This Month in the Markets

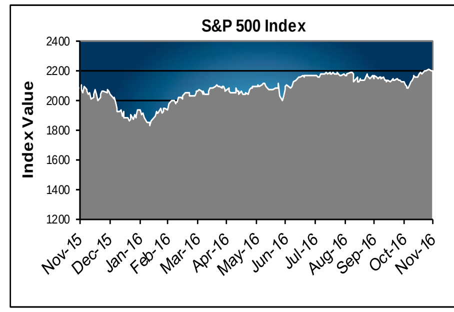
November 2016

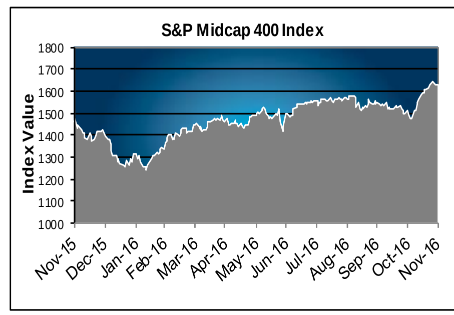
ANCHOR
Investment Management

EQUITY COMMENTARY

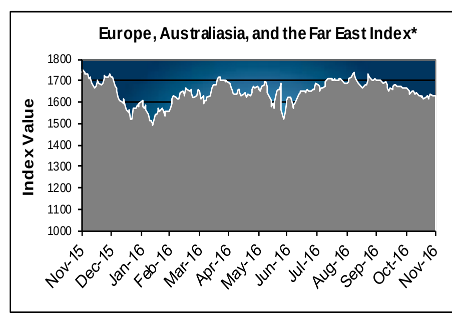
A Surprise Trump Victor Leads to a Comeback of the Reflation Trade

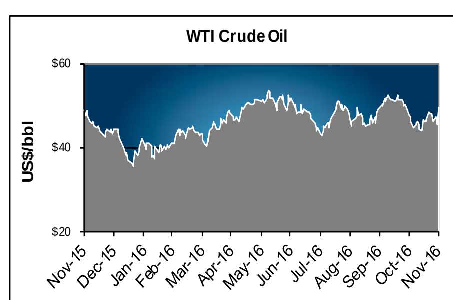
The key story of the month was Donald Trump's surprise victory in the U.S. presidential election. With prospects of a surprise Trump victory increasing as results poured in from key battleground states, equity futures sank, with the S&P 500 futures down the maximum of 5.0%. By the early morning it became clear that Republicans would retake the Senate and the Presidency and hold on to their large majority in the House of Representatives. With the world on edge Donald Trump's acceptance speech came across more measured than his tone during the campaign which proved to calm investors. The U.S. market opened the day slightly lower but closed up over 1.0% despite previous fears that a Trump victory could lead to a crash in equity prices. Sentiment shifted from concerns over Donald Trump's temperament and his ability to act as "Commander and Chief" to the potential benefits that a Republican sweep would have one the U.S. economy. The remainder of the month was highlighted by sharp rallies in equities which resulted from the anticipated benefit from increased spending on infrastructure and higher inflation. Financials, energy and industrial companies led the charge with gains of 7.5%, 5.1% and 3.5% respectively. With the sharp rise in interest rates, the perceived "safe" bond-like equivalents continued to sell off heavily. Utilities, consumer staples and real estate companies ended the month down 6.5%, 5.3% and 3.4% respectively. Overall, the Morgan Stanley Composite Index (MSCI) ended the month up 1.3%. The sharp rise in yields also led to a 3.1% increase in the U.S. dollar. As a result, in dollar terms, U.S. stocks significantly outperformed international stocks with the S&P 500 index up 3.4% versus the Europe, Asia, Far East index (EAFE) down 2.2%. For the year the MSCI is now up 3.0% with the S&P 500 up 7.6% compared to the EAFE which is down 5.0%.





As value based investors our focus has not really changed since the election. We have been underweight the perceived "safe" areas of the market as the chase for yield and safety had pushed valuations above fair value. The rise of interest rates that began in early July has only accelerated since the election. The yield on the 10-year U.S. Treasury security bottomed on July 8th at 1.36% and closed at 1.85% on Election Day. Yields spiked to 2.06% the next day and closed the month at 2.38%. Certain stocks which had been bought for their yields, despite slow growth and pricey valuations, have tumbled as Treasury yields have risen. The utility sector, for example, has fallen 10% since July 8th, compared to the 4% gain in the overall market. Consumer staples stocks are down 9.2% over the same period. While utilities and staples companies are getting a little bit more interesting after the recent pullback, our valuation work suggests that most of these companies remain overvalued. While we have been underweight the defensive sectors in the market all year, our big overweight has been in financials. After underperforming in the first half of the year financials have been the big winner with rising interest rates and the prospect of reduced regulation going forward under a Trump regime. Since July 8th financials have risen 19.3%, outperforming the market by 15.4% and utilities by 29.3%.





While we remain positioned for higher interest rates, we are cognizant of the fact that this recent move may correct some. While we are hopeful that a Trump presidency will lead to a lower corporate tax rate and higher investment spending, we are always mindful of valuation. Many of these plays are now pricing in a near perfect scenario that will be realized almost immediately. We will continue to rely on our valuation work to drive our investment decisions. Although narrative "trumps" numbers in the short run, it cannot replace any form of solid analysis.

