2016
3RD QUARTER
QUARTERLY COMMENTARY

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Chancellorsville

Abraham Lincoln suffered from clinical depression his whole life, but as 1862 drew to a close, even the most cheerful were likely to be losing faith in the Union cause.

Virginia was turning from battlefield to graveyard for the Union armies. In August, Union forces were routed (again) at the Second Battle of Bull Run (Manassas), incurring 14,000 casualties to the Confederacy's 3,000. In September, at Harper's Ferry, 12,000 Union soldiers were captured at the cost of just 286 Confederate losses. And in December, at the last major battle before the spring thaw, 12,000 Union soldiers fell at Fredericksburg, against 5,000 for the Confederates. In his year-end message to Congress, Lincoln famously noted, somewhat ambiguously, *We shall nobly save, or meanly lose, the last best hope of earth.* Which it was to be was anyone's guess.

Lincoln searched desperately for a general to command the Army of the Potomac. In the course of a few months in 1862, John Pope was dismissed after the Second Bull Run disaster, George McClellan's[1] dithering led to his sacking in November,

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[1] McClellan's nickname was Little Napoleon; unfortunately the only shared characteristics he had with his namesake was a large ego and a short frame.

and Ambrose Burnside[2] was dumped soon after Fredericksburg. For the coming campaign, Lincoln would turn to (Fighting) Joe Hooker, a self-promoting egotist who had but one approach in his personal relations and in battle of maximum aggression. Lincoln's letter to Hooker appointing him head of the army was filled with reservations, and Lincoln admonished Hooker to *beware of rashness, but...give us victories.*

Winter weather and spring rains made all but minor skirmishes impossible, but by late April 1863, the roads had hardened, and Fighting Joe Hooker led 134,000 troops across the Rappahannock River, poised to strike at the exposed left flank of the much smaller 61,000 men of the Army of Northern Virginia. The only rational response to this existential threat to the Confederacy was to retreat. Possibly, although unlikely successful, a concentrated attack to find a vulnerability in the Union line might have been considered. Carl von Clausewitz famously wrote, *the first principle of [warfare] is to act concentrated as much as possible.*

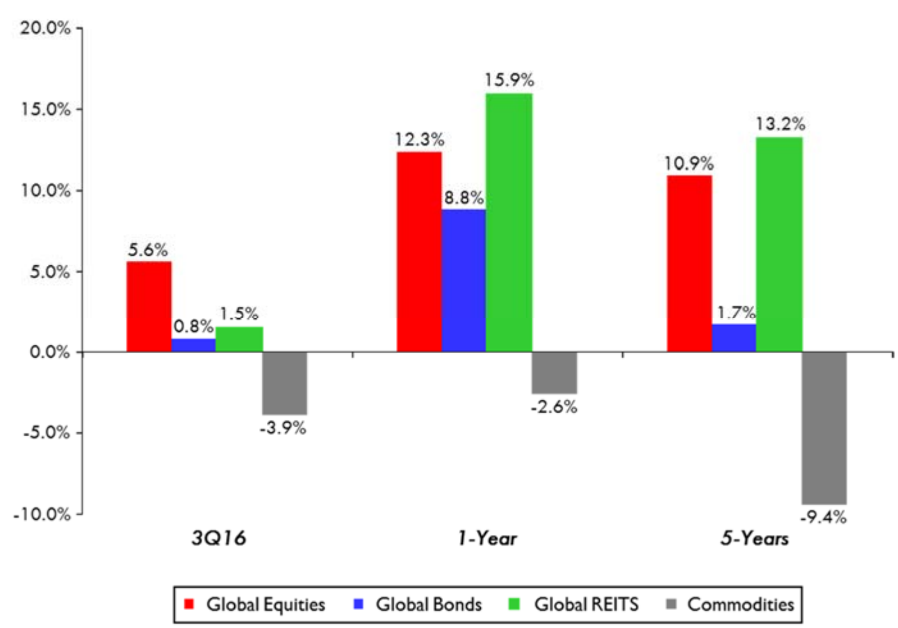
Robert E. Lee had already earned his reputation for military brilliance in racking up victory after victory against superior Union forces. But it was in this battle, at Chancellorsville, that his genius was sealed. With less than half the troops and armament of Hooker's army, Lee directly violated Clausewitz' maxim, divided his force, and achieved one of the most stunning victories in military history.

