Caldwell Trust Company

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Special Report

Economist Donald I. Luskin speaks to Caldwell board about oil (and Trump)

"Don Luskin is probably one of the most insightful people I've ever listened to," said Caldwell vice president Timothy J. Videnka, CFA. In introducing Luskin to the board of directors of Caldwell Trust Company he said, "In 2012 Don put together a model that predicted the presidential election within four electoral votes." If Tim's remark didn't catch everyone's attention, nothing would.

Vice president Timothy Videnka, CFA, Caldwell's investment officer, introduces Donald I. Luskin to the company's board of directors.

Luskin is the founder and chief investment officer of Trend Macrolytics as well as chief economist of The Heritage Foundation, a conservative "think tank" based in Washington, D.C. More important to those reading this newsletter, he is a long-time adviser to Caldwell Trust Company.

Don's approach is analytical, as indicated in his short biography on page 2, and it was this approach that led him to his previous, amazingly accurate electoral prediction.

Caldwell Trust Company CEO and president R.G. "Kelly" Caldwell Jr. welcomed Don on behalf of the directors. Some of them had already met him in March 2009, the era of TARP, bailouts and what he considered governmental overreach. At that time Luskin told the board, "We are being rescued to death."

This year his topic was "Oil: Can It Cause a Recession?" But before he took on this worrisome subject there was the election-day teaser Tim had mentioned. Don was ready for it.

THE ONE WORD

"Everything I need to know I learned in the movies," Luskin said, paraphrasing a famous book title. He then cited *The Graduate*, in which a man told the hapless young hero, "I have one word for you, Benjamin: plastics." Luskin said, "I've been in the investment insight business for 35 to 40 years and have learned that you've got to know the one word—and it's always different. In the summer of 2008 that word was 'Lehman.' The four most expensive words on Wall Street are, 'This time it's different.' No. The four *truest* words on Wall Street are 'This time it's different' because it's different every time. And the key is to know the one word for the time. Then you can focus all your decisions on that word.

"What is that *one* word right now? I'm going to cheat," Luskin said. "There are two parts to this presentation because there are two words right now. One is 'oil.' The other is 'Trump.'"

The Wall Street Journal, among others, has published Luskin's analysis of the oil situation. His recent *WSJ* articles on the topic include "The Shale Boom Shifts Into Higher Gear" (June 1, 2015) and "The Recession Caused by Low Oil Prices," (January 8, 2016). But before Luskin would discuss the effect of oil on the economy, he wanted to consider Trump's potential impact on the world.

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Economist Donald I. Luskin, center, is flanked by members or representatives of the Caldwell family on the occasion of his address to the Caldwell Trust Company board of directors. At left, board member Molly Caldwell Kraut, D.V.M., stands beside her brother, R.G. "Kelly" Caldwell Jr. To Luskin's left are Kelly's wife Melissa Caldwell and Irene Trimble, a Caldwell family friend.

"ONE WORD": TRUMP

"Conventional wisdom is not always true," Luskin said. With regard to Trump's presidential candidacy he said, "The conventional wisdom has been that Trump will blow himself up or that he'll plateau." At the time of Luskin's talk, both beliefs were wrong.

Caldwell executive vice president and trust officer Jan Miller, center, poses with board member James R. Woods and Karen Woods just before Donald Luskin's conversation with Caldwell's board of directors.

"One way to find out about Trump is to go to his website. You do this by typing 'JebBush.com.' No kidding. It takes you right to Trump's website. That tells you something about the man, his audacity, his sense of humor. What does it say about Jeb? How could he not register jebbush.com?"

Trump's website doesn't spell out his positions, and his political portfolio is scant according to Luskin. Rather than a plan or a vision he has based his campaign on nativism and a slogan, "Make America Great Again." Don said, "That's bad because the undercurrent of it means closing off America from the rest of the world."

Trade and immigration

Some believe America's problems could be solved by restricting trade, halting immigration or whatever. Trump wants to impose a 40 percent-plus tax on all goods and services from China. "I can't tell you all the different ways that's wrong," Luskin said. One is that Trump's argument is based on information that's about ten years old. Another reason is that much of what we buy was made in China. Luskin said if we taxed imports from China, 330 million Americans would be shocked to find they couldn't afford to buy so many things.

