1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

SEPTEMBER 2017 INVESTMENT COMMENTARY

MR. MARKET - DIG HOLE IN SAND, INSERT HEAD

Unintended adverse consequences are usually assumed to be unexpected and unforeseen. It is conventional wisdom that if adverse consequences were in plain sight, that decision makers would naturally avoid such actions, to the extent possible, that might trigger undesirable outcomes.

Financial markets continue to remain relatively complacent in the face of a policy agenda coming from Washington DC which has put in play a host of actions that could lead to economic disruption on a scale that we have not experienced in generations. The news media reports the most sensational and human-interest elements of situations involving North Korea's provocative nuclear program, the stated desire to withdraw from the Paris Climate Accord, the withdrawal from the Trans Pacific Partnership, the termination of the DACA program for the so-called Dreamers, and the renegotiation or termination of NAFTA. Any one of the aforementioned policy actions has the potential to cause meaningful short-term and/or long-term adverse economic outcomes that would most certainly have capital market consequences. Two or more of these potentially disruptive policies or geopolitical situations could lead to a recession and/or potential financial crisis.

Below I will highlight each policy area and the potential concerns that have economic implications:

<u>North Korea:</u>
There is no question that if a limited military conflict arises between North Korea and the United States that this conflict would meet with a sharp rise in market volatility and a significant, but ultimately short-term correction in the equity markets. Obviously, such a military conflict could spiral out of control and lead to a very dangerous and protracted war that would be extremely costly, from both a human casualty and financial standpoint. With the prospect of nuclear warfare in play, such a war could become a significant and protracted concern for the markets. Hopefully, the world will be able to avoid such scenarios. However, that avoidance may only be possible through rigid economic sanctions to include using trade with China as negative reinforcement to induce China to change North Korea's bellicose behavior. Any such trade actions involving China could have severe economic consequences on China itself, as well as, western nations, including the United States and the European Union.

<u>Paris Climate Accord:</u>
Over the last ten years renewable energy (predominately solar & wind) has been the fastest-growing source of electricity production among the four largest economies in the world (U.S., China, Japan, and Germany). The ten year annualized growth rates for renewable energy electricity production among the four largest economies were 19.46%, 40.51%, 22.20%, and

9.75%, respectively. It should be noted that Germany's annualized growth rate of renewable energy electricity production is notably slower due to Germany's early adoption of wind and solar power, relative to the other countries. 18.0% of Germany's electricity is currently produced using renewable sources, compared to just 7.1% for the United States.

The growth in renewable energy has been enabled by rapid technological innovation and incentive tax structures or "central planning" utilized in advanced industrialized countries to accelerate investment and adoption. Major wind and solar companies have emerged over the last ten years, and these companies have been innovating rapidly and creating a significant number of high paying jobs. China is home to six of the top ten solar companies and three of the top ten wind power companies. Although Germany has been the most aggressive major economy in converting its electricity production to renewable sources, it is not home to any of the top ten solar companies, but it is home to four of the top ten wind power companies. The United States is home to SunPower and First Solar, two of the largest and most innovative solar companies in the world, and General Electric, the number two wind power company in the world.

Solar energy is rapidly becoming the most efficient source of electricity among all sources of such production. Because solar will soon be the least costly source of electricity in the world, it is attracting significant investment, and this industry is a major source of employment in the countries that are rapidly adopting solar energy technology. In 2016, solar energy employment made up 43% (373,807) of all employment in the United States related to electricity generation. Solar energy jobs rank number one in electricity production employment, and this is two and half times larger than the next largest employer within electricity generation, fossil fuel (151,000). Wind energy ranks number three with 101,738 jobs. Solar and wind energy jobs together in the U.S., grew 24.5% and 32%, respectively from 2015 to 2016.

The Paris Climate Accord is an unprecedented voluntary accord signed by every nation in the world with the exception Syria, which has been torn apart by a brutal civil war and Nicaragua, which argued that the Paris Accord did not go far enough to reduce carbon emissions. It took the leadership of the United States, to bring the world's second largest economy, China, to the table during these negotiations. The United States and China are the world's two largest carbon pollution emitters. The United States leadership by example not only enables such accords, but it also aids our domestic renewable energy industry to compete globally. Being a visible leader in these areas of technology innovation also helps our nation to attract scientists and other workers who want to research and work in a country that is prioritizing the adoption of renewable energy technology.

A concerted global effort to reduce the human impact on climate change was formalized by the Paris Climate Accord. The impact of the Climate Accord has motivated nations around the world to take the reduction of carbon pollution seriously. Since the Climate Accord was agreed upon, many countries have announced policy goals, such as phasing out carbon fuel powered motor vehicles. China, the world's largest auto market, recently announced that the country would outlaw the sale of fossil fuel power vehicles in the future. In an article, titled China to ban the sale of fossil fuel cars in electric vehicle push, published by Bloomberg on September 9, 2017, it was stated "China, seeking to meet its promise to cap its carbon emissions by 2030, is the latest country to unveil plans to phase out vehicles running on fossil fuels. The U.K. said in July it would ban sales of diesel- and gasoline-fueled cars by 2040, two weeks after France announced a similar

plan to reduce air pollution and meet targets to keep global warming below 2 degrees Celsius (3.6 degrees Fahrenheit)."

