

Angeles



Maginot

Sedan is a picturesque village in northeastern France, a few miles from the Belgian border. It was settled 600 years ago by Protestants fleeing the religious wars of the time. The Meuse River passes through the town on its way from the French Alps to the Dutch North Sea. Sedan sits at the edge of the Ardennes, the vast forest of more than 4,000 square miles that spans France, Belgium and Germany. Today, Sedan is a tranquil, even idyllic place. But history had other designs for this charming village. Over three successive generations, Sedan would be at the center of three of the most momentous and cataclysmic events in history.

2024
3RD QUARTER
QUARTERLY COMMENTARY

Louis-Napoléon was a child when his family was exiled from France in 1815. The nephew of Napoléon Bonaparte eventually returned, entered politics, and was elected president in 1848 amidst the revolutions spreading across Europe.¹ He declared himself emperor three years later to restore France to its former *gloire* through a series of wars, including against Russia in the Crimea.²

While Louis-Napoléon was bleeding the finances of France, Otto von Bismarck was busy consolidating power. In 1864, Prussia defeated Denmark and annexed the provinces of Schleswig and Holstein. Two years later he invaded Austria, and within weeks Emperor Franz Josef capitulated. Bismarck then unified the numerous German states under Prussian control. In 1868, Spain deposed its monarch and Bismarck pressured Spain to offer the throne to Prince Leopold von Hohenzollern, a cousin of Kaiser Wilhelm I of Prussia. This was a bridge too far for Louis-Napoléon. Uneasy with the growing Prussian power, he declared war on Germany on 19 July 1870.

The French army, despite its victories in the prior decade, was poorly trained and ill-equipped, with

600,000 worn-out regular troops and another 400,000 untested reservists. Germany fielded 1.2 million troops of the highest quality. Led by the brilliant Helmuth von Moltke, the German army swept across France, attacking from both the east and the west in a pincer movement closing in on the village of Sedan, where Louis-Napoléon led the French army.

He had no chance. Four hundred German guns positioned in the heights above Sedan rained devastation. On 2 September, just six weeks after he had declared war, Louis-Napoléon surrendered his more than 100,000 troops to Kaiser Wilhelm.

His French empire collapsed, and Louis-Napoléon lived out his days in exile in London.³ Germany took the provinces of Alsace and Lorraine from France, and the 2nd of September was declared a national holiday, *Sedantag* (Sedan Day). Bismarck formally unified all the German states into the German Empire under Kaiser Wilhelm, but French resentment over its defeat would clash again with a rising German power a generation later. Sedan, a symbol of victory for Germany and mark of embarrassment and anger for France, would not be left in peace.

The French humiliation at Sedan festered for a generation. Another devastating war through Sedan would propel the French to revamp its military strategy, creating a defensive shield that would halt further German aggression. But the French would learn the wrong lessons, and Sedan again would pay the price for that failure, a failure we today would be advised to remember.



SURRENDER OF NAPOLEON III ON SEPTEMBER 2ND. THE GAZETTE BY NAPOLEON III.

Surrender of Louis-Napoléon to Kaiser Wilhelm I at Sedan, Library of Congress

¹ We wrote about the turmoil of 1848 in *Kapitalismus*: <https://www.angelesinvestments.com/insights/investment-insights/4th-quarter-2022-kapitalismus>.

² The Crimean War gave us Florence Nightengale, the Charge of the Light Brigade, and was a costly victory, but a victory, for France and its allies.

³ He died on 9 January 1873.

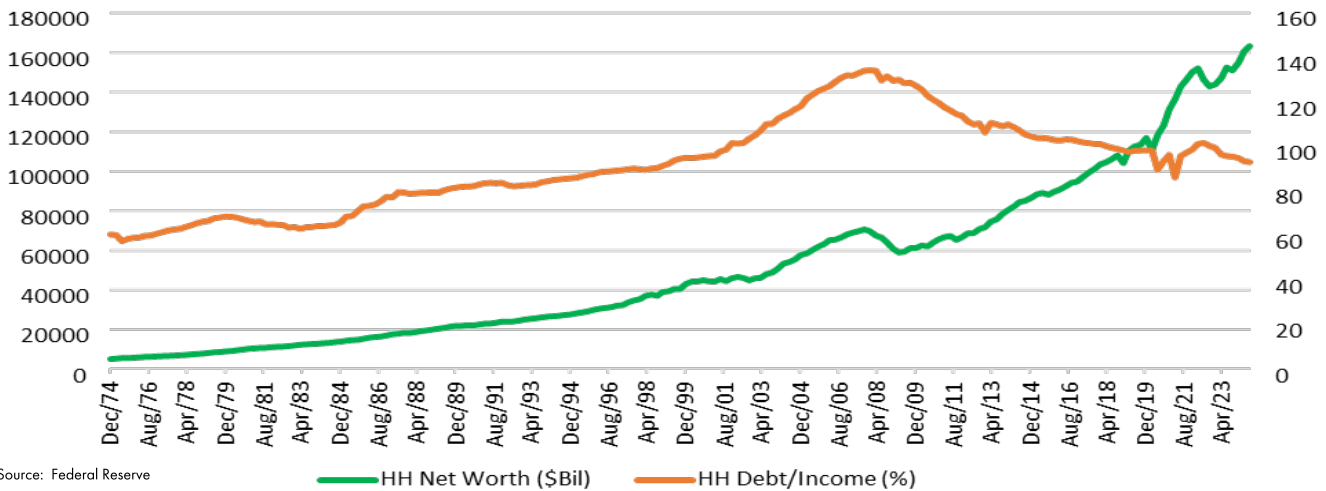
A soft landing is every pilot’s goal, but the US economy is having no landing at all with the economy accelerating above trend and monetary policy turning more accommodative. Investors should not fight the Fed and should not fight the data, which signal continued support for risk assets.

