Impact of the 2016 Elections

Changing Our Outlook

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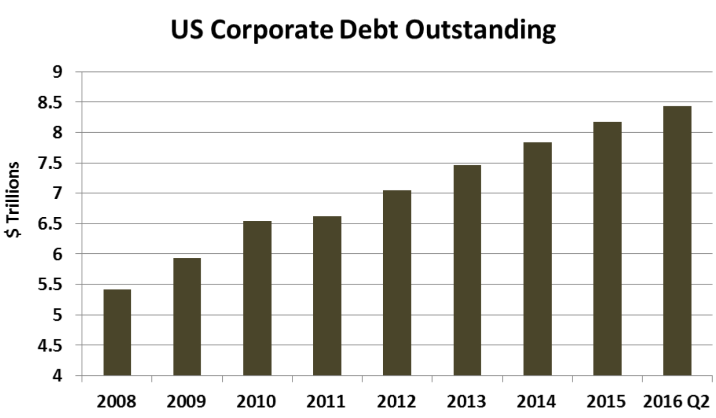
2016 US Elections – Change in Outlook

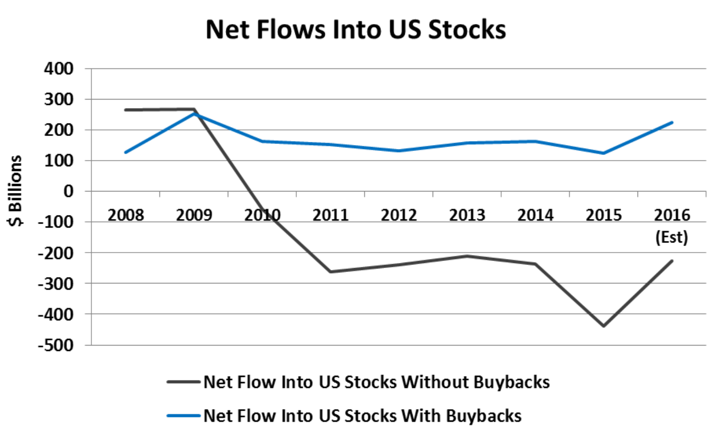
The 2016 US election, which resulted in decisive Republican victories at the Presidential, Congressional, and Gubernatorial levels, has taken most pundits and the Wall Street consensus by surprise. The outcome will potentially lead to new, game-changing policies with substantial implications for economies and markets both at home and abroad. In light of this outcome and the new post-election signals coming from the equity and fixed income markets, we are reexamining client Asset Allocations to align portfolios with our updated market forecasts.

Asset Allocation – Cautious Bulls

After a very long period of post –crisis bullishness, we turned cautious in mid-2016 as a result of equity markets reaching expensive valuations on a price/earnings basis despite little fundamental support. Each of the following concerns contributed to our defensive shift:

- An anemic US economy with GDP growth averaging only 1.5%,
- Zero corporate earnings growth and declining cash flows for 3 consecutive years (2014-2016),
- An all-time high in leveraged corporate balance sheets ($8.5 trillion in total corporate debt) supporting the largest share buybacks and dividends in history,





Source: SIFMA, Goldman Sachs

- The winding down of the Fed's $4 trillion QE experiment that previously supported markets,
- Looming Fed interest rate hikes which were likely to dampen already weak economic growth,
- A pickup in inflation not yet priced in bond markets, and
- A weakening global economic backdrop

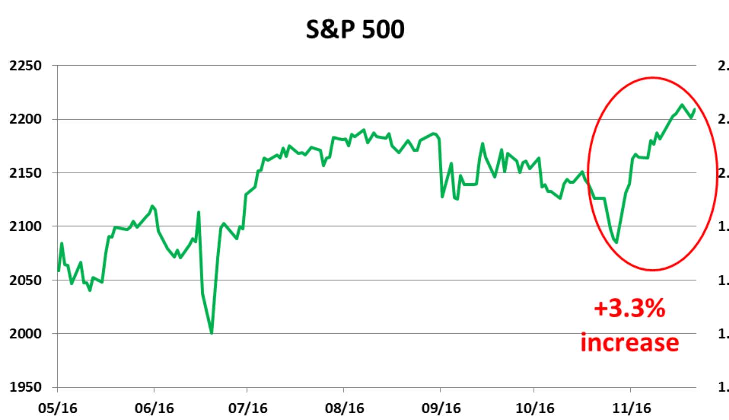
In short, after the second-longest bull market in US history (with the S&P 500 gaining 225% in the 7+ years since March 2009), we became worried these "red flags" were signaling the expansionary cycle may have finally run its course. Although timing markets is always tricky (if not impossible), these fundamental-based concerns informed our decision to modestly scale back equity exposures and reduce maturities in bond portfolios.

