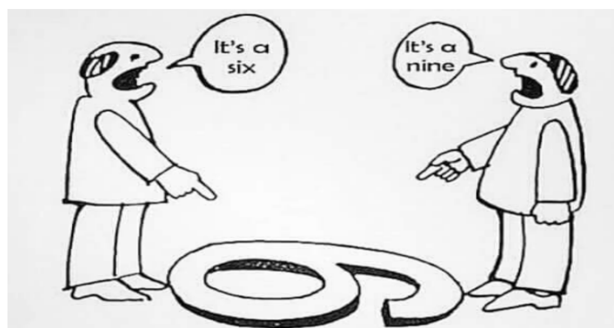
Insights: February 2017

Market Overview and Performance



For the third month in a row, we have no choice but to devote our Insights letter to the topic of Donald Trump. There is simply nothing else even remotely as relevant on a number of fronts. As we enter the third week of the Trump administration, very little clarity has emerged and the narrative of what Trump represents remains divided. On the policy side, supporters continue to view the President as a force to disrupt the status quo which has left the country stagnant. Detractors see a man who is unqualified at best and dangerous at worst. The market view is equally divided. The bullish case strongly holds the belief that tax reform, deregulation and fiscal stimulus will unleash a U.S. growth boom while bears fear that protectionism and trade wars will bring global growth to an abrupt halt. Of course both perspectives hold some element of truth. While markets remain well behaved (with surprisingly low volatility), the "Trump Trade" has in fact been in stall mode since mid December. Whether the next move is higher or decidedly lower remains to be seen.

As always, thank you for reading our latest Insights.

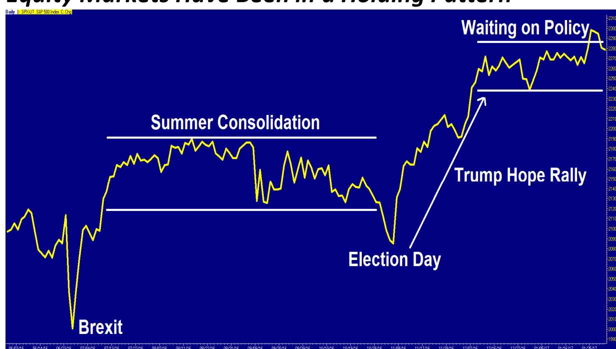
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.90	1.90
Russell 2000 Index	**0.39**	0.39
MSCI EAFE Index	**2.90**	2.90
MSCI Emerging Markets Index	**5.47**	5.47
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.20	0.20
Barclay's U.S. Credit Index	0.34	0.34
Barclay's Corporate High Yield Index	1.45	1.45
Barclay's Municipal Bond Index	0.66	0.66
Macro Measures		
Gold	**4.93**	4.93
Crude Oil	-1.72	-1.72
CBOE Volatility Index	**-17.10**	-17.10
USD Dollar Index	-2.67	-2.67

Current Theme – Trump's Attempts at Policy Implementation Raising Questions

Markets Still Not Sure What to Make of a Trump Presidency

January certainly didn't lack for excitement. Although Trump has only been in office for less than three weeks, things have been moving at such a frenetic pace that market participants are reticent to make changes to their positioning for the remainder of the year. In fact, with policy clues literally being issued daily via Trump's Twitter feed, it has been hard to keep abreast of where things stand.

Equity Markets Have Been in a Holding Pattern



Source: Thomson Reuters; Standard & Poor's

As the chart above highlights, after initial moves off of the surprise results of both the Brexit vote and the U.S. election, markets have settled into a tight trading range while waiting to see how things play out. In fact, things have been so quiet since mid December that the S&P 500 has gone 35 straight days without a 1% move in either direction (as of February 7th) according to Pension Partners.

