RGA INVESTMENT ADVISORS, LLC

December 6, 2012

November 2012 Commentary
The Fiscal Cliff (or not)

Complex Adaptive Systems

In October of this year, Jason and Elliot had the privilege of attending Santa Fe Institute's (SFI) conference in conjunction with Morgan Stanley called *Risk: The Human Factor*. It was a fascinating day, with many great lessons that can be applied to our investment process (for a complete summary, check out Elliot's review on his personal blog). Rather than discuss any of these specific lessons, we wanted to take the time in this November commentary to highlight a theme at the heart of what the Santa Fe Institute studies: markets, a complex adaptive system.

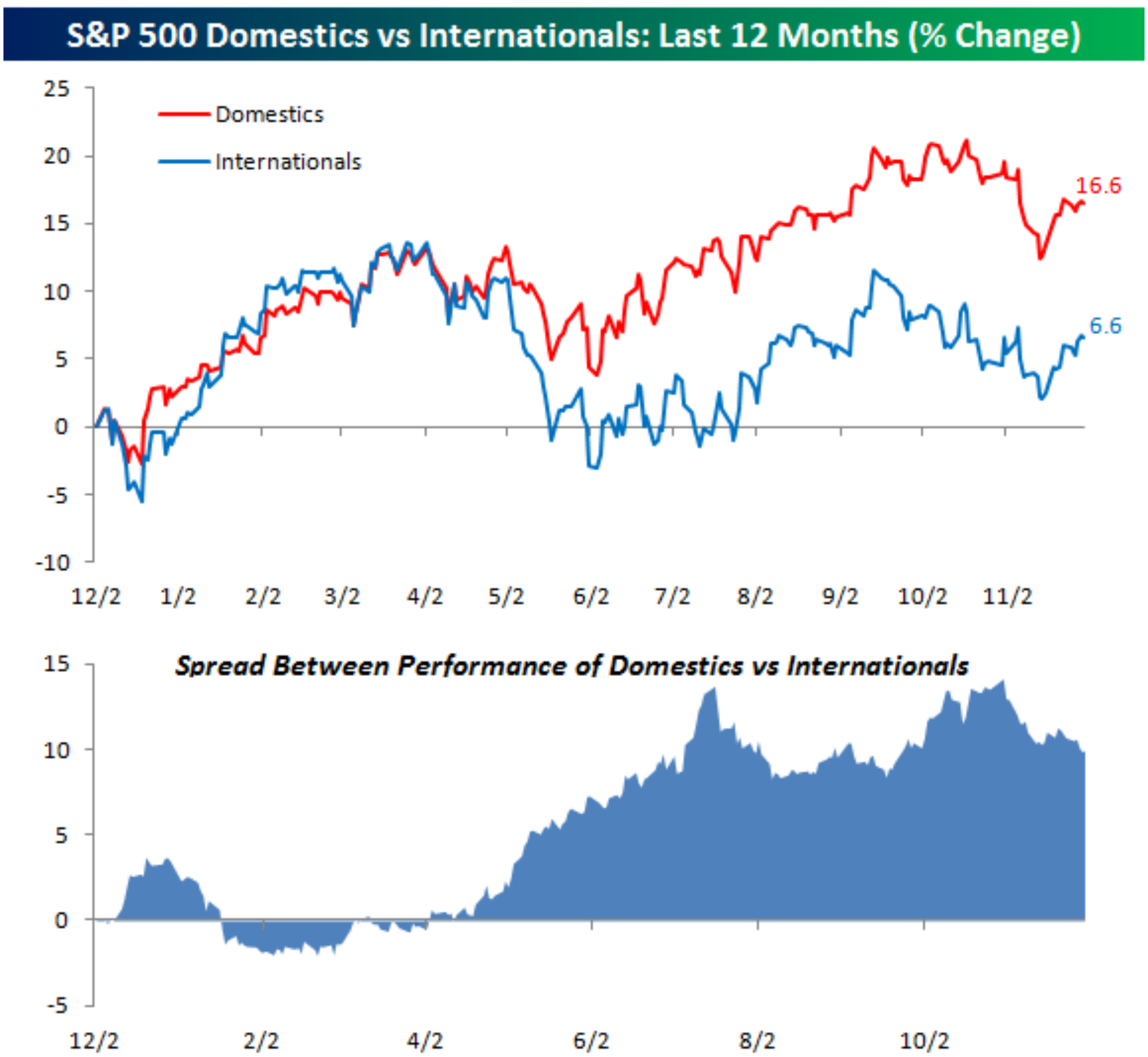
Complex adaptive system. What exactly does this mean? We know what each word means in isolation. Markets are complex, meaning they are "complicated" and have "interrelated parts." Markets are adaptive, such that they adjust to circumstances "by modification." Markets are systems, which consist of "regularly interacting …group(s)" joining together to form a "unified whole." This is very much our prevailing philosophy towards financial markets, and the reason behind our interest in the Santa Fe Institute. Such systems are found in many places, including nuclear physics, biology, anthropology, social structures, genomics, chemistry and drug discovery. What's particularly neat about the SFI is that it brings together leading researchers and practitioners from all of these disparate areas to share their ideas for the benefit of each other.