The US economy is growing at a 3% annualized rate, well ahead of the 2% pace it has averaged over the past 20 years. A record 159 million people are employed, and the labor force participation rate is near

its record highs. Household net worth exceeds \$163 trillion, and debt as a percentage of income has fallen from 137% to 93% (Chart 1).

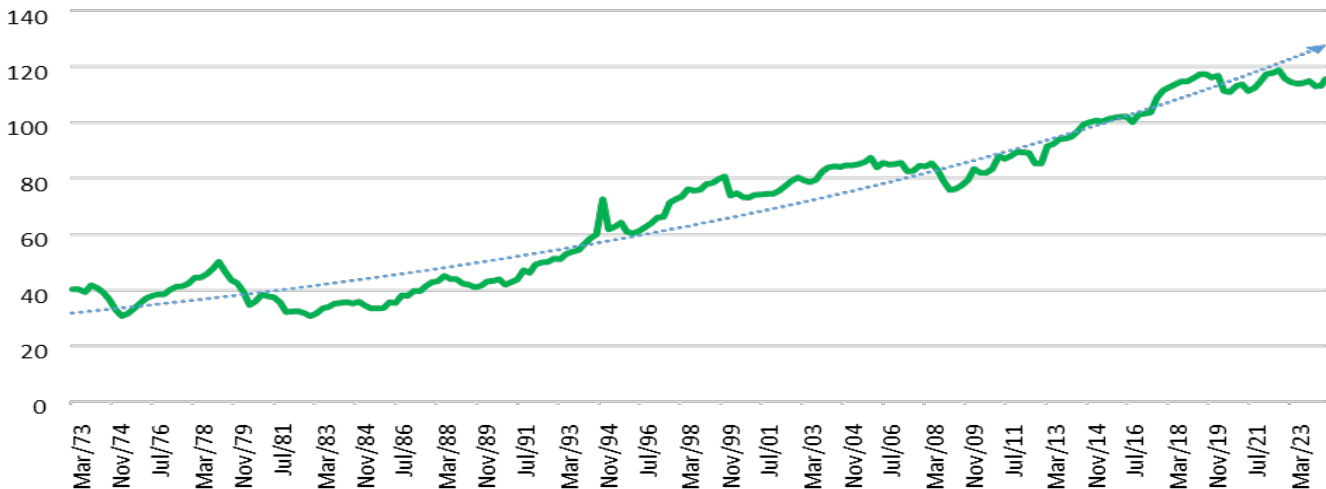
Economic data are often adjusted and revised, so especially valuable are data that are simple, cannot be manipulated statistically, and are central to economic activity. One such coincident economic statistic is truck tonnage. It rises when the economy grows, falls when the economy contracts. Currently, it is near a record high (Chart 2).

Chart 1 Household Net Worth (\$1Bil) and Debt-to-Disposable Income (%) 1974-2024



Source: Federal Reserve

Chart 2 Truck Tonnage Index, 1973-2024



Source: American Trucking Association

US economic data are strong and have surprised to the upside. This contrasts with the rest of the world, which is seeing negative revisions to their economic data (Chart 3). The US economy is the strongest in the world right now.

Follow the money was the phrase screenwriter William Goldin gave to Deep Throat in the 1976 film *All*

the President's Men. We have long argued for equity investors to *follow the profits*, as this is what propels equity markets. Interest rates, tax rates, geopolitical events are all peripheral to profits in driving equity markets. Profits are near a record high of 14% of GDP and profit margins have risen for decades (Chart 4).

