GVA Newsletter

January 2017

Trumped Up

"When all the experts and forecasts agree, something else is going to happen." - Bob Farrell - #9 of his 10 Market Rules to Remember

"The economy isn't that strong and anyone who thinks one man can reverse on his own the structural forces that led to the multi-year dis-inflation trend - and I'm talking about excessive debt, globalization, aging demographics and technology - needs to go back to economics school right away." - David Rosenberg December 2016

The question we find ourselves asking in the wake of the 2016 elections is: are we truly experiencing a paradigm shift? Will the new political dynamics usher in an era of inflation, growth and increased prosperity to justify the prices of assets such as real estate and stocks? Or, are we experiencing the final throws of a government stimulated bubble and the final "blow-off" top in stocks?

Mohamed El Erian, who we respect very much, has said that "Donald Trump has flipped the switch on three issues: liquidity, growth and inflation." (CNBC Dec 2016) He went on to express confidence in the team that Trump has assembled and their understanding of what is required to drive growth in the economy. But he also said that the structure has always been in place, the question remains as to whether the political will is there and the detailed plans to make it happen. Later that same week El Erian commented that the market had not priced in any policy risk and that he maintained 30% of his own investment portfolio in cash.

Regardless of the final outcome, in the near-term it appears that Trump has ignited a shift in markets that is based on more than just can kicking from Central Banks. It is impossible to know how high and for how long markets rise.

We are hopeful that new approaches to many of the problems we face as a nation will yield positive results, especially for the majority of Americans who have been left behind in the years since 2007. We have been consistent in arguing that the giant trickle down strategy employed by the Federal Reserve has been worse than ineffective, it has moved wealth from the middle class to the top .01% creating massive wealth inequality. Furthermore, the policies of the Fed have discouraged savings and encouraged reckless borrowing at every level of our economy. In 2016 alone global debt grew by $6.6 trillion once again surpassing GDP growth globally. Some estimate total debt-to GDP to be roughly 225%. In 2014 McKinsey published a paper (which we quoted here) discussing the risks of global debt-to-GDP when it stood at 199%

The rise in asset prices like stocks and real estate since 2009 has not been based on a similar level of rising economic fundamentals as much as it has been based on low interest rates and the expansion of debt. Donald Trump most likely would not have won the Presidency if economic fundamentals had truly been good for most Americans, nor would Bernie Sanders' campaign have experienced so much success. Rather, prices have been rising based on aggressive monetary policy and a sense that Central Banks and governments around the world are in control and will keep the markets rising indefinitely.

Peaks in markets take place when the maximum number of people believe in a paradigm and become engulfed in the optimism of that belief. In 2000 investors believed that innovation in technology had so thoroughly changed the world, that stocks would rise forever and that new methods for valuing stocks should be adopted. In 2007 investors believed that real estate was not prone to asset bubbles the way stocks were and that we were in a new time of broadly shared economic prosperity and home ownership. In each case the argument was made that this time is different.

In July, we wrote in our last newsletter that a new high in the stock market was quite likely. At the time, we were trying to imagine what the environment would look like at a new high. We could assume that there would be a burst of optimism - perhaps relief that the elections were over and that the status quo candidate, Hillary Clinton, won. But we also wrote in our July Newsletter that the advent of Brexit and the move against the status quo suggested that Trump had a better chance of winning than most gave him. Italy's recent referendum has been another move against the status quo that has major implications for the Eurozone.

Today we observe a market reaching new highs after the unexpected victory of Donald Trump alongside Republicans control of the House and Senate. The imagination of the market has been captivated by visions of infrastructure spending, tax cuts and the removal of regulation. What it boils down to, in our view, is the perfect peak in belief that governments are in control. The market seems to rationalize that the move from monetary stimulus to fiscal stimulus will keep the party going.

The truth is that no one knows what will happen next. Clearly there are new beneficiaries to the redirected government focus and the market has rotated toward these sectors. In addition, leaders in these industries are being given cabinet posts in the new administration to drive this point home. On the other hand, it appears that Trump may be fighting both the Fed and Congress to accomplish his goals.

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We deal in probabilities and risk management in helping our clients navigate a path toward their goals. What we do know for fact is that the market is as expensive as all but two times in the last 100 years - 1929 and 2000. We also know that we have not solved the problem that created the last financial crisis - excess debt. Furthermore, we know that the trajectory of demographics for the developed world have not changed.

