2016 3rd Quarter Stock Market Commentary

IT'S THE CULTURE, STUPID

Litigation is the basic legal right that guarantees
every corporation its decade in court.
- David Porter

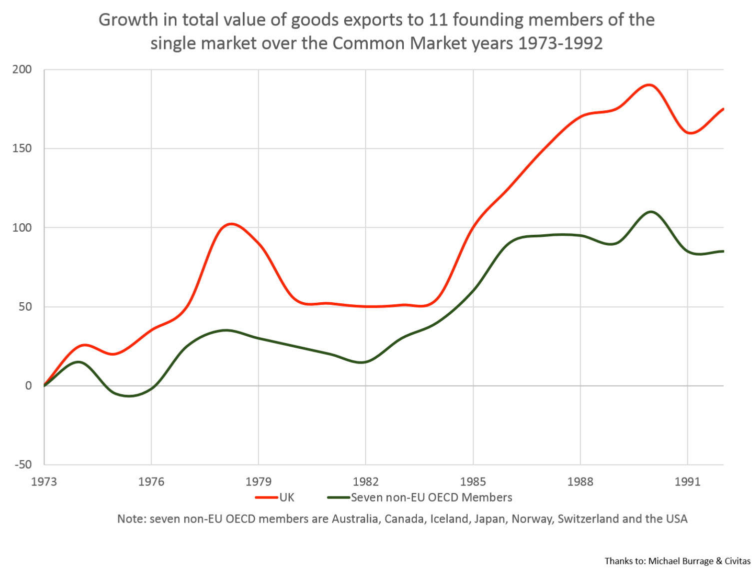
Banking On Death, published in 1961, was the debut novel written by Emma Lathen. Emma Lathen was actually the pen name for two American businesswomen, Mary Jane Latsis, an economist, and Martha Henissart, an economic analyst. The first name, Emma, was a mash-up of the "M" sound in Mary and the "MA" from Martha, while Lathen combines "LAT" from Latsis and "HEN" from Henissart. The protagonist in the series is Wall Street banker John Putnam Thatcher, senior vice-president of the Sloan Guaranty Trust Company, supposedly the third largest bank in the world. In each of the roughly 25 novels in the series Thatcher investigates a specific industry, usually around the time of some important current event, and utilizes his formidable forensic accounting skills to follow a money trail that unravels the mystery. The New York Times described this series as "Nero Wolfe with portfolio."

The phrase "follow the money" was a catchphrase popularized in the movie *All The President's Men* about the Watergate scandal, but that idea (if not the specific phrase) has been a common one in crime fiction. Its ubiquity is because it is almost universally understood that most people conduct themselves so as to maximize their own financial interest.

Which it is why it was so surprising when a majority of the British people stunned the financial world when they voted on June 23, 2016 to leave the European Union (the so-called Brexit), an apparent vote against economic self-interest.

The European Union (EU) is the successor to the European Economic Community (EEC), established in 1958. Great Britain applied for membership in 1969, when it was an economic basket case. It officially joined in 1973. For the first fifteen years of EU existence, economic output per capita in Germany, France and Italy, exceeded that in Great Britain. Moreover, during that period the gap widened, with gross domestic product per capita rising 95% in the three largest EU economies versus only 50% in Great Britain. By any measure, the British economy was struggling.

After joining, though, Britain's economic performance started to improve. Faced with increased competition within the European market, British businesses aggressively modernized, so that for the forty-two years 1973-2015, Britain's economy grew faster than its Continental rivals. Per capita output finally surpassed those of Germany, France and Italy in 2013, and was widely forecast to grow at a faster rate over the next five years, prior to the Brexit vote. Further, Britain's sales to the European Union grew faster than other nations in the Organization for Economic Cooperation and Development, such as the United States, Canada and Japan, which lacked the tariff free access to the region that EU membership confers.



But the previously forecast growth has come to a screeching halt now that the vote to leave the EU has occurred. In recent surveys several key industries have given downbeat assessments of future prospects. The Society of Motor Manufacturers and Traders (a proxy for the automobile industry) said its members were gloomy about the prospects for growth, jobs and investment. The British Retail Consortium said jobs were being shed in the months leading up to the referendum. The RICS, which represents chartered surveyors, said construction is weakening. Rents in the City of London, where most financial service firms have their offices, declined 6% in July. The British pound has weakened against the currencies of its trading partners, and the Bank of England slashed already low rates to help support the slowing economy.

