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Perspective

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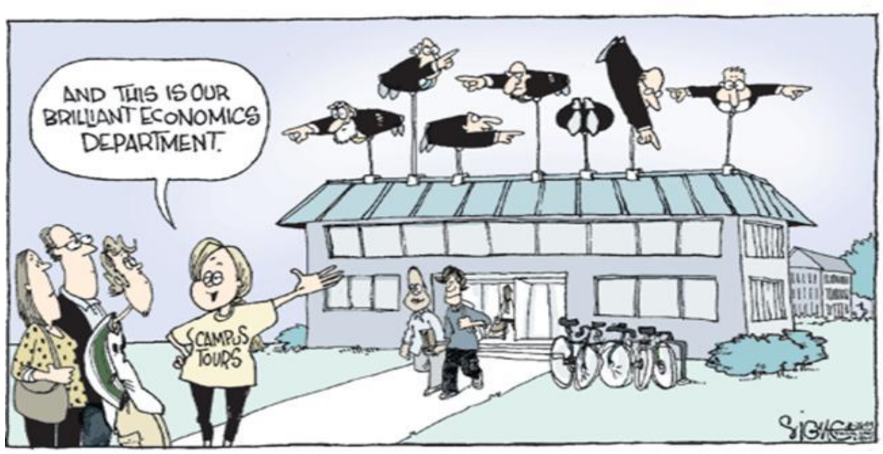
- ✓ Confusion across the political, economic and investment scene = a great unease.
- ✓ The late 1970s was a similar period of pervasive anxiety and pessimism.
- ✓ Forces for "experimentation that leads to action and change" building.
- ✓ Ways to allocate resources within an economy.
- ✓ Capitol-allocation; "top-down", government driven.
- ✓ Capital-allocation; "bottom-up", market driven.
- ✓ Complexity creates a fundamental information deficit in capitol-allocation approach.
- ✓ Favorable "action and change" underway?
- ✓ U.S. economic resiliency remains under-recognized.
- ✓ Change in mindset for some key capitol-allocation advocates?
- ✓ Low expectations bar.

Capital and Capitol Allocators

"If you're not confused, you're not paying attention", quipped business management guru Tom Peters some years back.

While Peters' words were intended to describe the dynamic business world, they also sure seem appropriate today given the current political, economic and investment scene.

In politics, the "Brexit" vote prevailed despite warnings against it from many (most) high-profile British *and* world leaders. Here in the U.S. there has been the surprising rise of "anti-establishment" presidential candidates Trump and avowed socialist Sanders.



In economics, confusion among policy makers and their advisors appears higher than it's been since the 1970s when stagflation confounded economists.

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Today, unusual policies being pursued in a number of countries include *negative* interest rates and discussions of potential "helicopter drops" of money. Despite these kitchen-sink efforts, effective "top-down" remedies for slow growth and economic stagnation continue to prove elusive around the globe.

Meanwhile, the so-called BRIC countries (Brazil, Russia, India and China) that many economists expected to be the world's growth engine for decades are dealing with various economic problems of their own.

While the U.S. can boast of the best economic growth path among "developed nations", growth is sub-par and widely feared as fragile. The Federal Reserve's (Fed) on-again/off-again policy stance towards normalizing interest rates suggests to some that they, too, are confused.

What are investors to make of all this?

Our perspective on the prospects of what may lie ahead and their investment implications follows.

The great unease

In his thought-provoking book, *The Fractured Republic*, Yuval Levin offers the following comments about the economic, societal and cultural trends presently at work:

> ***"We are uneasy. And unease leads men and woman to seek change, to innovate, to build the best that they have and to uproot the worst. The economy, the culture, and the politics of a free society are built to respond to unease with experimentation at the margins that ultimately leads to action and to change"[1].***

The great unease in the U.S. is certainly more than just dissatisfaction with current sub-par economic growth. It is likely also about *diminished expectations* for the future. Many are uneasy that a critical turning point is upon us, and the turn includes economic decline. Numerous surveys suggest most Americans believe the next generation will not be richer, safer and healthier than the prior generation.

