Post Election 2016: A Guide to the Markets

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Roosevelt Investments

While the 2016 election is over, understanding the potential impacts is just beginning. We have continued to ponder the implications of the new administration's anticipated policies and their influence on the markets in 2017 and beyond. President-elect Trump espoused a pro-growth agenda during his campaign, and three key points we are focused on include tax reform, reduction of regulatory burden, and fiscal stimulus/infrastructure spending, which we refer to collectively as the "Trump Triad". While other top campaign issues such as trade and immigration may also impact markets, we believe the intersecting forces of the Trump Triad are the most prominent.

In the weeks following the election, as investors have attempted to anticipate the ramifications of the Trump Triad, capital markets have, in some cases, reacted very strongly despite the fact that the inauguration is still weeks away. We have witnessed a stock market that has risen by several percent with sharp rotations between sectors of the market, a meaningful rise in interest rates, and a stronger U.S. dollar. What follows is our review of some of the key changes that have occurred, and our view of their impact upon certain sectors of the economy.

Market Landscape

We believe rates have moved up sharply because the market is starting to appreciate the possibility that the U.S. economy might experience stronger growth, as well as an increase in inflation, under the Trump administration. Broadly speaking, acceleration in economic growth tends to boost interest rates and increase the value of the dollar relative to other currencies. We have seen both of these take place since the election. Notably, the yield on the 10-year U.S. Treasury bond, has increased from 1.85% to 2.45%. This is a significant increase for such a short period of time.

In general, an increase in growth boosts demand for borrowing, and this incremental demand for loans tends to lead to an increase in interest rates. Given that our economy is now about eight years past the financial crisis and the unemployment rate has declined to what many believe is equivalent to a state of full employment, a boost in economic growth could also lead to inflationary pressure if wages rise in response to growth. A rise in inflation also tends to boost interest rates, as banks and bond investors demand higher income since future dollars will be worth less.

Related to the increase in rates, the treasury yield curve, the difference in rates between the 3-month Treasury bill and the 10-year Treasury note, has significantly steepened, going from 144bps to 186bps. The steepness of the curve is an important consideration for the market, as it allows lenders (dependent on the spread between short and long interest rates) to achieve wider spreads and earn a greater net interest margin, thus increasing their profitability. Steeper yield curves have historically been a signal that the market is anticipating economic growth.

With global investors viewing the potential for higher economic growth as more likely, the trade-weighted dollar index has increased 4% since the election. In our view, the increased likelihood of Federal Reserve rate hikes over the next 24 months, across the backdrop of central banks elsewhere which are still in monetary easing mode, has also probably boosted the dollar.

Trump Triad:

1. Tax Reform

2. Reduction of Regulatory Burden

3. Fiscal Stimulus / Infrastructure Spending

A stronger dollar has impacts which ripple across the globe. These include disinflationary tailwinds in the U.S. for those either importing goods from abroad or purchasing goods in other countries that become cheaper versus the U.S. For borrowers overseas who borrowed in dollars, their debt becomes slightly more onerous as it appreciates in value as a liability, while conversely borrowings by U.S. companies in non-dollar currencies become incrementally less onerous. This dynamic is particularly true in developing economies which may have more volatile currencies. In terms of trade with other countries, a stronger dollar is a headwind for U.S. exporters because it makes U.S. goods more expensive for foreign buyers, particularly in a competitive industry where there are plenty of alternatives offered by local companies.

Lastly, while it has often been true that dollar strength is typically accompanied by weakness in commodity prices, we have seen increases in the price of many industrial commodities since the election, including copper, nickel, zinc, lead, and iron ore. This may be due to anticipation of greater demand from economic growth or inflationary pressures overwhelming the impact of the strong dollar.

Sector Impacts

Financials

Given the anticipation of higher growth and the reality of a steeper yield curve, perhaps it should be no surprise that financials, and banks in particular, have been the best performing sector in the S&P 500 index since the election. Life insurers have also outperformed, since they may also benefit from higher interest rates, as their investment portfolios seek to generate income after what has been a historically challenging interest rate environment for the past several years. Sector performance has also likely been aided by anticipation of the regulatory relief aspect of the Trump Triad, because regulatory costs have added to the expense burden of financial services companies over the past eight years.

