

2016  
4TH QUARTER  
QUARTERLY COMMENTARY

# Angeles

INVESTMENT ADVISORS



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## Finland Station

**A**fter three years of war, and really, three centuries of Romanov repression, the Russian people had reached their breaking point. The Tsar's army suffered defeat after defeat against the Kaiser's superior forces, and the direct leadership of Nicholas II, as oblivious (maybe more) in military matters as he was in every other area, was ruinous. Food shortages in the capital St. Petersburg brought out thousands of protestors, even in the bitter cold of mid-winter. Nicholas sent in the army to disperse the crowds, but apparently the soldiers, too, had had enough of the corruption and incompetence of the Tsar's rule. Rather than attacking the protestors, the soldiers joined them, setting fire to government buildings, and driving officials out of the city. Nicholas attempted to rally his troops, but to no avail. He was advised to abdicate, and he did. He and his family fled to the remote safety of the Ural Mountains, waiting for his chance to return to St. Petersburg and reclaim the Romanov dynasty.

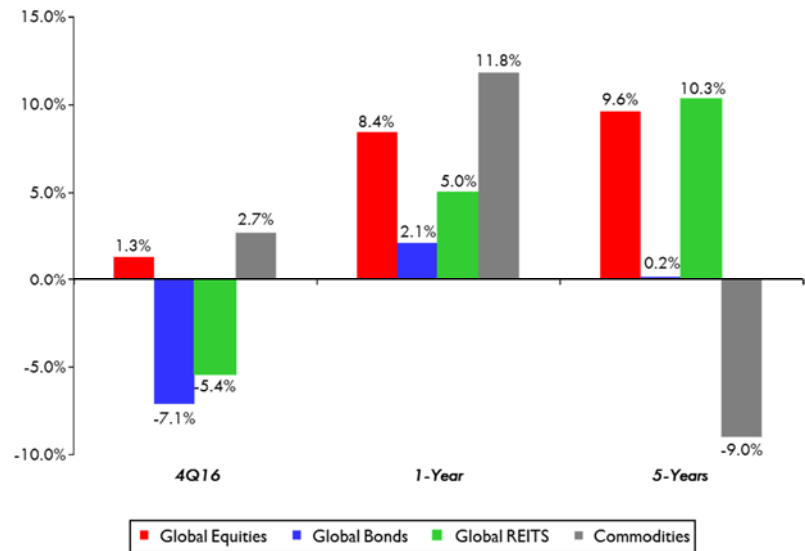
Fifteen hundred miles away, Vladimir Ilyich Ulyanov spent his days in the Zurich public library, reading newspapers and writing articles for his newsletter, *Iskra* ("Spark"), exhorting his countrymen to overthrow the Tsar.

Ulyanov was born in 1870, in Simbirsk, a small town on the Volga River, 500 miles east of Moscow, to a comfortable family. He graduated first in his class, and was about to leave for university, when his family life was upended. First, his father, a schoolteacher, was forced to resign for his outspoken support of public education, and died soon thereafter. Around the same time, his older brother, Aleksandr, was hanged for conspiring to assassinate Tsar Alexander III. Vladimir was suddenly head of a criminal family.

He attended university, but was soon expelled for joining an illegal assembly. He returned home, studied law on his own, and after many petitions, was allowed to sit for his law exams, which he passed with honors. But Ulyanov harbored a burning hatred for the reactionary regime under the Tsar, and joined the small, but growing followers of Karl Marx, agitating for a proletariat revolution. In 1895, his group was arrested, exiled to Siberia, and in 1900, banished from Russia. Vladimir settled in Zurich, where he remained till 1917.

When the Russian people rose up to overthrow the Tsar in February 1917, Ulyanov desperately wanted to get back to Russia, afraid that events would progress without him. But the Great War was raging across the continent, and travelling to Russia required passage through Germany, the enemy. But Germany had an interest in allowing this revolutionary in Zurich to reach Russia, as Ulyanov had long advocated that Russia abandon the war. And so, in secret negotiations, Germany proposed putting Ulyanov and a few dozen of his comrades in a sealed train car, so that no one would see them. A boat would then take them to the north of Sweden, close to the Arctic Circle, a sled over to Finland, and then another boat across the Baltic Sea where a train would be waiting to take him to St. Pe-

Chart 1 Capital Market Performance



tersburg. Two months later, in April, Ulyanov arrived at Finland Station, the main train terminal in the capital city. That trip, and his speech that evening, changed the course of history.