Lee's bold gamble is worth reviewing, for knowing when, and when not, to take risks is instructive. But the larger context of Chancellorsville, what drove that gamble and what was soon to come, has lessons for us today.

Equities posted strong gains in the third quarter, with more modest, but still positive, results from bonds and real estate. Commodities dipped in the quarter, as did the US dollar, with the euro and the yen showing strength. As usual, within equity markets there was wide dispersion. On the plus side was Egypt, jumping 22%, which was just enough to make up for all its losses over the past year. New Zealand and Brazil were each up more than 10%, bringing their one-year results to a world-beating +50%. New Zealanders cheered with lamb prices up 20% in the past few months. Brazilians are pleased that coffee prices are up a third in the past year, and nearly as pleased that their incompetent president was finally impeached. Also replacing an incompetent president, Argentina drifted 2% higher in the quarter, but is up 49% in the past year. It seems like it's a good idea to get rid of incompetent presidents.

On the downside in the quarter was Nigeria, off 12%, to add to its 43% drop in the past year. Lower oil prices and habitual corruption were the likely culprits. But a spot of good news was that Greece was up a fraction of a percent in the third quarter, and is down just 39% in

Chart 1 **Capital Market Performance**



[2] Burnside pioneered the style of very bushy hair running down the sides of his face; his contribution to history was sadly not found on the battlefield but on the play of his name given to this follicular style, side burns.

the past year. Lest we get too excited, Greece has posted a 30% decline over the past decade. That's 30% annualized, not a cumulative one: $100 invested ten years ago would be worth less than $3 today. Still, it didn't get any worse for Greece in the third quarter, so maybe that's progress.

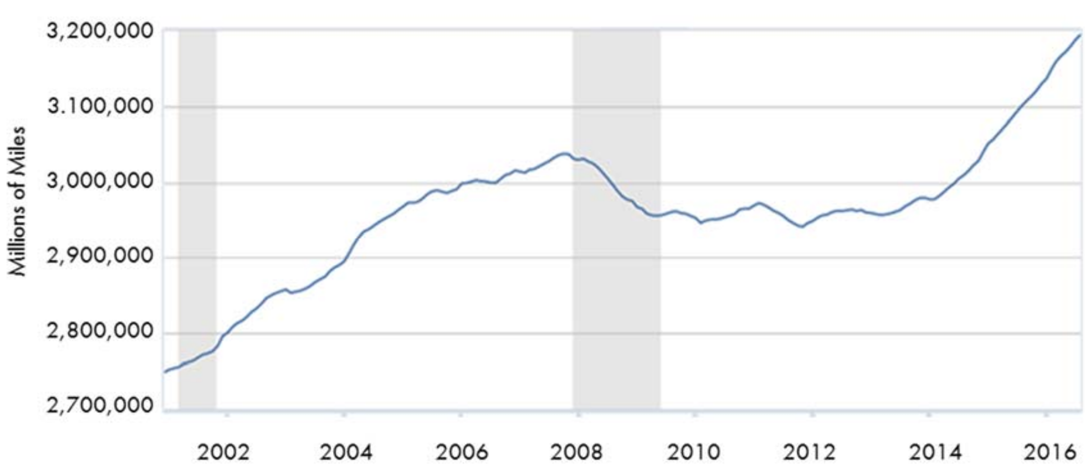
Equities are considered leading indicators of economic activity and, indeed, their gains presaged a pick-up in global growth in the third quarter, especially in the US, where GDP jumped to a 2.9% annual pace, more than doubling the growth rate of the second quarter, which itself was a near-doubling of the pace in the first quarter.[3] That pace is unlikely to be sustained as about half of the third quarter growth came from higher inventories and rising exports, both volatile data. Exports, for example, surged at a 10% rate last quarter, led mostly by soybeans. Soybeans are great, but demand is not that strong. The underlying trend growth rate for the economy is around 2%, consistent with the pace of the past six years.

