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Rewriting Economics

Minus all the invective political rhetoric, this year has mostly been a satisfactory one for investors. Both the S&P and Dow Jones have delivered healthy double-digit returns. For those whose portfolios reflected overweighting in Energy, Technology, and Financials their patience was rewarded handsomely.

The primary reason the markets continue to flourish, however, is because of an unusually benevolent global monetary bias. The net effect of the central banks' largesse was to swell the capacity for borrowing money and to expand capital commitments in the public and private sectors. The ramifications of this type of spiraling liquidity is to increase the employment rolls, infrastructure spending, military and defense expenditures, and foster a sense of economic stability that had been lacking just after the credit crisis. At the end of this "rainbow" is an enormous debt to pay.

In feudal times, commerce was limited to the range of one's horse and buggy. Politics...and monetary policies...were local. However, in our global industrialized world, the ills of one region affect the equilibrium of all other nations. Remember the old axiom, "*when China sneezes the rest of the world catches cold*"? That mantra is truer than ever, and more complex.

Simple financial issues...such as issuing debt or defining interest rate policy....can create international epidemics around the globe. Threats from far-away despots, heinous acts of terrorism, or economic disequilibrium now resonate wider than a "horse and buggy radius" and pose instantaneous concern to financial markets recorded on a minute by minute basis. While each of us tries to conjure our unique vision for the immediate future....the price of oil, holiday retail sales, job security....there is a precariousness about the sanity of world leaders whose actions thousands of miles away might impact our lives today.

If the answers to these macro situations don't match up exactly with our anticipations, the possibility exists that the economy might seize up and stagnate due to the uncertainty and pessimism that would be created. Because the markets have run so far, so fast, I envision that our most pressing issue is the intensity of expectations about financial and portfolio success going forward. Perhaps it might be prudent to reflect upon the past decade and realize that the equity markets missed out on the normal ebb and flow of typical financial cycles. As we enter the last quarter of this calendar year we need to allocate resources for that "rainy day" fund should it become necessary. Despite the fact that consumer confidence levels are rising as portfolio valuations do also, there is such a polarity in our global discourse that one can't help feeling that just below the surface of our zeal about the future lies a hidden apprehension regarding whether or not things will really turn out alright.

Markets

A guiding economic principle of Western financial markets is the law of supply and demand. It is, after all, the bedrock philosophy behind earnings-driven investing and for finding the "next big thing." Yet, oddly, stock market analysts often overlook the very essence of this "law" by applying subjective cognition to the shifts in the quantity of the very things they are trying to measure.

While it is undeniable that the intrinsic value of "an item" can be measured by the right tools, investors nevertheless continue to apply their subjective analytics to a innumerable number of factors that they think matter "most". The value of an "earning", for example, is mathematically unquestioned, but how people *perceive* those integers seems to hold greater importance to the buy/sell decision than the integer's relative value, itself.

Subjective matters aside, stocks go up and down because there are either too many, or too few, buyers.

So why do stocks keep going straight up?

Because more money is chasing a smaller amount of capital gains potential in a landscape that yields fewer and fewer opportunities. As stated earlier, with interest rates resting at historically low levels there are also fewer alternatives in the fixed income marketplace to compete with the allure of buying equities. As long as the public's appetite for risk is sated by a growing stock market, potential landmines in the economy can be averted by keeping one's eyes closed.

It would be unfathomable to think that equity markets might suspend the laws of physics, economics, and common sense by continuing to go up in a straight line without pause. Just looking at recent profit reports from the past quarter is enough to put a chill into any overly optimistic scenario for unabated economic expansion.

Further, the supply of good stock ideas cannot be financed forever by low cost, "free" borrowing. At some point a wave of profit taking will sweep over the markets. The offshoot of cheap money is a bacchanal of unrealistic proportions.

To be clear, I am not suggesting a stock market reversal of historic proportions nor an abrupt end to the market's good fortune. Rather, we should recognize that financial events are typically cyclical in nature and always provide us with a rolling stable of leaders and laggards. When scientists and business leaders offer us a "better mousetrap", the supply of potential capital gains never really wanes. The problem occurs when one puts all his eggs in one basket, consciously, and expects one idea to provide him instant success.

Strategy

Investors today are worried about holding on to the gains they have earned in the past half-decade, and about which catalysts might ignite big problems or changes for the financial markets. There is a multitude of potential negative changes to the status quo...from wage and wealth inequality, dismissive social oratory, global terrorism, inordinately high valuations in tangible assets and financial instruments, to job security, health care concerns, and our own moral accountability in a world punctuated by hunger and poverty. Whether it is any one of these, or a multiplicity of them combined, each (or all) of these topics transcends simple math or statistical stock market analysis.

These "exogenous deviations" occur in varying degrees for everybody, and represent very different meanings to each observer. But the sum of these factors weighs heavily upon our collective consciousness in our roles as investors, parents, employees, and citizens. We each have a responsibility to factor-in their meaning *before* they become intrusively bigger issues. At the end of the day, there is only a finite amount of currency to spend, days in a year, and time to calculate the cushion we have upon which to rely.

Instead, I prefer to execute a strategy of asset allocation, which I believe is the primary determinant for the probability of capital gains and asset protection. This quarter our focus is upon (1) taking profits when appropriate and (2) allocation of our equity funds into exceptional earnings performers in basic materials, technology, infrastructure (industrials), agriculture, and finance. While there are decidedly limited benefits to buying bonds in today's interest rate climate, we still recognize neutral to positive expectations for using bonds where equity risk might be too unpredictable. Low return does not mean no return, and as such we feel comfortable protecting a portion of our long-term performance by selectively avoiding equity-like risk. As with any serendipitous endeavor, there are few hard and fast rules except that we will remain methodologically pure and consistent with our macro overview which presupposes that growth is inevitable...as are cyclical ups and downs.

Conclusion

We see a number of "grey areas" on the horizon, circumstantial ambiguities which color investor's perception of the objective data. For some, this may be a selling inflection point. Others will have a more balanced scorecard with which to measure forward progress. It is imprudent at this juncture to put all your money "on black" and roll the dice. That type of stop-start investing is a perfect storm for inconsistency and potential disaster. After nearly a decade of good fortune and portfolio aggrandizement we would rather play it safe until we see a more discriminating set of global circumstances that orient towards multilateral trade, earnings acceleration, and social integration.

If you think about it, this would be a good time to wonder what your portfolio will look like 10 years ahead, and to organize those numerous factors...known and as yet unknown....that objectively make the investment process less stressful.

Suggested Balanced Account Asset Allocation, Q4, 2017

Equities: 42%
Fixed Income: 28%
Cash: 30%

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