

PCA Perspectives

Permit Capital Advisors' Thoughts on the Investing Landscape

October 10, 2016

The relevance to investors of the modern-day political discourse goes beyond the morbid curiosity that has all Americans engrossed in this election cycle. An understanding of the historical context in which we find ourselves may inform any resultant impact to the economy and markets, as well as its likely duration. We know we are in the midst of a business cycle where recovery from the abyss has been muted relative to the escape velocity we would expect to see coming out of a deep recession, bringing with it lackluster growth and largely stagnating wages. We also know that unprecedented levels and forms of monetary stimulus have supported these conditions, and that the Federal Reserve has told Congress that the baton must now be passed on to fiscal stimulus. This brings us back to the inescapable analysis of the politics involved.

It is tempting to believe that events unfolding around political and economic landscapes in the U.S. and abroad are so aberrant in nature that there is no historical precedent. Forces of particular interest at the moment include those pushing pro-populism and anti-globalization rhetoric. The aftermath of these efforts will weigh directly on growth prospects and indirectly on market fortunes. Before we look forward and analyze the potential impact of today's political environment, let's look backwards to another point in our history when the populist voice of this country was loud, and had globalization in its crosshairs.

On Populism and Globalization

In 1896, the popularity and interest surrounding William Jennings Bryan made him the 120-year predecessor to Bernie Sanders or Donald Trump. Speaking at the Democratic National Convention in Chicago on July 9, 1896, one day before he was nominated for President on the fifth ballot, Bryan gave a speech that focused on the debate involving the gold standard versus bimetallism, which added silver to the mix of currency coinage. The latter was seen as an inflationary measure that would have increased the amount of money in circulation and aided cash-poor and debt-burdened farmers. As he turned his focus towards the role of government, he explained his viewpoint as follows, enlisting imagery that could have been lifted from the current election cycle:

“There are two ideas of government. There are those who believe that if you just legislate to make the well-to-do prosperous, that their prosperity will leak through on those below. The Democratic idea has been that if you legislate to make the masses prosperous their prosperity will find its way up and through every class that rests upon it.

You come to us and tell us that the great cities are in favor of the gold standard. I tell you that the great cities rest upon these broad and fertile prairies. Burn down your cities and leave our farms,

and your cities will spring up again as if by magic. But destroy our farms and the grass will grow in the streets of every city in the country.

My friends, we shall declare that this nation is able to legislate for its own people on every question without waiting for the aid or consent of any other nation on earth, and upon that issue we expect to carry every single state in the Union.”ⁱ

Now Bryan did not carry every single state in the Union, and in fact, he was defeated by William McKinley in an intensely fought election. However, in his three presidential bids he made an indelible mark on the political discourse, promoting causes ranging from the bimetallism platform of 1896 to anti-imperialism in 1900 and trust-busting in 1908. Fast-forward to today and the level of protectionist bluster is significant, as both parties seem to be fighting the last war, not the ones we face today and tomorrow. As per the nonpartisan public policy institution, the German Marshall Fund of the United States, “The global economy is no longer about making a product in one country, and shipping and selling it somewhere else. It is about complex supply chains that weave together activities all over the globe, supported by investment, technology, and skills that know no borders.”