Economic data calculations can be very complicated, with sample biases and seasonal and quality adjustments. Sometimes simpler is better. For example, when the economy slumps, we drive less; when the economy picks up, we drive more. It doesn't take an army of statisticians to prove the economy is expanding (Chart 2).

Employment growth continues to outpace the broader economic recovery. Payroll gains averaged 192,000 per month in the quarter, about the same as the rate over the past year. Hours worked grew 1.5% last quarter, hourly earnings rose 2.7%, so average cash earnings (ex-bonuses and commissions) rose 4.2%. It's no wonder, then, that consumer spending has been leading the economy.

Other measures of employment have been strong as well. The median duration of unemployment is 10.3 weeks, a recovery low, and job openings are near an all-time high. The Quits rate, the percentage of workers

Chart 2 **Moving 12-Month Total Vehicle Miles Traveled**



Source: US Federal Highway Administration *fred.stlouisfed.org*

[3] If you're keeping score, US GDP growth was 0.8% in 1Q, 1.4% in 2Q and 2.9% in 3Q 2016.

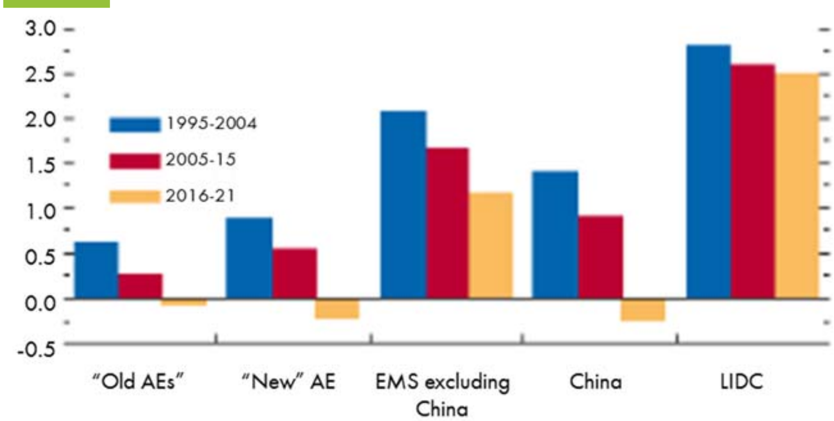
who quit their jobs, presumably confident in finding another one, is at 2.1%, up from the 2010 low of 1.3%, and nearing the pre-crash high of 2.2%. Janet Yellen says she really likes this indicator; she should be happy its up. Lastly, initial claims for jobless benefits fell to 253,000, the lowest level in 43 years (Chart 3). And that was when the labor force was 78 million; today it's 145 million.

Chart 3 **4-Week Moving Average of Initial Claims**

Source: US Employment and Training Administration *Fred.stlouisfed.org*

Employment rose 2% over the past year, nearly twice the 1.1% pace of growth in the working age population. So even if job growth slows, we can reasonably say that the economy is very close to full employment. This is especially true when we consider that the working age population is set to shrink over the next five years in both the developed world and in China (Chart 4). But demographics will not be the only drag on global growth.

Chart 4 **Working-Age Population Growth** (Percent)



Source: United Nations Population and Development database and IMF staff estimates.
AE: Advanced Economies
LIDC: Low Income Developing Countries