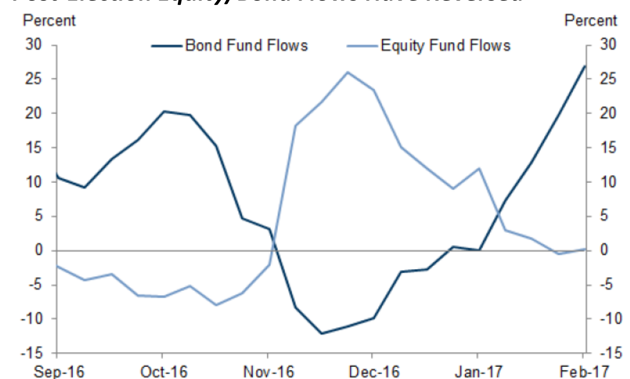
That is somewhat curious given what one would assume to be an extreme level of volatility based on the policy uncertainty both here and abroad. That is simply not what has transpired however. Volatility levels remain subdued and risk assets continue to float along near their all-time highs. But despite what the financial news might be telling you every evening, things are shifting. One simply needs to look at what asset allocators are doing versus what others have been saying.

"Trump Trades" Have Reversed in January

Source: Thomson Reuters; Standard & Poor's

As evidence, consider the chart above. After the election, investors quickly rotated out of bonds and precious metals and into material, financial and energy companies. Since the end of 2016, a quiet rotation has occurred once again that few seem to be focusing on. As you can see, emerging markets and gold have led the way in 2017 while energy, small cap and financial names have trailed. This does not fit with the strong dollar, pro-U.S. growth Trump story. And in fact, investors have even moved out of "risker" equities and back into bonds.

Post-Election Equity/Bond Flows Have Reversed

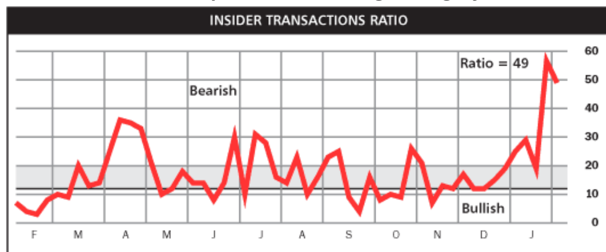


Source: EPFR Global; Goldman Sachs Invetement Research

As we said, one needs to pay attention to what investors are doing versus what you might be hearing them say. While the Trump-growth bull scenario is still very much on the table, there are also other indicators which suggest a caution, or at the very least fatigue after the moves higher seen since the election. This sentiment seems to be exacerbated by Trump's unpredictable impact on markets.

For example, insider sales, the ultimate "smart money" since they have complete transparency on their businesses, have seen a dramatic uptick in the first few trading weeks of 2017.

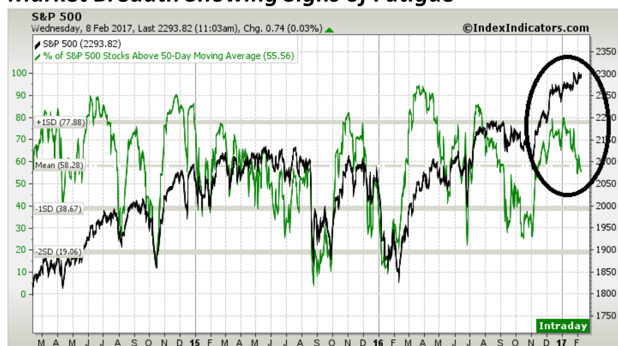
Insider Sales Have Spiked at the Beginning of the Year



Source: Barron's; Thomson Reuter's

In fact, the ratio of insider sells to buys is now at 49:1. A typical rule of thumb would suggest that a ratio of 20:1 would indicate insiders are bearish, and at 49, we are well beyond those threshold levels. Additionally, when trying to assess the overall health of the market one widely used measure is breath - essentially, a gauge of the percentage of names trading above their 50 day moving average, a technical indicator of strength. As you can see from the chart below, that number was as high as 82% in December but has now fallen to just 55% which is below the long-term median of 58%. Importantly, this measure tends to be a leading indicator, rising and falling before those moves are reflected in the overall market. As one can see, the current gap between breadth and price of the S&P 500 is quite wide.

