Insights: November 2016

Market Overview and Performance

With the U.S. Presidential election upon us, this month's Insights letter will take on a slightly different format. Instead of discussing the recent macro events that have shaped the investment landscape over the past month, we will focus more directly on the implications of the election itself. The simple reason being there is no other factor impacting global markets other than the surprisingly unpredictable outcome of the election. Markets are being held captive essentially, and for good reason. Whatever your particular views may be, the undeniable effect of the election has been a shockingly high amount of uncertainty. The market truly does not like this. From an impartial investor perspective, a far better scenario would be one in which either Clinton or Trump held a commanding lead heading into Election Day.

If that were the case, investors could be positioning themselves to take advantage of the trends that would likely emerge from that presumptive candidate's victory. Less than two weeks ago, this looked to be just the scenario unfolding as Clinton pulled ahead and hopes for the possibility of rally that could pull the market out of its four month malaise began to emerge. However in late October, the announcement of the FBI's further investigation into Clinton's email usage quickly derailed any hopes of an orderly conclusion. As a result, any appetite for risk quickly evaporated and stocks as a proxy marked eight straight days of negative returns. Buckle up as we head to the voting booth!

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	-1.82	5.87
Russell 2000 Index	**-4.75**	6.16
MSCI EAFE Index	-2.05	**-0.35**
MSCI Emerging Markets Index	0.24	**16.30**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.76	4.99
Barclay's U.S. Credit Index	-0.85	7.93
Barclay's Corporate High Yield Index	0.39	**15.56**
Barclay's Municipal Bond Index	-1.05	2.92
Macro Measures		
Gold	-3.34	**20.01**
Crude Oil	-2.86	**26.51**
CBOE Volatility Index	**28.37**	-6.32
USD Dollar Index	3.08	-0.39

Current Theme – All Eyes on the Election

Markets Unsettled as Presidential Vote Approaches

The majority of the month October was a fairly quiet period, however, looking underneath the surface it was clear that some unusual patterns were developing which indicated something was amiss.

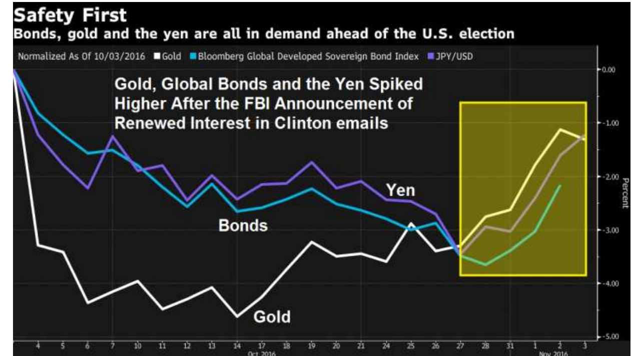
Stocks, Bonds, Gold and Oil all Fell While Dollar Rose

Source: Zerohedge

By month's end, bonds, oil and gold had all sold of by roughly three percent while stocks fell almost two percent. It is not common to have all asset classes moving together in the same direction at the same time except during periods of extreme duress. That was clearly not the case in October however, and perhaps the movements were merely a bit of selling to sure up dry powder before the election rather than an indication of panic. In fact, numerous markers of the selling have been accumulating for weeks now with the Dow Jones Industrials Average down for three straight months and bonds down for the last two periods. However, things quickly snapped into a very typical "flight to safety" pattern on October 28th when the FBI surprisingly announced that they would be re-opening their investigation into potentially classified emails belonging to Hilary Clinton appearing on the personal computer of Anthony Weiner.

With less than two weeks left before the election, the market did not welcome the news and traditional safe havens like gold, bonds and the Yen rallied.