The Brexit vote suggests the great unease is shared across the Atlantic. As one observer wrote in the *Financial Times*[2] leading up to the Brexit vote:

> ***"Success in the 21st century economy will not be about centralized command and control bureaucracies. It will be about freedom to innovate, flexibility, experimentation and networks.***
>
> ***The EU's bureaucracy (largely comprised of unelected bureaucrats) has stifled innovation in biotechnology, financial services, and technology. The centralization of all lawmaking for a single market in Brussels has turned into a lobbyist's meat market, defending interests of big business against disruptive innovators. Freed from the bureaucracy, Britain can become Europe's center for innovation, knowledge-based industries and entrepreneurship".***

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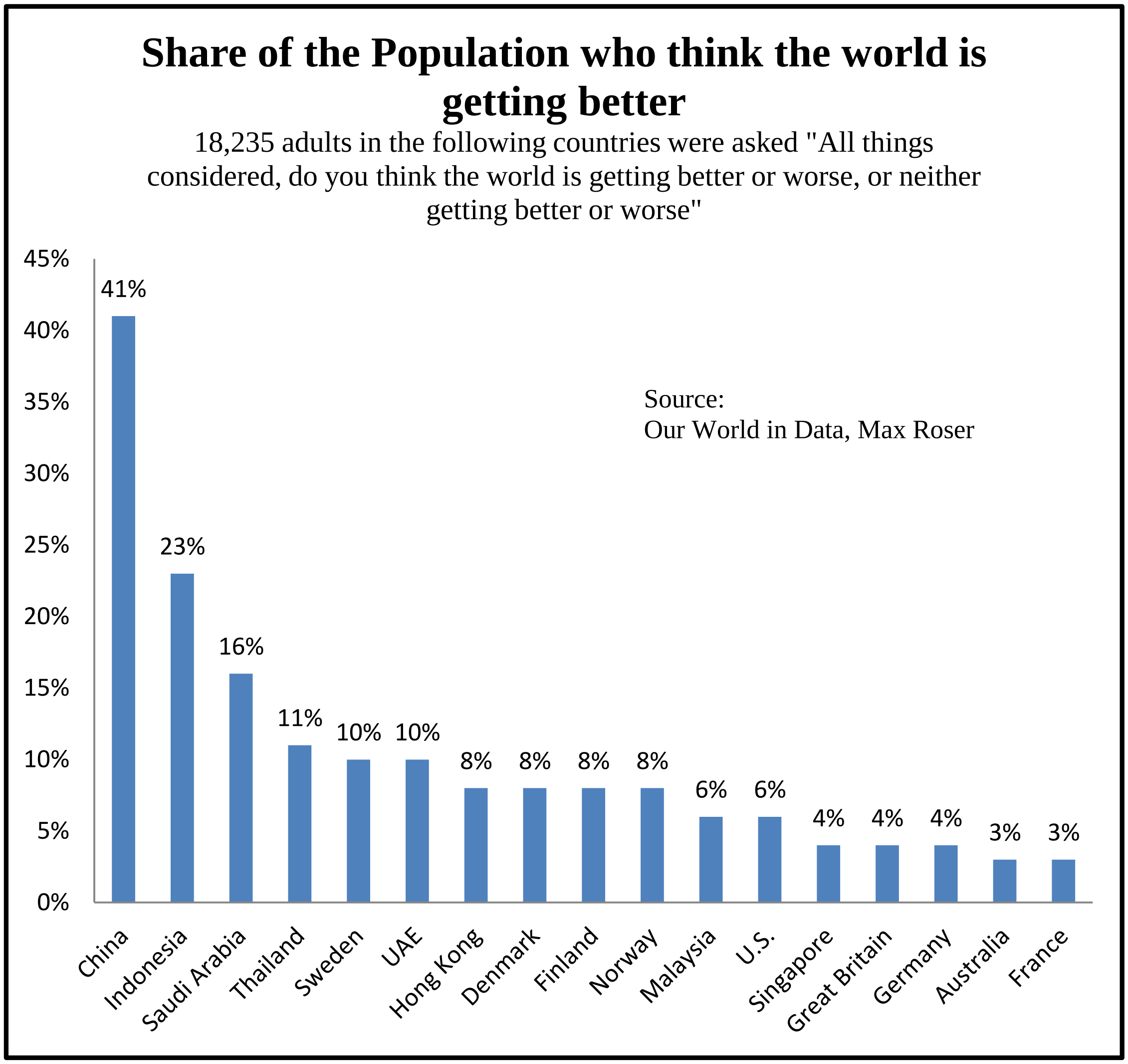
[1]Yuval Levin, *The Fractured Republic: Renewing America's Social Contract in the Age of Individualism*, Basic Books, 2016
[2]Paul Marshall, *British Trade can Flourish without the Shackles of Brussels*, Financial Times, June 26, 2016

Britain has voted to reject the status quo and instead "experiment at the margins" as it grasps for "action and change" to a better future. They are apparently willing to do so even at the cost of still-more near term economic uncertainty.

