Global Financial
Private Capital

A Unique Breed of Fear Monger

SYNOPSIS

- The presidential election is less than a week away, and politicians are in full force trying to sway voters to their side.
- Politicians are a unique breed of fear monger because they tend to be far more interested in their victims' votes rather than their wallets.
- Three common scare tactics that politicians love to use to frighten voters into thinking that change is needed are baseless and easily disproven.

POLITICIANS BEING POLITICIANS

The presidential election is less than a week away, and politicians are in full force trying to sway voters to their side. Some may believe that all is fair in love, war, and politics, but I disagree.

The use of scare tactics is one of the dirtiest, albeit highly effective, political strategies employed by both parties. They love to frighten voters into thinking that it is really bad out there, and that they are the only one that can make it all better.

Politicians are a unique breed of fear monger because they tend to be slightly more interested in their victims' votes rather than their wallets. This motivation can cause them to say some crazy things at times, and their position of perceived power often creates instant credibility in the minds of their constituents.

Throughout this election, three myths regarding the economy and stock market continue to receive attention from the candidates. Let's go through each and dispel them by using logic, reasoning, and most importantly data.

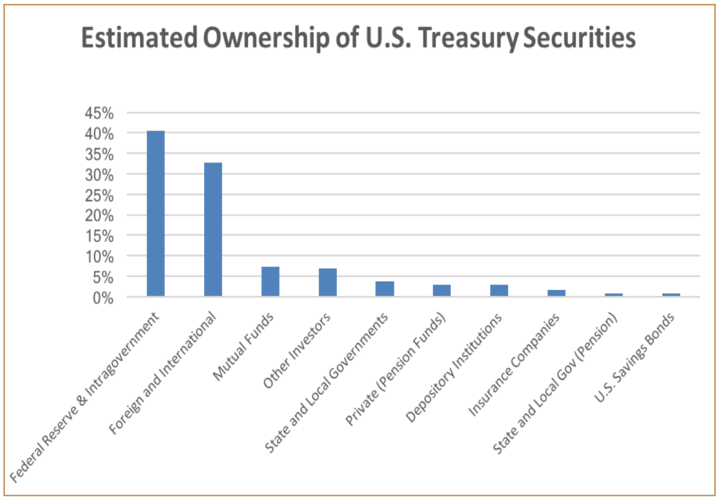
CHINA WILL OWN US

One of the more common warnings preached by politicians goes something like this – since China is the largest holder of U.S. government debt, we will one day be at their mercy when our government defaults.

Some may believe that all is fair in love, war, and politics, but I strongly disagree.

In fact, a TV commercial back in 2010 prophesized about a day in the future where the U.S. would end up working for China (https://www.youtube.com/watch?v=TYKAbRK_wKA).

Although this video is technically correct regarding the impact of debt on the great nations of the past, the rest is dead wrong. It's not even close to any semblance of accuracy. To start, the chart below lists the major holders of U.S. debt as of March, 2016.



Source: U.S. Department of Treasury, Aviance Capital analysis

Only 33% of our total public debt is owned by foreign and international entities, and although it varies over time, China has averaged around 6% of the total over the past few years.

***NOTE**: A tangential observation is that since U.S. entities hold the other 67% of the debt, our government ends up paying two-thirds of the interest on its debt back to itself and its citizens.*

Furthermore, government debt is very different than a bank loan. If a company defaults, the bank can seize assets and force change under a court of law. When a country defaults, there is little recourse because our nation's debt is only backed by a promise to repay and nothing more.

Meaning, even if by some miracle the U.S. did default on its debt, foreign creditors could not seize the Statue of Liberty or any other one of our country's assets.

Add it all up, and no matter what the politicians may say, the U.S. holds the overwhelming majority of our debt. China or any other country's share gives them no leverage whatsoever to change governmental policies.

THE U.S. DOLLAR IS DOOMED

A "reserve currency" is one that is held by governments and institutions in very large quantities to facilitate international transactions. Since the 1940s, the most widely accepted reserve currency has been the U.S. dollar (USD).

For example, a country that imports most of its energy would need to have access to dollars in order to pay for oil since international oil contracts are almost always priced in USD due to its perceived value, safety, and convertibility.

A favorite of politicians is to claim that the debt accumulation and printing of new money is going to lead to the demise of our dollar. Some have gone as far to say that a dollar crash is on the horizon, but nothing could be further from truth for three key reasons:

1. **Most Trusted**: The USD is the most widely accepted, trusted, and stable currency in the world. Traits like these take generations to reverse, and given the current strength of our economy and currency, any turnaround is even more difficult to imagine.
2. **Commodities Use Dollars**: Nearly all commodities are priced in USD for the reasons mentioned above. Therefore, if a company in Malaysia wants to buy a barrel of oil from Saudi Arabia, that transaction will be done using dollars.
3. **Must be Available**: Countries not only need to see real value in a currency, they also need to be able to acquire it with ease. At the moment, there is no other currency in the world that could supplant the USD, and it would likely take several decades before a true contender could build that large of a currency base to even rival the breadth of the USD.

Simply put, it has taken the USD over seven decades to achieve its current strength, so a sharp reversal when no realistic contender is available is highly unlikely.