The flip side of this upward move in interest rates is that in many cases, bonds, preferred stocks, and so-called bond proxies (REITs, utilities, telecom companies, and other high-yielding equities) have in some cases declined in value or underperformed the broader market since the election. This is fairly typical of what occurs with a rise in interest rates, where the yield currently received on these types of securities may now be incrementally less attractive.

Industrials

The industrials sector within the S&P 500 index has been the second strongest-performing group after financials, despite what may be a headwind in 2017 from a stronger dollar. We believe this is likely because investors believe the benefit from the assumption of stronger economic growth in the U.S. outweighs the headwind, and also secondarily perhaps because a Trump administration might take a stronger stance on foreign trade in defending the rights of U.S. exporters.

Leading up to the election, both candidates indicated that they would seek to boost defense spending, and defense stocks performed well prior to the election as a result. The group's outperformance has continued after the election, as investors anticipate how president-elect Trump might prioritize his spending plans. We have seen analysis that suggests as much as $250 billion could be added to defense spending over the course of Trump's term in office. In addition, Congress has signaled its goal of eliminating sequestration which has kept a lid on defense spending since it was enacted in 2011. An additional boost to defense spending could occur as a result of Trump's comments about NATO members sharing the burden of defense spending, as the majority have not lived up to their commitment to spend at least 2% of GDP on defense. This could represent incremental additional demand for products and services from defense companies.

Another group within the industrials sector which has responded favorably to the Trump Triad is transport stocks. For much of the past eight years the economy has experienced modest growth, and many transportation companies have had to cut costs wherever possible in the absence of meaningful sales growth. Freight transportation companies in particular are very sensitive to the level of volume shipped through their transportation networks, and have downsized in recent years to adjust to slower growth. In anticipation of higher growth in the coming years, rail and trucking company shares have appreciated meaningfully in the post-election period.

Spending on infrastructure was another area which both candidates touched on leading up to the election, and given the age of many of our roads and bridges it would seem to be an idea with bipartisan support in Congress. Ports, airports, public transportation, and water are a few additional areas which are in serious need of modernization or updating. While the devil is in the details regarding how funds would be raised and where the money would be spent, we believe it's likely that spending on infrastructure will increase during the coming years.

Healthcare

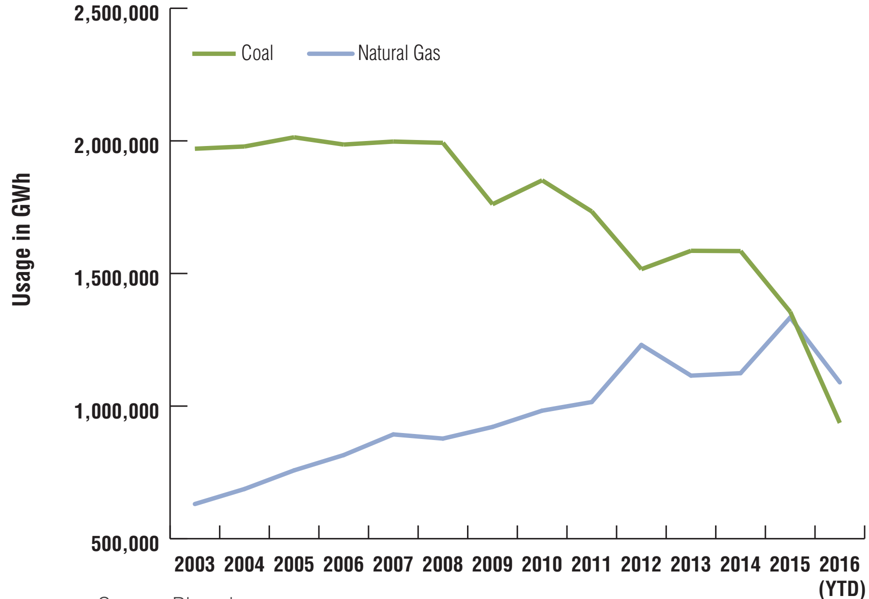
Leading up to the election, the healthcare sector was one of the worst-performing sectors of the stock market. This presumably was related to campaign rhetoric about drug pricing policies by pharmaceutical and biotechnology companies, as well as concerns regarding the Affordable Care Act. A diminishing number of plans are currently available on healthcare exchanges, and at higher prices, with many HMOs backing out of these exchanges because they cannot find a way to operate profitably. In the weeks after the election, the sector has continued to underperform. In our view, this relates to a weakened ability for companies to increase prices due to a greater national focus on the subject. Campaign comments by Trump perceived as "healthcare unfriendly" include potentially changing the way drug prices are negotiated, the concept of importing drugs from Canada, and perhaps most importantly, a repeal of the Affordable Care Act. While the impact on various areas of the healthcare sector under an "ACA repeal" scenario is unclear, this uncertainty is perceived negatively.