We believe the complex adaptive system is the framework and lens through which everyone should perceive broader markets, yet despite that, the mainstream media does everything in its power to prevent people from adopting this approach. Why is this? Because when you take this perspective towards markets, you inherently destroy the need for a financial media altogether. Financial media thrive off of attributing market moves to a narrative. What the media does is fit a story to the events that have transpired, and yet all too often in the 24-hour news cycle, stories are crafted to fit facts without any clear connection between correlation and causation. Providing a narrative for market moves is almost never a good idea.

The Fiscal Cliff (or not)

Again you might ask why we are talking about this topic today, and now we will finally answer: the fiscal cliff is one of the more media-friendly stories with all kinds of narratives crafted around its fate. These stories are good for little more than pageviews and TV ratings. If the media were to be believed, this past November's stock market action was completely attributed to the rumors and whispers about the fiscal cliff negotiations. Each day, the wiggle waggles of the market were portrayed as a direct result of the he-said-she-said negotiations between Democrats and Republicans.

Considering markets are complex adaptive systems, we know that this is a venue where many simultaneous crosscurrents meet and drive the action of the entire system. If you followed the fiscal cliff madness too closely, you may have missed the most important happenings of the month: we are finally seeing "green shoots" in the global economy, with China and Europe looking for better than they had been in a long time. That brings us to our next big point of the month—there has been a massive performance spread in stocks with a purely domestic revenue base vs those with a more diversified international base:

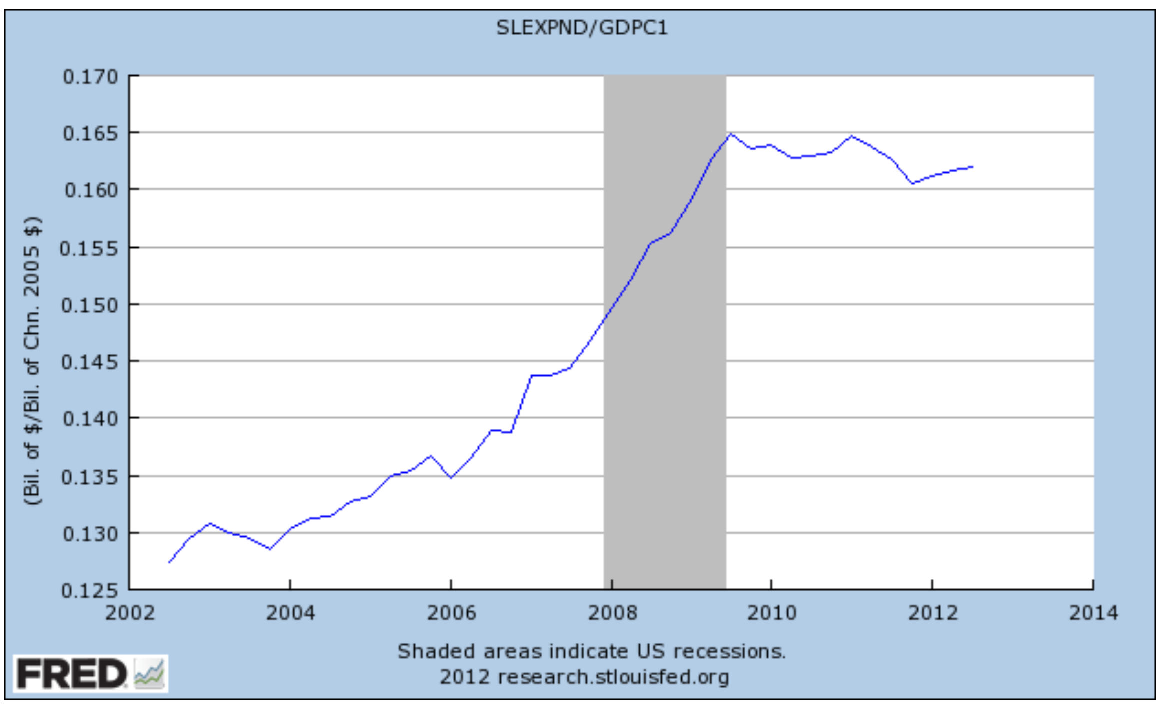


Hat tip to Bespoke Investment Group for the chart.

This chart is important for several reasons. First, it shows the strength and resilience of the US economy against the globe; second, it shows just how narrow the strong performance in the stock market has been this year. You can see clearly that from the end of November last year, until May of this year, all companies basically moved in lock step. That relationship broke down in May and has continued to stay that way since then, with the spread only recently starting to narrow. And it's been narrowing for all of the right reasons.

The Forces Driving the Market:

While the fiscal cliff is A force driving markets today, it is not THE force. Along with this one issue are perhaps the far more important forces of the global economic slowdown, which accelerated in the first half of 2012 and is finally abating, and the shift in state-level spending from contraction to expansion. This latter point is an important one that we almost never see mentioned. Since the recession ended, state and local government spending has provided a major headwind to GDP growth. The following chart shows state and local government spending as a share of GDP (note: the rapid growth during the shaded area is reflective of a decline in GDP more so than an increase in spending):



While the federal government has been stimulating the economy with deficits, the state and local governments have been effectively removing this stimulus with contraction of their own. Now, the fiscal cliff, whether we "go over it" or find a resolution will provide a headwind to growth in its own right. Yet, states are finally starting to spend more again and recently we see the first signs of an uptick in this chart. Further, we see confirmation coming from the corporate sector, as evidenced by John Chambers discussion in Cisco's Fourth Quarter conference call this past August:

> We first signaled slowing of the market almost **15 months ago, the initial indicators of the slowdown occurred first in the U.S. state and local government** followed by large, large global enterprise accounts, then general enterprise accounts in the U.S. then U.S. Federal and then into the commercial marketplace.
>
> In Q4, with the exception of Federal government, **we saw positive growth and/or uptrend especially in the second half of the quarter**. Now I want to say, it is way too early to call this a trend, but if this were to continue through Q1, this would be a solid indicator of potential future market improvement in the U.S. (emphasis added)

So we have confirmation from a company known as a bellwether of economic growth both of the contraction, and then expansion in spending on the state and local level. Why is this important? Well no matter what, we will have a headwind coming from the spending level of the federal government, but at the same time, we will also have a tailwind from the shift on the state level from contraction to expansion. Importantly, the shift from contraction to expansion has a far bigger multiplier than simply an acceleration in growth.

Getting complex, let's adapt:

So we've covered on some level three major forces impacting the stock market: the fiscal cliff, the global economic slowdown, and state and local government spending. And these are three of many forces driving markets. We can add to this the trend in consumer spending, corporate profit margins, the housing market, and/or the employment landscape, etc. This is far from an exhaustive list. Then we can factorize some of these areas. For example, global economic slowdown can be broken down into emerging markets vs developed markets; we can look at Europe alone, or we can break Europe down into core versus periphery. Each of these areas have distinct trends of their own.

But let's tie it together. No one point can be viewed in isolation. A change in any one of these disparate areas, for example, China, can influence many of the other areas, which in turn can then influence China again. George Soros called such phenomenon "reflexive processes" and that is the essence of a complex adaptive system. Changes beget changes, which beget further changes, and no one factor is ever strong enough to be THE factor.

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While the fiscal cliff does loom large in the media, the other stories that have a major impact on the global economy, with reflexive processes, are not nearly as sexy and don't sell headlines. It's important when looking at markets to take an entirely holistic approach in the grand scheme of things, but also to do extensive research into each individual security in order to insure that over the long run, their core business operations are in a position to succeed. This is how we overlay our micro-level company analysis with macro-level economic analysis, amidst our search for companies trading at a discount to their intrinsic value in areas where the overall outlook is best.

Please call us directly to discuss this in more detail. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers below.

Warm personal regards,

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