Q3 2016 Market Review & Outlook

Morgan Creek Capital Management

MORGAN CREEK CAPITAL MANAGEMENT

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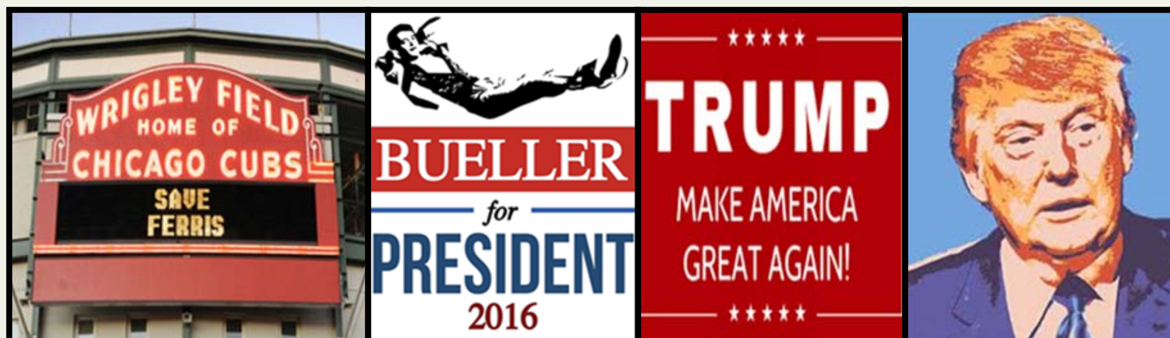
Letter to Fellow Investors

Save FairUS



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In 1985, legendary film director John Hughes sat down for a week and wrote his "love letter to Chicago" – a story of a slacker teen boy (Ferris Bueller) who decides to take a day off school to show his friend (Cameron Frye) some of the good things in life, and the result was the iconic movie *Ferris Bueller's Day Off.* In an interview with the AMC Blog, Hughes said, "I really wanted to capture as much of Chicago as I could. Not just in the architecture and landscape, but the spirit." That spirit is everywhere in the movie from scenes set on Lakeshore Drive on Lake Michigan to the spectacular vistas from the top of the Sears Tower (now called the Willis Tower for the younger generation who don't know that Sears was once the dominant retailer in the U.S. instead of a stock to be perpetually short). From mimicking the open outcry hand signals in the trading pits of the Chicago Mercantile Exchange (yes, there was a time when people traded commodities with people instead of machines) to the glorious works in the Art Institute. It's there in shots along the Miracle Mile of Michigan Avenue and in the Friendly Confines of Wrigley Field (home of the World Champion Chicago Cubs). Hughes shot the film in three months in 1985 and released it in June of 1986 to rave reviews of critics and audiences (including yours truly and his soon-to-be wife who were married two weeks later) and the film was a huge commercial success grossing $70 million after costing less than $6 million to produce. Rolling Stone magazine had an article celebrating the decision by the Library of Congress in 2014 to include the film in the National Film Registry as a work that is "culturally, historically, or aesthetically significant" (we agree on all three). 2016 was the 30th anniversary of the movie (and my marriage), and Paramount re-released the movie, which of course merited another viewing. *Ferris* was just as good as the first twenty-something viewings (which brought it to mind for the opening of this letter). One of the great parts of the movie is the breaking of the fourth wall, where an actor speaks to the camera/audience to reveal something happening in the film or to share their personal thoughts (like using the parentheticals in these letters) and we will explore some of Ferris's musings below.

The movie opens with some classic shots of the Chicago skyline, the Gold Coast and O'Hare Airport, with some radio talk show hosts talking about what a beautiful day it is in Chicago and then cuts to a darkened room with Ferris Bueller huddled under the covers with his parents standing over him.

Katie Bueller: ***"Feel his hands, they're cold and clammy."***
Ferris: ***"I'm fine, I'll get up."***
Tom & Katie Bueller: ***"No!"***
Ferris: ***"I have a test today. I must take it. I want to go to a good college so I can have a fruitful life."***
Katie Bueller: ***"Honey, you're not going to school like this."***

As his parents leave the room, Ferris pops out of bed and gives us the first of many glimpses into his evil genius and ingenuity. It is these elements of Ferris's character (and the setting in Chicago and the Cubs, which we will discuss later) that make this movie the perfect opening for this quarterly letter. Given what we just experienced in the U.S. elections, many of the themes, scenes and events in the movie are symbolic of, related to, or downright just déjà vu-ish of the election. If life imitates art, then here is yet another example. As Ferris throws open the blinds and begins fiddling with his stereo equipment to fake his voice, he breaks the fourth wall by turning toward the camera and saying:

Ferris: ***"Incredible, one of the worst performances of my career and they never doubted it for a second. The key to faking out the parents are the clammy hands, it's a good non-specific symptom. I'm a big believer in it. A lot of people will tell you that a good phony fever is a dead lock, but, you get a nervous mother, you could wind up in a doctor's office. That's worse than school. You fake a stomach cramp, and when you're bent over, moaning and wailing, you lick your palms. It's a little childish and stupid, but then, so is high school."***

Given the stunning surprise victory of Donald Trump over Hillary Clinton, this passage takes on a myriad of new meanings insofar as there are many who would argue that Trump was "faking it" throughout the entire campaign (some even mused that he was really a Democratic operative running simply to destroy the Republican party) and there are plenty of people who thought he was "childish and stupid," but in the end, the people that mattered (the voters) never doubted it for a minute and he won. There is a thesis (which I hope is correct), that Trump was indeed performing all throughout the campaign, following something called the *Southern Strategy*, where a candidate attempts to win over white voters by playing on common phobias and creating a coalition to secure enough Electoral College wins to counteract the northeast and west coast bias toward the Democratic side. The danger of this strategy is that given demographics (white people becoming a smaller proportion of the overall population), you have to win near unanimity of this cohort in order to win the election, which means the rhetoric has to be pretty extreme (and extreme it was). It is also important not to forget that this is not just a Republican strategy (although primarily) and that Bill Clinton won the White House using some of the same tactics. The rest of the thesis goes to something that I have been talking about for many years, that there are no longer the traditional two parties. There are simply those IN power and those who are OUT of power, and those who are OUT do or say whatever it takes to get IN, and those who are IN do or say whatever it takes to stay IN. Trump's performance in this regard was actually spectacular, as he achieved moving from OUT to IN not once, but twice, both against the Republican Party in the primary and then against the Democrats in the general election. With the ultimate prize being so important (top of the power food chain) the performance had to be perfect (there is another funny irony that with Ferris the symptom was clammy hands given all the jokes about Trump's hands). The thing about elections is that no matter how many great ideas you have, or how great a person some think you are (lots of people thought Mitt Romney was really smart and had great ideas), if you don't actually get elected it doesn't matter because you can't implement anything if you lose.

Ferris: ***"How can I possibly be expected to handle school on a day like this? This is my ninth sick day this semester. It's pretty tough coming up with new illnesses. If I go for ten, I'm probably going to have to barf up a lung, so I better make this one count."***

The final part of the thesis is that now that the goal of winning the White House has been achieved it is time to "make this one count" and it is no longer necessary to be the extreme personality that was needed to win, but it is

time to be presidential. Many of the great presidents from Kennedy to Reagan to Clinton used this same strategy of running way out on the extreme and then governing from the middle. Perhaps it is just wishful thinking (but we don't think so) that Trump was this strategic and that he was simply channeling his inner Ferris, but this path to power is not without precedent. In order to have the epic day in Chicago that Ferris is contemplating, he needs some supporting cast. In other words, he needs someone with transportation since he was not endowed with a car. A president with no political experience has the same problem; he will need to find a supporting cast with the "cars" that can navigate Washington and help him get to where he needs to go (and where he has promised a whole bunch of others he will take them). Ferris reaches out to his friend Cameron who does indeed have a car, but who is not excited about getting out of bed (as he is home from school and actually sick) to participate in Ferris's adventure.

Ferris: ***"I'm so disappointed in Cameron! Twenty bucks says he's in his car right now debating on whether or not to go out."***
Cameron: [in his car] ***"He'll keep calling me. He'll keep calling me until I come over. He'll make me feel guilty. This is ridiculous, ok I'll go. I'll go. I'll go. I'll go. I'll go. Sh%#!"***

Next we cut to Ferris in the shower (with wet hair neatly styled into a Mohawk) – again breaking the fourth wall – giving us some thoughts on the fact that he really did have a history test, but why it doesn't matter if he misses it. Again the comparisons to the election are striking. One of the central tenets of the Trump agenda was rebelling against the far left and the socialist tendencies that many ascribe to the Democrats today. In fact, part of the trouble for Hillary was that Bernie Sanders (a self-proclaimed democratic socialist) pulled apart the base of the party by appealing to those who do believe (like the Europeans Ferris was studying) in socialist philosophy. As believers in strong form capitalism, this was disconcerting to us, and we would make the point that there actually was risk in the U.S. becoming "European" (or worse yet - Japanese) if we didn't make some significant policy changes to combat the Killer Ds of demographics, debt and deflation.

Ferris: ***"I do have a test today, that wasn't bull****. It's on European socialism. I mean, really, what's the point? I'm not European. I don't plan on being European. So who gives a crap if they're socialists? They could be fascist anarchists and it still doesn't change the fact that I don't own a car."***

Unfortunately for Ferris, he was born a few decades before Uber (and Lyft), which have greatly eased the transportation headaches of car-challenged teens. The great thing is that because of investments in disruptive innovation, for many, there is no need to own a car today. The sharing economy is just one example of the type of creative disruption that is emanating from Silicon Valley. The refrain of the Trump campaign was Make America Great Again (#MAGA) and while we might argue that America is already great, we would argue vehemently that the innovation and wealth creation coming out of the Bay Area are what make America truly awesome and policy needs to be focused on making it easier (read: less regulation) and keeping it profitable (read: no change to taxation of carried interest).

Allow me one quick rant on the attack on carried interest. The idea that when an investor puts capital at risk (meaning it could go to zero and there would be no profits to tax) that the return on that investment is somehow the same as fixed income interest (which is protected by contract) is ludicrous. The concept of carried interest came from the ancient shipping practice that captains were awarded 20% of the goods they "carried" should the voyage be successful. There was huge risk in taking wooden ships across the ocean and when capital is put at risk,

the gains on that investment are in no way, shape or form income. Profits earned from venture capital investments must be taxed at capital gains rates, period. Now I can go further and explain why having a capital gains tax rate of zero would lead to much higher overall tax revenues (encourages investment & innovation which leads to more jobs which leads to more income which leads to more taxes), but we will leave that for another time.

After complaining about not having a car, Ferris sings into the hand-held showerhead a verse from Wayne Newton's *'Danke Schoen'* as he completes his shower.

Ferris: ***"I recall Central Park in fall, how you tore your dress, what a mess, I confess..."***

Suffice it to say that there have been many great leaders who have made what many of us would consider mistakes in the fidelity department. We don't have enough psychology training to know if it is a chicken or egg issue (does the character trait lead those men to pursue power, or does the position, once attained, create temptations that can't be resisted?) so we won't explore the issue too deeply, other than to say that choices people make in their personal life should not necessarily disqualify them from serving in public office and we probably should spend more time talking about more substantive issues. Ferris emerges from the shower with his head wrapped in a towel and continues the conversation about the Europeans and offers some commentary about fascist anarchists.

Ferris: ***"Not that I condone fascism, or any -ism for that matter. -Isms in my opinion are not good. A person should not believe in an -ism, he should believe in himself. I quote John Lennon, 'I don't believe in Beatles, I just believe in me.' Good point there. After all, he was the walrus. I could be the walrus. I'd still have to bum rides off people."***

Again, the parallels to the campaign and the Trump himself in this passage are uncanny. On many occasions over the past couple of years, Mr. Trump has made comments that were so outrageous that they struck many people as being reminiscent of the 1930s and 1940s European leaders where the word fascism would not be out of context. Ferris's point that he doesn't condone any -ism is probably a pretty good philosophy to live by as avoiding fascism, anarchism, communism, socialism, Marxism, authoritarianism, racism, cynicism, etc. is a better way to approach life (we would also argue that avoiding populism, nationalism, isolationism and protectionism is a better was to run a government). We disagree with the extreme comparisons that some have made, just as we were skeptical eight years ago when similar assertions were made that President Obama was really a Muslim who was secretly attempting to move the country toward socialism. On this point, the evidence is fairly strong against the Obama as a socialist assertion since after recovering from the global financial crisis, GDP has recovered, the stock market stands near all-time highs, employment has surged and the number of workers in the government has actually fallen. Clearly there were some things said on the campaign trail that we fundamentally disagree with, but the hope is that they were all part of the performance to achieve the end goal. There is one significant potential downside to the use of the Southern Strategy in that by having a leadership figure model such extreme behavior, some of the followers feel emboldened to act in ways toward minorities that are simply unacceptable. There have been some isolated reports of violence against immigrants and persons of color in days following the election and we can hope that these reflect a fringe element (that unfortunately exists whoever is in office) and that once in office President Trump will act more presidential and not condone this type of behavior (we maintain he should directly speak against it). In his victory speech he did say the things we need to hear in this regard, saying, **"Now it is time for America to bind the wounds of division, I say it is time for us to come together as one united people. It is time. I pledge to every citizen of our land that I will be president for all of Americans."** It is

easy to read words off a teleprompter, but much harder to live up to those words and actually become an inclusive leader. Obviously, if he were to move to center (which he will need to do to be truly successful) he will lose the support of the most extreme fringes of the populace (but he already won the prize), but that is a small price to pay for doing the right thing for America.

The second part of the quote – that people should believe in themselves – so clearly applies to The Donald that it is almost scary. There are very few people who have the self-confidence that Trump has and while he might have crossed over the line into arrogance a time or two, oftentimes the best way to judge is whether someone's statements are backed up with outcomes. Take the parallel of the professional athlete who was judged to be overconfident, but in the end proved capable of delivering on the promises they made. We did an *Around the World with Yusko* webinar a couple weeks before the election entitled *Election 2016, Dynasty vs. Dysfunction: Market Impact of the Lesser of Two Evils* in which we discussed the potential impact of the election on the capital markets and we opened the presentation with our traditional Words of Wisdom slide and had two quotes each from Trump and Hillary and his first one was ***"My whole life is about winning. I don't lose often. I almost never lose."*** This example of Trump channeling John Lennon on steroids could easily be considered the height of arrogance except that he was able to back up his words with results. Few people (outside his core supporters) really, truly thought he could win and coming into Election Day, the pollsters, pundits and betting sites all gave Trump a very slim chance of actually winning. The Donald clearly believes in himself and he proved (yet again) that he is the Walrus. Ironic too is that now that he is president he will have to bum rides off (heavily armed) people just like Ferris. Taking a really optimistic view for a moment, what we are desperately in need of in America today is optimism and confidence and a leader who can exude those characteristics could be a godsend as we struggle against the gale force headwinds of demographics, debt and deflation. As we wrote in our letter on George Soros, there is a reflexivity that can occur when animal spirits return and people are energized and confident about the future. What we need is a leader who can discard the caustic and divisive rhetoric that was needed to win the presidency and move to a truly inclusive and inspirational place in the center to ignite those animal spirits and turn the reflexive vicious cycle we are caught in to a reflexive virtuous cycle that actually would be in the spirit of making America great again (we maintain that America is great already, but is definitely at risk of decline).

In the next scene the principal of the school is talking to his assistant and reiterates the point about how extreme rhetoric can spiral out of control and become dangerous.

Ed Rooney: ***"What is so dangerous about a character like Ferris Bueller is he gives good kids bad ideas. Last thing I need at this point in my career are fifteen hundred Ferris Bueller disciples running around these halls. He jeopardizes my ability to effectively govern this student body."***
Grace: ***"Well, makes you look like an ass is what he does, Ed."***
Ed Rooney: ***"Thank you, Grace. I think you're wrong."***
Grace: ***"Oh, he's very popular Ed. The sportos, motorheads, geeks, … wastoids, dweebies, … they all adore him. They think he's a righteous dude."***
Ed Rooney: ***"That is why I have got to catch him this time. To show these kids the example he sets is a first class ticket to nowhere."***

Principal Rooney nails it in the first sentence when he talks about how charismatic leaders can trigger extreme behaviors that followers might not have been willing to embrace in the absence of the leader essentially giving them

"permission" to act out. When Rooney uses the word "disciples" it really resonates with the near religious fervor exhibited by some Trump supporters. If we think of Ed Rooney as the embodiment of "the Establishment" then Trump's constant attacks on the campaign trail did indeed achieve the outcome that Grace describes, he made the Establishment look like an ass, engendered serious negativity toward "the swamp" of Washington and (in the end) absolutely jeopardized the Establishment's ability to govern. Grace's next line about the broad based popularity of Ferris is one of my personal favorites of the movie as people all across America, from all walks of life, from investment managers, to garbage collectors, from those in the military to retired school teachers, from entrepreneurs to politicians all think Donald Trump is a *righteous dude*. Rooney's final comment was just like the reaction of the Establishment, to make the case that Ferris's ideas and actions were a ticket to nowhere, but the Trump disciples think that jumping on the bandwagon is a ticket to the promised land (because he told them so).

The next scene is the incredibly memorable (come on, we have all said this first line in real life) image of one of Ferris's teachers doing role call for the first class of the day.

Economics Teacher: ***"Bueller...? Bueller...? Bueller…?"***
Student: ***"He's sick. My best friend's sister's boyfriend's brother's girlfriend saw Ferris pass out at 31 Flavors last night. I guess it's pretty serious."***
Economics Teacher: ***"Thank you, Simone."***
Student: ***"No problem whatsoever."***

The second line is the inspiration for the title of the letter *Save FairUS,* which I guess actually could be just another way to say Make America Great Again (but #MAGA didn't get me the link to Ferris Bueller). Simone is pointing out that Ferris (according to the rumor mill and the extremism of the telephone phenomenon where each link in the chain exaggerates the situation a little) is sick and it looks like it is pretty bad. Yes, I am mixing the analogies here in that sometimes Ferris is a metaphor for Trump and sometimes he is a metaphor for America, but with a little willing suspension of disbelief it will all make sense in the end. The irony of Ferris collapsing in 31 Flavors is interesting to me in that America is like the famous ice cream store (with even more than 31 flavors). Polarization across the different factions is causing the sickness and it could indeed get pretty serious if we allow it to continue to foment instead of coming together in a Neapolitan unity.

We cut to a scene of Ferris waiting for Cameron to come pick him up to begin their day and he is making a making a horrible noise with a clarinet as he tells us,

Ferris: ***"Never had one lesson!"***

There are many who assert that Trump has no experience in politics and no experience in governing and will end up making the equivalent of Ferris's cacophonous noise when he becomes president. It's kind of hard to argue inexperience for a man who has built businesses (yes, some have failed, but learning from failure makes us better), managed capital in the real estate markets, worked with lenders, hired and (infamously) fired people, signed the front side of a paycheck (a common criticism of many in Washington is they have only signed the back), has managed professional and personal crises and transitions (not all pleasant, but again a chance to learn and grow) and, let us not forget, just completed an astonishingly successful strategic and tactical plan to win the presidency, so let's nix the no experience complaint. All that said, Trump is in need of some serious lessons (and will need them fast) on how to work within the system in Washington, as he has a lot of fence mending to do (not just with

Democrats, but Republicans too) and he will need lots of coaching and help to be effective. There are many who have been angered by the appointment of "Wall Street types and D.C. fat cats" to his transition team since they seem to want to take the "drain the swamp" campaign slogan literally and for some reason think that the president-elect can walk in and send everyone (including elected representatives) packing. Newsflash: the lobbyists are not going away. There are plenty of people who supported Trump financially and politically who expect (and will get) payback in the form of a position in the administration (that is how it works) and all the other elected officials in Washington have their own constituencies and supporters to answer to (and curry favor for), so there will be no clean sweep. Making promises on the campaign trail is easy, keeping campaign promises is hard (oftentimes impossible), so blowing harder into the clarinet will just making it sound worse without some lessons. Sadly, the person who was the absolute best at making the transition that Trump is about to go through, President Reagan, is no longer with us, but there are plenty of people who know how to be effective in managing the system and effecting change in the system and they are ready and willing to help. The key (and challenge) will be selecting those who are altruistic public servants (they actually do exist) and avoiding the self-interested self-servants. It can be done, but it will be hard.

In the next scene, Principal Rooney tries to inform Ferris's mom that he has not been an exemplary student this year and he tells her that he is determined to catch Ferris and would have no reservations about holding him back another year.

Ed Rooney: ***"It usually is. So far this semester he has been absent nine times."***
Katie Bueller: ***"Nine times?"***
Ed Rooney: ***"Nine times."***
Katie Bueller: ***"I don't remember him being sick nine times."***
Ed Rooney: ***"That's probably because he wasn't sick. He was skipping school. Wake up and smell the coffee, Mrs. Bueller. It's a fool's paradise. He is just leading you down the primrose path."***
Katie Bueller: ***"I can't believe it."***
Ed Rooney: ***"I've got it right here in front of me. He has missed nine days."***
Ferris: ***"I asked for a car, I got a computer. How's that for being born under a bad sign?"***

Mrs. Bueller is clearly befuddled by the assertion that her beloved (and perfect) son would be skipping school and she is certain that everything in fine and that Ferris is indeed home sick in bed. Rooney tries to warn her of the conniving nature of Ferris and that everything is not as it appears. There were plenty of people who tried to make the case that Trump was closing in on Hillary, despite all the polls to the contrary, and in just one more example of incredible parallel, as Rooney is staring at his screen that shows Ferris having nine absences (like all the polls that showed Hillary had a huge lead right up until Election Day), suddenly his computer screen starts counting down from nine to two and we see a cut away to Ferris sitting at his computer looking at the same screen. Ferris has hacked into the school computer system and is changing his absences in real time as he complains that he asked for a car and got a computer instead (which he has clearly mastered and is getting some good use from). The parallel comes from the allegations of Russia hacking into the election, and the image of Vladimir Putin sitting at a computer (probably while he is FaceTiming with Trump) and erasing votes for Hillary is kind of funny. Whether the Russians actually did hack any voting results is pretty farfetched (not impossible, but unlikely), but it sure made for some good reading in the media and was great fodder for *Saturday Night Live*.

We switch to Cameron Frye's home in Lake Forest (a tony suburb north of Chicago) and we see a lavish home with

a separate glass room next to the garage that houses Cameron's father's prized possession. Ferris and Cameron walk toward the car and Cameron begins to speak as Ferris caresses the bright red sports car.

Cameron: ***"The 1961 Ferrari 250GT California. Less than a hundred were made. My father spent three years restoring this car. It is his love. It is his passion."***
Ferris: ***"It is his fault he didn't lock the garage."***
Cameron: ***"Ferris, my father loves this car more than life itself."***
Ferris: ***"A man with priorities so far out of whack doesn't deserve such a fine automobile."***
Cameron: ***"No. No! Apparently, you don't understand!"***
Ferris: ***"Wow."***
Cameron: ***"Ferris, he never drives it. He just rubs it with a diaper. No! Ferris, forget it. You're just going to have to think of something else. I'm putting my foot down."***

The Donald is known for his expensive tastes, garish displays of wealth and penchant for things that others can't have (like his Mar-a-Lago home in Palm Beach), so having Ferris covet the Ferrari is a perfect analogy. Ferris gets what he wants and so does Trump. Ferris's rationale for taking the car for a ride (over Cameron's protestations) is a micro-analogy for the campaign. Trump wanted the presidency and everyone protested (none harder than the other 16 GOP candidates) and he would say it was the Establishment's fault for not locking the garage (not giving people what they wanted and needed). Trump simply took it as he would agree that those lifer politicians who valued their positions more than life itself didn't deserve the positions in the first place. When the framers set up the government, political service was a two-year gig (then you went back to work on the farm or in the business) and it was a means of giving back to your country, but over the years it has become an end in and of itself and one could argue that far too many politicians are more concerned about keeping their positions than doing the right thing. Cameron (kind of) tries to stop his friend, but Ferris, like Trump, doesn't lose. As Ferris revs the engine (such a sweet sound) and pulls slowly out of the garage, Cameron tries one last attempt to stop the madness.

Cameron: ***"How 'bout we rent a nice Cadillac? My treat! We could call a limo! A nice stretch job with a TV and a bar! How about that?"***
Ferris: ***"Come on! Live a little! Look, it's real simple. Whatever mileage we put on, we'll take off."***
Cameron: ***"How?"***
Ferris: ***"We'll drive home backwards."***

Ferris's line of "Live a little!" is reminiscent of many of the campaign slogans and sound bites along the Trump train ride over the past eighteen months. Trump was extraordinarily good at telling people what they wanted to hear: "I'll get your jobs back;" "I'll build a wall to keep out illegals;" "I'll get GDP growth back to 6%;" "I'll cut your taxes so you have more to spend," and plenty of other feel good themes that appealed to the masses and engendered support for his grand plan. When challenged on how he would actually do all the things he promised (like Cameron asking Ferris how they would get the miles off) he always had an answer and (most importantly) he said it with confidence and he never worried about the pesky details of whether his solutions were practical or even possible. So away they go toward school to pick up Ferris's girlfriend to come along on the adventure. Cameron does a phony phone call to the school to say that Sloane's grandmother has died and that she needs to be excused for the funeral.

Sloane: ***"What are we going to do?"***

Ferris: ***"The question isn't 'what are we going to do,' the question is 'what aren't we going to do?'"***
Cameron: ***"Please don't say we're not going to take the car home. Please don't say we're not going to take the car home. Please don't say we're not going to take the car home."***
Ferris: ***"If you had access to a car like this, would you take it back right away? Neither would I. It is so choice. If you have the means, I highly recommend picking one up."***

Sloane's question and Ferris's answer again epitomize the Trump attitude toward life and the campaign. Everything is fair game and he was going to do (and did) everything. In business Trump has been successful in many endeavors from real estate to media and entertainment to leisure, and his can-do attitude actually ***could*** be a much needed breath of fresh air in Washington. Cameron tries to implore Ferris to take the car home, just as many people have implored Trump not to enter a particular real estate market, not to over diversify his business interests and not to enter the presidential race. But like Ferris, who is emboldened to keep driving the more Cameron says please go home, Trump has always been emboldened by those who said he couldn't. In fact, there is an amazingly prophetic video of President Obama and Seth Myers roasting Trump at the 2011 White House Correspondents' Dinner in which they essentially bait him into running for president. In the most amazing part they suggest that he will run as a Republican (switching from his life-long Democratic affiliation, remember he was a friend and supporter of Hillary & Bill for years) and as you watch the video you can almost see the wheels turning in his head saying, "you think this is funny, huh, just wait." Who's laughing now? Perhaps he was thinking of the last line above saying if you had access to a job like that, would you turn it down? Neither would I. The presidential job is, like the Ferrari, "so choice," and it turns out that Trump did indeed have the means to pick it up.

The perfect fit of the next scene to the current economic, market and political environment is quite extraordinary.