Market Breadth Showing Signs of Fatigue



Source: www.indexindicators.com

Not surprisingly, what this tells us is that the "Trump Hope" trade has paused. Clearly, the somewhat erratic and hasty nature of the Trump administration's efforts to implement new policy measures have had a profound impact on investor sentiment. Within the last week alone, highly respected voices from the investment community such as Ray Dalio, Bill Gross, Seth Karman and Stanley Druckenmiller have expressed their concerns regarding the repercussions of policy miscues by the Trump administration. Trump and his cabinet have done little to assuage these concerns and the reality of Trump's immediate focus is essentially what the markets had feared. Instead of prioritizing his "Make America Great Again" campaign promise, Trump has spent most of his energies on foreign trade issues and protectionism.

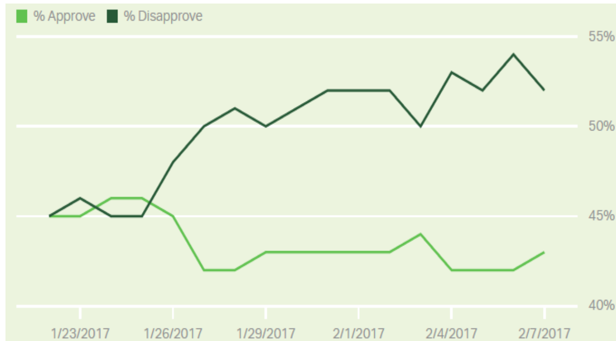
Trump's First 100 Day Agenda Not Pleasing the Market

Source: Citigroup

As the chart above from Citigroup highlights, tax reform and fiscal spending initiatives are the primary drivers of future growth that originally sparked investor enthusiasm about the potential of a Trump presidency in the first place. By the end of January, it became more and more apparent that the challenges of repealing Obamacare, agreeing on infrastructure spending and creating a sensible new tax structure for both corporations and individuals could take quite some time. Senior congressional aides were quoted as saying, "The spring of 2018 might be a more likely time than this year for the passage of legislation". Now, these are still early days and Rome was not built in a day, so there remains quite a lot of time for the Trump growth narrative to come to fruition. However, it seems that the reality of the obstacles that lie ahead is beginning to settle in.

These concerns, in combination with the clumsiness of executive orders like the travel ban and a pettiness over unimportant matters have taken their toll on Trump's approval rating. His approval rating was always perilous at best, however we have seen a clear deterioration since the inauguration.

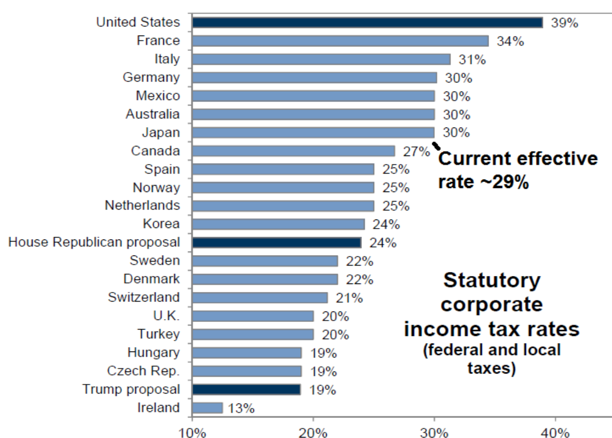
Trump Approval Rating Has Declined since Inauguration



Source: www.gallup.com

So what is Trump to do to stem this tide and get things moving back in his favor? For better or worse, the number one thing that will determine whether he is judged as a success or failure will be his ability to stimulate dramatic growth within the United States. The most straightforward and immediately impactful way to begin that journey is with a reform of the tax code. Consider the following.

US Corporate Tax Rate is Among the Highest Globally



Source: Goldman Sachs Global Investment Research

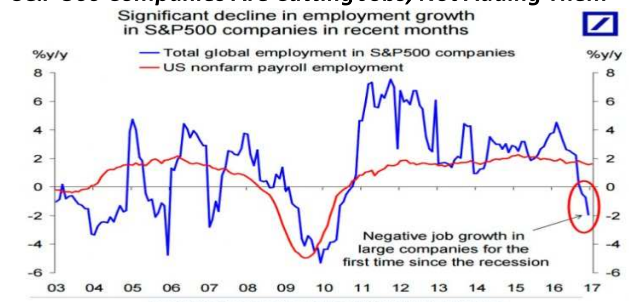
Bringing the U.S. corporate tax rate lower would allow U.S. companies to both compete more effectively on a global basis *and* help incentivize companies to bring more of their operations within the Unites States borders, both items Trump has promised he would deliver. That is the low hanging fruit so to speak. The harder part is creating jobs for those who have been left behind during the economic environment of the last eight years. Despite President Trump's confidence that will be a challenge.

