We live in a democracy that provides freedoms and liberties to its citizens. Linked closely with our democracy is capitalism, the exchange of goods and services for a profit. Since the 1930's, a consistent hallmark of our form or capitalism has been free markets which have reasonable government regulation to protect market participants. In 2015, we wrote that we believed "our form of democracy was evolving." Having observed how our capital markets function over the past nine years following the Financial Crisis, we believe that our form of capitalism is evolving as well.

We are nearing a crossroad that will likely define what our capital markets will look like over the next several years. The path we take as a country, as we approach this proverbial fork-in-the-road, is marked by three critical issues: the Federal Reserve's stated intention to reduce its asset portfolio which it built as part of an monetary experiment following the Financial Crisis, the growing public and private debt levels, and the inability of Congress to pass meaningful legislation that helps sustainable economic growth. Our thesis is that we are not moving back to the way things were pre-Financial Crisis. *In fact, we are in a new paradigm for investors, including a new central bank paradigm that impacts investment decisions and portfolio structure.*

Ultimately, we believe that the large portfolio of securities resting of the Federal Reserve's balance sheet are a permanent fixture and will prove difficult to reduce in a significant amount. Similarly, the large amount of debt, which is in essence subsidizing our quality of life and muting the effects of any economic deterioration, is also a permanent fixture waiting for the economy to grow into. At the root of the disorder is a government that has lost its sense of direction and unable to pass meaningful legislation that improves the quality of life for the middle class.

However, In order to assess the potential changes in capitalism and its impact on markets, we need to understand the investment paradigm in which we currently exist.

The Evolution of Democracy and Capitalism

We are not suggesting that capitalism is going to end in the United States. Rather, we are suggesting that incremental changes in global capitalism will impact the economy, investment decisions, and portfolio structure in the coming years.

Through the late 1800's our capital markets were driven by the buildout of railroads and manufacturing plants supporting the industrial revolution. In the early 1900's, our government directed the resources of our economy to support the war efforts. And, after World War II, we shifted resources in the economy and capital markets to support consumerism, as well as our social services infrastructure for veterans and the elderly. Today, private investment is directed at artificial intelligence, technology and robotics that will lead to dramatic shifts in the labor market and powerful impact on business models across companies operating in every industry.

The globalization of the developed economies has intertwined the socialism of Europe, the central state controlled communism of China and imperialism of Russia, and the democracies of the United States and

Japan under one general form of capitalism. However, every country influences capitalism differently. For example, the governments of China and Russia are directly involved in their financial system. As a result, they do not have "free market" capitalism as we know it in the United States. The evolution of capitalism in the United States is heavily impacted by the following seven issues over the past two decades:

1. Increased Globalization has resulted in the transfer of capital to lower cost producers. The growth in globalization has, at the margin, moved manufacturing and service jobs to countries that can produce those goods and services at lower costs. This has contributed to sustained higher profit margins for corporations and a shift in the labor market as high paying jobs have been pushed overseas. While global trade has reduced the real price of many consumer goods, it has also contributed to the growing inequality and income dispersion in our society.

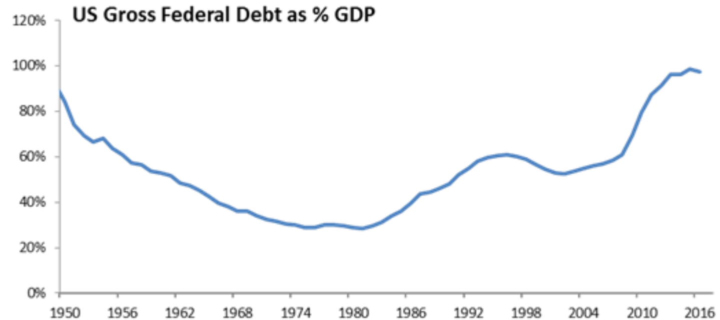
2. Companies have reduced costs by substituting high cost labor with automation and low cost workers. Compounding the shift in labor to overseas markets, following the Financial Crisis there remain excess resources in developed economies including industrial capacity and labor. Job growth remains low and is distorted by the growth in part-time and seasonal positions. Structural problems in the economy result in a large number of underemployed workers unable to obtain benefits. As a result, wage growth has been abysmally slow. As this persists, income inequality will grow and the government will step in through social programs in order to stabilize consumption among the working class.

