

## Something to Think About



OAKWORTH  
CAPITAL BANK

COMMON CENTS

We will undoubtedly remember 2016 as one of the more confounding, frustrating, and tumultuous years in our nation's peacetime history. I think it fair to say most of us, if not all, felt some measure of significant angst, if not disillusionment, at some point over the last 12 months. I would further argue, when taken as a whole, most of us will be happy to see 2016 in the rearview mirror, regardless of any personal successes we might have had along the way.

One of the things I am most saddened about is Thomas Sowell's retirement from his syndicated column. I was a huge fan, and have read any number of his books. His work Basic Economics: A Common Sense Guide to the Economy is the only 'business' book I consistently recommend without reservation or qualification.

What was strange about his retirement was I didn't see it coming. He had written a "Random Thoughts" column only the day prior to his last, and off cycle, one. The former wasn't one of his best, as he came across somewhat surly and curmudgeonly. Here are a few excerpts:

"You cannot live a long life without having been forced to change your mind many times about people and things — including in some cases, your whole view of the world. Those who glorify the young today do them a great disservice, when this sends inexperienced young people out into the world cocksure about things on which they have barely scratched the surface."

"There are words that were once common, but which are seldom heard any more. The phrase "none of your business" is one of these. Today, everything seems to be the government's business or the media's business. And the word "risqué" would be almost impossible to explain to young people, in a world where gross vulgarity is widespread and widely accepted."

"When I was growing up, we were taught the stories of people whose inventions and scientific discoveries had expanded the lives of millions of other people. Today, students are being taught to admire those who complain, denounce and demand."

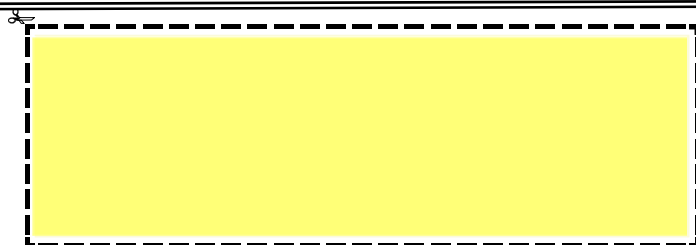
Now, if you were a reader of his column, you will recognize these comments as so many variations on themes he espoused over and over, almost to the point of being redundant. To be sure, they are "conservative" in nature, or at least fit contemporary society's definition of conservative. However, it would be hard to argue there isn't a measure of truth in them.

There is also some measure of truth to the reason he decided to retire, or at least what he allowed in his final column the next day:

"During a stay in Yosemite National Park last May, taking photos with a couple of my buddies, there were four consecutive days without seeing a newspaper or a television news program — and it felt wonderful. With the political news being so awful this year, it felt especially wonderful."

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This made me decide to spend less time following politics and more time on my photography, adding more pictures to my website ([www.tsowell.com](http://www.tsowell.com)).”

Then he concluded his public writing career with:

“We cannot return to the past, even if we wanted to, but let us hope that we can learn something from the past to make for a better present and future.”

‘Goodbye and good luck to all.’

Those are true words. So, what did we/I learn from this year?