Unemployment Rate Tends to Trough at Markets Peaks

Source: Bloomberg

Observe the graph above. One of the blessings (strong momentum) and the curses (harder to achieve gains) of the economy that Trump has inherited is a very solid foundation of positive employment trends. Now, we will readily admit that there are nuances here in terms of people in the labor force, but at the core, it will be difficult to created jobs in an economy that is at "full employment" already. There are other forces at play as well. As we have discussed in the past, Trump likes to blame China and Mexico for "stealing" jobs from U.S. workers. More realistically, it has been advances in technology. A recent study by consultant McKinsey and Company found that 49% of activities currently performed by humans could be handled by a machine. What's worse, 58% of CEO's they surveyed plan job cuts over the next five years because of robotics. These trends are here to stay and companies are being true to word.

S&P 500 Companies Are Cutting Jobs, Not Adding Them

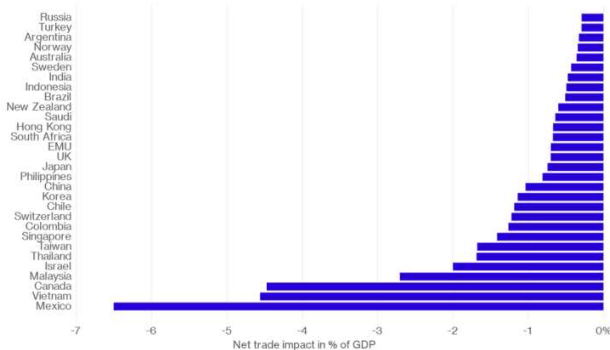


Source: Bloomberg; Deutsche Bank Global Markets Research

Look at the chart from Deutsche Bank on the previous page. For the first time since the 2009 recession and rebound in 2010, large companies as represented by those in the S&P 500 are cutting jobs, not growing them. There has also been a notable focus on the automotive industry as a source of employment by the Trump administration. However automobile sales (and also housing, another historical pillar of the economy) are widely regarded to have peaked in 2016 after a very robust five years of growth. Jobs are simply going to have to come from somewhere else and workers re-trained. Steve Case, the founder of America Online, wrote in his recent book *The Third Wave*, that 50% of venture capital dollars go to entrepreneurial companies in California, much of the balance to small companies in New York and Massachusetts and only about 15% to another 30 states combined. These are the type of companies that are actually creating new jobs and easing their ability to conduct business should be a top priority for the Trump administration.

As we have discussed over the past two months, protectionism and trade tariffs should most definitely not be the priority. As one can see below, a 20% border adjustment tax would have severe consequences for many counties.

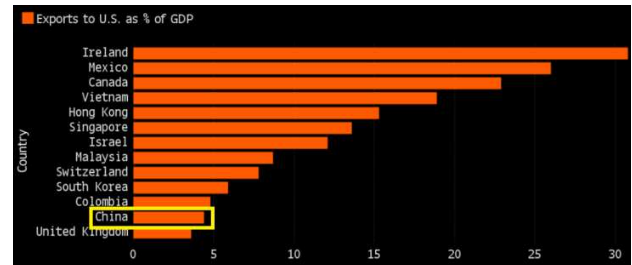
Net Trade Impact to GDP by a 20% US Border Adj. Tax



Source: Deutsche Bank Markets Research; Bloomberg

It is also important to keep in mind that other nations would likely retaliate and have many tools to do so at their disposal. At the head of that list would obviously be China. Whether its disagreement over trade or dealings in the South China Sea, China has a tremendous amount of leverage on several fronts, but particularly since less than 5% of their exports actually end up in the United States.

