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April 5, 2016

To: Our Clients
From: Peter Cavelti

## Age of Discontent

Dear Client:

In a recent survey by IPSOS, an independent global research firm, citizens of only six nations feel things are going well for them. Of the six, only one is in the G10: Canada. In contrast, 57% of Japan's residents feel their country is headed the wrong way, while 63% of Brits and 65% of Americans feel that way. In worst place is continental Europe, where 68% of all Germans, 78% of Spaniards, 82% of Italians, and 88% of all French disapprove of the way things are managed in their country. Welcome to the age of discontent!

The problem, as we have said for several years, is that the majority of people in the industrialized world feel disenfranchised. Their life appears to be in the hands of an unaccountable elite, where corporate, political and academic leaders collude. A large number of Europeans, Japanese or Americans cannot identify with any of the political alternatives open to them—they can vote for the major parties, with the outcome that a profoundly unsatisfactory status quo is perpetuated, or they can vote for a fringe party that promises to shake things up, but typically brings with it elements of extremism and lack of experience. The U.K. Brexit vote and the election of President Trump were a warm-up for the upheaval that lies ahead as France, Germany and Italy approach federal elections.


What's interesting to me is how the establishment, through its handmaiden, the mainstream media complex, deals with this. I may as well pick the U.S. and the U.K as relevant examples. If you regularly read the *New York Times* you're led to believe that Mr. Trump's rise to the presidency was caused by angry, mostly uneducated, white males (or, even more conveniently, by Russia). That is a viewpoint that patently ignores what happened. In my opinion, both Donald Trump and Bernie Sanders acknowledged the glaring problems in the America's economy, lambasted ineffective social policies, and attacked its foreign policy. By doing so, they courted the massive contingent of people who understand that the glowing reports of excellence or even exceptionalism peddled by politicians and commentators are bunk. You didn't need to be clairvoyant to recognize the message people wanted to hear. The Democrats ignored it and threw Sanders under the bus. Donald Trump understood, hijacked the Republican party, and won the White House.

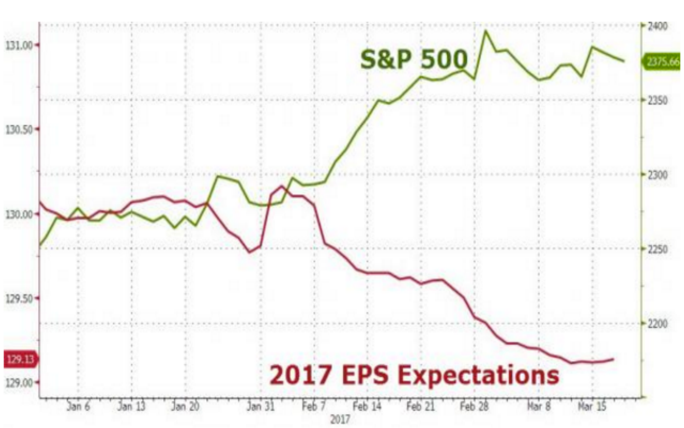
In Europe matters are much the same. Instead of paying attention to popular sentiment, media outlets like *The Guardian* and the *BBC* used fear tactics to discredit Brexit, warning of economic Armageddon if Britain left the EU. The fact that the European Union had turned into a bloated, unaccountable, and demonstrably corrupt entity, without which Britain and many of Europe's economies may be better off, was rarely mentioned. When the voters spoke, the blame was placed with the uninformed and uneducated—much like in the United States.

The conservative media are no better. New York's *Wall Street Journal* or London's *Telegraph* are as culpable as their liberal counterparts. In the U.S. and most of Europe, polarization is now a hugely profitable business platform for the media complex and chances are high that it will grow further. The resulting dynamic is easy to understand: as aggressive and highly divisive coverage tactics abound, more radical political opinions emerge, some of which are bound to resonate with an increasingly frustrated and mistrustful public demanding change.

## From Honeymoon to Hangover

As I write this, 143 days have passed since the U.S. presidential election. The behavior of financial markets since then can be put into two categories: 110 days of blind euphoria, followed by 33 days of sobering realization that things will be more complicated than articulated by candidate Trump during the campaign. It's too early to declare that Wall Street's will soon wake up to a nasty hangover, but there is plenty of reason for restraint.

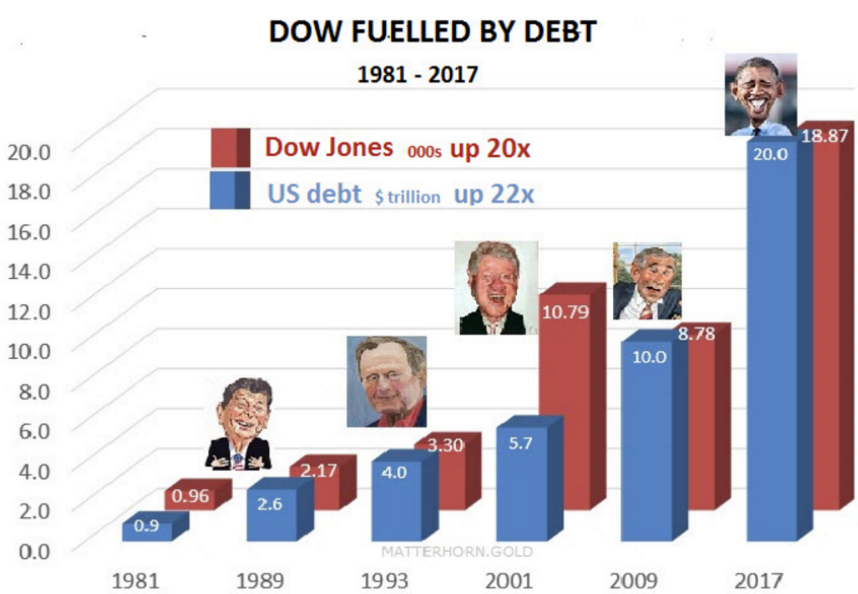
Mr. Trump's economic and trade proposals suddenly look less realistic than a few weeks ago; "America First" still sounds terrific, but details like the Border Adjustment Tax may run into a wall of resistance. Fiscal reform may be delayed or watered down, too, now that the repeal of the Obama-care health regime has failed. Social controversies, meanwhile, are being tinkered with piecemeal or relegated to the states. Ideas that fueled much enthusiasm only weeks ago, appear less grand and far-reaching, while the chances of their implementation seem more distant. On the foreign policy front, where a serious change of course was promised, disappointment may also loom. Recent developments suggest that both Democrats and Republicans are ready to embrace a neoconservative agenda in which the military-industrial complex will once again dominate. Obama was the first president whose America was at war each day during his two terms. With Russo-phobia back with ferocity, Iran and North Korea in Washington's crosshairs, and renewed tinkering in Syria, full-time foreign engagements are likely to last for many years to come. Greater contributions from NATO allies may moderately reduce the costs of America's war machine, but will also lessen Washington's ability to dictate strategy. A continued incoherently interventionist U.S foreign policy seems assured.




