Ivory's Economic Outlook

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No amount of experimentation can ever prove me right; a single experiment can prove me wrong.
Albert Einstein

It was 1979 when my father walked into an elevator with our neighbor who marveled at how fast children grow up. It seemed to him like just yesterday my sister was only a little girl and here she was driving around the neighborhood. The problem was my sister was only 15 years old and did not have a driver's license. Instead, she had a spare set of keys to dad's 1973 rust colored Ford Galaxy 500.

Serial rule breakers and expert envelope pushers tend to get busted from the most unlikely of sources. My sister had no way of knowing my loquacious neighbor would be on the elevator at the same time as our father and that said neighbor would have not only recognized the car but seen her behind the wheel. From that point on, any time my friends told me how easy it was to get away with something I thought of my neighbor and that fake wood paneled elevator and how my father would treat me much different and much harsher than he had his daughter.

In that same vein, economic growth has been weaving its way lower, snaking and hissing through indigenous rhetoric and central banking pep talks from around the globe – everybody's on board. The engine of commerce is impervious to the gravity-stricken earnings numbers, that while beating expectations, are not improving on a rate of change basis. And since Einstein once said (something along the lines of) life is like riding a bike, that if you're not moving, you're bound to topple over, and since Einstein was known to be smart, these facts are at the very least unsettling.

It is both noteworthy and concerning that economic conditions do not cause market disruptions, the kind that change retirement dates and disparage nest eggs. The 2008 housing crisis manifested itself not from the irresponsible behavior of people buying homes they could ill afford, but because waves and waves of adjustable rate mortgages reset at the same time and could not be refinanced and when they could not be refinanced went into default together, like one big unhappy family. It was an event, not some red flag in the form of economic minutia nobody understands anyway that begot the market's descent.

These are the world's biggest economies

Based on data from the International Monetary Fund, 2018

Country	Value (in trillions)
1 United States	20.4
2 China	14
3 Japan	5.1
4 Germany	4.2
5 United Kingdom	2.94
6 France	2.93
7 India	2.85
8 Italy	2.18
9 Brazil	2.14
10 Canada	1.8

Source: IMF

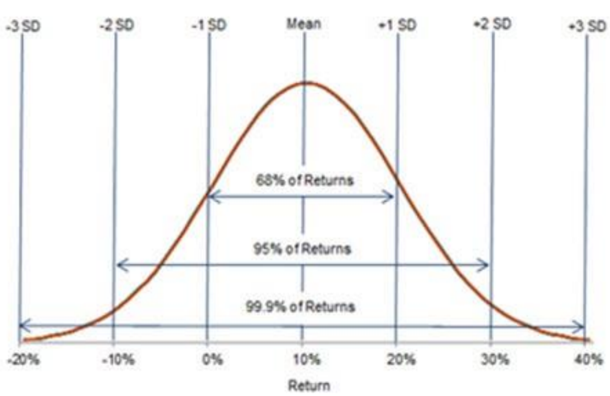
The coronavirus was thought to be a speed bump, and maybe that's what it will become. I am not a scientist. What I do know is the SARS outbreak happened in 2003 when China was four percent of global GDP. The Coronavirus, on the other hand, is taking place when China is 17 percent of the global economy[i] and they have shut down the provinces that represent 80 percent of commercial activity and 90 percent of exports[ii].

Moreover, any U.S. company with a supply chain in China could have a broken link. Nobody knows how it all turns out, maybe it's nothing at all, but the markets don't like not knowing things. If anything, it is not immaterial that a PriceWaterhouse Coopers report showed the global impact could reach at least 0.7% of GDP and Goldman Sachs sees zero earnings growth for U.S. companies this year because of coronavirus[iii].

James Madison and the founding fathers intended the Senate to be a place where legislation sent from the House was cooled off, a body that protected the minority from the passions of the majority. That's why a president can sign legislation, but only after the Senate has voted on it, can nominate a judge, but can't confirm, can be in support of a treaty, but needs the Senate's authority to sign it.

After the horrors of WWI, the Senate became isolationists and blocked every effort to maintain world peace. First, they undermined the Treaty of Versailles in 1919. Just four years later they rebuffed Coolidge's proposal that the U.S. become a member of the World Court that settled global disputes. In 1931 Japan invaded Chinese Manchuria and the League of Nations sat on their hands knowing the U.S. Senate would oppose any action.

In 1933 F.D.R. asked for Congressional authority to block arms shipments to aggressive countries - the House agreed and the Senate refused. When Hitler rearmed in 1935 and collaborated with Mussolini, F.D.R. asked for an embargo and the Senate tied the President's hands with the Neutrality Act of 1935 that prevented any action. F.D.R. asked again in 1937 when Hitler menaced Czechoslovakia and it never made it out of committee. The Senate, in fact, did not relent until 1940 when Germany invaded Poland, and still there were efforts to sit on the sidelines until Pearl Harbor.