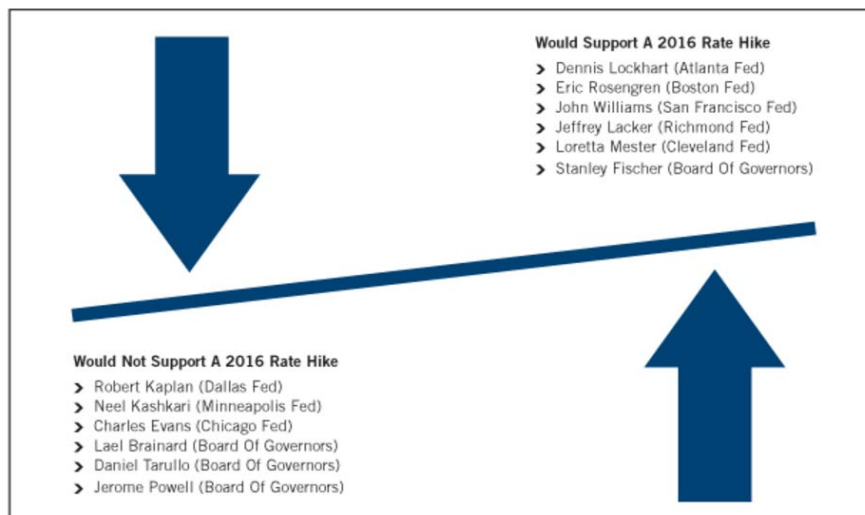


Alex Wong/Getty Images



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The perception about globalization may very well be ill-founded, as while critics say it only benefits the wealthy, in fact a less open world would primarily hurt the poor. Not only has the vast improvement in global living standards since World War II been underpinned by an explosion in global trade, bringing hundreds of millions out of poverty in transformed economies from China to Ireland to South Korea, but also in this country exporting firms have higher productivity and pay higher wages, on average. Keep in mind that roughly 50% of America’s exports go to countries with which it has a free trade agreement, even though the economies of these same countries account for less than 10% of global GDP. Further, the anger appears to be misdirected, as there is a world of difference between improving globalization and reversing it. At the heart of the problem is a global growth malaise, but this could worsen rather than improve if nations intentionally turn inward. “The medicine that is being often prescribed is protectionism, and that is exactly the kind of medicine that is going to hurt the patient, not help him,” said Roberto Azevedo, director general of the World Trade Organization. On the domestic front, rather than eliminate open borders, we should start as a country to focus on doing a better job of protecting the downside, as currently the U.S. spends a paltry 0.1% of GDPⁱⁱ on policies to retrain displaced workers and help them find new jobs.



NOTE: WE EXAMINED THE PUBLIC REMARKS OF EACH FED POLICYMAKER SINCE AUGUST 26. THEIR CATEGORIZATION IS BASED ON OUR ASSESSMENT OF WHETHER EACH POLICYMAKER WOULD ARGUE IN FAVOR OF A RATE HIKE AT A 2016 FOMC MEETING, ASSUMING NO MAJOR CHANGES TO THE ECONOMIC OUTLOOK.

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Source: BCA Research, September 29, 2016

However, this movement, along with the anger it captures, may well prove to be a convenient vehicle to propagate the shift towards fiscal stimulus that is seemingly required to keep our economy and markets afloat. This, in light of the Fed’s recent indication that a) the support for a rate hike is building (as seen in the illustration above), and b) they are going to stick to conventional tools, by today’s unconventional standards, meaning Quantitative Easing and forward guidance. To warrant the unconventional distinction, a central bank now has to take a Bank of Japan approach and engage in price targeting and debt monetization. This looming transition is both appropriate and necessary for the long-term, as monetary policy doesn’t fix structural issues, it only buys time. Clearly, the U.S. is not the only country where the growth of a populist movement is pushing for more interventionist actions, and where the fear of this movement will likely prompt policymakers to open the fiscal spending spigot to placate an angry electorate. The most obvious example being the U.K., where in Prime Minister May’s first speech she displayed an awareness of her party’s shift to the left, promising to fight “burning injustice” rather than espousing the usual supply side reforms, tax cuts, and trade deals. The liberal government in Canada was also elected partly on a promise to increase infrastructure spending.

Whither Fiscal Stimulus?

One obvious question that a skeptic might ask, is despite what candidates for various offices are saying on the campaign trail, will the President and Congress need to see a recession before approving a meaningful stimulus package? The political will to push forward tough legislation is a must, as the conversation around an increasing budget deficit will be difficult. Already, the projected deficit of 3.2% of GDP in 2016 is estimated by the Congressional Budget Office (CBO) to rise to 4.6% by 2026ⁱⁱⁱ, reflecting a sharp increase in outlays driven primarily by an aging population and rising healthcare costs.

One unifying topic for American voters is the desire for higher-paying jobs, and commensurate safety enhancement, that infrastructure spending could facilitate. With the cost of funding for governments unusually low, there is a strong economic incentive to increase public infrastructure investment. When considering infrastructure upgrades, which both Presidential candidates espouse, the spectrum will extend beyond the traditional roads and bridges to include air traffic control systems, the electrical grid, ports, rail systems, and cyber security.