If we accept the initial premise that most individuals act to maximize their economic interests, and the data show that Britain's economy clearly benefitted from its membership in the EU, why did the majority vote to leave? We would suggest it was a cultural divide that the vote revealed, rather than an economic one. In 1993, 7% of the population of Great Britain was foreign born. By 2005 that figure had risen to 9.1%, and by 2013 it was 13.8%. The Brexit vote was at heart a protest vote against the political class by people wanting to turn back the cultural clock. A recent poll by Lord Ashcroft, a Tory peer, found Leave voters less comfortable with concepts such as multiculturalism, social liberalism, feminism and environmentalism. In 1992 political strategist James Carville coined the phrase "It's the economy, stupid" as the campaign slogan for Bill Clinton's successful run against George H.W. Bush. The phrase was meant to suggest that first and foremost voters will vote their pocketbook. In this case, though, the more appropriate slogan would be "It's the culture, stupid."

Even though there was a vote to leave, the actual process of separating is likely to be protracted. First, the British government needs to invoke Article 50(1) of the Treaty on European Union, which permits any member of the EU to withdraw from the Union. Under David Cameron the

Government deliberately refrained from allowing the civil service to do any serious contingency planning on how to implement a Brexit decision. After the referendum result, it needs to spend a minimum of a few weeks or months working out a plan and timetable for the actions the UK will need to take leading up to exit.

Once that step is taken, Britain needs to negotiate an agreement setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. But the staff required to negotiate this has not yet been hired, due to tensions between Foreign Minister Boris Johnson and International Trade Secretary Liam Fox over who should steer the process. Britain's membership will terminate once this agreement is negotiated, but if no agreement is reached its membership will cease two years after invoking Article 50, unless both sides agree to an extension. In August the Sunday Times reported that the government may not invoke Article 50 until the end of 2017, which would push Brexit to the end of 2019.

Certainly, some consequences of the vote were actionable. Currency traders sold the British pound, which fell sharply. The Bank of England implemented additional monetary stimulus measures, dropping interest rates and boosting gilts. But in most markets the economic impact of Brexit is unquantifiable, and moreover it most likely will not occur for several years. Nevertheless, financial markets reacted to the referendum as if economic Armageddon was imminent. The Dow Jones Industrials plummeted 611 points on the day after the referendum, followed by a 261 point drop the following trading day. The two-day decline wiped out well over $1 trillion from the value of U.S. equities. Similar steep declines occurred world-wide, with combined losses in excess of $3 trillion. Once the knee-jerk selling was over, investors realized that not much had really changed in the short term. Those who sold out in a panic missed the subsequent rally of roughly 10% off the post-Brexit low.

This over-reaction to bad news (and under-reaction to good news) by investors is unfortunately typical. It has been documented in hundreds of academic research papers over the last three decades. Earlier this year the stock market swooned sharply from January 1 until February 11. The impetus for the selling was a report of a slowdown in the Chinese economy, which was implicitly confirmed by a sharp drop in the price of oil. But the moderation in the previously booming Chinese economy was, in fact, an old story which had been going on for five years. And historically, it is a rise in oil prices that sends stocks into a tailspin, not a decline. Savvy investors who correctly assessed the causes of the decline as being not particularly ominous and who bought into the market at the bottom of the decline are up a nifty 20% since then.

This tendency to over-react to bad news has become even more pronounced in recent years due to the rise of algorithmic trading. There are networks of supercomputers programmed to scan news releases looking for key words with negative connotations and to issue sell orders when such words appear. The most glaring example occurred on April 23, 2013 when a fake tweet reported that the White House had been bombed and that President Obama had been injured. Almost immediately the market plunged 10%, a drop that was completely erased within four minutes when the tweet was proved false.

The good news is that over-reaction to bad news is a cognitive bias that is exploitable. Contrarian investors are constantly trying to take advantage of over-reaction to bad news. As long ago as the 1700s, the British Nobleman Baron Rothschild was credited with saying that "the time to buy is when there is blood in the streets." Famed value investor Benjamin Graham, in his seminal book *The Intelligent Investor*, cooked up the metaphor of Mr. Market, a manicdepressive investor who is constantly offering to buy shares during his manic phase, and recklessly selling them when he is depressed. Graham's goal was to take advantage of his over-emotional partner. This doesn't mean that every news item that drives down stock prices is a buying opportunity. It does mean that patience is required to carefully analyze the investment implications of a bit of bad news, to see if perhaps things are not quite as gloomy as the initial market move might suggest.