



Averaged Down

The best argument against democracy is a five-minute conversation with the average voter.
– Churchill

On June 23, British voters were queried in a referendum, “Should the United Kingdom remain a member of the European Union or leave the European Union?” 72% showed up to the polls and 52% of them selected “leave.” Queue Armageddon.

From the Monday before Brexit until the Monday after, ten-year UK gilts declined in yield from 1.24% to 0.96%, ten-year German bunds fell from 0.05% to -0.11%, ten-year US treasuries fell from 1.7% to 1.45%. It cost \$1.47 to buy £1 before and only \$1.32 after. Queue that vacation to Yorkshire.

Most of the media reacted with such hyperbole that we at Gryphon were surprised to discover on the following morning that our commuter trains were still operating, the barista still showed up to steam our lattes, and the US Army had yet to ensure order by rolling out tanks onto the streets of Evanston—a good thing at that, as it’s already July and the town has yet to conquer its winter potholes.

Most of the asset management firms published their predictable investment updates, emailing out paper after paper with illuminations such as, “the Brexit will cause investors to re-examine their portfolios,” “unpredictable events will occur,” and “there are risks to the global economy that will cause volatility.” Suffice it to say that the internet’s bandwidth janitor sure needed his electronic plunger that morning.

The most disheartening reality is that these publications were authored by legitimately brilliant and industrious individuals, who had been “averaged down” by the fear of failing unconventionally. Hence, their conventional missives were stuffed with “on the one hand, on the other hand” predictions that could be justified no



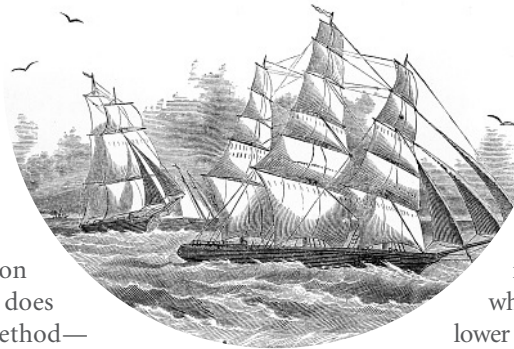
matter the outcome. For example, take the claim, “there are risks to the global economy that will cause volatility.” Imagine that subsequent to this prediction the European equity market rallied by 10%; the forecaster would have been correct because price changed - in this case, it increased—and a change in price is the exact definition of volatility. However, what if the price instead declined by 10%? The forecaster would still be correct. Given the nature of the prediction, the only possible way for the forecaster to be wrong would be if the price holds steady; a highly unlikely outcome given the historical precedents of binary outcomes to coin-flip events. The “right on almost all accounts prediction” is equivalent to the weatherman reporting that there will be sun or rain on a June Chicago day. The only way he is wrong is if it hails. The prediction is not helpful because it doesn’t allow you to determine whether or not you need an umbrella; a much more relevant consideration than the hail. The weatherman is only worth his salary if he can consistently advise you on whether or not the umbrella is necessary. Similarly, the predication of price volatility tells us nothing that we don’t already know.

Another drawback is that the “right on almost all accounts” type of forecasting does not closely adhere to the scientific method—as scientific as one can be in investing—because it does not advance a reasonably falsifiable hypothesis. In other words, there’s practically no way to prove the forecaster wrong. At Gryphon, scientific and evidence-based methodologies pervade our investment process. As such, we make forecasts for which the magnitude of our accuracy or error can be determined so that our clients know how much value we are adding or subtracting. Before even making a prediction, we gather as comprehensive a set of data as we can and test our hypothesis against this data to determine if our argument holds up. Here’s a highly simplified example of our scientific process...