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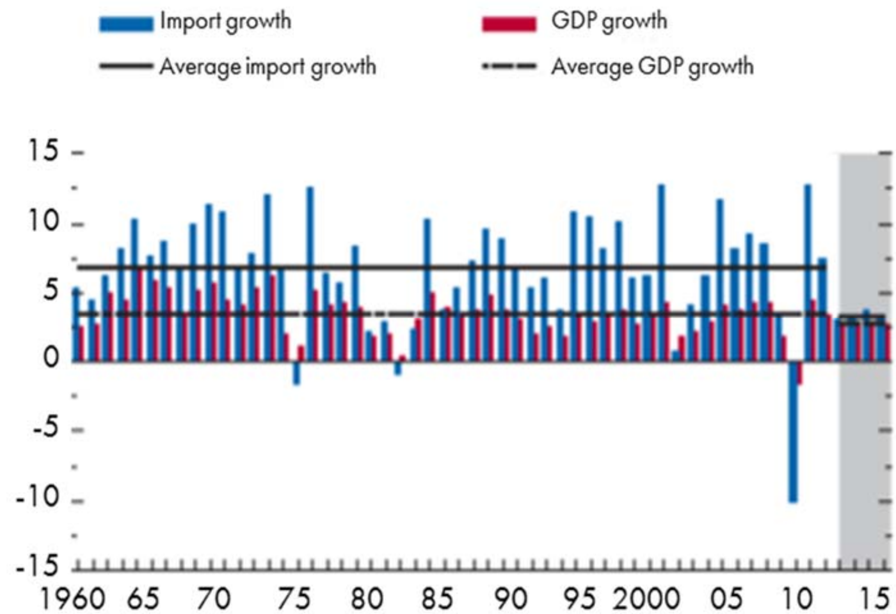
Trade has long been an important driver of the global economy, rising twice as fast as world GDP. Following an unprecedented drop in 2008, and a sharp rebound in 2010, trade has expanded at less than half its rate of previous decades, barely in-line with world GDP (Chart 5).

Chart 5 **World Real Trade and GDP Growth, 1960-2015 (%)**



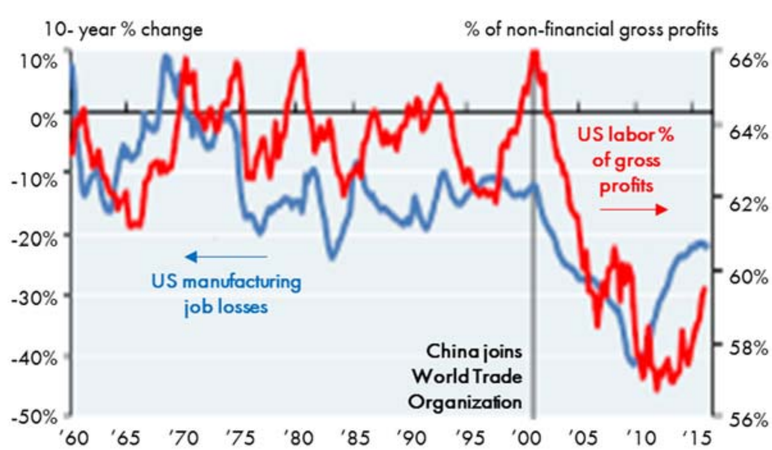
Source: IMF

Trade improves productivity, raises living standards and promotes economic growth. Resources are allocated more efficiently to more productive firms and uses. Prices are lowered for producers and consumers, boosting real incomes.

Conversely, restrictions on trade retard growth, thus lowering incomes. Trade expands the economic pie, protectionism shrinks it. At the same time, protectionism causes prices to rise. There is wide empirical evidence that countries open to trade experience lower inflation than those closed to trade. With capital flows also restricted, the global financial system is more susceptible to stresses.

While expanded trade is unquestionably beneficial for the global economy as a whole, not every group benefits equally, and some are harmed, even as the majority gain. The US had been losing manufacturing jobs for decades, but China's entry into the World Trade Organization (WTO) in 2001 accelerated that trend. Similarly, labor's share of gross profits peaked precisely in 2001 and has sharply declined since (Chart 6). These trends were in place long before China entered the world economy, but China has certainly had an impact. Policies to ameliorate these costs should be considered. But restricting trade harms everyone.