Economics Teacher: ***"In 1930, the Republican controlled House of Representatives, in an effort to alleviate the effects of the... Anyone? Anyone? The Great Depression, passed the... Anyone? Anyone? The tariff bill? The Smoot-Hawley Tariff Act? Which, anyone? Raised or lowered...? Raised tariffs, in an effort to collect more revenue for the federal government. Did it work? Anyone? Anyone know the effects? It did not work, and the United States sank deeper into the Great Depression. Today we have a similar debate over this. Anyone know what this is? Class? Anyone? Anyone? Anyone seen this before? The Laffer Curve. Anyone know what this says? It says that at this point on the revenue curve, you will get exactly the same amount of revenue as at this point. This is very controversial. Does anyone know what Vice President Bush called this in 1980? Anyone? He called it something –doo economics, "Voodoo" economics."***

We have been mired in a time that closely resembles the 1930s for years as zero interest rates, high levels of government debt and demographic headwinds have slowed economic growth. The rise of nationalism and a backlash toward global trade after WW I had left the country seeking ways to try to ameliorate the effects of a growing recession that eventually became The Great Depression, and the government turned to the age-old idea of trade barriers. Many (myself included) would argue that the decision to adopt the Smoot-Hawley Tariff Act was one of the worst possible things that the U.S. could have done at the time. One of the primary messages of the Trump platform during the campaign was a war on trade, which is a key component of his version of Southern Strategy (it also played well in the Rust Belt which helped tip the scales to victory). Trump promised to get the jobs back that have been lost as the manufacturing of things like furniture, textiles and cars has moved to China and other developing markets. It was a bad idea in the 1930s and it is a bad idea today. The real risk here is after the election, the Republicans now have control of the presidency and Congress (as they did under President Hoover)

and while there are some who would argue that the Republican sweep is a blessing because "things will get done," sometimes doing nothing at all can be preferable to implementing unsound policy (like erecting trade barriers). To those who want to compare Trump to Reagan, the biggest difference is that Reagan began the march toward globalization that ended in the fall of the Berlin Wall and ushered in the greatest period of economic prosperity the world has ever seen. It seems difficult to compare Trump to Reagan when Trump's talk (hopefully just campaign rhetoric) about erecting walls and moving away from globalization could not be further from Reagan's vision and policies.

Further to the point, David Ricardo was right nearly 200 years ago when he wrote about the theory of comparative advantage, that each country should produce what they are best suited to produce and then trade. Rather than try and put the genie back in the bottle and try to bring old-line manufacturing jobs back to the U.S. through restrictions on trade, we should focus on taking advantage of our extraordinary advantages in technological innovation to create more jobs in the knowledge economy and advanced manufacturing. We need to focus on harnessing the power of digital labor (the intersection of big data, computing power and scientific advancement) and move the focus toward new methodologies of education and retraining to compete in the New World. One thing that Trump brings to the table (his huge self-interest) is a return to the Adam Smith's invisible hand where we stop focusing people's actions on providing for the good of society, but rather let individuals focus on self-interest that will ultimately create the maximum economic uplift.

Another art imitating life moment comes from the second half of the quote from the economics teacher about the Laffer Curve and George Bush's famous line about Voodoo economics. There was a lot of discussion about taxes during the campaign and a lot of promises were made about lower taxes (although Trump never did go to the "read my lips, no new taxes" phrase of George H.W. Bush) and under the current system many of these promises are likely to be broken (as the numbers don't foot). While there is some merit to the Laffer Curve concept (although how can you take the name seriously) and if we were to lower corporate tax rates (and reduce loopholes) we might see more revenue from corporations and, more importantly, we would likely see an increase in investment (which would temporarily lower tax collections, because it reduces current income), but the increase in long-term growth would boost future tax revenues by a greater degree. When it comes to personal taxes, there is an easy solution. Abolish income tax. Now before readers go crazy, the idea is not to abolish taxes, but rather to move to a consumption-based tax system that would restore incentives to maximize income and wealth creation (more innovation from the lower/zero capital gains rates and the preservation of carried interest treatment discussed above) and would reduce the overall cost of the tax system. Taxing income is silly. It dis-incentivizes wealth creation and encourages special interests to lobby to create loopholes in the system that allow the wealthy (like Trump himself) to avoid taxes through creative structuring. There are three key benefits to taxing consumption, 1) you can't cheat; taxes are seamlessly collected at points of sale, 2) you capture the incomes generated in the black market (estimated at $2 trillion) that avoid taxes today, but when someone who hides their income buys an expensive car, house or bottle of wine you collect taxes and 3) you eliminate an insidiously complex and arcane system and free up lots of intellectual capital for more creative pursuits. One thing Trump brings to the White House is a businessman's perspective. Let's hope he sees the merits of this type of simple system to help create better incentives, greater innovation and business formation and greater overall government revenue (to enhance needed services).

So Ferris wheels the car into a parking garage, and the trio is approached by a rather sketchy looking pair of garage attendants.

Garage Attendant: ***"You fellas have nothing to worry about. I'm a professional."***
Cameron: ***"A professional what?"***
Sloane: ***"What could happen to it? It's in a garage."***
Cameron: ***"It could get wrecked, stolen, scratched, breathed on wrong, or a pigeon could poop on it, who knows?"***

Cameron's worry about the attendants is well -placed here. Many people (particularly those who voted against Trump or for Hillary) are having the same response to the idea of Trump as the president: very uneasy and worried that he is unqualified and downright unfit to be president given his abhorrent behavior in his personal life and on the campaign trail. We will ignore the personal indiscretions for now (very few people are perfect in every aspect of their life, glass houses, first stone, etc.). We have proffered a thesis that the unseemly behavior on the campaign trail was an act to get elected and that The Donald is not just out to take the country on a joy ride (like the two garage attendants). Cameron's extreme concern for the car is similar to many who fear for the country under a Trump presidency and we can almost hear a faint echo of *Save FairUS*. From the garage, the kids walk to the Sears Tower and head for the Sky Deck (kind of a metaphor for the penthouse in Trump Tower).

Sloane: "The city looks so peaceful from up here."
Ferris: "Anything is peaceful from one thousand, three hundred and fifty-three feet."

From the penthouse (or the White House) things can look pretty calm and peaceful, but what we learned during the election was that things were pretty restless on Main Street and when you went down to street level you got a totally different perspective. One of the flaws of the Clinton campaign was they didn't come down the elevator often enough and walk around in the hustle and bustle of the streets to listen to the average American (what Trump refers to as the "forgotten men and women"). The message is that perspective is important.

Next, it is time for lunch and Ferris leads Cameron and Sloane into the finest French restaurant in Chicago where he walks past all the patrons in line, scans the reservation list and announces to the classically French Maître D' that he is Abe Froman and is ready for his table.

Maître D': ***"You're Abe Froman?"***
Ferris: ***"That's right, I'm Abe Froman."***
Maître D': ***"The Sausage King of Chicago?"***
Ferris: ***"Uh yeah, that's me."***
Maître D': ***"Look, I'm very busy. Why don't you take the kids and go back to the clubhouse?"***
Ferris: ***"Are you suggesting that I'm not who I say I am?"***
Maître D': ***"I'm suggesting that you leave before I have to get snooty."***
Ferris: ***"Snooty?"***
Cameron: ***"Okay Ferris, can we just let it go, please?"***
Sloane: ***"Ferris, please, you've gone too far. We're going to get busted."***
Ferris: ***"A) You can never go too far, B) If I'm gonna get busted, it is NOT gonna be by a guy like THAT."***

In a scene where you could easily see Donald Trump playing the "Abe Froman" role and challenging the Maître D' (and the title of Sausage King kind of fits Trump), Ferris stiffens his resolve and does not back down, even for a second. Even when Cameron and Sloane plead for him to give it up, he breaks the fourth wall once more and

makes one of the most memorable statements of the movie saying, *"you can never go too far"* (which Trump would agree with wholeheartedly and often demonstrated during the campaign). In fact, right after the election, a reporter asked Trump if some of his rhetoric was too strong and his response was, "I won, didn't I?" Ferris is also absolutely defiant in saying that if he is going to lose it will not be to a guy like *"that."* Again, the similarity to Trump during the campaign is amazing as he was adamant that he would win, but that if he were to lose, it would not be to "them," either the GOP empty suits or the Democratic machine embodied by Hillary. After Ferris and team once again make use of multiple phone calls to confuse an assumed authority figure the defeated Maître D' shows the trio to a table and quips:

Maître D': "I weep for the future."

There are many today who feel defeated by the Trump victory and are weeping for the future (both literally and figuratively) as they believe he will steer the country off course and even worry that he is so unstable that we should fear his access to the nuclear launch codes. Again, we think Mr. Trump is "crazy like a fox" and has been underestimated time and time again and we don't think he is truly crazy (or unfit to lead). While we are not ready to cheer for him yet, we are more hopeful than fearful.

So the kids finish lunch and head out to grab a taxi and run smack into the back of Ferris's dad and his business colleagues who have just finished lunch as well.

Ferris: ***"Four thousand restaurants in the downtown area, I pick the one my father goes to."***
Cameron: ***"We're pinched, for sure."***
Ferris: ***"Only the meek get pinched. The bold survive."***

Again, these lines are such a perfect description of the way that Trump lives (and wins). There were dozens of times along the campaign trail where it looked like he was "pinched" and there was no way he could win the election. From scandals related to his business interests to scandals involving his treatment (or mistreatment) of women, from the Melania plagiarism incident to his penchant for extremist remarks that were sure to alienate entire swaths of voters, from his unwillingness to release his tax returns to allegations that he "stiffed" contractors, employees and philanthropic commitments, The Donald was Teflon man. They say that "fortune favors the bold" and clearly that is a mantra that Trump follows in his life. That fortune is now going to follow him all the way to the White House.

While Ferris is enjoying all that Chicago has to offer, Principal Rooney assumes that he has simply ditched school to go to the local pizza joint and he goes looking for his quarry. He walks into the restaurant and stands next to the bar where the Chicago Cubs game in on a TV on the wall. He is preoccupied with scanning the tables for Ferris, so he half-heartedly asks the owner about the game.

Ed Rooney: ***"What's the score?"***
Pizza Joint Owner: ***"Nothin' nothin'."***
Ed Rooney: ***"Who's winning?"***
Pizza Joint Owner: ***"The Bears."***

This exchange is a great example of how the Establishment (both the GOP in the primary and Democrats in the

general election) failed to listen and ended up alienating their bases and losing their votes. We think of the owner's response of "Da Bears" as the disgust that many now feel toward Washington and the government over the years. People don't care what you know until they know that you care, and Trump convinced the masses he cared about them more than his opponents. He displayed a skillful mastery of social media where the crazier his statement, the more clicks he got, and the more times the algorithms would feed his stories to voters to solidify their commitment (this lack of balance in social media is a huge problem that is causing massive divisiveness that needs to be addressed). Poor Ed (like the Establishment) thinks he has "won" when he walks up behind a person who appears to have on a jacket similar to Ferris's signature leather coat and he proclaims victory (too soon, kind of like the Democrats on Sunday before the election).

Ed Rooney: ***"Les jeux sont faits. Translation: The game is up. Your *** is mine."***

The figure slowly turns around revealing a young woman (not Ferris) who slowly slurps some coke into her straw and spits it out at Rooney. That spit is the perfect metaphor for the election outcome. Rooney walks over to the bar to get some napkins to wipe off and as he is looking down, he misses the scene on TV of Ferris celebrating catching a foul ball at the Cubs game (Ferris, like Trump always seems to be in the right place at the right time).

We cut to the live game and Ferris, Sloane and Cameron are enjoying the sunshine and the atmosphere of the Friendly Confines.

Ferris: ***"Hey, Cameron. You realize if we played by the rules, right now we'd be in gym?"***
Cameron: ***"Hey batta batta batta hey batta batta batta SWING batta!"***

If Trump had played by the rules (less extreme rhetoric, fewer attacks on the Establishment and Hillary) he probably would have lost and would not have won the ballgame. Babe Ruth used to say that every strike out gets me closer to my next home run and was the epitome of someone who only plays hard, and plays to win. Trump plays the same way, he will take a lot of cuts, but he is prone to knocking a few home runs. He clearly hit this one out of the park and onto Waveland Avenue. As the trio strolls out of Wrigley Field, Cameron begins to get a little worried about getting the car home (like there are a few people worried about what comes next with President Trump). As a reminder of our primary theme, as they walk under the iconic Wrigley Field – Home of the Chicago Cubs sign, the words *Save Ferris* are emblazoned on the light board (most recently, those words read World Series Champions and just a quick aside, the last time the Cubs won the World Series, in 1908, we were mired in a major banking crisis and stock market collapse).

Cameron: ***"It's getting late, buddy. We better go get the car back home."***
Ferris: ***"We have a few hours. We have until 6:00."***
Cameron: ***"I'm sorry. I know you don't care, but it does mean my ass."***
Ferris: ***"You think I don't care?"***
Cameron: ***"I KNOW you don't care."***
Ferris: ***"Cameron, what have you seen today?"***
Cameron: ***"Nothing good."***
Ferris: ***"Nothing… what, what do you mean nothing good? We've seen everything good. We've seen the whole city! We went to a museum! We saw priceless works of art! We ate pancreas!"***

Ferris tells Cameron that they still have a few hours and Cameron begins to lose it a little thinking that Ferris doesn't care about him. Again, there are many who believe that Donald Trump doesn't care about anyone but himself (and maybe his empire and his family) and that he certainly doesn't really care about America and hence the need for *Save FairUS.* Ferris fires back asking Cameron what they have done today and when Cameron protests "nothing good" (like those who believe that nothing good can come from the vitriol that was spewed during the campaign and the corruption inherent in D.C.). Ferris lists all the great things they have done and says, "We've seen everything good." If we take an optimistic view for a moment (maybe a willing suspension of disbelief, but perhaps it could be real), we could make a case that Trump really does want to Make America Great Again, that he really does want to fix what is broken in Washington, that he has a vision of the good, and truly wants to effectuate change to bring that good to all of us. Realizing that this is a pretty big leap (and on thin evidence) and realizing that despite his constant reminders that he was the only one who could fix things, we will need more than The Donald to make the vision of greatness a reality, there actually have been some hopeful signs in the past few days during meetings with President Obama and the Congressional leadership that could develop into the equivalent of priceless works of art or fine French cuisine.

Now the life imitating art actually starts to get a little spooky. The camera follows Sloane and Cameron walking along Michigan Avenue and you suddenly Ferris's voice blasts over a loudspeaker.

Ferris: ***"Ladies and gentlemen, you're such a wonderful crowd, we'd like to play a little tune for you. It's one of my personal favorites and I'd like to dedicate it to a young man who doesn't think he's seen anything good today. Cameron Frye, this one's for you."***

Ferris has jumped up on a float in the Von Steuben Day parade and has grabbed a microphone amidst a bevy of dancing girls in traditional German Oktoberfest garb. Von Steuben Day is a celebration of Baron Friedrich Von Steuben who immigrated to the U.S. to volunteer for General George Washington to fight for American independence. Irony abounds. Ferris has once again seized the opportunity to be the center of attention as Trump is prone to do and the fact that it is during a German inspired celebration symbolizes the comparisons many have made between Trump and another famous historic German figure. The fact that the celebration honors an immigrant who fought for liberty while Trump has taken some hard lines against immigration and many believe Trump could be against some personal freedoms and civil liberties (again we are not in this camp) drips with irony. Finally, the linkage of the annual parade to the first president is interesting given that Trump has ascended to the presidency.

Ferris: "***Danke schoen, darling, danke schoen, thank you for all the joy and pain. Picture shows… second balcony… was the place we'd meet, second seat, go Dutch treat, you were sweet."***

Standing in a crowd of cheering fans saying thank you, thank you is clearly an image we can associate with recent events that Trump has participated in, culminating in his standing on the stage to make his victory speech. The second line kind of triggers thoughts of Trump's promise that when he built "The Wall" (our prediction is this never happens) the Mexican's would pay for it (not even go Dutch). As Ferris croons the last line of "Danke Schoen," the band suddenly breaks into the much more raucous Beatles tune, "Twist and Shout."

Ferris: " ***Well, shake it up, baby, now (shake it up, baby), Twist and shout (twist and shout), Come on, come on, come on, come on, baby, now (come on, baby), Come on and work it on out (work it on out)."***

We don't need a lot of explanation here in that Trump is clearly intending to shake things up in Washington and there will be plenty of twisting and shouting in the coming months (and years) as the battle lines are drawn on many of the proposals in the Trump agenda. What we can all hope (and we are surprisingly optimistic on) is that those in Washington will *"work it on out."* Ferris gives a stunning performance on the float, whipping the entire city into a frenzy with onlookers all joining in the singing and dancing (including an amazing flash mob) and even Ferris's father starts twisting in his office many floors above the parade route. At the crescendo of the song, Ferris grabs the baton from the bandleader (which kind of looks like a king's scepter) and takes many bows to the screams of the jubilant fans. There is no question that many of the Trump rallies had this same feel and now that he has grabbed the king's scepter as president, the challenge will be to see if he can keep the music playing and get this party started toward Making America Great Again. Cameron screams toward the throng of people for Ferris to climb down and then sums up something very interesting about Donald Trump.

Cameron: ***"Get off the float! What are you doing? As long as I've known him, everything works for him. There's nothing he can't handle. I can't handle anything. School, parents, the future, Ferris can do anything."***

The Donald told us that his life was about winning and that he rarely loses. Things just always seem to go his way. Maybe Cameron is right and there really is nothing Trump can't handle and maybe he really can do anything. We will temper that enthusiasm a little bit insofar as there is no question that Trump's accomplishments are noteworthy and his campaign plan was nearly flawless (congrats to his team and strategists), but now comes the hard part. The president can't actually just "do anything". He has to set out a vision, build consensus, forge coalitions, and he has to fight against those who would seek to derail him (to gain their own advantage). The problem with the "drain the swamp" analogy is that all the people within the Establishment are still in Washington, the only person he has displaced from D.C. is one GOP leader (whoever would have been the candidate but for him) and Hillary. All those other people have positions of power and influence and they have vested personal interests, constituencies and (most importantly and maybe most sad) very powerful special interest groups to which they "owe" things for supporting them (remember it takes $100 million to become a Senator these days). Jumping up on a parade float is great fun and so long as the police don't come and drag you down you can have a good time for a few minutes. Donald Trump needs to get things done where the stakes are much higher and while we think he is quite talented, we would disagree with his statements that "only [he] can fix" things in Washington. He will need help, and lots of it. As Ferris walks up to Sloane and Cameron as the parade is dispersing, Cameron has a few choice words for him.

Cameron: ***"You're psychotic. You're out of your mind. I can't believe you went on a (GD) parade float!"***

Again, the similarities between the movie and real life are stunning. There are a large number of people who would say (and have said quite loudly) that Trump is psychotic and out of his mind (among other things). We disagree (until proven otherwise) and will stick with the crazy like a fox description and give him the benefit of the doubt as he has said, and done, some very logical and level-headed things this week and we think many of his plans (like repealing Dodd-Frank and bringing back Glass-Steagall) could help get America back on track. If John Hughes had written a response for Ferris here we think the line would be, "I didn't just go on a parade float, I rocked the parade!" Similarly, when people say that "I can't believe Donald Trump actually ran for president," his response would be "I didn't just run for president, I rocked the campaign, and I AM the president."

So the crew strolls back to the parking garage to retrieve the car right as the two attendants pull the car down the ramp, and all appears fine. In reality the garage guys have been joyriding all afternoon (including an epic scene where the Ferrari goes airborne over a railroad crossing and you see a close-up of the license plate, NRVOUS). Ferris tips the sketchy attendant and the gang piles into the car and head north on Lakeshore Drive toward home. After a few minutes on the road, Ferris looks at the odometer, looks at the camera in horror and then asks Cameron a question.

Ferris: ***"How many miles did you say this thing had on it when we left?"***
Cameron: ***"A hundred twenty-six and halfway between three and four tenths. Why? How many miles are on it now?"***
Ferris: ***"Three hundred and one…. Here's where Cameron goes berserk."***
Cameron: ***"Aaaaaaaaaahhhhhhhhhhhhhhhh!!!!"***

As the screen flashes a rapid-fire collection of scenes of Chicago (showing the reach of the scream) and then zeroes back in on Cameron's open mouth in full scream, the comparisons with this week are evident once again. That same sound (the collective scream of the anti-Trump and pro-Hillary voters) could actually be heard on Tuesday night when CNN called Florida for Trump and it gradually became apparent to all that he was going to be the next president (one friend texted me saying he actually heard people screaming into the dark in his neighborhood). While half the nation was screaming (clearly the Trump supporters were cheering, not screaming), global markets actually did go berserk. Stock markets all around the world began crashing, Japan was down (6%), U.S. futures were down (5%), bond yields fell and gold surged 3% in a matter of minutes. Global investors were clearly convinced it was the end of the world and they were selling first and asking questions later. Well, actually, not everyone was selling. We found out the next day that some savvy investors (many who were Trump advisors like Carl Icahn) were actually buying into the panic (Carl reportedly bought over $1 billion of stocks). One of our favorite sayings is investing is the only place that when things go on sale, everyone runs out of the store and investors were not only running, they were driving away as fast as they could. After a couple hours a funny thing began to happen. Markets not only stabilized, they slowly (very slowly at first) began to go back up and by the opening of the U.S. markets on Wednesday, S&P Index futures were only down a little over (1%). Then another funny thing happened. Despite the fact that almost no one thought Trump could win (again other than him and his supporters) and most investors, pundits and market commentators had predicted a Trump victory would mean at least a (15%) to (20%) decline for equity markets, when the markets opened they began to recover and by the end of the trading day they had actually turned positive. Bond markets totally reversed and not only did yields not fall (the safe haven reaction), they began to climb and then began to accelerate upwards and then the unthinkable happened, and the narrative began to change. Suddenly investors decided that all of Trump's campaign promises to kick-start growth could actually happen and the rout was on in the bond markets. By the end of the week yields had risen so much that over $1 trillion (with a T) of bond market value had been erased. The bond markets could go really berserk next week if all the highly leveraged risk parity (or as my hedge fund friend calls it, risk disparity) funds have to start unwinding their long bond trades. If that does indeed happen, the collective scream from global savers will make Cameron's scream sound like an inaudible whimper.

While Ferris and the gang have been enjoying their day off in Chicago, Principal Rooney has been scouring the neighborhood to find Ferris and finally resorts to going to his house and ringing the doorbell. Ferris has rigged a system (a common refrain during the election) that will play a message when the doorbell rings.

Ferris: [recorded message] "***Oh, I'm sorry. I can't come to the door right now. I'm afraid that in my weakened condition, I could take a nasty spill down the stairs and subject myself to further school absences. You can reach my parents at their places of business. Thank you for stopping by. I appreciate your concern for my wellbeing. Have a nice day!"***

Ferris telling one of the freshmen earlier in the movie that he was really sick and might even need a new kidney has mobilized the student body to start collecting money to Save Ferris and someone has even painted "Save Ferris" on the town water tower. This quote is another part of the motivation for the minor tweak to the title of this letter to *Save FairUS.* We have been making the argument all year that the U.S. economy has been weakening (likely headed for recession in early 2017, just like in 2001) and that the equity markets could take a nasty spill down the stairs as valuations compressed to more normal levels that reflect how growth has fallen, earnings have declined and numerous other indicators (highlighted in our Not So Nifty Fifty List in the Market Outlook section) are saying that FairUS really is sick. It will take a lot more than talking about making changes in Washington to *Save FairUS* and it is critical that President Trump act much differently than Candidate Trump if he really does want to get things done.

The gang rolls into Cameron's house and carefully pulls the car into its special glass garage. They jack up the back, crank it up, shift into reverse, pin the accelerator down to try and erase the miles off the odometer. After a few minutes Cameron walks over to the car and looks at the dashboard.

Cameron: ***"The miles aren't coming off going in reverse."***
Ferris: ***"No? I thought that might be a problem. We have to open the odometer, roll it back by hand."***

As you would expect, Ferris (like Trump) has an answer for every eventuality (even if it does involve something a little close to, or maybe even over, the line), but before Ferris can take to dismantling the odometer, Cameron stops him. Cameron's character in the movie is a great metaphor for the American public today. At the beginning of the movie he lies in bed not wanting to get up and participate in Ferris's adventure, which is reminiscent of the fact that more registered voters chose not to cast a presidential ballot (including George and Laura Bush) in the election (42%) than voted for either candidate (26% +/- each). This very sad fact (it is every citizen's right and duty to cast their vote) speaks to the disillusionment of the American populace today when it comes to politics. Part of the reason we need to *Save FairUS,* is represented by Cameron's plodding through a day filled with amazing activities and thinking that he didn't see anything good. A large portion of the American population is downtrodden today, lacking inspiration and energy to make changes in their lives and looking everywhere (and in particular Washington) for someone to blame, from immigrants to the Establishment, from the Chinese and the Russians to the Elites or the One Percent. They think "The Man" has got them down and a target for their aggression relieves them of any responsibility for their current situation. Trump played on this anger and fear with surgical precision and capitalized on the technological advances of social media (particularly Twitter), where the algorithms have created echo chambers which foment divisiveness by feeding people only stories that support their view and, worse yet, that are negative about opposing views. In the "old days," when people got their news from newspapers, the articles were written by professional journalists who had a mandate to be fair and balanced and there were editors to make sure that stories (even when they did have an angle) stayed within editorial limits. Today, when anyone with an internet connection can be a journalist (bloggers and anyone who posts on Facebook and Twitter) and now much of the "news" is "written" by bots and then allocated out to users based on what they have previously "liked" there is much less discourse and debate and much greater polarization and rigidity in views.

Cameron suddenly wakes up from his slumber (like so many Americans aroused by Trumps strategy) and gives a soliloquy on why he needs to stand up to The Man.

Cameron: ***"No, forget it. I put up with everything. My old man pushes me around. I never say anything. He's not the problem. I'm the problem. I've got to take a stand against him. I am not going to sit on my ass as the events that affect me unfold to determine the course of my life. I'm going to take a stand. I'm going to defend it. Right or wrong, I'm going to defend it. Who do you love? Who do you love? You love a car!"***

As people suffer setbacks in their lives, many (though certainly not all) retreat and become disinterested, inactive and dispassionate about their work, their options and their lives. They begin to feel powerless. At the beginning of the movie Cameron was feeling this way as he lay in his darkened room moaning about his diastolic, but suddenly (perhaps because of his amazing day off) he decides that he can no longer sit back and be a passive participant in the events that are going to determine the course of his life. The American people sent a clear message with the election of Donald Trump that they were ready to take a stand and determine their own direction. As Cameron kicks the car repeatedly yelling, "Who do you love?" (a powerful metaphor for the obsession of material wealth and things rather than relationships and people) the jack teeters over and the spinning tires of the car hit the floor and the car races toward, and crashes through, the glass doors of the garage and falls into the ravine twenty feet below. As the car smashes into the ground, Cameron asks a seemingly rhetorical question.

Cameron: ***"What'd I do?"***
Ferris: ***"You killed the car."***

At this point of our comparison of the movie to the Trump campaign we will have to see which alternate ending we actually get in the future. There are many who fervently believe those who voted Trump into power have "killed the country" and think that America will look like the Ferrari crashing through the glass and plunging helplessly toward complete destruction (taking the capital markets along with it and plunging us back into another Great Depression). The risks of this outcome are clearly not non-zero (but we don't think they are very high), but this outcome is possible if there are a series of policy errors like those that occurred in the 1930s (erecting trade barriers and raising rates from zero too soon in 1937, to name a couple). Equally unlikely (in my opinion) is the alternate ending where the brick slips off the accelerator when the jack tips over and the car stops short of flying through the glass doors and everything is perfectly fine and all of Trump's promises of heady GDP growth, the immediate recapture of jobs lost overseas and a surging stock market (one of Trump's economic advisors predicted on CNBC last week that the DJIA would soar to 25,000 in 2017) come true. We will take the under. What is more likely is that there will be a honeymoon period in the markets where investors try to sort through all the promises and plans that have been bandied about (one of the problems is that Trump frequently changed his mind on the campaign trail, making it tough to pin down many of the exact plans) and the HFT algorithms will push certain sectors to short-term extremes. We saw some evidence of that last week with huge moves in Biotech and Pharma (more of a relief rally that HRC didn't win) and Industrials (on the belief that fiscal stimulus will happen immediately – it won't). Yes, a surprise victory by a "Republican" (he was rejected by the party and he claims to wanted to be Independent) coupled with a Republican sweep of Congress does create an administration that has been favorable for equity markets historically (average 15% returns). That said, the idea that Trump and the Republican Congress are going to work flawlessly together is a stretch and the bigger problem is that the challenges are bigger than ever. Policy makers and the government have fewer tools at their disposal (the Fed is out of bullets and is actually talking about raising rates), government debt is already very high so flexibility with fiscal stimulus

could be challenging (and even more challenging if the largest owners of Treasury bonds start selling, rather than buying) and things could get really problematic if rates were to begin spiraling out of control and debt service becomes more of a burden.

