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"Chasing Your Tail"

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The Chinese stock market located in Shanghai has a rich history dating back to 1866. It experienced its first real panic jU.S/t five years later in 1871, followed by a steep increase in prices that ended in a deflationary decline in 1883. Just seven years later another panic occurred in 1890. Volatility continued throughout the early 1900's. By 1941, the Shanghai stock market was officially closed as Japanese soldiers occupied the city. Even during Mao's infamous Cultural Revolution, there were several unsuccessful attempts to restart the exchange.

Finally, in November of 1990, the exchange's doors were reopened. A delegation from the United States, who were advising the Chinese, were struck by the motives for wanting to develop a stock market. The Chinese saw the exchange not as a reflection of economic conditions in a free market, but as a tool to assist them in achieving economic outcomes, an instrument of policy. At the time, the American advisors were openly critical of the Chinese approach, although with hindsight, it appears the Chinese were on to something. Today, Western governments are engaged in a highly manipulative strategy of pushing equity valuations higher through misguided interest rate policy. They fear a loss of confidence will further the trend of deflation. Ironically, it may be that their interest rates, by favoring debtors over savers, are actually making deflation worse.

Free markets can produce pain but also pave the way toward prosperity. Markets, if permitted to operate free from government interference, offer a fair trade-off between risk and reward. But a rigged game usually ends in a misappropriation of resources and severe overvaluation. To the extent that investors feel that the risk is underwritten, they are incentivized to speculate; however, success is never guaranteed.

Inflation expectations for the U.S. have risen sharply since the election, although the signs of higher inflation have been with us since summer. Tighter labor market conditions and rising wages have been the strongest argument for rising price pressures. There has also been a strong rally in commodity prices, particularly in the energy sector. Promises that President-elect Trump will embark on a major fiscal program, while the Federal Reserve simultaneously tries to promote faster growth, has

provided the catalyst for a repricing of market risk. The 10-year Treasury has risen by over 100 basis points from its summer levels with most of the increase occurring post-election. Steep rises in interest rates historically prove to be counterproductive. A rise in real rates within the context of secular stagnation increases systemic risks.

Globally, deflationary pressures persist. The trend toward populist and nationalist political ideologies threatening globe trade is one culprit. Yet, higher U.S. interest rates and a stronger dollar also offer severe headwinds to reaching the promised land of prosperity assured by President-elect Trump. The benefits of stimulus from tax cuts and increased spending occur with a significant lag, if and when enacted. Meanwhile, interest rate and currency movements happen in real time. Financial conditions are tightening. Debt remains a contractionary force which is made more difficult through higher rates. Investors are starved for high-quality sources of income. It is increasingly problematic to service debt as conditions tighten.

In the U.S., the euphoria surrounding the Trump victory is similar to periods surrounding the victories of other Republican presidents. Both Ronald Reagan, in 1980, and George Bush, in 2000, rode into Washington on the ideals of American exceptionalism. Enthusiasm quickly faded though as the reality of appointing advisors and implementing policy took center stage. For Ronald Reagan, it was exiting a recession, bringing inflation down, and putting people back to work. For George Bush, it was recovering from the shock of 9/11 and preparing the nation for war. In both cases, the markets retreated soon after the inauguration. Reagan was able to turn the U.S. economy positive and was rewarded with stock market performance of 129% during his presidency. George Bush's legacy is less fortunate, however. He presided over a financial crisis and saw stocks decline by 19% during his term.

So far, the markets have responded with surprising excitement over the Trump agenda; dare say exuberance. Some degree of deregulation and reduced taxation appear inevitable. Fiscal spending, on the other hand, faces more obstacles. It will likely be trimmed, either politically through congressional opposition or practically by bond markets overreacting to the threat of higher debt burdens. Trade and immigration policies remain the incoming administration's wild cards. Markets are assuming that few of the more provocative stances taken by then candidate Trump will be pursued by the incoming administration. We should not be surprised if markets are too self-assured and complacent.

In truth, the Trump presidency remains an unknown. Only with the benefit of hindsight will we be able to evaluate his success. He enters the White House following a subpar recovery in its seventh year. The Fed is attempting to normalize interest rates while debt levels are high. There has been a significant improvement in the unemployment rate, but structural employment problems persist. Although wages have recovered, real wages remain depressed. The number of people leaving the workforce is elevated. Productivity is suffering and shifting demographics and technology further complicate the outlook.

The populists' siren song is to return manufacturing jobs from foreign shores. It is romanticism to herald back to the good old days when American workers made

everything. However, the real problem may be more in the war of capital versus labor than foreign versus domestic labor. Machine learning and artificial intelligence threaten to revolutionize the factory floor. Tomorrow's jobs will likely be a poor match for today's labor force. Today's workers will need retraining and new skills for the future workplace. Ultimately, efforts to hold onto jobs today, by penalizing free trade, no matter how well intentioned, will raise the cost on everything without a commensurate increase in growth.

There is a certain rudimentary appeal to nationalist and protectionist urgings, but even such rhetoric present risks for global conditions which remain quite fragile. World trade has contracted during the last several years. A further contraction presents risks for all, "protected" or not. Meanwhile, the global debt burden continues to swell. Creditors remain the most challenged. To a large extent, the public sector has stepped into the private markets to support large underperforming loans. Eventually, deficit spending, increased debt, rising interest rates and a strong dollar will undermine the ability of the public sector to sustain its support, despite what the President-elect suggests. In building a casino empire, it may be smart to borrow, spend and default (and repeat), but to "Make America Great Again" we will need to try a different formula.

Like the kitten chasing its tail in pursuit of happiness, it is doubtful that current government policies will spur the economic growth officials so desire. Rather, in paraphrasing the wise old cat, economic growth is likely to come, not by frenetic action chasing economic growth by restricting the market, but by leaving the market be.

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