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We are not retreating, we are advancing in a different direction
By Alan Snyder

Regime change may be coming to us. We don't mean new kings and queens or republicans versus democrats, but multi-year macroeconomic shifts. Quantitative easing and money-printing dominated from 2010 through today depending on the country (viz. Ben Bernanke's recent book, *The Courage to Act*). Now, attempts to combat deflationary risks seem to have triggered a potential regime shift to "reflation" and other actions intended to dampen the popular revolt.

Any true shift will have dramatic impact on various asset classes going forward. Changeovers are messy and uneven at turning points, a tug of war between old and new. Witness the disparity between the U.S., Eurozone, Japan, and China.

What are the "tells" of this potential regime shift?

1. The U.S. economy is gradually strengthening.
2. China, so far, has avoided the pundit predicted "hard landing" and motors along, albeit at less than their headline rate of 6.5%.
3. Brazil, undergoing political regime change, has enjoyed a robust stock market.
4. Russia, not withstanding sanctions, has not fallen into the abyss and its equity and currency markets have rebounded.
5. G-20 meetings focus on fiscal measures after seeing the limits of monetary authorities.
6. Both U.S. candidates for president speak openly for aggressive actions to be taken such as tax reductions for the middle class, infrastructure spending, free college, etc.

Pension plan underfunding, rather than an indicator of this shift, might become more of a driver as elected officials deliver inflation in order to increase nominal returns. Pensioners and pension funders are in deep trouble, a $1.7 trillion shortfall.

<u>Look out below</u>

Pension plan actual returns have been dismal:

- Last year results were an average of 1.07% with the prior year being 3.43%.
- Most plans use an actuarial assumption of 7.5%, a far cry from actual results or most predictions for the future.
- McKinsey, BlackRock, and the Pension Consulting Alliance forecast a 4.5% return in the future.
- The Federal Reserve estimates the current shortfall at $1.7 trillion and climbing quickly.
- Many plans are eating their seed corn by using current assets to pay liabilities, depleting their future earning power.
- Few plans have faced this harsh reality. Tinkering around the edges is the norm with rate assumptions being lowered by 25 basis points, as the Pennsylvania school system has done.
- Ostrich-like reactions are embodied by CalPERS, the largest U.S. pension plan, hiding behind more robust 30-year assumptions provided by their consultant, Wilshire Associates, weighing in with an estimate of 7.83%.

Puerto Rico is the canary in the coal mine:

- $70 billion in debts plus $43 billion in unfunded pension obligations.
- The local government actually is trying to increase pension payments, amazingly.
- Pensioners have been favored like in Stockton, California, and in the G.M. restructuring. Compounding the challenge is a liberal policy of lending to pensioners for "cultural travel," mortgages and personal loans, further indebting the pension plans to the tune of $1 billion.

Inflation can drive yields higher, which is an easier solution than raising contribution funding from payers or cutting pension benefits.

But, there is more

Regime change is more holistic than simply the Fed and others seeking inflation. Voters are antagonistic to current policies. Savers, whether in pension plans, IRAs or personal portfolios, have gotten hammered. Confounding Keynesian orthodoxy, consumers are saving more not less, a win for behavioral economics. With rates artificially low, the only way to ever retire is to save more. Higher savings rates take money away from current consumption, no matter how logical.

With the global body politic restless, pulling inward behind national boundaries gathers steam. Shockingly, both presidential candidates signify a regime change on the merits of free trade. Keynesians argue free trade benefits all because each country optimizes its resource allocation between skilled and unskilled labor, capital, land, and other resources, e.g., cheaper imports than can be produced locally to make up for any wage declines. The appurtenant assumption is that labor is versatile, adaptable, and moveable. This last assumption has become quite dubious. Moving, when many houses and their owners are underwater, kills "mobility."

The politicians have noted that jobs and the job holders dislocated in manufacturing, as one example, have not easily moved to greener pastures. Maybe Hillary and Donald have been channeling the Stolper-Samuelson economic theorem on this phenomenon. Whatever the case, this regime shift, not just in trade policy but taxation and minimum wage policies, has consequences for investors. Some industries and companies will be hurt. Outsourcing, offshore cash accumulations, relative weight of labor in the mix between labor, capital and other resources, and beggar-thy-neighbor political responses from other governments in devaluing currencies, highlight this outcome.

Regime change and its known knowns and unknown unknowns create opportunity and risk. For sure it demands thought and portfolio recalibration. Our reaction is greater focus on niche investments less sensitive to macro effects, short duration alternative lending specialists, the insurance policy provided by managed futures, and as much as possible an "anti-fragile" portfolio as Nasim Taleb chronicles.