We will dive deeper into some thoughts about the markets going forward in the Market Outlook section below, but let's tie together why the theme of this letter is so important to investing right now. In the movie, Ferris was never sick (he didn't need to be saved), he just wanted a day off to enjoy some time with his best friend and his girlfriend before they all separated later when he and Cameron went off to college (Sloane had one more year in high school). In real life, the U.S. economy is a little sick (and looking worse each quarter) and we do indeed need to *Save FairUS* (and hopefully avert a nasty fall down the stairs in the markets at the same time). We have elected a president who claims to have the solution to all the things that ail us and seems eager to get started saving the fair U.S. He would have us believe that if we follow him that we can Make America Great Again. However, also in real life, there are those who think that Trump (unlike Ferris) is actually a little sick, and that he will be unable to guide the country on a sound path (particularly after having done such a good job creating dissent and division). Therefore, the thinking goes that it will only be a matter of time before the country crashes into a ravine. Until proven otherwise, we are going with the view that Donald Trump is a real life, grown up version of Ferris Bueller and that he isn't sick, he knows how to get things done, he knows how to marshal friends and resources to help him and he is always one step ahead of those who doubt him and would try to restrain him. Again, until proven otherwise, we will go with the view that Candidate Trump will not be the same as President Trump and that since he aspires to be like the great presidents before him, he will move away from the bombastic rhetoric of the past two years and govern from the center, bringing his business acumen and relationships as an added advantage to *Save FairUS*. As we come to the close of the movie, Ferris Bueller repeats the line that he opened with, and which we would all be well-served to pay attention to more often in our daily lives.

Ferris: ***"I've said it before, and I will say it again. Life moves pretty fast. If you don't stop and look around once in a while, you could miss it."***

Life does indeed move pretty fast (seemingly faster all the time with all the technology) and the reason to step back and take it in is that we are truly blessed to be alive in such a glorious time. Clearly not everything is perfect, and there are many places in the world where life is downright miserable, but we live in a time when billions of people have been lifted out of abject poverty over the past few decades, a time when advances in science, technology and medicine have improved living standards and the overall health of the global population to unprecedented levels (better on life expectancy, infant mortality, exposure to disease), a time of unprecedented freedoms and lower levels of violence and unparalleled access to education. Much of this amazing human progress has been driven by the fall of the –isms (as Ferris told us in the beginning of the movie) and the globalization of the planet as technology has sped the spread of information and capital around the world, which has resulted in higher levels of creativity, innovation and wealth creation. Yes, these same trends have led to more inequality (which was the fuel for the Trump campaign), but what gets missed in thinking about the larger spread between the "top" and the "bottom" is that those at the bottom are so much better off than at any time in history.

At this point in the movie the credits role and the screen goes dark for a moment and then flashes to a scene of an empty hallway in Ferris's house. Suddenly Ferris pops his head out of the bathroom doorway, steps into the hallway clad in his robe, walks toward the camera with a very puzzled look on his face and (breaking the fourth wall one last time for good measure) says,

Ferris: ***"You're still here? It's over… Go Home... Go!"***

After Ferris says, "go home," he turns and walks back toward the bathroom, then stops and turns back to the camera and makes a shooing motion while he says, "Go!" Ferris is basically saying don't just sit here crying over the election, get on with your life. Then he turns and walks back into the bathroom. Fade to black.

Cartoonist Joe Heller (hellertoon.com) created a great cartoon during the campaign showing Trump clad all in black on one side and Hillary clad all in white on the other side of the following verse with a line indicating that this was a Trump quote, then at the bottom of the verse he said "for Hillary, read from bottom to top." I want to modify the directions - for Candidate Trump, read from top to bottom, and for President Trump, read from bottom to top. Maybe that is too optimistic, but after a few days we have already heard him talk about an infrastructure plan to build bridges and nothing about building the wall… Let's hope the trend continues.

"It's Getting Worse
So Don't Try To Convince Me That
The Future Is Bright In America
Because When You Take A Closer Look
There's Anger And Hate
Even If
It's Not Who We Are As A Nation
But
You Should Be Scared
Crime, Terrorists, Illegals
We Need To Do Something
Believe Me
Fear
Is Greater Than
Hope
Because
We Can't Be Optimistic
And You'll Never Hear Me Say
We need Bridges not Walls"

Third Quarter Review

For the past year we have opened this section of the letter with a comparison of the equity markets around the world during the quarter to a roller coaster ride. We wrote during the dog days of summer (a perfect time to think about amusement park rides) that in the U.S., *"the Bulls argue that the chain lift (Central Bank liquidity) is fully engaged and the lift hill has a ways to run, while the Bears argue that the chain lift is disengaging here and we are in for another swift descent. To see where the ride ends up insert another quarter about mid-Autumn."* We started the summer with the Central Banks acting like carnival barkers announcing how much stimulus they would throw into the markets to avoid any disruption from the Brexit vote. At which point the S&Peedcoaster locked into the chain lift and rose 3.6% in July and kept right on rising in the first two weeks of August to peak at 2190 on 8/15 (a nice 9.5% surge off the bottom on 6/27). Then the roller coaster ride resumed with a series of whoop-de-doos (a motocross term for a series of bumps) as markets dropped (2.9%) over the next month to hit 2127 on 9/13, then quickly rebounded 2.4% back to 2177 on 9/22 and finally slid back down to 2168 to finish the quarter. The coaster continued down in October with another (1.9%) drop to 2126, right about where it was after the Fourth of July holiday. We wrote a couple quarters ago that, *"the nice thing about roller coasters is that after every down (no matter how steep and scary) there is an up and you always end up in the same place in the end,"* and we have been locked into the bumpy ride to nowhere for the better part of two years. As we come to Thanksgiving it does appear that we are looking over the edge of a rather large drop and the heightened uncertainty surrounding the recent election makes that plunge seem even scarier, but we will have to wait until next quarter to see if the S&Peedcoaster turns into the Screamcoaster.

Across the Atlantic, the Eurocoaster ride has not been as much fun as the American version. While the drops have been just as harrowing, the recoveries have not been as robust. We wrote two quarters ago that *"normally with roller coasters the larger the drop, the bigger the ascent on the other side, but European equities didn't follow that blueprint,"* and the Euro Stoxx 50 Index continued on this bumpy path of making a series of lower highs since the peak in April of 2015. As we discussed above, the thing about roller coasters is that when you go for a ride you end up in the same place after every loop of the track. The Eurocoaster has been returning to the same place for even longer than the U.S. We wrote last time that European equities are *"not only at the same level they were to begin 2014 but the ups and downs have delivered the cars back to the same spot as in September of 2008 (while there has been some return from dividends, the price has been the same for the better part of a decade)."* Like all global equity markets the Euro Stoxx 50 enjoyed the chain track ride up in July, rising 4.4% to finish at 2991 on 7/29, but then dropped immediately (2.8%) to 2907 on 8/2, before jumping back up 6.4% to 3092 a month later on 9/7. Another steep drop followed as the cars careened down (5%) to 2935 on 9/16 before jumping back on the track to finish the quarter at 3002 on 9/30 and continue in the upward trend in October, rising another 1.8% to 3055 on 10/31. The Eurocoaster has been very bumpy ride to nowhere in 2016, but there have been some signs of life in the second half of the year as the chain track has dragged the Index up 7.5% from the 6/30 close (nearly five times the increase of the S&P 500). There are a lot of very cheap companies in Europe (particularly the Financials and Cyclicals), but uncertainty about the U.S. Election and consistent rumors of the ECB getting ready to taper bond purchases have put the brakes on any meaningful advance in the Euro Stoxx 50 this year.

At the beginning of the year we described the Samuraicoaster in Japan as a *"truly motion sickening"* ride as the BOJ's refusal to increase QQE stimulus and the boneheaded (apparently based on market reaction) move by Kuroda-san to embrace a Negative Interest Rate Policy ("NIRP") combined to "put the thrill in thrill ride" and the Nikkei had plummeted

(21.5%) from December to the double bottom trough on 6/24 (day after Brexit). We wrote last time that post-Brexit the *"rumors began to circulate that Ben Bernanke was taking the helicopter to Tokyo to explain how to really grease the wheels and the chain lift fully engaged on the front end of [July],"* which pulled the market up 6.4% for the month. From 16,569 on 7/29, the Samuraicoaster went on a rapid-fire series of free rides and chain tracks that was the complete opposite of the Eurocoaster. Each successive peak was higher than the previous and (surprisingly) Japanese equities have been one of the best performing markets over the past four months, rising 11.3%. After a quick drop to 16,083 on 8/3 there was a 5.2% rebound to 16,919, followed by a (3.3%) decline to 16,361 on 8/26 and another 4.4% jump to 17,082 on Labor Day. When traders came back from the beaches they jumped in the cars for a quick (4%) drop to 16,405 on 9/15 and coasted into the quarter end at 16,450 before catching a serious chain track lift in October, surging 5.9% to finish at 17,425 on 10/31. For the first half of the year investors were clearly perturbed that Kuroda-san had been hesitant to expand the BOJ stimulus program and buy more securities in the markets. We wrote that *"perhaps the simplest explanation was that they already own 1/3 of all the Government Bonds (JGBs) and 1/2 of all the ETFs in Japan,"* but after releasing the results of their *Comprehensive Assessment of their Policy Initiatives* the BOJ did expand their purchases of REITs and ETFs, so perhaps some of that liquidity helped fuel the recent rally. We posed a question at the end of this section last quarter that *"the issue for those investors still on the Samuraicoaster is the question of who is minding the track. With the Yen surge likely to hurt profits in the near term, will the next hill on the Nikkei thrill ride be a real screamer?"* It appears that Kuroda-san got the message on the Yen and has been active in the FX markets to stem the strength and the USDJPY has weakened from 100 back to the mid-104s.

The least fun roller coaster ride in the world during the 2011-2015 period was in the Emerging Markets where the scrEEMcoaster made six chilling laps around the track filled with hair raising drops and stomach turning rises only to wind up back in the same place before careening down a gigantic drop, plunging (34.8%) from 43.02 to 28.03 on January 20, 2016. After a quick bounce and subsequent drop over the next three weeks, "something changed" on 2/10 as oil prices bottomed, the Dollar began to weaken and EM began a steep ascent that would last for the next seven months. We wrote last time that *"there appears to be 'a very different rhythm to the scrEEMcoaster compared to the other global equity thrill rides.' Instead of making a series of lower lows and lower highs, EEM is making higher lows and higher highs."* EEM had surged 22.6% off the February bottom by the end of Q2, surged another 5.4% in July and another 4.6% to 37.87 on 8/5 before disengaging from the chain track and giving riders some fun for the next couple of months. A drop of (3.5%) to 36.53 on 8/31 was followed by a sharp bounce to the peak (for the year) of 38.21 on Labor Day, and (like in Japan) when traders came back from the beach they jumped in the scrEEMcoaster for a (5.4%) drop to 36.14 on 9/14 and a quick rebound of 3.6% to finish the quarter at 37.45. After the series of five higher lows and higher highs, the string was broken in October as fears of a Fed rate hike in December pushed the Dollar higher and EEM could only muster a bounce to 38.10 on 10/10 before falling (2.5%) to finish the month at 37.14. After a very strong 14.5% rise in 2016 and an even stronger 31.5% jump off the bottom in February, there is a lot of "air" under the track and a lot of market prognosticators are predicting a big drop in EM equities should the Fed pull the trigger and the Dollar continues to strengthen. We on are the other side of this view and think that there are lots of fundamental reasons to be bullish on EM going forward.

After being the wildest ride of them all in early 2016, the Dragoncoaster in China has settled down and recovered nicely since the lows in February, locking into the chain lift since May. We wrote last time that during the summer *"the Dragoncoaster has was hooked in tightly to the lift hill for the next two*

months, rising 9% to a peak of 3,061 on 7/13 before falling back (2.7%) to finish the month at 2,979." There was one "wee hill" during the late summer as the SHCOMP rose 4.9% from 2,979 to 3,125 on 8/15 before falling back (4.6%) to 2,980 on 9/26 and then locked back in the track to rise up 4% to 3,100 on 10/31. The best ride at the carnival in 2016, despite the cancellation of their actual Carnival due to budget woes, has been Brazil. We noted last quarter that the Canarinhocoaster, *"was firmly back in the chain lift surging 16.4% to a new high for the year at 57,308 to end July, up an astonishing 52.8% from the January low."* The Canarinhocoaster has been locked in the chain lift track all summer and fall and has risen all the way to 64,925 by the end of October. That 13.2% surge over the past three months brings CYTD gains for the Brazilian equity market to an astonishing 49.7% in local currency and 62% in USD as the BRL continued to strengthen.

The global equity markets over the past year seem to be caught in a *Groundhog Day* (the movie) kind of endless loop that triggers a sense of déjà vu when looking at the roller coaster ride of the individual markets. That feeling grows even stronger when we look at just how similar the path of the S&P 500 has been over the past year when compared to the similar period in late 1999 and 2000. Leaving aside that both years were election years (and both are the 8th year of the seated President), 2016 has played out very similarly to the #2000.2.0 scenario we had laid out in past letters. From June of 1999 to November of 2000, the S&P 500 rollercoastered between down (10%) and up 10% and was up 4% for the trailing sixteen months on the cusp of the election. Looking at the period since June 2015 to today, the S&P 500 rollercoastered between down (11%) and up 6% and is up 1% for the trailing sixteen months. One difference between 2000 and 2016 is that the NASDAQ Index has tracked the S&P 500 nearly perfectly (up 1% as well), while in 2000 NASDAQ had surged from late 1999 to be up 85% in March before screaming down the first hill (of a horrific 78% plunge) to be up "only" 25% for the period. There are many more listed companies on the NASDAQ today so let's use the FANG stocks (FB, AMZN, NFLX, GOOGL) as a proxy for the crazy (read as buy at any price, the anti-value strategy) part of the market. This group caught the chain lift in late 2015 and peaked last month, up 55%, 95%, 35% and 55%, respectively (up 60% on average over the past sixteen months). While the FANGs are not a perfect comparison to the NASDAQ in 2000, they have exhibited a similar cult-like following in recent years (just like MSFT, INTC, CSCO, ORCL experienced in 2000).

Looking at just the comparison of 2000 and 2016, the S&P 500 had a wild ride in 2000, was down (9%) by mid-February, rallied back to be up 4% in March, back down (5%) in April, was flat for most of the summer, rallied to be up 3% in September and then fell back to down (10%) and limped back up to be only down (3%) going into the election. This point was the last chance to get out without losing a lot of money before the monster drops that occurred over the ensuing two years. So far in 2016, the S&P 500 was down (11%) in mid-February and had rallied back to up 3% by mid-April before falling to down (3%) post-Brexit and then rallying hard to be up 7% by early September before falling back to only up 2% on the cusp of the election. The FANGs have had a volatile ride too, but had managed to be up 27%, 24%, 11% and 7%, respectively, in mid-October before struggling with Q3 earnings and falling back to be up 15%, 12%, 7% and flat, respectively. Given the uncertainty even now that the election has been decided, the high valuations, declining profit growth and uncertainty about global growth and interest rates, we continue to err on the side of caution right now in portfolio positioning. As we discussed last quarter *"the other issue of concern relates back to the election year cycle and how the eighth year of a sitting President has been a treacherous time for investors in stocks. Since 1900, there have been six occasions where there has been an eight year term and five of the six produced negative returns for the year, averaging down (14%)."* Interestingly, the bulk of those losses occur over the summer, and through the

election and, most surprisingly, into the end of the year (there is no Santa Claus rally in Year 8). As we sit here eleven months into the year, 2016 actually looks closer to a normal election year where the markets are mostly flat during the year and surge 8% on average during the final few months. With the election results now decided, we will see over the last eight weeks of the year whether we get a normal up 8%, an eight-year normal (14%) or somewhere in between.

Let's take a look at the performance within the U.S. equity markets during Q3 from a size and style perspective in what was a strong quarter for the overall market with the S&P 500 Index rising 3.9%. Clearly it was a good quarter for equities across the capitalization spectrum, but the larger story was the dispersion between the capitalization segments as a "Risk-On" rally triggered by the Fed backing away from a rate hike post-Brexit (and all the other Central Banks pledging once again to do whatever it takes…) fueled a breakout by smaller cap names. Large Cap (RTop200) was up a respectable 3.8% in Q3, but Small Cap (R2000) was up a stunning 9.1% and Microcaps were the star performers surging 11.3% for the period. The strong Q3 by the little guys completely reversed their deficit to the big guys for the CYTD as the RTop200 is up 7%, the R2000 is up 11.5% and the Microcaps are up 9.4% (after climbing out of a monster hole in Q1). In the Style side, Value had been leading Growth this year and we had hypothesized that *"primary reason for the change is the recovery in commodity-related names this year after oil began to recover in mid-February. It is possible that there is a meaningful shift underway in global equity allocations to favor more value and cyclical names. While this shift doesn't fit exactly with a slowing global economy and stress in the financial sector, we feel this trend will be worth monitoring very closely in the months and quarters ahead."* That trend came to a screeching halt in Q3 as investors flocked to Growth names and the Growth Indices beat their Value counterparts. The RTop200G surged 4.6% versus the RTop200V at only 3.1%, the RMidG was also up 4.6% versus the RMidV up 4.5% and the R2000G jumped 9.2% versus the R2000V up 8.9%. For the CYTD, those rankings are all still reversed with RTop200G up only 5.7% versus the RTop200V up 8.4%, the RMidG up only 6.8% versus the RMidV up an impressive 13.7% and the R2000G up only 7.5% while the R2000V is up more than double that, rising a stunning 15.5%. It turns out that when companies get very close to bankruptcy (as many small/mid companies were) and they don't go bankrupt they surge dramatically (and crush any hedge funds who happen to be short those names as well). In the Golden Age of free money, really bad companies have been allowed to survive (unlike a normal business cycle) and these stocks that act like options have distorted the equity markets in 2016.

Looking more closely at the performance of the sectors of the S&P 500, Q3 was the inverse of the Value shift in Q2 as the "Risk-On" sectors took the lead for some inexplicable reason despite increasing sense of economic weakness and the threat of higher rates. What is interesting is how the shift was so extreme given how things played out in the 1H16. We wrote last time that *"what seemed a little odd in Q2 was that despite the media narrative that the broad Bull Market was alive and well, these defensive sectors continued to lead the overall markets as Telecom, Utilities, Healthcare and Consumer Staples took four of the top five slots and were up 7.1%, 6.8%, 6.3% and 4.6%, respectively. If we extend out to the CYTD period it is very clear that the defensive safe havens of Telecom and Utilities are crushing everything else, up 24.4% and 21.7%, respectively."* Perhaps it was a belief that HRC would win the election and therefore the Fed could raise rates in December without risk of political fallout, but these sectors were hammered in Q3 with Healthcare up only 0.9%, Staples down (2.6%), Telecomm down (5.6%) and Utilities down (5.9%). We also wrote last quarter how *"further, the Growth related sectors like Technology and Consumer Discretionary had very tough Q2s, falling (2.8%) and (0.9%) respectively and while the CYTD numbers are better (up 7.4% and 5.2%) they are clearly toward the bottom of the sector group."* So the last shall be first (and the first shall be last) was the

theme of Q3 in the sector space as Technology surged an astonishing 12.9%, Financials rallied 4.6%, Industrials were up 4.1% and Materials were up 3.7%. Even though Consumer Discretionary and Energy lagged the group at the top, they were still up 2.9% and 2.3%, respectively. Looking at the CYTD numbers gets rather confusing (risk on or off?) as Energy is now in the lead, up 18.7% (makes some sense with oil recovery). The Defensives are next with Telecomm and Utilities up 17.9% and 16.1%. The third group is more offensive with Tech now up 12.5%, Materials up 11.5% and Industrials up 10.9%. The S&P 500 comes next at 7.8% followed by Staples up 7.6%, Consumer up 3.6% and the laggards are Healthcare (afraid of HRC) and Financials (afraid that QEeen Janet won't raise), both up only 1.4%. Finally, we discussed last time that *"significant momentum in the commodity recovery in recent months and the falling dollar has been a modest tailwind, but we warned that quarter that 'any change in the Dovish tone from QEeen Janet will take the air out of the commodity recovery in a hurry.'"* While Janet did revert back to her Dovish roots and skipped raising rates in September (perhaps so as to not appear political), there is growing unanimity (which might mean that consensus will be wrong again) that she will pull the trigger in December and while Financials rallied as expected, the commodity related sectors didn't fall in Q3 (waited until October), so it should be a very exciting last few months of 2016 in the equity sectors space.

We wanted to make one last reminder of the linkage between Fed bond purchases (QE) and increases in U.S. equity markets (that we have been writing about for past couple of years). Our views are based on the great work done by Larry Jeddeloh of TIS Group on this phenomenon as his historical analysis showed how "*every $100 billion of QE has translated into 40 S&P 500 points."* We wrote in 2014 that, *"given U.S. equity markets have been driven by the QE equation since 2009, the cessation of QE this month does beg the question of what happens in 2015? The larger question is, again, how would equities continue to rise?"* Last time, we commented that given the lackluster results in 2015 and 1H16, the answer was, they actually won't go up much at all. Other than a few percent of dividends, the S&P 500 Index sat in June almost where it was in December 2014, around 2,100. Now we are four months later in the year and the Index sits almost precisely in the same spot, at 2,085, so the lack of upward movement continues in the absence of additional easing. Many have talked about the "Third Mandate" of the Fed (to maintain equity prices), and it does appear that every time there is even a hint of a correction in the S&P 500, the Fed either doesn't raise rates (no hike in January, March, April, June, July, September or November) or one of the Fed Governors makes noises about QE IV. We still can't find a catalyst for higher equity prices (no EPS growth, no room for multiple expansion) and we can find a lot of risks that could trigger lower prices (EU problems), so it will be interesting to see if Janet really does channel here inner Lucy Van Pelt and is willing to pull the ball away in mid-December.

We stated in Surprise #2 (Two Wrongs Won't Make It Right) of our Ten Surprises that *"the Fed would realize the error of their decision to hike in December and would not raise any more in 2016, thereby providing a tailwind for further dollar depreciation in the New Year and relieving much of the pressure from the Chinese to devalue the RMB."* The biggest challenge for the Fed is that despite many claiming that they are behind the curve and they must raise rates, it is really tough to see how a tightening bias makes sense in a world where the world's largest economy continues to languish below stall speed (2% GDP growth). Without any direction on interest rates, the Dollar has languished as well in 2016 (DXY was flat in Q3 and is actually down (1.9%) for the CYTD). The second part of Surprise #2 said that not only would the Fed not hike the Fed Funds rate in 2016, but by the second half of the year there was a chance that they would be forced to reverse course from the 2015 "tightening" (one and done hardly seems like tightening) and be forced to ease again (QE IV or something new). The biggest challenge for

implementing QE IV is it appears the Fed is running out of bonds to buy as the Deficit shrinks and fewer Treasuries are issued. The BOJ and SNB solved this problem by buying equities and ETFs directly, but the Fed is prohibited (by law, for now…) from buying stocks and it would take a Congressional change to allow this change. One thing we have learned since 2009 is to "expect the unexpected" (as John Burbank says) when Central Banks are involved as they continually find ways to do things that seemed impossible just a few short years ago.

When people discuss International Equity markets, there are a handful of countries in the EAFE Index (beyond Japan & Europe) that are often overlooked by market observers. When it comes to ignoring these countries, we have been a consistent offender in that regard since they are not included in the Europe or Japan sections. A distinguishing feature is that these markets share a common characteristic insofar as they have been historically highly correlated to commodities and, in fact their FX are referred to as Commodity Currencies. Canada, Australia and New Zealand have relatively small equity market capitalizations (probably why many don't bother monitoring) but big things can come in small packages, and this year their currencies have turned sharply (from prolonged downturns) and their equity markets have been some of the best performing of 2016. As a group, these markets dramatically outperformed the EAFE Index in Q3 (which was up a very robust 6.4%), rising 4.9%, 7.9% and 12.4%, respectively. Having a solid Q3, on the back of strong 1H16 performance, the CAN-do Commodity Currency Countries are now up 20.6%, 10.7% and 32.8%, respectively, for CYTD (in USD terms). The strength of the currencies has contributed 6.5%, 5.5% and 7.7% of those returns for the year. In further support of the idea that these markets are worth paying attention to, we wrote last time that *"one of our favorite research groups, 13d Research, thinks that these markets will have a built in currency tailwind for the foreseeable future and that equity returns could continue to surprise to the upside as the commodity bull market develops."* An additional selling point (that appeals to our Contrarian character) is the fact that most global equity managers are very underweight these markets, making them that much more attractive. Given their relatively small size it wouldn't take much of an allocation change from the big global managers to initiate additional big price moves in these markets. The one caveat is that if the Dollar reverses course and climbs again (as it did in the second half of October) these markets could struggle and we saw that scenario play out this month as they gave back some of their gains, falling (0.6%), (3.1%) and (6.9%), respectively. There is an increasing number of people jumping back on the King Dollar bandwagon in anticipation of a Fed hike in December, but we remain on the other side with the belief that the Dollar has hit a secular peak and will decline for many years to come which should provide a tailwind for these countries over the long-term.

European equity markets recovered quite strongly after the Brexit jitters subsided and surged 5.4% in Q3. The strength was broad-based as fourteen of the fifteen markets in Developed Europe generated positive returns and only Denmark suffered a loss of (6.3%). The gains in Europe were led by Austria, which rose a surprisingly strong 16.7%, Germany, which jumped 10% and Spain, which rose 9.3%. The laggards for the quarter (beyond Denmark) included Switzerland and Italy, which managed only 2.6% and 2.2%, respectively, during the period. One other Developed Market that struggled during Q3 was Israel, which fell (2%) and is now down (15.3%) for the CYTD. The weakness in Israel is somewhat surprising given the high weight in technology (which has done well in the U.S.), but perhaps not surprising given the continued tensions in the region. Draghi (aka the boy who cried wolf) was at it again in October as he hinted that the ECB could begin tapering their bond purchases (translation: there are not any bond left from them to buy…). The European equity markets went into Taper Tantrum mode and fell (3%) with more than 100% of the loss coming from the drop of (4%) by the Euro versus the Dollar

(MSCI Europe up 0.9% in local currency). There were some significant drops during the month as Belgium shed (7.4%), Denmark dropped another (7.2%) and Ireland, Switzerland and the UK all fell (5.1%). We will write more about the inverse Oktoberfest next time, but suffice it to say that global investors are not buying what Super Mario is selling. We (along with many other investors) have been frustrated by the ineffectiveness of the ECB QE program to generate any meaningful benefit for equities since inception of the program in Q2 2015. In fact, the Euro Stoxx 50 Index is down around (16%) since the peak on April 13, 2015 and is down around (4%) CYTD. We have discussed over the course of the year our efforts to quantify the impact of ECB bond purchases on European equity markets using the TIS Group methodology they developed for the S&P 500. We wrote last time that *"after a couple of false starts, we came up with a formula that appeared to be reasonable and concluded that 'we can recast the formula that for every 100B Euro of purchases you get 20 Euro Stoxx 50 points (significantly smaller than the original calculation).'"* The problem was that with half of 2016 in the books we should have seen a gain of 80 Euro Stoxx 50 points by mid-year, yet despite the ECB buying bonds the Index was down nearly 300 points from the starting point of 3268. We went further to say that *"While plenty of 2016 remains, the likelihood of the Euro Stoxx 50 surging 419 points from here (up 14%) seems reasonably remote, so it appears we will have to adjust the model again."* The problem is that here we are at the end of October and the Index is at 3079 (still down for the year) despite the ECB buying 800B Euro of bonds that should have pushed the Index up 160 points. Clearly our model (and maybe the ECB model) is broken and there does not seem to be any meaningful linkage between ECB bond purchases and European equity prices. In trying to reconcile why QE worked so well in the U.S. and not in Europe, perhaps the confidence in the magical powers of the global Central Banks is waning and investors are reverting to the tried and true conclusion that without economic growth and rising corporate profits it is difficult for equities to rise no matter how low interest rates are pushed (the proverbial pushing on a string hypothesis). We might even go one step further and say that Negative Interest Rates destroy the fundamental bedrock of capitalism and it was only a matter of time before equity markets came to their senses (even if they haven't yet in the U.S…).

