November 14th, 2016

Maybe it all makes sense! Maybe it doesn't…

In a word, 'schizophrenic' is how I would describe the action in capital markets last week. How else would you explain a market that rallied +265 points on Monday in anticipation of Hillary Clinton becoming the next U.S. President, after the news over the prior weekend that FBI Director Comey found nothing new in the never ending email drama? Recall that coming into last week the stock market was in the midst of a nine day losing streak on fears that a Trump Presidency was possible (still improbable at the time, but his odds were on the rise). The table was set going into Tuesday's election with all the polls and betting odds assigning high probabilities on the outcome of a divided government and continued gridlock – a mix that history indicates is favorable for capital markets.

As the saying goes, "that's why they play the game".

Then the improbable started to materialize as the election results began rolling in that a Trump Presidency was shifting from improbable to probable, which sent equity futures into a tizzy as the Dow Jones Industrial Average plunged by more than -800 points at one point. But, just to show you how quickly markets react to events and then move on, as was the case with Brexit in June, futures started to rally throughout the morning and by the opening tick on Wednesday, stocks opened higher. The Dow ended the day up more than +250 points in what was an epic 1,000 point swing in the matter of 12 hours (putting to shame the two days it took to digest the surprise Brexit outcome).

The symmetry of this surprise Trump victory with the surprise Brexit outcome over the summer is surreal as in both instances the initial sell-off in stocks was -5% and in both instances the consensus view was unequivocally negative if either of these votes ended up going the way they did.

Is it really that simple – heads I win, tails you lose?

Come on, these gyrations and inconsistent investor behavior attests to a maniac market on medication. This isn't me railing for or against the outcome, but the narrative drift pouring out of all the talking heads on bubble vision trying to explain to people why markets are reacting the way they are to an outcome they said going into it would have had the exact opposite market reaction is beyond humorous.

Undoubtedly, I too can see the positive potential impact on the economy from a pro-growth / pro-business Republican policy agenda – deregulation, tax cuts for everyone, and don't forget the yuuuge infrastructure spending package. But, don't you think a little restraint and reflection is warranted before we get too far down this road to nirvana?

After all, how strong is Trump's mandate when he actually lost the popular vote count to Hillary? What's more is that of the 129 million people who voted, 70 million didn't vote for him. Not to mention that at least half his vote was an anti-Hillary vote and he carries into office an unprecedented near 70% 'unfavorable' rating. Fully four million fewer voters showed up at the ballot stations compared to 2012 and in what has to be considered a subtle shade of irony, Trump took in 1.6 million fewer votes than Romney did in 2012. Look, the issues and populist movement going into this election were very much consistent with the issues that ignited the U.K. voters to want to exit the Eurozone: a walking back on globalization, anti-immigration, and a loss of trust and confidence in government's responsibility to adequately represent the citizens they were put in office to represent. While this movement has been afoot for decades it really gained traction during this economic expansion as it benefitted the few at the expense of the many. We have the second strongest bull market in the history of the U.S. stock market, yet it is occurring on the back of the weakest economic expansion in the post-WWII era. What's more is that the top 10% of wealth holders in the U.S. own nearly 85% of all financial assets.

So you see, this is a recovery that has been significantly skewed toward the 1- and 5- percenters, with the ninety-five percenters wondering why things are so tough for them. You need look back no further than the last two recessions to gain some perspective for why the discourse is reaching such a fever pitch today. In the aftermath of the popping of the Tech bubble there were significant job losses and ample displacement among individual security and confidence. But, in that time of shared stress the average Joe saw some of the perpetrators that drove that bubble persecuted for their transgressions: Enron executives were thrown in jail, Wall St. analysts were arrested, and dotcom billionaires lost their fortunes. It was a difficult time, but it at least left the impression that the hardship was shared across the income and wealth strata.

However, when reflecting on the fallout from the Global Credit Crisis back in 2008, it's more challenging to come to a similar conclusion that the financial adversity and displacement was equally distributed. Recall in the '08 financial crisis how the government inserted itself into the game of selecting winners and losers, and as a result decided to bail out the banks with billions of tax payer dollars. Let me be clear in my view that I think the bailouts were necessary as the financial system was on the brink of collapse, but unlike in the popping of the tech bubble – nobody went to jail, asset markets were saved, and many of the bankers who got rich on the mortgage bubble stayed that way. All the while, the ninety-five percenters saw nearly eight million jobs lost, countless home foreclosures, and all the pain and misery that accompanied that financially distressing period.