History, quite likely, shifted course in the last quarter of 2016, although time will tell if recent events are minor perturbations or something more meaningful (I lean toward the latter). Equities were a bit higher in the quarter, paced by the oil-dominant markets of Saudi Arabia (+27%) and Russia (+18%). Egypt and Israel have more in common than may appear, as each were the big losers in the quarter, with Egypt off 23% and Israel down 12%. For the year, Israeli stocks lost a quarter of their value, not quite as bad as the one-third drop in Ghana or the 39% fall in Nigeria, where civil insurrection more than offset the benefits of large oil deposits. The big winners in the year were Brazil and Peru, up 61% and 54%, respectively, amply rewarded for tossing out incompetent socialist governments in favor of more sensible leaders.

Commodities posted a strong advance after years of declines. Natural gas jumped over 50% last year, and

breakfast, too, became more expensive: coffee rose 8%, milk and sugar each jumped 28%, and orange juice surged 34%. We advise switching to cocoa in the morning (although anytime of day is appropriate for chocolate), which fell 34% (a reason Ghana suffered last year).

Bond prices tumbled in the quarter, with US investment-grade off 3% and global bonds dropping 7%, as the US dollar was especially strong, rising 5.7% in the past three months. Bond investors clearly don't like all the good economic news recently (the Citibank Economic Surprises Index is at its year's high—Chart 2).

The US labor market is close to full employment. Despite an increase in the labor force of 1.8 million, the most in a decade, nearly 2.2 million net new jobs were added in 2016, which is why the unemployment rate fell from 5% at the beginning of the year to 4.7% at the end of the year. Average hourly earnings were up 2.9% and hours worked rose 1%, so total compensation advanced nearly 4% last year, nearly twice the pace of inflation.

Inflation is low by historical measures, rising 2.1% over the last twelve months, but that's the highest pace in

**Chart 2 Citibank Economic Surprises Index 2016**



CESIUSD Index (Citi Economic Surprise – United States) Daily 21JAN2016-20JAN2017

five years. Investors are not expecting inflation to move any higher (2.0% is the expectation for the next decade—see Chart 3), but the threat of deflation has abated.

Powerful deflationary pressures have receded. Globalization enabled a huge labor cost arbitrage, but the wage gap now between developed and emerging

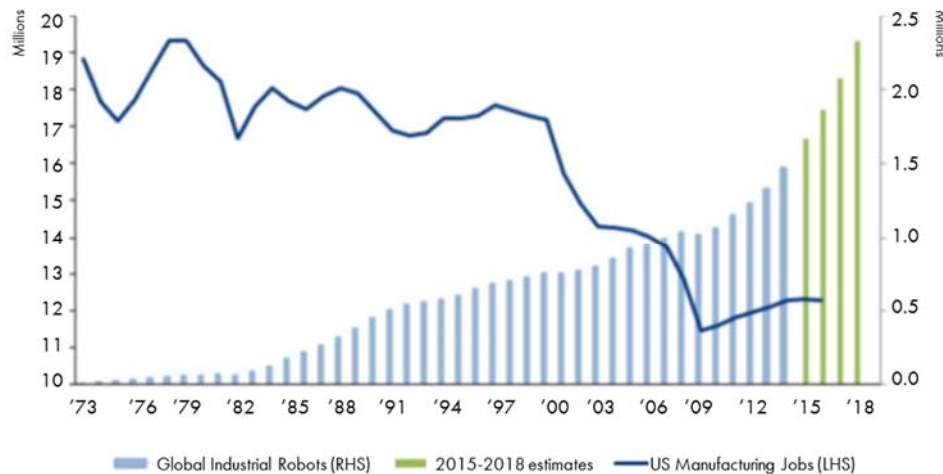
economies has narrowed significantly. US wages are rising at the fastest pace since the 2008 crisis, reflecting a shifting supply/demand equilibrium. Of course, the other major global deflationary force has been technology, which is likely to persist indefinitely. Technology has displaced US manufacturing jobs for decades (Chart 4), but even Chinese labor is being inexo-