A sound argument can be made that pulling out of the Paris Climate Accord will make it harder for U.S. companies to compete globally and will act as a disincentive for the best minds in the renewable energy industry to choose the United States to conduct their work. Therefore, a real or even perceived lack of global leadership by the United States caused by the withdrawal from the Paris Accord risks hurting our domestic renewable energy companies' global competitiveness. The loss of perceived leadership in a rapidly growing global industry in the U.S. would most certainly hamper the growth and job creation of our currently robust solar, wind and battery techology companies.

Trans Pacific Partnership:

The U.S., along with Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam negotiated the Trans Pacific Partnership. This multi-lateral trade agreement began with discussions in 2006 among the original members of the Trans Pacific Strategic Economic Partnership Agreement (Chili, New Zealand and Singapore) and expanded the parties to include the U.S., Australia, Canada, Japan, Malaysia, Peru, Vietnam, and Mexico. The central goal of the Trans Pacific Partnership was to provide a counter to China's growing economic influence in Asia. China had grown to become the third largest economy in the world, and it was quickly closing in on overtaking Japan for the number two spot. The trade agreement would have made it much easier for the United States to compete against China in the Asia/Pacific region by eliminating over 18,000 tariffs and expediting customs between members. Additionally, the trade agreement mandated strong environmental protections, set high human rights standards, strengthened intellectual property protections, and it set high corporate governance standards. All of these provisions would have helped American corporations better compete with China in the Asia/Pacific region. Pulling out of this agreement after ten years of negotiations weakens the U.S.'s standing in the region, and the loss of the hard fought trade provisions which advantaged U.S. companies will most likely hamper U.S. trade in the region for many years into the future.

Threatened Termination of the DACA Program:

It is widely reported that the number of undocumented immigrants who were brought to the U.S. as minors approaches 800,000. Many of these so-called "Dreamers" have been in the U.S. for more than ten years, were educated in U.S. public schools, attended some form of college, and now are gainfully employed, and productive contributors to our economy and society.

In a Newsweek article published August 30, 2017, titled DACA By the Numbers, the following characteristics of DACA individuals were highlighted:

- They must have come to the U.S. before turning **16**. They must have lived in the U.S. since June 15, 2007.
- In a Center for American Progress survey of roughly 3,000 DACA recipients, **nine-tenths** of respondents said they had jobs.
- Their average hourly wage was **$17.46** an hour, up from $10.29 before receiving DACA.
- About **72 percent** of respondents were in higher education.
- After getting DACA, nearly **80 percent** of respondents said they got driver's licenses. About half became organ donors.
- A Morning Consult poll from April found that **56 percent** of registered voters said Dreamers, another name for people who came to the U.S. as kids, "should be allowed to stay and become

citizens if they meet certain requirements."

- The Center for American Progress estimated that the U.S. would lose about **$460 billion** in GDP over the next ten years without DACA.
- About **700,000** people could lose their jobs.

From an economic perspective, GDP growth is governed by a simple equation with the primary inputs being working age population growth and productivity increases. Should the 800,000 "Dreamers" voluntarily or involuntarily leave the United States, this would leave a hole in our productive workforce that will restrict GDP growth.

I do not believe that it is very likely that these "Dreamer" individuals will be forced to leave the country. However, if their continued status as protected and legal immigrants is left uncertain, these individuals will likely not fully integrate into society and the workforce and such uncertainty will result in an economic opportunity cost that is very avoidable.

NAFTA Renegotiation or Termination:

According to the U.S. Census Bureau, U.S. trade totaled $3.6 Trillion in 2016. The number one trading partner with the U.S. was China, with trade totaling $579 Billion. The next two largest trading partners with the U.S. in 2016 were Canada and Mexico, with combined U.S. trade totaling $1.07 Trillion. Thus, over 30% of all U.S. trade in 2016 was governed by NAFTA. NAFTA was a bipartisan trade agreement signed into law in 1994 by President Clinton. In 2004, ten years after the trade agreement was signed, U.S. exports to Mexico and Canada were $301 Billion. Over the next twelve years, U.S. exports to Canada and Mexico have increased to $498 Billion (2016 U.S. exports to Mexico and Canada). This growth in exports under NAFTA equates to a 4.98% compound annual growth rate over the twelve-year period from 2004 to 2016. Over the same period, the U.S. trade deficit with Canada and Mexico has shrunk from $111 Billion to just $74 Billion in 2016. Thus NAFTA over the last twelve years has increased exports to Mexico and Canada at a growth rate of approximately 5% per year and reduced our trade deficit with these countries by 30%.