Since the beginning of time there has always been a populist undertone to our politics: the rich against the poor, the elites against the non-elites. There has always been a distrust of government and an undertone of skepticism, but we needed a catalyst to push us back into a populist mode. My view is that since the turn of the century, where the U.S. has endured two recessions, median incomes that are no higher today than they were in 1999, and the view that for the first time ever the next generation will be worse off than the one that came before it represented the matches to ignite this movement.

This is a real world phenomena that needs to be accounted for when making assumptions and forecasts about the future. Did anyone else find it interesting that the likes of populist leaders from around the world like Marie Le Pen in France, Theresa May in the U.K., and populist flag-bearers in Hungary and the Netherlands were some of the most enthusiastic voices praising President-elect Trump's victory?

Look, I'm not playing politics here as I'm impartial to which side of the isle anyone falls on. For me and this job, it's about the policies and how they impact economies and asset prices. In that regard, likely one of the most significant and welcome capital market developments of this election was the fact that the Republican Party took both branches of Congress as well as the Executive branch. The historical data speaks for itself on this issue, where there has been 13 occasions with one Party control (10 times for the Democrats and 3 times for the Republicans). During these united government periods GDP growth was higher which correlated with higher annualized returns in the equity market.

One logical reason for this superior performance in the economy and stock market in prior periods is likely the result that the government is able to get more done with a united front than it is able to do with gridlock. In my opinion, this is what markets were reacting to this past week – a walking back of a host of regulations on businesses, pushing through massive fiscal stimulus, and tax reform both on the corporate and individual level. Expectations are that these changes will lead to economic growth increasing to +3-4% (the higher end of the range is a level the U.S. economy hasn't seen for over a decade). Moreover, this will finally get us out of the deflationary glut that has hampered the global economy since the Global Financial Crisis – a feat the central banks have been aggressively trying to achieve for years.

But let's get back to The Donald for the moment and take a bit more measured look at what it may mean going forward as I think it is very hard to predict the path of U.S. policy from here. Thus far, everything on the surface appears very amicable and cordial – from Trump's presidential acceptance speech to Hillary's concession speech which exceeded expectations and removed any doubt that the election results would be contested. Then Speaker of the House Paul Ryan said all the right things and gave the impression that any previous tension or difference of opinion he had on issues with President-elect Trump are in the past and Congress is ready to push forward with their responsibility to govern under a Trump Presidency.

As a result, the wide spread anxiety of Trump being unpredictable and a wildcard vanished like a bad dream in the middle of the night. As cozy and loving as this honeymoon period looks from afar, wouldn't you think that it's a bit premature to expect him to move towards the center on day one of his term? After all, he is unlike any politician we've ever seen – this isn't to imply that he can't be great, please don't misconstrue my skepticism. But this is a guy that defied all the odds throughout the entirety of this election cycle. Why should he tack to the middle? What benefit does he get from not doing exactly what he said he would do to get himself elected?

Mind you, some of these measures were pretty extreme and only a week ago viewed by the markets as being extremely negative for growth and asset prices. Have a look at his 100-day action plan:

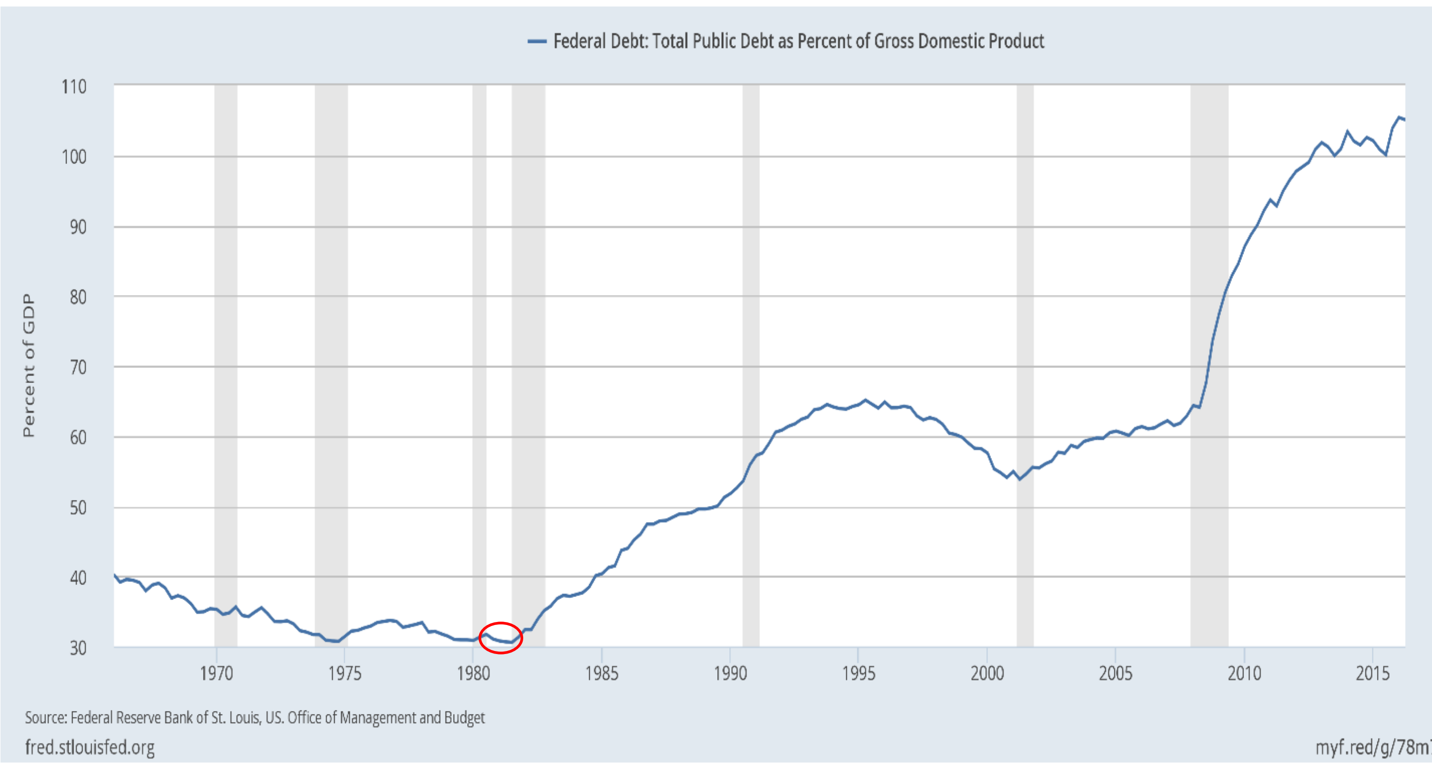
- Among other proposals, Trump says he will declare China a "currency manipulator", renegotiate or withdraw from the North American Free Trade Agreement (NAFTA), and withdraw from the Trans-Pacific Partnership (TPP).
- Trump proposes "removing the more than two million criminal illegal immigrants" and "suspend[ing] immigration from terror-prone regions where vetting cannot safely occur."
- He also says he will construct a "wall on our southern border with the full understanding that the country of Mexico will be reimbursing the United States for the full cost of such wall". He has also proposed to introduce many other restrictions on immigration.
- Trump has said he would not reappoint Fed Chair Yellen when her term ends in February 2018. Trump will also have the opportunity to reappoint Fed Vice Chair Fischer in June 2018 and select nominees for two vacancies on the Board, potentially leading the Fed to be more hawkish.

Let me say it again – I'm not approaching this from a political viewpoint, but rather just trying to execute a little more diligence and thought when framing a view on the short and long-term implications for the economy and capital markets.

Perhaps you're wondering as much as I am how in the matter of a twelve hour interval a President-elect and his policies can go from the view of market panic and setting off the next global recession to being an economic savior that will rival FDR and Ronald Reagan.

I get it, I do – the enthusiasm, excitement, and hope that accompanies change, but can we please table for now the comparisons to these highly accomplished leaders until we have something to compare them on? One thing FDR, Reagan, and even Obama had going for them prior to when they took office was an economy that was near or at the worst parts of their respective downturns or bear markets. Things are just the opposite today – let's compare and contrast the economic set-up between when Reagan took office in 1981 and today.

