SEVEN SUMMITS CAPITAL

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SEPTEMBER 2019 INVESTMENT COMMENTARY

THE FOG: EMOTIONS-CONFIRMATION BIAS-INTUITIVE CONCLUSIONS

At its core, investing is the process of identifying the value of a particular asset-based upon one of many valuation methodologies and then buying that asset at an acceptable discount to the derived value assumption. In today's market, security prices seem to be more sensitive to Presidential tweets and utterances from Federal Reserve officials, than any particular valuation metrics. One has to wonder whether the market price setting functions have been short-circuited by the truly abnormal times that we are living through?

Being that this month marks another anniversary of the September 11th terrorist attack, I am reminded of shock and emotionally charged thinking that resulted among otherwise rational and thoughtful individuals. I clearly recall participating in a conference call of portfolio managers in the week following the attack on the twin towers and Pentagon. One stock discussion that I will always remember from this meeting was Disney. Disney stock had dropped from the high 20's before the terrorist attack to just under $17 per share in the weeks following the attack. Many very intelligent and seasoned portfolio managers were discussing whether Disney would continue to be a good long-term investment if the public so feared flying that Disney World and Disney Land amusement park attendance would be permanently reduced. I interjected my opinion during this call which looked beyond the present "fog" of fear, uncertainty, and panic and focused on Disney's enormous embedded franchise value that is both durable and scalable. My opinion was that Disney stock, hitting levels not seen in six years should not be sold, but should be added to on this weakness. My assessment during this chaotic period was rational, but it was not what most people wanted to hear.

Unfortunately, I have many memories of managing money during times of both fear and exuberance. Each of these opposing extremes of human emotions is equally dangerous to an investor's success. Whether fear, exuberance, or some other set of factors which obscure rational thought, my experience has taught me to look through the "fog."

I don't use the word fog lightly. When the financial crisis hit in late 2008, there were extremely serious factors weighing on the global financial system and the very foundation of our capital markets. However, there was a fog of panic and fear which distracted investors from being able to weigh value, risk, and opportunity. During this time, I was able to purchase stocks at prices that valued very good and healthy companies at less than the value of their tangible assets. I also purchased many bonds at 80-85 cents on the dollar in spite of being able to identify sufficient cash flow and collateral coverage.

The title of last month's commentary referenced normalcy or the lack of normalcy. In reality, normalcy is elusive, and as investors, we routinely must navigate ever-changing and evolving risks, both familiar risks and unfamiliar. Familiar risks are less disruptive and more manageable for an investor because history can provide a road map of how markets react to various scenarios. Unfamiliar risks, such as occurred on September 11, 2001, in the second half of 2008, and today require more forward-looking "game theory" thinking and value-seeking methods versus back-testing and pattern following.

When the fog surrounding markets is unfamiliar, an experienced long-term investor doubles down on ensuring that information inputs are honest and not driven by wishful thinking or self-reinforcing conclusions. It is easy to "feel" something when we are scared or excited. It is much harder to feel a certain way and reject bad information that confirms those feelings. I recently read a fascinating article titled *An Expert on Human Blind Spot Gives Advice on How to Think*, by Brian Resick and published by Vox. In this article's interview with David Dunning, one of the authors of the Dunning Krueger Effect Syndrome stated "Whenever we reach a conclusion, it just seems like it's the right one. In fact, a lot of what we see and conclude about the world is authored by our brains. Once you keep that in mind, hopefully, it does give you pause, to think about how you might be wrong, or to think about how another person might have a case. And you might want to hear them out." I see this type of thinking playing out on a regular basis when it comes to assumptions regarding markets and the economy.

Over the last several months, much has been written about signs of an economic slowdown in the U.S. and the risks of a recession increasing. However, this drumbeat of warnings has been met with one consistent counter-argument. This argument is that there have been no signs that consumer spending is weakening and unemployment remains very low. Those espousing this intuitive counter-argument confidently suggest that without evidence of a consumer-led slowdown and rising unemployment that talk of a recession is overly pessimistic.