However, we can also see that Trump represents a significant shift in market expectations that must be respected. In this newsletter we will briefly examine what the prospects for the economy and markets are for this new incoming administration. If nothing else, we certainly live in interesting times.

Thanks for reading,

Matt and Tom

Trumped Up

Executive Summary

Trump vs Reagan - The parallels have been drawn between Trump and Reagan but the differences in economic realities are more stark than the similarities. We should also consider the lessons from Nixon, Bush II and Herbert Hoover.

Economic History Note – Most U.S. Presidents experience recession in the first year of their administration and every President in the last 100 years that has followed a two-term President has experienced recession.

Fed Note – After years of asking Congress for economic help the Fed reverses course in Yellen's December FOMC news conference. Also, the dynamic between the incoming administration and the Fed is off to a rocky start. Trump pointed out in his campaign that the Fed has, in his words, created a "Big, fat, ugly stock bubble."

Market Valuation - Market Valuation is not a timing mechanism but rather a good indication of long-term returns. Let's look quickly at what today's market valuations are suggesting about future returns in the stock market. Hint - there are only two times in history where stocks have been more highly-valued in the U.S. - 1929 and 2000.

Interest Rates - Interest rates tend to rise for one of three reasons; inflation, growth or an increase in deficits, i.e. credit risk. We think the most important consideration today is what is driving the move higher in interest rates. Every financial crisis in the last 30 years has been set off by a rise in interest rates.

Solutions - Thoughts on investing in the coming year.

Create Your Own Economy Corner – Making Progress Leads to Pleasure

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Trump- The Next Reagan.
What do people/Wall St think has changed?
Markets have traditionally been kind to new Presidents, at least initially in the "honeymoon" period. Since election day the S&P 500 is up more than 5%. Bush II enjoyed a bounce in the market after his victory in 2000, before the market fell 50% in the first two years of his presidency and the NASDAQ fell 80%. Ronald Reagan saw an 8.5% bounce in the markets after his election, but people forget that the market fell 20% shortly after. This recently from Dallas Fed President Richard Fisher warning on CNBC that the market is likely getting ahead of itself:

> *"Ronald Reagan was a market-driving president-elect, but after he was inaugurated, the market adjusted to how long it would take to push his policies through, former Dallas Fed President Richard Fisher told CNBC on Tuesday.*
>
> *"Ronald Reagan gets elected. The market, S&P 500, up 8.5 percent until he gets inaugurated. Next year, down 20 percent," Fisher said on "Squawk Box," cautioning viewers that the excitement surrounding Donald Trump's election and pro-growth agenda may come with pitfalls."*

Nixon saw markets appreciate after his re-election and peak during the month of his inauguration and then slide 45% over the next two years. Interestingly Nixon enjoyed similar approval ratings of 66% in January 1973 and resigned in disgrace in August 1974. Herbert Hoover enjoyed a 13% move in the market after his victory in 1928 before the market fell 90%.

All of these Presidents were pro-growth, deregulating, business friendly candidates. So what are the positives and negatives as we look at the prospects of a Trump Presidency? Here is what the market's basic thesis is around the new incoming administration:

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Pros:

- Repatriation of corporate cash held overseas from tax incentives - generally leads to buybacks helping support stock prices.
- Major tax reduction for corporations and individuals.
- Fiscal stimulus in the form of defense spending and infrastructure.
- Deregulation benefiting certain industries in particular - financial and health care.
- Renegotiation of trade deals to better favor American interests.
- Rising interest rates in the U.S. attracts capital from abroad strengthening the case for investing in America. There is a school of thought that one of Trumps strategies is to negotiate with the Chinese for making major infrastructure investments in the U.S.

Cons:

- Repatriation money could already be being spent on future growth but isn't partly because corporations do not see a driver of future demand.
- According to Barron's, while the stated corporate tax rate is high, the effective rate is already at its lowest ever.
- Major tax cuts may be hard to pass given that the Republican congress led by Mitch McConnell is very concerned about high debt and deficits.
- Likewise major stimulus plans will be resisted by republicans who saw the last attempt at stimulus in 2009 as wasteful and ill-planned. McConnell has already expressed his concerns and need to see details.
- Any stimulus will take more time than people expect to make it through to the real economy.
- The level to which Trump will follow through on deregulation is uncertain as he has already walked back some of his campaign promises around health care and financial regulations.
- Interest rates are already rising. The question is, is this driven by expectations of inflation and growth, or fear of deficits. Higher costs of borrowing for the U.S. government crowds out other spending needs and social programs.
- According to Barron's, there is $2 trillion of corporate debt that needs to be refinanced over the next two years. Refinancing this debt at higher interest rates will hurt the profitability of these firms.
- Trump's, pro-America, anti-trade, anti-globalization, protectionist policies are likely to be a damper on global growth at best and may lead to greater conflict at worst.