Chart 6 **US Manufacturing Job Losses and Labor Share of Profits, 1960-2015**



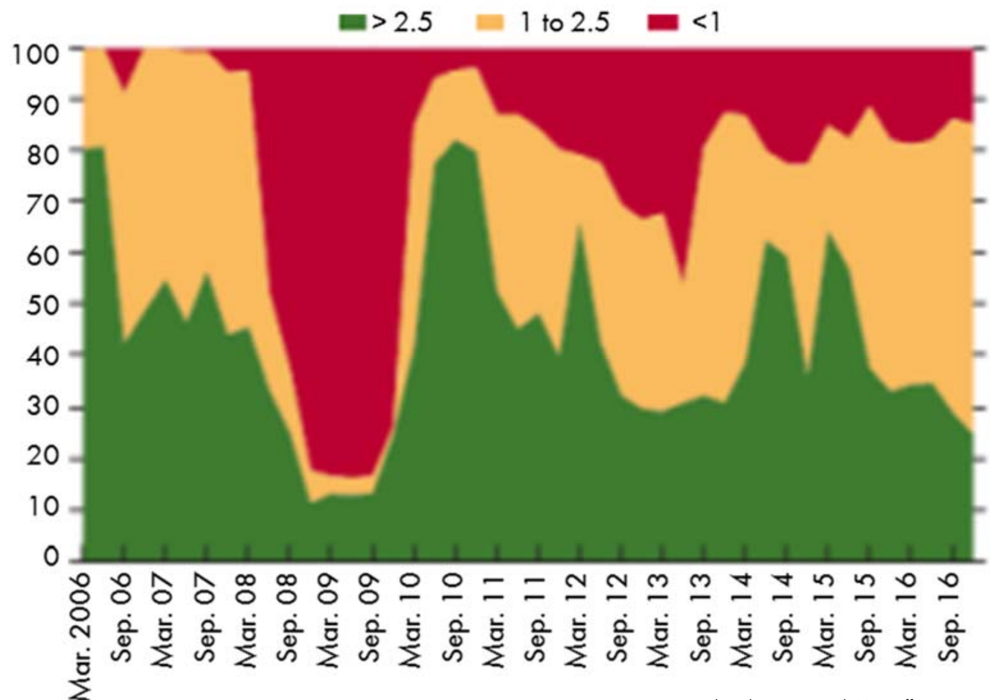
Source: BLS, JP Morgan

Monetary management (manipulation) has been the principal policy tool in the developed world post-financial crisis. Its principal goal was to stimulate economic growth through two related mechanisms: a wealth effect and more borrowing. By raising asset prices, balance sheets would be able to support more debt, which would be further encouraged by lowering its cost.

At a high level, global growth did recover strongly in 2010, rising 5.4% from a -0.1% contraction in 2009, but the rate has slowed in each subsequent year, and is expected to be about 3.1% this year. Sluggish growth now characterizes the majority of the world economy (Chart 7). The monetary response contributed significantly in the initial phase of the recovery, but has become less effective over time, even as policies have reached unprecedented extremes.

Central banks have pushed real interest rates negative by buying up much of the available issuance of bonds. Nearly half of the $43 trillion of developed world government bonds outstanding is on the balance sheets of central banks. European governments plan to issue

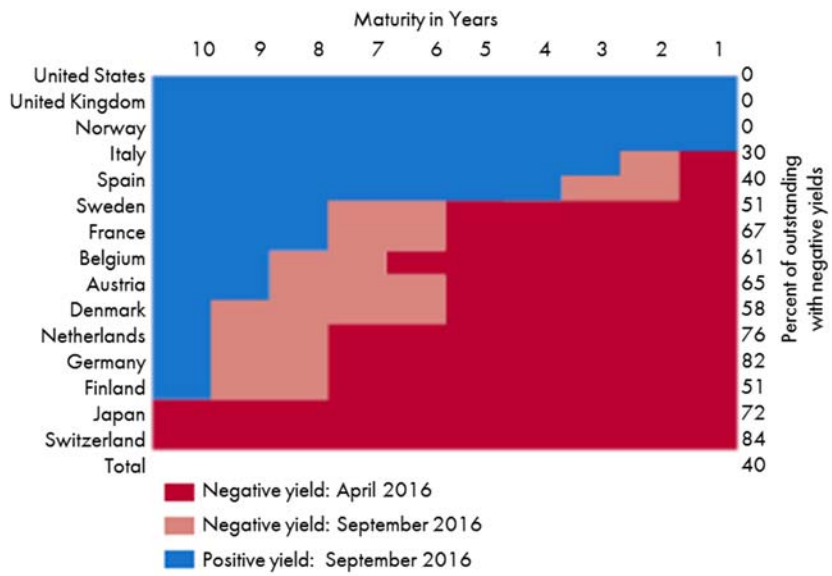
Chart 7 **Distribution of Level of Real GDP Growth, 2006-2016** (Growth rate over previous four quarters, share of total GDP in each growth bracket; percent)