**Chart 3 US 10-year Breakeven Inflation Rate, 1999-2016**



USGGBE10 Index (US Breakeven 10 Year) Monthly 01JAN1997:20JAN2017

**Chart 4 Rise of the Robots**



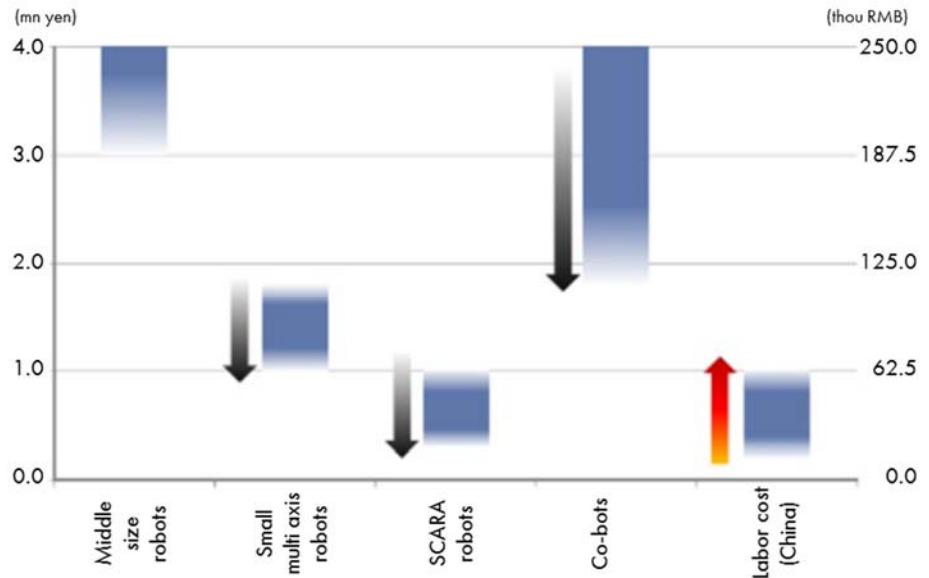
Source: BofA Merrill Lynch Global Investment Strategy, IFR Statistical Department

rably supplanted by diverging cost trends (Chart 5). The rise of the robot has only just begun.

Still, central bankers (especially the Fed) must be very pleased with themselves. Inflation has picked up enough to allay the deflation fears that have lingered since 2008, the economy is at full employment, confidence is high, and after declining for six consecutive years, global growth is expected to accelerate in 2017.<sup>1</sup>

**E**conomic data generally don't lie, but they may become a little less relevant to investors in the future, as politics come to dominate the investment landscape in wake of the most surprising presidential election in US history. The election's historical context can be traced to the Populist movement of the late 19<sup>th</sup>-century, which began in rural America. Falling agricultural prices and collusion by railroads to keep transport prices high brought hardship on farmers, and they organized to protest the railroads' monopolies. The Populist Party ran James Weaver for President in 1892, gaining 8% of the vote, then merged with the Democrats and nominated William Jennings Bryan three times for president. In addition to opposing the railroads, Bryan attacked Wall Street, with its insistence on "hard" currency backed by gold, which favored lenders over debtors. Bryan averred not to "crucify mankind upon a cross of gold," argued for the more inflationary metal, silver, to

**Chart 5 Comparison of robot prices, personnel costs in China**



*Note: Robotic prices are the estimated range by GS. Labor cost here is the annualized wage of the direct labor force in factory (i.e. assembly work). Seasonally adjusted. FX translation at 1RMB=16yen.*

*Source: Goldman Sachs Global Investment Research.*

back the currency, and while he met with defeat each time, much of his platform was eventually co-opted into law.<sup>2</sup>

Over the subsequent century, there were populists on the left, from William Jennings Bryan to Huey Long to Bernie Sanders, and on the right, from George Wallace to Pat Buchanan and Ross Perot, the most successful third-party candidate since Theodore Roosevelt.<sup>3</sup> But the traditional labels of liberal and conservative are categories that mislead more than inform the populist message. Rather than dividing the world between left and right, populists see themselves as defending the large majority against both a haughty elite and also (at

<sup>1</sup> The IMF shows global GDP rebounded 5.4% in 2010 from the 0.1% decline in 2009, and growth has steadily fallen to an estimated 3.1% in 2016. The IMF expects growth to rise to 3.4% in 2017 (and to 3.8% in 2018, for what that's worth).