Japan has been one of our favorite equity markets since late 2012 when Abe-san came back to power and committed to a "Three Arrow" program of economic and monetary stimulus dubbed "Abenomics." Arrow One was to weaken the Yen from the near all-time high of 77.61 on the USDJPY. Kuroda-san at the BOJ said forget a bow and arrow and whipped out a bazooka to fire massive monetary stimulus that took the Yen down dramatically (and Japanese stocks up dramatically) to a peak of 124.73 last year. Arrow Two was to initiate substantial fiscal stimulus, which proceeded according to plan as well. Arrow Three was a little trickier in that it required a change in regulations to encourage more innovation and business creation (read increase animal spirits), but the long bout of deflation left an indelible mark on the psyche of Japanese business. All that said, we came into 2016 with pronouncements from both Abe-san and Kuroda-san that they would not accept anything less than a total victory on Abenomics, so we took them at their word. In fact, we believed them so much that one of our MCCM Ten Potential Surprises for 2016 focused on Japan and how BOJ Governor Kuroda would continue to attack the Yen so that Japan could remain the *"Land of the Rising Stocks."* We thought that Kuroda-san would fire his bazooka again and that the USDJPY might hit 135 (from 120), causing corporate profits to surge and the Nikkei to rally to 21,000 (from 19,033). As we wrote last time *"the good thing about Surprises is that they are only supposed to be right (by definition) a little over 50% of the time, so there will be some that are simply wrong."* Simply wrong might be an understatement on this one, we were dead wrong. Not only did Kuroda-san not fire his bazooka, he fired up a NIRP program that caught everyone off guard and the Yen soared from 120 to begin the year all the way to 100,

dragging down stocks with it as the Nikkei plunged (21.5%) to a nadir of 14,952, hitting that precise level not once, but twice, on February 12th and June 24th. Despite feeling very wrong as we penned the letter in July, we did write that *"it takes serious conviction to be supportive of Japanese equities when the Yen is crashing toward 100 and foreigners are selling in waves, but earnings growth is positive (best of the major Developed Markets) and valuations are back to levels described as "stupid cheap" by one of our favorite Japan specialist managers."* While we didn't rush out and back up the truck, we did stop ourselves from selling at the bottom (we thought about it) and that paid some dividends in Q3.

Interestingly there is a chart pattern than technical analysts utilize called a Double Bottom (think of a letter W) and the distinguishing characteristic is the second bottom has to have lower volume than the first (a sign that sellers were exhausted on the first leg down). June 24th was a very unique day in that it was quite volatile due to the surprise Brexit vote the night before and volumes were high as well, pushing the Nikkei down (7.9%) for the session. Yet, surprisingly, the volume was lower than the February 12th low, so we had a textbook Double Bottom. At that moment there were very few intrepid investors who were willing to call the bottom and buy. Even when the market rallied 2.4% the next day (and 4.2% over the last week of the month) there were very few buyers as foreign capital continued to flee Japan. We wrote last time that investors feared (rightly so) that *"with the Yen surging so far, so fast, the negative impact on Japan Inc. earnings has been real and there is the risk of a reflexive vicious downward spiral if Abe-san and Kuroda-san don't find a way to stimulate economic activity."* In Q3, the somewhat less than dynamic duo did find a way (or so it appears) to turn things around as GDP rebounded back into the black and, after one last test of the bottom on 7/8 at 15,106, the Nikkei surged 8.6% for the quarter, bringing the CYTD return back to a positive 2.5%. However, these returns are in USD and local investors are still down (13.7%) thanks to the surge in the Yen, but after touching 100 three times on 7/11, 8/18 and 9/27 (this last one a week after the release of the BOJ Comprehensive Assessment) the USDJPY has rallied back to 104.7 at the end of October. With the weakening Yen, Japanese stocks have been surging, rising 5% in local currency in October and while that is a more pedestrian 0.9% in USD it still puts the Nikkei up 3.5% for the CYTD (well ahead of European stocks and only a couple points behind the S&P 500, which is remarkable given that the gap was double digits at mid-year).

Kuroda-san had tried to defend his NIRP decision by saying the Program was designed "to force the banks to lend excess reserves into the economy and 'break the grip of the deflationary mindset.'" Given the inertia that had persisted at the Banks for the past two decades in a positive net interest margin environment, it seemed like a stretch to think that a plan that tears at the very fabric of fractional reserve banking (the concept of attracting deposits with positive interest rates and lending at higher rates) would be successful. The initial market response was underwhelming at best as the broad market collapsed and the banks fell twice as much (down (40%) in a matter of weeks). We discussed the value in the banks last time, saying *"we have been talking about how cheap these banks are for a while, and though early observe, the Japanese mega banks are selling at single digit P/E ratios with rising EPS and extremely strong balance sheets. So while we understand that NIRP is bad for financials, there does come a point where all the bad news is already priced in and you have to plug your nose and buy."* Over the past three months, the basket of SMFG, MTU and MFG did indeed rally nicely and the basket was up around 4% versus a decline in the S&P of (2%), but there could be significant gains ahead if the BOJ can actually steepen the yield curve as they committed to doing during their last meeting. "Curve it like Kuroda" is the new rallying cry, and we will have to wait and see how his effort plays out over the course of the next year. Returning to technicals for a moment, it does appear that the Mega-Banks also made a nice Double Bottom on July 8th and are up

22%, 18% and 16% from that point. Interestingly, if we look at the Japan listed securities the gains are even bigger as JP:8316, JP:8306 and JP:8411 are up 31%, 28% and 24%, respectively. We say interesting in that the USDJPY has moved 4% over that period so there clearly is some other "slippage" between the local listed shares and the U.S. listed ADRs over this period.

Over the last year many investors have avoided talking about Emerging and Frontier markets, and reasonably so. The Developing Markets had been locked in a brutal five-year Bear Market that began in the second quarter of 2011 and dragged down the MSCI EM Index (40%) to the trough in January of this year. Given the carnage in those markets we began to make the case in Q4 of last year that it *"might be nearing the time to buy 'what is on sale' in EM."* We made reference to our letter about Sir John Templeton and his wisdom to buy at the point of "Maximum Pessimism," and at what seemed to be that darkest hour in late January (where the EM Index was down another (13.3%) and the FM Index was down (10.5%) in three weeks) we referenced George Soros' wisdom that *"the worse a situation becomes, the less it takes to turn it around, the bigger the upside."* As bad as the broad Indices were, some individual markets particularly stood out as Brazil was down (16.9%), China was down (17.3%), Russia was down (17.6%), South Africa was down (17%) and Greece was down (27.5%). Some of the Frontier Markets were struggling as well with Argentina down (8.9%), Saudi Arabia down (20.1%) and Nigeria down (17.4%). It really appeared to be the point of maximum pessimism, and, as might be expected, there has been quite a dramatic turnaround over the last few quarters. In Q3, the MSCI EM Index was up a very strong 9% to bring CYTD returns to a robust 16%. Despite all the headline fears of a hard landing in China, a hawkish Fed, conflicts in the Middle East, a rising Dollar and weak commodity prices, Emerging Markets lead nearly all Developed Markets in 2016 (Canada and New Zealand are better) and are up more than triple the MSCI World Index increase of 5.5% and more than double the 7.8% return of the S&P 500.

Looking at the countries within the EM Index, there was quite a bit of dispersion in Q3, with returns ranging from shockingly strong (two normal years of returns in three months) to rather poor. Starting from the bottom of the list, the laggards were the Philippines, Turkey and Mexico, which lost (5.3%), (5.3%) and (2.2%), respectively. One bad quarter does not spoil the whole year as the CYTD returns for these countries are better (7.1%, 6.1% and (1.4%)). The common thread with these three countries is the poor leadership, and we could see continued weakness from these regions (and others with poor quality leadership) in the coming quarters. The rising nationalism, populism and protectionism trends are hurting global trade, and if those trends accelerate, some of the Developing Markets countries could suffer disproportionately. At the bottom of the CYTD list are Greece, down (23.8%), China A-Shares (which are beginning to make a comeback, up 5.4% for Q3), down (7.3%), and Poland, down (3.2%). Turning to the top of the list, the leaders for Q3 were Brazil (change in leadership), China (strong leader getting stronger) and Taiwan (tech booming), which jumped 11.3%, 13.9% and 11.7%, respectively. For the CYTD, the returns are very strong with gains of 62.9%, 8.6% and 21.2% for the first nine months. That said, one strong quarter in the Asian markets was not enough to pull them into the top three spots for the CYTD as Russia and Columbia edged them out as the recovery in oil prices lit a fire in their currencies and their equity markets jumped 8.4% and 2.8% for Q3 to push them to 30.6% and 29.5%, respectively, for the first nine months. Having just made my yearly pilgrimage to the GMO annual meeting and seeing my friend Arjun Divecha (Chairman of the firm and head of the EM team) he reminded us of his now famous quote on EM, that "you make the most money in Emerging Markets when they go from truly awful to merely bad." The best performers in 2016 definitely share that characteristic in that the average investor would still tell you that things are bad in Brazil, Russia and Columbia (many might even say they are not

investable), yet there was lots of money to be made as they touched truly awful in January and have made it back to merely bad today.

We wrote last time how Eastern Europe had been a star performer in the Developing Markets in the past few quarters but *"took a body blow from the Brexit vote and the EE Index fell (2.4%), but some countries like Poland and Greece were pummeled, falling (17.5%) and (14%), respectively."* Things began to recover in July and Q3 was another strong one for this often forgotten region of the Emerging Markets; the MSCI EE Index was up a very strong 7.1% to bring the CYTD returns to 20.6%. Looking at individual countries, returns were mixed as Poland was up 3.1%, Greece rose 1%, Hungary jumped 10.8% (on the heels of 8.1% in Q2) and the Czech Republic was flattish at (0.4%). Turkey continued to suffer from the *"self-inflicted wound"* of the failed Coup and fell another (5.3%) in Q3. We noted last time that *"some EM observers have been saying that Turkey is beginning to look a lot like Russia during the early phase of the sanctions and that stocks are looking cheap."* Divecha offered a different perspective at the GMO meeting when he presented a study on the correlation between EM returns and the Quality of Institutions (QOI) score (a measure of regulatory quality and government effectiveness). Their findings showed that the better a country is at improving the quality and effectiveness of their institutions, the better the returns to shareholders (better institutions have less "leakage" to the family majority owners). Arjun said that while the quantitative models love Turkey (really cheap) they are hesitant to buy since the QOI score is collapsing (removing judges, jailing political rivals). Some pundits are now comparing Erdogan to Putin and saying that Turkey (like Russia) is no longer a safe place to invest. We beg to differ with the view on Russia. Last quarter we noted that Russia was one of the best performing markets in 1H16, and the positive returns continued in Q3. We noted that *"there are emerging signs of a broadening in the Russian equity bull market and some managers we admire have been talking about the retailers (Magnit, X5, Lenta, DIXY) as a buy for the next phase of the recovery."* Over the past three months, while RSX rose 2% and the S&P 500 fell (2%), the Russian retailers rallied 5%, 39%, 2% and 9%, respectively, and our favorite play on Russia, Sberbank, rose just another 8% (to up 68% CYTD). Finally, we noted that, *"Greece has continued to be a dark spot amidst the breaking dawn in EM, but we believe that they have finally resolved the issues with the EU and the time is now to begin wading back into Greek equities."* We said to start with the Banks Greece finally stopped going down in Q3 (up 1%) and jumped another 5% in October as talks with the EU progressed somewhat positively. The bank stocks were quite volatile over the past three months (up nearly 20% by late September) and election jitters limited returns to (6%), 4%, 9% and 7% (with the riskier names rising the most). We would expect this story to play out much in the same way that Sberbank did in Russia, as banks are a leveraged play on economic recovery.

China continues to grab daily headlines and the constant barrage of pundit predictions of the impending deflation of bubbles in the housing, stock and debt markets is actually getting a little tiresome, particularly when the economic data continues to surprise to the upside (facts getting in the way of another good narrative). We wrote last quarter that these predictions come from the same people *"who have been claiming for years that China is headed for (the most vocal will say is already in) a hard landing and any minute now there will be a collapse of the RMB and crashes in the equity and housing markets. The most strident will go to the extreme and say the entire Chinese financial system is on the verge of implosion and the carnage will result in massive civil unrest and a meltdown of their entire society."* Now, perhaps, if you keep saying the same thing over and over and it eventually happens you can claim some sort of pyrrhic victory, but like the broken clock being right twice a day, being right sometimes over the course of a decade doesn't seem to be very useful to investors trying to make money every year. We will continue to take the under on the total Doomsday

scenario, but we are willing to concede the point that there are some stress points in China's economy that must continue to be managed. Where we differ from the Chicken Littles of the world is that we think the Chinese Leadership is doing a good job doing just that. If we look at the scoreboard of economic data, we see that the Chinese economy is doing just fine and is actually showing signs of slight improvement over the course of the year. Q3 GDP came in a little above expectations at 6.7% (right in the target zone of 6.5% to 7%), the latest retail sales growth came in at a 10.7% year over year increase, Manufacturing PMI is slightly above 50, Non-Manufacturing PMI is at 53.7 (important as they transition toward consumption and services) and Industrial Production continues to expand (unlike the U.S. where it has been contracting for over a year). One of the keys to maintaining growth is the continued expansion of credit and money supply. The government has stepped up in a big way in 2016 as credit growth continues apace at 13% (down slightly from the 16% average over the past decade) and M2 money supply growth has been 11.5% in the past year. Importantly, urbanization continues and urban investment and property prices continue to trend in a positive direction. Of course there are many who have now flipped their criticism of China from showing videos of ghost cities (too much RE supply) to videos of mad rushes to buy condos (too little RE supply) and as the old saying goes, you can't have it both ways.

Shifting from the macro view to the micro view, Q3 was extremely strong in the Chinese equity markets as the MSCI China Index surged 13.9%, Hong Kong jumped 11.9% and the MSCI China A-Shares 50 Index finally had a winning quarter, rising a healthy 5.4%. After a very difficult Q1, Chinese equities have (for the most part) scrambled back into the black CYTD as the MSCI China Index is now up 8.6% (higher than the S&P 500), the Hang Seng Index is up 12.3% and only the A-Shares have some work left to do as they are still down (7.3%). We wrote last time that *"the correction in Q1 moved P/E ratios of the primary indices back below 10x, which has historically been an entry point from which significant gains can be earned by investors with the appropriate time horizon."* We certainly didn't anticipate the strength of the moves in Q3, but we do believe that valuations merit a considerable overweight to China relative to the Developed Markets going forward. The persistent fears of an impending devaluation of the RMB has continued to be the rallying cry for the China Bears, and that fear has caused many investors to hesitate in allocating to the Chinese equity markets this year. We discussed last time how *"we laid out our case for why there wouldn't be an RMB devaluation in 2016 (too much at stake with getting RMB included in the SDR) and that the hedge funds who were betting on that event would have been better off deploying capital elsewhere."* The Yuan has been relatively stable thus far and although there appears to be some willingness to let it gradually depreciate, the costs of putting on a hedge against devaluation have far exceeded the (4.6%) move and managers who tried to fight the PBoC have lost (though things could certainly change). Another compelling presentation at the GMO conference made a case for why there would not be a significant RMB devaluation within the next year. The two primary components of the thesis were; 1) the fears of the NPLs in the banking system were unfounded because SOEs (manufacturers and banks) are on both sides of many of the loans (one as liability and one as asset) so they cancel out (require no bailout that would drain FX reserves) and 2) that Premier Xi would not allow such a significant event in advance of the 19th National Party Congress in 2017, as he has too much at stake in his plans to consolidate power.

Last quarter, we discussed how we had come across an interesting Chinese New Year forecast with very specific market expectations for 2016, which we summarized, *"while the early 2016 returns in China have been poor, on the eve of the lunar New Year, the forecasts for the Year of the Monkey indicate that there will be a meaningful rally in the Chinese equity markets in the second half of the year."* Looking back at some older forecasts, it was a little uncanny how

accurate they had been. We said last quarter that there were increasingly "*signs of momentum returning to the China equity markets as market watchers have become more comfortable with the government's commitment to further fiscal stimulus*." Almost like a light switch, Chinese equity markets began to rally in July and have been very strong over the past four months. While the S&P 500 is up only 2% of that period, FXI (a proxy for large caps) was up 8%, EWH (the Hong Kong ETF) was up 10% and even ASHR (the A-share ETF) was able to muster a 4% gain. When we look closer at a few of the sectors (and have been overweight) like e-commerce, healthcare and consumer, the returns are even better. Hospital operator Phoenix Healthcare (HK:1515) was up 15%, Tencent (HK:700) was up 18%, JD.com (JD) and VIPShop (VIPS) were both up 22% and Alibaba (BABA) surged 28%. While the China markets consolidated a bit in October along with other EM as fears of rising interest rates began to creep into the collective psyche of global investors, the broad-based strength of the Chinese equity markets is much healthier than the very narrow advance of the U.S. market where the bulk of the gains in the past year have been concentrated in the #FANG stocks (FB, AMZN, NFLX and GOOGL).

The China story will play out over the next decade and it will be critical to have a patient, long-term focus. We continue to see tremendous opportunities to make strong returns in the public equity markets and even more so in the private investment markets. The private capital markets in China have continued to develop and mature and the depth of exciting new opportunities is the most extensive we have ever seen. We have said on many occasions that the optimal approach to investing in China is to commit to building substantial exposure to the sectors/ companies that are likely to benefit most from the *"powerful shift toward consumption in a country of 1.4 billion people. This transition will take some time and a long-term perspective is essential for capitalizing on some of the best investment opportunities available in the coming years."* We continue to believe that the best opportunities in the China markets over the next decade will emerge in the five core industries that dominated U.S. equity market returns over the past fifty years (during our transition from Manufacturing to Consumption); Technology (e -commerce), Consumer Retail, Consumer Staples, Healthcare and Alternative Energy. Harry Dent wrote a book in 1993 called the Great Boom Ahead where he predicted the massive boom that would occur in the U.S. as the Baby Boomers moved into their peak spending years over the next fifteen years (he also predicted the fifteen year period from 2008 to 2023 of sub-normal returns we find ourselves in today) and that the next Great Boom will occur in China (and India) as the massive growth wave of the Chinese Middle Class evolves.

Frontier Markets have struggled to keep up with their Emerging Markets kin and Q3 was no different, as the MSCI FM Index was up 2.7%, bringing CYTD returns to only 2.2%. That said, within the ho-hum Index returns were some real winners and losers. On the upside, it was all about the Balkans as Croatia, Romania and Slovenia topped the charts, rising 17.1%, 13.2% and 12.4% for the quarter and 26.1%, 19.5% and 2.9% for CYTD, respectively. Ukraine was only slightly behind in Q3, up 11.1% and now quietly up 21.7% for the CYTD. Once again Sir John Templeton was right in saying don't look for where things are going well, but look for where things are the most miserable (it would have been tough to find a more miserable place last year than Ukraine, maybe Brazil). On the downside, it was mostly about Africa as the continent had losses across most countries with Nigeria leading the pack, down (11.1%), Zimbabwe down (9.1%) and Ghana and Botswana both down (5.6%). One of the Balkan Peninsula residents, Bosnia and Herzegovina also had a rough year, falling (10.5%) for Q3 and down (21.8%) for the CYTD. We mentioned last time that *"there are some very interesting developments occurring in Vietnam and Pakistan and we would expect to see continued strength from these small, but mighty, markets in the coming quarters and years."* Indeed, Pakistan

continued their winning ways in Q3, rising another 6.4% to be up 20.9% for the CYTD, but Vietnam was more muted, up only 0.7% and up a modest 2.9% for the CYTD. The real story for these two markets may develop in 2017 as they are both candidates for inclusion in the MSCI EM Index. History shows that markets included in the Index rise between 60% and 120% in the year leading up to the actual inclusion (see UAE, Qatar and Dubai as recent examples).

The other country that is likely to be included in the EM Index in 2017 is Saudi Arabia, and we think there is tremendous opportunity in this market in the coming year. You might not believe it from the recent performance as Saudi stocks fell (10.7%) and are now down (13.1%) for the CYTD. There is a lot of angst within the global investment community about Saudi and the oil prices (neither of which appear to be very stable), but what we believe many are missing is the significant change that has occurred in the leadership of the country with the ascension of Deputy Crown Prince Mohammad Bin Salman. The installation of a 31 year old as the heir apparent to the Crown is a significant departure from history in Saudi and reflects a modernization in thinking about the future of the Kingdom in the post-hydrocarbon era. Change could not come soon enough for equity investors in Saudi Arabia as the Tadawul All Share Index ("TASI") peaked at 11,149 on September 9, 2014 and has been in a cascading decline even since, shedding more than half its value and hitting a low of 5,416 on October 3rd of this year. Interestingly, like the Nikkei, the TASI made a textbook Double Bottom pattern in 10/18 at 5,461 and has rebounded the last few weeks and looks poised for additional gains as investors begin to anticipate the stronger inflows from Index inclusion. There is more to the story than just MSCI inclusion as corporate profits are recovering as oil prices have stabilized, the government budget problem was solved with a recent debt issuance and the prospect of an IPO of some portion of ARAMCO has animal spirits flowing again. We have been adding exposure to Saudi in our portfolios and would expect to see some outsized returns in the coming quarters.

Another of our favorite Frontier Markets for the past couple of years has been Argentina. As we wrote last time *"all of the things necessary for investment success seem to be falling into place in Argentina. The bond hold out issue was resolved, newly elected President Macri has made a series of bold moves that are very pro-business, the capital markets have opened up widely as the first new bond issue was the most over-subscribed issue in bond market history and there have been a wave of new IPOs bringing fresh supply to eager investors."* One of the biggest challenges in Argentina was the low level of equitization relative to GDP as so few companies were able to access the capital markets during the long road back from the defaults of 2001. The small number of investable options has been a blessing in disguise in the short-run as it has not taken much capital moving to Argentina to raise prices. Q3 was another solid quarter as the Merval Index rose 2.7% for the period, bringing CYTD returns to 19.5% and TTM returns to a FM leading 50.2%. Fears about past defaults, currency devaluations and corruption have made global investors skittish about re-engaging with Argentina. We wrote last quarter that there was a silver lining in that reticence in that *"the reluctance of global investors to come back quickly to Argentina would extend the investment opportunity (so far, so good) and we expect to see meaningful opportunities to make excess returns in this market for many years to come."* If we look at the past three months, the banks have done fine, GGAL up 6% and BMA up 2%, the oil company YPF struggled a bit, dropping (4%). All the while, the utility, Pampa Energia (PAM) has been, dare I say, en fuego, rising another 26% (to be up 66% CYTD). For perspective, the other names are up 15%, 32% and 13% for the year and the ETF ARGT is up 32%. Viva Argentina!

When looking at the bond markets in Q3 it appears that there was not much excitement as the Barclay's Aggregate Index was up a scant 0.5% for the period and the Barclay's Long Treasury Index fell a fraction, down (0.4%). Even with no return in Q3 the returns for fixed income are still gaudy with the Aggregate

Index up 5.8% for the CYTD (only slightly lagging equities) and the Long-Bond Index up a stunning 14.7% for the CYTD (nearly double the return of the S&P 500). But this seemingly calm performance during the quarter masks some significant volatility as there was one last cathartic melt-up in the first week on July and it has been a downward march ever since. For reference, the long duration Treasury ETF (TLT) jumped 3.6% from 6/30 to 7/8 and then fell (3.9%) by 9/30. The net effect during the quarter looks like no movement, but the bottom fell out in October and TLT fell from 137.26 to 130.45, declining (5%) for the month. It appears that the Fed has finally convinced people that they are truly serious (as opposed to Sutherland serious in Animal House from the last letter) and bonds responded by shedding one-third of their gains as we came to Halloween. We wrote last time that *"one would think that the doomsayers in bond land who keep saying that bonds are going to get crushed any day now must be getting tired of being wrong at this point,"* but it is perhaps possible (emphasis on perhaps) that the Fed really does go through with what appears to be an ill-advised rate hike to end the year (and maybe the crushing will continue). We say ill-advised because all the economic data that we see is pointing to a fairly serious slowdown in economic activity, and it appears to us that a tightening of liquidity would be a policy error at this point. We said in January, in our Surprises #2 (Two Wrongs Won't Make It Right), *"that QEeen Janet would channel her inner dove and not raise rates in 2016"* and after five FOMC meetings it is still so far, so good, on the "no hikes for you" mantra. We did say last quarter that *"there is still a lot of 2016 left and the Fed has tried to "keep fear alive" before each meeting in an attempt (lame though it may be) to keep the bubbles they have been blowing across financial markets from getting truly out of hand."* They have apparently been successful in stoking that fear and fanning the flames and investors are yelling "Fire" in the crowded theater. After spending some time with one of our favorite managers in London who owns a lot (and we mean a lot) of long bonds (Treasuries and Bunds) he convinced us that nothing has changed that warrants shifting the view that the Fed missed their opportunity to raise rates in 2013 and there is not enough going right for them to propagate any meaningful increase. As for the December hike, he thinks it could possibly happen, but that would be it and it would then be even more likely that they would be forced to ease again (QE IV or something better) in 2017 as the economy tips toward Recession.