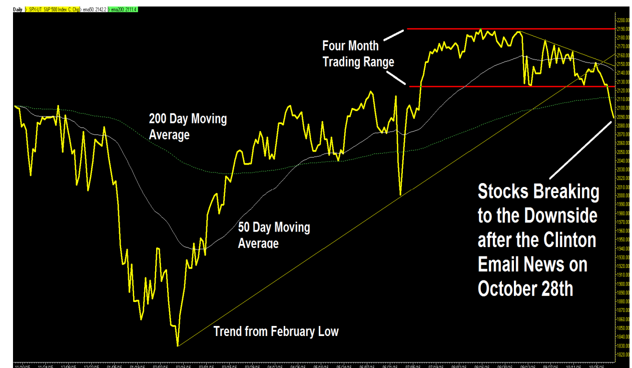
Flight to Safety After October 28 Clinton Email News



Source: Bloomberg

After the shock of the original completely unexpected announcement, things began to snowball so to speak. In fact, as of November 3rd, the S&P 500 had declined for eight straight days, something not seen since October of 2008. Granted, the drop eight years ago was a harrowing -23 percent and this move is a scant -3 percent, but it is nonetheless and unusual event. Coincidentally, stock volatility has marched 53 percent higher over the last eight days, far outpacing similar streaks in 2012 and 2013.

Stocks' Downward Trend Accelerates in November

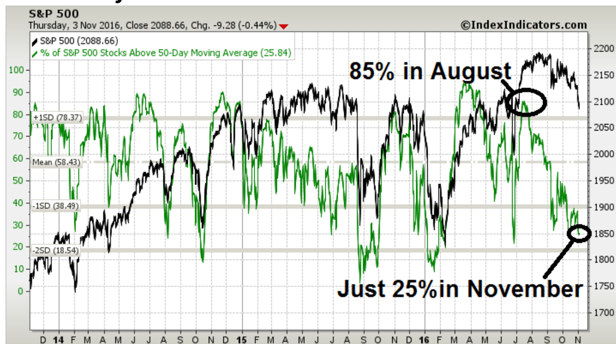


Source: Bloomberg

Even though the absolute level of the declines seen has been muted thus far, there are signs that the

underlying foundation is deteriorating as well. Consider the following chart. As recently as August, over 85 percent of stocks within the S&P 500 were trading above their respective 50 day moving average. This is a very good indication of broad market strength. However by November 3rd, that measure had collapsed to just 25 percent. Historically, this has been a leading indicator of stock prices meaning that when the gauge falls, stocks subsequently follow suit.

Just 25% of S&P Stocks Now Trade Above their 50 DMA

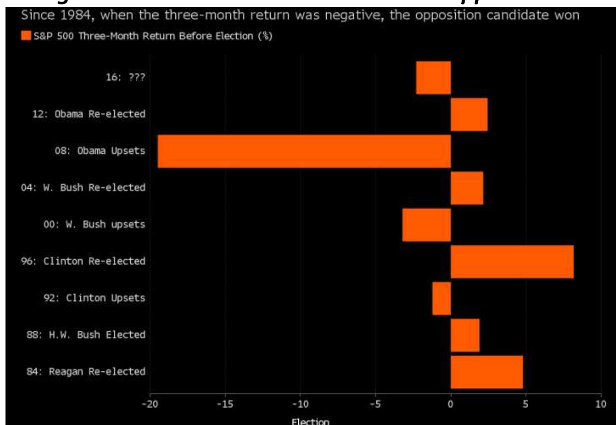


Source: www.indexindicators.com

How is the Market Viewing the Potential Election Outcome?

Given the extraordinary nature of this year's election, one could easily assume that ripples in the market could simply be attributed to the fact that the Market is trying to come to terms with the notion that one of these two candidates will actually become the "Leader of the Free World". And that may very well be true. But again using history as a guide, the recent action would suggest otherwise.