Figure 1: A "bull market" in pessimism



Meanwhile, the rise of anti-establishment candidates here also reflects great unease and restlessness. Many U.S. voters are also apparently willing to make a leap and "experiment with action and change" for a different path forward.

Episodes of great unease

Will the path ahead for the U.S. be a process that "*builds the best and uproots the worst"* as Levin suggests*?*

We believe progress in such a direction is ahead, as we will soon explain. But the path will no doubt trace a very crooked line. One can almost certainly count on lots of twists and turns on the political side of the equation in the months ahead as the election "silly season" plays out.

We think it is informative, however, to look back to an earlier dark time when our problems appeared intractable, the country seemed to be coming apart, unease and economic confusion were pervasive and the expectations arc was bending downward.

The environment of the 1970s was marked by ecological doomsday predictions, rotten productivity growth and stagflation. The last aspect—rising unemployment and rising inflation—was not supposed to happen according to conventional economic thought. It was widely believed that a tradeoff between inflation and employment existed. Policymakers could boost employment according to conventional theory at a cost of a little more inflation.

In his acceptance speech, the 1974 Nobel "Prize" winner in economics, Friedrich Hayek—not a believer in the inflation/employment conventional wisdom—summarized the situation:

> ***"…Economists are at this moment called upon to say how to extricate the free world from the serious threat of accelerating inflation which, it must be admitted, has been brought about by policies which the majority of economists recommended and even urged governments to pursue. We have, indeed, at the moment little cause for pride: as a profession we have made a mess of things."***

As *both* unemployment and inflation topped double digits, unease escalated. Like today, the heightened state of anxiety led to most Americans becoming convinced that future generations would not live as well as they did.[3]

This earlier great unease set the stage for "experimentation, action and change" that ultimately laid the foundation for more than two decades of general economic flourishing—both domestically and around the world—as countries followed our pro-growth policy leadership.

How to solve THE problem of economics: the allocation of resources

In an interesting twist on things, Hayek shared the Nobel "Prize" with socialist Gunnar Myrdal. The co-recipients were about as far apart on the economic spectrum as one can imagine. Myrdal believed economic problems would be solved via "top-down" command and control solutions. We'll call this a *capitol-allocation* approach to reflect a relatively few minds of influence attempting to solve economic problems from the "commanding heights" of a capitol in say, Washington D.C., Brussels, Copenhagen or Caracas.

In sharp contrast, Hayek believed that only "bottom up" market-oriented actions that rested on individual rights and freedoms would provide orderly and enduring solutions to economic problems. We'll call this the *capital-allocation* approach where individuals and firms are free to make commercial transaction purchases in a mutually beneficial manner (see nearby CEO quote).

[3] Ronald Bailey, *America Pessimism*, Reason.com, July 7, 2016

CEOs need to do two things well to be successful: run their operations efficiently and deploy the cash generated by those operations—i.e. allocate capital. Essentially, capital allocation is investment, and as a result all CEOs are capital allocators and investors.[4]

Hayek's Nobel acceptance speech, *The Pretense of Knowledge* augmented by his additional writings, outlines the fundamental flaws that ultimately undermine capitol-allocator economic structures.

Even when the "best and brightest", most well intentioned and caring minds act as a capitol-allocator, they can only possess a fraction of the information that market-oriented capital-allocation inherently possesses.

Whether it is the incredible complexity involved in making something as simple as a pencil (see "*Creative Energies"* market commentary archived at capinv.com) or enjoying the miracle that is a cup of coffee which include beans grown in Sumatra and through incredibly complex logistics is brought to us where and when we want at a price most can afford, the allocation decisions underlying the goods and services most of us take for granted are massive.

