Diversified Trust
Comprehensive Wealth Management

white|paper
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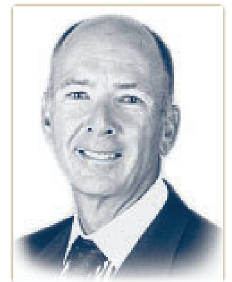
It’s *Really* Complicated



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Several months ago, we published a paper called “It’s Complicated” that concluded with the following paragraph:

Understanding and accepting the complex nature of politics and economics should help us both emotionally and financially. First, a key lesson is that one should not overreact to headlines because the ultimate implications of a given event are never clear. Second, we should take the forecasts of most “experts” with a grain of salt. With respect to investing, it is rarely smart to make meaningful changes in a portfolio in response to news and it is very dangerous to take an extreme position based on a particular point of view. The better course is to admit that we don’t know a great deal and invest accordingly. That means, a well thought plan, diversification, and a consistent approach. Also, you will sleep better along the way.

Last week’s Presidential election provides an opportunity to revisit this subject because pundits, investors, and the media are once again making the mistakes that were cited in our paper: jumping to snap conclusions, overreacting to headlines, and oversimplifying complex issues. So, let’s review the critical conclusions listed above.

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Experts

First, we somewhat cynically suggested that the forecasts of experts be taken with "a grain of salt." Well, several polling organizations with good track records gave Ms. Clinton a 70-90% probability of victory. And so called prediction markets, in which people actually bet money on the outcome of events, had the odds of her winning at greater than 80% on the afternoon of the election. Enough said!

Overreaction to Headlines

Late on the evening of election-day as the outcome became clear, U.S. stock futures fell by as much as 900 points on the Dow Jones Index. By the next morning, the index was basically flat and it ended the day up seventy three points. As of this writing, it is up some five hundred points or about 3%, and the Russell 2000, which is an index of small capitalization stocks, is up more than 8%. US Treasury rates increased about 40 basis points or .4% in the three days following the election which is a massive move that is expected to occur a small fraction of 1% of the time. It is not clear whether the 900 point initial selloff or subsequent rally represents the overreaction but we can certainly say that there was a significant shift in sentiment in just a couple of hours.

Prevailing Wisdom

The strong stock market and rise in interest rates seem to be based on the current conventional wisdom which can be summarized as follows:

- Mr. Trump is a businessman and will therefore inevitably pass legislation that is pro-business which ultimately benefits stocks.
- He has promised both individual and corporate tax cuts which will stimulate the economy, again ultimately benefiting the stock market.
- He will implement major spending on infrastructure that will also help boost economic growth with special focus on companies tied to industries such as construction, materials, heavy equipment, and so on.
- Both the tax cuts and infrastructure spending are likely to place upward pressure on the Federal Budget deficit which sparks fear of ultimate inflation and rising interest rates.

This may all turn out to be correct. But, remember the title of this paper: It's Really Complicated. So, let's take a hard look at some of these assertions.

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Pro-Business

We will get to tax cuts and infrastructure spending in a moment. But first, let's review a couple other positions Mr. Trump took during the campaign. First, he vowed to "get tough on trade," specifically suggesting that he might pull out of NAFTA, kill the Trans Asia Trade Agreement, impose a 35% tariff on goods from Mexico and China, and so on. Understanding all of the implications of these potential decisions is beyond our pay grade, but most economists believe they would be detrimental to U.S. economic growth generally, and corporate profits in particular. Similarly, his threat to deport large numbers of immigrants and place limits on future immigration would likely dampen economic activity and tax revenues with particular pressure on certain industries such as agriculture and homebuilding. Our goal is not to opine on the wisdom of any of these potential actions but to suggest that there may be offsets to the economic benefits that many expect from tax cuts and infrastructure spending.

Tax Cuts and Infrastructure Spending

As previously stated, current wisdom is that these policies will result in stronger economic growth, improved corporate profits, and a strong stock market. So, let's consider them in terms of the following questions:

- Are they likely to get passed as proposed?
- Will they have the expected impact on the economy?
- Will there be other, perhaps unintended, consequences?