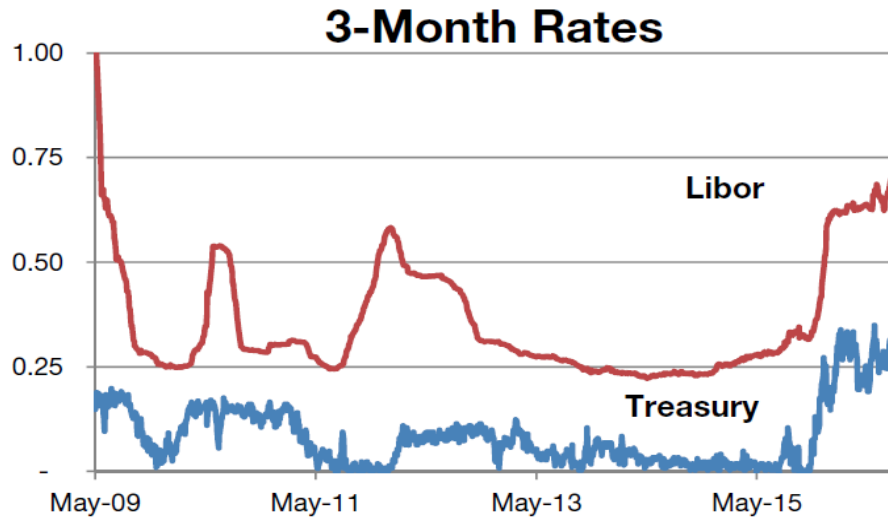
While it appears clear that expansionary fiscal policy is necessary at this point to increase aggregate demand, what is less clear is what the totality of its impact will be. Coming at a time, as seems likely, that the Federal Reserve will be walking back its efforts to tamp down interest rates, these policy measures may accelerate upward pressure on rates, as the increased budget deficit could stir the ire of bond vigilantes and contribute to higher inflation. We believe that low interest rates have had a number of virtuous effects on markets, including the fact that they have made equities appear to be attractively valued, when the fundamentals may not have pointed in the same direction. They have also provided a boost to long duration fixed income and credit. In this light, we think it behooves investors to create an investment profile around modest growth, rising interest rates, and building inflationary pressures. This base case leaves room for positive portfolio returns, but they must be earned via targeted risk-taking, with a critical eye towards sector exposures and duration management.

As it pertains to equities, fiscal stimulus can be done in two ways, either by increasing government expenditures or by implementing tax cuts. The former would be more supportive of construction-related sectors and projects, while the latter would likely provide a lift to consumer discretionary stocks. One of the ways we attempt to reduce duration risk at the portfolio level is to increase expected cash flow. Real portfolio income not only provides support for total returns, but it also maintains a steady flow of dry powder that can be redeployed in the event of an eventual dislocation. While holding a portion of a portfolio in traditional fixed income is prudent from a diversification perspective, it is currently offering little return for the risks involved. This has led us to spend a meaningful amount of time looking for non-traditional fixed income strategies that are expected to result in no permanent loss of capital in most market and economic scenarios (assuming investors are willing to stay invested through short-to-medium term price volatility), that have higher return expectations than traditional fixed income categories, and that possess very limited interest rate risk. These strategies range from niche mortgage, municipal bond, and floating rate loans, to private opportunities.

Gaming Rising Rates

One dynamic that has already started to unfold that presents an investable opportunity is a widening of spreads between risk-free government based funding and funding for financial institutions. This spread shift is reflected in an elevation of LIBOR rates to the highest levels since May 2009. It is likely that the spread will continue to widen, making assets that price off of LIBOR, like corporate floating-rate loans, attractive. The driver is a new SEC rule that is set to take hold on Friday, which is requiring certain money market funds to abandon the traditional fixed \$1 NAV in favor of a floating NAV, and at the same time instituting potential new redemption hurdles and fees. This has been in the works since the credit crisis in 2008, and specifically came to a head when the Reserve Fund Primary Fund, a \$65 billion prime money market fund, broke the buck. The rule makes a distinction between different types

of funds, as retail funds and institutional government funds are excluded from the floating NAV requirement, meaning it only applies to institutional prime funds. This has increased borrowing costs for financial institutions, which is the basis for London Inter-Bank Offering Rates, or LIBOR. The recent move represents the first meaningful disconnect between LIBOR and Treasury rates since 2011, when European financial stability was called into question.



Source: Bloomberg, Piper Jaffray

While in this instance rising rates represent opportunity, we must also be vigilant about the manifold related risks. Theoretically the relationship between valuations and interest rates is not necessarily straightforward, as low rates can be a reflection of a poor earnings growth outlook, which warrants a lower multiple. In recent times, however, where a TINA (There Is No Alternative, to stocks) mindset rules, investors have chosen to view low rates through the prism in which they increase the present value of future cash flows, and in turn warrant a higher multiple. From a valuation perspective today, the median U.S. stock now trades at a record P/E ratio of 21, even higher than its peak in 2000.^{iv} As we often remind investors, while valuation is not a particularly effective market-timing tool, it is a tried and tested method for evaluating long-term equity returns.