Global Fixed Income markets had been non-stop a party during the first half of 2016, as the relentless front running of Global Central Banks (particularly the ECB), who had basically told the world "if you issue a bond, we will buy it…" created a massive race to the bottom, leading ultimately to over $13T of bonds trading with negative rates. Add a falling Dollar, and U.S. investors in international bonds got a double bonus. That said, the Barclay's Global Bond Index took a little breather during Q3 after the torrid 9% surge in 1H16 and rose just 0.8%. Once again the sedate outcome masks a very volatile period where the oscillations around zero became very rapid (usually the sign of a trend change, like water atoms vibrating rapidly before they turn into steam or ice) and global bond yields looked like just as much of a roller coaster as global equity markets. One example, the German Bundercoaster (10 year) began the quarter at a yield of (0.13%) and fell to (0.19%) by 7/8 before jumping back in to positive territory on 7/15 at 0.01%. Then it was back down the slope to (0.12%) to end the month on 7/29, only to pop back above the line at 0.07% on 9/13 and back down below the line to end the quarter right back where it started at (0.12%) on 9/30. That's where the "fun" (less fun if you actually owned Bunds, or any other bond for that matter) started as fears of the Fed actually raising rates in December (and a bunch of highly acclaimed Bond Gurus talking their short books on TV) triggered a near panic selling spree turning the normal party month of Oktoberfest into Rocktober for bondholders and the Global Bond Index shed a third of the gains in the month, falling (3%). The Bundercoaster locked in to the chain lift and yields jumped from (0.15) at the trough on 9/28

to 0.17% a month later (which is a really big move at these low levels). On both sides of the English Channel, the amusement park rides turned scary, as the GILTcoaster ran from 0.68% to 1.26% and the Italian BTPcoaster ran from 1.19% to 1.59%. There is a rising cacophony that "this time is the big one," and that foreign government bonds are the short of a lifetime. Before we get too carried away, let's recall that Bund yields (as a proxy for all) have had multiple surges in the past five years (many much larger than the current one) and the yield has always peaked at a lower level (lower highs) and headed right back down to new lows (lower lows). From 7/20/12 to 9/14/12 Bund yields surged from 1.17% to 1.71% (and everyone was convinced the lows were in…), then from 4/26/13 to 9/13/13 yields surged from 1.21% to 1.98% (and everyone was convinced the lows were in…) and then from 4/17/15 to 6/26/15 yields surged from 0.08% to 0.92% (and everyone was convinced the lows were in…). As we all know the 10-year Bund hit (0.15%) on 9/28 of this year (new lower low) and now that they have backed up to 0.17% people are panicking. Until we surpass the 0.92% 2015 high there is nothing to see here. The real question we have to ask is what has changed so much in a positive direction that rates must rise? Is European and German GDP growth better? No. Has European inflation emerged? No. Are European politics stable and supportive of better growth? No. Have European Demographics gotten better? No. Are European banks extremely healthy and rapidly growing new loans? No. So until we get a few more Yeses, we will still take the under on the secular bottom being reached for global yields.

Credit markets shifted into "Ludicrous Speed" in Q3 as the Barclay's High Yield Index surged 5.5% (for the second quarter in a row) as investors continued to scramble for yield wherever they could get it with no regard for credit quality (may the Farce be with them). The mad dash for yield is the result of living in a world where 40% of global sovereign bonds have not just a low, but actually a negative, yield. After another strong performance, the HY Index is now up 15.3% for the CYTD and despite other bonds getting whacked by rising rates in Rocktober, HY has cruised right along as spreads keep tightening and the BofAML Index is looking to be up another 0.7%. For some perspective, credit was getting crushed in the first six weeks of 2016 as markets were nervous about an RMB devaluation (news flash – USDRMB is higher today than then) and the threat of a Fed rate hike (still hasn't happened though suddenly viewed as a positive if it does happen in December). Option Adjusted Spreads (OAS) were soaring from 6.95% to 8.87% on 2/11 and the HY Index was down (5.1%) and headed lower when suddenly everything changed in an instant and we have seen eight months of record flows into HY and eight straight positive months of returns (and a 22.5% bounce off the bottom). The other odd thing is the junkier the company is, the more people want it today as CCC rated bonds (rated CCC because 50% default within four years) are up nearly twice as much as regular HY, up an astonishing 28.8% through the end of Q3. OAS had collapsed to 4.97% as of 9/30 and kept tightening down to 4.69% at the end of October. We wrote last time the *"despite the fact that corporate debt levels are at all-time highs and there are many companies with suspect balance sheets issuing bonds, sure enough, since the bottom in February, there have been record inflows into HY bonds. Normally this kind of rush into an asset class has been a contrarian indicator for future returns, but not so far in 2016 as HY Bond prices keep getting larger and the yield in "high yield" keeps getting smaller."* Another interesting fact is that the HY market in 2016 is now set to have the third best year in the past two decades, behind only 2003 and 2009. The reason that is interesting is that both of the two other years were coming out of a Recession (and a massive wave of defaults) and this year has neither of those tailwinds.

The trend has not only continued in Q3, but has accelerated despite the fact that there have been a near record number of corporate defaults in 2016 (the default rate has doubled to 4.6%). Worse yet, the recovery rates on defaulted bonds have dropped to

their lowest levels ever, since the "quality" of the balance sheets of the companies that finally do succumb to bankruptcy is horrific (you have to be in really, really bad shape to die in a world of free money). Looking forward, from these levels the expected return to HY bondholders over the next year (assuming default rates don't increase, which is a stretch given the natural four year cycle of defaults and the wave of issuance in 2013 is now ready) is zero. Should default rates rise next year to the more normal level for this stage of the cycle (7.5%), that expected return falls to (9%). Return free risk seems like a really bad thing to own. We noted last time that *"we went so far in January as to "agree with Uncle Carl Icahn made MCCM Surprises #10 (The Bus Stops Here) and we looked intelligent for the first six weeks of the year, but have looked overly cautious since."* "Overly cautious" is generous; we look silly at this point for doubting the power of the global stretch for yield, but when valuations reach extreme levels we think it pays to remember the words from our tribute to Shakespeare earlier in the year where he writes in the *Merry Wives of Windsor* that *"you can be three hours early, but not one minute late."* Turning back to our #TheValueOfValue theme from last quarter, we know that market history is filled with examples of paper gains being wiped out when prices finally do adjust to fair value, particularly when investors pile into an asset with no margin of safety as they are today. It might be time that HY investors all don their Dark Helmets and strap in for what could be a very bumpy ride on Larry's Party Bus.

Another result of the global stretch for yield is that it turns out when investors demand something creative investment bankers will gladly underwrite new supply. We discussed last time how *"the EM Debt market has grown dramatically over the past decade and the diversity of issuers, higher real (and nominal) yields and better overall credit quality has attracted huge inflows into the space from global investors."* What has been a bit surprising is how EMD has become the go-to Safe Haven trade when things get rocky as investors perceive there to be better credit quality in EM than in the more highly leveraged Developed Markets. Clearly that doesn't mean that all EMD is good and all DM HY is bad. It is more to point out that on average investors can find superior issuer quality and more diversity of product in EMD today than ever before. The global search for yield continues to create massive demand that has swamped what appeared to be ample supply (the I-Bankers have been working overtime) and the JPMorgan EM Bond Index rose another 3.1% in Q3 to push the Index to up 12.8% CYTD. We probably need to repeat our admonition about Bonds someplace in the letter, so it might as well be here, *"the challenge of owning bonds in the current environment is that three things can happen and two of them are bad; 1) you hold them and inflation chews up your returns because yields are so low; Bad, 2) you hold them and rates rise and you actually lose money; Worse, 3) you hold them and rates fall and you make money; Good (but then we may have other issues to deal with since falling rates are a sign of economic weakness)."* Now that EM Bonds have gone mainstream, the bond holders dilemma now applies to EM Debt as well as all the other forms of fixed income we have discussed above. In so many global bond markets yields have been compressed so far that there is simply no margin of safety (there is no Value) and the expected return from this point forward is likely to be very unappealing. When you resort to buying something simply because you expect some greater fool to pay an even higher price (translation, the cash flows on the actual investment generate little to no return), you have become a speculator and while speculation can work out from time to time, you move from the realm of probabilities (if you buy an asset at a discount it is probable you will make money) to the realm of possibilities (if you buy an asset at a silly price it is possible you could make money). We wrote last time (and wish to echo the sentiment now) that *"granted that given the choice between Developed Market corporate debt and Emerging Market corporate debt, we would still favor EM, but we would choose lots of other investments over both of them, like market neutral arbitrage strategies, private*

lending strategies, BDCs and MLPs."

Speaking of other yield related assets, 1H16 was a party zone for REITs and MLPs, and while the path was different for the two asset classes, the destination was the same – double digit gains for both through June 30th (REITs up 13.3% and MLPs up 14.7%). After the great divergence last year when MLPs were smashed and REITs continued to surge, global investors ran from falling oil prices and toward rising RE prices (actually probably makes more sense to do the opposite over the long-term, but short-term is trickier). We discussed that divergence in the Q4 letter saying *"it might seem safe to assume that assets which investors purchased primarily for yield would move together depending on the rate environment (would rise with falling rates and fall with rising rates). The breakdown in that thesis is that the source of the yield may be impacted by different elements within the environment and an asset might not follow the pattern in the event that business fundamentals changed more rapidly than the change in the rate environment."* More simply put, not all yield assets are created equal; different structures, different leverage levels, and different underlying asset quality *should* produce different return streams. The problem lies in those times when investors ignore all the differences and simply buy the yield of what they consider to be comparable assets (REITs and MLPs). We were back to not all yield assets are the same in Q3 as the S&P U.S. REIT Index began to sell off on fears of rising rates, falling (1.3%), while the Alerian MLP Index rose 1.1% with ebullience about the chances for an "OPEC Freeze" (agreement by OPEC members to cap production). The slight drop in REITs trimmed CYTD returns to *only* 11.8% (still far ahead of the S&P 500 return of 7.8%) and we reiterate what we wrote a couple quarters ago that *"the most impressive thing of all about REITs is that, interestingly, they have outperformed equities over nearly all trailing periods during the past twenty years, so perhaps there is something to this yield construct after all."* With that said, we can't help but feel that this is not a particularly good time to put new capital to work in REITs as it is beginning to feel a little like 2007 (when we made a lot of money for clients going short REITs along with short Sub-Prime) where investors seem to be willing to pay any price for real estate related assets. When the margin of safety disappears, usually forward returns disappear, and perhaps we have seen a glimpse of what could happen this month. If October became Rocktober for bonds, it became RockEmSockEmtober for REITs as the Index collapsed (6.5%), losing more than half the returns generated in the first nine months of the year.

Back to MLPs, the Alerian MLP Index after the explosive 19.7% move in Q2 it wasn't surprising to see MLPs take a little breather, but with the Index up 15.9% for the CYTD, it is one of the best performing asset classes in 2016. In January, we talked about how trying to catch falling knives in investing was a very dangerous sport, saying that the best strategy is to let the knife hit the ground, bounce around a bit and then go over and pick it up by the handle. In discussing how effective it can be to buy really cheap assets when they are significantly marked down, we wrote last quarter that *"in Q1 we observed that perhaps the knife had indeed hit the floor and stopped moving and highlighted some really impressive moves from the mid-February trough as MLPs like ETE, PAGP and WMB were up 125%, 75% and 50% off the low, respectively."* We have been making the case that there were indeed a bunch of oil & gas related companies that never should have been allowed to utilize the MLP structure, but the mid-stream transportation companies had long-duration assets and relatively stable cash flows that were ideal for MLPs (when the markets sorted themselves out these pipeline companies would surge). At the bottom in February, investors had thrown all the babies out with the bathwater and had priced all MLPs as if there essentially would not be any production growth in hydrocarbons in the U.S. in our lifetime. It truly was a generational buying opportunity. We looked specifically at our favorite mid-stream companies in the last letter, saying *"it appears that investors have come around to the idea that hydrocarbons will*

continue to need to be transported in the U.S. and ETE, PAGP and WMB were up 33%, 17% and 24% respectively over the past three months and are now up an impressive 215%, 75% and 85% from their bathwater phase in February." Updating the scoreboard for the past three months, ETE hit a little resistance (was a bit overbought) and fell (9%) while PAGP and WMB continued their impressive recoveries jumping 18% and 24%, respectively. From the 2/11 generational low in prices, this trio has been nothing short of spectacular, rising 175%, 125% and 125%, respectively. To keep things in perspective, consider that if we back up to the CYTD returns the numbers fall to a much less spectacular (but still strong) 10%, 33% and 15%, and if we back up to the 6/22/15 date of the announced hostile takeover of WMB by ETE (turns out they do ring a bell) these MLPs are still down (54%), (53%) and (52%), respectively (so still significant headroom above). The total peak to trough drawdown from June to February was an astonishing (88%), (80%) and (82%), respectively. Now that is what one might call a serious discount, and was clearly a Value buyers' dream (which is probably why Klarman and Tepper bought so many).

To say that there has been a meaningful change in sentiment toward commodities in 2016 would be a huge understatement. After a punishing five-year Bear Market from 2011 to 2016 not only did no one want to invest in commodities (and many managers were still heavily short), no one even wanted to talk about commodities. Trade show attendance was down, commodity company management break-out sessions at investment banking conferences were sparsely attended and long-time commodity bulls like Jim Rogers had been relegated to "has been" status. What better time could there be to buy? We wrote last time the stage was set perfectly for a commodity rebound as *"the Dollar was confounding the pundits who had predicted a major rise, Oil was in the bottoming process (actually bottomed on 2/11) and Gold was firmly locked in recovery mode. In our MCCM Ten Potential Surprises for 2016 presentation, MCCM Surprise #9 focused on "the one truism in commodity markets, The Cure for Low (high) Prices is Low (high) Prices. It turns out capitalism works and high prices bring on new capacity that eventually collapses prices and then low prices lead to shuttering of capacity that eventually allows prices to move back up."* Continuing with the roller coaster analogy, the GSCreamcoaster (GSC is the GSCI ETF) had plunged (15.8%) down the initial hill during the first three weeks of the New Year in one final cathartic sell off and then locked into the chain lift and steadily rose 41% over the next five months to crest in June. We wrote last quarter that *"like the locusts in A Bug's Life, they came, they ate, they left and as quickly as the money appeared, suddenly on June 8th it began to vanish and commodities began to correct. GSCI dropped (14%) in the seven weeks to the end of July"* and the roller coaster ride was back on. We further noted, *"It will be very interesting to see over the next quarter if this recent move was a normal correction in a new commodity bull market or whether the strength in the first half of 2016 was a steroid (read liquidity) induced pause in the ongoing commodity crash that began in 2011."* The GSCreamcoaster gave us the answer as it came quickly to a bottom on 8/2, down a gut-wrenching (16.5%), but careened back up 11.6% over the next two weeks before plunging (7.2%) over the next month and ramping back up 4.4% to finish the quarter down (3.9%). The cars kept rising in October, up 2.7% and now up 8.2% since we wrote the last letter. If we look at the GSCI chart today things look pretty good with a series of four higher lows over the course of the past eight months and a nice 10% return in the bank for the CYTD. Again, to gain some perspective, the GSCI Index is 56% lower than where it was two summers ago and is down (60%) since the beginning of the Commodity Bear Market in May 2011. So there is plenty of room for this recovery to run. An interesting tidbit is that over the past five and a half years the S&P 500 and the GSCI make a perfect Alligator Jaws pattern with SPX up 60% and GSC down (60%) and we all know that eventually alligator jaws will close.

Realizing that the roller coaster theme may be getting a little tired by now, it is hard to not use it since nearly every asset market is locked in a high volatility circular trip to nowhere these days and the oil market is no exception. The Crudecoaster was incredibly wild in the first half of the year and for the first four months of the second half the price of WTI has fluctuated wildly again but moved a *massive* $0.13 from $48.33 on 6/30 to $48.24 on 9/30 (down a scant (0.2%) for Q3) to $48.46 on 10/28. After four more months, we have gone another lap with no movement in price, but the ride was incredibly wild. From the starting ramp of $48.33 on 6/30 the cars plunged down a hill in July and finally found a bottom on 8/2, down (18.5%) to $39.51 and then careened up 22.8% in the next two weeks to hit $48.52 on 8/19. The Crudecoaster crested that hill and plunged back down (11%) to $43.16 on 9/1, surged back up 10.3% to $47.62 a week later on 9/8, fell another (9.6%) over the next week to $43.03 on 9/16 and then caught the chain lift back up one last hill to rise 19.9% to $51.60 on 10/19, released and coasted down (6%) to glide back into the starting gate right where it started 120 days before. Will we take another lap over the coming months? We will write about that next time, but we do know that November and the first half of December are seasonally weak periods for oil (with an average decline of 7%) followed by a little rally into year-end and another seasonally weak period in January and February so it could be a wild ride over the Holidays.

We had a view on oil coming into the New Year that has actually played out pretty closely to the script. We wrote in our Ten Potential Surprises in January that Surprise #4 would lay out the path for WTI saying, *"the resumption of Iran oil trading and short-term storage concerns push the market into steep Contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production declines push prices back toward $50."* With only a couple of months left in the year, and prices hovering right around $50, we feel pretty good about our chances on this surprise. However, we discussed in Q1 how a notable oil trader in London had upped his forecast for 2016 to $60 (which he released on 2/10 and perhaps caused the reflexive bottom at $26.21 the next day). We reiterated last quarter that *"we are clear-eyed about the dangers of disagreeing with a legendary oil trader on oil prices, but to be clear, we completely agree with his directional call, but just think the market rebalancing will take modestly longer based on our conversations with our private energy fund managers who are running U.S. shale companies."* The key to our view is that the technological innovation that is taking place in the U.S. oil business is impressive. Saudis back in 2014 might have thought that by pushing prices down into the 70's they could drive the U.S. shale producers out of business, but the plan backfired and the top companies in the best basins (Permian, Scoop, Stack) can now produce oil very profitably at $50 (maybe even lower in the core of the Permian). We expect to see Texas play the role of swing producer in the oil markets going forward. We will update our oil forecast for 2017 in our next Ten Surprises in January, but for now, we are content with the $50 target and a $40 to $60 range around that target for the next few quarters. One last note on oil is that we have been spending a disproportionate amount of time with our private energy managers this year (an indication of how attractive we think the opportunities are) and every time we talk to one of the teams in the oil patch we come away even more excited about the potential to make outsized returns in the private oil & gas markets.

Not a day goes by that you don't read a story in the financial press or hear some talking head on TV talking about Oil and Gold (the glamour commodities). There are plenty of other commodities that are not only newsworthy, but can be great places to make money as well. Natural Gas has been a traders' dream over the past few years as it has made a number of significant trend moves (as opposed to choppy moves that chew up most of the trading profits) and there are some very interesting developments with the transition from El Niño to La

Niña that could make this winter particularly interesting in the Natural Gas space. Copper and Iron Ore are two commodities normally associated with global GDP growth (more specifically of late, China GDP growth) and the price trends in these industrial metals are very closely watched for clues as to the state of the global recovery (or lack thereof). In Q3, we can forget the roller coaster analogy for Natual Gas and use a trampoline instead. While the price fell only (2.1%) for the period, the price moves in the past few months have been unusually volatile (to say the least) with double-digit plunges and surges becoming commonplace week to week. We wrote in the Q1 letter that *"there seems to be some balance around the $2 level and the futures curve puts Natural Gas above $3 sometime later in the year."* Prices started Q3 at $2.88 on 6/30 and we wrote last quarter that, *"prices touched $2.99 on the first day of July (leaving our $3.00 "sometime this year" for later in the year*" and then Natural Gas proceed to start bouncing on the trampoline, dipping (11%) to $2.66 on 7/20 and bouncing back 8.3% to end July right back to $2.88. At that point we were deep in writing the quarterly letter and we had just met with one of our favorite resources managers who thought that the production levels in the Marcellus and Utica were so high that there was a small risk we could run out of storage so there was risk of one last drop back to $2.00 before beginning a slow climb toward $4.00 sometime in 2017. The day we were writing this section we got another piece of source information (on gas injections) and wrote that *"the most recent injection data showed that high demand due to scorching summer heat has trumped supply and it looks like the path of least resistance for Natural Gas is higher."* Over the next ten days there was the first of many double-digit moves as prices fell (12.7%) to $2.55 on 8/11 and then bounced 13.3% over the balance of the month to finish August at $2.89. Another (7.3%) drop down to $2.68 (again a higher low) and then the big upward moves began. "Sometime this year" finally occurred on September 20th when Natural Gas hit $3.05 (up 13.8%) and then slipped back under the $3.00 line over the balance of the month to trough at $2.91 on 9/30 (down (4.6%), but another higher low). Then the fun really began as prices surged an astonishing 31% during the first two weeks of October to peak at $3.34 on 10/13, only to plunge right back down (18.3%) to $2.73 on 10/26, followed by a 14.6% bounce over two days back to $3.13 on 10/28 (phew!). Now we know why trampoline has become an Olympic sport. From here, the move down to $2.73 is troubling because that took out the prior low, so we need to see a move back above $3.34 in order for the upward trend to stay in place. With temperatures unseasonable warm in October (so the A/C has been working overtime) prices in the next few months will likely shift to being influenced by just how bad a mood La Niña is in this winter and how quickly she sends her blast of artic air down into North America.

Copper has been mired in one of the more brutal Bear Markets of all of the commodities since 2011, falling (57%) from the early 2011 peak to what appears to be a final trough at $194 on January 5th this year. The best analogy for Copper over those years was not a roller coaster, but a rubber ball bouncing down a set of stairs as there were some meaningful bounces (kinetic energy), but the end of the trip is a bad place (much lower). The roller coaster did kick in this year as Copper prices fluctuated wildly, but eventually ended up in the same place where they had started (making laps). We wrote about this last quarter saying *"while the move in Copper prices in Q2 was actually 0.0%, the volatility was nausea inducing and some market observers think this is a dramatic bottoming process and that Copper will head higher along with other commodities in coming quarters."* We also discussed how one highly regarded hedge fund manager was so confident in the impending rally in commodities (and especially Copper) that he was raising a long only fund with a unique fee structure (no management, only incentive). Q3 was more of the same in the Copper markets, lots of volatility and essentially no movement in the price, up only 0.4%. Copper started the quarter at $220 and quickly fell to $212 on 7/8 and then bounced dramatically up to $226 on 7/19, but then headed right back down over

the course of the next six weeks to $208 and the boo-birds were out claiming that a new Bear Market had begun. But the higher low held and Copper bounced back to $221 to end the quarter (lots of noise, very little signal). The volatility continued in Rocktober as prices sank to $209 by 10/21 (again, a higher low) only to spring right back to $221 on 10/31 (flat again). There is something important about that $221 close. Since the January low, Copper prices have made a series of four higher lows and a series of four lower highs (picture a wedge shape like a pennant flag) and $221.05 was the last lower high, so any breakout above that level could indicate that a new primary trend (up) has been established. The narrowing of the volatility range is another sign of a potential "phase shift" as in Q1 price swung from $194 to $229, in Q2 the price range tightened to $203 to $228, in Q3 the range tightened again to $207 to $226 and now in October that range has shrunk again to $209 and $221. We will definitely have something to write about on Copper next quarter, as the coiled spring will break one way or the other.

We discussed in the Q1 letter something else that could be a confirming signal for the upward trend for Copper, *"the trading company stocks have soared off the bottom, with some up more than 100% and those most tied to Copper, like Glencore and First Quantum are up 160% and 360% respectively since January."* We wrote about this type of reflexive movement in our letter about Soros a couple years ago, but reiterated the point last time as we had seen so many examples of this type of rebound across the commodity complex, saying *"it turns out that when companies come close to bankruptcy, but stay alive, their equity acts like an option and returns can be staggeringly good."* To update what went on in the Copper-related companies in Q3, FCX (Freeport-McMoRan) gave back some of the huge early gains and fell (15%), SCCO (Southern Copper) rose 7%, FM.TO (First Quantum) was up another 8%, GLEN.L (Glencore) jumped another 31% and TCK (Teck Resources) was the best of the bunch (with help from their coal business too), up 32%. From the late January bottom to the end of October these companies are up an astonishing 175%, 25%, 325%, 210% and 520%, respectively. Iron Ore has been the opposite of Copper insofar as the prices have rebounded sharply this year, and while they have also been volatile there has been a strong upward trend since the bottom in January. Iron Ore experienced one of the most brutal Bear Markets in all of Commodities since early 2011, falling (78%), from a peak of $185 to $40 (technically prices had a three handle for a few moments). We wrote last quarter about how there was some serious volatility at the end of Q2 around the loss of Chinese buyers in the futures markets, but other buyers clearly stepped in as we highlighted, *"Iron Ore said not so fast and surged back 9.6% in July and is now up 39% CYTD dragging pure play names like Vale, Fortescue and Cliffs along for the ride, up 164%, 204% and 555% from the January nadir (more examples of optionality)."* The July move was most of the move in Q3 as Iron Ore was up 10.3% to end the period at $58. The Iron Ore related equities had a solid Q3 for the most part with VALE up 20%, FMG:AU up 24%, BHP up 18%, RIO up 5% and only CLF consolidated some of their outrageous gains, falling (32%). Since the January trough these stocks are up amazing 200%, 260%, 75%, 50% and 290%, respectively. Like Surprise #9 says, the cure for low prices is low prices and buying assets when they go on sale is the essence of The Value of Value.

Precious Metals were the big story in the 1H16 as the bets made by legendary investors like Stan Druckenmiller in late 2015 to put one-third of his portfolio in gold at $1,100 (when many called him crazy) suddenly looked crazy like a fox with gold at $1,300. Part of the allure of the metals in 2016 was their currency character as faith in fiat currencies was waning and threats of an RMB devaluation seemed imminent, investors sought out the protective benefits of hard currencies. After a big surge in Q1, we wrote last time that Q2 was very strong as well as *"the PMs surged again in Q2 with Gold up 7.2%, Silver up 21.2%, Platinum up 5% and even Palladium (more*

industrial than precious) got out of the doghouse and rose 6.3%." Q3 was much more muted in the precious metals space and the question on everyone's mind today is whether this break in the action is the pause that refreshes or the rounding top setting up for a resumption of the Bear Market from 2011. PMs were essentially flat with Gold down (0.5%), Silver up 2.5% and Platinum up 0.3%. Palladium went along with the industrial rather than the precious and surged 20.2% as supply issues surfaced again. A series of five lower highs in Gold make for an ominous chart pattern and the (3.2%) decline in Rocktober isn't helping confidence in the metals. Whether it was election uncertainty or fears of a Dollar rise should the Fed actually raise rates in December is not critical to discern, but both are likely to result in heightened volatility as we head into the end of the year.

As investments go, there are the metals and then there the companies that dig up, process and distribute the metals and history has shown that while the long-term return on commodity futures is pretty close to nil, the return on commodity equities has been very strong (albeit quite cyclical). We discussed this dichotomy (that can even exist in the short term) last quarter when we wrote, *"as solid as the returns in precious metals are, they pale in comparison to the gaudy returns posted by the miners as GDX jumped 39%, GDXJ surged 53%, SIL soared 64% and SILJ screamed upwards 68%. The miner party kept going in July with GDX, GDXJ, SIL and SILJ up 10.5%, 17.5%, 17.5% and 23%, respectively to bring the CYTD returns to alchemical levels of 123%, 160%, 176% and 255%, respectively."* The party kept going another two weeks after we wrote the letter and then the music stopped. They say that "if a trend is unsustainable it will not be sustained" and we saw proof of that statement in the fact that stocks can't keep rising 10% a month for very long before investors get nervous and will take profits (thereby reflexively causing the trend to end). That profit taking moment came in the middle of Q3 and at that point GDX, GDXJ, SIL and SILJ were up an astonishing 13%, 20%, 24% and 32% (for six weeks), but proceeded to give back most (if not all) of those gains and finished Q3 with returns of (4.5%), 4%, 3% and 6%, respectively. Note to self for future letters, when you use words like gaudy to describe returns it is time to think about the other side of the trade as we were two weeks away from a major turn for the Miners and they have fallen (22%), (21%), (22%) and (24%) over the past three months to bring their CYTD returns to a somewhat less gaudy (perhaps rock solid) 75%, 105%, 115% and 170%, respectively. We wrote in Q1 that, *"historically when gold miners and silver are outperforming the gold metal that has been confirmation of a bullish trend and clearly the Bull is loose in the Precious Metals shop."* The question now is does the inverse apply and when Gold is outperforming the Miners and Silver is there a problem, or do buyers just need some time to digest before the next course? We remain constructive on the metals and the miners (with the caveat that there will be heightened volatility related to elected administration and Fed) and we will be back in three months with an answer.

