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July 3, 2017

To: Our Clients
From: Peter Cavelti

Deviations from the Norm

Dear Client:

It's always interesting how few people take note when a major deviation from an established norm occurs. Last year, we had a global breakdown in Delta Airlines' operations; this year so far, we've had comprehensive paralysis at Lufthansa, Air France and, most recently, British Airways. Clearly, our technological framework is as vulnerable as most other manifestations of infrastructure are. It's important to realize that these problems are mostly due to the age of IT equipment, not outside challenges perpetrated by hackers.

Hacking, as we first learned in early May, when over 70,000 computer systems in close to 100 countries were infected, poses an even greater threat. Nearly four dozen British hospitals were crippled, German trains stopped running, Telefonica users in Spain couldn't make phone calls, and Fedex deliveries in various parts of the U.S. came to a halt. Russia was one of the worst affected countries, while in China key universities and corporations were hacked. Last week, a second wave of malicious attacks was unleashed. Ironically (but not at all surprisingly), the software used was developed by America's National Security Agency, who had designed it to invade personal electronic devices.

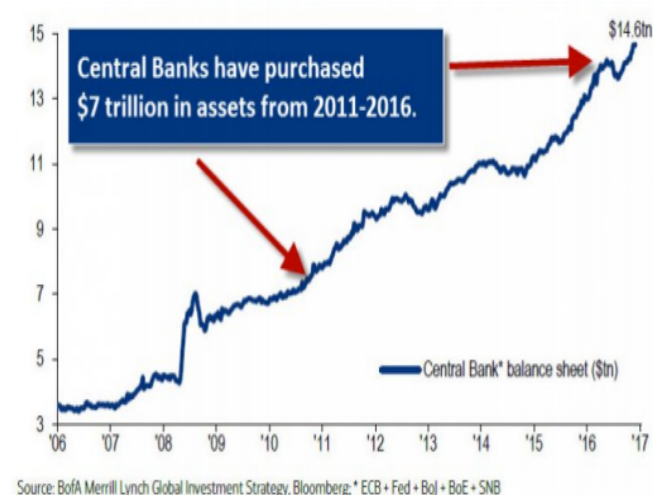
Predictably, media coverage has dwelled on aspects that are not central to the problem. The narrative is that it's lamentable that thousands of people were stranded at Heathrow, it's tragic that hackers targeted hospitals and ambulance networks, and it's infuriating that the government's cyber spies have now become a threat to public security. Yet little is said about a far more important fact: sometime in 2017, we started to deviate from the infrastructural norms experienced in recent years, moving from code *"working but in serious need of overhaul"* to code *"prone to comprehensive failure"*. If government doesn't understand the seriousness of this shift and the media complex continues to focus on the fallout rather than the cause, we are destined to live through increasingly more frequent and intense IT failures and hacking incidents.

Similar deviations from the norm have taken place in many areas. At some point during the last few years, the U.S. educational system slipped toward bottom in most rankings of developed countries; at another, American life expectancy slipped into last place and American health costs into first. The European migrant crisis has tipped over into the realm of the socially untenable, while Japan's addiction to government debt has spiralled into the stratosphere.

As unrelated as these dynamics seem to be, they all demonstrate the same thing: once a tipping point is reached, trying to reverse it becomes virtually impossible. Immediate and drastic action would be needed to do so, and in our government structures, legislators are far more concerned with re-election than with doing the right thing, which is why multi-year debates are far more likely than action.

No Going Back

Because these dislocations will not only continue, but deepen, it's only logical that, in time, they will change our lives and seriously undermine our standard of living. Most likely, one of the early signs that such a development has started will be a deterioration in asset prices. Many strategists have predicted a serious correction for some time, but so far markets continue to hold their own and in some cases make new highs. Why?



As we've pointed out for some time now, central banks are a key reason. During the five years ending in 2016 they purchased \$7 trillion in financial assets, propping up markets. Moreover, if central bank purchases continue at the pace of the first six months, a stunning additional \$3.8 trillion will be added this year. How do central banks do it? They print money and use it to buy bonds and equities. Curiously, the Swiss National Bank now owns more publicly traded shares of Facebook than Mark Zuckerberg! The Bank of Japan, meanwhile, is the largest shareholder in 55 corporations listed on the Nikkei 225 index.

What will happen in the end? Central banks talk about 'normalization', a process by which they will gradually raise interest rates and sell their bond and stock holdings again. There are many who believe this isn't possible. Since it took many trillions of interventionist asset purchases to keep markets from falling, doesn't it follow that normalization would trigger just that—falling markets?

There are various ways to project the extrication from the current central bank model, and here they are:

- Central banks manage to normalize, interest rates return to the free-market level where they reflect risk, and all will be well;

- Central banks raise rates and sell off assets and, unintentionally, throw the economy back into recession. If that happens, the central banks have two options. They can let the economy suffer through its downturn and stand aside. If the stresses to the financial system cause some players to fail, so be it. Or, the central banks can reverse direction once again, printing more money to rescue, bail out, and buy distressed assets.