3. Since the repeal of the Glass-Steagall Act (which separated banking from investment banking, insurance and other financial services business) in 1999, the lack of "political will" in Congress has lowered the threshold of regulation in the financial services industry which, in turn, has negatively impacted loan growth particularly to small businesses. Banks do not exclusively need to make loans in order to make a profit, they have other products and services that they can sell that require less capital.

4. Increased risks for businesses and the lack of private credit expansion has reduced business formation. Research from the Kauffman Foundation shows that the country's rate of new business creation, which peaked about a decade ago, plunged more than 30 percent during the economic collapse to levels not seen since 1983 and has been slow to bounce back following the recession. And, that is despite the fact that, over the last few years, the portion of the U.S. population between the ages of 25 and 55 – historically the prime years for starting a business – has been expanding. In turn, slow business growth has had a negative impact of job growth.

5. Our Federal Reserve is directly involved in our capital markets today influencing the level of interest rates. As a means to increase economic activity following the Financial Crisis, the Federal Reserve (along with the central banks of other developed countries) implemented programs to buy bonds in the open markets as a way to lower interest rates across the yield curve. Called "Quantitative Easing", this tool has helped the public debt of develop countries to balloon to record levels. The US debt to GDP is now over 100%, its highest level since World War II. *Ultimately, quantitative easing is a direct intervention in our capital markets to manipulate the*

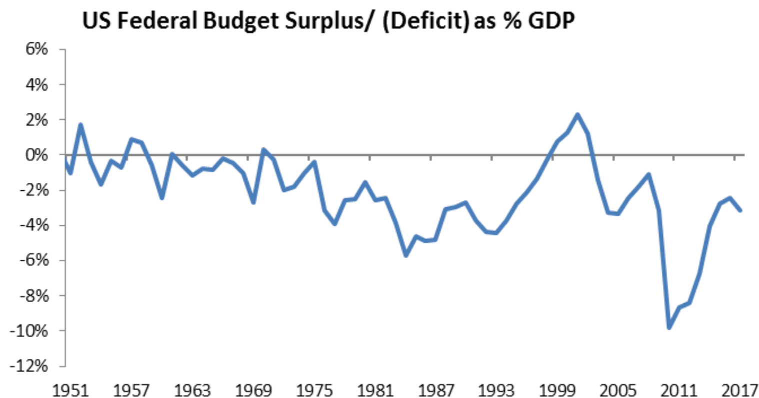
level of interest rates, which in turn lowers the borrowing costs for corporations. While the effects on business investment and consumerism are questionable, it has proven to be a powerful central bank tool that we expect is here to stay.



Source: Federal Reserve

6. <u>Low rates of inflation globally have forced interest rates lower in developed economies.</u> The Fisher Effect illustrates this, as lower inflation coupled with lower real interest rates has resulted in sharply lower nominal interest rates on a global scale. In the United States, although slack remains in productive resources, growth is likely to remain tepid, which compresses real interest rates. While the rate of unemployment has moved to 4.3%, Capacity utilization has remained below 80.4% since 2008. And the labor force participation rate is near 62.6% where it was in 1978. Workers are not coming back into the labor market and there is excess capacity in the form of warehouse, manufacturing facilities.

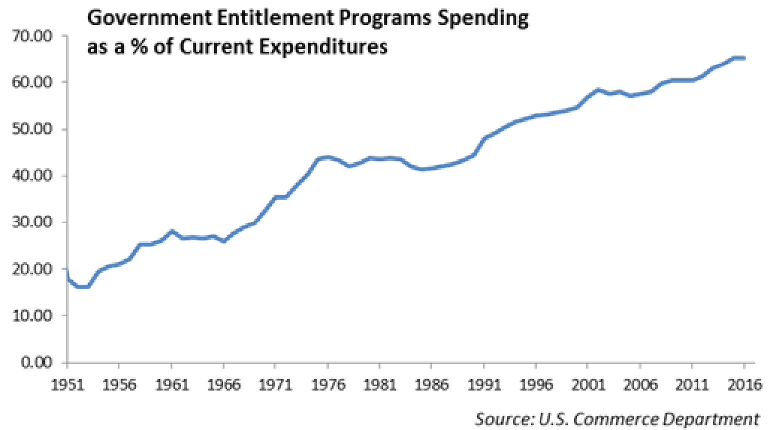
7. <u>Our form of democracy is evolving</u>. Congress lacks the political will to implement fiscal reform and discipline. As a result, entitlement programs are entrenched and will continue to grow, funded with debt. Baby boomers are just now entering the period that will stress social security and Medicare. We expect that we will continue to experience budget deficits in the future in order to sustain our fiscal expenditures.