We have chosen to be agnostic about Agricultural commodities this year and wrote a couple quarters ago that *"extreme volatility due to weather, uncertainty about the Dollar and global growth concerns meant it has been best to simply ignore the sector altogether from an investment perspective and we will remain consumers of Ags in restaurants, but not in our investment portfolios."* Q3 was a repeat of Q1 where everything plunged hard. Wheat fell (13.6%), Soybeans fell (16.5%) and Corn was the "standout" falling *only* (9.3%). La Niña has made herself right at home and we have had record heat in the U.S. (and now predictions of record cold this winter) and she has been messing with the Starbucks Index (Coffee and Sugar) as those prices followed up their Q2 surges 11% and 30% with another gain of 2.2% and 12.6%, respectively. These markets continue to be "un-investable" in our minds and we wrote a few letters ago that *"perhaps these markets will revert back to a more consistent trend following pattern, but until then, we will leave them to those with higher levels of short-term trading acumen."* There are lots of

markets to invest in around the world and our preference is to focus on those where we can perform fundamental analysis and get an edge (meteorology is not our strong suit). All that said, there is a case to be made that La Niña is going to really mess with harvests this year and that the Ags will be a good investment at some point in 2017, so we will keep talking to the handful of managers we think have some expertise in these areas and we will try to remain open to the idea that at some point the price will be low enough where incremental supplies will be impacted and the headwinds in these markets could turn into tailwinds.

We probably don't need to write this next sub-section of the letter anymore because (as everyone knows) Hedge Funds are dead. It turns out that Hedge Funds must be like cats because this is at least the fifth time in my career that the media has proclaimed the death of Hedge Funds (only to have the immortal words of Mark Twain on the reports of his demise being premature apply again). HFs died in 1996 when Business Week wrote *The Fall of the Wizard* and proclaimed that Julian Robertson (who had dominated the industry for 15 years) has lost his edge (he was down (9%) that year) only to have him produce nearly triple digit gains the next year. HF AUM was $250B. My former employer believed the article and actually banned hedge funds that year (right before I got there in 1998) and we had to work hard to convince them that the ban was a bad idea (we were successful and hedge funds saved us from 2000 to 2002). HFs died again in 1998 when Long Term Capital Management imploded when they mismatched their leverage and their strategies and blew up a couple Billion of equity capital (and were accused, incorrectly, of nearly taking down the entire financial system). HF AUM was $375B. HFs died again in 2000 when Julian stepped away from the business and closed down Tiger Management citing an inability to understand the extreme valuations of the tech bubble (better to live to fight another day he would always say). HF AUM was $500B. HFs died again in 2005 when Brian Hunter torched $6B (almost seems like real money) in a battle with legendary Natural Gas trader John Arnold caused Amaranth to shutter and the resulting run on the bank in Convertible Bonds nearly wiped out the entire segment. HF AUM was $1.1T. HFs died again in 2009 when firms who had crushed it being short financials in 2007 & 2008 got blindsided by the TARP bailouts and were down when the long only guys were feasting on the dead cat bounce after QE I. HF AUM was $1.6T. HFs died yet again this year thanks to a horrific Q1 where we had a repeat of Q1 2000 where the best companies (HF longs) went down and the worst companies (HF shorts) went up while the Indices were flat. HFs lost twice. The headlines talk about the worst outflows from Hedge Funds since 2009 ($60B, which is < 2% of AUM and 1/3 the outflows from Mutual Funds) and the media keeps reprinting the same story about a handful of big public Pension Funds that are selling their HFs (where they are following up their terrible buy timing (after the GFC) with terrible sell timing to chase the hot returns of passive long-only). HF AUM is still $2.95T. In fact, we even know one really smart CIO of a large California pension fund who is increasing his allocation to hedge funds, and we think he will be proven very wise indeed over the next decade.

So why is it that while Hedge Funds have generated superior returns to traditional equity strategies over many decades the financial media, boards of asset owners (Pensions, Endowment & Foundations) and even the actual users of hedge funds have been so quick over time to declare that these investment strategies are "dead" and that investors would be better off (despite the data to the contrary) in low cost Index Funds (or other passive strategies)? The answer (perhaps) can be provided in two words, professional jealousy. A friend of mine told me once that "people want you to do good, just not *that* good," and the fact that a reasonably large number of hedge fund managers have become billionaires (despite the fact that the vast majority have not) seemingly rubs most people the wrong way. This phenomenon is not unique to asset management. There is a point at which

the compensation of a group of people (actors, CEOs, professional athletes) becomes so high that there is collective Schadenfreude where people begin to root against that group and take pleasure in their misfortune when it comes. There is another ironic twist to this story in that it is seemingly okay for the founders of traditional Index firms (like Vanguard and Blackrock) to become billionaires because they do it slowly by taking a small amount of fees from a large number of people rather than larger fees from a smaller number of people (the hedge fund model). What seems to be missing from this emotional response is the realization that it is the net return over long periods of time that matters in wealth creation, not the absolute level of fees you pay. It seems illogical to consider a hedge fund manager who generates a 10% net return over a decade (net of his 2% and 20% fee, roughly 250 bps of total fees) somehow inferior to an Index Fund manager who generates a 9% return over the same period (net of their 1% or 100 bps of total fees). The trouble always seems to arise when a shorter period within that ten years shows that the net return of the hedge fund manager is inferior to the return of the Index Fund and there seems to be an expectation that the hedge fund should win every year (which is also illogical).

Over the long-term, hedge fund managers have historically outperformed (by almost a 2:1 ratio over four decades) because, primarily, the nature of every industry is that the most talented professionals migrate to the place where they can maximize their compensation. The best doctor, lawyer, football coach or basketball player usually makes the most money. Capitalism works. Professionals produce superior results because they have an edge – they practice more, they have better coaching or they have better equipment. We discussed last time how edge in the investment management business can come from many different places, better technology, better analytics, better process, better people, better networks or some combination thereof. We also wrote that *"Edge does not come cheap and the genius of the Hedge Fund model (propagated by A.W. Jones and discussed in our letter titled A.W. Jones Was Right) was it provided superior levels of fees which allowed hedge funds to acquire the best talent and resources, develop the best networks and build the best systems."* We are staunch proponents of the hedge fund asset management model because we believe it aligns the interests of the manager and the client insofar as the incentive is not to raise huge assets to gather huge fees (as size is the enemy of alpha), but to limit fund size and charge an incentive fee structure. In this model, when the client wins, the manager wins. There will always be examples of where this relationship breaks down (either manager doesn't acquire edge to generate alpha or gathers too many assets and dilutes ability to generate alpha), but the client can always choose not to maintain capital with that manager. Periodically (as noted above), we go through a period of time (like today, usually caused by Central Bank easing) where hedge fund strategies underperform and a cacophony builds that they have lost their edge, *"that they have become 'rich and complacent,' that 'Active Management is dead,' that there is 'too much money chasing the same ideas' and myriad other negative 'explanation' for why the high fee strategies are underperforming the low fee strategies and why everyone should immediately fire all the high fee managers and only buy Index Funds and ETFs."* We are there now, and what we know from nearly three decades of allocating capital to managers is that these are the best times to maintain discipline and allocate to managers who have strong long-term track records (demonstrated edge) but have just had a difficult short-term period. The key to success it to *"do the opposite of what the media reports that the big Pensions are doing. They hired hedge funds after the Global Financial crisis (chasing their strong relative returns) and are selling now to buy Passive strategies (chasing their CB steroid induced strong relative returns)."* As we like to say, we've seen this movie before and (spoiler alert) it ends badly.

Let's look at the performance of the various hedge fund strategies in Q3. The HFRX Equity Hedge Index

was up 3.4%, a very respectable number when compared to the long only S&P 500 Index, which was up 3.8% for the period. Given that the Equity Hedge portfolio is about 50% net long, that implies a solid alpha during the quarter. We say "solid" because it is a little above the level we would expect to see over the long-term (1.4% for Q3, with expectations of 4% annualized). The headwinds we have discussed this year on the short side have shifted from gale force to trade breeze and "*our expectations that these winds will change soon (like the shift from El Niño to La Niña earlier this spring)"* that we discussed last quarter have been met. The Global results were worse than the domestic results this quarter as the HFRX Global Hedge Index managed a 2.1% gain, compared to the MSCI World Index gain of 4.8%. We believe that alpha generation across long/short equity managers has troughed at levels we have witnessed only a few other times in history (most recently in 2000 and 2008). We asked after the first quarter, "*So what is going on? Have long/short equity hedge fund managers lost their edge?"* We spend a lot of time thinking about, identifying, analyzing and monitoring manager edge, and we would not conclude that the fundamental approach utilized by active long/short managers is no longer effective. Clearly in a time of Central Bank largesse, we have seen the lack of a true business cycle to allow for the natural creative destruction to occur has impaired the ability to short truly bad companies. As we wrote last time *"there have been plenty of incidences over the decades where active management has underperformed passive management, where traders beat fundamental analysts and where long only has trumped long/short strategies. In every one of those instances mean reversion has occurred and to paraphrase Sir John Templeton again, it won't be different this time."* The stronger relative performance of many long/short managers we work with in the past few months, leads us to believe that the cycle has turned and we are in for an extended period of outperformance of hedge funds relative to traditional long-only equity strategies. We discussed last time the biggest change that we see that could catalyze this transition saying *"in the past few quarters a funny thing has happened beyond the shores of the U.S., the ECB and BOJ have continued to stimulate, but equity markets stopped going up, in fact they have gone down. Perhaps there is an upper bound to the benefits of Monetary Policy and perhaps the U.S. will "catch down" to the other markets shortly."* As the effectiveness of QE programs globally has waned, we see increasing opportunities for managers to generate returns on both the long and the short side, and we would expect the alpha of these strategies to compound at a much higher rate in the coming quarters.

Activist strategies finally produced a good quarter as some high profile targets, like YHOO, generated superior returns and the persistent drag from Valeant abated (temporarily). The broader HFRX Event Driven Index finally had another solid quarter and rose 3.8% in Q2 to bring CYTD returns to a respectable 7.2% (in line with equities). Event Driven strategies also benefitted from the continued tightening of credit spreads and the ability of many highly leveraged companies to get debt relief as the banks continue to "extend and pretend" (we know that this music will stop one day). The narrower HFRX Activist Index surged 6.4% in Q3 and finally got back into the black for the year, up 5.3%. We have discussed in the past how MCCM has historically not allocated much capital to Activist managers (primarily because they don't hedge) as we have not found many compelling firms. We also mentioned last time that *"If one were a cynic (not that we are), one could make the argument that Activist managers are really just a concentrated "pump and dump" strategy and the success (or failure) of the strategy is contingent on the credibility of the portfolio manager to convince others to "buy what he has already bought" by using the media to point the spotlight on what they own."* One of our favorite managers in London continues to take this stance on the Activists and has made solid returns shorting the stocks that they are long as he contends that by using the media as a tool the manager becomes trapped in the names and must defend them at all costs (always good to be on the other side of

emotional managers). There are plenty of unique investment strategies and Activism is one where we are happier as spectators rather than participants.

Credit continues to the be the one area of hedge funds that has not struggled at all and the HFRX Distressed Index jumped another 5.8% in Q3 with credit spreads tightened as the number of bankruptcies and defaults subsided (for the moment, we think these accelerate again in 2017). For the CYTD, the Distressed Index is now up an impressive 13.6% (nearly double the equity market) and has moved solidly into positive territory over the trailing year, up 5.9%. We can't help but be reminded of what we described last quarter, that this ferocious rally feels like the *"last gasp rally in 2001 within the Telecom sector before companies like WorldCom and Qwest defaulted (and disappeared, taking huge piles of investors' money with them). There were some tremendous opportunities to make big returns buying the good assets from the bad balance sheets in 2002 and we would expect those opportunities to come again, but not until 2017 or 2018."* There is still a big wall of energy debt that comes due next year, and while oil prices are better today than in Q1, they remain materially lower than when that debt was issued so we expect to see continued defaults. Another problem we have seen in the credit space is that once companies actually do default the recoveries have been much lower because you have to be in really bad shape to default in a world of "free" money. One potential positive in the Distressed space is that there has been a huge amount of capital raised to buy all the problem debt that was supposed to have been created in the last wave of high-yield issuance and that capital is burning holes in those managers' pockets so they will feel increasing pressure to put it to work. That endless bid for bonds could keep returns in this segment above average for the foreseeable future (absent a really bad Recession).

In 2015, a couple of the "least bad" (read flattish) hedge fund strategies were Macro/CTA and Absolute Return. Some of the sub-strategies, like Merger Arbitrage, were even able to make a little bit of money as M&A activity surged to record highs (only to be surpassed in 2016). 2016 has been more challenging as the constant pressure of ZIRP (no return on cash) and the choppiness of the markets month to month have hurt the trend followers. In Q3, the HFRX Absolute Return Index rose slightly, up 0.9%, the HFRX Market Neutral Index was up 1.1%, the HFRX Merger Arbitrage Index matched the Q2 return of 0.7% and the HFRX Macro/CTA Index was down fractionally at (0.8%). We have discussed the challenges facing Arbitrage related strategies in past letters saying, *"Absolute Return strategies (Merger Arb, Market Neutral) continue to fight the brisk headwind of Zero Interest Rate Policy (and now negative rates, or NIRP) and the generation of alpha (or simply avoiding negative returns) in such an inhospitable environment is a positive outcome."* Those challenges have not abated much and the CYTD returns for the various strategies have been poor (other than Merger Arb) with Absolute Return at 0.7%, Market Neutral at (3.9%), Merger Arb at 3.2% and Macro/CTA at (1.2%). If we look at the trailing twelve months the results are not much more encouraging with returns of 0.9%, (3.1%), 6.5% and (1.6%), respectively. Despite the lackluster returns, we still believe that there are legitimate reasons to overweight these strategies in a portfolio, as we would expect them to outperform bonds (and perhaps stocks) over the next few years in the event that interest rates normalize. In a rising rate environment, bonds would suffer negative returns from capital losses (the precise reason why buying bonds for capital gains is a fool's errand) while Arbitrage strategies should provide positive returns both from the alpha of the strategies and the rising return from the cash collateral. In essence, A/R has a positive correlation to interest rates while traditional fixed income has a negative correlation, and after a thirty-year bull market in bonds, it is somewhat logical that hedging some portion of that portfolio with A/R makes sense. We have made the case before that Macro/CTAs were an attractive addition to portfolios as their protective nature during market dislocations (like 2000, 2008) made them a low-cost form of

insurance in the current environment. By generating modestly positive returns during the past couple of years (while the S&P 500 was up low single digits) the Macro/CTAs, in essence, were paying their own premiums. After spending time at the GMO meeting we mentioned above, we came away convinced of Jeremy Grantham's perspective that this bout of market overvaluation is more likely to be remedied over a longer time period (read not a quick crash, but a long, slow decline) and in that environment the value of disaster insurance is diminished. While there could still be a role for these strategies as overall risk reducers (due to lower correlation with traditional assets), we believe that using them as a replacement for long-duration fixed income exposure might make more sense in the current environment, as there are signs that the risks of rising rates continue to increase. In that environment, the risks of an unwinding of the risk parity model (leveraged long bonds) could exacerbate the moves on the long end of the curve and cause the historical relationship between stocks and bonds to diminish.

To reiterate an important point that we have written about on numerous occasions over the past couple of years, *"historically, the primary purpose of fixed income in a diversified portfolio has been to counter balance the volatility of equities, which are necessary as the core of the portfolio in order to generate returns in excess of inflation. Given current conditions, traditional bonds are unlikely to deliver adequate returns to warrant their inclusion in portfolios, despite their risk reduction benefits (the opportunity cost is too high)."* We continue to argue that substituting a diversified portfolio of hedge fund strategies for traditional fixed income exposure will prove to be a superior strategy in the coming years. The primary advantage of this swap is that you get the benefit of lower portfolio volatility with significantly higher expected returns (at current valuations) with alternative investments versus traditional bond exposure. When valuations, uncertainty and volatility are above average, alpha will likely outperform beta and we find ourselves in just such an environment at present and, unfortunately, we expect that environment to persist for many years. We wrote last time that, *"Alpha is a precious and scarce commodity and it turns out that it is not found in quiet, safe and stable environments, but rather in chaotic and unstable environments where it takes courage 'to be greedy when others are fearful and fearful when others are greedy' (to quote Ben Graham)"* (who knew we would dedicate the whole letter to him three months hence). We can appreciate how challenging it is to consider rotating away from the strategies that have performed the best this year (passive) toward those that have performed the worst (active), but we also wrote last time that *"history shows us again and again in the discipline of investing it is at the precise moment when you have the greatest urge to sell, that you have to muster the courage to buy."* Ben also reminds us that courage comes from process and having the discipline to follow your process, even when it is difficult (especially when it is difficult), will yield the best results over time. All of the elements of our process are lining up in support of shifting the allocation of portfolios away from traditional (beta) and toward alternatives (alpha), and the fact that the constant barrage of media stories is proposing exactly the opposite gives us comfort that, as Seth Klarman told us last time, ***"because investors are not usually penalized for adhering to conventional practices, doing so is the less professionally risky strategy, even though it virtually guarantees inferior performance."*** At times like these Courage = #Edge.

The roller coaster rides across most markets over the past couple of years have provided lots of thrills and chills and very little return and the third quarter of 2016 was more of the same as investors worried about all kinds of political (and macro) factors from the impeachment of a President in Brazil to the resignation of a Prime Minister in the UK, from trying to impute the motivations of "rogue" (in U.S. eyes) Presidents in Russia, China and the Philippines, to concerns over who would be the next President in the United States. The political risks will actually accelerate as we head into the New Year, as a

Constitutional Referendum goes to the people in Italy in December and elections all over Europe in 2017 will provide lots of grist for the mill on whether the EU will hold together (or tear itself apart) under the stress of rising populism and nationalism. As Ferris Bueller reminded us, -isms are not a good thing and they tend to increase the risks in the capital markets, so we may need to notch our seat belts a little tighter as we get ready for the next lap on the global investment coasters in the quarters ahead. In conclusion, as we head into 2017, it is important to recall that the investment environment is still tracking the 2000 to 2002 environment (#2000.2.0) very closely. In 2000 (like 2016), the equity markets were relatively flat for the year (up low single digits) after a lot of volatility and the fun really began in 2001 as the Recession took hold. Mark Twain reminds us that "history doesn't repeat, but it rhymes," and the ability to navigate through what will likely be a challenging couple of years will be facilitated by focusing on the tried and true strategies of Value investing and the discipline of protecting capital by having the courage to do nothing when there is nothing to do. Ben Graham emphasizes this point by quoting Nathan Mayer Rothschild in his classic book, saying ***"it requires a great deal of boldness and a great deal of caution to make a great fortune; and when you have got it, it requires ten times as much wit to keep it."***

Market Outlook

Before we dive into our views on the various markets and how the U.S. election may impact global financial markets, we wanted to repeat a little bit of what we wrote last time in *The Value of Value* to reset the tone that it feels like we are perilously close to a tipping point where the construct of value investing (which is being thrown out along with active management and hedge funds as no longer relevant) is likely to make a comeback. We wrote about the history of Seth Klarman's Baupost group and we discussed how in 2000 no one wanted to hear about value investing (or hedging) because the last five years in the S&P 500 had been so great (lots of Fed stimulus and a tech bubble), but the reality was that value was about to make a comeback of epic proportions (17% compounded per year versus (1%) for a decade). There is a sense of déjà vu for sure. Klarman says that "***Value investing is simple to understand but difficult to implement"*** and we wrote *"there are plenty of things in life that are simple in concept, but very challenging to commit to and, more importantly, to adhere to over time."* We also said that *"There is another roadblock to success (similar to get rich quick schemes and fad diets) that "**while some might mistakenly consider value investing a mechanical tool for identifying bargains, it is actually a comprehensive investment philosophy that emphasizes the need to perform in-depth fundamental analysis, pursue long-term investment results, limit risk, and resist crowd psychology."*** Klarman wrote the book *Margin of Safety* about value investing and how the concept of margin of is centered on utilizing the buffer provided by buying below intrinsic value to manage risk. He said, "***A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world."*** We wrote about how Ben Graham taught us all that price and value are two very different things saying *"the price of something is what a buyer is willing to pay a seller, while value is the intrinsic worth of that thing. In the markets, investors should only buy stocks, bonds, or other assets when the price is meaningfully lower than the value. The difference between the two is the margin of safety and limiting yourself to only buying assets when there is adequate margin of safety is how you protect yourself from cardinal sin of investing, losing money."* In the end, Klarman summed the philosophy in five simple words, ***"Value investing is risk aversion."*** He then went on to say ***"In contrast to the speculators preoccupation with rapid gain, value investors demonstrate their risk aversion by striving to avoid loss."*** We bring all this

back up again at the beginning because it feels like investors have decided that "it is different time" (again) and that buying assets simply with the notion that someone else will buy them from you at a higher price is a sound strategy. History would beg to differ and Sir John Templeton reminds us that those are the four most dangerous words in investing. The biggest problem with not having a margin of safety in your investments is that in an uncertain and volatile world, to paraphrase Ferris, #RiskHappensFast. So let's get to the outlook.

Our January ATWWY Webinar was entitled "*Channeling Byron: 10 Potential Surprises for 2016*" (with a nod to Byron Wien, the former Morgan Stanley strategist who originated the annual 10 Surprises idea). When talking about Surprises, it is important to clarify that Surprises are intentionally non-consensus ideas and have some reasonable probability of not occurring (they are not necessarily predictions). The unlikely nature of a true Surprise fits in perfectly with the famous Soros quote about how meaningful returns are made by *"discounting the expected and betting on the unexpected."* Michael Steinhardt was famous for saying that, *"We made all our big returns from variant perceptions that turned out to be right."* To his point, the definition of a Surprise is a variant perception (an idea that is materially different from the consensus) that we believe has a better than 50% chance of occurring in the current year. The key point here is that a variant perception must be *materially* different than consensus to be valuable. One other important point to be mindful of is a year is a long time, things can change (sometimes dramatically) and we need to remember the wisdom of John Maynard Keynes who famously quipped, *"when the facts change, I change my mind, what do you do, sir?"* We will remain vigilant during these last two months of the year to track the progress of each of these Surprises and look for opportunities to capitalize on them in the portfolios, but we will also be ready to change our minds (and our positioning), should the facts change.

My, oh, my, what a difference a few months make. Talk about Surprises, 2016 has been the year of surprises, from Kuroda-san shocking the world with his about face on negative interest rates in late January to the shocking recovery in commodity prices, from Brexit (where polls were wrong right up to the day of the vote) to the Trump victory (where the polls were wrong again right up to the day of the election). We said above that when the facts change, we may need to change our minds and we will run through each of the Surprises to see what impact (if any) the New World Order will have on the various markets involved in each Surprise. We started out to write 10 and threw in a bonus #11 Surprise back in January and after the unexpected U.S. election outcome we will add a double bonus Surprise #12 here to tie this whole letter together.

Surprise #12: An Orange Swan Alights in America. After a very contentious campaign leading up to the 2016 U.S. election, Donald Trump surprises the pollsters, the politicos, and we could probably safely say the majority of the people on the planet, as he emerges as the victor over Hillary Clinton and will become our 45th President. Under normal circumstances, potentially risk-off inducing tail events are labeled black swans, but given Mr. Trump's signature "tan" he has been anointed "the orange swan" by a few financial pundits.

The consensus going into the election was that a Trump upset over Hillary would likely lead to a serious crash in global financial markets (down as much as (15%) to (20%), or even more), but as The Donald has been prone to do, he is once again upending the forecasters (so far… but it has only been a few days). Since everyone was riveted to the television (yes, TV still won the most eyeballs on election night, maybe for the last time), everyone knows what happened to the global capital markets as it became apparent that Trump might take Florida (the completion of the Southern Strategy sweep, just like in 2000. More on that later…). As the clock struck midnight on Tuesday, November 8, 2016, CNN

called Florida for Trump and The Donald turned from an ugly duckling into a beautiful swan and it began to dawn on people that he was going to win. Mexican peso futures got obliterated, stock futures began screaming downward (Dow futures were down 870 points at the nadir and trading halts had been triggered) and bond futures and gold futures began to soar (as safe havens). Asian markets were already open and as an example of the level of fear that engulfed the markets, the Nikkei shot down (6.2%) and set the stage for what appeared to be a very ugly Wednesday. Then a very interesting thing happened. As the hours ticked by and the political commentators began to make up all kinds of new narratives about how this outcome was really a "good thing" and how it really wasn't that big an upset after all (despite all the data, albeit incorrect data, that said it wasn't close and Hillary would walk into office) and how a Republican sweep was always great for markets (despite the fact that Trump was a Republican in name only after thrashing the GOP during the campaign process). By the time markets opened in the U.S. the next day, losses in the equity markets had been cut to below (0.5%), bonds were actually now down (rates were rising) and while gold was still up 2% at the open, it was crashing. By the end of the day, the S&P 500 was up 1.1%, the Barclay's Aggregate Bond Index was down (1%), long duration bonds (TLT) were down four times that much and gold had fallen back to flat. By the end of the week, U.S. equities finished right where they were Wednesday night (with lots of wild swings within the different sectors that we will discuss), Japanese equities had rallied back to be even with U.S. stocks, up 1.1% (up 2% if you hedge the yen), bonds fell (1.8%), long bonds got smacked, down (6%) and gold lost (4%), but investors took the hard core populist rhetoric to heart and smashed Emerging Markets as EEM shed (8%), the Mexican peso got pounded (14%) and Mexican equities were taken way south of the border, down (18%).

One of the most fascinating things about this election cycle is how many people are comparing Donald Trump to Ronald Reagan (and expecting similar results) and in fact many are now talking about Trumponomics and thinking it will have the same outcome as Reaganomics (be careful what you wish for as you might just get it). So I guess it is official that every new President gets a –nomics now, Reaganomics, Clintonomics, Abenomics, Modinomics and now Trumponomics (which will undoubtedly be yuuuuge). The supporters of Reaganomics referred to it as supply-side economics (as an affront to the demand driven Keynesian model), while the detractors (as we heard from the teacher in Ferris's Economic class) referred to it as Voodoo economics or trickle-down economics. The positive view was based on an idea called the Laffer Curve created by Arthur Laffer that posited that high tax rates did not incentivize investment, income production and wealth creation and that by lowering tax rates, the government would actually collect more revenue because investment and growth would be higher. The negative view was that by cutting taxes for the rich you were simply currying political favor and that the Voodoo math was ludicrous. Further, the derisive term "trickle-down," was a challenge to the construct that if the rich got richer they would put more money back in the economy and it would trickle down to the less wealthy. The results were hard to confirm because while total government tax revenues rose, what is not discussed is that Congress passed tax increases in seven of Reagan's eight years in office (through a combination of business and other taxes). We will agree that cutting capital gains taxes does indeed spur the kind of investment that creates businesses and jobs (best form of trickle-down), but we don't believe that the effect translates as well to income taxes because of the complexity of the tax code and the myriad ways to game the system at the top end.