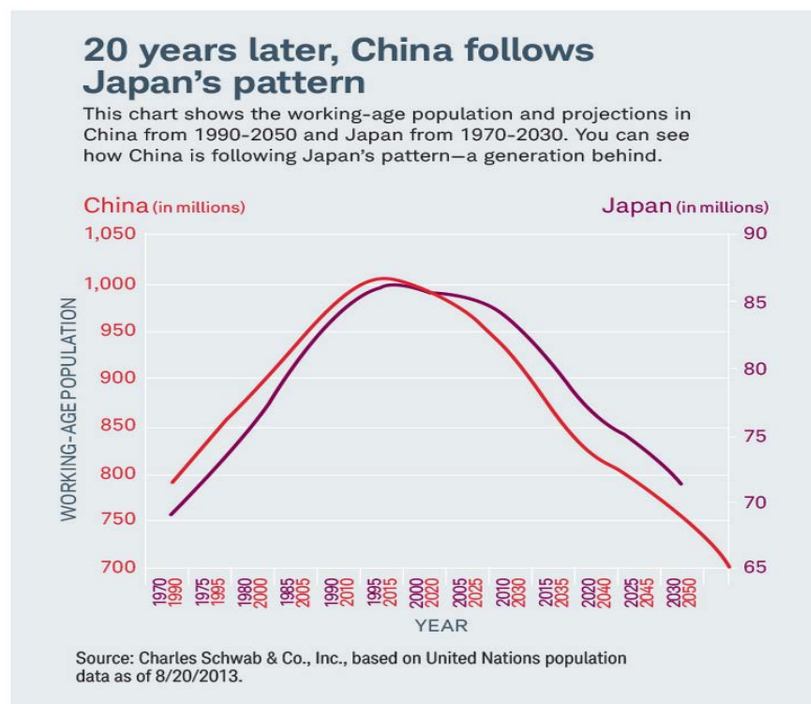
Business Cycle Identification

An analytical complement to valuations is an understanding of where we are within the business cycle. At the moment, while economic growth is sluggish it is positive; however, if you exclude consumption figures, real GDP is contracting at a steep and recessionary pace. Fortunately, the consumer in this country accounts for roughly 70% of total nominal growth. Historically, it is rare for overall GDP to diverge from ex-consumption GDP for long, suggesting that broader growth slippage is an imminent danger. One factor that may render this traditional relationship less relevant is the fact that we are living in a more fixed asset-light, as well as knowledge-based, economy, relative to our past. Even if we do accept that we are in a late stage of the current cycle, late stages often last for extended periods of time.

Further, there does not appear to be a consistent set of signals to look to for guidance. Factors that were pertinent prior to the bursting of the dot-com bubble and the great financial crisis, such as tightness in the labor and housing markets, or measures of business debt, were less pronounced during earlier recessions. Other indicators that have proven reliable over time – such as slope of the yield curve, and labor force participation statistics – may be less reliable this time around due to the effects of central bank balance sheet manipulation and structural changes in employment dynamics, respectively.

Property of China

Given the delicate state of lofty valuations and tenuous growth, the last thing our markets need is a shock emanating from the world’s second largest economy. Fortunately, when things in China slow down to the target growth rate, Beijing throws in some stimulus. Year-to-date credit formation is about 8 trillion yuan, or roughly double the 2009 stimulus. Unfortunately, the money multiplier is shrinking. Of late it appears that it takes more money to create a percentage point of growth, and public debt-to-GDP is already above 200%. For that matter, private sector debt-to-GDP is more than 250% according to the Bank for International Settlements.^v Further, the demographic tailwind that China has enjoyed for the last 25 years seems poised to turn into a headwind, akin to what Japan faced at the turn of the century.



Where the ultimate focus should be with respect to systemic risk and China is the real estate market. Government officials there would seem to concur, as new restrictions on property purchases are cropping up across the country to try to cool soaring home prices stoked by property speculators. Last week Beijing increased down payments for first-time purchasers to a minimum of 35%, while other cities are taking measures including suspending sales of new properties to families who already have two or more properties.^{vi} In the scary anecdote department, we have

clients living in China who have seen their apartment appreciate in value almost 90% since the beginning of the year, and there have been stories of couples in Shanghai filing for divorce so they could qualify to purchase an additional property! If those aren't bubble indicators, we don't know what would be.

Idiosyncratic Opportunities

While there are clearly challenges aplenty, portfolio decisions boil down to the trade-off between the expected benefits and costs of being cautious. Fortunately, we believe that they don't always need to be mutually exclusive. In the last several weeks we have had the opportunity to invest in a number of idiosyncratic strategies and funds that aren't dependent upon equity beta, falling interest rates, or credit spread compression to prove successful. These include the aforementioned floating rate preferred securities and high yielding municipal bonds, as well as niche investment opportunities like specialty finance companies and infrastructure developers. We believe this blend of finding value in the mundane and sourcing advantages in the less-mundane universe will allow us to continue to provide steady returns, sustainable cash flows, and appropriate risk management to our client base.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

ⁱ William Jennings Bryan, "Cross of Gold" Speech, Democratic National Convention, July 9, 1896

ⁱⁱ The Economist, Why They're Wrong, October 1, 2016

ⁱⁱⁱ Berenberg Capital Markets, US elections; policy uncertainties abound, September 9, 2016

^{iv} BCA Research, Bank Credit Analyst, September 29, 2016

^v Barron's, Asia Roundtable: What's Next for the Region, October 3, 2016

^{vi} Shanghai Daily, Cities Bid to Cool Property Market, October 3, 2016

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