Source: Bloomberg L.P.; and IMF Staff estimates

Chart 8

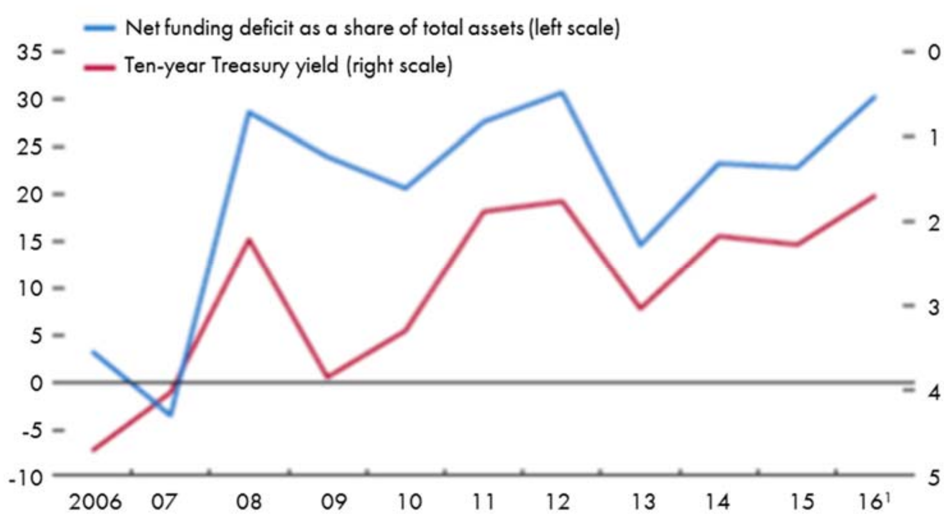
Share of Sovereign Bond Markets with Negative Rates



Source: IMF

Chart 9

US Funding Deficit of Defined Benefit Pension Funds and the 10-Year Treasury Yield (Percent), 2006-2016



Sources: Bloomberg L.P.; Bank of America Merrill Lynch; and IMF staff calculations.
Note: Top 100 firms in the Standard & Poor's 500. The positive values are below the zero line for the right scale.
[1]Bank of America Merrill Lynch estimates.

€844 billion of debt this year, but the supply of government bonds outstanding will actually shrink by about €600 billion due to the massive bond buying by the European Central Bank (ECB). Half of the European government bond market now carries a negative nominal yield (Chart 8). In an amazing turn of financial alchemy, Henkel, a German consumer products company (Persil detergent), issued a negative-yielding bond last quarter in order to buy Sun Products (All, Snuggle), thereby convincing lenders to pay the company to make an acquisition.

However effective or appropriate monetary policy was in the immediate aftermath of the financial crisis, its transmission to the real economy is weakening, and some of its negative consequences are becoming more prominent. The efforts to lower the costs for borrowers comes at the expense of savers, who are now unable to achieve even modest returns on their savings. Rather than stimulating growth, repressive monetary policy is having the perverse effect of retarding economic activity. Borrowers are reaching limits of taking on more debt, and savers are saving more in order to compensate for the lower returns on their savings. Financial intermediaries (banks, insurance companies) are caught in this squeeze, while pension funds see their funded status worsen with each drop in yields (Chart 9).