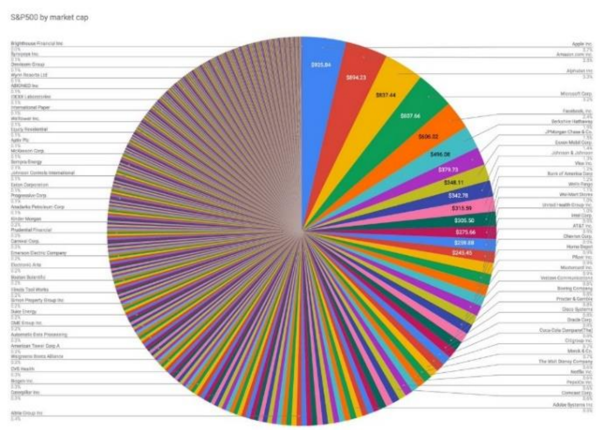
This is all relevant because risk can linger for long stretches of time, even if the consequences happen with the speed of a switchblade. For our purposes, the math used to measure volatility is obscured by suspect and antiquated theories. Unbeknownst to many investors is that the predominant pillar of this veiled black box of risk management is standard deviation that manifests the bell curve said to illustrate the normal distribution of outcomes.

An example of the methodology might deduce that 90 percent of men stand between 5 '4 and 6 '2 inches tall. In financial risk terms, that means there's a five percent chance of a man being shorter than 5 '4 or taller than 6 '2. The average height may be 5 '9, except the markets don't move in a linear fashion.

When you apply this strategy to the financial markets, it might give one the impression that there's a 90 percent chance that the stock market will return, for instance, between -20 percent and +20 percent. Moreover, if you were to mix stocks with different characteristics, so as one zigs the other zags, a prudent investor can reduce the odds of an extreme event.

The problem is real markets are wild, and like turbulence, the risk can happen in clusters. Experience tells us that prices do not follow the proportions of the bell curve. In fact, most changes are small and an extremely few are large and unpredictable. Additionally, prices are not independent, being influenced by yesterday's activity, something not captured by the math.

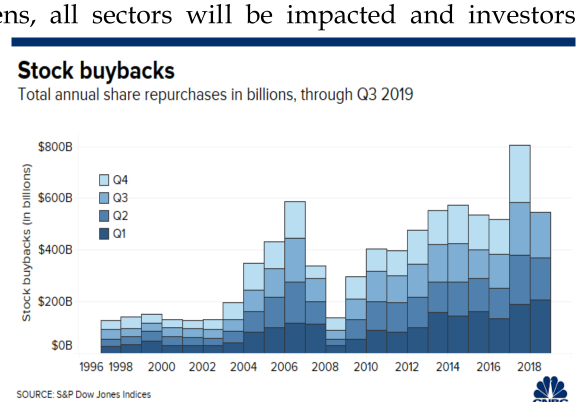
Mathematician Benoit Mandelbrot studied daily index movements of the Dow Jones Industrial Average from 1916 to 2003. He describes in the book "The Misbehavior of Markets" that financial orthodoxy would have us believe that there should have been 58 days when the index moved more than 3.4 percent when in fact there were 1,001 such days. The index should have swings of more than seven percent every 300,000 years, even as the 20th century saw 48 such occurrences.



My sense is investors are impervious to the risks they take in their portfolio. Just because a 15-year-old taught herself how to drive in Manhattan doesn't make it safe. How, for example, can you account for the fact that five companies in the S&P 500 represented 30 percent of the market's 2019 returns? Here we are under the impression that our eggs are in 500 different baskets when truth be told there is one really big basket and 495 smaller ones.

Who measures the outsized risk of stock buybacks when S&P 500 companies spent $480 billion in 2019 to purchase their own shares[iv], a 30 percent decline from the previous year[v], and what happens if that trend continues for all the reasons stated earlier? The conditions I am discussing are things that in and of themselves may be harmless, but when triggered, like a virus, can in rare cases cause outsized damage.

What keeps me sound asleep at night is knowing there are repeatable processes of buying sectors based on whether GDP and inflation is accelerating or decelerating. It is not a crystal ball, those do not exist, and anyone who tells you he/she is in possession of one is either a liar, or a thief, or both. Any time GDP and inflation growth slows at the same time, however, I am likely to own utilities, bonds, gold, housing and consumer staples. That said, there are times when the volatility reaches a point when a selloff broadens to include all asset classes. Think about what it must be like to hit a golf ball in 40mph winds, no matter how well you hit the ball it's still going to be a bad shot. Should volatility get to a certain height, which happens when standard deviation widens, all sectors will be impacted and investors should act accordingly



And since I'm in the mood for sharing, I must confess that I too stole my father's car, except by the time I was 16 he had a 1979 two toned Buick Century because somebody had stolen the Ford Galaxy 500. Unlike my sister, and very much like our decelerating economy, I never got busted. In fact, eyebrows weren't raised until my dad decided to teach me how to drive and suspected I had been behind the wheel before.

Let me finish by stating I did not get away with anything - God has a tremendous sense of humor to compliment his long memory because he gave me a son who likes to drive as much as my sister did in 1979. As is always the case, it was not the traditional red flags, but the event, in this case prom night, that got him busted and had me down at Sears fixing the control arm he bent while driving too fast and challenging the integrity of a sidewalk that was minding its own business.

Suffice it to say this is serious business, difficult to predict and all but impossible to avoid in its entirety. A lawyer once told me that sometimes winning is not losing badly, so don't get me wrong, I love it when the markets go up. I'd just prefer to not lose too badly if they get caught driving without a license in uncharted territory the risk managers didn't know existed.

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[i] IMF
[ii] Hedgeye Research
[iii] CNBC; sees zero earnings growth for US companies this year because of coronavirus; 2/27/20
[iv] MarketWatch; Buybacks are the 'dominant' source of stock-market demand, and they are fading fast: Goldman Sachs; 11/9/19
[v] CNBC; A huge driver of stock prices got off to its worst start in 7 years, but that could change; 2/28/20