We certainly don't qualify as political analysts so we won't make book on the odds that any given piece of legislation will be passed. But, it is worth noting that both tax cuts and infrastructure spending could potentially have a significant impact on the U.S. Budget deficit, particularly over the short term. And while the Republicans will control both the executive and legislative branches, there is a significant faction of the party that has historically blocked any expenditures that weren't offset by spending cuts. This includes infrastructure programs that were proposed by the Obama administration. Will the new President's honeymoon be sufficient to overcome the budget hawks?

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The markets are currently taking it as a given that tax cuts will lead to stronger economic growth and a couple of pundits have suggested that our growth rate could as much as double. Well, let's not forget that the price of oil fell last year from $108 to $26 with a commensurate decline in the price of gasoline. This was tantamount to a large tax cut yet consumer spending and economic growth barely budged. As currently discussed, a large proportion of the cuts would go to upper income individuals who would be likely to increase their savings rather than consume incrementally. Once again, our goal is not to argue for or against tax cuts but to suggest that their impact is uncertain.

As previously mentioned, large tax cuts and infrastructure spending are likely to lead to an increase in the U.S. Budget deficit even if they do ultimately spur economic growth. And, this may occur at a time when there will already be considerable upward pressure on the deficit due to the demographics of entitlement spending which Mr. Trump has promised not to touch. So, it is reasonable to believe that inflation expectations, and ultimately interest rates, will rise. (As mentioned, both have already increased about 40 basis points.) Don't forget that the Federal Reserve has been on a path to raise short term interest rates as well. Rising interest rates typically negatively impact important sectors of the economy such as housing and corporate capital spending and generally provide a significant headwind to stocks. And, this all is occurring at a time when many stock valuation metrics are at the high end of their historical range. So, once again, it is not clear at all whether there will be offsets to the expected positive benefits of tax cuts and infrastructure spending and the longer range impact on stocks is uncertain.

Market Reactions

In addition to the headline increases in stocks and interest rates, the markets reacted virtually instantaneously to Mr. Trump's election in a number of interesting ways. Volatility decreased sharply, an outcome that was diametrically opposed to what most investors expected in the event of a Trump victory. U.S. stocks have significantly outperformed both industrialized and emerging markets outside the U.S. and the Dollar has been quite strong. Multinational stocks and technology stocks in particular have underperformed due to fear of restrictive trade legislation. Infrastructure and some commodity related stocks have rallied. Small capitalization stocks have been particularly strong because their revenues are mostly domestic which should allow them to benefit disproportionately from the expected U.S. economic growth. And, there has been renewed interest in investment vehicles that may provide a hedge against inflation. Given the prevailing wisdom, all of these trends are logical and ultimately may prove correct. But, given the likelihood of secondary and tertiary effects as well as the offsets discussed above, we caution against making too much of them.

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Implications for Investment Strategy

So, should you make meaningful changes in your investment strategy? Our response is that for all of the complexities described above, one should avoid radical changes and overreaction. Once again, initial interpretation of major events frequently proves incorrect in the final analysis, and in any case, the ultimate outcome may take years to work through the system. Additionally, you should know that our portfolios were already positioned in a way that turns out to be consistent with many of these trends. We were underweight fixed income due to low prospective returns and the potential for rising interest rates and our portfolios have a full allocation to equities.

But, we do believe there are some modest changes that should be made at the margin. First, we plan to make an initial allocation to an inflation protection strategy and expect to build out that exposure over time with a variety of inflation hedging vehicles. Second, despite the fact that non-U.S. stocks are cheaper than their U.S. counterparts, we believe that the fundamentals will favor U.S. stocks so we will make moderate shifts in relative exposure.

Beyond that, we caution against either undue optimism or pessimism and instead recommend sticking with diversification and a well-designed investment plan. ■

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