A Negative 3-Month Return Portends an Opposition Win

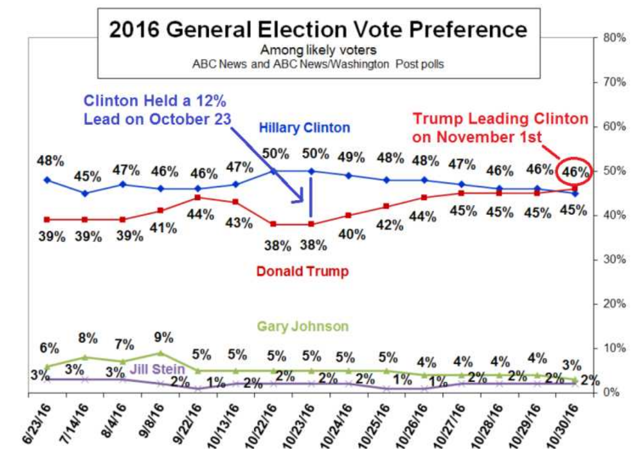


Source: Stategas Research; Bloomberg

According to Strategas Research, the price action of stocks in the months leading up an election has been a remarkably reliable predictor of the eventual victor since the days of Ronald Reagan. In fact, they claim that the stock market has "called" the presidential election correctly 19 out of last 22 times. This does not bode well for Hilary Clinton.

Stock behavior leading up to an election is not an undiscovered secret and traders are therefore understandably worried at the moment. To be honest, if this letter was written two weeks ago, we would not have even considered devoting the entirety of its content to the election. However, the chart below clearly outlines why we should be concerned.

Trump Leading Some Polls Just Days Before the Vote



Source: ABC News; Washington Post

Regardless of your political views, what the Market really would like to see is a Clinton victory and Republican control of the House and Senate – status quo in other words. At the two tails of possible outcomes is a Democratic sweep or Trump winning the presidency. If either of these outcomes were to come to pass, the market reactions would likely be a severe move to the downside. Obviously, a Trump victory would cause the most indigestion, first, because it is an unexpected event, and second, because his comments on policy have suggested a high degree of protectionism which hurts global trade, and a willingness to back away from international treaties which threatens peaceful relations across the globe.

And as we all learned just five months ago with the vote by Britain to leave the European Union, unexpected events do happen.

Brexit Surprise Caused Extreme Moves in Asset Prices

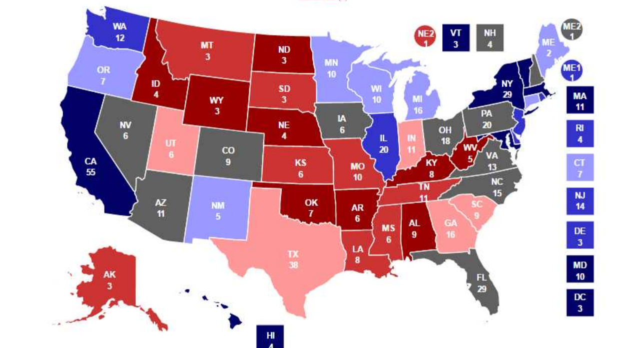
Source: Bloomberg

Polls going into that referendum vote suggested that remaining as part of the EU was virtually a sure thing, however, betting houses within the UK noted a spike in small scale Brexit bets immediately before the event. The same pattern is occurring here within the US as Clinton is seen as the clear favorite yet the UK gambling firm Paddy Power Politics reported that *91%* of the bets being placed were for a Trump win as of November 2nd (*Washington Post*). Oh and by the way, they had already paid out on Clinton winning wagers. In light of anecdotal evidence like this, investors are keen to avoid being negatively impacted by price moves like the ones seen in the chart above.

So what are we really looking at in terms of probabilities and the winner? Until the Clinton email scandal version 2.0 was announced, Clinton had reached as high as 92 percent probability of winning according to the New York Times. The landscape is of course quite different now. Most sources are now placing a Trump victory at somewhere between 30 and 35 percent. Seems low, right? Low enough that the market should be happy, right? A 70/30 bet would in general be considered a good one since it implies a better than average chance of winning. But as Nicholas Colas at Convergex writes, those odds are somewhat deceptive. 30+% is essentially the same probability as it raining on any given day in Washington D.C., the New England Patriots winning the Super Bowl this year, or you flipping a quarter and having it come up heads twice in a row. How comfortable would you be positioning against those outcomes? Not as clear cut as it seems. Without question, this scenario is putting investors on edge and the issue only becomes more concerning when one begins to look at the nuts and bolts of getting elected in this country.