Starting with all the hoopla over this yuuuge infrastructure and fiscal stimulus plan (estimated to be $1 trillion over ten years) – where is the money going to come from? Back in 1981 the debt-to-GDP level in the U.S. stood at 30% which provided ample room for Reagan to ramp up government spending and cut taxes without having to worry about bankrupting the nation. Debt-to-GDP is at 105% currently with the budget deficit widening last year for the first time since this expansion began back in 2009.



Let's not forget that this election brought with it a Republican sweep – this is a party that is perceived to have fiscally conservative views, especially when it comes to the country's burgeoning debt levels. It's more than a bit ironic that while on the campaign trail Trump railed against President Obama for raising the federal debt level by over $8 trillion during his eight years in office while estimates of Trump's tax cuts and spending policies indicate that federal debt will increase by $11 trillion over a full two terms. What will be even more interesting is President-elect Trump having to go cap in hand to Congress in March (only two months into his Presidency) and ask them to increase the debt ceiling – a feat that over the last four years has proven to be a very contentious issue under a gridlocked legislature.

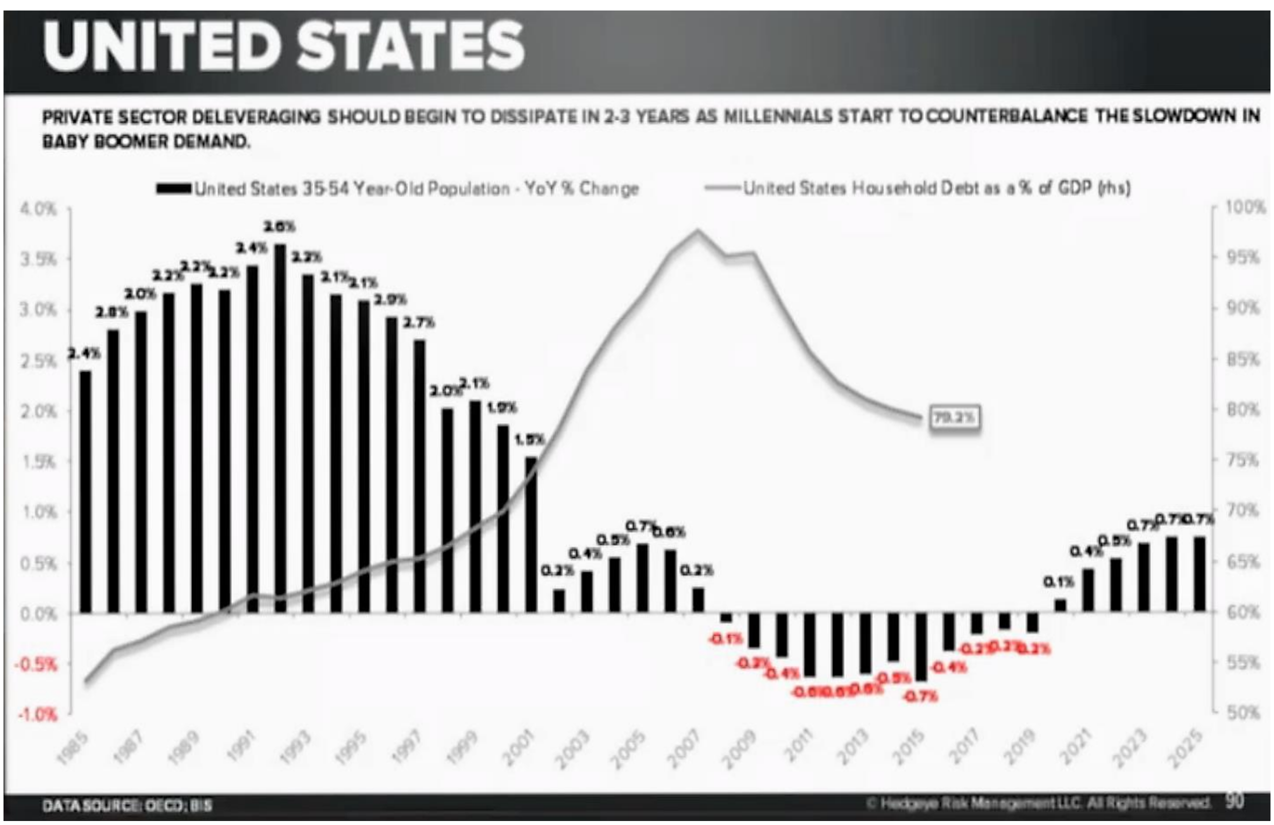
Look, the economics are what they are. President Obama tried a "shovel" ready fiscal stimulus program back in 2009 which failed miserably to move the needle. Why? Because the fiscal multiples for an economy that is already highly leveraged – which was the case back in 2008 with debt-to-GDP already approaching 80% – are vastly different than in an unlevered economy. This is the same sort of situation the economy is dealing with as it pertains to the efficacy (or lack thereof) of monetary policy when interest rates are at the zero-bound.