THE MARKET WILL CRASH

Countless hours of financial news television have been dedicated to debating whether a Democrat or a Republican has historically been better for the equity market.

Two commonly cited analyses are what happens to the market shortly after the election results are announced and comparing the annual returns of the S&P 500 when Democrats and Republicans are in office. In the eyes of the media, the party with the most favorable short-term reaction and/or higher annual returns over time is deemed the winner.

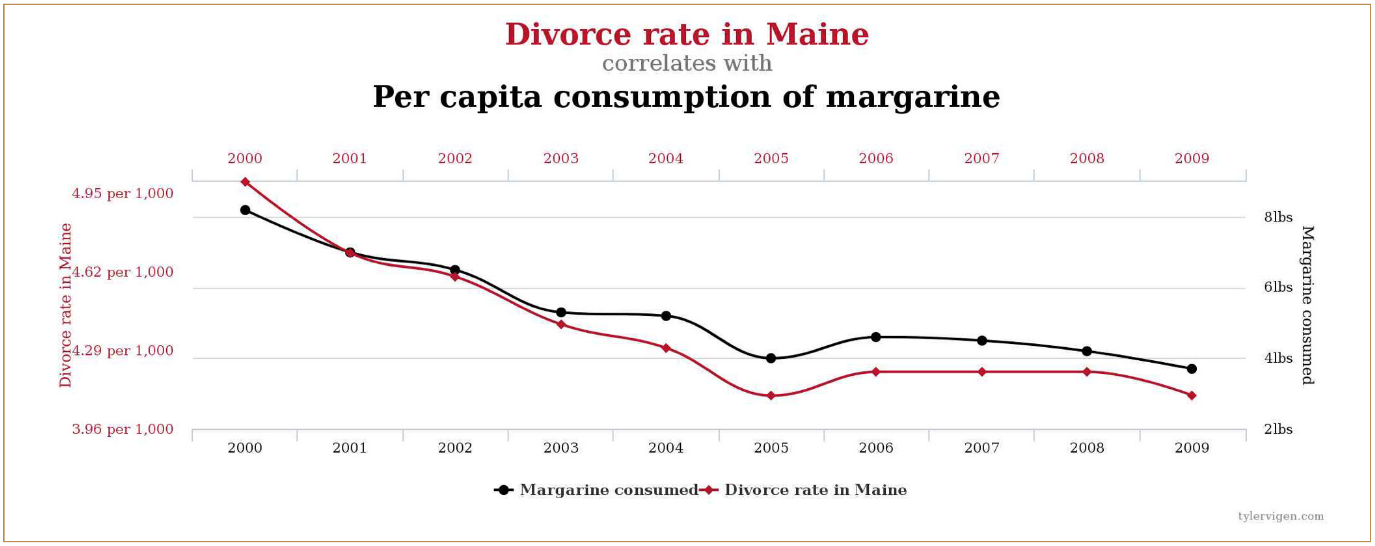
There is no question that politics can drive stock prices over short time periods. Back when President Obama secured his reelection in November 2012, those who felt that his policies toward big business and healthcare reform would bankrupt America were not surprised to see the S&P 500 fall precipitously that week.

However, the index recovered within a month. It was as if all the harm that Obama could do magically disappeared. In fact, despite all the fear mongering throughout his time in office, the market has surged.

A decade earlier, President Bush executed a myriad of controversial policy decisions including cutting taxes and increasing the deficit. He fought an unpopular war and was vilified for acting as the world's police at the expense of our tax dollars.

However, the market did not seem to notice the uproar and rewarded those who remained invested. Two different parties with opposing views, yet both times the stock market surged. How can that be? Were the Republicans wrong to think Obama was bad for business? Did the Democrats make false assumptions about the impact of Bush's foreign policy on the domestic economy?

I would not dare answer such questions, but fortunately, there's no reason to try. Just because two things happen at the same times does not mean that they are related. The chart below drives this point home.



Upon first glance, this chart depicts an incredibly strong relationship between the divorce rate in Maine and the per capita consumption of margarine over the last seventeen years. However, it is more likely that this is coincidental, and any relationship between the two is spurious.

The truth of the matter is that a President is practically powerless to drive our $19 trillion economy at will. Now, a leader can certainly promote and/or kill sectors, as President Obama has shown the coal industry, but as a whole, it's just too big and has too many moving parts for any one man or woman to control.

Hence, Presidents love to take credit for the booms and blame others for the busts, but given how long it takes policy decisions to work its way through the economy, it's more coincidence than causality.

IMPLICATIONS FOR INVESTORS

Next week will likely be very dramatic, and I have no idea how the stock market will respond. Politics are some of the most powerful emotions out there, and it will be interesting to see how traders and investors digest the outcome of the election.

What I am far more certain about is the impact to our economy and the longer-term direction of stock prices. Within this context, I see very little change unless one party were to sweep Congress along with the White House. Even then, either party's ability to help or hurt the economy would mostly likely take years to play out.

I am also quite certain that politicians will never change either, so expect to hear more doomsday scenarios for years to come. Scare tactics are just too powerful of a weapon for fear mongering politicians to ignore.

The bottom line is that politicians often try to scare voters, but these tactics are almost always baseless or at the very least nothing more than a highly exaggerated viewpoint.

Sincerely,

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