<sup>2</sup> By the Republican Theodore Roosevelt, most notably.

<sup>3</sup> Perot won 18.9% of the popular vote in 1992; Roosevelt won 27% of 1912 vote as leader of the aptly-named Progressive Party, ahead of the Republican Taft, but behind Woodrow Wilson.

times) an outside group seen as undermining their jobs, language, religion and values.

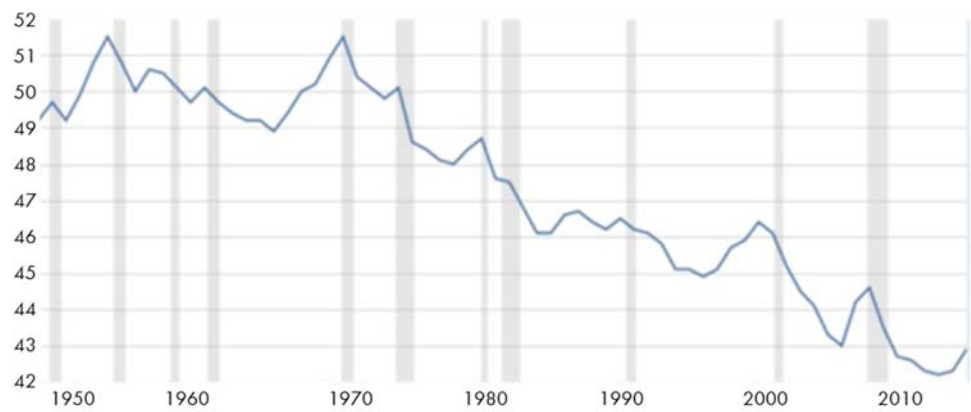
The populist message is usually rooted in legitimate grievances: farmers were harmed by the monopolistic practices of the railroads, high-paying manufacturing jobs were lost in trade agreements.<sup>4</sup> Wealth, health and well-being have reached unimaginable levels, in the United States and around the world since the end of World War Two, but the benefits of that prosperity have not been equally shared. Corporate profits have risen to record highs, while wages, for example, as a percentage of total income, are at record lows (Chart 6).

The election of Donald J. Trump can thus be seen as a continuation in the hundred-year tradition of the populist message rooted in the legitimate grievance of the growing disparities in wealth and income. It's worth noting that these disparities are evident in most every advanced economy (Chart 7<sup>5</sup>), which partly explains the rise of the popu-

list message across Europe as well. Trump merely tapped into this frustration to garner enough support for his insurgency to win the Electoral College vote.<sup>6</sup>

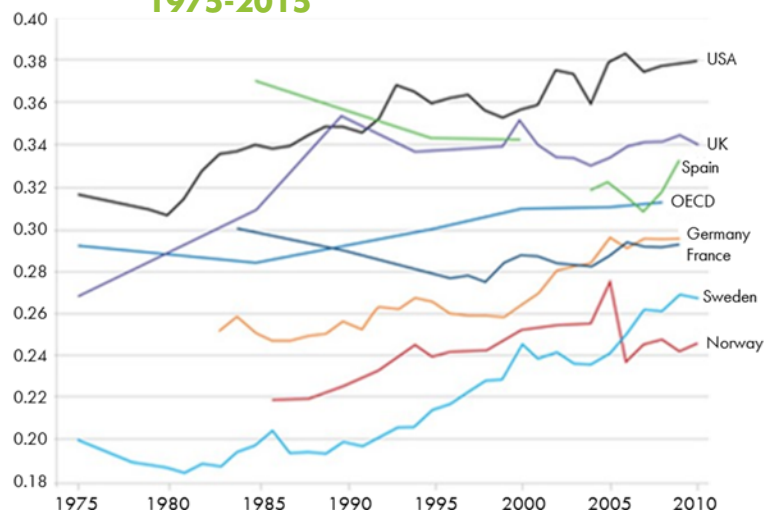
There is continuity in Trump's populist message, but his election may also be seen as an entirely new chapter in American politics. The populist agenda has generally been co-opted by the mainstream parties, but here is the reverse: a populist takeover of a major party. Also new is that we have never before had a president with no prior government or military service. Or have a