There was no greater decade for infrastructure spending than the 1930's when the U.S. was trying to work its way out of the Great Depression. And guess what? It was World War II that got us out of the era of paralysis – not the construction of the Golden Gate Bridge, Lincoln Tunnel, or the Hoover Dam. Eisenhower rolled out the country's highway infrastructure in the 1950's and even that didn't forestall three recessions from occurring under his watch.

So color me a skeptic on the idea that infrastructure spending is the panacea markets are thinking it will be – if that was the case then Japan wouldn't be smaller today than it was 25 years ago and China would be back to growing at 12% instead of sub-7%.

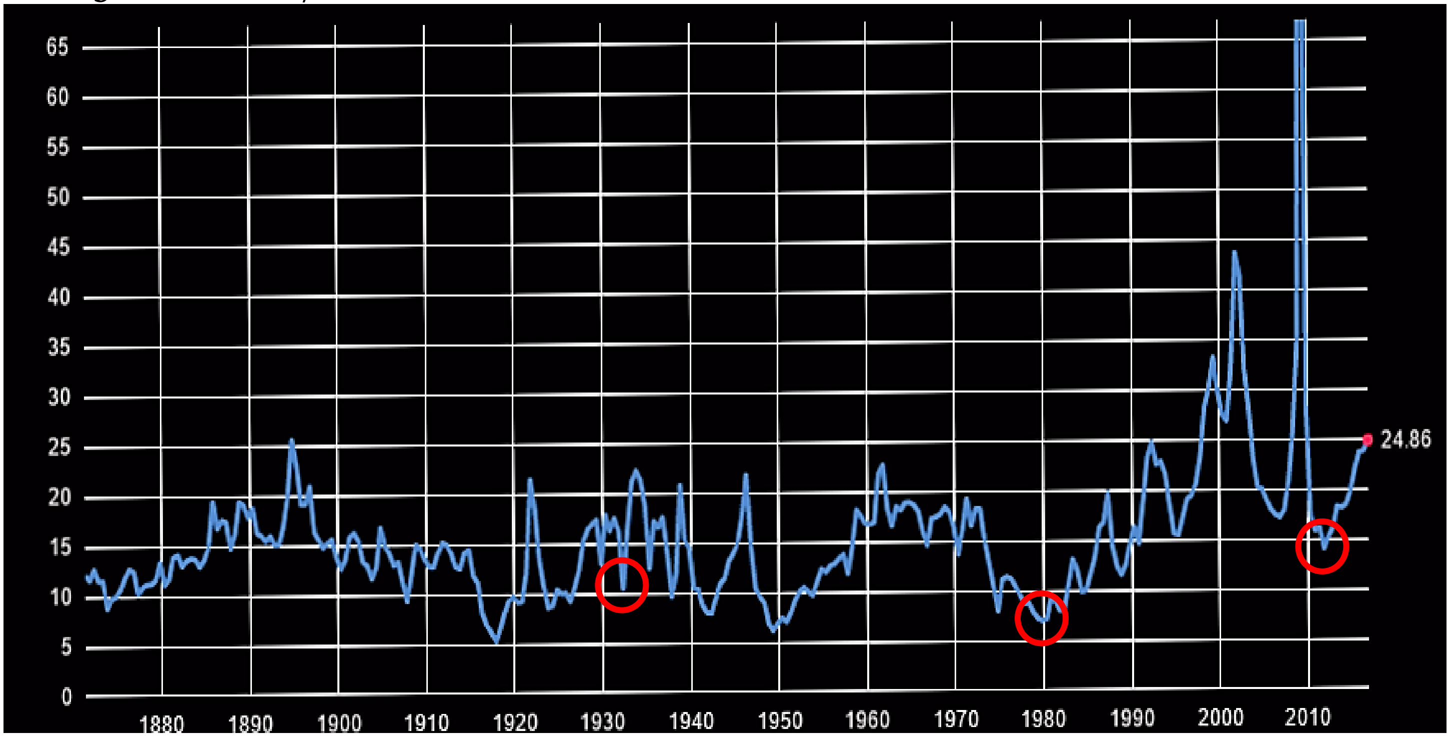
Another big difference today versus the early 1980's when Reagan was getting set to take office is the demographic make-up of the U.S. Back then the oldest of this huge demographic 'pig in a python' we call the baby boomers was just reaching the ripe age of 34 (the youngest of the boomers was turning 16). So the decades of the 80's and 90's had this structural tailwind where an 80 million strong population pool was transitioning into their peak spending and earnings years. The demand on the U.S. economy to create, build, and serve this population pool was the biggest the U.S. has ever seen. The below chart dates back to 1985 and shows the year-over-year change in the growth of the 35-54 age cohort for the U.S., where it's not a coincidence that growth went negative in 2008 and will remain a headwind until about 2020.

