

# C<sup>c</sup>avelti

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To: Our Clients  
From: Peter Cavelti

## Annus Horribilis

Dear Client:

In late 1992, on the occasion of the 40<sup>th</sup> anniversary of her ascension to the throne, Queen Elizabeth II referred to the year as an 'Annus Horribilis'. Her main complaints were various scandals besetting the royal family and a fire that ravaged Windsor Castle. Others reflecting on the same year would have noted that Presidents Bush and Yeltsin had declared the end of the Cold War, that the Russian Parliament had ratified the START Treaty, or that the Yugoslav Federation had broken up. Depending on viewpoint, even the British public had things to cheer about: the country emerged from a brutal recession that had lasted for five calendar quarters, the Church of England voted to allow female priests, and, ironically, parliament decided that the Royal Family would have to start paying tax on its vast income.

2015 was a genuine Annus Horribilis. There were few parts of the world that were not affected by significant economic challenges, while geopolitical tensions caused acute problems of their own. On virtually every front, the world dealt with the phenomenon of unintended consequences, something I have extensively written about during the past few years. Policy decisions by central banks have created massive distortions in currency and asset prices and thrown a significant part of the world into recession. Badly conceived foreign adventures have triggered dramatic migrations and are, at best, evoking the specter of endless proxy wars or, at worst, a confrontation between the U.S. and its allies on one side, and Russia, China and a host of developing nations on the other. In short, 2015 was a horrible year by any definition and most likely, more chaos is yet to come.

Last quarter-end, under the heading "Butterflies Turning Into Black Swans", I listed a number of developments that will contribute to the extremely complex dynamic through which we are currently living. I see no harm in repeating them and adding what I think might be relevant comments under each item:

-The benefits of globalization and productivity growth, arguably the two most powerful economic dynamics of the past two or three decades, are now testing their limits.

Global trade has sharply contracted during recent weeks and will not likely return to past volumes for years to come. Productivity gains will continue, but due to their job-destructive effect will no longer be a positive to the overall global economy.

-We have entered a messy transition from an era of American moral leadership to a multi-polar geopolitical arrangement, in which even U.S. allies find it difficult to attribute credibility to Washington's agenda.

The reputational damage to the U.S. from decades of poorly conceived attempts at regime changes, especially in the Middle East, is enormous. Worse, America's deep-rooted alliances with regimes no better than the ones it wants to replace, erode Washington's standing.

-Central bank policies and the lack of meaningful political reform are eroding our Middle Class, creating a massive disparity in wealth. Nowhere is the development more pronounced than in the United States, which is fast descending into an oligarchy.

In America, the EU and Japan the middle class is deeply disenchanted. Access to cheap credit is delaying a social reaction, but will not be able to prevent it.

-The demographic bubbles in Japan and several key European economies are entering their most critical stage. In Europe, the social cost of the 'old age' problem is now being compounded by the massive influx of migrants and refugees.

The past three months have stressed EU cohesion to the breaking point. Stay tuned for more tensions. In Japan, an eroding standard of living will weigh heavily.

-China, whose rapid growth generated massive demand for raw materials and consumer goods in the mainstream economies, is undergoing a painful restructuring that is likely to suppress domestic and global growth for the foreseeable future.

China's swoon continues to punish raw material prices; this will add to the strains in producing nations, causing massive cutbacks in capital spending and mass unemployment in related industries.

-The collapse in oil prices threatens the economies and destabilizes the social orders of at least a dozen major energy-producing nations in Africa, the Middle East and South East Asia.

After deliberately ushering in the 65% collapse in oil prices, Saudi Arabia will end up perilously isolated. It will be interesting to see how long the kingdom can contain blowback from within its borders and from without. Even if it can, the economic chaos caused by Saudi actions throughout the Muslim world will materially swell the ranks of terrorist organizations.

## More Volatility

Considering all these weighty issues overhanging the global economy and social order, it seems a fair bet that financial assets markets will be marked by growing volatility. Yogi Bera's caveat, "It's tough to make predictions, especially about the future," will be increasingly used, maybe even by those analysts who are still bold enough to make disconcertingly detailed forecasts.

My own view is that what lies ahead is unknowable and, because of that, the only strategy that makes sense is to keep an eye firmly on downside protection. For Melissa and me that means we maintain exposures to assets that will flourish under various possible scenarios, while also maintaining a robust liquidity reserve. This has been our core belief for the past two years and will continue to guide us into the future.

Much has been and will be made of the Fed's "lift-off" that saw its lending rate rise by one quarter percent. I could easily fill a page telling you why further increases at this time may be unwise, and I could also articulate at great length the negative repercussions of leaving rates at current levels. The world's key central banks, led by the Federal Reserve, have moved in the wrong direction for far too long—now that we are deep into the experimental realm, a return to what people my age would call "normalcy" will prove extremely difficult and painful. Consider what the looming threat of a very minute rate adjustment uttered throughout 2015 did to markets and you can imagine what a return to a Fed rate of, say 3%, would do.

Are there any positives? Luckily yes, at least in the United States. Consumers attitudes are cautious, but by and large Main Street America continues to march on, something which cannot be said about most of Europe, Japan, or China and the emerging economies. Another source of our comfort with the U.S. is the relative strength of its banking system, which is well capitalized and far less leveraged than many of its foreign counterparts. However, not all is well. One notable risk to the U.S. economy is the business sector, which is getting badly hurt by the soaring dollar. Another is regional in nature: recession looms for regions that have major exposures to energy and other raw material extraction, as producer spending is scrapped, financial calamities mount, and large numbers of jobs are lost.

The bottom line is that we continue to march to the beat we set a couple of years ago. I repeat from last quarter's letter:


- We are cautious.
- We continue to favor the U.S. equities over others.
- We hold exposures to the commodity and emerging markets sectors, where valuations have collapsed and fundamentals could make for a robust rebound.
- We believe high volatility will be with us for considerable time, with periods of sharp sell-offs and robust rebounds both a distinct possibility.

Let me finally turn to the performance of your account, which has declined during 2015. I usually compare your returns to something relevant, but that is extremely difficult this time.

The U.S. market had the first down-year since 2011, even though it considerably outperformed the world. However, achieving the return posted by U.S. benchmarks would have entailed significant investment risk, as just four very fully valued stocks carried the market: Amazon, Alphabet (formerly Google), Microsoft and Facebook. Without these four, results would have been similar to ours. Global markets fared worse, with some declining by depression-era margins: Brazil led the sad parade with -42%, while Malaysia was Asia's biggest loser with -19%. Finally, there was carnage in other assets classes too. Bonds fell, with the U.S. long bond down 9%, and commodities had a horrible year, led by oil's 38% fall. As you can see, a comparison to any one index would be meaningless.

We reiterate that conditions are extremely difficult and we will continue to do our best, bearing in mind the objectives explained above. As always, if you have questions or concerns, please let us know.

Melissa and I wish you a happy, healthy and prosperous New Year. May my end-of-2016 letter be more upbeat!

A handwritten signature in black ink, consisting of a large, stylized initial 'P' followed by a cursive name that appears to be 'P. He'.