Chart 3 Citi Economic Surprise Indices, US, China, Eurozone, Japan, Past One Year

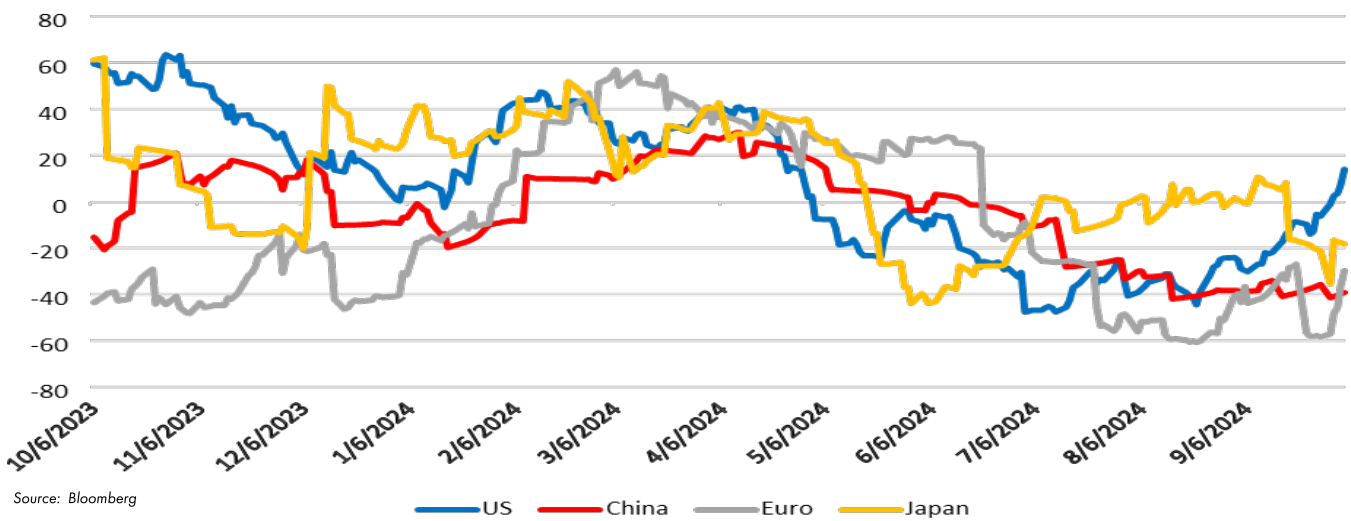
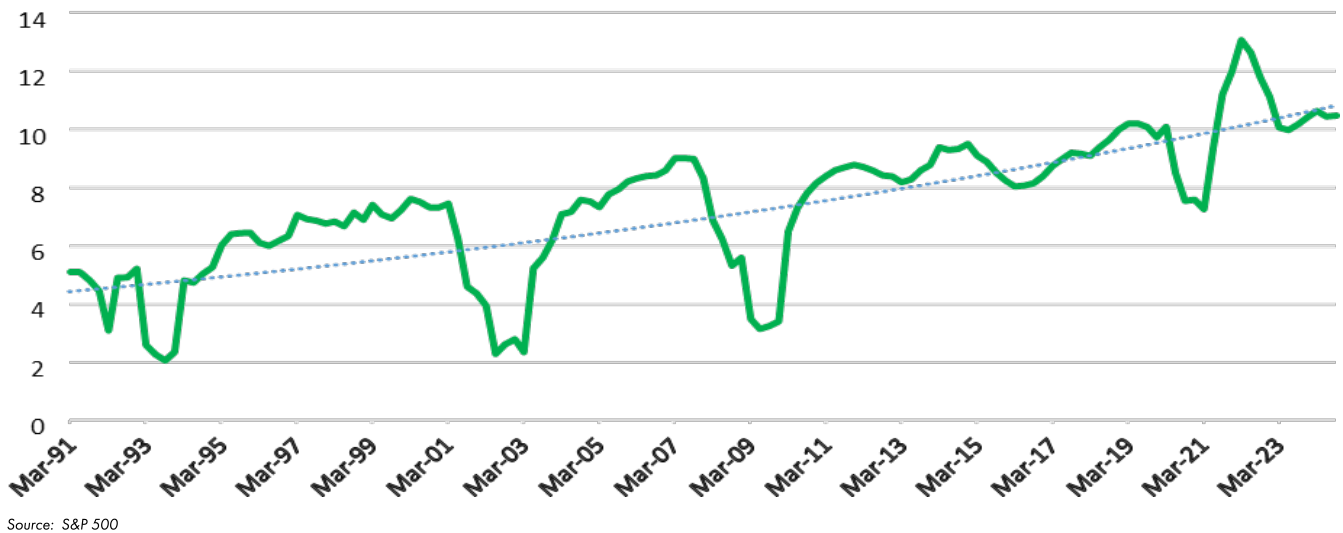


Chart 4 Profits Margins, S&P 500 Index, 1991-2024



Profits fully explain the rise in the US stock market (Chart 5).

