the fact that Canada is finishing off its EU trade deal just as the UK is getting ready to exit puts it in a unique position in reconfiguring world trade alliances – with an Anglo-American group involving Canada a potential outcome. Trump’s severe comments about Mexican and Chinese trade need to be counterbalanced with positive examples, perhaps with the UK and Canada. Trade matters because Trump wants to show that he is focusing on jobs and the economy both domestically and internationally.

I would expect there to be overtures around bilateral trade as soon as Trump gets in, if not before, given the Obama Administration’s cool stance toward a potential UK deal. There are mutual needs here. The UK’s need to develop alternative trading arrangements and the Trump Administration’s pivot away from China.

UK Prime Minister Theresa May is due to be the first foreign leader to meet with President Trump on Friday. That speaks volumes. It’s clear that Donald Trump sees Britain as America’s closest ally, with Germany now moving into a decidedly secondary role in US-European ties. It is also clear that Theresa May and Donald Trump are going to talk about a trade agreement. Rumors are flying (at least in Canada) that a trade deal with the UK could even involve labor mobility. I think it is way too early to speculate to that degree of specificity. But I see the UK-US talks as a sign both to a ‘German-led’ EU on politics and to China on trade.

Where Canada fits in here is that it is the next obvious candidate in line for a UK trade deal. The EU, having just signed a deal with Canada, that still only has provisional support from the Belgians from my understanding, will look askance at a UK – EU trade negotiation. Therefore, a possible arrangement that works politically here would be to use Canada as an adjunct to a US-UK deal that squeezes out Mexico.

Why? First, we know that the UK is keen to complete a deal with the US. Second, we know that the Trump administration is keen to show a positive trade example to counterbalance the negative one with China. Third, we know that Trump also would like to renegotiate NAFTA almost entirely because of Mexico. (He has said nothing about Canada stealing American jobs.) Fourth, we also know that Trump’s trade team hates multilateral deals and likes bilateral ones.

The Trump administration is wasting no time in scrapping the Trans Pacific Partnership and in opening renegotiation of NAFTA, the North American Free Trade Agreement. I believe the next probable step would

be to renegotiate bilateral agreements with both Canada and Mexico that would be very different from one another.

Last quarter, I concluded this section with:

*“Bottom-line, the US economic trend remains mildly positive, essentially mirroring a Goldilocks economy—strong enough to keep recession risk muted but too soft to fully dismiss growth concerns. But macroeconomic momentum has picked up after flattening earlier in the year. Labor markets are settling into a slower-but-still-healthy rate of growth as payrolls continue to expand. We believe that the Eurozone’s growth is improving despite the long-overlooked problems of some of its major banks.”*

At this juncture, worldwide growth prospects have improved versus all of last year. As we noted earlier, global industrial production is picking up; in fact, Eurozone industrial production growth is outpacing that of the US. We are very likely in the midst of a coordinated increase in economic activity worldwide, even though it is still in its infancy. Industrial commodity prices have risen more than 25% in the past year, providing decent confirmation that economic activity is indeed picking up. It is very unusual to experience this sort of a lift in commodity prices at a time of US dollar strength. I believe that commodity prices and the dollar are moving up together is that the world has been surprised at how resilient economic activity in both the U.S. and the world economy has been (recall that everyone has been very pessimistic for years). Markets move when things turn out to be different than expected. Demand for dollars has been strong because the U.S. economy and its prospects look better today than people thought they would. Commodity prices are up because producers underestimated global demand for commodities.

What are the potential negatives in the global economy? We see the possibility of continued political turmoil as a result of European elections, turmoil as far as Brexit-EU negotiations, and volatility in the potentially strained relationship between President Trump and Congress as potential political factors. Markets seem to be on a sugar high. John Maynard Keynes was right to emphasize the great importance of “animal spirits”, but other economists have also been right to emphasize that it is economic fundamentals that dominate in the medium and long terms. Doubting the value of the EU and NATO risks undermining our principal democratic allies at a time when they are already politically fragile. This will have consequences. Unilateral imposition of tariffs or enactment of a tax system that subsidizes exports and penalizes imports risks both retaliatory protectionism and a spiking dollar, with somber consequences for the global economy. Suzanne Collins, author of the *Mockingjay* and *Hunger Games* wrote, “But collective thinking is usually short-lived. We’re fickle, stupid beings with poor memories and a great gift for self-destruction.” Let’s hope that animal spirits will not be capricious and fickle.

As always, we appreciate your confidence and trust!



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