- People are fed up with the status quo, or whatever their definition of the status quo is. Had Bernie Sanders come out of the gates as aggressive as he was down the stretch, he might have been able to overtake Clinton in the Democratic primaries....that is if the party apparatus would have allowed it. On the GOP side, one word suffices: Trump. Who would have thought the Donald had any chance of not only winning the nomination but also the Electoral College? For one, I thought he started his campaign as a not so veiled attempt to get a good book deal or another television program.
- It didn't matter what the message was, as long as it wasn't the 'same old same old' from the 'same old same old.' To be sure, Trump doesn't always sound like a 'real Republican.' For his part, Sanders doesn't seem to have a real firm grip on economics, scratch the seem to. However, it didn't matter to the electorate. It wanted something different.
- I learned giving \$25 to a political campaign entitles you to an enormous amount of email and countless pleas for more money. What a mistake that was.
- The Federal Reserve is really a glorified regulatory and policy making bureaucratic arm of the Federal government. While we have long known this to be true, we have willingly played along with the old fiction: “The Federal Reserve System considers itself ‘an independent central bank because its monetary policy decisions do not have to be approved by the President or anyone else in the executive or legislative branches of government, it does not receive funding appropriated by the Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms.” In 2016, I think we learned we can finally put this one to bed. Just because we want something doesn't make it so....just like Santa Claus.
- When I started my career on a buy-side bond desk in Baltimore all those many moons ago, we would buy 30-year stripped Treasuries prior to a Fed rate hike, or at least when we felt certain the Fed was going to raise the overnight target. The reason is simple: a tighter monetary policy should reduce long-term inflation expectations. Since interest rates are/should be a reflection of the markets' outlook for inflation, rate hikes on the short-end could/should have a depressing effect on long-term rates....or at least flatten the yield curve by have short rates go up faster than long ones. Basically, we 'barbelled' the bond portfolios, typically to good effect.
  - After the election, when the probability of a Fed rate hike on 12/14 went to 100%, the long-end of the yield curve rose in excess of 50 basis points. How now brown cow? It wasn't until the Fed actually raised the overnight target AND threatened to be more aggressive in 2017 that we returned to some sense of normalcy in the bond market. So, a barbell worked after the fact (as it typically does), but had you gotten ahead of the game by employing a barbell in advance, you got absolutely crushed. As a result, we learned in 2016, perhaps some of the 'old rules' aren't quite as hard and fast as they once were. Sure, they might still end up working, but not quite as neatly as previously.
- There is an old axiom (or variant thereof): “don't put it in writing, unless you have to do so.” Today's technology and social media outlets enable folks to utterly disregard this tried and true 'rule of thumb;' and have opinions on everything, and plaster the internet with inappropriate/embarrassing photos. As I have told my kids: “being a teenager really hasn't changed as much as the technology which allows everyone to know just how stupid teenagers can be at times.” Thank heavens we didn't have smart phones (and the internet) around the fraternity house back in the late 1980s. My goodness... “naw, I never did that, and you can't prove otherwise.”

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- Our collective dissatisfaction isn't unique to the US. The surprising 'yes' vote for the Brexit this summer proved the UK, or England at least, is also tired of the 'same old same old.' This sent shock waves down the spine of Europe, if not the world. It shouldn't have. The data suggests, to me, the EU and the euro (for those in the Eurozone) haven't been economic geese with the golden eggs, as envisioned. Apologists might say otherwise, but we would agree to disagree.
  - First, the Brexit wasn't a fait accompli. It was simply a plebiscite to allow the UK to enter into negotiations to leave the EU in an orderly fashion.
  - Second, the EU proved the British right by overruling Irish tax/contract law and mandating Apple pay something like \$14 billion in 'back taxes' which Dublin didn't request. In fact, the Irish government actively fought against the ruling. If a country can't guarantee its contracts/promises, it really loses a chunk of its sovereignty.
  - Third, many Europeans are concerned about nationalism, and believe the EU is an effective bulwark against it. After two World Wars, perhaps they have a point. However, the balance of global military power is not the same as it was prior to either World War, nor is the disparity in military technology between the 'West' and the 'East.' The world has three primary military powers: the US, Russia, and China. None of these is in the EU. To that end, the biggest threat to Western Europe's safety is a defunding of NATO by the US. It has nothing to do with the EU government in Brussels.
  - Fourth, let me give you a riddle: what does a Scot in Aberdeen have in common with a Neapolitan in southern Italy? Virtually nothing...completely different language, culture, history, cuisine, religious practices (Aberdeen is 43% irreligious and Naples is overwhelmingly Catholic), and economic comparative advantages. Think about it.
- Neither the Israelis nor the Palestinians truly want a 2-state solution. When you factor out the relatively sparsely populated Negev Desert (South District), you are talking about a land area smaller than Connecticut in which to cram millions of people who have been at odds for years, if not millennia, and who believe the territory is theirs by birthright. Well, maybe I already knew that.
- Since the end of the Cold War, US foreign policy seems to have viewed Russia as more of a regional annoyance than a global threat. Russia has now exerted itself into geopolitical affairs to its greatest degree since the USSR. In 2016, we should have learned the wisdom behind what Otto von Bismarck famously said: "The secret of politics? Make a good treaty with Russia." That might be a bitter pill for many Americans, but the bear ain't going away any time soon.
- Much has been made of cyber hacking (particularly from Russia) during the Presidential election. Welcome to the banking industry....we have been putting up with that for years.
- This Christmas, I figured out what I really wanted out of life: to be George Bailey.