Strong economic growth, rising employment, solid household balance sheets, robust corporate profits and central bank easing monetary policy all paint an encouraging backdrop for investors. Households and corporations are in strong shape to weather future

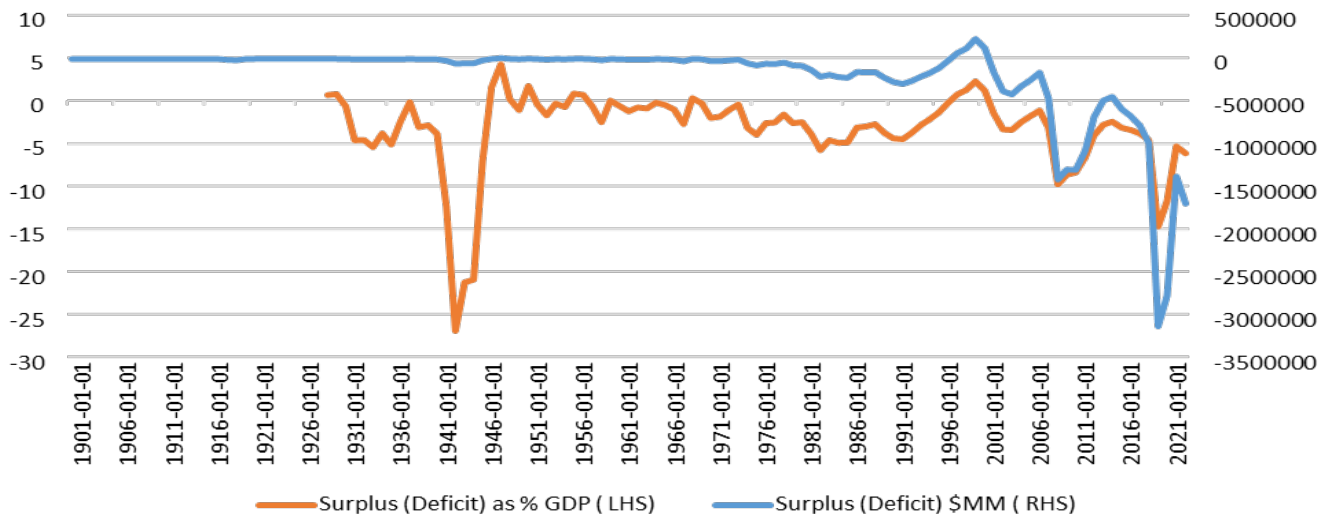
adversity. The federal government, in contrast, is living on borrowed time, and its impact on the overall economy may become problematic.

The Congressional Budget Office projects a budget deficit this year of \$1.9 trillion, 6.9% of GDP, unprecedented outside of World War Two (Chart 6).

Chart 5 S&P 500 Index Price and Earning per Share, 1995-2024



Chart 6 Federal Budget Surplus/Deficit in \$MM and as Pct. GDP, 1901-2024

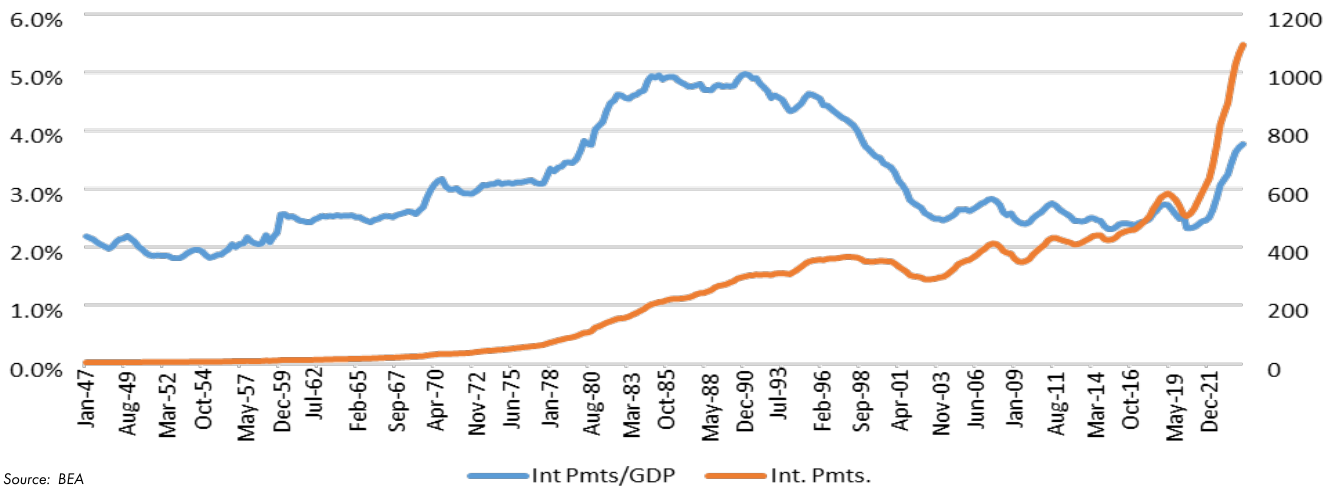


Source: OMB

One consequence of these deficits is the rise in the cost of servicing this debt. Interest payments have doubled to over \$1 trillion per year, nearly 4% of GDP (Chart 7). This crowds out a lot of other (potentially productive) spending.