Energy & Utilities

In the energy sector, we anticipate performance will be correlated with the price changes of the underlying commodity. While a Trump administration is unlikely to be able to impact the global oil price, a reduction in the regulatory burden facing energy companies could provide a boost to potential production rates in the future, perhaps given easier permitting for pipelines and drilling in certain areas. However, in an environment where the global demand for oil is in balance with supply, any increased production coming from the U.S. could keep a lid on prices or even depress them.

Coal is a key source of energy for many utilities in the U.S. and abroad, and is also in demand for steelmaking. Trump was very vocal in his support for coal during his campaign, but coal has been in decline since about 2000, when it represented roughly half of what was used to generate electricity in the U.S., and is now closer to 30%.

Coal & Natural Gas Energy Usage, 2003 - 2016 (YTD)



Source: Bloomberg

Natural gas has taken up much of the slack since many utilities have the ability to substitute gas for coal, and it is difficult to envision how this shift away from coal could change. Sources of incremental demand for coal may be primarily overseas as electricity generation infrastructure in many developing countries is still largely geared towards coal. Nevertheless, we continue to believe that coal is in long term secular decline, despite Trump's pro-coal stance during the campaign.

Shares of some companies focused on clean energy have underperformed since the election, and we think this may represent an interesting opportunity. Utilities are largely state regulated and states have been pushing utilities to shift to renewables. These companies are not likely to change their plans to continue expanding the share of electric needs met by wind and solar, and the cost of building such facilities has declined to the point where it may be cheaper than natural gas or coal. As part of legislation earlier this year to enable U.S. exports of crude oil, tax incentives for wind and solar energy projects were extended for several more years. In addition, many companies are pushing ahead with their plans to source energy directly from clean energy providers, especially technology companies building data centers to support cloud services. We believe this is a longer-term trend which is unlikely to be altered significantly by the Trump administration.

Technology

Technology shares, particularly many large cap stocks, have generally underperformed since the election. While we do not see a clear reason behind their underperformance, part of it may simply be a shift by investors from growth to value stocks. (Somewhat counterintuitively, in an environment of improving economic growth, value stocks tend to outperform, while growth stocks often perform best in slow growth environments where growth is scarce.) We believe the tax reform aspect of the Trump Triad is particularly interesting when it comes to technology shares, because many have large cash balances which are 'trapped' overseas from a tax standpoint. It is believed that repatriation of overseas cash is part of the Trump administration's tax reform plans, and we think large technology companies are likely to be significant beneficiaries of such reform.

Final Thoughts

More broadly, we believe lower taxes and reform involving repatriation have the potential to be stimulative to the economy as well as the stock market. If we assume corporate tax rates decline, then corporate earnings should increase. Higher corporate earnings, all else equal, should equate to a higher stock market. That said, higher interest rates and/or inflation, which tend to depress valuations, could impact this scenario. Beyond lower taxes, if cash can be repatriated without significant penalty, that cash could be used for acquisitions, share buybacks, and investment in new plant and equipment. Acquisitions and share buybacks tend to boost stock prices. Capital investment has been depressed for many years, and an increase tends to stimulate economic growth as well as demand for hiring.

For a long time now, our economy has been operating in a low-interest rate, low-growth environment that many economists believed would persist well into the future. At this point, we believe that we may be on the cusp of change leading to an improvement in economic growth, driven by policies comprising the Trump Triad. While there are many variables at work, and certainly risks to such a view, it's possible that we may be witnessing a significant inflection point in the trajectory of our economy as well as the stock and bond markets. For much of 2016 we have seen outflows from equities to bonds, but that has reversed since the election and may continue. It's important to keep in mind that periods of uncertainty, such as a new incoming administration, usually create opportunities as well as traps. While key questions remain as to whether anticipated growth materializes and how the Federal Reserve responds, election impacts are just one of many factors that investors must heed in order to properly navigate the investment landscape, achieve desired returns, and meet long-term planning needs.

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