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Believeland

Our offices sit less than 30 miles south of Cleveland, a city whose sports disappointments were recently chronicled in an ESPN program titled “Believeland.” Through 52 years of rooting with no championships to show for it, the fans of Northeast Ohio still “believed,” and in June their Cavaliers rewarded them with a championship victory over the Golden State Warriors, who had merely won more games this past season than any team in any season in NBA history. For the people of this area, the long wait and frequent heartbreak made this championship all the sweeter, and a staggering 1.3 million of them showed their appreciation by flooding downtown Cleveland for the championship parade. To top it off, the team was led by native Akronite LeBron James, who two years ago decided to return to the below-average Cavaliers in order to try to bring a championship to his hometown. He succeeded. It sounds like a Hollywood script, except it actually happened.

While the citizens of Northeast Ohio may have never lost belief in their teams, the broader US population has seemed to lose its belief in the benefits of free trade. The candidates in the presidential primaries battled over who could talk toughest on trade with China or other nations. Presumptive Republican nominee Donald Trump rails against China and says he is for “fair” trade and against “bad” deals. Likely Democratic nominee Hillary Clinton withdrew her support for the Trans-Pacific Partnership. Here in Ohio, Senator Rob Portman is the target of TV ads portraying him as being too soft on China, even after he accused them of currency manipulation. Of course all of this rhetoric is a result of the perception that free trade is hurting our nation, mainly through lost jobs. For decades Americans were told that free trade benefited all, and for the most part they believed. Now many have lost faith.

This is potentially dangerous if it leads to less or more restrictive trade. Free trade raises standards of living by making goods more affordable and increasing economic growth. Take an extreme example: If the US all of a sudden stopped allowing imports of steel, the cost of steel here would increase. This would make cars that are produced here more expensive. It would make machinery more expensive. It would dramatically disrupt any industry that uses steel as an input to its manufacturing.

Of course when steel is imported it does hurt domestic steel producers and their employees. And when a company chooses to move certain manufacturing offshore it hurts those people in the US that would otherwise fill those jobs. The problem with free trade, or the problem with the *case* for free trade, is that the costs of it are visible while the benefits are much less so. When someone in Taiwan assembles an iPhone it is simple to deduce that that is a job that an American did not have the chance to do, and it is easy to mentally “add 1” to the US unemployment column. But the benefits are less obvious. It isn’t clear what the price of the phone would be if it had to be manufactured in the US, but we can be fairly sure it would be higher. A cheaper iPhone means people have more money to spend on other things. It also means that more people can afford it, which improves their standard of living. With more people (than would otherwise do so) buying iPhones, Apple is able to spread the cost of design and development over a larger customer base, which helps to reduce the cost (and price) even more. And through this free trade the citizens of Taiwan are able to use their wages to buy iPhones for themselves, further enriching Apple and its tens of thousands of American employees.

So, while they are no less real, the benefits of free trade are less obvious than are the costs. Unfortunately, this makes it an easy target for the politicians who know the electorate is looking for a scapegoat for our economic ills. When in doubt, blame China, or Mexico. But if free trade were such a bad thing and costing this country so many jobs, would we be adding 200,000 jobs per month? Would our unemployment rate be 5% (granted, the labor participation rate has declined, for various reasons)? In Europe they have job security – and double-digit unemployment. With all the jobs we have "shipped overseas" one would have expected unemployment to be at an astronomical level. But it's not - because of the immeasurable beneficial effects of free trade.

To be clear, there are those that free trade hurts, and the US economy is by no means roaring right now. But it is easy to lose perspective and forget how well the vast majority of our population lives today. Many of the products and services we take for granted didn't exist a generation or two ago or were far inferior or cost more in terms of hours worked to acquire. One can walk into Wal-Mart and buy a bicycle for $70, a microwave for $40, and a DVD player for $30. All of this resulted from the combination of capitalism and free trade, two ideas currently under attack. It is interesting how often humans repeat the mistakes of the past. Time will tell if the recent erosion of "belief" leads to counterproductive policies or is just a blip.

It would be easy to connect this with the vote by UK citizens to leave the European Union (Brexit) in late June, but it would appear that the main impetus behind that outcome was dissatisfaction with immigration policy. US stocks declined 3.6% on the news of the vote and another 1.8% the following Monday. The fear was that other nations would follow Britain's lead and trade would become more difficult. As we type this the US market has recovered nearly all of its losses. Whether the UK is in the EU or not (and there is still a possibility that it will not actually leave), we would expect it to remain an important trading partner for the rest of Europe as well as the US.

Stocks overall posted modest gains in the second quarter and have been flat for nearly 18 months. Market participants continue to be transfixed by fear, worried that the next financial crisis may be around the corner. One sign of this mindset is the inexplicable fascination with bonds, despite yields that are negative in some cases. A year or two ago we saw yields on some short-term sovereign debt go negative, and that was considered a milestone. But now it is happening even further out on the yield curve. Ten-year bonds in countries such as Japan and Germany now yield well below 0%. This means that if you buy a German bond today and hold it for ten years, you are *guaranteed* to get back *less* than you invested. Think of it as paying someone $100 with the agreement that, in return, he or she will pay you $99 over the next ten years. In the meantime you would be taking risk that the value of the bond you are now holding would decline in value at some point. So these bonds couple risk of loss with zero upside. Actually, that's not entirely true. There is the possibility of upside; if more and more people show an interest in purchasing these instruments with guaranteed negative return, the prices of the securities may rise and the holders would then have the opportunity to sell at a higher price before maturity, thereby generating a gain. Of course this relies on the greater fool theory, which can be hazardous. We believe investing based on the idea of fundamental value leads to better long-term results.

Not only are bonds around the world in a bubble, it would appear to be one of the most obvious bubbles in history, if we limit our assessment to before-the-fact. With the housing and oil manias there was at least a narrative that one could use to attempt to justify why the high prices were sustainable. But with sovereign bonds yielding less than zero, there is literally no narrative to turn to (returns are negative!), other than the belief that someone else (central banks, institutions, etc.) will be willing to pay even more in the future, at an even more negative return. We don't know when the bond bubble will end, but we know it will - and that when it does there will be many casualties.

Another sign of fear in the market is the proliferation of low-volatility strategies in the equity market. The focus on downside protection and stability is intense, for a multitude of reasons. Such attributes can generally be good for portfolios, but like anything else they can become overpriced, as they look to us to be now. The relative free cash flow yields of stable stocks, the relative forward P/E ratio of low-beta stocks and other related measures are at extreme levels. As such we are looking for new ideas in the more economically-sensitive parts of the market.

In the last month the Cavaliers won the city's first championship in 52 years and the baseball Indians won 14 straight games, a feat the team had never accomplished in over 100 years of existence. The consensus belief today is that global/domestic economic growth will remain moribund for many years to come and that interest rates will never rise. But as we learned in Northeast Ohio, things can change.

Best regards,

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