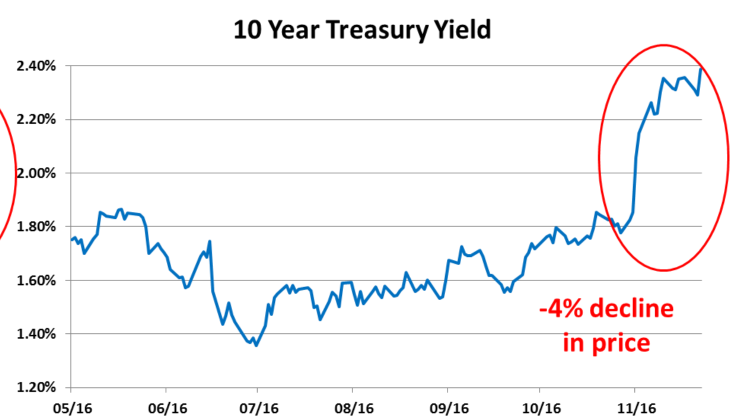
Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2016.

Source: JP Morgan Guide to the Markets

Election Impact: Equities

In the aftermath of Donald Trump's victory, domestic markets are signaling a new consensus view that major federal policy changes are on the horizon. Three weeks after the election, the S&P 500 has risen to new all-time highs and Treasury bond yields have spiked.





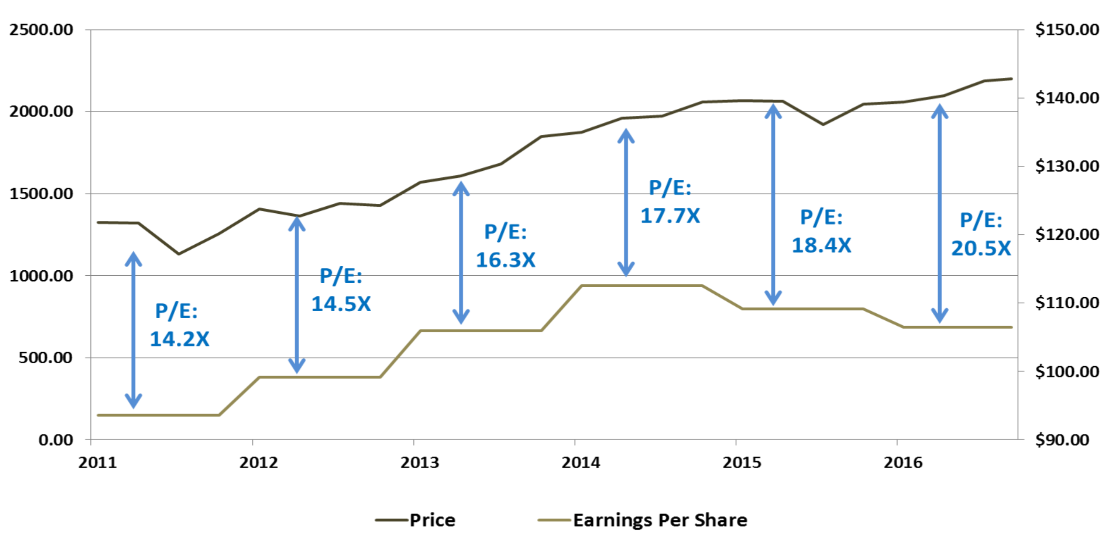
Source: Bloomberg

These significant shifts reflect the market's optimism for the substantial new economic reforms outlined in the President-Elect's campaign platform:

- Broad regulatory relief (i.e. strike two existing regulations for every one new regulation),
- Personal income tax cuts,
- Corporate tax reform (including the potential repatriation of $2 trillion of US corporate profits held off-shore),
- Approval of shovel ready fossil fuel projects (including the Keystone pipeline), and
- An infrastructure modernization program of undetermined (but significant) size and scope

Enacting any of these major initiatives would be positive for stocks. However, although the details and likelihood of Congressional approval are still unknown, the equity market has nonetheless already adjusted higher on the basis of their *potential* impact on the economy. Effectively, this means the post-election rally has largely pre-loaded the future benefits of these policies. As a result, while we've become more positive on the prospects for newly-found growth, we remain cautious bulls. We believe this new market consensus represents a shift towards a more lenient and optimistic forecast of future growth, one that is not yet supported by tangible improvement in the fundamentals. Accordingly, we plan to add equity exposure and reduce fixed allocations. However, given our conservatism when the S&P 500 was pricing at over 19x earnings earlier this year, we naturally retain some skepticism now that it trades at an even-richer >20x earnings.

S&P 500 - Price and Earnings Per Share



Source: Bloomberg

Election Impact: Fixed Income

Contrary to rising equity markets, bonds prices have dropped and yields have moved higher. US 10 year Treasury yields have risen 100 basis points to 2.36% since setting their all-time low of 1.36% this past July. Over 50 basis points of this move occurred in the past 3 weeks. In a remarkable example of the distortionary results of ultralow rates, this sudden 50 basis point uptick translates to a 4.5% fall in the 10 Year Treasury's price. The Barclays US Aggregate bond index suffered its largest percentage drop since 2013, dropping 2.40% from November 8th to November 25th.

