Cavelti

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To: Our Clients
From: Peter Cavelti

On Arrogance

Dear Client:

A few weeks ago, Melissa and I went to a concert. The guest conductor, Mathias Pintscher, first presented his own composition, *Towards Osiris,* an orchestral study, which was followed by a Mozart piano concerto (K. 491) and Mahler's sweeping Symphony No. 1.

Throughout these world-class performances, I reflected on the purity of their message. No posturing here—not by the conductor, who looked very vulnerable when introducing his opus, nor by the pianist (the New York Philharmonic's Inon Barnatan), who injected a degree of rarely seen passion into Mozart's concerto, which he played entirely from memory. This earned him a standing ovation, which he accepted with humility. When Mahler's symphony came to an end the audience leapt to their feet a second time, demanding three reappearances from Mathias Pintscher. He seemed almost embarrassed by such accolades, each time attributing the credit to the musicians that made such a success possible.

What fascinated me about all this was the complete absence of hubris, at a time when arrogance, condescension and duplicity have widely replaced honest human communication. Talk to your utility, insurance company or bank, and what you get is artfully constructed narrative. Worse, look at the people who run our governments or administer its policies, and you find little but conceit, blind ambition and narcissism. Barrack Obama's vain moping about not being recognized for mostly imagined accomplishments, Hillary Clinton's changing and duplicitous messages as she navigates different campaign audiences, and the self-absorbed Donald Trump's impetuous sulking are all variations on the same theme. Look at the U.S. Congress or Japan's National Diet: prominently stocked with legislators mandated and paid to be the people's representatives, but steered by corporations and interest groups whose agenda is not even vaguely related to what might benefit the electorate.

The European Tangle

Arguably the worst example of governance in the democratic world is the European Union. Led by a spectacularly bloated bureaucracy, it lacks many of the attributes of a functional political structure. Its economic system is anchored in contradiction; the EU presides over a monetary union, but has no control over fiscal policy. It cannot project its political will, because foreign policy is in the hands of more than two dozen sovereign states, while military engagements are largely dictated by NATO. Worst, the EU is hamstrung by colossal cultural disparities that continuously challenge its limited political and economic powers and evoke massive social tensions. No event has exposed these fault lines better than the migrant crisis currently underway. That's why the outcome of the Brexit vote was not a surprise to me, but rather an inevitable consequence of structural dysfunction and political arrogance.

> *"…Britain has always had a scandalously transactional perspective of Brussels. In the 1970s it voted to stay in the EU because it was the economic future. It should now vote to leave the EU because it is the economic past."*
> John Hulsman, foreign policy expert, German Council of Foreign Relations – a few days before the referendum

In respect of Britain's future, too, my opinions sharply differ from those of the political and corporate elites and their parrots in the mainstream media. I think the odds are better than 50:50 that Britain will be better off without Europe and will, three to five years down the road, be politically, economically and socially less challenged than most of the continent. If I'm proved wrong, it'll most likely be because Brexit will be a catalyst for change and because the threat that other nations may hold referendums of their own may eventually trigger comprehensive reform. That would be a wonderful outcome, but given the seemingly boundless arrogance of the EU's political class and the fact that a meaningful transformation will need to be sanctioned by 27 discordant voices, I think it's far more likely that the European Union will die a slow death.

> *"Obsessed with the idea of instant and total integration, we failed to notice that ordinary people, the citizens of Europe, do not share our Euro-enthusiasm."*
> Donald Tusk, President of the European Council – a few days before the referendum.

> *"The British have violated the rules. It is not the EU philosophy that the crowd can decide its fate".*
> Martin Schulz, President of the European Parliament – a few days after the referendum

A Global Problem

In her speeches, Germany's Angela Merkel frequently makes the point that the EU makes up less than 10% of the world's population, 25% of its GDP, and more than 50% of its welfare spending. Such disparities, she argues, are not only unsustainable, but will unleash massive social consequences if not swiftly and decisively addressed.

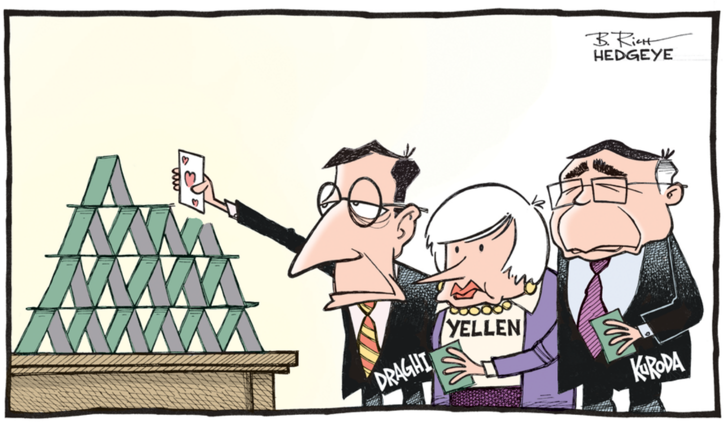
It's important to realize that Europe is not the only place where broad structural reforms are necessary to control colossal excesses. The United States is a fiscal basket case; were the dollar not the world's reserve currency, America's model of fervently advocating consumption over production would long ago have been challenged. National debt, pension shortfalls and social security deficits are almost certain to eventually lead to social revolt.