At the elementary level, a candidate needs to garner 270 Electoral College votes to win the Presidency. As of November 3rd, the current state of affairs vis a vis votes is as follows:

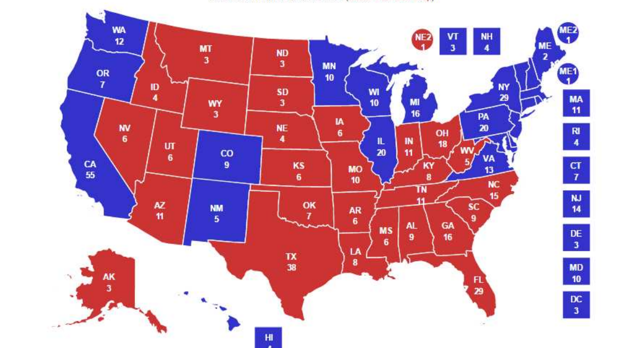
Clinton Seemingly Holds Advantage in Electoral Votes



Source: Real Clear Politics

However, when one incorporates the impact of "Toss Up" states moving in the direction which they are now leaning as Real Clear Politics does below, we are faced with the following:

Toss Up States Create a Virtual Tie within the Election



Source: Real Clear Politics

The votes are virtually tied. Adding another wrinkle, Independent candidate Evan Mullin appears as if he might win his home state of Utah which represents 6 electoral votes. While this would likely detract from Trump's confers, but it brings up another unsettling question – what if the vote is so close that it becomes contested, or worse, no one gains the full 270 votes needed?

There are a lot of details relating to the sequence of events that would be set into motion under certain circumstances, but the point is that this has a real chance of happening. We simply may not know the winner of the election on the morning of Wednesday November 9th. Again referencing the work of the quantitative group at Convergex, the odds that we will not know the winner immediately after the election appear to be 50/50 - a coin toss. Their research further reveals that 11 states currently have either automatic or voluntary recounts if the margin of victory is small including important states like Florida, Ohio and Pennsylvania. Together, these eleven states represent 132 electoral votes or almost half of the required total. All this is to say that there is an incredible amount of unknowns heading into an election that is only days away.

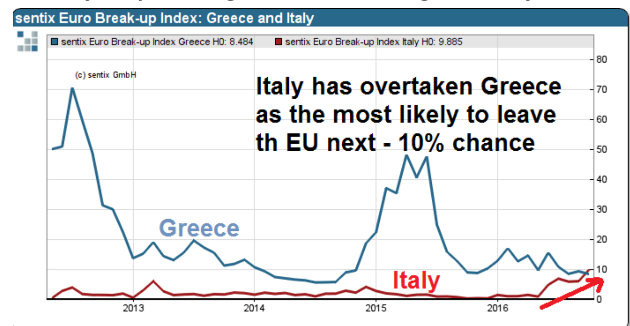
And finally, remember that due to the unclear voter results in Florida and from overseas voters during the 2000 election, Al Gore did not concede the election to George Bush until *December 13th!* That would represent an eternity of chaos in today's markets.

European Elections

One last topic that we would like to bring to your attention is the coming elections in Europe. There are federal elections scheduled for the spring and summer of 2017 in France and Germany which will prove vital to the future of the European Union, however, more pressing is the referendum vote in Italy which is now just a few weeks away. On December 4th (this is a weekend and will precede our next Insights) Italian voters will go to the voting booth and voice their opinion regarding the ratification of Prime Minister Renzi's constitutional reforms. Virtually all of the current polls suggest a "no" vote, a result which Renzi has pledged will force his resignation.