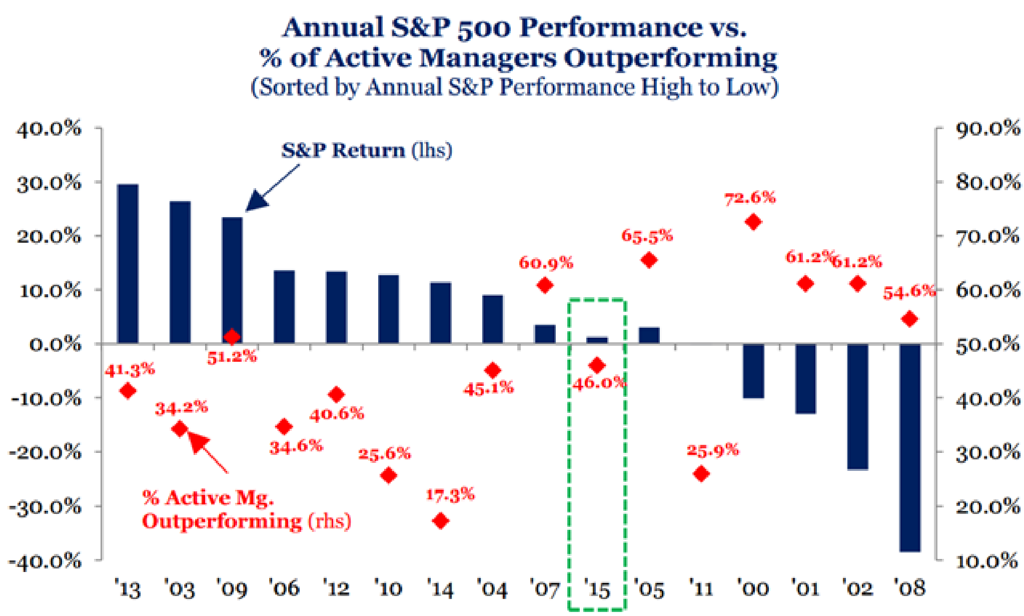
The bond market rout is based on the new consensus outlook for increased federal deficit spending to support President-Elect Trump's ambitious fiscal stimulus plans. Any enacted stimulus measures would likely also support the case for higher inflation expectations, particularly in the context of an already tight US labor market (with sub-5% unemployment). All of these factors are associated with rising rates across the curve. As such, the 30 year bull market in bonds may finally be ending, as we enter a new, bearish phase of rising yields and falling prices.

For all these reasons, we remain cautious, not outright bulls. We share the consensus belief that improved economic growth driven by the President-Elect's anticipated reforms and stimulus measures can restore corporate profit growth, and feel that redeploying fixed income allocations to equities is warranted at this time.

Active Managers vs. Passive ETF Investing

For over three decades, we've been applying a rigorous discipline in selecting individual equity managers who display sustained risk-adjusted outperformance compared to equivalent indices. The strategy generally provided healthy returns with lower volatility. In years of declining markets, managers demonstrated clear outperformance even without adjusting for risk.

The "secret sauce" to successful active management has always involved taking advantage of volatility, which creates the environment necessary for opportunism and valuation changes. But since the 2008 financial crisis, global central bankers have overwhelmingly suppressed market volatility at every turn. Although the major global banks' mandates involve some combination of stimulating employment while controlling inflation, they've been quick to respond to periods of market instability by maintaining zero/negative interest rate policies and "jawboning" the markets. 'Whatever it takes,' 'the Yellen Put,' etc., were mantras to complacent, range bound markets. As a result, for an extended period of time and across a variety of asset classes, volatility has been snubbed and individual equities within indexes have traded in tight, neat bands. Not an optimum environment for research driven equity managers.



Source: Strategas

As a result, this environment of dampened volatility has naturally led to general levels of manager (absolute, non risk-adjusted) underperformance. We're disappointed with certain manager results and will be replacing these underperformers with passive ETF index exposure at lower fees. This will create better alignment between performance results and benchmarks in our overall equity exposure.

As you know, our overall strategy was to allocate to both active and passive ETF strategies. We will not entirely eliminate active managers due to their historical downside protection in negative market environments. Although volatility has long been dormant, it would be foolish to bet it will always remain that way. Rather, we'll raise the allocation to passive ETF strategies to lower costs, retain exposure to those we consider "best-in-class" managers, and ideally capture the benefits of both active and passive investing.

Conclusion

We will continue to carefully monitor the investment climate and fine-tune client Asset Allocations as circumstances change. Please don't hesitate to reach out to us if you'd like to discuss any changes to your portfolio in more detail.

All cited market statistics as calculated by Bloomberg