

## Brexit-Squared

If you're reading this, the world didn't come to an end last night with the U.S. election. However, underdog real estate mogul and reality TV star Donald Trump appears to have secured the presidency by capturing more than 270 electoral votes. Whether it was a late rally or systematic polling error, in the end, the Republicans will take back the White House in a surprise victory. Reminiscent of the Brexit vote, but on a much larger scale, a populist uprising has defeated the status quo.

Down ballot, the U.S. House of Representatives predictably remained in Republican control. As of this writing, it appears the Republicans have also narrowly retained control of the U.S. Senate.

## The Markets

Global capital markets are feeling the weight of the U.S. vote and have gone "risk off" in a big way. As of this writing, S&P 500 and Dow Jones Industrial Average futures are down 4% and 3%, respectively. Futures on the Euro Stoxx 50 are down 4% while the Nikkei 225 is down over 5% in Asia. Bond are rallying with yields down in U.S. Treasuries from 5 to 10 bps across the belly of the curve. Unlike most flight-to-quality rallies, the broad U.S. Dollar Index is actually down just over 1% as investors trim dollar-based assets. Gold is up over 3% and the Mexican peso, considered a bellwether for Trump's chances of success, is off a stunning 9%.

## Uncertainty Reigns

As noted above, the Trump victory has thrown markets into chaos in the short term. This reaction is hardly a surprise. First, his victory has been considered a long shot since the beginning of his candidacy. Markets clearly weren't expecting a Trump victory which by itself would cause a spike in volatility. Second, and more importantly, Trump has little-to-no policy history to assess and much of his rhetoric is contradictory. He has been antagonistic towards the Fed arguing that super-low rates are artificially propping up a failing economy. He has floated comments about "negotiating" U.S. financial obligations and threatened to pull back from international organizations like NATO. The hallmarks of his campaign have been promises to curtail immigration and punish what he sees as unfair trade practices and currency manipulation. He has proposed a significant increase in infrastructure spending but the budget math doesn't add up as his proposals to lower tax rates will dramatically expand the deficit and likely produce higher interest rates. He is volatility personified.

## Thank You Montesquieu

It is important for investors to recognize that this volatility won't last forever, however. First, our system of checks and balances assures separation of powers. In spite of a maintaining majorities in both the U.S. House and Senate, Trump will not enjoy unlimited power. Republicans in both houses are highly skeptical of Trump's conservative bona fides and are leery of his polarizing and combative style. He has made enemies on both sides of the political spectrum and will not be handed a blank check by his Republican colleagues. They will also, out of self-preservation, seek to influence his cabinet personnel, transition process, and legislative agenda.

Second, as we're already seeing, markets will react to and digest this new reality very quickly. New equilibrium levels across asset classes will likely be discovered in a few days to weeks. While not of the same magnitude, it might be instructive to remember that risk assets regained their footing within 2-3 days after the Brexit vote.

## Portfolio Implications

In the short run, we expect higher sustained levels of volatility and for risk assets to perform significantly worse with Mr. Trump en route to the White House as evidenced by the markets' reaction already.

We are also skeptical of sector-based strategies designed to profit from the occupant of the Oval Office. There are few direct lines from the candidate's proposals to policy implementation. As noted above, the separation of powers, if not divided government, will keep Trump from getting a lot of the things he has proposed.

Most importantly, for all the hype and rhetoric, investors would be wise to remember that in many ways, this election has left most of the key investment variables unchanged. Both the U.S. and global economy stumble forward at sub-par real and nominal growth rates. Poor demographics continue to drive a global savings glut. Central banks are largely tapped out in a world with almost zero fiscal latitude or leadership. Equity valuations, broadly speaking, remain at elevated levels. High quality/sovereign bond yields are paltry at best and near-0% cash rates still lose value after adjusting for low inflation.

Post-election, our broad investment themes remain largely unchanged. We believe that stocks offer reasonable relative valuation (vs. high quality bonds) where returns are likely to

be positive but sub-par, constrained by valuation and only a slow improvement in earnings growth. We think that the credit sectors of the bond market still offer attractive relative yields with less interest rate risk than sovereign bonds. Commodity prices have broadly stabilized, but gains will, in our opinion, be sporadic in a world of over-capacity and limited nominal growth.

Is there a silver lining? Perhaps some. Our view is that losses created by the U.S. election results will improve valuations at the margin. Stocks and credit-sensitive fixed-income just got cheaper. If you were worried about the downside effects of a Fed tightening in December, that may well be off the table. We think that falling yields will make sovereign bonds even more expensive. As we approach year-end, rebalancing strategies may add incremental value. Only time will tell if the economic fundamentals will deteriorate over the near-term horizon. Against the worst expectations, this has not happened in the UK post-Brexit... yet.

We expected volatility to rise in 2017 as the capital markets wrestle with an end-game for central banks. The Trump victory has only quickened this timeline. As volatility increases across asset classes that are fully-valued, we expect beta, broad market returns, to be modest. The most interesting opportunities for investors are likely to come from alpha, mispricing within the indexes, as opposed to the returns on the indexes.

In the long run, perhaps a Trump presidency can achieve some sought-after economic goals. Trump, along with Republican leadership, will be keen to scale back or eliminate some of the regulatory burden that is hampering business. This could include looser constraints in the energy sector, banking industry (i.e., Dodd-Frank), and a full-frontal assault on the Affordable Care Act (ACA). Setting aside externalities (like safety, climate, or systemic risk issues), changes in these areas could act as a much needed boost to business productivity.

Finally, as we noted with Brexit, this surprise result can be instructive for investors. Markets are unpredictable and polls are often wrong. Investors can use this experience as a guide to their own risk tolerance. Accurately assessing your pain threshold is the only way for long-term investors to ride out short-term losses.

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