All in all, we believe there is a huge disconnect between the world's economic, social and political challenges on the one hand, and the pricing of financial assets on the other. America, Europe, Japan and the emerging markets complex all face ongoing problems. Yet stocks and bonds are priced for perfection. Short-term yields for near-bankrupt nations like Spain, Italy or Portugal are in negative territory, while long term yields are at multi-decade lows. In equity markets, valuations are at scary levels, too: price-earnings ratios have sharply risen, at a time when earnings expectations have trended lower.

What's to blame for this disconnect? In two words: central banks. Wherever government debt is out of control, the world's monetary agencies step in, scooping up bonds investors shun and paying for them with freshly printed money. Because government debt accumulated in this fashion is to the central banks an asset and the money issued a liability, this exercise has the effect of vastly swelling their balance sheets. In this way, the combined assets of the world's major central banks have risen from US$6 trillion to US$18 trillion since 2008. By far the most aggressive actions have been undertaken by Japan, the industrialized world's most indebted nation: government debt owned by the Bank of Japan is now surpassing the size of the country's entire economy.

There are two logical outcomes to this. One is that the central banks keep doing this, thus allowing governments to continue spending today at tomorrow's expense; if they do that, the eventual outcome will be wildly inflationary. The other is that the central banks stop supporting the bond market, forcing their governments to balance their budgets, which will cause brutal deflation. (We believe the odds favor the former).




The stock market's stellar performance is, to a large extent, also the handiwork of central banks. First, by carrying on their massive support operations in government bond markets, central bankers have put investors on notice that government debt may never be paid back. That, all by itself, helps equities look good: wouldn't you rather own a piece of a productive enterprise than a promise made by politicians? (It's why we haven't held bonds in our client portfolios for quite a few years now.) The second important reason why stocks have been on a tear is that central banks around the world have kept interest rates at ridiculously low levels. There are other, more technical, causes for the stock markets exuberance, but what I'm trying to illustrate here is that without the active help of the U.S. Federal Reserve, the European Central Bank and the Bank of Japan, financial asset prices would have collapsed.

## Prepare For A Variety of Outcomes

So, here I am once again—explaining why we believe our strategy of being prepared for a variety of outcomes makes more sense than being true to what our industry calls an "investment style". Will central banks manage to extend the illusion that they have a realistic and realizable plan to withdraw from the world's greatest monetary experiment? If so, for how long can they do so, and how much further will they drive up stock prices? And finally, what will the end game be—will an inflationary spiral ensue or will the global economy endure another Great Depression? The answers to these highly relevant questions are unknowable, which is precisely why embracing any given dogma will lead to certain failure.

Given this dilemma, what's our investment *approach*? Melissa and I continue to believe in a diversified and pragmatically managed stock portfolio. Although richly valued, we feel the equities are likely to range-trade with a slight upward bias, partly because investors are still hopeful that some key Trump initiatives like tax reform will gain traction, and partly because stocks look favorable when compared to other asset classes. The stock market continues to give us a great gift: it gyrates as the great economic and political narratives are adjusted, and it's our job to take advantage of such gyrations. We're not day-traders, but we will readily sell an investment if it runs ahead of itself, whether we've held it for six weeks or six months. Doing so has been very rewarding during the past year and we expect it will continue to help our performance as we move forward.

We also believe that the time is right for you to review *all* your investment holdings, with emphasis on the following points:

- We believe it is prudent to trim exposure to bond-heavy portfolios, such as typical pension accounts. There are several strong reasons to avoid the bond sector. First, bonds are paper promises and the more promises are issued, the less their fundamental value; second, central banks may attempt to normalize interest rates; and third, inflation may rise. There are far better income alternatives than bonds!

- Stock portfolios that embrace a specific 'investment style' should be cut back or, alternatively, hedged through other 'investment styles'.

- In addition to exposure to a pragmatically managed stock portfolio that combines growth and income objectives, you should hold gold, in physical, segregated form—ideally in a politically stable country that has a history of non-interference with gold ownership. Given the cascading flood of paper promises, we believe that the outlook for gold prices will dramatically improve.

If you would like to discuss these points with us or would like our help in reviewing your investments, please contact us.

Finally, a word regarding performance. Your portfolio appreciated just over 7% during the first three months of the year, again substantially outperforming all relevant indices. We are more than satisfied with this result, especially in light of last year's substantial outperformance.

Kind regards,