If reforms are not undertaken, Italy is danger of losing its sovereign credit investment grade rating and therefore become ineligible for the European Central Bank's bond buying program. The economy is very challenged in Italy, the banks are still in disarray, and there is already a well-entrenched populist leaning within the country and government. It's therefore not a stretch to imagine Italy becoming "the next domino to fall" after Brexit.

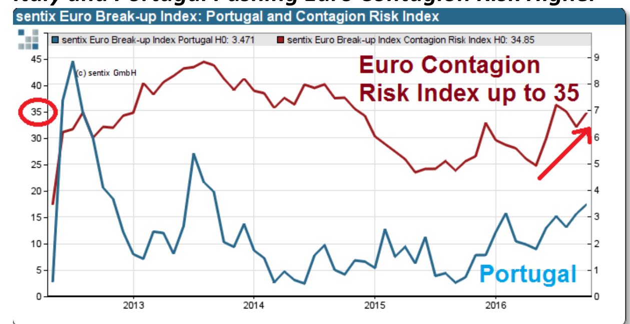
Odds of Italy Leaving the EU Increasing Ahead of Vote



Source: Sentix

Obviously, these developments have the potential to become very disruptive to not only Italy and the European Union, but also to global markets as a whole. Brexit clearly taught us that lesson and an Italian break could prove far worse especially given the fact that their beleaguered banks are saddled with an estimated $400 billion in bad loans. There would be no easy solution should they choose to leave and the European Contagion Risk Index below illustrates this elevated risk.

Italy and Portugal Pushing Euro Contagion Risk Higher



Source: Sentix

One last reminder, against this backdrop the Federal Reserve is likely to raise interest rates at its December 14th meeting. Volatile times ahead.

Going Forward

With the very uncertain outcome of the election at hand, we remain defensively positioned in our portfolios with elevated cash levels as we have been for much of the summer. We are actively monitoring events with an anticipation of increased volatility in the coming weeks. However we do continue to believe that this volatility will present us with an attractive opportunity to put fresh money to work as we look to the seasonally strong period that lies ahead. The caveat to our current positioning and favored areas of the market is obviously the fact whichever candidate prevails will have a large degree of influence on the behavior of certain asset classes and segments of the market so we prefer to remain nimble.

Within equities we continue to favor the large cap segment of the U.S. market. Small cap equities, which had advanced nicely relative to their large cap brethren, have now surrendered all of those relative gains within the last month. At present, we feel that the risk/reward proposition in the technology, health care and financials sectors remains appealing due to their lower valuation and higher growth rates. It should be noted however that healthcare names broadly have been pressured by the prospect of a Clinton presidency and her victory may spur further weakness.

In light of Brexit, unresolved debt issues in various countries and the ongoing precarious banking situation, Europe continues to face challenges. However, economic data from 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. Japan continues its efforts at reforms that are risk-asset friendly, however, policy actions continue to face the headwinds of their “safe haven” currency status which strengthens the investor appetite for the Yen.

After an extended period of underperformance, emerging markets are more of an interest. As a whole, they have performed surprisingly well in 2016 rising over 16 percent, however headwinds remain in place. Most notably, slowing growth in China and the potential protectionist policies of a Trump administration. Despite their strong move higher this year, emerging market stocks still remain attractively valued when compared to other regions.

Traditional fixed income is now very, very expensive relative to history as a result of the distorted demand dynamics that are the result of central bank asset purchasing actions. However, we do think it is prudent to maintain exposure to bonds in an uncertain environment. As we witnessed this past month however, losses for bond holders do remain a risk. In a rising interest rate environment, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to favor our explicit exposure to the muni markets which has provided stable returns in a year with increased uncertainty levels.

With regard to commodities, the oil market is suffering from extraordinarily oversupplied conditions highlighted by the record build inventories witnessed in October. The price of the commodity has quickly moved down from $50 to $45 as a result. With the prospect of OPEC members actually implementing agreed to production cuts seemingly less and less likely, challenges remain for the near future. Thus far in 2016, gold has been the one asset class to both serve its purpose as a diversifier and provide attractive returns. 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.

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