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- When the government controls the means of production and distribution in an economy, it squeezes out the C & I variables of the  $C + I + G \pm \text{Net Exports}$  equation for Gross Domestic Product (GDP) until it effectively becomes 100% ( $\pm$  Net Exports). As a result, the economy can only effectively grow, in real terms, by the effective use of global leverage by the government (very difficult) and/or a widening trade surplus every year. This is certainly attainable over shorter periods of time, particularly when the economy is starting from a small base and/or is rich with unexploited natural resources, including cheap labor. As cheap labor and resources shrink and capital/technology grow in importance in production, the government controlled economy stagnates due to the lack of long-term profit/retained earnings (read capital to be deployed).
  - Basically, the long-term potential for economic growth should slow as G eats up more of the GDP equation. We are currently seeing this play out in Venezuela (after seeing previous examples in the 20th century). Even so, there are those who strongly believe in greater governmental control of the economic means of production/distribution, actually there are a lot of them....a whole lot of them, which became apparent in 2016. Hey, it is just math guys.
- Pursuant to the paragraph above, the greatest potential for rapid economic is in sub-Saharan Africa. It has cheap labor and ample natural resources. In aggregate, poor governance (corruption) and inefficient use of aid/foreign capital have hindered its growth for decades. Should the various countries in this area ever figure this out, it could be to the 21st Century what SE Asia was to the latter half of the 20th. More leaders like the vastly underrated, late Seretse Khama and fewer like Robert Mugabe (still hanging on after 35 years) would do the continent much good.
- Yes, apparently you can have higher stock multiples when the Fed is in a tightening mode IF there are few other options with which to generate a higher, absolute rate of return. To that end, where else are you going to put your money in the developed world?
- More than stocks, bond returns are just math. When yields go up, prices go down. Period. There isn't any gray area here. Further, that 30-year municipal bond trading to its 10-year call will kick out to its 30-year final maturity IF interest rates rise fast enough. People won't know what hit them if and when that happens.
  - After basically 35 years of generally declining interest rates (read a bond bull market), there is very little absolute return left in the bond market. Bond investors are going to be made painfully aware of bond math when they get their quarterly statements for 4Q.
    - Sure, the US stock market did fine, and that got all the headlines. However, bonds got rocked and international stocks didn't do much better than that.
- There is nothing, absolutely nothing, to suggest anything more than a 6-7% annualized rate of return for US stocks over the next decade....**absent** some major shakeup to the US tax code and regulations which frees up significant amount of capital. This is the reason why so many investors are anxiously awaiting just what happens during the first 100 Days of the new Administration and Congress. IF they don't deliver the 'goods' in a meaningful way, the stock market will revert back to historical patterns and multiples....that is code for 2017 could be a difficult year for the stock market in light of somewhat stagnate corporate earnings, mandated higher minimum wage laws in 21 states, and higher borrowing rates. Okay, this is more of a prediction than something I learned this year.
- In 2016, we heard a lot about 'the elites' and 'the establishment.' However, I am kind of unclear on just who they are. According to some of the definitions I have read, it appears I am one of both, but I certainly don't feel that way. Do I get a medal, plaque, stipend, or something? Where should I go to pick these things up? Is there a lunch? I do not mind going if a lunch is provided.
- I found the quickest way to end an awkward discussion is: "Well, I am deeply offended that you are deeply offended." Then laugh uproariously. The other person will either walk away or laugh with you. Seriously.
- In 2016, I ran some numbers and come to the following conclusion: the best way to rapidly expand the width and breadth of government services is to grow the economy at an even more rapid rate. In fact, that really seems to be the only effective way. As a result, the best thing anything a government go do for the general welfare of its people

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is to enact policies and procedures that will increase the width and breadth of the economy, as opposed to those designed to expand the width and breadth of government.

I could go on, but I will spare you. 2016 was a weird year in which very little seemed to go according to plan or prediction. We exit no worse for the wear financially, maybe even a little ahead. But it sure felt like a roller coaster ride didn't it? And I doubt anyone would like a full repeat in 2017. I know I wouldn't, as I have told folks a few more years like this one and I will be in a box before you know it.

In the end, we all need to get on the same page with our common goals and desires, and put aside what I would call denominational differences. While the latter might be legion, there is enough commonality on which to focus in order to ensure a prosperous future for the country, without trampling on hard earned rights. Admittedly, that is so much rhetoric and soft words, but I mean it. If the GOP can deliver what it says it can deliver on the economy, no one should be upset. If it can't, 2018 isn't that far away.

Have a Happy New Year....or should I close as Sowell did: "Goodbye, and good luck to all. " Well, until goodbye until next Friday that is.