The most common comparison for Trump is to Ronald Reagan who came into office after a period of stagnation and high inflation to "Make America Great Again". But the differences in economic conditions are so vast we think they are important to point out:

- Reagan came in at the beginning of an era of globalization and free trade. Trump is riding a wave of protectionism and nationalism.
- Reagan came in as a consensus builder, Trump is coming in as a hard-line deal maker.
- Reagan entered into a world of completely different set of financial realities including declining interest rates and low debt. Consider the following data points compiled by Lance Roberts of RealInvestmentAdvice.com:

	1982	**Today**
Fed Funds Rate	18%	.5%
10 Year Treasury Yield	15%	2.3%
Mortgage Rates	16.25%	3.87%
Household Debt to Income	62%	130%
U.S. Gov. Debt-to-GDP	30%	105%
Total U.S. Debt-to GDP	90%	360%
Productivity Growth	2%	.25%
Actual Inflation Rate	8%	1.6%
Personal Savings Rate	10%	5%
Labor Force Participation	64%	63%
S&P CAPE 10 yr Average	7	27.9
S&P Median Price-to-Sales	.50x	2.20x
Median Baby Boomer Age	26	60
Global Trade Barriers	Falling	Rising

Reagan had the tail winds of declining interest rates and very low debt to support his big expansion of government. He also came into an economy with excess demand relative to supply so he could use supply-side economics to address the problem. Today we have excess supply in almost everything making it very difficult to generate inflation.

Economic History Note

In the past 100 years every U.S. President who has come into office after a two-term president has experienced a recession in their first year. In more recent years (meaning since 1960) the following Presidents experienced recession in the early part of their administrations: Kennedy, Nixon, Ford, Reagan, Bush I, Bush II and Obama. Also, every time we have seen unemployment "officially" dip below 5% the economy has been in recession within 12-36 months. In October 2016 unemployment came in at 4.9%. While we are optimistic that Trumps policies may eventually work, there remains a likelihood that we have some tough spots to go through before we see the

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benefits. Also, if we see GDP rise to 3.5%-4% as some predict, that would be equal to the 1970's when stocks suffered three major declines - the third, a 50% decline from 1973-1974, being the worst. In other words, we could ultimately see greater growth long-term but that does not change the possibility of significant declines in stocks.

Fed Update

Watching the Fed try to explain their position in the past eight years has been fascinating but the December 14th news conference following the Fed's quarterly FOMC meeting took the cake. Setting aside conversations about levels in the stock market for a moment, for years Bernanke and then Yellen have suggested that monetary policy has done all it can do and that fiscal policy must address structural issues. But now that Trump has raised the prospect of real fiscal stimulus and structural reform Yellen suggested that several of her colleagues were surprised and she appeared to talk back the idea. Below is from the transcript of the news conference

> *"Question from the Washington Post: I'm curious, you and your predecessor had both at times called for more fiscal stimulus, to help with the outlook, the growth outlook. I'm wondering how much do you judge the economy has capacity for fiscal stimulus right now? It's a version of Steve's question but I think we are trying to get at, how much can happen before we run the risk of overheating?*
>
> *"Janet Yellen: Well, I believe my predecessor and I called for fiscal stimulus when the unemployment rate was substantially higher than it is now. So, with a 4.6 percent unemployment, and a solid labor market, there may be some additional slack in labor markets, but I would judge that the degree of slack has diminished. So, I would say at this point that fiscal policy is not obviously needed to provide stimulus to help us get back to full employment."*

Then later she expressed a concern that we have long mentioned in this newsletter about debt and demographics:

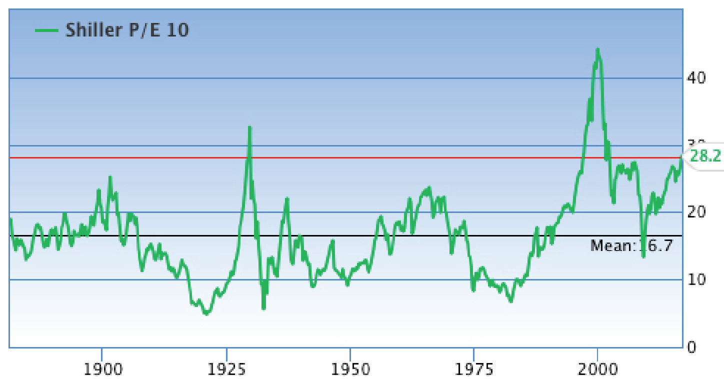
> *Yellen: "Of course, it's also important for Congress to take account of the fact that, as our population ages, that the debt to GDP ratio is projected to rise, and that needs to continue to be taken into account. So, there are many factors that I think should enter into such decisions."*

This has the potential to leave the market very confused about what the Fed does or does not want from the Trump administration. We don't think Donald Trump will be as ambiguous. One thing is clear - the Fed is in a corner that it does not know how to get out of.

It also should be noted that Trump made a point during his campaign of referring to the Fed as "the most political Fed ever" that had created a "big, fat, ugly bubble" in asset prices. Mark Spiznagle, hedge fund manager and economic advisor to Rand Paul's presidential campaign has recently noted that Trump might consider letting the bubble deflate at the beginning of his administration so that it would be clear that it was due to policies enacted during the Obama administration.

Market Valuation

Below is a chart of what is considered by many as the most accurate measurement of market valuation the Shiller CAPE which stands for Cyclically Adjusted Price Earnings.



This measurement is looking at the ten-year average in Price/Earnings multiples and has been helpful in understanding future stock market returns. There have only been two very brief times in history when stocks have been more expensive, based on this measurement. Those times, 1929 and 2000, preceded very difficult times in the stock market.

Goldman Sachs recently said the following concerning market valuations:

> ***"S&P 500 valuation is stretched relative to history on nearly every fundamental metric.*** *At the aggregate level, the S&P 500 index trades at the 85th percentile of historical valuation relative to the past 40 years. For portfolio managers, the more important fact is that* ***the median S&P 500 company trades at the 98th percentile of historical valuation.."*** *- Source Zerohedge*

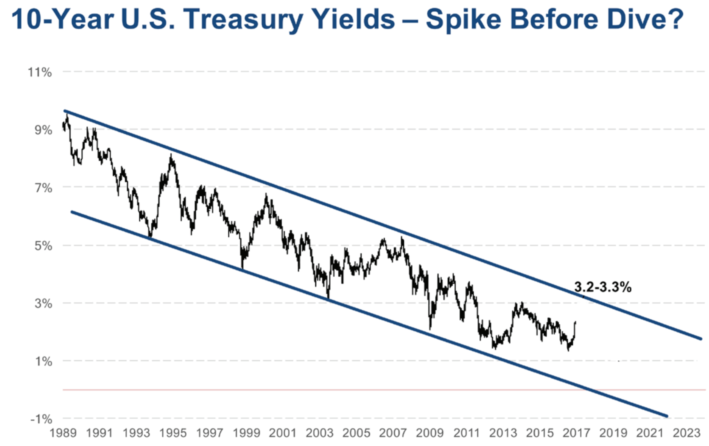
The conclusion to draw is not necessarily one of imminent collapse in the market, but rather an indicator that investors in stocks are likely taking ever greater risk for ever smaller potential returns over the next ten years. To reiterate, this time may be indeed different, but the odds of that are not great based on history.

Keep in mind, however, that the market is a voting machine in the short-term and a weighing machine in the long-run and we never know when the top will be. In 1985 Japan's Nikkei was very richly priced at 20,000 with a CAPE of 40. In the next four years that market would rise from 20,000 to 40,000 with a CAPE of 90 before falling to 8,000 - a decline of 80%. This was all driven by a massive increase in debt to finance stimulus followed by a long and painful decline in equity and real estate prices. We just don't know where the top is.

Interest Rates

Two charts to share in this segment. The first is a chart of the 30 Year Treasury Yield. The yield has been on a steady decline since the early 1980's but has seen some significant spikes along the way. In each major move since the mid-1980's we have seen an impact of rising rates somewhere in the financial markets. Almost every time since the 1990's when interest rates rise there is a conversation about the end of the bond bull market.

This next chart shows the 10 Year Treasury and the channel it has moved in since 1989. Goldman Sachs has said that the market can handle the 10 Year up to around 2.75% before it starts having a negative impact on the economy. Jeff Gundlach has suggested 3% on the Ten Year is the problematic number and a threshold that would indicate a true end to the bond bull.