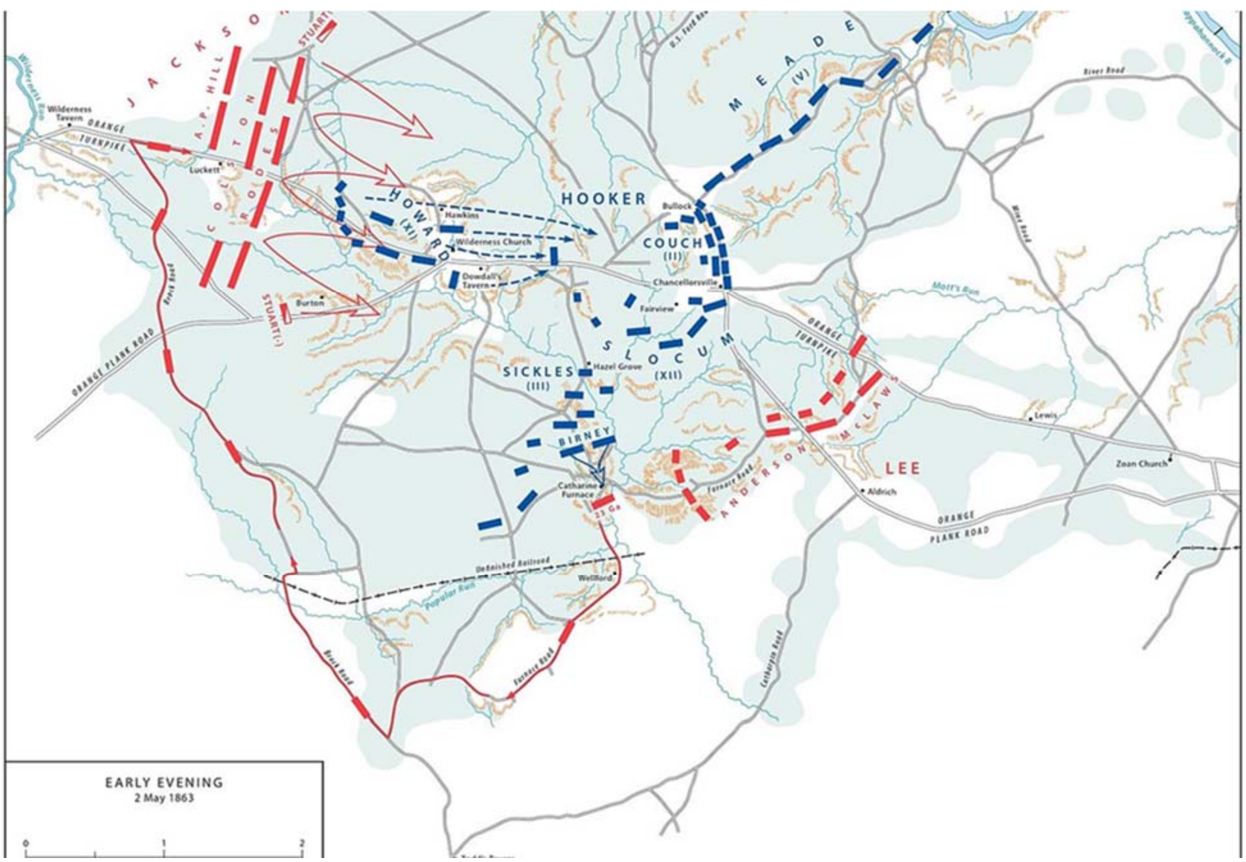
The monetary response to the financial crisis was successful in providing the necessary liquidity to enable the markets to function, but its effectiveness has eroded over time, and some of the harmful consequences of this monetary approach are increasingly evident.

Transitions are always fraught with risks, and at a time when the world economy is soft and asset prices high, those risks are magnified. A transition to a new regime is required, but to navigate this path will be extremely challenging, not unlike the predicament Robert E. Lee faced in 1863.

Despite his string of improbable victories, Lee understood that the strategic position of the Confederacy was precarious. The Western theatre, the Mississippi River and into Tennessee, were of much greater military importance than anything in Virginia. Ulysses S. Grant's Army of the Tennessee, was winning critical battles, threatening soon to take full control of the Mississippi and split the South.[4] As the war entered its third year, Lee knew time was against him. The Confederacy could not win a war of attrition against the much larger Union.