Constant trial and error and effective feedback loops provide incredible nimbleness within the complex chain of capital-allocators. They are constantly trying to understand how to please their customers. Failure to do so means personal economic pain. As Henry Ford noted:

"The competitor to be feared is one who never bothers about you at all, but goes on making his own business better all the time."

Mikhail Gorbachev—then President of the U.S.S.R.—is once said to have asked British Prime Minister Margaret Thatcher: "How do you see to it that people get food"? Thatcher answered "I don't. Prices do it".

Incredibly complex knowledge, flexibility, constant feedback and experimentation are traits even the best and brightest capitol-allocators cannot come close to replicating. Economies marked by significant capitol-allocation activity are less dynamic and less efficient. Just as towering trees crowd out sunlight that inhibit sapling growth, top-down policies tend to prevent potentially more effective bottom-up solutions to perplexing problems from taking root.

Finding the balance between allocators

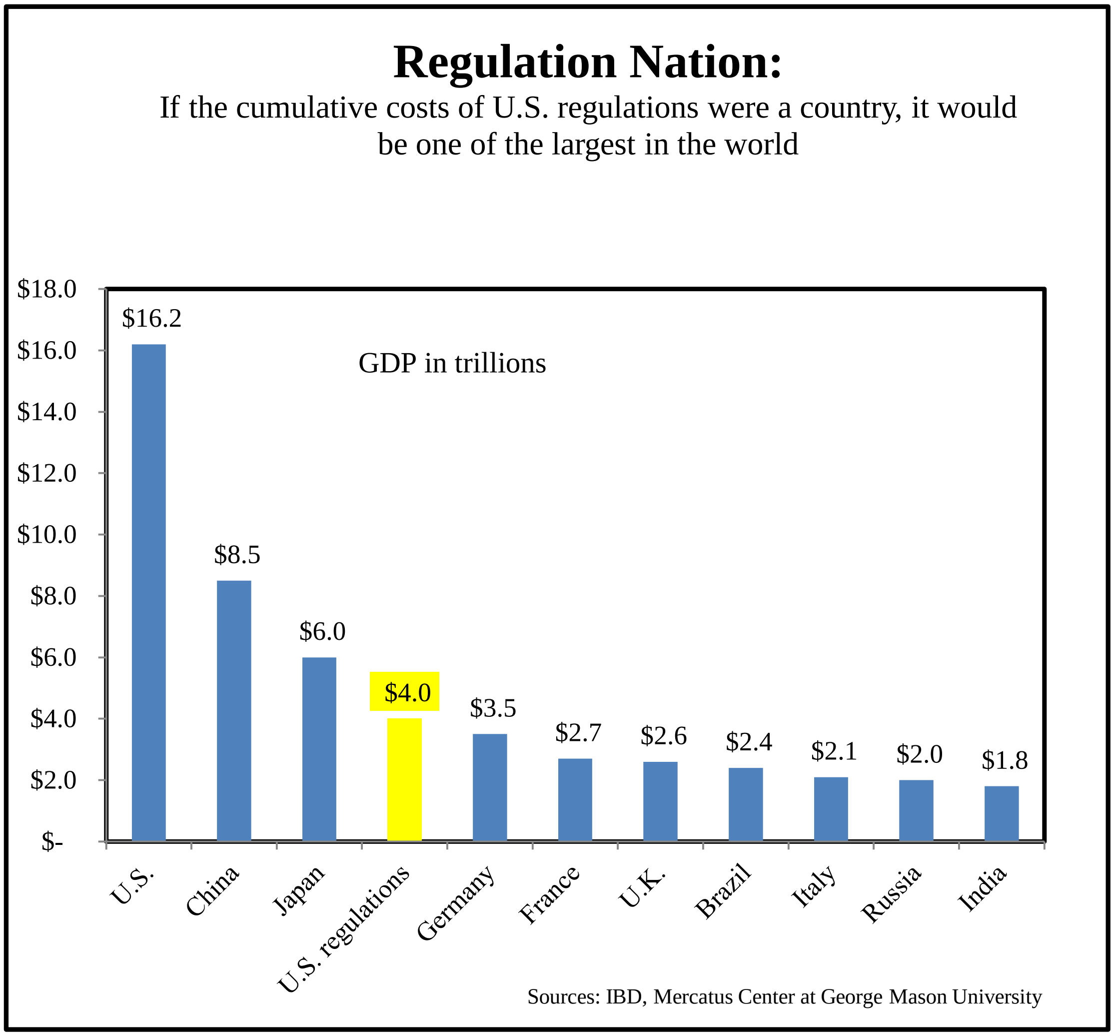
One of the defining characteristics of the past century has been the ever larger expansion of *capitol allocation* within the economy.