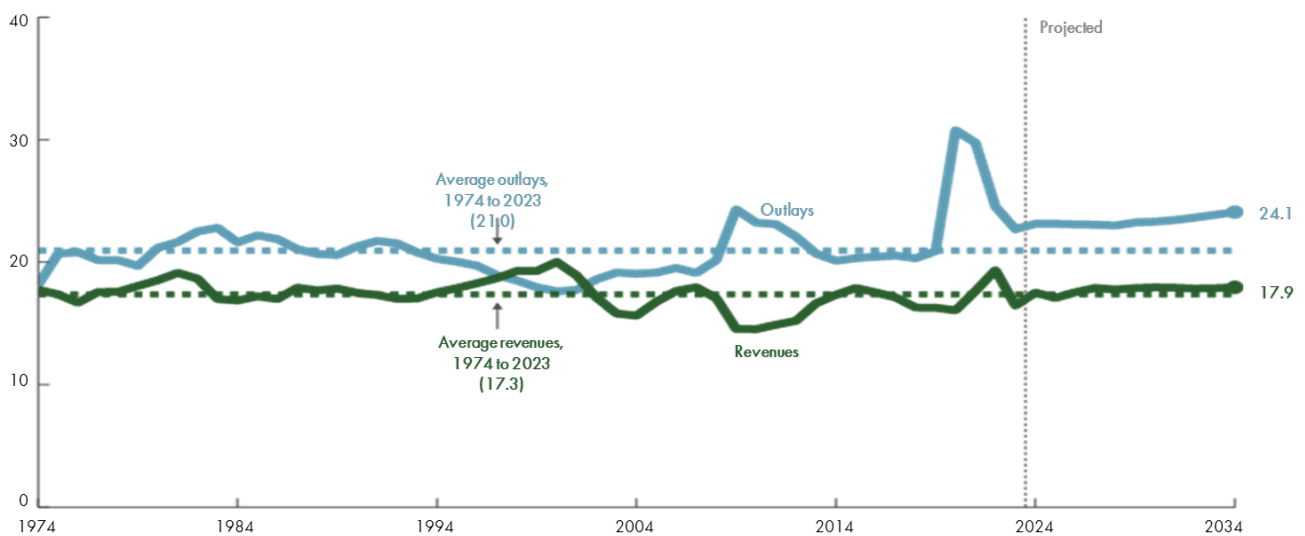
The problem is not a shortfall in tax revenue; revenues are a little higher than historical averages (Chart 8). The near-term problem is that expenditures have risen well above trend, but the larger challenge is that the federal government has become a bigger

Chart 7 Federal Government Interest Payments (\$bil) and as % of GDP, 1947-2024



Source: BEA

Chart 8 Revenues and Outlays, Federal Government, as Pct. Of GDP, 1974-2034 (proj.)



Source: CBO

and bigger part of the economy (Charts 9). There are nearly 200,000 pages of federal regulations, impossible for anyone to follow them all (Chart 10). Greater government intrusion in the economy risks stifling growth and prosperity.

China created the greatest economic advance the world has ever seen, pulling one billion people out of poverty since Deng Xiaoping set China on the path to prosperity, a path paved by capitalism. The Chinese Communist Party has always

maintained strict control over domestic politics, but Deng and his successors freed the economy from the shackles of total centralized control. The result, in just a generation, is an economy that has soared from \$300 billion to \$18 trillion.⁴

But in recent years, China has shifted its policy to favor greater state intervention in the economy by designating certain sectors as national security interests, and by promoting and protecting these industries at the expense of the rest of the economy.