Source: Federal Reserve

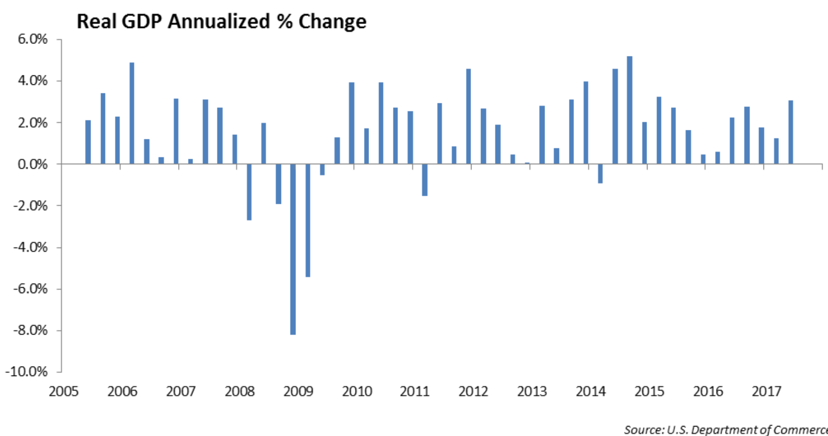
Unlike capitalism under China's or Russia's government, our form of capitalism today is not dependent on the initiatives of an imperial state. However, capitalism has continued to evolve as we have moved through the inflation of the 1970's, the market crash of 1987, and through the Financial Crisis of 2008. This evolution occurred in the background of declining economic growth, growing inequality and rising levels of public and private debt. Over the years leading up to and following the Financial Crisis, these three issues have become increasingly linked: low growth contributes to inequality by intensifying the need for social programs; inequality dampens growth by altering markets through cronyism; high levels of debt distort credit markets and increase the risks in the financial system; reduced regulation increases the fees and distribution of expensive investment products that serve financial institutions better than the investors, an overgrown financial sector adds to economic inequality. And, on and on it goes.

Our form of democracy over the past ten years has been defined by partisan grid-lock and an inability to pass thoughtful and meaningful regulation to protect and enhance the lives of our citizens. The one common thread throughout this gridlock is the mutual desire by both parties to grow entitlement programs such as Social Security. Medicare and Medicaid at the expense of increasing the public debt. The result is that our democracy today is moving more toward socialism, a government which primarily takes care of the people through programs and subsidies.



The Economy

The domestic economy is showing stable and sustained growth marked by a revised 3.1% increase in GDP in the second quarter of 2017. Nearly 70% of the domestic economy is based on consumption, and the household sector is in reasonably good shape. Household balance sheets are showing increased debt; however, household debt as a percentage of disposable income, while increasing, is still below peak levels reached prior to the Financial Crisis.



Consumer spending has been slow over the summer and slow growth has been compounded recently with the hurricanes in Texas and Florida. Retail sales have been slow as well as brick and mortar retail has been clobbered. We are expecting a challenging holiday shopping season this year marked by heavy discounting.

Slow wage growth has been a contributing factor to the low labor force participation rate. In turn, the lack of business formation combined with slow loan growth from the banks will have a muting effect on the employment picture going forward. As a result, we expect the economy will continue to muddle along at 2% growth.