[4] William Thorndike, *The Outsiders: Eight Unconventional CEOs*

In 1913 (the year the federal income tax was ushered in by Constitutional amendment) U.S. government spending was less than 8% of the total economy (GDP). In 1960 it was in the 20% area, in 2000 in the 30% range, and now it is well into the 40% area.

And, by the way, the nearly unrelenting trend towards expanding the role of capitol-allocation has—with only a few exceptions—been administered by both of the established political parties.

Figure 2: Certainly regulations are necessary, but isn't there room for a lighter touch?



Yet the economy has "worked" pretty darn well over large portions of this period, so what's the problem?

We believe the record is clear that general standard of living advanced the most during the periods when the environment nurtured capital-allocators. The 1920s, 1950s, most of the 1960s, and the 1980s-2000 standout.

As capitol-allocation increases its economic influence by taking on more and more tasks, the impact of the information flaws noted by Hayek are compounded. The result is the more the government tries to do, the less it does very well.

To quote Yuval Levin once again:

> ***"When a team from the University of Michigan studying national elections asked Americans in 1964 how much of the time they thought the federal government could be trusted to do the right thing, 76% said either 'just about always' or 'most of the time'. When Gallup asked exactly the same question recently these two options garnered a combined 19% of the responses".***

In the three big areas the capitol-allocation has been busiest; education, healthcare and infrastructure, quality of outcomes has become increasingly questioned, inflation has been rampant and red tape has exploded.

> ***The astonishing rise in college tuition correlates closely with a huge increase in public subsidies for higher education. If over the past three decades car prices had gone up as fast as tuition, the average new car would cost more than $80,000.*** [5]

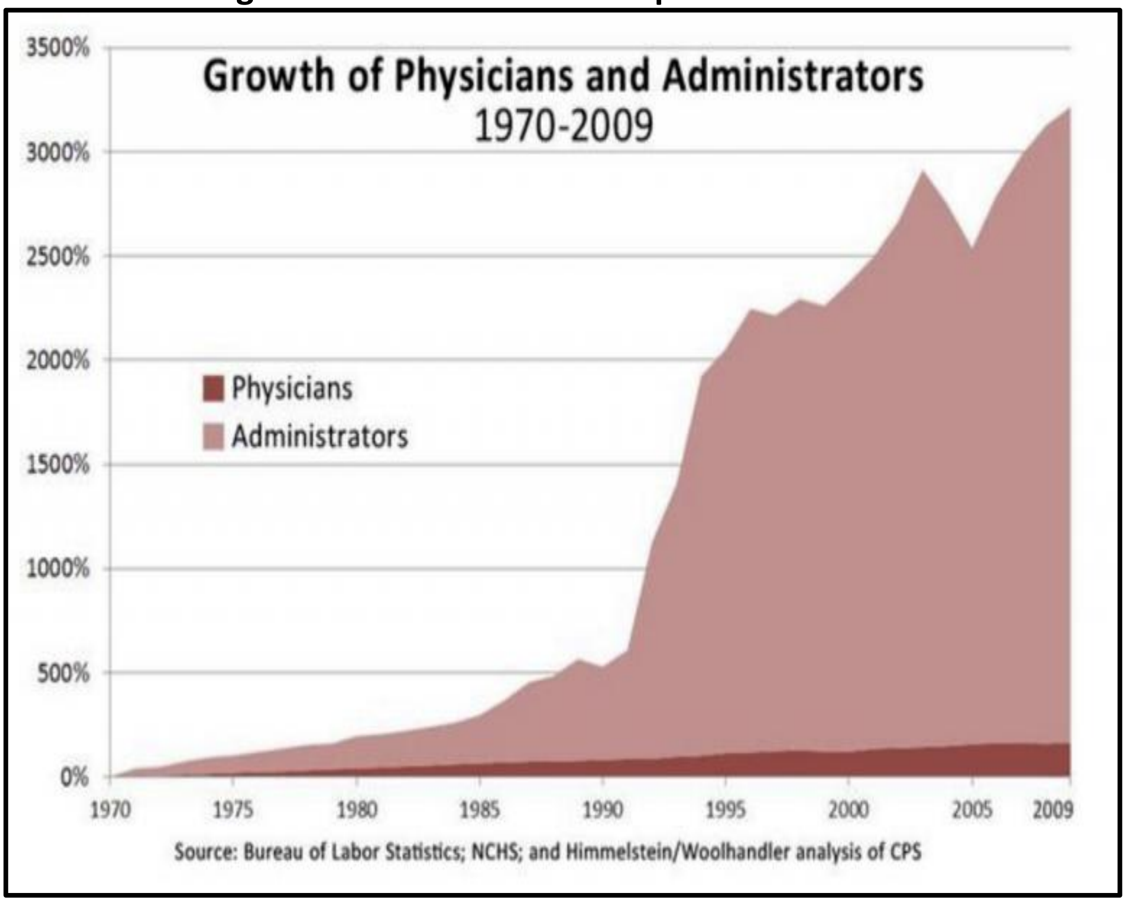
Economies that are driven to a significant degree by top down capitol-allocation have had a remarkable tendency to end up ultimately as basket cases inflicting serious hardship on their citizens. The tragic outcomes in East versus West Germany, North versus South Korea, Mao's China, and today's Venezuela provide real-world "lab experiments" between capital and capitol-allocation approaches.