Source: Yahoo! Finance

We are quickly seeing headlines from the *Wall St Journal* like "Game Changer" detailing how mortgage refinancing is set to drop 46% in 2017. This has long been a concern regarding the unwinding of the Fed's experimental policies. And it creates a feedback loop when you have a highly leveraged economy:

- Interest Rates rise
- Real estate values and other asset prices decline as borrowing costs rise
- Economy slows setting off a default cycle
- Cost of borrowing for high risk borrowers rise (think Greece in 2010 and today)
- Interest rates decline as government tries to stimulate the economy and the bond market reflects slower growth.

So the question is: are we on the way to higher yields, inflation and growth or is this just another head-fake? Two economists that have been the best at answering this question for the last 30 years, Gary Shilling and Lacy Hunt, are continuing to call for lower interest rates. The following is the concluding paragraph from the Hoisington Management Interim Bulletin written shortly after the election by Lacy Hunt:

> ***"Markets have a pronounced tendency to rush to judgement when policy changes occur. When the Obama stimulus of 2009 was announced the presumption was that it would lead to an inflationary boom. Similarly, the unveiling of QE1 raised expectations of runaway inflation. Yet neither happened. The economics are not different. Under present conditions, it is our judgement that the declining secular trend in Treasury bond yields remains intact."***

These guys are clearly in the minority - but that was true in 2009 and 2011 and for much of the past 20 years. And they have been more accurate than not.

But let's think about another reality of rising interest rates, the cost for governments and corporations to service their debt becomes less manageable as interest rates rise. Peter Boockvar of the Lindsey group recently estimated that every 100 basis points increase in market rates causes interest charges in the U.S. to soar by $470 billion or 2.5% of GDP. If that money needs to be dedicated to service debt, it will have to come from somewhere.

Solutions

Let us consider what solutions may work over the next 5 years in investing regardless of whether Trump is successful or not.

1. Cash flow is still king - specific types of real estate and energy infrastructure investment whose value is supported by their cash flow and favorable trend should work regardless of inflation or deflation. Deregulation should help both real estate and energy although energy deregulation should create more supply and put downward pressure on prices.
2. Cash. There is so much uncertainty and we believe volatility will create opportunity if you have the means to take advantage of it. We still firmly believe that deflation remains the greater risk but we respect the potential for inflation. If cash flow is king, cash is queen. Gary Shilling, David Rosenberg, Mohamed El Erian, and others are recommending above average cash holdings.
3. Active vs passive management. Indexing has been great for the past seven years but we think an economy driven by fiscal policy rather than monetary policy will be more volatile and less even in the distribution of rewards. Passive index strategies are filled with bad companies that have been able to survive purely because of extremely low interest rate policies and mal-investment. Fed tightening and the threat of higher interest rates will likely narrow the playing field.
4. Financial and insurance companies and products. If interest rates do continue to rise this should benefit insurance and financial firms but the path is likely to be rocky. Deregulation should help the financial and insurance industry allowing greater leverage and lower costs.
5. Health Care. Aging boomers are still the clearest trend. Deregulation should help health care.
6. Owning your own business. A business friendly environment will be good for business owners - that does not mean owners of over-valued pieces of paper, it means owning the business where you can manage production and cash flow.
7. The U.S. dollar. It has already made a big move up and may need to pull back in the short-term, but dollar strength has been and continues to be one of the strongest trends we see over the next three years.
8. Commodities are very hard to judge. Gold and other commodities have declined significantly from their highs so much of the damage may have run its course. Inflation will drive commodities higher - if we see sustained inflation. The main commodities index, CRB, declined 67% from the top in 2008 until the beginning of this year and has bounced in 2016 but more downside is not out of the question.

Create Your Own Economy Corner - Keep Your Focus

To say there are a lot of distractions today is an understatement. As business owners we must make every effort to steel ourselves from letting others distract us from our purpose. If you are in business you are there for a purpose, honor that.

If your goals are important to you, keep them in focus. Have a process to do it every day.
We believe in being involved and engaged citizens in our great democracy. But we know our power to influence is greatest when we remain focused on the ends we want to achieve.

There is a difference between being an engaged citizen, and being a distracted consumer of news stories filled with drama and spin. Being clear about how you direct your focus will keep you in the driver's seat and give you the best chance of achieving your goals.

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