Chart 9 Federal Expenditures as Pct. Of GDP, 1947-2024

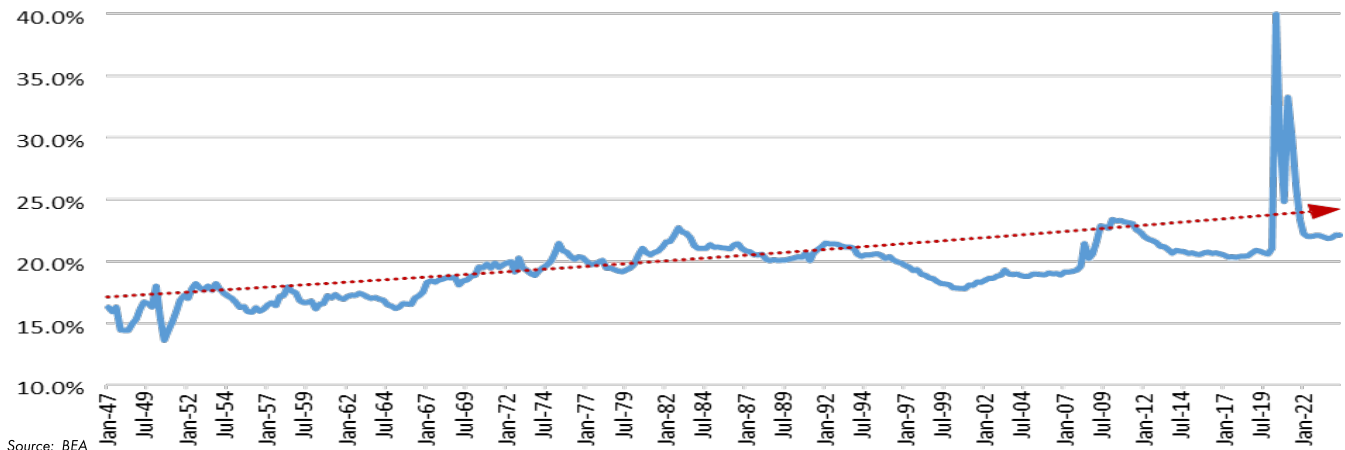
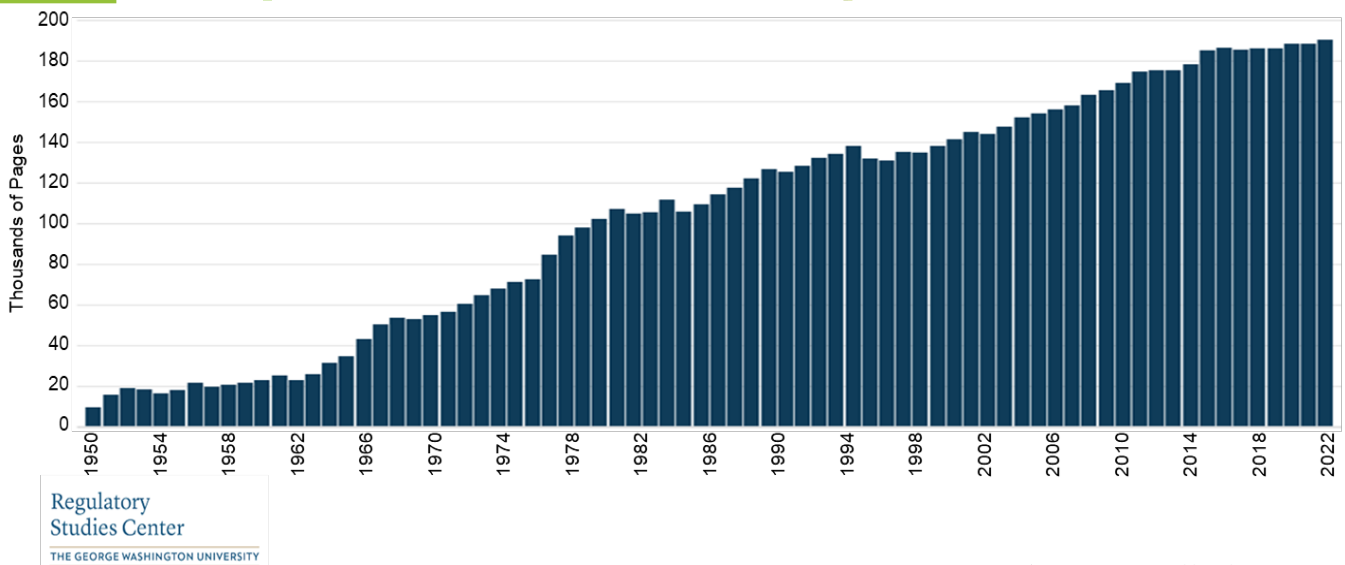


Chart 10 Total Pages Published in the Code of Federal Regulations, 1950-2023



Source: govinfo.gov for the years 2022 and onwards; Federal Register. Statistics for all the prior years

⁴ 1980-2023, World Bank.

The result has been a misallocation of resources on a massive scale. Investment flowed to infrastructure and manufacturing, flooding the world's markets with excess production. This caused prices to drop, and the government responded by mandating even more production to make up the shortfall, resulting in a deflationary spiral. This was precisely what Irving Fisher warned against a century ago, just before the Great Depression took hold.

The excess savings generated by these massive manufacturing exports flowed into real estate as a store of

value. Nearly three-quarters of Chinese living in tier-one and tier-two cities own more than one home, and an estimated one-in-five own more than three homes, according to a survey by Citi Research. There may be as many as 90 million empty housing units in China. But with a population projected to decline by 200 million over the next 30 years, these units may never be filled.

Unsurprisingly, new residential housing has plunged 75% (Chart 11) and consumer confidence has plummeted (Chart 12).

Chart 11 China Property Floor Space of Houses Newly Started Residential, Sq. Meter, MM, 2009-2024



Chart 12 China Consumer Confidence Index, 2000-2024



Source: National Bureau of Statistics of China. Copyright© 2024 Bloomberg Finance L.P.

Chart 13 Shanghai Shenzhen CSI 300 Index, 2019-2024



Source: Bloomberg Finance L.P.