Even the Sweden, Denmark, Canada and European "models" for capitol-allocation either have had fiscal breakdowns which required significant reform towards more capital-allocation, and/or suffer from persistently anemic economic growth and high unemployment.

"Action and change" underway?

Is the rise of presumptive Republican candidate Donald Trump a signal that voters want "experiment, action and change" that will mitigate the capitol-allocation trend? We're not sure he even wants to reverse the trend, but his stated economic plan appears to foster capital-allocation. The separate programs outlined by the Republican Party do as well, in our estimation.

Figure 3: Do these trends improve healthcare?



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[5] Paul Campos, *The Real Reason College Tuition Costs So Much*, New York Times, April 4, 2015

But isn't Bernie Sanders' rise to prominence instead the sign that voters want "experimentation, action and change" towards still larger dosages of capitol-allocation within the U.S.? If we go still further down that path, what does this portend for investors?

Europe is a guide in this regard. The developed countries in Europe have operated with capitol-allocations above our current level. Slow growth, chronic fiscal issues and a nagging unemployment problem have been the norm for so long that the term "Euro-sclerosis" has evolved to describe the situation.

Fortunately capital-allocators at work within our economy are more dynamic than is the case in Europe. So our economy would also likely grow, but not at a pace likely to ease the unease.

True, Millennials are "different"—just as baby boomers were different than their parents. But we suspect they will not prove to be that different when it comes to their impact on the economy.

Figure 4: U.S. Population: Most common age by year

(Source: Calculated risk)

Rank	2010	2015	2020	2030
1	50	25	29	39
2	49	26	30	40
3	20	24	28	38
4	19	23	27	37
5	47	27	31	36
6	46	56	26	35
7	48	55	32	41
8	51	22	25	30
9	18	52	35	34
10	52	28	34	33