The oldest of the baby boomers turned 70 this year, and every year for the next fifteen-years there will be roughly 1.5 million other boomers joining the ranks – a stage of life where spending and consumption habits are drastically different as will be the needs and demands on society.



The last major difference I want to highlight is the valuation level in the stock market between then and now. Heck, you can lump FDR, Reagan, and even Obama into this category where one of the commonalities when all these Presidents took office was not only an economy was nearing the worst of its downturn, but also a stock market that was in the midst of utter dislocation. None of them were taking the office with the market having just tripled, as is the case for President-elect Trump. As is highlighted in the chart below, both FDR and Reagan had the benefit of a stock market that was trading at a historically low P/E multiple whereas President-elect Trump is inheriting a stock market that on many metrics is one of the more expensive in history.

1: S&P 500 Historical P/E



What I'm really trying to get at is that there is still a whole lot of unknowns, yet investors and markets are reacting in neurotic fashion as if it is all so clear. Frankly, I lack the confidence at the moment to conclude that a policy agenda that only a week ago would all but assure a global recession is all of the sudden the cure to all that ails the U.S. Like many, I'm hopeful, but as the steward of other people's capital I know that hope isn't a prudent strategy.

If there is anything we've learned over the years when it comes to politics, it's that there is a difference between campaign promises and actual policymaking once elected. However, we also know that many of Trump's policies have not been detailed beyond broad proposals. As a result, below is a list of questions I have which number too many unknowns for me to rush to judgement:

- Maybe the surprising spike in interest rates on the premise that growth and inflation are sure to increase as a result of a Republican sweep will prove to be the right assumption…
- Maybe there will be no payback to eight years of massive central bank intervention around the globe, where global asset markets prior to Trump's victory expected a very gradual and drawn out rising interest rate cycle…
- Maybe a four standard deviation price move in U.S. Treasuries in one week will not impact the rest of the credit channels that price off of this market…

- Maybe Trump's base will be fine with him not building a wall across the entire Mexico border, (according to his 60 Minutes interview, some of it will be a fence), trimming the number of deportees to 2-3 million from 11 million per his campaign, and not hiring a special prosecutor to 'throw Hillary in jail' – all extreme talking points that sold well on the campaign trail, but are being walked back after the election results…
- Maybe the start of unwinding more than four decades of progress towards globalization, free trade, and lower inflation will ultimately make for a stronger and healthier U.S. economy…
- Unlike the beginning of the year where stocks got off to their worst start to a calendar in U.S. history on the fears of a U.S. dollar bull market and higher interest rates – maybe this time it will have minimal impact on the $10-$13 trillion in emerging market dollar denominated debt…
- Maybe NATO, the UN and other multinational institutions don't matter anymore
- Maybe EU countries will need to defend themselves against Russian aggressions soon without help from the U.S. or the U.K…
- Maybe Europe will pivot towards China and Russia in the next decade…
- Maybe the U.S. and the U.K. will sign a free trade agreement…

You get the point. *Maybe* we should just sit back and let the dust settle before making investment decisions with other people's money on narratives that are still not yet fully fledged out.

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