"Then there's the track record thing," he said. He cited the Smoot-Hawley Tariff Law, passed in 1930, which raised tariffs to record levels and extended the length of the Great Depression. "That's what made the lights of the world go out and we don't want to do that again. If we raise tariffs, others will retaliate. The world works best when the world can trade with the whole world."

"Trump's position on immigration is well-known," he said, calling it a legal, ethical and moral issue. He added, "The mobility of human beings is important to job growth."

The good side of Trump's message

"How long has it been since any politician said, 'Make America Great Again'? Ronald Regan? Clinton? The message of most politicians is 'It's over for America. Vote for me and I'll try to cushion it as long as I can.' I'm sick of hearing that message. It's a mistake for any leader to fail to encourage people not to be

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Donald Luskin: Who he is and why it matters to Caldwell's investors

R.G. "Kelly" Caldwell Jr., CEO and president of Caldwell Trust Company, has ensured the success of the business by surrounding himself with supremely qualified consultants who can help steer investments in the most effective direction. He places Donald I. Luskin in this rarefied list. "Don is a longtime adviser to our company. Over the years we have placed a high value on his recommendations and this has resulted in outstanding financial benefits for our clients," Kelly said.

Prior to founding Trend Macrolytics, Luskin was vice chairman and co-chief investment officer of Barclays Global Investors. After a decade building Wells Fargo Investment Advisors into the world's largest and most innovative investment manager—where indexing, tactical asset allocation and quant-active investing were invented and popularized—he was a member of the three-man management team that sold the firm to Barclays Bank PLC in 1995. (It has since been acquired by Blackrock.)

At Barclays, Don created the first sector ETFs, now the dominant iShares family of funds. He invented and patented target-date mutual funds, which have since become a standard for retail retirement investment and the cornerstone of the federal government's employee savings plan.

Previously Don was the investor of POSIT, the first "dark pool" ECN, and founder of Investment Technology Group at Jefferies & Company.

After Barclays, Don was CEO and co-founder of MetaMarkets.com and manager of the path-breaking Open Fund—the world's first "interactive mutual fund," showing all its holdings and trading activity in real time on the web.

He has been a market maker on the Chicago Board Options Exchange, the Pacific Stock Exchange, and the New York Stock Exchange. Don appears regularly on CNBC's "The Kudlow Report." He contributes frequently to the editorial page of the *Wall Street Journal*. He is the author of *I Am John Galt.* He is also the author of *Index Options and Futures: The Complete Guide* and the editor of *Portfolio Insurance: The Guide to Dynamic Hedging*, all published by Wiley.

great again," Luskin said, adding that Romney tried to hide his wealth and religion. This was in contrast to the belief of John Maynard Keynes that the economy is driven by 'animal spirits'— the instincts, emotions and possibly trust— that guide human behavior. Don contrasted Romney's behavior with Trump's message: "Hey, I'm a billionaire. I got a hot wife. You can be a billionaire too."

Election predictions

Luskin's election model, which evaluates six economic factors, predicts that if the election were held today the Democrats would win by 107 electoral votes. However, noneconomic conditions have to be factored in. "In every election since 1952 and many before that, no party has held the White House for more than two terms except for the first Bush, who followed on Reagan's two terms," he said. "If you build that into the model the Republicans could win by 73 electoral votes, which would be extremely close."

> ***"If the election were held today, the Democrats would win by 107 electoral votes. However …"***

In Luskin's opinion, if Trump runs and wins, there would be a move towards protection, which is a negative, but also some optimism—a positive. If the Republican candidate loses, Democrats would ride the coattails of the winner, picking up seats in the Senate and House. In mid-term years it would reverse. He reviewed several possible scenarios: Some Republicans believe they cannot lose seats in the House and Senate because of gerrymandering but he said that's not true. Another scenario: What if there's a landslide? "We've learned since 1952 that the greater the landslide, the more seats change in the House—and you only need 30 votes to make that change."

THE OTHER "ONE WORD": OIL

The world consumes 95 million barrels of oil a day according to Luskin, who digressed to ask, "Where do we even get that many barrels?" Over the past 22 months the price of a barrel of oil has declined from $168 to under $30 today.

Oil production in this country has been in decline for 40 years. "We came back to our highest level of production in just four years," he said. "That's not just because we've figured out the miracle of fracking. It's because there is frackable shale everywhere in the world. We will have oil well into the lives of our great-grandchildren. Oil is on the way to becoming free."