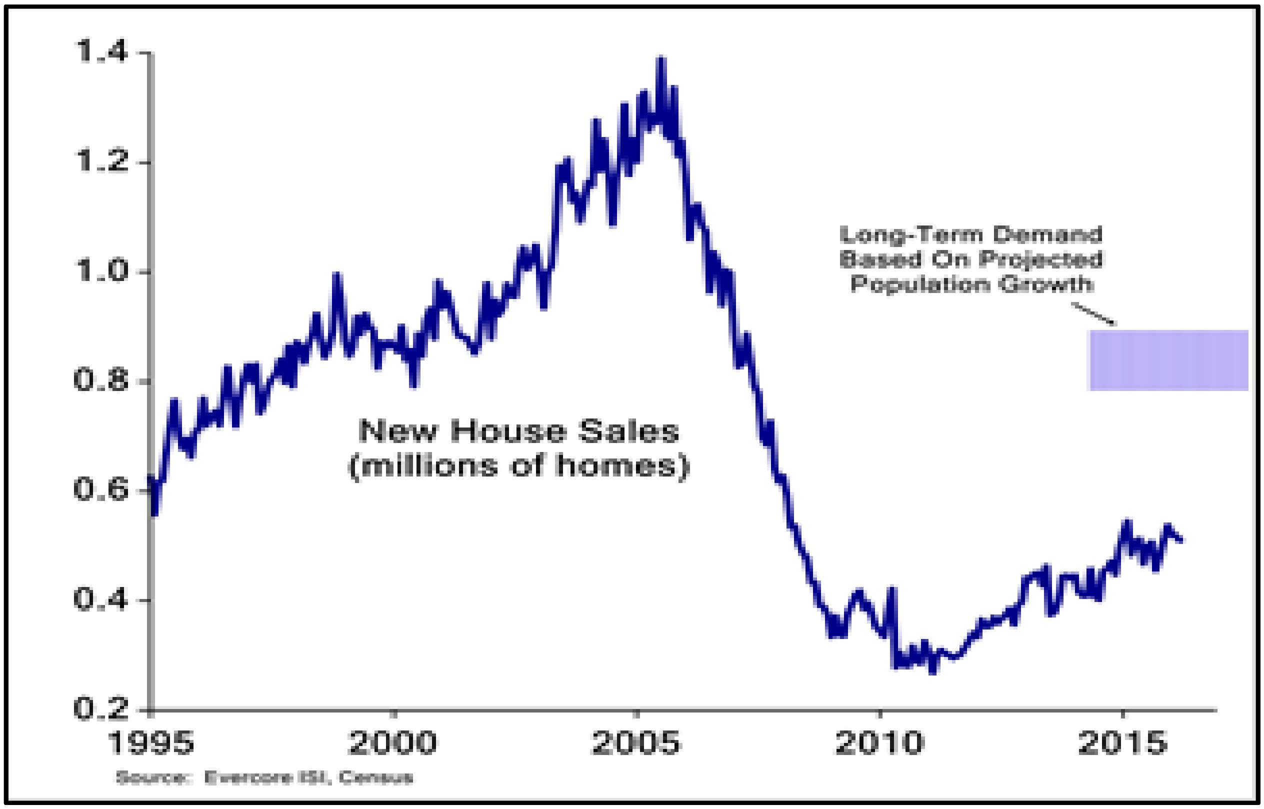
From an investment standpoint, as has been the case the past few years as an expanded U.S. capitol-allocation state has been a wet blanket on overall growth, the stocks of companies that prove to be strongest *capital allocators* would likely still prosper and reward investors.

In addition, many bottom-up capital-allocators are planting the seeds of future productivity growth—which is the ultimate driver of improved living standards.

Unprecedented abilities and the ease to share ideas and collaborate, big data, the internet of things, cloud computing, software simulation, 3-D printing, material science, and medical advances are laying the groundwork for improvement. These efforts are not likely to all be crowded out by increased capitol-allocation.

Also in contrast to Europe, Japan, and China, U.S. demographics are favorable for economic growth. The so-called Millennials out number baby boomers. Increasingly, the economy will be driven by this consumer demographic. For it is this age group that forms the greatest number of new households, creates the greatest number of new companies, buys the greatest number of homes, related furnishings and durable goods (Figure 4 on the previous page and Figure 5 below).

Figure 5: Pent up demand!



Added resilience also is provided by the business cycle dynamics of our economy—as least over the near term. A lack of broad based type of excesses (typically accumulated debt and rising inflation) that makes an economic expansion brittle, and a well-capitalized banking system provide resilience even if things go wrong economically elsewhere around the world.

Profound change in capitol-allocation thought?

But there are reasons to expect the path forward may evolve differently than so far discussed.

First, it is interesting to note that the *two fastest growing* economies in the developed world (U.S. and U.K.) are signaling the need for "action and change" (Figure 6 on the following page). As was the case in the late 1970s, the world is ripe for pro-growth capital-allocation leadership to show the way forward.