The massive oversupply of manufacturing has blocked the principal path of employment for new entries to the labor force. The youth unemployment rate is over 17% now.⁵ Large numbers of unemployed youth can cause unwanted mischief for governments.

Capitalism created China's wealth. Central planning directed money to oversupplied manufacturing goods. Central planning directed banks to lend money to unneeded projects. Central planning directed savings to real estate that may never be occupied and whose values may never fully recover.

In response to this economic crisis of its own making, last month China unveiled a series of actions designed to boost the economy. Interest rates were cut, downpayments on new homes were reduced from 25% to 15%, and loans are provided to local governments to buy unsold homes and to companies for stock buybacks.

Investors were impressed, sending shares up 27% in two weeks. Of course, this follows a 40% decline over the past 4 ½ years (Chart 13). These actions were welcomed by investors, but the fundamental problem of centralized control of the economy remains. China's economy will struggle unless and until

it reembraces the capitalism that propelled its prosperity in the first place.

Industrial policy is another name for central planning whereby the government intervenes in the market to favor a particular firm or industry through subsidies, tax breaks, tariffs and other forms of preference. It has a long, and generally unsuccessful, history in this country (and even more so abroad).

Saving jobs and "national security" are often cited as justifications for industrial policy actions, but these have often come at a high cost and misallocation of resources. For example, in 2009 President Obama slapped tariffs on tires to protect American tire workers. He did manage to "save" about 1,200 manufacturing jobs, but at a cost of \$1.1 billion. It would have been easier to give those workers \$1 mm each. The tariffs imposed by the Trump administration, and largely left in place by the Biden administration, did not save any manufacturing jobs, did not reduce our trade deficit, but did increase the costs of goods to American consumers.

⁵ It peaked over 21% in June 2023 and the government decided not to report it anymore. They recently revised their data and began reporting it again. Latest date from July 2024. Allegedly.

A recent study⁶ of 18 industrial policies implemented between 1970 and 2020 concluded that industrial policies are ineffective and inefficient when directed at protecting jobs or companies or industries, or contain multiple objectives. The two signature industrial policy actions of the Biden administration, the CHIPS Act and the (wrongly-named) Inflation Reduction Act, will cost more than \$1 trillion over the next decade, and suffer from containing competing goals. For example, recipients of CHIPS Act funds are required to offer expanded access to affordable childcare. The latter may be a worthy goal, but tying it to semiconductor manufacturing risks slowing that development.

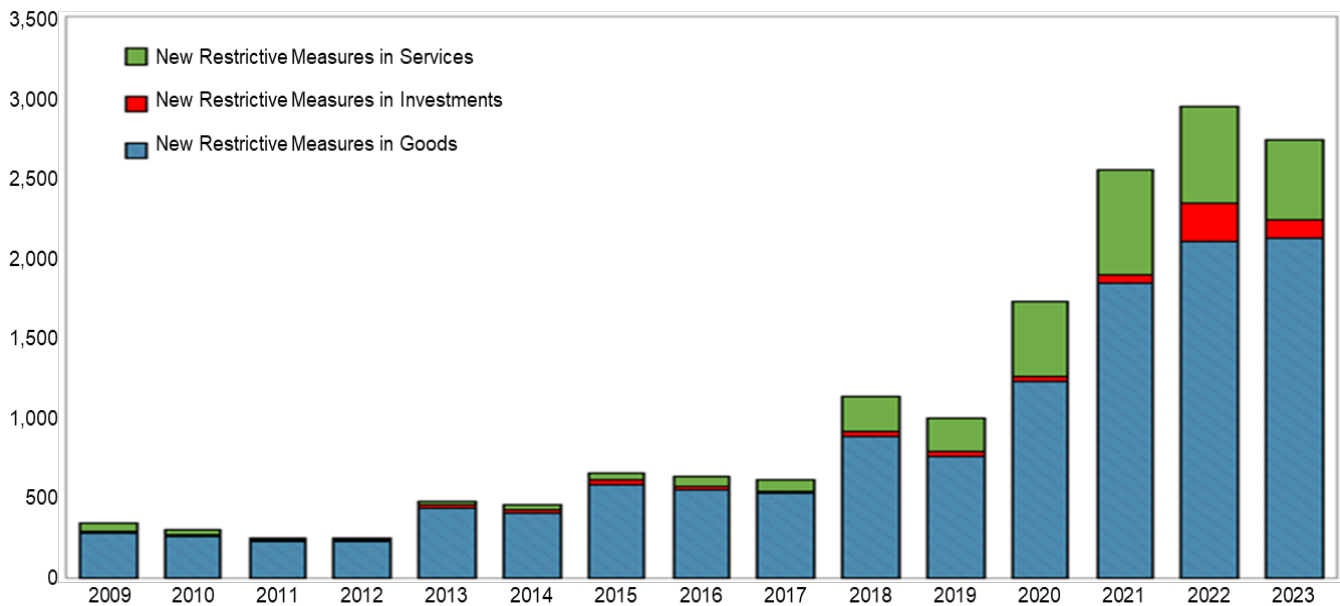
Tariffs are a terrible idea, although that does not seem to stop governments from tripling the number of trade restrictions over the past five years (Chart 14). All evidence points to their costs borne by consumers, and jobs that are “saved” in sunset (declining) industries at enormous cost to taxpayers. The argument for free trade, as David Ricardo laid out more than 200 years ago, is not to create jobs, but to increase wages by

raising the productivity of workers through specialization, what Ricardo called comparative advantage. Opening new markets for trade is far more effective for increasing wealth than imposing barriers to trade.

