Insights: December 2016

Market Overview and Performance

As you know, we dedicated the entirety of last month's Insights letter to the election and the possibility that Donald Trump might actually defy all odds and claim victory. Lo and behold, Donald Trump is now in the words of *Time Magazine*, "The President of the Divided States of America". While this year's Presidential election was extraordinary in many regards, contentious and acrimonious challenges for leadership are part of the bedrock of the American electoral system. As Alexis De Tocqueville wrote in his extensive analysis of American politics and society almost 200 years ago in *Democracy in America*, "…As the election draws near, the activity of intrigue and agitation of the populace increase; the citizens are divided into hostile camps, each of which assumes the name of its favorite candidate; the whole nation glows with feverish excitement; the election is the daily theme of the press, the subject of private conversation, the end of every thought and every action, the sole interest of the present. It is true that as soon as the choice is determined, the ardor is dispelled, calm returns, and the river, which had nearly broken its banks, sinks to its usual level..." It would seem however that in this particular election year, ardor has not been dispelled and the proverbial "river" will take a longer time to return to its usual level. Even with a Trump administration poised to take over the reins in just a matter of weeks, we still know very little about what the future will look like. Regardless of one's opinion, there really is no alternative other than to root for his success and therefore the success of the United States.

As always, thank you for reading our latest Insights.

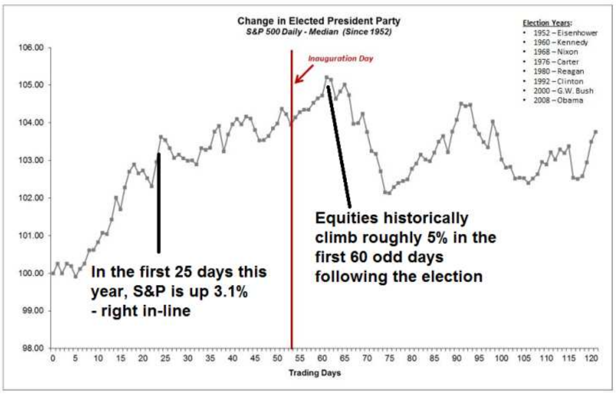
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	3.70	9.79
Russell 2000 Index	**11.15**	**18.00**
MSCI EAFE Index	**-1.99**	**-2.34**
MSCI Emerging Markets Index	**-4.60**	10.94
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-2.37**	2.50
Barclay's U.S. Credit Index	**-2.73**	4.99
Barclay's Corporate High Yield Index	-0.47	**15.01**
Barclay's Municipal Bond Index	**-3.73**	**-0.92**
Macro Measures		
Gold	**-8.07**	10.66
Crude Oil	5.53	**33.48**
CBOE Volatility Index	**-21.86**	**-26.80**
USD Dollar Index	3.22	2.82

Current Theme – Hope for Trump to Deliver

Markets Rotate Based on the Campaign Trail Promises

As President-elect Trump would surely tell you, he is a winner! And despite the research we had done leading up to the election which suggested he had a fighting chance of stealing the election away from long-time favorite Hillary Clinton, we were surprised. But even if we had had perfect information, knowing ahead of the election that Trump would win, our positioning would have proved completely wrong. And we would not have been alone. Without fail, every strategy piece we read leading up to the election suggested that the most detrimental outcome for the markets would be a Trump victory and Republican sweep which would lead to a 10 percent fall in equities and a flight to the safety of bonds and gold. Well, that didn't happen obviously.

