

Dancing In The Dark



"Message keeps getting clearer Radio's on and I'm moving 'round the place I check my look in the mirror I want to change my clothes, my hair, my face Man I ain't getting nowhere I'm just living in a dump like this There's something happening somewhere Baby I just know that there is..."• Bruce Springsteen, [Dancing in the Dark](#)

A toxic cocktail of elevated stock market valuations, a less accommodative pivot by global central bankers, wayward fiscal policy (adopted by both parties), a market structure (influenced by the rising dominance of machines and algos) that increase the interconnections among different markets (and asset classes) and a chaotic White House shrouded in random policy actions (e.g., yesterday's tariff announcement) without a process and that fail to consider the consequences are being served up. This is serving to create a backdrop of unpredictability and uncertainty that is in marked contrast to the calm

experience of the last five years. For years, a consistent expansion price earnings multiples, markets without corrections, record low volatility, near zero interest rates, (too) generous central bankers and, more recently, an incalculable, erratic and autocratic President -- have been normalized. Resultingly, stock market price discovery has been limited -- leaving market participants ill prepared for change. It is my view that the hangover of early February is now likely poised to be a long and deeper one -- extending throughout the next few months... and perhaps much longer. Investors and traders are now dancing in the dark of unknowns and are being controlled/dominated by automated and passive investment strategies/products, events, narratives, crises and players' (actions) rarely seen. **Tariffs (And Other Policies "Done on the Fly") Give New Meaning to "March Madness"**

"Surprise #1: President Trump's Behavior Finally Does Matter •With domestic economic growth slowing by mid-year, Trump retaliates against China in a major trade war, serving to exacerbate the economy's slowing rate of growth." • Kass Diary, [15 Surprises](#)

Actions have consequences -- particularly policies that are ad libbed and that have no process. The proximate cause for Thursday's 35 handle drop in the S&P Index was the imposition of steel and aluminum tariffs -- a recommendation that apparently was "done on the fly" by the President. I wrote yesterday about the potential sledge hammer of tariffs that might *"Make Americans Poor Again"* in my Diary:

Over the objection of Republicans and advisors, the Administration has announced the imposition of large tariffs on steel and aluminum that will be instituted next week. The White House is living in the past as tariffs will help a handful of companies that provide little value added (and are members of the "old economy") -- and will hurt countless companies and the consumer (H/T Smalls!) Tariffs suggest a rising chance of "stagflation" -- higher inflation and moderating global economic growth. I also believe that Gary Cohn's days are now numbered. Finally I stand by my comments on expanding risks this morning: I am increasingly fearful of the rising political and geopolitical risks.

*** These growing risks are not market friendly** Away from my personal political views -- I am raising my political and geopolitical concerns as they relate to the markets. This is a very subjective issue but I believe we are seeing an unraveling (a dysfunctional White House, the potential for trade wars, terrorism, etc.) that is not currently priced into the markets. The timing is also difficult to predict -- but I believe political and geopolitical headwinds are likely creeping up on investors (and the world). This means that it will be increasingly difficult to ascertain what the effect on world wide economic growth will be. My guess, for now, is that it will be a magnitude that none of us can compute. Remember several of my questions that I ask myself everyday:

- *In a paperless and cloudy world, are investors and citizens as safe as the markets assume we are?*
- *In a flat, networked and interconnected world, is it even possible for America to be an "oasis of prosperity" and a driver or engine of global economic growth?*
- *With the G-8's geopolitical coordination at an all-time low, how slow and inept will the reaction be if the wheels do come off?*

As I wrote, I don't have the answers but I am increasingly fearful of rising political and geopolitical risks. On the implementation of steel and aluminum tariffs I further wrote:

- * *You have to out compete -- you can't tax your way to prosperity and tariffs are taxes.*
- * *The tariffs reflect the ignorance of Peter Navarro and the disorganization and lack of*

*clarity of thinking in the White House. * Tariffs will hurt more industries and employees than it will help. * Tariffs can lead to trade wars which may lead to a cold war -- they will hurt our security more than it will help our security. * Tariffs will contribute to a rising probability of "stagflation" -- by raising inflation and reducing economic growth and trade.*

I then tweeted:

16 US steel stocks market cap up \$1B as a result of tariff announcement today. Rest of S&P 500 down \$400B. "Making Americans Poor Again." (H/T Smalls)

3:49 pm - 1 Mar 2018 In some quarters my comments on the White House's disorganization and dysfunction are objected to for being political -- they are not. I am simply providing my view of the White House's policy impact on the markets. As support, here are some relevant comments in the conservative Wall Street Journal's [editorial page](#) this morning, "*Trump's Tariff Folly*":

"Donald Trump made the biggest policy blunder of his Presidency Thursday by announcing that next week he'll impose tariffs of 25% on imported steel and 10% on aluminum. This tax increase will punish American workers, invite retaliation that will harm U.S. exports, divide his political coalition at home, anger allies abroad and undermine his tax and regulatory reforms. The Dow Jones Industrial Average fell 1.7% on the news, as investors absorbed the self inflicted folly. Mr. Trump has spent a year trying to lift the economy from its Obama doldrums, with considerable success... Apparently, Mr. Trump can't stand all this winning. His tariffs will benefit a handful of companies, at least for a while, but they will harm many more. "We have with us the biggest steel companies in the United States. They used to be a lot bigger, but they're going to be a lot bigger again," Mr. Trump declared in a meeting Thursday at the White House with steel and aluminum executives."