Industrial policy has had better success when there is a clearly defined goal that is achievable and relies on market competition to implement. Operation Warp Speed, the program to accelerate the development of a COVID-19 vaccine, is a prime example of such a policy success.

By far the most successful policy is funding basic research and allowing the private sector to benefit from these developments. DARPA, the Defense Advanced Research Projects Agency, is the gold standard here, developing technologies that led to the commercialization of the Internet, artificial intelligence, GPS, and many more transformative innovations. American taxpayers have earned an enormous return on their investment.

Chart 14 Number of New Trade Restrictions Globally, 2009-2023



Source: IMF. Global Trade Alert. Note: 2023 includes policies announced through December 6.

⁶ Hufbauer, Gary Clyde and Euijin Jung, *Scoring 50 Years of US Industrial Policy, 1970-2020*, November 2021.

The failures, and successes, of industrial policies, of central planning, are lessons that our political leaders ignore again and again, at significant cost to our welfare. But the failure to learn the lessons of past military mistakes would prove more deadly for the residents of Sedan, indeed for all of France.

Count Alfred von Schlieffen, head of the German General Staff, was tasked with designing a military plan on two fronts, with Russia in the east and France in the west. His plan envisioned a quick strike against France through neutral Belgium, before turning to the east. In August 1914, the Schlieffen Plan was put into action,⁷ and Sedan was the first French town to fall. It remained occupied by the Germans for the next four years.

André Maginot was a career civil servant who entered politics and served as the undersecretary for war. When war broke out in August 1914, he enlisted in the army, and was wounded at Verdun. After the war, Maginot served three terms as Minister of War and advocated for a series of fortifications to be built along the German border, coincidentally (or not) protecting his childhood home in Lorraine. His experience at Verdun led him to believe that defensive fortifications would be effective deterrents in a future war.

Maginot died in 1932, before his plan could be finished, but his series of defenses running from Switzerland to Luxembourg were soon completed. The French now had a secure border against Germany, which they named the Maginot Line in honor of its creator.

The Maginot Line stopped at the edge of the Ardennes, the thick forest of hills thought to be impenetrable. This allowed the French to concentrate their troops along the Belgian border where the Germans had invaded in 1914.



Erich von Manstein, a German Field Marshall, was tasked with drawing plans for an invasion of France. Betting that the French would expect a repeat of the First World War, an invasion through Belgium, Manstein revised the Schlieffen Plan. The Manstein Plan called for an attack into the Netherlands, drawing the French (and the British) north, opening the route through the Ardennes, where the new German Panzer tanks were in fact able to maneuver effectively.

On 10 May 1940, the Germans bombed Dutch and Belgian airfields and captured Rotterdam. Two days later German tanks crossed the Meuse and surrounded Sedan. For three days the town changed hands 16 times before the Germans finally took it. The French government fled Paris that same day, surrendering a month later. The British managed to evacuate 338,000 troops to safety from the port of Dunkirk, including 140,000 French troops.⁸

⁸ By Helmuth von Moltke, the Younger, nephew of Helmuth von Moltke, the Elder, leader of the German victory in 1870.

⁷ The 2017 Christopher Nolan movie, *Dunkirk*, is highly recommended.



Source: Dymetrios

The Maginot Line failed to defend France from a third German invasion because it was based on the flawed assumptions that Germany would attack through Belgium, and that the Ardennes was impenetrable. Germany simply ignored the Maginot Line and won a swift, decisive victory.

The failure of the Maginot Line was a failure of imagination. André Maginot could not foresee tanks maneuvering through the Ardennes. He, perhaps, favored protecting his home region of Lorraine at the expense of the rest of the border. He assumed the last war of

defensive fortifications would characterize the next war. The small village of Sedan, and all of France, all of Europe, the whole world, really, paid the price for this failure.

Investors, too, risk harm by seeing the world through their narrow political, philosophical or emotional lenses. The facts are that the economy is strong, financial conditions are loose, profits are high, and this is as favorable an environment for investing as we are likely to see.

Likewise, politicians are burdening future generations with unconstrained spending, and risk harming the economy by restricting trade and protecting favored companies and industries. These policies have been tried, and have failed, in the past. We don't need more self-inflicted wounds to our economy, our portfolios, or to the good people of Sedan.



André Maginat. Source: Library of Congress



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