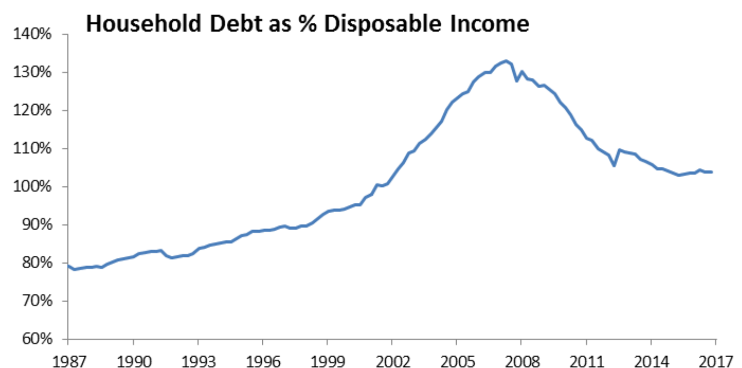
What are the Risks?

In the absence of reducing our debt load and effectively shrinking our financial system, we are simply waiting for our economy to grow in size to fit into our distorted debt levels. However, we do not believe the economy will grow fast enough and the risk that we continue to take on more debt (both public and private) is greater than our ability to achieve financial discipline measured by historic norms. *While tax reform may be a catalyst for a stock market rally, we expect any tax reduction policy will compound the growth in debt as we incur budget deficits to fund entitlement programs.*

The aggressive monetary policies of the developed countries have acted as a form of anesthesia for the capital markets as volatility has declined sharply and equity valuations climb slowly higher. At this point, we do not see signs of a market break or crash like 1987 or 2009. In fact, as we study the history of our capital markets, we do not see a time period marked by prolonged easy monetary policy, sustained low volatility, low inflation, low interest rates, and high equity valuations. We are living through historic times.

In the past, we would expect to see markets "correct" as average returns move back to their historic mean. However, in this new paradigm, we expect high equity valuations and lower returns to be the norm and we may simply sit here for a long time. The risks to our thesis are the following:

1. A tightening in monetary policy would do severe damage to this recovery. However, if accommodative global central bank policies are allowed to persist with easy money and quantitative easing, we believe this would force asset values even higher, compounding the over-valued position in financial assets.



Source: U.S. Department of Commerce

2. China's economy is recovering as financial reforms are stabilizing their capital markets. However, a severe downturn in the Chinese economy combined with heightened volatility in their financial markets would be stressful on the U.S. economy and our capital markets. China is living out its own experiment in central state planning, and its economy and financial system is fragile.

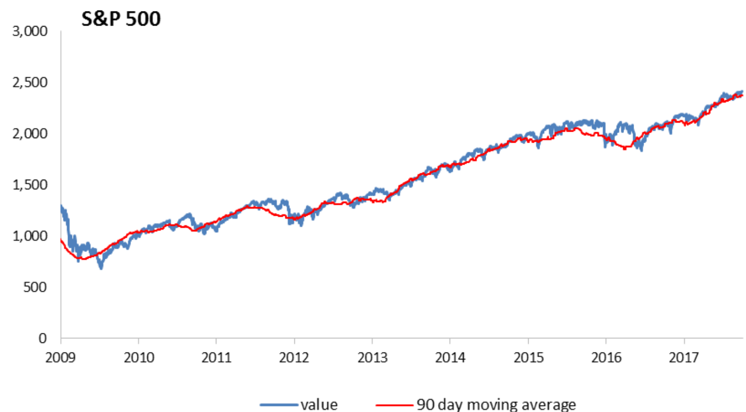
3. Financial regulatory reform causes a disincentive for efficient growth in private credit expansion which results in slower loan growth from the banking sector.

4. Sustained low bond yields will result in low investment returns for banks, insurance companies and retirement savings. Ultimately, this is the environment that we are on and it is not sustainable for insurance companies which cannot profitably fund premium growth. In addition, as savers move toward retirement without the safety net of a steady monthly pension check, they simply

do not have enough money to retire. The result, is that people will stay employees longer and inequality will grow.

What Does This Mean For Investors?