Stocks Historically Rise for 65 Days after Party Change

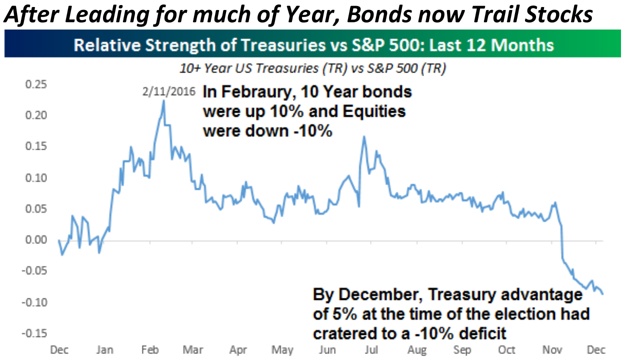


Source: Renaissance Macro Research

Technically it did, with stock futures tumbling over five percent as the reality of Trump set in. However, that reaction only lasted for a matter of hours in overnight trading. By the time the markets opened on the morning of the 9th, stocks traded up and bonds traded down, effectively shutting out any opportunity for the average investor to take advantage of the pullback. And the trend has run almost unabated ever since. However, it helps to put things in perspective. First, with regard to equities, in the first 25 days after the election, which brings us to December 2nd, the S&P climbed a little over 3.1 percent. This is completely in-line with virtually all Presidential cycles' "honey-moon period" as Renaissance Macro puts it.

Second, not all asset classes have magically floated higher. The gains seen in equities have come at steep price for bond holders. Consider the following chart.

After Leading for much of Year, Bonds now Trail Stocks

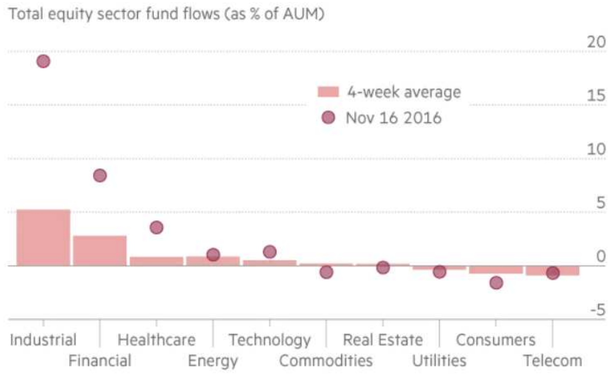


Source: Bespoke Research

During much of 2016, bonds had handily outpaced equities. In fact, earlier in the year equities had fallen over -10 percent while bonds had risen by over 10 percent resulting in a relative performance gap of over 20 percent as seen in the chart above. However, if we fast forward to the post-election period, in the last four weeks bonds have fallen roughly -7.5 percent while equities had climbed roughly 3.5 percent resulting in a relative gap of over 10 percent. This has implications which we will expand on shortly.

Third, the Trump rotation was not just limited to stocks versus bonds. If we look to sectors, again we see the theme that "not all boats" have been lifted.

Investors Piled into Pro-Trump Sectors in November



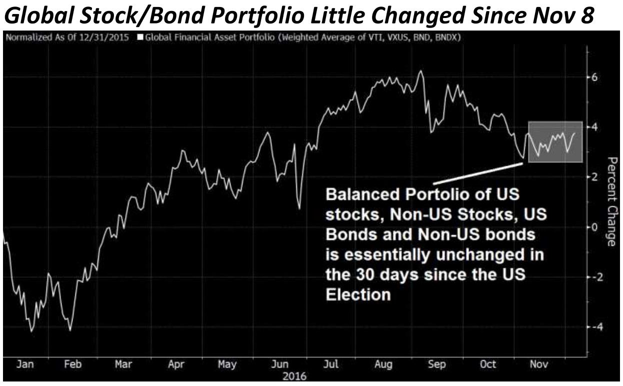
Source: FT.co; EPRH; Haver Analytics; Barclay's Research

As you can see from the chart above, investors not only moved money out of bonds and into equities, but they also moved it out of traditionally defensive and higher yielding sectors such as Telecomm, Consumer Staple and Utilities and plowed funds aggressively into the Industrial, Financial and Healthcare sectors. This was logically based on the belief that Trump will preside over an era of fiscal spending and higher interest rates. We should note that as of this writing in early December, the energy sector has also surged on the announcement of an oil production cut by OPEC on November 30th. At same time, the healthcare sector has been hurt by Trump's very Hillary Clinton-like proclamation that, "I am going to bring down drug prices; I don't like what's happened with drug prices".

Fourth, the rally in stocks has been a good deal narrower than financial headlines would lead you to believe. The Dow Jones Industrial Index for example has climbed 1200 points or roughly 6.5 percent over the past month, a sizable gain in such a short period. However, since that index is price weighted, meaning the highest priced stocks hold the greatest weight, almost 50 percent of that gain can be attributed to just three stocks that happen to fit nicely into the Trump policy narrative: Goldman Sachs, UnitedHealth and Caterpillar. Together they have accounted for 565 points out of the 1200 total gain.