**Chart 6** Shares of gross domestic income: Compensation of employees, paid: Wage and salary accruals: Disbursements: To persons



Source: U.S. Bureau of Economic Analytics

**Chart 7** Gini Co-Efficient, selected countries 1975-2015



Note: Break in series for Spain in 2000  
Source: OECD

<sup>4</sup> But I haven't seen a single legitimate study that shows the benefits of trade to be, on balance, harmful to the overall economy.

<sup>5</sup> Chart 7 displays the Gini coefficients for selected countries over time. The Gini coefficient is a measurement of the statistical dispersion of income, where 0 represents everyone has the same income and 1 represents one person having all the income. It was developed by Corrado Gini, an Italian statistician, in 1912.

<sup>6</sup> Trump won 304 Electoral College votes to Clinton's 227. Clinton won a plurality of the popular vote, 48% to 46%.

Table 1 First Job Approval Rating

YEAR	PRESIDENT	APPROVE	DISAPPROVE	NET APPROVAL
1945	Harry Truman	87%	3%	+84
1963	Lyndon Johnson	78	2	+76
1974	Gerald Ford	71	3	+68
1961	John Kennedy	72	6	+66
1953	Dwight Eisenhower	68	7	+61
1977	Jimmy Carter	66	8	+58
2009	Barack Obama	68	12	+56
1969	Richard Nixon	59	5	+54
1989	George H.W. Bush	51	6	+45
1993	Bill Clinton	58	20	+38
1981	Ronald Reagan	55	18	+37
2001	George W. Bush	57	25	+32
2017	Donald Trump	45	45	0

Sources: Gallup

president begin his term with a net approval rating of zero (Table 1).

As a consequence, political uncertainty is especially high. Markets have chosen (so far) to emphasize the positive potential policies of streamlining regulations and reducing taxes, while dismissing the negative ramifications of inhibiting trade and immigration.

It is in the realm of geopolitics, rather than economics, that may see the widest range of outcomes. "America First" is a favorite phrase of the new president, and it's unclear exactly what it means for policy, but it's also a phrase from a dark past in American history. The America First Committee was formed in the late 1930s to keep the US out of World War Two, but was tinged with xenophobia and anti-Semitism.<sup>7</sup>

In foreign policy terms, "America First" could mean persuading our allies to share more of the burdens of our political and military alliances. But it could also signal a significant withdrawal of American power from the world stage, ceding spheres of influence to regional powers, such as Russia in eastern Europe, Iran in the Middle East and China in east Asia. Since the Second World War, and especially after the fall of the



<sup>7</sup> The AFC's most famous spokesman, Charles Lindbergh, said in a speech in Des Moines 11 September 1941, *Instead of agitating for war, the Jewish groups in this country should be opposing it in every possible way for they will be among the first to feel its consequences....The greatest danger to this country lies in their large ownership and influence in our motion pictures, our press, our radio and our government. The Japanese attack on Pearl Harbor three months later put an end the America First Committee.*