> ***"Oil is on the way to becoming free. We will have oil well into the lives of our great-grandchildren."***

Conventional oil production has been falling in the U.S., in the Gulf of Mexico (stasis) and Alaska (decline). In the face of decreased oil prices in the last 22 months, fracking companies have not wanted to invest to increase production. The number of oil rigs in the United States has decreased but production is down only 400,000 barrels a day. "We didn't know fracking five years ago but we've gotten so good at it. In 2007 the most efficient wells were producing 100 barrels a day. Now they're producing 800," Don said.

"This is what happened to the semiconductor industry in the 1960s. You produce more and more and more and as you do, you learn and learn and learn and become more efficient. Gordon Moore of Fairchild Semiconductors predicted that semiconductor prices would improve by 100 percent every two years—but it happened every 18 months and has been doing it for 15 years. Semiconductors are now essentially free. You get a Visa card with a chip in it for free. Intel hasn't gone out of business, by the way. The oil companies don't have to go out of business either. Most just have to adapt. That said, a whole bunch of oil companies are going out of business. If I were Exxon or Chevron, I'd have my checkbook out because these assets are coming on the market at terribly depressed prices—and the oil molecules will still be there," he said.

Donald Luskin illustrates his discussion with charts depicting his key points.

That's the supply side of oil. Another reason for lower oil prices is decreased demand. Electric cars and other technologies are replacing oil with different energy sources. Consider the electric Tesla. Earlier electric cars were marketed to our fears: climate change, global warming, going green and the like: "Own this miserable car to drive in this miserable world." But Tesla markets its electric cars as hot and desirable. "When you get in the cockpit of a Tesla it's like you're inside an iPhone," Luskin said.

"If you put the supply side and demand side together, unless there's a nuclear war in Syria or something, you can see that oil will never be $100 a barrel again in today's dollars," he said.

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OUTLOOK FOR INVESTORS

Luskin said that in our subprime market, a risky corporate bond might have a yield of 10 percent and a treasury of the same maturity might yield 2 percent. The spreads overall in the junk bond market have risen to the equivalent of 18 Fed rate hikes on top of the hikes last summer. “This is one of the many things that *every time* causes a recession.

“That’s why the Fed raises rates,” he said. “They do it to slow down the economy. And when the economy itself naturally raises rates, it slows down the economy. The slowed economy causes a recession—but don’t think of the recession of 2009. That was a global financial crisis. What we’re in for now is a garden variety recession caused by tightening financial conditions emanating from the energy sector. We see it in banks, in the strength of the dollar and in energy companies.

“We’ve been in an earnings recession with the S&P all along. In every pre-recession there’s one sector to blame (e.g., dot com, tech, banks, etc.). And there’s always some lie you can tell yourself, for example, ‘take energy out of the equation.’ But earnings of the major oil companies are down by 80 percent. The dollar value of earnings of all 40 major energy companies combined is less than Apple.

Positive Outlook

“We’re going through a shock and not all shocks are bad. Booksellers were shocked by Amazon, taxi companies by uber. But this affects global corporations, giant companies, cartels and whole countries that have been monopolizing and controlling oil for 150 years. That is a shock. It’s also positive. When oil prices are low, productivity is high. America is about to be great again, not because of Trump but because of oil prices. It’s that one word again.

CEO and president R. G. “Kelly” Caldwell Jr., center, and Donald Luskin, right, share a laugh with board member Thomas Stuhley.

“What does this mean for investors? We’re in a recession but not a bear market. In late January the S&P 500 was down 15.5 percent vs. all-time-high earnings in mid-May. Stocks lost 57 percent of their value in 2008-2009 and 51 percent in the fairly mild recession of 2001 but that’s not typical. In most recessions stocks actually go up. What’s more, historical surveys indicate that the stock market usually bottoms early in a recession.

“I believe we’ve already borne most if not all of the pain we’re going to bear because of the shock. I’m not scared about China. That’s absolutely ridiculous,” he said. So should investors take some action? “It’s too late,” he said. “And we are not in a crisis, just a little recession. It’s a special recession because oil prices are at their lowest in 20 years. For consumers, who rule the U.S. economy, it’s such a beautiful, soft cushion.”

“Don’t be scared of a little recession,” he concluded. “We’re not recession-proof, but we probably are disaster-proof.”