In sum, what we are speaking to is the idea that many investors have the feeling that, "Everything I hear and read is telling me that markets are at all time highs, but my portfolio doesn't feel like it.." That's because in most cases, its not. The chart below in part helps to explain this sentiment. Very few people hold their entire portfolio in just Dow equities for example or even an S&P 500 Index fund as their only investment.

Global Stock/Bond Portfolio Little Changed Since Nov 8



Source: Bloomberg; Orcam Financial

Investors are much more likely to hold a more diversified portfolio and as the graph below illustrates, a broadly diversified global stock and bond portfolio has been virtually unchanged since the election. Even if one were to just look at Vanguard's US 60/40 Index fund, the November return was only 1.6 percent.

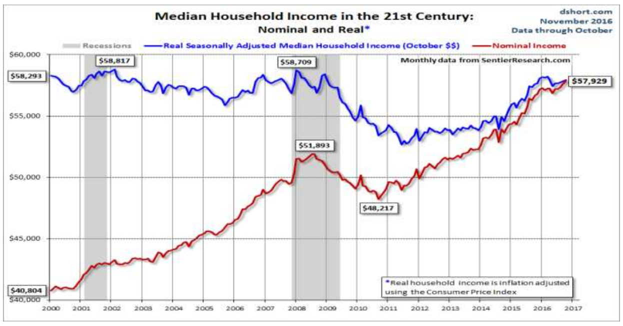
While this market context is important, it is still in essence, "water under the bridge". As many have observed, Donald Trump somewhat ironically ran on a campaign of fear over a continuation of the status quo rather than hope about the future. Now, he (and the broad market it seems), are asking that we put our hope in the belief that he can deliver on his promises. Well, hope is not a strategy as they say, so it's only fair to ask a man like Trump, "What are you going to do for me?" Let's take look at what he is actually inheriting and needs to fix.

Wealth Has Been Funneled Away from Most Americans

Source: Bof A Merrill Lynch Global Investment Strategy; Saez & Gucman

As has been well analyzed at this point, Trump won a wave of support from Americans who feel they have been left behind. As you can see above, the increase in wealth accumulation has been disproportionate. There is also a very similar chart demonstrating how globalization of trade and a strong US dollar has essentially funded the growth of the middle class in emerging markets at the expense of the U.S. Having the living standard across the globe climb higher is undoubtedly a good thing and if the global economy is chugging along everyone should theoretically benefit from the overall growth. But the global economy is not lifting all boats. Median household incomes in U.S. while rising 42 percent over the past 16 years in nominal terms, have actually declined by -0.6 percent over that time as the this chart from Doug Short highlights.

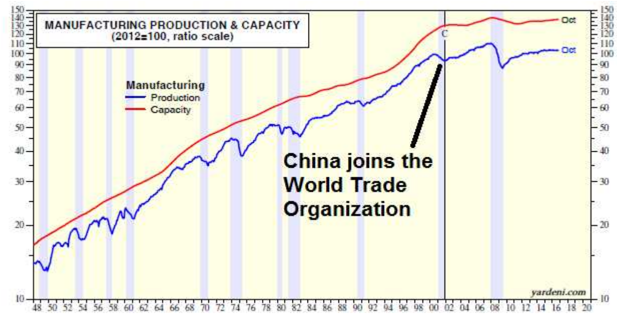
Median Household Income Has Declined in Real Terms



Source: Doug Short

This is exactly the type of frustration over what many felt was real world stagnation that Donald Trump successfully tapped into. And he very keenly played into the populist notion that this is all China's fault. It is in fact, easy to craft this argument, but as usual, there is a very big caveat.

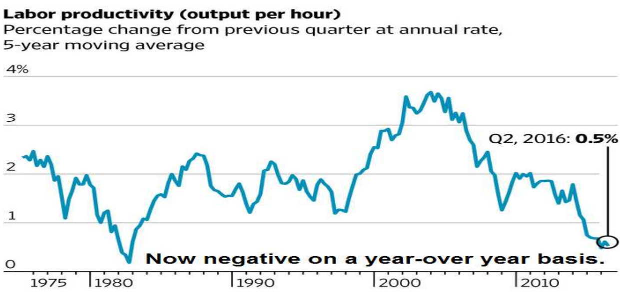
China's Impact on US Manufacturing has been Real



Source: Ed Yardeni

As you can see from the chart above, US manufacturing production and capacity grew steadily from post World War II until 2001 at which point China joined the World Trade Organization and large segments of manufacturing were moved to cheaper areas of the globe.