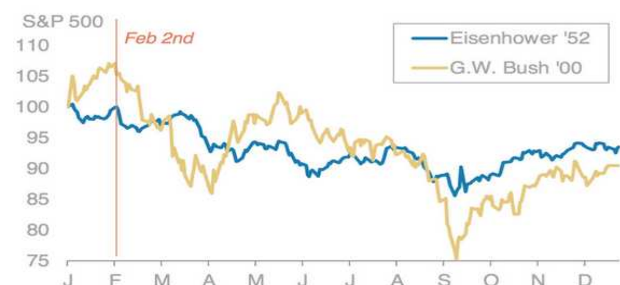
China is Not Very Dependent on Exports to the U.S.



Source: Bloomberg

A couple of other parting thoughts. First, in terms of seasonality, the historically returns in the first year of a presidency have only averaged 4% which is half that of an average year since 1950. More specifically, in years when there has been a Republican sweep, the market has somewhat surprisingly declined by -5 to -10 percent.

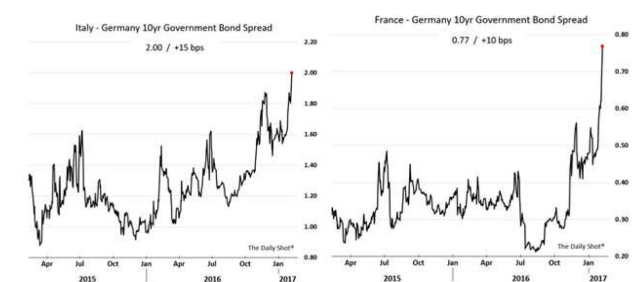
Early Term "Peaks" Seen in Past Republican Sweeps



Source: Morgan Stanley Research: Bloomberg

Second, concern is growing in Europe over the coming elections. In both France and Italy, populist candidates stand a decent chance of winning the election with the follow-on effect being a withdrawal of their respective countries from the European Union. As a result, bond spreads in both nations haves risen sharply versus German bunds, reflecting the caution.

Italian and French Bond Spreads are Flashing Caution



Source: The Daily Shot

Going Forward

As we have stated since the election, there is very little in Trump's policies going forward that can be viewed with any certainty. With valuations at historically high levels and tax and fiscal policy implementation not likely to appear anytime soon, we maintain our cautious posture. We are still in "show me" mode regarding Trump's actions during the first 100 days of his Presidency. His administration has been moving at rapid pace, however it has lacked the focus on domestic growth policies which many market participants had hoped for. If he disappoints on the details of his domestic agenda or turns his attention more sharply toward creating disruption internationally, the "Trump Rally" could easily reverse lower in short order. We choose to be nimble at present allowing us to take advantage of both positive and negative developments.

Within equities we continue to favor the large cap segment of the U.S. market specifically within the financial and industrial sectors which would benefit from a raising interest rate environment, increased fiscal spending on infrastructure and a lower corporate tax environment. We also favor the technology and healthcare sectors which have rebounded since an initial post election sell-off since the election and have now outpaced the broader market year to date. If the Trump administration can succeed in getting tax holiday legislation passed, it would also allow these companies to re-patriate billons in cash currently trapped overseas. This has the potential to unleash a tremendous wave of mergers and acquisitions since both sectors derive a large amount of revenue from outside of the United States. 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. underperformed significantly in 2016 and therefore are an area of focus for 2017. Despite unresolved debt issues in various countries, the ongoing precarious banking situation and the potential for disruptive elections, economic data within the Euro Area has shown remarkable resilience and with continued accommodative policies in place, Europe could present an opportunity for the balance of the year. Particularly if we get an increase in inflation that policy makers have sought for so long. As we discussed, the heavy European election calendar will shape this narrative going forward. Protectionist policies and tariffs would further alter the landscape. This view holds true for our Japan exposure as well. After an extended period of underperformance, emerging markets have taken a leadership role so far in 2017. While growth remains strong in these areas, many emerging markets are particularly vulnerable to punitive Trump measures.

As the post election down-draft 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.

Despite the OPEC production cut in late November, the price of oil has declined as supply data continue to show robust production. Energy companies themselves however, should benefit from an end to challenging environment seen in 2015 and 2016. After a notable and surprising post-election sell-off, gold has rebounded nicely in 2017. 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 the commodity has been an additive exposure thus far in 2017.

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.

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