Quarterly Newsletter - July 2016

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Dear Client,

Brexit has happened. Justified or no, wise or not, the British vote to leave the EU was a shock to the markets. And it provides, in real time, a lesson in our way of investing.

The vote to leave was very much unexpected. Various polls and betting sites in England had been predicting a narrow but fairly certain victory for the Remain side. The equity markets wanted a Remain victory. These polls encouraged optimism. Market prices rose on Monday the 20th, then more on Tuesday, more on Wednesday and still more on Thursday. The vote results were then announced late Thursday, after the markets had closed. Remain lost. Leave won. The markets had not expected this result and on Friday the 24th they closed down very sharply. The losses continued the following Monday. The markets were loaded with fear and even open panic.

The fear was that this departure would hurt the UK a lot, and that it might hurt the EU and the Euro even more. The referendum urge might spread and Euro then entirely unravel. There was the thought that this decision by Britain to leave the Euro zone was another Lehman moment ? a moment in which an unexpected, disastrous and entirely unnecessary shock hurt the world financial system badly.

It is very true that the decision in 2008 to let Lehman Brothers fail was both disastrous and unnecessary. And it is also true that the dreadful financial and social conditions inside the Euro zone now are likewise disastrous and unnecessary. Both of these were and are entirely conscious, deliberately deflationary, policy choices. Both come from the same mindset, what might be called financial moralism. ?Let them fail. Lehman did this to themselves. Teach the s.o.b.s a lesson, let them fail.? This is the voice of the American moralists. ?Let debtor countries pay us, every single Euro they owe, in hard Euros, not the soft inflated Euros they want to use. That will teach them a lesson.? This is the voice of the European creditor countries now. The creditor countries have created a hard-Euro standard and that hard-Euro standard is spreading deflation everywhere, just as the gold standard did in the U.S. before Roosevelt came in.

Of course, we should be so lucky as to have this be another Lehman moment ? given that equities are up about 65% in the five years since then.

In the case of Brexit however the market reversal did not take five years. It took less than a week. By Thursday June 30th, exactly one week after the Leave victory and the quick equity losses the markets had made most of the losses up. Anyone who sold on Friday the 24th or Monday the 25th was feeling sad by the end of the week. And the world equity markets have continued to do very well in early July. Rumor has it that many timer hedge funds have lost a very great deal of money in this unexpected fall and even more with the unexpected recovery.

Why did the markets recover? Confidence. Confidence in the presence and power of central banks. There has been a lot of talk recently to the effect that monetary policy, easy money, has lost its punch. Such talk is silly. The Federal Reserve could refrain from raising rates. They could stop paying interest on excess reserves, which is deliberately deflationary. And if the Fed, or the ECB, were to announce that they would be willing to tolerate somewhat higher wage inflation until nominal incomes are back to rising again then both the real economy and the financial markets would recover very sharply. This is exactly what Roosevelt did when he took the country off the gold standard in April 1933. Monetary policy is an issue of confidence. It is an issue of the central bank signaling what their long term monetary intentions are. Roosevelt signaled that his intentions were reflationary. He wished to undo the deflation of the previous three years. The response of both the economy and the markets was immediate and electric. Beginning in Aril 1933 confidence and employment recovered sharply. Equities rose nearly 90% in three months.

There are similar Roosevelt style policy changes the central banks are aware of and could do now. The Bank of England has promised rate cuts in England. The UK markets are in recovery mode largely because they know the Bank of England is there and is quite capable of printing up pounds and throwing them out of airplanes if they must. In the economics literature this is known as helicopter money. It was invented and recommended by Milton Friedman. To be used in extremis only, but nevertheless to be used if necessary. Finance government spending directly by printed money. Taxes are then used not to finance spending but rather to prevent inflation. This is the way the US financed WWII and it worked quite well. Ben Bernanke has written and spoken about the power of helicopter money in the US now. And if, if, the ECB were to ease up on the idiotically tight money in Europe the threat to the Euro and the EU would vanish overnight. Inflation is better than deflation. Central banks can create and control moderate inflation whenever they want. And we therefore believe inflation is what there will be.

The market reaction to the UK referendum illustrates our way of investing because it illustrates, in a very short time period (less than two weeks) the way we think investing should proceed. In the case of the Lehman failure the market recovery took a long time to unfold. With the UK referendum the switch in ?informed? opinion was rapid. From confidence to straight panic back to confidence in micro-seconds. The markets created the confidence by rising and then the fear by falling. Many investors sold out at the bottom, and many are still out today. We did not sell. We rebalanced and bought. Our method is to sit still. Pay attention to your emotions but do not act on them. Zen-vesting.

We have no idea what will happen next. But we remain optimistic. There is a lot of ruination in a nation. And even more in markets. Invest, sit, and do not panic. This is our approach.

Jim John Richard & Ryan