HIRTLE CALLAGHAN & CO

Chief Investment Officers

INVESTMENT PERSPECTIVE 1Q 2021

THE TRUMAN SHOW

CHRISTOF: Truman, there's no more truth out there than in the world I created for you. The same lies, the same deceit; but in my world, you have nothing to fear.

-The Truman Show

One of the first assignments in my freshman economics survey class was an essay by a French statesman Frédéric Bastiat.[1] It is a parable about a small merchant whose son accidentally breaks his shop window. As the by-standers lament the circumstances, one of them chimes in that without broken windows, the glaziers would have no livelihood. The crowd soon agrees that the broken window has led to an increase in economic activity. Bastiat proceeds to heap scorn on their reasoning. He points out the money paid to the glazier would otherwise have gone to the cobbler or the bookseller. Taken as a whole, society is worse off by exactly the damage done. It's a simple explanation of opportunity costs now known as the 'broken window fallacy.' More importantly, it is a reminder that economists need to account for unseen transactions and unintended consequences.

THE TRUMAN SHOW

Continued

Our great fortune in this past year of misfortune has been that policy makers and central banks moved forcefully to underwrite the losses from the pandemic and the lockdowns that followed. Rather than cite the litany of stimulus measures, one statistic suffices. On current estimates, U.S. GDP in the third quarter of this year will exceed the pre-pandemic trend of output. Within six quarters of the on-set of the greatest headwind since the Great Depression, it will be as if it never happened. Like Harry underneath the cloak of invisibility slinking right by Voldemort, we have skirted doom.

"Nothing to see here. Move Along" is the dominant narrative in the financial markets. Stocks are at all-time highs. Significantly, price/earnings ratios are also at 20-year highs. This suggests that expected earnings growth relative to interest rates is more attractive. There are two troubling aspects to the received story. First, it seems that everyone is all in. Inflows to stock mutual funds are at highs; cash levels are at lows; hedge fund gross and net leverage are close to peaks. This is a manifestation of the fact that we have climbed a wall of worry. We got to the crest, and there does not seem to be any more wall to climb. Second, this story is anchored on an exogenous contrivance. When Keynes surveyed the wreckage of the Great Depression, he diagnosed the cause as 'failure of some immaterial devices of the mind.'[2] If government could prime the pump sufficiently, he thought it could engage the 'animal spirits' of the economy. Well, we have primed the pump. And we now have some sense of the human imagination. Consider that you and I meet to finalize the sale of a car. I have two envelopes: one holds a flash drive containing the private key to 1 bitcoin. The other envelope is a little awkward because it has 1 ¾ pounds of gold. How good is your imagination? At least a little of that imagination depends on how strongly you trust in the on-going grace of the government's fiscal stimulus and the Federal Reserve's monetary support. So far, they have justified every ounce of that trust. Their munificence has been unwavering and unbounded. No longer does anyone talk about productivity enhancement or operating margin uplift due to rationalization. No one talks about the gains from supply chain efficiencies or information technology systems. The story for stocks has come down to more Federal spending and a benign Federal Reserve.

Like Truman Burbank, we are living in a sort of managed environment. The earnings growth and low interest rates are real, in the same sense that the cast of The Truman Show are real people. But we all know that what we are experiencing is carefully engineered. My concern is that everything is riding on the good graces of the show's producers. At some point, we will have to escape the contrived world and rely on our own devices. We are intently focused on positioning portfolios to capture the upside of the current positive sentiment while keeping a careful eye on emergent risks.

We are fully invested in equities with a slight bias to defensive secular growth companies. Correspondingly we are slightly underweight the most cyclical areas of the market, e.g. high yield, small capitalization stocks, energy and banks. While these areas will benefit from continued growth, they are likely to suffer disproportionately from even slightly reduced economic scenarios. In fixed income, we are very underweight sensitivity to rates which we believe are not appropriately priced relative to the economic environment. We are also attracted to specialist managers in private markets who have carved out attractive niche expertise.

—T. Brad Conger, CFA
Deputy Chief Investment Officer

[1] *Bastiat, CF. What Is Seen and What Is Not Seen, 1850.*
[2] *Keynes, JM. The Means to Prosperity. Macmillan and Co., 1933.*