Japan is even worse off: it has now accumulated deficits for nearly three decades, without any success in boosting the economy. Given Japan's highly challenged demographic profile and the country's blind adherence to the dictates of a corrupt political class, the future looks miserable. The problems in key emerging economies loom large too. The idea that growth in countries like China and India can help pull the mainstream economies out of their rut now seems preposterous; on the contrary, the interconnectedness of major economies at all stages of development significantly add to the problem.

The Blame Game

Monetary policy makers have been widely accused of failing to stimulate economic growth, while impoverishing the productive middle class. And it's true that they're doing a terrible job providing society with a credible justification for their actions. After all, central bankers are by definition unaccountable and by choice uncommunicative. The narrative they present us with appears overconfident and unnecessarily dismissive of both input and criticism. But, having said that, if we are to engage in the blame game, we need to examine the root causes of the current mess, and when we do that, we see that the central bank chiefs are not the only ones to blame.

It's the politicians who put into place a completely unsustainable economic and social framework. They squandered the bonanza of tax revenues that accrued when the generation of baby boomers was at its most productive; they incurred and encouraged indebtedness and, in concert, allowed ever-greater leverage in the banking system; and they incessantly undermined functional and responsible laws to accommodate special interest groups and industry lobbies. When market forces reacted and the banking system wobbled, central bankers added to the problem, by flooding the market with oceans of liquidity—always under the motto that the economy must be kept growing.

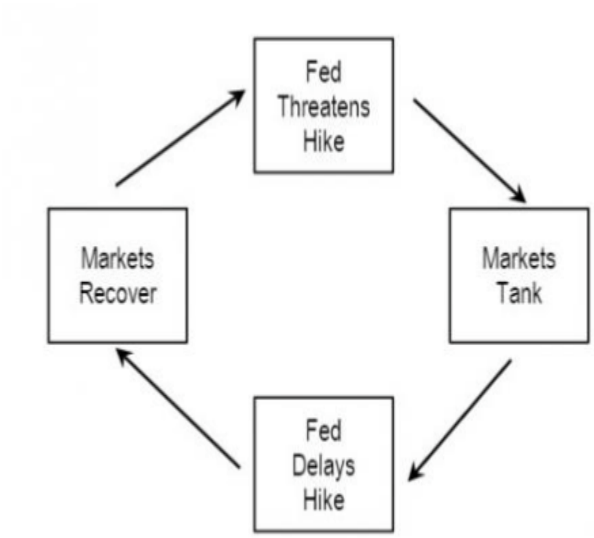


Unfortunately, it's a mathematical fact that nothing can grow uninterruptedly, especially not when the rate of growth is incessantly boosted by artificial means.

America, Europe, Japan, China and others are now indebted to an extent that seems irreversible without the experience of severe agony. What nobody knows is when the central banks decide, or are forced to, capitulate and abandon their expansionist course.

Happy Days Are Here Again

If we look at financial markets, we are led to believe that things are relatively well. The treasuries of extremely indebted nations like Japan, Italy, France, Ireland, Portugal or Spain continue to happily issue debt obligations and the market buys them—always convinced that they'll be backstopped by central banks aiming to drive rates ever lower.



In key stock markets, a similar game has unfolded and is now well into its third year. As Citigroup's then-CEO Chuck Prince famously observed in 2007, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." A lot of people have forgotten what happened to Mr. Prince's bank when the music actually stopped.

Deciding when to stop dancing is arguably the most difficult decision for investment managers. Turning cautious too early costs opportunities and makes for seemingly terrible performance results, while stopping too late can results in huge drawdowns of capital.

Our Strategy: Prepare For A Variety of Outcomes

Given this dilemma, what's our investment approach? Three months ago I said, "In the absence of knowing in which direction our domestic economies or the global economy will move, and exactly when, it seems to us that a strategy recognizing various possible outcomes and diversifying accordingly, makes the most sense." In addition, Melissa and I have pragmatically adjusted holdings, reducing exposures into what seem to be excessive advances, and adding to exposure at times of sharp corrections.

Finally, a word regarding performance. Your assets have appreciated at a healthy clip during the first six months of the year, substantially outperforming any relevant indices and exceeding our expectations. We are more than satisfied with this result, especially given the many political, economic and social uncertainties. As always, if you have concerns or questions, please let us know.

Kind regards,