Figure 6: The World's ready for growth leadership

GDP Change 2009-2015

U.S.	**+24.6%**
U.K.	**+24.0%**
Germany	**-1.6%**
European Union	**-4.6%**
France	**-10.3%**
Japan	**-18.2%**

Secondly, there are signs from surprising places of a potentially profound mindset change regarding the capitol-allocation approach.

Economist John Cochrane[6] has recently been highlighting these changes. He notes a mindset change at the state and federal levels in regards to stifling real estate zoning laws and regulations. Such laws restrict labor mobility (people can't afford to move where jobs are plentiful), and there's growing recognition zoning red tape is making social stratification and inequality worse.

Perhaps more significantly, Cochrane provides links to comments by Larry Summers, a key economic advisor to Bill Clinton, Barack Obama and (likely) Hillary Clinton.

> ***"I (Summers) am a progressive, but it seems plausible to wonder if government can build a nation abroad, fight school decay, run schools, mandate the design of cars, run health insurance exchanges, or set proper sexual harassment policies on college campuses, if it can't even fix a 232-foot bridge competently. Waiting in traffic over the Anderson Bridge (in Boston), I've empathized with the two-thirds of Americans who distrust government. It's not about who cares, it's about competence. We can work together to fix this.***
>
> ***Investigating the reasons behind the bridge blunders have helped to illuminate an aspect of American sclerosis — a gaggle of regulators and veto players, each with the power to block or to delay.***
>
> ***At one level this explains why, despite the overwhelming case for infrastructure investment, there is so much resistance from those who think it will be carried out ineptly.***
>
> ***More than questions of personality or even those of high policy, the question of how to escape this trap should be a central issue in this election year."***

Sounds to us like the type of epiphanies that can lead to an environment fostering capital-allocation!

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[6] The *Grumpy Economist* blog

Low expectations bar

A couple of final points need to be made about investing in the contemporary environment.

Hardly a day goes by without the phrase "financial markets hate uncertainty" being repeated. And with an abundance of fear, uncertainty, and doubt surrounding the world, it may seem hard to believe the stock market can make forward progress.

Yet we would argue the U.S. financial markets are, in fact, pricing in a great deal of *certainty* about the future. That certainty involves the widespread expectation that economic growth will remain fragile and weak for an extended period.

Recession forecasts remain prevalent and even in the lengthening shadow of the Financial Panic of 2008; investors are attuned and focused on every event as the next "black swan" that will trigger another Panic.

The pervasive view?

Meanwhile, investment dollars continue to herd into bond investments and higher yielding stocks as perceived "safe havens". (Higher valuations for these investments have altered their risk/reward prospects unfavorably in our estimation.)

With general expectations so glum, reality has a very low bar to clear in order to provide positive (favorable) surprises. For those with a "half-empty" view of things, the low expectations "bar" essentially means the economy only needs to be less crummy than expected to surprise on the upside.

We believe the path ahead will be more "half full" than many expect. Economic resiliency in the U.S. is understated as we suggested earlier. The problems of today may appear as a mighty Goliath. But the capital-allocators, in a never-ending quest to bring better products and services to please customers, represent an "Army of Davids[7]".

[7] Glenn Reynolds, *An Army of Davids*, Thomas Nelson Publishing, 2006

Appendix: That world no longer exists

Some capitol-allocator advocates yearn nostalgically for the 1950s when high personal tax rates and large union solidarity existed and yet the U.S. economy dominated the world.

As Yuval Levin details extensively in his book, the 1950s represented an unusual and *unsustainable* period in time. After nearly two decades of pent up consumer demand (due to the Depression and World War II), the U.S. economy was coiled like a spring. Meanwhile, the rest of the world was in economic ruin, and we were able to dominate economically and fill the massive void. The U.S. could prosper despite high tax rates and artificially high wages directed by unions.

While nostalgia for those "good old days" may exist, those economic circumstances no longer exist. It is rarely good to confuse correlation with causation. A return to the high-tax-rate policies or union membership in place back then will not bring back the 1950s or 1960s.

Low-skill manufacturing jobs are disappearing globally (as China can attest) with an expansion of the knowledge of the economy. Like days long gone, those jobs are never coming back. As Larry Summer's comments earlier suggest, the path forward is going to take new approaches to solutions. Fostering bottom-up, capital-allocation to problem solving is the right direction.

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