*MSCI EAFE Index

FIXED INCOME COMMENTARY

A "Bigly" Move in Yields

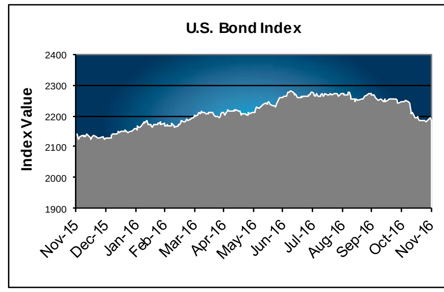
The highlight of the month was the U.S. presidential election and the Republican's win of all three chambers – President, Senate and House. After a brief risk-off period in the night after Election Day, market participants made a volte-face and a "bigly" move in interest rates followed. The ten-year U.S. Treasury security yield rose 56 bps in November, which was the biggest monthly move since December 2009. Following Donald Trump's election victory the federal funds rate promptly adjusted upwards and has made a rate hike at the FOMC meeting on December 14th a near certainty. The U.S. dollar extended its rally from October with another 3.1% jump in November.

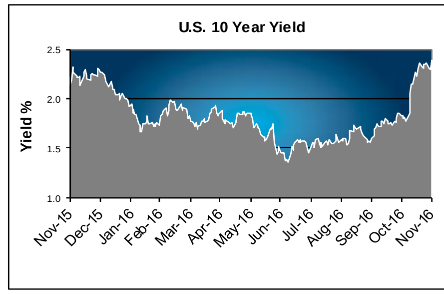
The outcome of the U.S. election could prove to be an economic inflection point. Although the current expansion in the U.S. has been one of the longest on record, it has also been one of the weakest since World War II with economic growth and inflation well below the potential rate for 6 ½ years. The proposed policies by president-elect Trump have the chance to be a game changer. The key-pillars of the campaign were de-globalization, a stricter immigration policy and higher fiscal spending. Fiscal stimulus would increase federal debt by about $6 trillion over the next ten years and provide around 2.5% of additional GDP growth per annum. Those numbers appear to be extreme but even a watered down infrastructure and tax accord will provide substantial stimulus to the U.S. economy. Real economic growth will likely be accompanied by higher inflation due to increased trade protectionism and less immigration on top of a relatively tight employment market. Such an outcome has been reflected in the entire yield curve which adjusted sharply upwards shortly after the election. The market now expects a rate hike in December, two more in 2017 and another two increases in 2018.

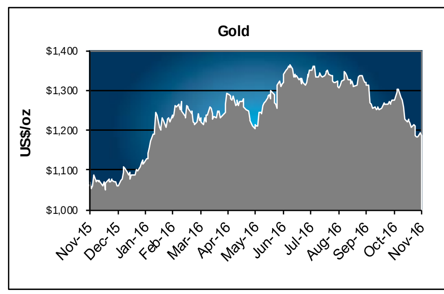
Many of the recent economic data points were rendered useless since they reflect the landscape before the U.S. election and do not take into account the fiscal and monetary reset which is expected over the coming legislature period. Nevertheless, research by the International Monetary Fund (IMF) has shown that even before the U.S. election the output gap of advanced economies has narrowed from a high of 3.8% of GDP in 2009 to 0.8% at present. Once the gap has been closed some additional inflation pressure can be expected.

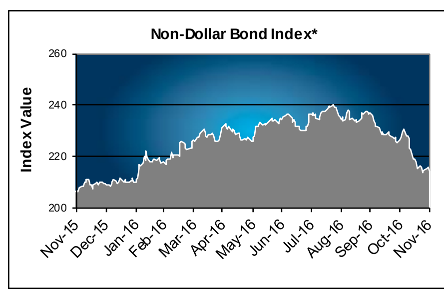
Despite the hype around Trump's plans, the outcome may be positive for the U.S. and not necessarily for the global economy. World trade has slowed down considerably with the year-over-year change in global export volumes essentially unchanged. The proposed renegotiations of existing trade agreements (e.g. NAFTA) and additional protectionism measures will likely improve the U.S. trade deficit but consequently hamper growth prospects of other economies, especially emerging markets. So far the visible adjustment has happened in the foreign exchange market. Primarily vulnerable is the Mexican economy and the peso lost 9.1% in November alone. Other emerging market currencies, like the Turkish lira, the Indian rupee, amongst others, have sold off to record lows. De-globalization will not only impact growth prospects but has also the potential to reduce foreign direct investment into emerging markets and reverse capital flows back to developed economies, putting further upside pressure on the U.S. dollar.

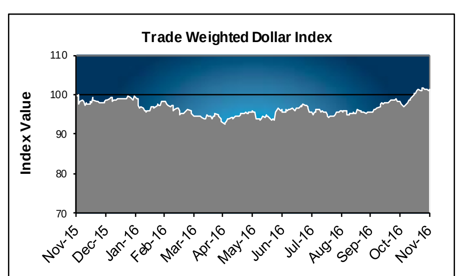
Divergent monetary policies - with the Fed expected to hike rates and the European Central Bank and the Bank of Japan still pursuing asset purchase programs - led to a sell-off in the euro and yen of 3.6% and 9.2%, respectively, in November.











*Merrill Lynch Global Broad Market, Ex US Dollar Index