Labor Productivity Decline is now Negative Yr-over-Yr



Source: Real Clear Politics

As the pervious chart shows, the effect of those moves has been a steady decline on labor productivity over the past 15 years. And as a populist like Trump will tell you, this is why wages have been flat. (In reality, the real reason closer to the truth is the fact that technological innovation over the past 15 years has not required nearly the amount of investment that was once required for manufacturing).

And now as for the caveat to this populist rhetoric – the US consumer has benefitted enormously from the increase in global trade. The prices for must-have items for Americans like iPhones, sneakers and jeans are half of what they would cost if they were manufactured in the United States. And this brings us to the realities of what enacting the Trump promises would entail and their consequences.

At the most simplistic level, Trump has talked aggressively about imposing tariffs on goods made overseas and sold into the U.S. To start with, studies have repeatedly shown that it is cheaper to provide income support and re-training capabilities to workers who have been harmed by globalization than it is to impose tariffs, force domestic production, and suffer through the resulting price increases.

More specifically though, Trump's announced intention of placing a 45 percent tariff on Chinese goods and a 35 percent tariff on Mexican goods is fraught with danger. The Peterson Institute for International Economics has estimated that this would cost the U.S. 5 million jobs and would push the U.S. (and likely the Globe) into recession. Others have reached similar conclusions. How you might ask?

The short answer is this – punitive trade tariffs placed on trading partners would lead to swift retaliation on U.S. goods and services, U.S. exports and imports would shrink, import prices would rise, stock prices would fall, investment would rapidly decrease and a recession would result.

That's just hyperbole the populist would counter, only a worst case scenario. Fine. Let's assume things don't quite go that far. Let's assume that tariffs are imposed but are not nearly to the level Trump imagines, maybe only a third of the numbers he throws out.

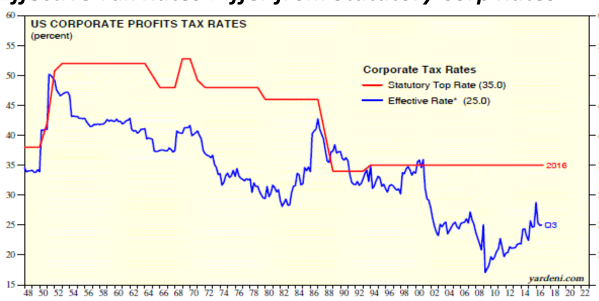
Barclay's, Citigroup and others have looked at his scenario as well. Estimates are for a drag on U.S. GDP of anywhere from 0.5 to 1.0 percent on GDP next year if these policies were implemented. Why? Because, assuming countries like China and Mexico stood by and let the tariffs happen and everyone plays nice, their immediate response would be to simply increase prices. Input goods become more expensive and U.S. companies, acting to protect their profits, would raise prices they charge customers.

Importantly, this would be a price increase due to an "exogenous shock" in economic terms, not an increase fueled by an expanding economy where wages go up as well. The punch line is that the disenfranchised base of Trump support would suffer the most since prices would rise while their wages wouldn't.

What if everyone chooses not to play nice? In a more dire scenario, China and others could choose to not only rebuff the U.S. efforts at tariffs, but to further decide to turn punitive against the U.S. A trade war. China could easily kick things off by letting their currency devalue further relative to the U.S. dollar, thus making Americans exports more expensive. They could follow this up by restricting the supply of goods that flow into the U.S. driving prices up even further. Other nations would have little choice but to follow suit, all at steep cost to U.S. consumer.

What about taxes the populist might ask? If Trump cuts taxes surely it would stimulate growth in the U.S.? Taxes cuts are undoubtedly a good thing for both individuals and corporations, but again, a bit of a caveat here. The populist argument would tell you that if you reduce corporate tax rates, companies will use the windfall to invest in future growth.