No, they won't. The immediate impact will be to make the U.S. an island of high-priced steel and aluminum. The U.S. companies will raise their prices to nearly match the tariffs while snatching some market share. The additional profits will flow to executives in higher bonuses and shareholders, at least until the higher prices hurt their steel and aluminum customers. Then U.S. steel and aluminum makers will hurt as well... Mr. Trump seems not to understand that steel-using industries in the U.S. employ some 6.5 million Americans, while steel makers employ about 140,000... The National Retail Federation called the tariffs a "tax on American families," who will pay higher prices for canned goods and even beer in aluminum cans. Another name for this is the Trump voter tax... The economic damage will quickly compound because other countries can and will retaliate against U.S. exports. Not steel, but against farm goods, Harley-Davidson ([HOG](#)) motorcycles, Cummins ([CMI](#)) engines, John Deere ([DE](#)) tractors and much more. Foreign countries are canny enough to know how to impose maximum political pain on Republican Senators and Congressmen in an election year by targeting exports from their states and districts. Has anyone at the White House political shop thought this through?" In other words, actions have consequences -- in our daily life, in the economy and in the markets. **More Uncertainties Abound -- Many Are Being Delivered By Machines and Algos That Have Changed the Market Structure (For the Worse)**

"Increasingly, only the collective human ego - what I call 'the Big I' - bounds and defines this constructed world. We subordinate, alter, and reinvent almost everything around us according to our own interests, from the mountains of Vancouver Island to the Isle of Dogs and the very sky overhead. Seduced by our extraordinary technological prowess, many of us come to believe that external reality - the reality outside our constructed

world - is unimportant and needs little attention because, if we ever have to, we can manage any problem that might arise there. And, in any case, as the pace of our lives accelerates, we have less time to reflect on these broader circumstances. All these trends can push us into narcissism, as they weaken our sense of awe at the universe beyond our human ego; and what is perhaps more important, they also weaken our receptivity to critical signals from the external reality that might awaken us to our deep ignorance of the potential consequences of our actions, and warn us against hubris. Without this awareness we have a less accurate understanding of how much and what types of ingenuity we will need to meet the future's challenges." • Thomas Homer-Dixon

In our flat and interconnected world, an odious contagion is a much more likely byproduct when decisions are being made by machines and algorithms who worship at the altar of price momentum and correlations and who are agnostic to fundamentals and a sense of intrinsic value. My friend, *Credit Strategist's* Mike Lewitt, puts the uncertainty I [highlighted](#) yesterday into perspective in his latest market commentary:

"As we learn of the serial systemic and human failures that contributed to the school shooting in Parkland and simultaneously watch financial markets wrestle with the aftermath of the brief but violent February correction that wiped out a number of investors who thought it was a good idea to short record low volatility, we are reminded of the illusory nature of our grasp on the future or control of our environment. There is no area of human activity that better exemplifies this illusion than financial markets. How can we possibly expect to manage something as complex as markets when we can't even protect our children from obvious threats? Some may consider that a false equivalence but I would strenuously argue that it is precisely these types of connections that we need to make. Everything is connected. Changes in market structure significantly increase the interconnections among different markets and asset classes and the potential contagion effects that are triggered by risks hiding in plain sight. We now inhabit a world where the very notion of asset classes is rendered obsolete by financial technologies that digitalize all financial instruments into the same basic elements (i.e., 1's and 0's). And increasingly machines rather than humans trade these instruments with diminishing regard for their fundamental economic value. As a result, the causes of the next market correction and financial crisis are staring us in the face; an interconnected, automated market structure trading overvalued stocks and bonds as central banks tighten policy in a grossly overleveraged world. Such a combination is prone to bursts of volatility and instability. In February, we experienced what it feels like to live in markets dominated by machines copulating with each other without regard to economic fundamentals. I don't know about you, but this gave me no pleasure."

I am more fearful of our investment future than our investment past. Since, today, investors and traders seem to be dancing in the dark, I prefer dating, drinking and dancing with C.I.T.A. ("cash is the alternative") rather than with T.I.N.A. ("there is no alternative").

"You can't start a fire sitting 'round crying over a broken heart This gun's for hire Even if we're just dancing in the dark You can't start a fire worrying about your little world falling apart This gun's for hire Even if we're just dancing in the dark..."