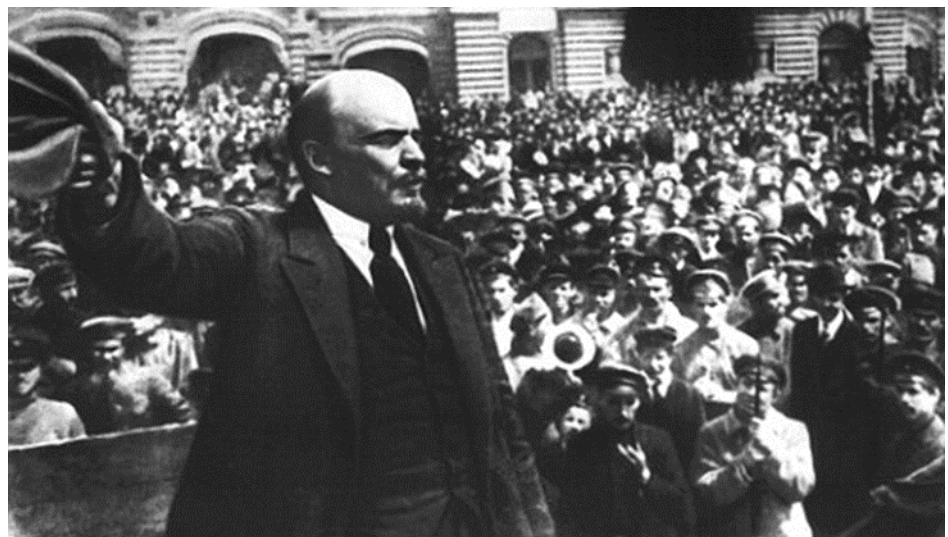
Communist bloc nearly 30 years ago, America has been the world hegemon, the power that established, monitored and enforced the world order. A world order that is imperfect, but one that brought unprecedented prosperity across the globe. Supporters of America withdrawing, or at least, reducing, its global obligations, see the upsides of conserving our resources, saving money, keeping out of harm's way. But that view is myopic. Geopolitics, especially, abhors a vacuum, either voluntary or otherwise, and history shows that a world without a dominant power to keep the order soon disintegrates into violence and chaos. Britain's (involuntary) loss of power in the early twentieth century resulted in the Great War, and America's (voluntary) withdrawal from global responsibilities in the 1920s led to the second great carnage in a generation. America bears a large burden in its global obligations. But the consequences of ceding those obligations will be far costlier, for America, and for the world. The alternative to American hegemony is not peace and prosperity, but suffering and turmoil.

**N**icholas' abdication in February 1917, ending 300 years of Romanov rule and 1,000 years of Russian monarchy, was greeted with jubilation by the Russian people who, on their own accord and by their own means, came together to overthrow the most autocratic and incompetent regime in Europe. A Provisional Government was quickly formed, which promptly provided for freedom of speech, assembly and religion. The Tsar's hated police and cruel court system were disbanded, and overnight, the most repressive regime in Europe be-

came its most liberal. The yoke of tyranny that had bound the Russian people for a millennium was finally lifted in a spontaneous uprising of the people.

While in exile, Vladimir Ilyich Ulyanov, who had adopted the pseudonym, Lenin, had little time for the finer points of debate with his colleagues over Marxist theology; he was a pure pragmatist, clear and consistent in his views that there could be no "stages" of revolution, that authority must be given immediately to workers' groups ("soviets"), organized and directed by a small group of committed revolutionaries, led, of course, by Lenin.

Lenin was greeted at Finland Station with bouquets and embraces by Provisional Government officials. In his welcoming speech, the leading official said, "Comrade Lenin, in the name of the Petrograd (St. Petersburg) Soviet and the whole revolution, we welcome you to Russia . . . but we consider that the chief task of the revolutionary democracy at present is to defend our revolution against every kind of attack both from within and without. . . . We hope that you will join us in striving towards this goal."







Lenin thanked him for the welcome (and the flowers), but stepped outside to address the gathering crowd directly: “Comrades, I greet you without knowing yet whether or not you have been believing in all the promises of the Provisional Government. But I am convinced that when they talk to you sweetly, when they promise you a lot, they are deceiving you and the whole Russian people. The people need peace; the people need bread; the people need land. And they give you war, hunger, no bread—leave the landlords still on the land. . . . We must fight for the social revolution, fight to the end, till the complete victory of the proletariat. Long live the world-wide social revolution!”

His comrades thought he had lost his mind. Rather than work to support this new revolutionary democracy movement, Lenin attacked it as not true to the principles of a proletarian revolution. He called for an immediate

uprising of the peasants to seize the land, and for an unconditional withdrawal from the Great War. The following day he spoke for two hours to his supporters, the Bolsheviks, who were a small minority among the collective socialist groups that formed the Provisional Government: “The republic which has issued from the February revolution is not our republic, and the war which it is waging is not our war. The task of the Bolsheviks is to overthrow the imperialist government.... We are beginning the international revolution.”