As with all trade agreements, there are inevitable disputes and negotiations to resolve brought about by imbalances and unfair practices that were unanticipated. However, the current threats coming from the U.S. President and trade negotiating team are unfairly characterizing NAFTA as structurally unfair to the U.S., requiring significant changes or termination. This hardline approach risks soaring our relationship with trading partners which represent more than 30% of all U.S. trade.

Most major U.S. multinational industrial companies rely upon a supply chain that is complex and multi-national. Such supply chains have taken decades and hundreds of billions of dollars to establish under the architecture of NAFTA. If we damage our relationship with Canada and Mexico as a result of these unnecessarily hard line negotiations, we risk doing significant harm to our large U.S. companies' competitive position in the global economy. More specifically, we risk disrupting efficient supply chains, which would increase the cost of goods for U.S. consumers, and risk triggering trade wars that could slow both the U.S. and global economy.

How we respond to today's realities matters for investors:

Mr. Market, after last November's election, heard the siren song of tax cuts and this, plus the allure of the promised of ability to repatriate hundreds of billions of dollars of foreign profits without incurring a significant tax liability, has apparently overshadowed all of the very real economic risks discussed above……FOR NOW.

The risk of engaging in populist propaganda instead of long-term strategy driven policy elevates political expediency too the forefront of policy consideration. Recall that the Trans Pacific Partnership talks began in 2006 under a Republican Administration and concluded in 2016 after two terms of a Democratic President. This

evidences a long-term strategic, not political motived process. Populist leaders advocate policies that rely less on long-term strategic decision-making and more on simplistic and coincident cause and effect observations for their justifications. For example, in order to properly address a trend of slowing economic growth in the U.S., our leadership first needs to understand the root cause for such slowing, as opposed to scapegoating politically convenient variables that are coincident, but not causal. The U.S. economy is more globally interwoven than ever, and the relationships that exist to enable our private sector to compete globally are extremely complex. An astute observer will always be skeptical of simple, blunt actions in response to problems involving complex systems.

Most investors know that the U.S. economy has been very sluggish since the 2008-2009 financial crisis. However, given how globally interwoven advanced economies are, it is disingenuous to judge an advanced economy's growth in isolation. Instead, any rigorous assessment of an advanced economy's health requires understanding both local demographic trends and the global economic backdrop. Based on data compiled by the OECD, our economy outgrew every G7 (Group of Seven) nation, except Germany, since the end of 2008. Our nominal annualized GDP growth rate was 2.99% since the end of 2008. Germany led the G7 with an eight-year nominal GDP growth rate of 3.28%. The average nominal GDP growth rate for the G7 since 2008 was 2.07%. In spite of the relative strength of the U.S. economy following the financial crisis, the current sentiment coming from leadership in Washington appears to view the U.S. economy as a "train wreck." The blame for the wreck appears to be squarely being put on the past multi-lateral trade agreements, the growing percentage of the U.S. population made up of non-U.S. born individuals, and the historical role of the U.S. to lead by example when it comes to solving global issues. The risk to misreading the complex nature of sluggish U.S. and global growth is that we undo the very foundation of the U.S.'s success when it comes to global trade and leadership.

It is far too simple to look to past times when economic growth was higher, observe structural differences between the past and present economies and conclude that the differences are the causal factors that have led to reduced growth rates. This desire to return to an economy when U.S. manufacturing jobs were the backbone of the middle class and a 4% Real GDP growth rate was considered normal sounds very appealing on the surface. However, the sheer size of the U.S. economy, demographic trends, and the shift from an industrial led global economy to an information and technology driven economy are secular realities that cannot be reversed.

I will end this commentary by summing up my observations the following way:

The current leadership in Washington DC is broadly saying the right things about the importance of higher and sustainable economic growth, a friendly business environment, and the need for much greater infrastructure investment. This diagnosis is not controversial and these objectives have broad agreement across the establishment political spectrum. Unfortunately, the market seems to be overly focused on the aggressiveness of how such mainstream concepts are being promoted, however, the "hype" appears to be clouding a critical discounting of any adverse consequences that could result from the current slate of proposed actions. Some refer to this market-based euphoria that we are witnessing as "Animal Spirits". As a professional investor, I see such "Animal Spirits" as a stampede kicking up a cloud of dust that obscures critical thinking and strategic forethought. As my Great Grand Father used to say, "it pays to keep your wits about you."

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Coastal Investment Advisors), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Coastal Investment Advisors. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Coastal Investment Advisors is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of Coastal Investment Advisors' current written disclosure statement discussing our advisory services and fees is available for review upon request.

Curt Stauffer is an Investment Advisory Representative of Coastal Investment Advisors. Coastal Investment Advisors is not affiliated with Seven Summits, LLC. Investment Advisory Services are offered through Coastal Investment Advisors, a US SEC Registered Investment Advisor, 1201 N. Orange St., Suite 729, Wilmington, DE 19801.

Any mention in this commentary of a potential securities or fund investment should not be construed as a recommendation for investment. Investors should consult their financial advisors for advice on whether an investment is appropriate with due consideration given to the individual needs, risk preferences and other requirements of the client.