Effective Tax Rates Differ from Statutory Corp Rates



Source: Ed Yardeni

As the previous chart shows, the effective tax rate company's pay now is much lower than the statutory 35 percent. If Trump closes off the credits and reductions that allow them to get to this lower level, the real impact might be a bit of a wash. And incidentally, companies have a very well entrenched tradition of using free cash flow to reduce debt rather than invest in growth. Add if monies are used instead for M&A for example, the proceeds would flow to the 1 Percent, not to the Trump voter base.

We write all of this to emphasize that right now "The Market" seems to be all-in on the hope that Trump can deliver on what he says is possible. There are some very real and creditable obstacles standing in his way, but as we said in our opening, there is no alternative to rooting for his success.

Two quick charts to leave you with: U.S equites are now at peak valuations levels last seen in 1929, 2000 and 2007. We are now beyond 2007.

Equity Valuations are at Historically Extreme Levels

Source: Robert Shiller

Societal Generale highlights this as their "scariest chart" – global uncertainty is at its highest level ever, yet credit spreads, a measure of risk, remain subdued.

"Scariest Chart I Have Seen in a Long Time"

Source: SG Cross Asset Research/Credit; BBD

Going Forward

As we have discussed, despite what short-term market behavior would suggest, there is very little in Trump's policies going forward that can be viewed with any certainty. That being said, as an investor, one has to look at the higher probability of events occurring and invest accordingly until facts change. Therefore, we are in the process of periodically allocating a portion of the cash balance in our portfolios to areas that would benefit from a suggested "Trumpenomics" agenda. Namely, we have added to value sectors which have underperformed for quite some time and stand to benefit from a fiscally simulative environment in the United States. One key element we will be monitoring however, is the fact that Trump has a good deal of momentum to implement his agenda items within the first 100 days of his Presidency. If he fails to deliver or creates more disruption internationally, the "Trump Rally" could easily run off-track by end of the first quarter of 2017. If that indeed turns out to be the case, we would then adjust positioning accordingly once again.

Within equities we continue to favor the large cap segment of the U.S. market specifically within the financial, industrials, and energy sectors which would benefit from a raising interest rate environment, fiscal spending on infrastructure and a lower corporate tax environment. While the technology and healthcare sectors have been out of favor since the election, the prospect of a tax holiday allowing them to re-patriate billons in cash sitting overseas could potentially unleash a tremendous wave of mergers and acquisitions. We therefore continue to favor those areas as well. Although small and mid cap stocks are well positioned to benefit from Trumpenomics' domestic growth bent, that area of the stock market has become notably expensive. We would wait for a more attractive valuation levels before adding to exposure.

Equity markets outside of the U.S. have underperformed significantly in 2016 and therefore may present an area of focus for 2017. Despite unresolved debt issues in various countries and the ongoing precarious banking situation, economic data within the Euro Area has shown signs of resilience and with continued accommodative policies in place, Europe could present an opportunity as we look to next year. Particularly if we get an increase in inflation that policy makers have sought for so long. Again this is highly dependent on what transpires with Trump policies. If protectionist tariffs lead to trade and currency wars, the environment overseas could quickly turn challenging from an investment perspective. This view holds true for our Japan exposure as well. After an extended period of underperformance, emerging markets are intriguing, however, the prospect of a strong US dollar and rising borrowing costs going forward are significant headwinds so we would prefer to monitor before adding to exposure.

As November clearly demonstrated, traditional fixed income is in fact vulnerable to periodic declines. As interest rates look almost certain to climb throughout 2017, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. With the recent sell-off after the election we feel that the opportunity in the muni markets is very attractive at present with reasonable valuations and compelling yields.

With the announcement of an OPEC production cut in late November, the price of oil has seemingly stabilized around $50 and could potentially climb in 2017. That is a good backdrop for energy companies. Industrial metals have been aggressively bid higher since the election in anticipation of infrastructure spending. Proof of implementation will be needed to push this area of the commodities market higher. Despite what we and others would have presumed, gold has sold off meaningfully since the surprise of the election. Given the macro outlook of a rising interest rate environment and a strong U.S. dollar, we are not buyers of gold for fundamental reasons. However, we have maintained a small position in certain portfolios as a hedge and have used to the recent pullback in the price of gold to add to positons when appropriate.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.