Based upon my experience and the many economic cycles that I have seen come and go, this simplistic and believable counter-argument was unconvincing. Any long-time reader of mine knows that when it comes to economic cycle forecasting, I have come to rely upon economist Paul Kasriel. Even though Dr. Kasriel has been retired from the position of Chief Economist of Northern Trust, he still publishes his research and observations on a fairly regular basis. I have been fortunate in the past, and have told him so, that whenever I am in need a point of clarification or a cogent forecast, he seems to publish a very timely article. Dr. Kasriel's timeliness happened again recently regarding my questioning of the "strong consumer" counter-argument against the chorus of experts warning about increasing recession risks.

On August 26th, Dr. Kasriel published a Linkedin article titled *If Some Bloomberg TV Guest Pundits Were Weather Forecasters, They Probably Would Be Predicting Tomorrow's U.S. Weather by Looking East*. This article looked at every recessionary period since 1956 to determine if consumer spending and the unemployment rate were relevant indicators which turned down prior to the beginning of a recession. Dr. Kasriel summarized his finding by stating, "In sum, looking at the behavior of coincident indicators such as real consumer spending or the unemployment rate has been unreliable in forecasting the onset of a recession." It is interesting to look at the charts in the Kasriel article, which illustrate each recessionary period since 1956, consumer consumption and the unemployment rate, to see that these two economic metrics have not meaningfully foreshadowed imminent recessions.

I am not overly worried about a severe economic downturn over the next 12-18 months. I am, however not willing to fall into a false sense of security based upon an intellectually dishonest “glass half full” counter-argument which relies upon an assumed thirst for a simplistic and intuitive explanation of uncertain and complex subjects. I currently assess that the U.S. domestic economy has reverted to post-financial crisis trend GDP growth of 1.50% to 2.50% after a very short period of tax cut induced above-trend economic activity. I have written about my concern that the late 2017 tax cut legislation would only temporarily boost economic growth.

The legitimate concern about a trend GDP growth rate which averages around 2% is that this low growth provides very little cushion against geopolitical and energy shocks or global slowdowns to keep our economy from falling into a recession. This was a concern during the Obama years and remains a concern as our economy has reverted to lower growth rates approximating what the Federal Reserve calculates to be “potential growth.” When I looked at a economic indicators last year at this time following annualized quarterly GDP growth rates for the proceeding four quarters of 3.2%, 3.5%, 2.5%, and 3.5%, respectively, I did not see a sustainable level of growth materially different than trends that began in 2009. I wrote in the September 2018 commentary that “The reality is that for the most part, our economy is simply following long-standing trends that naturally produce new post-financial crisis milestones as time passes. Broadly speaking, areas such as employment, average hourly earnings, and GDP are currently following cyclical trends that began in 2009.” This was a timely statement, as the Third Quarter GDP growth rate moderated to 2.9%, and we now know, after several revisions that the Fourth Quarter 2018 GDP growth rate fell significantly to 1.1%. For 2019, after two quarterly GDP reports, the average GDP growth rate has been 2.55%. The economy is clearly exiting the short fiscal stimulus-induced above-trend period that began in anticipation of the end of 2017 tax cut legislation and lasted through the third quarter of 2018. Slowing GDP growth does not necessarily mean that the economy is headed for a recession in the next 12 months. But what the slowing growth does is reduce the margin of safety our economy has in the face of trade tariffs, Brexit, unrest in Hong Kong, monetary policy miscalculations, or any other unanticipated shock to the global economy.

My current assessment is that there is very little reason to expect the broad equity markets to rise materially between now and the 2020 Presidential Election. Thus, protecting against a potential 15% to 25% decline is much more important being worried about missing out on the next 15% advance. At Seven Summits Capital, this assessment does not mean that market timing is appropriate, but it does mean that risk management through security selection, asset allocation, and hedging are driving portfolio decisions.

Through the end of August, Seven Summits Capital portfolio results are proving that with active management and a clear-eyed view of the macro environment, one can manage risk while positioning portfolio positions to capture sizable upside performance. I hope that our clients are pleased with the results that they see on their statements this year and are comforted that I remain on guard against downside risk.

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