The four pillars of Reaganomics were to 1) reduce the growth of government spending, 2) reduce federal income and capital gains tax rates, 3) reduce government regulation and 4) tighten the money supply in order to reduce inflation. As the discussion

of Trump's policies evolves, we have heard elements of the first three, but somehow the fourth pillar has morphed into tightening the money supply in order to increase inflation (we're not sure how it can do both, and may need a consult with Art Laffer here). So let's go to the replay booth and see how the implementation of Reaganomics stacked up with the theory of Reaganomics. On pillar 1), we know that government spending actually went up (a lot, from 20% to 22% of GDP) during the Reagan years as defense spending went back to Vietnam War levels (up from 4.9% to over 6%) and in particular due to myriad spending programs created by the Economic Recovery Act of 1981 to combat the recession of 1981-82. Because of spending (and lower revenue from tax cuts) the federal deficits rose and the national debt tripled from $997 billion (26% of GDP) to $2.85 trillion (41% of GDP). Over this time, the U.S. actually moved from being world's largest international creditor to the world's largest international debtor. Reagan himself described the increase in government debt as the "greatest disappointment" of his presidency. On pillar 2), we know that Reaganomics cut the top rates for income and capital gains, but interestingly all of the other tax increases, closed loopholes and other changes during massive bills passed in 1982 and 1984 were described by historian Joseph Thorndike as "constituting the biggest tax increase ever enacted during peacetime." On pillar 3), it is clear that there was less regulation, the problem is that many will contend that the massive deregulation of the banking system led to the banking and S&L crises that caused another two recessions in the next decade. It is also clear that many other regulatory changes had positive effects, but it is tough to tell which was better/worse. On pillar 4) it is very clear that inflation was tamed as Paul Volcker at the Fed broke the back of inflation with super tight monetary policy.

So the reason we write that people should be careful what they wish for insofar as Reaganomics is because we know that it led to two recessions and the equity market was down nearly 20% over the first eighteen months of his presidency. The resulting recovery over the next six years took the S&P back to a level that was equivalent to a 10% compound return over the eight years (about average). The bigger issue we have with comparing Trump's plan to Reagan's is that the environment that existed as Reagan came to office could not be more different than today. The stock market was beaten down from a long bear market that started in 1968, yields on the S&P 500 were close to 5% and the market P/E ratio was single digits. Economic growth boomed over the course of the next two decades not because of any policies (red or blue) but because we had the greatest working age population boom in the history of the world as the Baby Boomers (80 million strong) began to turn 35 and enter their peak spending years. We will give Reagan a huge assist for helping to usher in the greatest global boom in history as he helped break down the Cold War barriers, which resulted in the end of the Soviet Union and the fall of Berlin Wall and led to the greatest period of globalization ever. The Trump campaign rhetoric was in direct opposition to globalization (which is why we think it will turn out to be just rhetoric). Talk of building walls is definitely Donnie, not Ronnie, and actually sounds much more like a previous president that we think is perhaps a better analogy for Trump. Yes, there are many similarities between Reagan and Trump; both were lifelong Democrats before they switched parties to run for office, both are entertainers, and Donald edged out Ronald for the honor of oldest person to be elected president by a few months. But there are also many differences and we think it will be very difficult to try and emulate a program that was effective when interest rates were near all-time highs and government debt was near all-time lows in an environment that is exactly the opposite.

Donald Trump is only the third man to be elected president who has never held a national elected office, been a Governor or a General. The first was William Howard Taft and the second was Herbert Hoover in 1928. Hoover (like Trump) was the son of a German father and a mother with roots in the British Isles.[1] He

was born in Iowa, and after a series of unfortunate circumstances with deaths in the family moved around a great deal as a young man. In a very interesting story he applied to a new university in Palo Alto, CA in 1891 and after failing the entrance exam essentially talked his way in and claims to have been Stanford's "first student" as he was the first to sleep in the dormitory (Trump went to a different elite university, Penn/Wharton). Hoover graduated with a degree in geology (Trump majored in economics, so maybe Trumponomics fits) and set off on a global mining career where he ended up in Australia. Known as a bit combative (similar), Hoover became estranged with his superior in the organization and was shipped off to manage mining projects in China. Hoover married his Stanford sweetheart, Lou Henry (known for her riding skills and her uncanny aim with her .38 caliber pistol; ok, no similarities here to Trump's wives), and she accompanied him to China, became fluent in Mandarin, and while working on projects, the couple began fighting for the rights of Chinese workers in an attempt to end indentured servitude (perhaps some similarities and differences with Mr. Trump here). Hoover was very successful in his mining career and he became an independent consultant traveling the globe to teach mining companies how to improve operations. By 1914 (age 40) he had amassed a personal fortune estimated at $4 million (roughly $100 million today) and was quoted as saying "if a man has not made a million dollars by the time he is forty, he is not worth much" (certainly not a stretch to think that might have come out of Trump's mouth in the past). After returning to California, Hoover was recruited by the Democrats after WWI, but rejected their advances in 1920 and tried to run for president (another similarity as Trump ran unsuccessfully in 2000 under the Reform Party) that year, but was narrowly defeated in the primary in California, so he (like Trump) was never considered a serious candidate. After throwing his support to Harding, he was rewarded with the position of Secretary of Commerce making him somewhat less of an outsider than Trump.

That said, there are some real similarities with how Hoover approached the Commerce Department and Trump's claims that only he himself can fix Washington. Commerce had only existed as a department for eight years and was a very minor entity with limited power. Hoover wanted to change that and make the Commerce Department the center of the nation's growth. He seized power across many industries and created huge sub-committees and sub-departments to regulate everything from manufacturing, communications, transportation and the census. Hoover took over other Cabinet officials' offices when he deemed they were not performing well (sounds familiar, "you're fired") and rose to a level of prominence that actually overshadowed two presidents. The media referred to them as the Secretary of Commerce and the "Under-Secretary of Everything Else" and in an interesting twist, under Hoover, the 1920 Census became the only one to not be used for Congressional reapportionment, which ultimately impacted the 1928 Electoral College (which he won). When Coolidge decided not to run for a second term as President, the GOP turned to Hoover. Interestingly, Coolidge did not endorse Hoover (Trump was not endorsed by former GOP presidents) who referred to him in a not so nice manner as "Wonder Boy" and remarked that, "For six years Hoover has given me unsolicited advice, all of it bad." The Republican Party ran a very harsh campaign (although Hoover, unlike Trump largely remained above the fray) that was designed to be anti-Catholicism against the Democratic challenger, four time New York Governor Alfred E. Smith. The campaign was described by the media as a "lily-white campaign" to crack the "Solid South" (the original Southern Strategy), and they actually purged black leaders from the southern portion of the GOP in order to appeal to southern white voters. The efforts were successful in turning Virginia, Tennessee, Florida, North Carolina (the last two being big wins for Trump as well), and Hoover was the first Republican to win Texas. By campaigning against Prohibition, against Catholics and by winning the southern white vote, Hoover won in a landslide with

58% of the popular vote (even better than Trump).

Hoover came into office with a very strong agenda of wanting to fight against government inefficiency, a plan to reform and reduce the nation's regulatory system (ironic since he created much of it as Secretary of Commerce, but sounds a lot like Trump), a plan to create less dependence of individuals on government by encouraging public-private partnerships (sounds familiar), a mandate to build greater global trade, particularly in Latin America, (clearly the antithesis of Trump rhetoric) and a focus on the areas of justice (he started Federal Bureau of Prisons), education (he proposed the Department of Education) and civil service. Hoover also made a public claim that he would live to regret during the Great Depression when he said that the U.S. was close to defeating poverty. As Hoover took office in January the economy was already beginning to slow into a recession (another fresh face in the White House another recession in year one) and things accelerated to the downside into the Great Stock Market Crash of 1929. As the markets sank and the economy tanked, Hoover abandoned his lofty goals and began desperately trying to prop up both the market and the economy by attempting to legislate wages for workers (failed badly) and in what is nothing short of a complete déjà vu started the Mexican Repatriation program in 1929 (heard something like this recently). Then in June of 1930, over the objection of leading economists, Hoover reluctantly (at least it was reluctantly) signed the Smoot-Hawley Tariff Act that Congress believed would help ease the growing recession by limiting imported items in favor of "made in the U.S.A." Having seen this movie, we know the true result was accelerating the recession and eventually plunging the economy into the Great Depression (along with the Fed trying to raise rates from zero; wait, that sounds familiar too). In the depths of the depression, unemployment had skyrocketed, thousands of banks failed as businesses defaulted and shanty towns derided as "Hoovervilles" by the Democrats sprang up across the country. Rather than cut taxes to spur growth, Congress passed tax increases which not only didn't spur growth but were (unsurprisingly) wildly unpopular. That combination of punches was game over for Hoover and he was soundly defeated in the 1932 election by FDR who promised a "New Deal" (because the American people were done with the old deal).

Herbert Hoover ascended to the presidency from relative obscurity by riding a huge wave of populist sentiment (sounds very familiar) to a landslide victory (electoral college for Trump was pretty solid). Yet despite that strong start, why has the Hoover presidency has been described as "tragic" by historians? Was it Hoover's lack of government experience that didn't allow him to truly execute his pro-business agenda over the very powerful Republican Congress? Was it Hoover's hubris that he was better and smarter than everyone else that led to his inability to form coalitions within the party? Was it that Hoover was blinded by retaining his own power and when he was faced with the deterioration in the markets and economy, a "self-made man" with a "superman" complex (hmm, are we talking about Hoover or Trump?) wasn't able to change his mind and change the plan? Perhaps there are kernels of truth in all of these, but many economic historians will claim that it was his extreme fiscal conservatism that did not allow him to waver from a balanced budget or accept any inflation (no similarity to Trump here). While it is certainly likely that the 1932 tax hike into the recession was an error, recessions themselves are necessary and normal and we would posit that the errors of protectionism and interfering in the normal business cycles through regulation was more to blame. As we think about a Trump presidency in 2017, the similarities to 1929 are clearly robust (with some differences), but we see many more similarities than to 1981, and if we have to settle on something in between, we see lots and lots of similarities to 2001 (#2000.2.0 year two).

So the question we are faced with now is whether the orange swan will turn black and cause all kinds of problems for investors in the coming years, or will the

orange fade to white (like a spray tan) and President Trump will be a positive for investors. We outlined in the opening section some things that we think President Trump will need to do (like move center and be a positive leader) to be successful and to give us a chance to *Save FairUS* (and to save the rest of the global capital markets as it seems difficult to have a healthy global economy without an engaged and well-functioning United States). Let's explore how this big surprise might impact our other surprises and where we might look for compelling investment ideas for the balance of 2016 and for the New Year.

Surprise #1: There Goes the Boom…

Despite massive Central Bank stimulus programs around the world, economic growth continues to surprise to the downside as the rising costs of aging populations weigh on the Developed Markets. One (or more) of the U.S., Europe and Japan slip into recession and global interest rates continue to plumb new lows.

One of the first things you have to do to solve a problem is to actually acknowledge that you have a problem and that has proven difficult for the global central banks over the past few years. Despite mounting evidence to the contrary, QEeen Janet, Super Mario and Krazy Kuroda-san continue to believe that when it comes to trying to stimulate economic growth all you have to do is throw more money at the economy in the form of Quantitative Easing. The issue is that Japan slipped briefly into recession again earlier this year (then "revised" their way out, by changing the GDP calculation) and Europe has been teetering on the edge of recession for nearly a year. Back in the U.S., the Q1 and Q2 GDP numbers were horrible (less than half of expectations) and only a suspect Q3 number (that still has two revisions to go) of 2.9% looks like anything close to normal. Some believe that the Q3 number was tweaked for the election (although the thesis is that it would have been tweaked to help Clinton, which obviously didn't play out…) and that they just pulled forward some GDP from Q4 (so Q4 will be lower), but there has actually been a ramping up of expectations for the Q4 number recently. What is interesting is that QE has not been in effect in the U.S. since the end of 2014, so it would be hard to make the case that the growth spurt is due to monetary stimulus. Even if Q3 and Q4 stay around 3%, the 1.1% and 1.4% numbers for Q1 and Q2 still make 2016 a very sub-par year (and unsurprisingly well below the Fed forecast from last year) at right around 2%.

Trump has hit the ground running in trying to change the narrative here as he has already started talking about big fiscal spending plans to improve infrastructure and create jobs. There are a couple of small problems with all the hype of the last week surrounding this story, Trump won't actually be president until late January and it will take months to get legislation created and passed, and then it will likely take another couple of quarters to line up "shovel ready" projects that can be started, so it is unlikely that much (if any) of the fiscal stimulus (assuming it gets passed, which seems pretty likely) occurs until 2018. So the rally in infrastructure and materials stocks in the past three days seems a bit premature to us. Some of the moves were simply stunning as companies like Caterpillar (CAT) jumped 10%, Vulcan Materials (VMC) surged 12%, steel companies AKS and X soared 22% and 24%, respectively, and Manitowoc (MTW) screamed upwards an astonishing 25%. Ferris reminded us that "life moves pretty fast," but this is crazy fast. In fact, these moves look more like short covering to me than well-reasoned purchases, as many investors likely had some pair trades going into the election and given that the polls and betting odds were so heavily in favor of Clinton and Democrats in the Senate, a full house of Republicans was not the hand that most players were expecting to be dealt. Yes, it would appear that the political narrative is changing toward more fiscal (and less monetary) stimulus, but at the deficit and debt levels we have, navigating the debt ceiling and the fiscally conservative posture and promises of the GOP, it is tough to see how these early gains don't prove to be ephemeral and a more durable rally begins

when we see more evidence of a plan.

The second part of the Surprise was going along incredibly well all year (much to all the pundits' chagrin as they had all called for higher rates in 2016) as government bond rates all around the world were making new all-time lows in the first half of the year. With the adoption of negative interest rate policies (NIRP) in Japan and Europe, trillions of dollars of government debt had moved to negative rates (think about that for a moment, paying shaky governments to hold your money for ten to thirty years). Suddenly, on July 8th, a seemingly innocuous comment by the suddenly Not So Super Mario Draghi that he might have to begin tapering ECB bond purchases triggered a series of interrelated events including a couple of high profile "Bond Kings" (Bill Gross and Jeffrey Gundlach) talking about their books saying the bond bubble was getting ready to pop, and some increasingly hawkish commentary from the Fed, that slowly accelerated the global selling of bonds. The rise in rates was reasonably orderly from July through the election and the increase was actually only half as big as the rise in Q1 that preceded the collapse to new lows in Q2, but last week was a bloodbath in the global bond markets and the increase in rates over five days was equal to the previous four months. There are now rumors flying that there is some trouble in risk parity land and that the unwinding of the leveraged bond trades in these funds could exacerbate the selloff in coming weeks. We have heard this rumor in the past (and we always made lower lows later on), but given that a manager we know well has recently raised a "risk disparity" fund to capitalize on the coming turbulence in the bond markets, we need to be a little more vigilant (we actually did cut the duration of our bond investments last week).

Our go-to guy on the bond market is Van Hoisington and he and Lacy Hunt have a very different view (the view that has been more correct than anyone for over a decade) that despite efforts to provide both monetary and fiscal stimulus in 2016, economic growth slowed and interest rates fell. In their words, "the outward evidence indicates that this "stimulus" was at best extremely fleeting (if it were beneficial at all) since the economy's real growth rate is on track to slow significantly in 2016 versus 2015." On the campaign trail, Trump promised everyone that he would get GDP growth back to 6% and it appears that investors are taking him at his word (despite the fact that what he suggests is nearly impossible - Van and Lacy might omit the "nearly") and with all the talk of new stimulus in 2017 (despite the challenges of actually making that happen discussed above) everyone is convinced that we are at the end of the Great Bond Bull Market (just as they were convinced in 1999, 2007, 2011 and 2014) and rates are going to surge from here. While it is true that TBT (the double short long duration bond ETF) was up 14% last week, it is still down (10%) CYTD and down (14%) over the past year, down (25%) over the past two years, down (50%) over the past three years and down an astonishing (85%) since inception eight years ago (they don't call this the widow maker trade for nothing). Van and Lacy have some thoughts on the impact of the plans under the new Republican Administration, "Unfortunately, the 2017 economic horizon is clouded by the fact that further rises in government spending relative to its income appear to be advocated. We believe the inevitable result will be slower economic expansion and declining interest rates, a pattern similar to that experienced in 2016." We always love how these guys tell it like it is and their message remains to #SellTheRips.

Surprise #2: Two Wrongs Won't Make it Right.
After trying to flex their muscles by raising rates in December, the Fed realizes the (policy) error of their ways, acknowledges that they missed the window to raise rates in 2013 and puts further increases to the Fed Funds rate on hold for 2016. In a total about-face, discussions of QE IV begin in the 2H of the year as economic growth continues to disappoint.

Given that everyone (and we do mean everyone, from the Fed to 100% of the economists surveyed by Bloomberg to start the year) believed that Ms. Yellen

would raise rates multiple times in 2016, we are taking a win on this Surprise regardless of what happens in December. Even if she pulls the trigger on a 25 basis point hike before the holidays (we still think the odds are below 50%), a token move a couple of weeks before year-end is the same as not raising rates as far as markets are concerned. QEeen Janet is, at her core, a giant dove and she loves being the hostess who keeps the party going by not taking away the punch bowl. The real issue is that short-term rates really should be higher as they should be roughly equal to nominal GDP (around 3.5%) as they have been for most of the last century. The Fed should have hiked back to that level in 2013 as the economy could have taken it, but the equity markets would have fallen as discount rates rose and it appears that the 3rd mandate of the Fed (no bear markets) is more important that the first two mandates (stable prices and strong employment). Everyone is pointing to the rise in inflation expectations as showing the need for higher rates, but the logic is flawed in that yes, they have rebounded sharply off the record lows, but they remain below the levels that triggered previous round of QE (sub 2%). The dangerous thing about interest rates is the amount of leverage in the system given the size of the futures markets and the derivatives transactions that are linked to Treasurys. It doesn't take much of a spark to kindle a roaring fire and if you are then forced to yell fire in the crowded theater (read, investment market), bad things can happen.

There are some who think that the Trump win really does change the likelihood of future rate increases. They contend that since it was made clear by Trump during the campaign that he has no use for Ms. Yellen in his administration that she “pulled” the September hike to try and buy a few votes for Clinton by keeping the stock market up. Those same people now think that since Janet knows she is out when her term expires she will “stick it to Trump” by raising rates (maybe even do 50 basis points in December) to crash the market so the Democrats can blame him for the mess that higher rates are likely to cause for stocks sitting at the second highest valuation in history (after 2000). What is most interesting is that stocks have actually gone up slightly (2%) since the July nadir in rates and as the 10-year Treasury yield has surged from 1.38% to 2.2% while the Aggregate Index has shed (3.5%) and TLT has plunged (15%). This is an unusual move and the move last week after the Trump surprise win, was just as odd with the S&P up 1% and the AGG down (1.5%) and TLT down (6%). Clearly investors must believe that somehow economic growth is going to explode higher and push earnings much higher (hope springs eternal) so the effect of multiples compressing (as discount rates rise) is counteracted. This stance seems a little aggressive, so we might treat last week’s moves like we should have treated the polls going into the election (false positives).

Surprise #3: Save Us Kuroda-san. You’re Our Only Hope.

BOJ Governor Kuroda surprises everyone at the end of the Japan Fiscal Year and pulls out another bazooka to weaken the yen and stimulate the economy and markets. The yen falls dramatically, with USDJPY hitting 135. Corporate profits surge to new record highs and Japanese equities rally hard, finishing the year at 21,000.

Yeah, so this Surprise didn't play out so well for us this year as Kuroda-san gave us the big Surprise instead in January and the yen and the Japanese equity markets were pummeled during the first half of the year. With the yen strengthening to 100 and the Nikkei twice dipping below 15,000 it appeared that Abenomics maybe was the Voodoo economics (Laffer Curve) that the economics teacher in the movie was trying to get the class to discuss. Japanese equities were no laughing matter for anyone who was long. Then suddenly the winds of change came blowing from an unlikely direction and comments by Mario Draghi in Europe triggered a reversal of fortunes in the Yen and Nikkei. Since that bottom in July, the yen has weakened all the way back to 106.7 and the Nikkei has surged 15% to 17,375 (financials have rallied even more). There was a moment of doubt in September

when Ben Bernanke flew to Japan before the BOJ meeting (supposedly to teach them how to do Helicopter Money), but the rumors of helicopters in the sky dropping yen on the streets of Tokyo proved to be false, and after a short set-back, the rallies continued in October and November.

The Trump effect in Japan is likely to be transient as he has not spoken much about Japanese trade relations or their renewed military aspirations, but the growing belief that a Trump presidency means higher interest rates (and supposedly stronger growth), which translates into a higher dollar and a lower yen. A weaker yen leads to higher profits for Japan Inc. and then Japan can return to being the Land of the Rising Stocks as they had been from November of 2012 until January of this year. With the new information of Trump winning the election, we are reevaluating our view on the dollar (see Surprise #8 below) and that view will clearly impact how we approach Japan in the coming year. For now, we are gratified that our patience with absolute cheapness of the mega-banks (and great patience it was as we were really early) is finally being rewarded as these stocks have surged (along with other global financials) in the past few weeks. The big three, SMFG, MTU and MFG, are up a very strong 28%, 32% and 22%, respectively, since the turn in July and are still very cheap. There are other names in the RE and exporter sectors that would also benefit from a weaker yen (or stronger Dollar, whichever way it happens), but we will have to see more recovery of the move from 120 to 100 before we get too excited.

Surprise #4: Saudi Is Not Fracking Around.
Realizing the end of the hydrocarbon era is approaching more rapidly than anticipated, Saudi abdicates their role as swing producer within OPEC and recommits to maximizing their production and grabbing market share. The resumption of Iran oil trading and short-term storage concerns push the market into steep contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production declines push prices back toward $50.

Oil has played out almost precisely according to the script of the Surprise and as prices plunged in early Q1 to hit a low of $26 before rallying back to hit $52 in June (earlier than we thought), fall back to $39 in August, rise back to $52 again in October and slide back down to $43 today. We expect that the $40 to $60 range will persist for longer than people anticipated, as the U.S. producers (primarily in the Permian basin in Texas and the Scoop/Stack basins in Oklahoma) have harnessed technology to dramatically reduce their costs and have essentially wrested control of global swing producer status from Saudi Arabia. So maybe we need to change the name of this Surprise to *Don't Mess With Texas* as what started as a decision by the Saudis to try and cripple the shale producers in the U.S. has turned into an extremely happy outcome for those producers as the old saw "necessity is the mother of invention" was spot on one more time. Faced with extinction, as the Saudis' decision not to cut production pushed prices from $107 to the low of $26, many U.S. producers would have been expected to collapse under huge debt burdens and high costs (and some were forced to declare bankruptcy), but another old saw "what doesn't kill you makes you stronger" became readily applicable as company after company showed that they could reengineer their production to become astonishingly competitive at these lower prices. Once again it was all about location, location, location, and companies in the less productive basins like the Bakken and the Eagle Ford have struggled, but the winners in Texas and Oklahoma have produced outstanding returns this year. We have invested in a basket of Permian producers including RSPP, PE, FANG, PXD, APA and the sand company SLCA (turns out that part of the changes in production techniques has been jamming up to four times as much sand down each well) and have been short a basket of oil services companies (essentially OIH) which have borne the brunt of the cost decreases. Those stocks are up 60%, 80%, 40%, 40%, 30% and 145%, respectively, CYTD and while they have given a little back in the past month as oil

prices have declined, we expect great things in 2017 from these all-star producers.

President-elect Trump has already started talking about making it easier for oil companies to drill and has talked about everything from tax incentives to opening up the government lands to new exploration and production. Generally speaking, the Republicans were expected to be good for oil & gas, pipelines and coal, while the Democrats were expected to be good for solar and other alternatives and were likely to be a slight net negative for energy as they were contemplating some changes to some drilling tax credit programs that would hurt overall profits. A Republican sweep should be a tailwind for the oil & gas business and coal has been doing just fine on its own as with such a huge number of companies going bankrupt (and the subsequent closing of supply), the survivors have surged (and are likely to continue to generate high levels of profit (although we would like it to go away, coal will be with us for a long time). As an example of how strong the performance in coal has been this year, the coal ETF (KOL) is "only" up 125% CYTD, while CLF (not even a pure play) is up 350% and TCK soared an astonishing 525% as they have emerged as the dominant player in the absence of the old leaders (who all folded). One of those old standards, Arch Coal (ARCH) has recently emerged from bankruptcy (with a clean balance sheet) and was up 24% last week and is now up 35% since their IPO a few weeks ago.

Surprise #5: The Black Swan Alights in Europe.
The relentless bear market in commodities since 2011 comes to a head with a messy bankruptcy of one (or more) commodity trading companies (Glencore, Trafigura, Vitol, Nobel Group, and Mercuria). The resulting unwind of complex derivatives positions causes huge losses within the European banks, pushing one or more of them to the brink of insolvency.

Perhaps it is fitting that the Surprise that caused the greatest consternation in January when it was announced will be the subject of our last topical Around the World Webinar next week (the final #ATWWY will be the traditional year-end review of all the previous topics). When we said that we thought there was a risk of bankruptcy in the global trading companies that could drag down the European banks along with them (a true black swan event), the people at Glencore took great offense and actually reached out to me and proclaimed that there was no such risk. At the time it seemed to me a case of "the lady doth protest too much, methinks" (Shakespeare) and why was a giant global firm calling "nobody from nowhere" for making a comment (one of dozens of comments at that) at an ETF conference in Florida (it truly is a small world). Turns out everything did indeed work out as Credit Suisse stepped up and provided even more credit to Glencore (rescue financing at its finest, which they had to do as estimates were that they would take $100 billion in losses if GLEN.L went down) and despite the fact that copper prices were sloppy all year (until the last couple of weeks), bankruptcy was averted and the stock did what all companies that avoid BK do and surged 210% over the course of the year (even more off the bottom after the rescue financing). The surge in names like Glencore (and First Quantum and Freeport-McMoRan, up 180% and 105%, respectively) smacked a number of hedge funds, which stayed short since they couldn't see any fundamental improvement. Market inflection points are not great places to be heroic as Soros always says, "I'm only rich because I admit my mistakes faster than others" and while it could be hard to call staying short a bad company a mistake, it clearly is a failure of risk management because of the market's ability to behave irrationally longer than a levered investor can remain solvent.

The European banks were "an albatross" (staying with the bird analogy) within the European markets for the first half of the year as they kept falling and falling no matter how many bonds Mario and the ECB bought and they got hit really hard one last time during the Brexit shock, hitting their lows in early July. By the

Fourth of July the Euro Banks were a total mess as DB, CS, SAN, RBS and EUFN (the ETF) were down (48%), (55%), (24%), (55%) and (28%), respectively, and the negative momentum was building. Then the silver tongued devil that he is, Mario once again said they would do whatever it takes (along with saying that he was running out of bonds to buy) and banks all began to surge (just short covering at first, but then buyers began to appear) and the group above rose 25%, 36%, 18%, 16% and 22%, respectively. Now remember that leaves them down (33%), (35%), (6%), (42%) and (10%), respectively, so there will be plenty for us to talk about as to whether we are in the clear or whether we are on the edge of the precipice of another European banking crisis. The sudden rise in interest rates around the globe has everyone pointing to higher net interest margins at the banks and people are expecting profits to surge, but we think they are overlooking the risk that higher rates will slow growth, limit lending and lead to higher NPLs which could hurt profits, so it will be interesting to see which impact is more important to the bottom line. While Europe is not on the top of President Trump's hit list (yet) and it is unlikely that the dollar surges enough to really pound the euro (but stranger things have happened recently in these crazy markets), so there is not a lot of new information that changes our view on the European banks with the Trump victory. Should Trump cajole QEeen Janet into giving up her dovish tendencies and rates really begin to rise aggressively (not our base case, but plainly possible), then there could be increasing pressures on the ECB in the new year that would take us back to the currency wars of a couple years ago. The sight of central bankers wielding light sabers is not a pretty one and someone is likely to get hurt. Not to give away the ending of the #ATWWY (we want everyone to tune in), but we have conceded the point that the trading companies are not going away and therefore the pressures that we thought might mount on the banks are likely to continue to dissipate. I just happened to get lucky and be on CNBC the day that the rumors about the DOJ fines for DB were being discussed and everyone was convinced that they were on the verge of their European "Lehman moment" (such a ridiculous idea to compare as systemically critical German institution to a relatively small investment bank in the U.S.) and I played the Devil's advocate and said that DB might actually be a good long-term buy. Sometimes it is better to be lucky than good as DB is up 41% since that 9/29 appearance on Squawk Box (more bird terminology).