- Central banks see economic data deteriorating as a result of their minuscule recent interest rate adjustments and lose their nerves. To prevent a recession, they reverse course much sooner and continue printing and buying.

Cultural Implications

The cultural implications of each of these options are profoundly different. If the central keep rates too low, the ethics imprint of hundreds, if not thousands, of years is undermined. Instead of being rewarded, people who've produced and saved are financially distressed. Moreover, their pension regimes will go bankrupt, and banks and insurance companies will suffer. The idea that interest rates should be a reflection of financial risk collapses. On the other hand, if central banks raise rates to levels that mirror risk, a generation of people who've become accustomed to taking on imprudent debt burdens and a large number of investors who rely on the central banks to prop up unhealthy asset markets, will be destroyed. In other words, the world's central banks face highly unpalatable choices, which goes a long way to explain why they've been muddling along without clearly articulating their intentions, doing as little as possible.

Yet, policy adjustments by central banks are by no means the only threat to financial asset valuations. Consider the number of black swans circling the geopolitical waters alone: the Qatar - Saudi spat; the growing hostile rhetoric toward Iran; escalating tensions between Washington and Moscow, and Washington and Beijing; the North Korean crisis; America's intentions to re-engage in Syria and Afghanistan; the Britain - EU negotiations; and, finally, the Trump presidency.

In regard to the latter, I recently made the mistake of telling a U.S. audience that the euphoria over President Trump's *America First* platform would be short-lived, predicting that no more than 40% of his stated objectives would ever become reality. Several people took great exception to that suggestion. Having experienced a few months of Mr. Trump's leadership, I now boldly reduce my projection to 25%. I'm not happy making this revision: I believe that Obamacare is deeply flawed and in urgent need of an overhaul, and I also believe that comprehensive U.S. tax reform is woefully overdue. But other things worry me, not just on the policy front, but also Mr. Trump's abrasive personality and his off-the-cuff style, which keep burning up political capital at an alarming rate. This does not bode well for American stability, especially at a time when the anger of a disenfranchised middle class with both the Democrat and Republican establishments is still on brisk boil.

Finally, it's interesting to note that the U.S. dominated post-war order is now visibly crumbling. At the end of World War II, the U.S. niftily imposed a construct of military, economic and monetary institutions upon the world. Of course, that's not how it was sold. Rhetorically, the World Bank, the International Monetary Fund and NATO were to be run by consensus between the most powerful of the victorious nations, but the reality is that the U.S. had the majority vote in each of these bodies. That reality has assured U.S. supremacy for seven decades. Well, we're now at the stage where the IMF and the World Bank openly criticize U.S. policies (such as trade protectionism) and where the Europeans spurn U.S. demands for fair-share support of NATO, unless they have an equal say in what NATO's role and strategy should be. The only unchallenged part of the post-war order is the dollar's status as the world's most accepted reserve currency. Let's see how long that lasts.

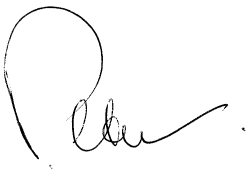
Dogmatism Hurts, Pragmatism Works

As a general rule, when the unknowns starts to crowd out the predictable, it's best to be cautious. When considering the whole array of monetary, economic, social and foreign policy manifestations, what's highly apparent is that most of them are moving in a direction that is unsustainable. I find it absurd that, in the face of that, most investment professionals still stick to fairly dogmatic 'themes' and 'styles'.

As I've tried to explain for several calendar quarters, we believe a open-minded approach works much better. We realize that the narrative of the moment is all-important and so we embrace it on a tactical level. However, we equally allow for a number of other outcomes, not knowing which of them will see reality. This strategy, along with paying attention to downside risk and occasional retreats into cash, has helped us to considerably outperform during the past three years.

For 2017 to date, your assets have appreciated in line with the relevant indices. We do not know what's next, but we will continue to shy away from dogmatic projections and err on the side of pragmatism.

Kind regards and happy summer!

A handwritten signature in black ink, appearing to be 'R. L. H.', with a large, stylized initial 'R'.

Postscript:

As the U.S. is headed toward the next phase of its forever war, here's a reminder of a narrative that once sold, and is selling again. Some things never change.

*I've learned to hate Russians
All through my whole life
If another war comes
It's them we must fight
To hate them and fear them
To run and to hide
And accept it all bravely
With God on my side.*

*But now we got weapons
Of the chemical dust
If fire them we're forced to
Then fire them we must
One push of the button
And a shot the world wide
And you never ask questions
When God's on your side.*

With God on our Side—Bob Dylan, 1964