He held his band of Bolsheviks together with the sheer force of personal persuasion, in unyielding opposition to the Socialist Government, led by Alexander Kerensky.<sup>8</sup> So bitter was his relationship with the Socialists, Lenin himself was forced to hide in Finland. The Provisional Government enacted many liberal reforms, but made two serious mistakes: dismantling the Tsar’s police force and courts made governing nearly impossible, and it chose to continue the widely-despised war effort. There were some military successes over the summer, but the Germans re-grouped and routed the Russian army. Disillusion with the government grew, and sensing the time was right, Lenin, in disguise, slipped back into St. Petersburg, rallied his Bolsheviks to overthrow immediately the Provisional Government. It was a near-bloodless coup that brought the Bolsheviks to power.

The Provisional Government had set a free election for the following month, and Lenin could not stop it. It

<sup>8</sup> In one of the ironic coincidences of history, Kerensky’s father was headmaster of Lenin’s (then Ulyanov) school, allowing him to stay even after his father was officially disgraced. His kindness would not be reciprocated on his son.

would be the only free election in Russian history, and the Bolsheviks, who re-named themselves Communists, won only 156 of the 601 parliamentary seats. The next day, Lenin, as head of the government, threw out the results. But he took two very popular actions. First, he confiscated all of the land of the aristocracy and over 1,000 properties of the Orthodox Church and distributed them to the newly-formed soviets. Secondly, he persuaded his comrades to accept the harsh terms of withdrawal from the war in the Treaty of Brest-Litovsk. This was more an unconditional surrender than a negotiated peace, as Russia ceded all of its western lands, including Poland and Ukraine, to Germany, which was about one-third of its population, most of its arable land, and 90% of its coal and iron reserves. Lenin sensed that the people were tired of war, or maybe tired of a losing war, and Lenin needed to focus all his efforts on solidifying his power base. For the next four years, Russia fought a bloody civil war, which included troops and materiel from the US, UK and Britain in support of his rivals, but Lenin (and Trotsky, who was the organizational and military mastermind) prevailed.

Lenin had brilliant political instincts, and a singular focus on achieving his goals without compromise. Yet he attached himself to a morally bankrupt ideology, and lived to see its corrupting force take over his revolution in the person of Josef Stalin. He tried to warn of the dangers of Stalin, but suffered a series of strokes, and died in January 1924 at the age of just 54.

There were two revolutions in Russia in 1917. The February Revolution, a spontaneous democratic uprising of the people, toppled the Tsar. Lenin and his Bolsheviks played no part in that. The October Revolution, the one the Soviet Union would celebrate each year, was a violent overthrow of a liberal democracy. The October Revolution created the Soviet Union, and it would have been impossible without the singular personage of Vladimir Ilyich Lenin, whose ambition to lead the revolution knew no bounds and brooked no compromises.

Lenin was no ideologue, and morality was not part of his plan. As he put it, "There are no morals in politics; there is only expediency."<sup>9</sup> He sought the overthrow of the world order, but only with himself leading it. While his coup was nearly bloodless, the subsequent civil war claimed millions of lives, and the corrupt ideology in whose name he fought would cost tens of millions of lives, and result in one of the most destructive, dehumanizing regimes for three generations. That may not have been his intent, but it was the inevitable result of the forces he unleashed. The world would have been wise to take seriously then (and now) the unknown and unintended consequences of determined men seeking to overturn the world order. William Butler Yeats, writing at the time, described those consequences well:<sup>10</sup>

*Things fall apart; the centre cannot hold;  
Mere anarchy is loosed upon the world;  
The blood-dimmed tide is loosed...*

<sup>9</sup> Sadly, a philosophy one could imagine being embraced today by too many of our political leaders.

<sup>10</sup> William Butler Yeats, *The Second Coming*, 1919.

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## Michael A. Rosen

Principal & Chief Investment Officer

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