We begin with an observation - nominal interest rates are at low levels - and a question - why are they low? In order to address the query, we advance competing explanations; 1) nominal interest rates are low because there is an overabundance of demand from savers for safe assets relative to low demand for credit from borrowers, or 2) nominal interest rates are low because companies have declining profits and therefore cannot afford to pay high interest on the bonds that they

issue. We then examine the data to test each hypothesis. In this case, the data shows that corporate profit margins have been at very high levels for the past decade despite the prevalence of low rates. Also, there have been periods, such as the first half of the 1980’s, when interest rates were rising even though corporate profits were falling. (The effective Federal Funds rate rose from 7.5% in the late 1970’s to almost 20% in the early 1980’s while after-tax corporate profits relative to GDP more than halved between the late 1970’s and the mid 1980’s). This provides evidence against the argument that rates are low because corporations cannot afford to make high interest payments to lenders.

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Also, the data shows that aggregate household sector leverage in the US remains low and that total leverage has fallen to about 16% of net worth, down from almost 25% right before the onset of the Great Financial Crisis. In addition, the household debt service ratio has fallen from a peak of 13.2% in 2007 to 10% now and the personal savings rate in the US has risen from under 2.5% before the Great Financial Crisis to over 5% currently. In other words, relative to income and net worth, Americans are borrowing less and saving more than they were ten years ago. This not only correlates with the fall in interest rates, but there are logical reasons as to why saving more and borrowing less would cause lower rates. Bingo! We have proved our first argument false and confirmed our second.

In the real world, many factors contribute to low interest rates, and confirmation from a single set of data isn’t enough to verify a hypothesis. Our simple explanation may only be one part of a fuller description, but this example illustrates our goal of advancing clear and measurable arguments. This scientific method allows us to evaluate our performance; determining where we were right or wrong, why we were right or wrong, and how we were right or wrong. By “clear and measurable,” we do not mean that our forecasts predict that a single event will occur with 100% certainty. They may include five different possible outcomes with a probability assigned to each, but the forecast will still be clear and clearly measurable, and should not be confused with an assertion so general as to assert nothing.

We would consider it a waste of our clients’ time to send out a communique interwoven with useless generalities. Instead, we want to take this opportunity to emphasize that just slightly more than half of UK voters’ desire to exit their current relationship



with the EU is not as leading indicator that portends some massive shift, but rather a coincident indicator that confirms the current trend. Under Article 50 of the Lisbon Treaty, the negotiation could take up to two years, with an option to extend. In the near future, we think the exit will cause British GDP to grow by 1%-1.5% less than if Britain remained, down from 2.5% to 1%-1.5%. We anticipate the GDP shock to the Eurozone will be limited to about 0.25%, with most of that reduction resulting from tighter financial conditions. More significantly, the Brexit is another data point that supports a key secular thesis; the end of the debt supercycle and the consequent Japan-ization of the developed economies.

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The Brexit was mostly driven by the desire of lower-income native workers to stifle the competition for labor that they face from immigrants under the EU's free flow of labor provision. This aversion to competition in the labor market is just one more reason to expect relative stagnation in the developed world, with lower potential growth and, eventually, inflation via higher wages. The onerous welfare system is already entrenched in Europe, and supported by both Presidential nominees in the United States. But don't make the mistake of believing that the Brexit is a game-changer. Unlike the UK, any country that shares the euro as a common currency will have a more difficult exit course because currency uncertainties would suddenly be introduced, disrupting a wide range of securities and private contracts. The impetus for the UK's exit wasn't nearly so great. So, there is no immediate risk of further exits; our concern is focused on nations that would leave the union a half-decade from now. The most likely core European country to exit the common currency is Italy, where Prime Minister Matteo Renzi is attempting to fend off the socialist Euro-skeptic Five Star Movement. But Italy is mostly by itself here—maybe joined by the Dutch nationalist movement led by Geert Wilders' Party for Freedom – as even the Spanish elections that followed right on the heels of the Brexit vote produced no net gains for Euro-skeptic parties. At the end of the day, democracy is a double-edged sword; citizens determine their own future, and the nature of the future mirrors the quality of the citizenry. If the average voter desires a bloated, insular welfare state, then that is what will emerge. 🐉