Surprise #6: Déjà Vu, Welcome to #2000.2.0.
The U.S. economy and equity markets have entered a challenging period resembling the unwinding of the tech bubble from April 2000 to April 2003 and 2016 closely resembles 2001 with the S&P 500 down in the low teens. Economic growth falters, corporate profits fall and equities begin a relentless decline that will last through the end of 2017.

We came up with the #2000.2.0 idea last year when it looked like U.S. growth was really collapsing and equity markets were fairly muted (like 2000), but as the campaign heated up in Q1 it dawned on us that we were "early" (sometimes the euphemism for wrong) and that 2000 was really more like 2016 than 2015. Both were election years and in both years the incumbent resident had been in office for eight years, equity valuations were the highest they had been since 2000, and the Fed was making noises about raising rates. There were other similarities as well. In 2016, we had just completed one of the best five-year periods for the U.S. equity markets in history (the 1995-1999 period was the best ever) thanks to central banks flooding the system with liquidity (similar to the Fed pumping money into the economy to ward off the effects of Y2K in the late 90s). Given the strong performance of the capitalization weighted S&P 500 (contrary to popular belief, an active, albeit slow motion, momentum fund where the PM is the S&P committee), money was pouring into passive funds and the old record for flows into index funds (set in Q1 2000) was broken in Q2 2016. Everyone was pronouncing the death of active management (just like in 2000) and hedge funds, the most active managers of all, were having their worst year since

(you guessed it) 2000. In fact, Q1 was the worst quarter for hedge funds since 2000 as a very rare phenomenon (seen only during times of central bank excess) was occurring. The best companies' (those in the top quintile for profits and quality) share prices were actually going down and the worst companies (bottom quintile for profits and quality) were surging. Much of this "worst to first" phenomenon could be explained by the unexpected recovery in the commodities sector and a bunch of companies that were on the verge of bankruptcy (and that the best managers were short) averted default and soared in price (many going up multiple fold over just a few months). With all these similarities, we revised our Surprise to say that 2016 would look like 2000 (down single digits, most coming after the election), 2017 would look like 2001 (recession in Q1 and markets down low teens) and 2018 would look like 2002 (defaults would surge and markets would be down in the twenties).

We also discussed in our last letter on *The Value of Value* how there was one more big similarity to 2000 in that people truly, and deeply, hated value investing strategies and were completely head-over-heels in love with technology and growth investing. We talked about how Tiger Management (one of the greatest value investors ever) was forced to close down and we related a story about how GMO, once a darling of the investment world, had become everyone's least favorite manager. We wrote, *"Just how great was the aversion toward Value in 2000? GMO lost half of their business and my Board chair at UNC said I couldn't use the letters G, M or O in a sentence ever again. We all know how the story ends, it turns out that Jeremy was precisely right, the S&P 500 compounded at a stunning rate of negative (1%) from 2000 to 2010 (let that sink in, a decade of negative returns from the U.S. equity market), but what you probably don't know is that Klarman did modestly better (well, actually, WAY better) and Baupost compounded at an astonishing 17% for the same period (remember that the decade from 2000 to 2010 included two declines greater than 50%...)."* So to ask the same question again today, just how great has the aversion toward value been in 2016? Once again, the assets have been flying out the door at all the great value shops (including GMO and Baupost) and if we use hedge funds as a proxy for value investing given their conservative positioning and overall bias toward value strategies, we would have to conclude that the current environment is definitely equivalent to 2000. Throw on top of all these similarities the fact that corporate profits turned down year-over-year (which always, yes 100%, indicates a recession within twelve months) just like in 2000, and you have a solid foundation for the #2000.2.0 thesis. But then the story gets even better as the election plays out.

In 2000, we had a Democratic president (who just happened to have the last name Clinton) and a Republican Congress just like we have in 2016. Hillary Clinton was the FLOTUS in 2000 and was now the Democratic candidate for POTUS in 2016. In 2000, the Democratic candidate was Vice President Al Gore, so not quite the same, but with Hillary having last served as Secretary of State it is pretty close. The Republican candidate was George W. Bush who was widely considered to be less than well-qualified to be president; having limited experience in national politics which sounds pretty similar to the Republican candidate in 2016 (who had no governmental experience). Bush ran a strong campaign, and won one of the tightest races in history (he only got 271 Electoral College votes) and the entire election came down to Florida (where his brother was governor). In 2016, Trump had a similar sweep in the south, but he also learned from the Mitt Romney Rust Belt strategy and picked up PA, OH & WI (and maybe MI) to eke out a slightly larger Electoral College victory. However, in both instances, the Democratic candidate won the popular vote, just one more similarity between 2000 and 2016. So Bush came into the White House with a Republican Congress and all kinds of plans to stimulate economic growth, but was greeted by a recession in the first quarter of 2001 (just as all seven post-WWII presidents following a two term president have faced, how is that for a daunting

statistic as you head into a new job?) and a stock market that fell for more than two years and didn't turn back up until Q1 2003. Come January we will have a president with no Washington experience, a Republican Congress, near record high equity valuations and an economic expansion that is long in the tooth (perhaps only being supported by cheap money), which all sound very familiar…. We have seen that movie before and we didn't like the ending.

In the U.S. equity markets there is one fundamental difference between 2000 and 2016. Back in 2000 there were some pockets of significant undervaluation, which are much harder to find today. Even though the S&P 500 was more overvalued than it had ever been, the crazy valuations were pretty restricted to a relatively small number of technology companies and things like small value, REITs and cyclical companies were actually quite cheap (they would go on to generate double digit returns for the next decade while the S&P was down). In the "old" days, when a sector, or industry, fell out of favor it would languish for a while and you had time to study the problem and find companies that were making positive progress and take your time to buy. You usually had to wait a while to realize the value, but you felt confident that you made your money on the buy. Today, technology and transparency (all information at everyone's fingertips on the internet) have leveled the playing field and (as Ferris says) things move pretty fast. But there are some places to look for value today in the U.S. equity markets. Biotech and Healthcare were hammered in the past eighteen months, as everyone was sure Hillary was going to win and she was going to beat up on healthcare. With a Republican sweep, Biotech and Specialty Pharma look very attractive and could provide significant returns for a while as the combination of data processing power and scientific advances have reached levels never seen in history and the combination of the two creates an exponential (rather than linear) acceleration. Energy stocks, and particularly energy infrastructure stocks (MLPs) look very attractive, and now look even more attractive with a president who doesn't acknowledge climate change as an issue. "Drill, Baby, Drill" is likely to have legs under this Administration. The focus on shifting from monetary policy toward fiscal policy will clearly be a tailwind for Materials and Industrial stocks, but the euphoria last week (some names up 25% or more) seems overdone and we would wait for better entry points (when the honeymoon is over and investors realize it will take time). We would also search for buying opportunities in the small and mid-cap names in these spaces. The one conundrum is technology (FANG) as the fears of rising rates are pounding these stocks as investors fear that discount rates must rise so they are not willing to pay quite as crazy a multiple for growth as a week ago. We are not convinced yet and #Lower4Longer could still apply to interest rates (see the Van Hoisington logic in Surprise #1), so multiples could expand again and one thing that people are missing (people are bad at exponential math) is that the biggest technology companies are creating an exponentially more valuable asset every day, the personal data of their users, and the Law of Increasing Returns will make these franchises more valuable than anyone can imagine over time.

Surprise #7: Dragons & Tigers Beat Bears, Oh My! Emerging Markets divide into two very different groups based on whether they are commodity producers or commodity consumers. Producers (Brazil and Russia) continue to struggle with budget deficits and pervasive currency weakness, while consumers (China and India) enjoy the tailwinds of lower inflation and higher growth courtesy of lower commodity prices and the Dragon and Tiger markets beat the Bear and finish up for the year.

This Surprise started out way wrong as the Chinese got ticked at Ms. Yellen for her rate hike in December and messed with the RMB in early January. Global equity markets were getting killed and Chinese equity markets got killed even more, despite the windfall of oil falling to $26 (no one cared about that). Then a funny thing happened, and the Chinese did what they always seem to do, they calmly introduced additional stimulus into the markets and there has been a very

slow and steady recovery in share prices over the past couple of quarters. The tortoise beats the hare according to Aesop and the Hong Kong market actually overtook the S&P 500 at the end of Q3, but then weakened on the rise of Mr. Trump (with his anti -trade rhetoric) and fell back to a dead heat today. The Shanghai composite fell even harder in the first two months of the year, but has locked into a slow and steady pace since March 1 and has nearly doubled the return of the S&P 500 since then (up 20% vs. 12%). Perhaps most interesting, it has not faded at all during the past week as all the other emerging markets have been getting hammered. Two things are compelling about this development. First, investors are coming to realize that the U.S. is not as big a trading partner as it used to be (given increased intra-Asia trade) and the U.S. has given up some negotiating leverage by abandoning the Trans-Pacific Partnership (TPP). Second, valuation actually matters, a lot. Stocks in Shanghai are very cheap (on both an absolute and relative basis) and when we look at the fact that economic numbers have been coming in better than anticipated over the past few months, those valuations may be set to become more attractive as forward profits are likely to increase. We continue to believe that the best investments in China will focus on the five key sectors for that transition to a consumer economy, Technology (particularly e-commerce), Consumer Staples, Retail, Healthcare and Energy (particularly alternative and infrastructure). When Trump talks about China (all I can hear is Alec Baldwin on SNL saying, "It's pronounced Jiii-na") he waffles a lot and so it is hard to see where he will come down on China policy. Our guess is he will label them a currency manipulator (easy, low cost) and then trade barbs about tariffs, but they have a bigger stick than him right now and since Trump doesn't like to lose, we don't think he will pick this fight (at least not right away). What he is likely to do is try to create more of an alliance with Russia to create a block against Chinese incursion into European trade, but it may be too late as Putin is always (it seems) playing chess when everyone else is playing checkers.

The story in India had been quite similar to China in 2016 (for different reasons) as the Nifty Index plunged (12%) over the first two months of the year on fears of rising U.S. interest rates (which still haven't happened), a change in the RBI Governor (people didn't think anyone could be as good as Rajan, but the new guy might actually be better), a third bad Monsoon and the Modi honeymoon wearing off. It was basically a collective realization that for all Modi's big promises, the bureaucracy of the Indian government was making it harder to get things done than everybody thought (we will bet we will be reprinting these words later next year to describe someone else's challenges with bureaucracy). So rates didn't rise in the U.S. (although they have backed up a bit in the past week and EM investors are freaking out a little), the new guy at the RBI is actually a better fit with Modi's agenda (and it turns out he is nearly as big a stud as Rajan), the Monsoon was good and some progress was made in moving the Modinomics agenda along. All this good news has created a nice tail wind for Indian equities over the past couple of quarters and the Nifty Index recovered all of the early losses. We continue to think the growth story in India is very compelling (fastest GDP growth in the world) and the lower average oil prices this year have created an additional tailwind for the growth story. One of the best ways to play growth in the developing world is by owning the banks. In India it is important to distinguish between the state owned banks and the privately owned banks (we favor the latter) as the state owned will have some headwinds with NPLs going forward. Owning names like ICICI and HDFC will continue to be a winning trade and there are other finance related issues that should benefit from the rising level of consumption in the middle class. The rise of the Asian Consumer has been one of our key themes for many years and we actually see signs of acceleration of this trend in India, so having a focus on domestic consumption stories should be very profitable.

We got the other side of this surprise totally wrong as commodity producing countries like Brazil and Russia

not only didn't struggle this year, they have surged. Brazil is an amazing turnaround story and we were remiss in not applying our "if it doesn't go bankrupt, you have to back up the truck" strategy when this market got obliterated last year thanks to horrible growth, pervasive corruption and relentless currency weakness. Klarman says, "Bad things happen, but really bad things don't happen." Arjun Divecha continually reminds us that, "you make the most money in EM when things go from truly awful to merely bad," and that is exactly what happened in Brazil this year. When the threat of impeachment of President Dilma became a reality, this market became a reflexive rocket ship as shorts had to cover and rising stock prices actually helped stabilize the economy and led to improved fundamentals. We did an #ATWWY on Soros' First Law that "The worse a situation gets, the less it takes to turn it around, the greater the upside," so not really capitalizing on this one hurts even more. We did have some exposure, but we should have had a lot of exposure. Russia is another place where we have been positive, but we were concerned about the impact of lower oil prices on the economy (we were right there), but what we missed was how quickly markets would readjust oil prices in Q2. While it appears that oil will play out about like we thought (finishing the year around $50), we thought the recovery wouldn't happen until the second half. So again, while we had some solid exposure to Russia, we should have backed up the truck (not that our Russia manager wasn't pounding the table, they were), but you can't get them all right. Curiously, investors have pounded Brazil in the last week as if it was the same country as Mexico (makes no sense to us, they don't even speak the same language), while they have been more lukewarm on Russia than might have been anticipated with a Trump victory. We remain in the Bull camp on EM and will use the sell-off over the past week to continue to build our overweight as the historical data, contrary to popular belief, shows that EM actually does well in a reflationary environment (rising U.S. rates).

Surprise #8: King Dollar Gets Dethroned.
Contrary to the powerful narrative that the U.S. dollar must continue to appreciate in the face of the Fed taking a different monetary policy course (or at least threatening to take a different course) than the ECB & BOJ, the old saw "Buy the Rumor, Sell the News" turns out to be true once again and the USD peaks and actually begins to weaken against other global currencies. The surprising dollar weakness takes some pressure off of the Chinese to further weaken the RMB and the yuan continues on a path toward becoming a world reserve currency.

This Surprise was probably looking the best of the bunch in the first three quarters of the year, as there was no one on our side of the S.S. King Dollar coming into 2016. If you read the headlines recently you would think the dollar was up double digits and in a wild bull market this year, yet if you actually stopped to look at the DXY Index you would find that even with the meaningful move over the past month on anticipation (and realization) of the Trump win, the dollar has been roughly flat (and has been flat since Q1 2015). There was some early weakness that may (or may not) have helped with the decision to include the RMB in the SDR, but it did indeed happen and one more step toward pushing the RMB to world reserve currency status has been achieved by China. However, while we got that part of the Surprise right, the Chinese have allowed the RMB to weaken gradually during the year, but we think there has been a method to these moves. Each time the Fed made noises about raising rates, the Chinese would move the exchange rate a couple percent as if to say "back off," and in each case this year there has been no hike. With the Trump victory markets have moved the probability of a December hike to nearly 100%, but we are watching the 6.8 level on the RMB as we think the PBoC is once again signaling to QEeen Janet to channel here inner dove and beat back the hawks. It is tough to bet against the probabilities and every time the percentage has been above 75% there has been a hike, but we still think there is a significant problem for China (and therefore for everyone else) if the

dollar gets too strong. History does show that the dollar peaks as the Fed raises rates (it is strong in anticipation of the hikes, buy rumor, sell news), so if the broad Dollar Index stays behaved and begins to retreat then the Fed will have a clear path to hike away, but if foreign exchange markets continue to focus only on Fed Funds rates to prices USD, then it could be an interesting battle. In the end, we think Ms. Lagarde is really in control and she did hint that a December hike would be okay in a recent speech, so maybe we are set to test "normalization." The bigger question than the dollar will be what does normalization mean for discount rates and multiples on equities?

What has been most amazing in the past week is how fast the narrative changed on Trump. Candidate Trump was a disaster waiting to happen for global financial markets and everyone was convinced that markets of all kinds would go into free fall if the unthinkable happened and he were to actually win.

Surprise #9: Cure For Low Prices Is Low Prices.
The severe bear market in commodities that began in 2011 destroys sufficient industry market capitalization spurring companies to dramatically slash capital spending, cancel large swaths of projects and reduce productive capacity to a point where commodity prices begin to find a floor and some generational investment opportunities arise amidst the bankruptcies and restructurings in places like MLPs, Miners and Exploration & Production companies.

This Surprise has been following the script as well as #5 on oil (obviously linked) as the supply disruptions that were caused by the fallout from the brutal five year bear market from 2011 to January of this year began to create a floor under commodity prices. Since the end of January the recovery in these markets has been nothing short of extraordinary (details in Q3 review above) and there actually were some generational investment opportunities (we were trying to be hyperbolic to make a point) if we define "generational" as making multiples of your money in a matter of months (doesn't happen very often unfortunately). A lot of things came together perfectly (the inverse of the perfect storm) to allow a number of companies that probably would have gone bankrupt in a "normal" (what is normal anymore?) cycle as the ZIRP policies allowed excessively leveraged companies to live another day, which turned out to be just enough to get some free cash flow again to service the debt. There were also a number of examples of rescue financings from banks who actualized the old saw that if you borrow a million dollars, you have a banker, but if you borrow a billion, you have a partner (in the case of CS and GLEN make that $100B). Another contributing factor was that the Chinese needed a place to invest (or gamble if you prefer) some of their hot money as that money was fleeing their falling equity markets, so they made it easier for retail investors to speculate in commodity futures (and speculate they did). There was also the reflexivity of money finally coming back to the markets, which improved the fundamental story of some of the companies as they could issue new debt and equity to try and repair their balance sheets. This created a virtuous cycle of rising stock prices and money flowing into those stocks. Finally, the Fed and the dollar cooperated and stayed down so that the momentum in the recovery could build. Where does the rally go from here is the big question. Is this the beginning of a new commodity bull market (or better yet, another commodity super cycle) or is this a dead cat bounce that will end in tears as we enter the New Year?

The elusive answer to that question will be impacted by the Trump victory in the election. On the positive side, the increased focus on fiscal stimulus has people talking about a rapid increase in commodity prices, as inflation will surge under Trumponomics. The equity markets clearly agree with this view as companies in the Steel, Aggregate, Copper and Machinery industries, among others, have soared (I mean seriously soared), rising as much as 50% in a matter of days. Too far, too fast, seems to be the logical response, but I was reminded of one of my favorite

maxims about trading the other day, that to be a successful trader, one should strive to do more of what works and less of what doesn't work. Paul Tudor Jones was known for saying #LosersAverageLosers all the time and I created another hashtag for the other side based on Julian Robertson's uncanny ability to "Double Up," #WinnersPressWinners. One thing about Trump is that he rarely loses (as he will tell you, and he does tell everyone); in fact, he almost never loses, and if that type of animal spirit has been unleashed in these markets, this move could go for a while. But even with that said, we would still be a little cautious short term and watch the overbought indicators on individual names (like AKS, X, CAT, VMC, MTW, etc.). As we said earlier, it will be late 2017 before any real fiscal stimulus will be felt and even then most of these companies are going to be involved in relatively small (millions vs. billions) of projects. The other issue is that there is a huge difference between reflation and inflation. Japan has been doing fiscal stimulus to reflate their economy for decades (more than $274 billion) and has not been able to generate a whiff of inflation due to the problems of the Killer D's of bad demographics and too much debt which lead to deflation. Without inflation, it is tough to have much tailwind in commodities, but investing in the equity of the companies in the commodity business can still be fruitful because of operating leverage.

Surprise #10: The Bus Stops Here…
Uncle Carl Icahn is right and there is danger ahead in the credit markets around the world. Excess Central Bank liquidity has created a bond bubble across myriad sectors and there are abundant opportunities to short credit in emerging markets, high yield (particularly energy) during this new distressed debt cycle.

This is another Surprise that looked great for six weeks early in the year and faded pretty badly (read high yield bonds surged) over the past couple of quarters. The global search for yield and the Central Bank policies of ZIRP and NIRP have led to a crushing financial repression that has pushed investors out on the risk curve to try an earn returns. We have talked at length about the destruction of negative interest rates so the policy implications that are being discussed by the Trump team are somewhat welcome to reverse the damage done by the central printers around the world. It does get a little tricky and the image we borrowed for this Surprise of the low yield party bus falling off a cliff onto a big black rock (an elbow to the side of Larry Fink by Uncle Carl) is fairly accurate. There is no real way out of this mess without someone getting hurt. Mathematically, interest rates cannot go up without bondholders losing money. It is even worse for high yield because higher rates will limit the access to credit of the worst companies (good, cleansing) and there will be even greater hits to return from capital loss. The base case for HY from here is low single digit returns and the downside case (defaults rise to average levels) is negative returns for the next five years. We don't see many ways President Elect Trump can help investors here, so we would avoid HY for now (maybe even short) and substitute EM Debt or Absolute Return Hedge Funds.

Bonus Surprise: Unicorns Have Ten Lives.
Contrary to the drumbeat of negativity that too much money went into venture backed start-ups in 2015 pushing up valuations to levels triggering the mocking moniker "Unicorns," disruptive innovation continues to emanate from Silicon Valley and Route 128 in Boston and late stage venture has been generating superior returns for investors.

As a bonus Surprise, we won't spend too much time on this one for this letter (as it is running long), but suffice it to say that the rumors of the Unicorns demise were definitely greatly exaggerated. There have been a number of very high profile companies raising money at very attractive step ups in valuation, like Uber and Lyft (the ride sharing companies) and Snapchat (the disappearing message App). Snapchat is actually in the process of filing for an IPO that would value the company at $25 billion (with reports

that it will likely hit $40 billion on day one). While it is true that there have also been some write-downs in companies where valuations had gotten a little ahead of themselves, that is the nature of the game – a few big winners make you the bulk of the returns. Silicon Valley remains the center of the universe and the opportunities to invest in disruptive innovation are only going to accelerate in the coming years as the confluence of big data, pervasive computing and new scientific breakthroughs all come together to make growth exponentially faster.

The Trump win came without a lot of help (read support) from Silicon Valley, so there is some non-zero risk of retaliation of sorts, which (if he was so inclined) could include an attack on carried interest (discussed above) or some form of intellectual property tax, transaction tax or other form of increased regulation to slow the pace of wealth creation. Any such move would be disastrous long-term and the opposite of the campaign slogan that won the election.

Ferris Bueller was right, ***"Life moves pretty fast."*** A year ago it seemed like the election would never get here and two weeks ago it couldn't get here fast enough. Now it has been over for a week and it has been a blur of shock, awe, media frenzy, market gyrations, global discourse, political posturing and lots and lots of forecasting, predicting and handicapping what is likely to happen. Our job in the investment business is to look at all the pertinent facts, form a hypothesis and execute investment strategies to try and capitalize on opportunities that we see. Investing is all about taking intelligent risks, those risks you are compensated correctly for taking. In order to make decisions on which risks to take, you must have conviction about your ideas and your strategies. It was interesting, the other day I was giving a speech at Andrea Szigethy's new company's first event as a spin-out from Morgan Creek (she gets to build something amazing that she has always wanted to build and she will still be around to help us when we need it) and I gave my usual "highly convicted" talk on where we saw investment opportunities in the current environment (yes, the rumors and pictures, are true. I did indeed give the talk wearing a bath robe and hair towel like Ferris Bueller) and after the talk someone asked a question that was interesting but puzzling. She asked why the other speaker and I (my friend, Dennis Gartman) would say things that sounded so assured when there was risk that we could be wrong. Both of us looked at each other and laughed and said, "We're wrong frequently. If people have a need to be right in this business, they will be very unhappy" (and unlikely to be very successful). I quoted the statistic that the legends of the business (like Julian Robertson) are only right around 58% of the time. The other important point that Stan Druckenmiller said he learned working for Soros is *"it doesn't matter if you are right or wrong, all that matters is how much you make when you are right and how much you lose when you are wrong."* If you only say things that have a low risk of being wrong, you will obviously be right a lot more often, but you won't make good returns, because conventional wisdom is already in the price. Michael Steinhardt said it best, *"we made all our big returns when we had a variant perception that turned out to be right."* Finding great variant perceptions is difficult, but the key to really being successful in the investment business is admitting you are wrong quickly and moving on the next idea. George Soros says it best *"I am only rich because I admit my mistakes faster than other people."* Dennis quoted the legendary Jack Nash who said, *"being wrong is not a problem, staying wrong is a problem."* I offer one last point, that it has been shown that successful people in all fields make more mistakes (are wrong more) than the less successful people because they try more new things more times. Michael Jordan talked about why every shot he missed (turns out he missed a lot) made him a better shooter and Babe Ruth talks about how every strike out got him closer to the next home run. So it is possible that the entire hypothesis of this letter is wrong and President Trump will not move to the center and Candidate Trump will live in the White House for four years. If that happens, we would

expect this movie to end more like Hooverville than Reagantown and Mr. Trump will not get his lease extended (or worse, he could even get evicted). We are hoping for the best, though preparing for the worst, because this is really important. This is about how we all *Save FairUS*.

Update on Morgan Creek

We hope you have been able to join us for our Global Market Outlook Webinar Series entitled "***Around the World with Yusko***." We have had many interesting discussions in the last few months including: *Bubble Trouble: Closing in on Jeremy Grantham's S&P 500 Target* and *A Black Swan Alights in Europe: Banking Crisis 2.0 or Time to Buy*. If you missed one and would like to receive a recording, please contact a member of our Investor Relations team at IR@morgancreekcap.com. Mark your calendar now for our **December 13th** webinar **at 1:00pm EST.**

We are also a proud sponsor of The Investment Institute, a newly formed Educational Membership Association for Institutional & Private Investors and Managers in the Southeast. The date of the next program will be **May 22nd-23rd, 2017** at **The Umstead Hotel & Spa, Cary, NC**. For more information on how to become a member and join this elite group please visit www.theinvestmentinstitute.org.

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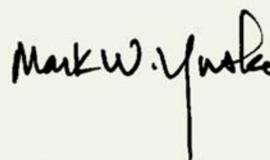
As always, It is a great privilege to manage capital on your behalf and we are appreciative of your long-term partnership and confidence.

With warmest regards,



Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

Endnotes:

[1] https://en.wikipedia.org/wiki/Herbert_Hoover

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Russell 3000 Index (DRI) — this index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Definition is from the Russell Investment Group.

MSCI EAFE Index — this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index — this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

91-Day US T-Bill — short-term U.S. Treasury securities with minimum denominations of $10,000 and a maturity of three months. They are issued at a discount to face value. Definition is from the Department of Treasury.

HFRX Absolute Return Index — provides investors with exposure to hedge funds that seek stable performance regardless of market conditions. Absolute return funds tend to be considerably less volatile and correlate less to major market benchmarks than directional funds. Definition is from Hedge Fund Research, Inc.

JP Morgan Global Bond Index — this is a capitalization-weighted index of the total return of the global government bond markets (including the U.S.) including the effect of currency. Countries and issues are included in the index based on size and liquidity. Definition is from JP Morgan.

Barclays High Yield Bond Index — this index consists of all non-investment grade U.S. and Yankee bonds with a minimum outstanding amount of $100 million and maturing over one year. Definition is from Barclays.

Barclays Aggregate Bond Index — this is a composite index made up of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index, which includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $100 million. Definition is from Barclays.

S&P 500 Index — this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index – each stock's weight in the index is proportionate to its market value. Definition is from Standard and Poor's.

Barclays Government Credit Bond Index — includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries and agencies. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specific maturity, liquidity and quality requirements.

HFRI Emerging Markets Index — this is an Emerging Markets index with a regional investment focus in the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.

HFRI FOF: Diversified Index — invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets. Definition is from Hedge Fund Research, Inc.

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

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