But Lee also understood the psychic importance of the Virginia campaign. The two capitals were only 100 miles apart, and battles so close to these capitals and population centers carried extra significance in swaying public opinion. The Confederacy was losing its strategic position in Tennessee, and the victories in Virginia would not stop the inexhaustible flow of men and materiel from the North. And now, on 30 April 1863, Lee faced an army more than twice his size, poised to annihilate his Army of Northern Virginia, ending the war.

Battle of Chancellorsville



[4] Which Grant did in June 1863 by capturing Vicksburg.

On the first of May, Lee conferred with his top general, Thomas Jackson, known widely then and now as Stonewall, for his courageous defense at the First Battle of Bull Run (Manassas), and devised one of the boldest plans ever conceived in battle. Lee's left flank was on vulnerable ground and Lee knew that is where Hooker would attack. Lee decided to split his army, giving Jackson 30,000 men, to outflank Hooker's right, and attack from the rear. Meanwhile, Lee would keep less than 30,000 troops to confront the rest of Hooker's army of 134,000.

The following day, Jackson crossed his army in front of Hooker's right flank, and then around to its rear. Remarkably, Jackson was undetected, helped, in part, by the fact that the ground Hooker occupied was thick with trees; for good reason it was called the Wilderness, difficult to see, hear or maneuver. Late that afternoon of 2 May, Jackson's men attacked, routing Hooker's right flank.

Still, the battle was far from over. The Confederate Army was split in two, isolated from and unable to aid each other if needed. And tragically, that night, when riding on open ground, Stonewall Jackson was mistakenly, and mortally, wounded by his own troops. Some say the South never recovered from this loss.

The next day, still possessing overwhelming superiority, part of Union Army broke through on the eastern front, threatening to envelop the Army of Northern Virginia. But Lee personally led the counter-attack at Salem Church, and the Union was driven back. Three days later, Hooker retreated back across the Rappahannock, having suffered 18,000 causalities.

Chancellorsville was the most brilliant victory in the storied career of Robert E. Lee. His plan to split his forces and Jackson's maneuver around the enemy's flank is studied in war colleges today. As remarkable an achievement as it was, Lee understood that the strategic balance between the Union and the Confederacy was largely unchanged. He believed that the Confederacy's only hope of winning recognition was to ignite a popular uprising in the North against the war, and to do that Lee needed to push the theatre of war out of Virginia and into the heart of the Union. Two months later, he did just that, near the small Pennsylvania town of Gettysburg. It was to be the bloodiest battle of the war, and it marked the end of the Confederacy's hopes for victory.

Chancellorsville remains the archetype of what imaginative leadership can achieve against overwhelming obstacles. It was also the moment of maximum despair for the Union. An overwhelming army was placed in exactly the right position to destroy the enemy and, somehow, again, it was routed by an inferior force. Fighting Joe Hooker became the latest general that Lincoln fired after just one battle, replaced with George Meade, but the Union cause was waning.

Lincoln declared the day of the battle to be a "day of national humiliation, fasting and prayer." He proclaimed that this war was:

> *a punishment, inflicted upon us, for our presumptuous sins.... We have been the recipients of the choicest bounties of Heaven. We have been preserved, these many years, in peace and prosperity. We have grown in numbers, wealth and power, as no other nation has ever grown.... and we have vainly imagined, in the deceitfulness of our hearts, that all these blessings were produced by some superior wisdom and virtue of our own.*

Lincoln could not know the Union's fate was about to turn. But Lee knew, despite his brilliant victories, that the Confederacy was running out of time, and that he needed another bold gamble to end the war on favorable terms. It was not to be.

We also face a transition today. The current monetary regime is losing effectiveness and generating collateral tensions, but we lack the imagination to foresee a new paradigm, while intuitively aware of the risks of getting there. Our politics have transitioned from dysfunctional to divisive, and it's easy to see our national election as *a punishment, inflicted upon us, for our presumptuous sins.*

While despondent, Lincoln never despaired, and he concluded his proclamation with a hopeful wish, for

the restoration of our now divided and suffering Country, to its former happy condition of unity and peace.

Amen.

Founded in 2001, Angeles Investment Advisors LLC provides investment advice to select institutions and high net worth families and individuals.

Michael A. Rosen

Principal & Chief Investment Officer

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