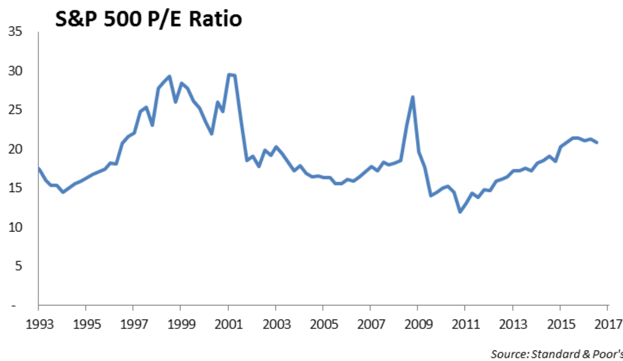
We are in a period where the rate of inflation is persistently low and the economy is showing modest growth and, as a result, excess resources are being slowly put back to work. However, this will be short lived. As our form of democracy and capitalism evolves, it is important to recognize the subtle impacts on the capital markets and investment opportunities.



Source: Standard and Poor's

1. In spite of the Fed Reserve's desire to push interest rates higher, we expect interest rates will remain low. The Federal Reserve will struggle to tighten. It will be unable to reduce its large portfolio and free itself from direct involvement in our Treasury market. Inflation will remain low as slack resources in labor will persist.

2. Low interest rates and easy monetary policies will support current elevated equity valuations. While Price/Earnings ratios have been higher in prior periods such as 2001 and 2008, those elevated levels have been during periods which culminated in peaks in the equity market.



Source: Standard & Poor's

3. The size of the capital markets will continue to grow but the number of investment opportunities in publicly traded stocks and bonds will continue to decline. The growth in passive investment products including ETFs and robo advisors, will continue to impact market opportunities and liquidity.

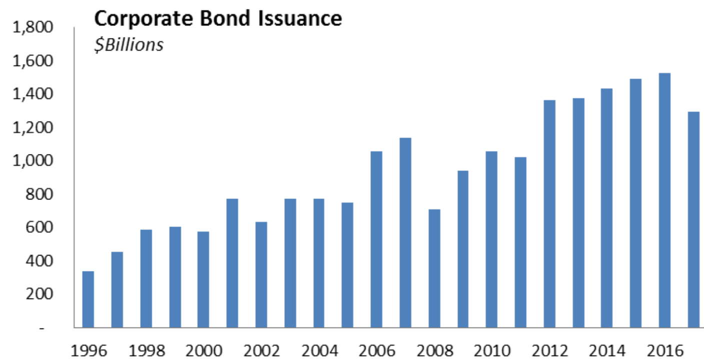
4. Market volatility will remain low and market corrections will be short lived. Both debt and equity markets trade in narrow ranges and with low volatility.

5. Equity managers must be active in order to generate performance. Traditional business models in many industries including retail, media, cable, and automotive are moving through rapid change which makes projecting revenue difficult. In addition, the number of stocks driving performance in certain indices is concentrated. If investors are not invested in those stocks, they have lagged.

The governance over many of these public companies has been abysmal as management has continued to increase their compensation and allocate capital inefficiently.

6. The number of new businesses starting in our economy today is declining and the concentration in big companies in indices is growing. Roughly 30% of listed companies accounts for 95% of U.S. market capitalization. As investors look for equity "exposure" through exchange traded funded funds, the higher percentage of Mega-Cap stocks results in higher level of idiosyncratic risk.

7. Credit spreads will remain tight and volatility in the credit markets will remain low. Strong corporate bond buying coming out of Asia and Europe will continue as new issuance declines in 2018. The US credit markets have experienced record issuance which exceeded $1.2 trillion each year over the past five years. However, we expect we are nearing the end of that record issuance. Spreads in non-investment grade bonds in particular have tightened dramatically and near historic tight levels. Domestic and foreign demand for yield will continue to keep pressure on spread levels for both investment grade and high yield.



Source: SIFMA, as of 9/30/2017

8. Expected returns on publicly traded assets, over the near term, will compress. We expect total returns on domestic equities to range between 3-5% and fixed income returns to range between 1-3% over the next several years.

9. In equities, we are concerned over the stewardship of shareholder capital. Passively managed ETF's control a larger portion of shareholder votes which are not necessarily aligned with individual or corporate shareholders. We are cautious on stocks in the healthcare, consumer discretionary and energy sectors.

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