Asset Management

News or Noise Special Edition: A Wild Night (and Day) in the Markets

By David Fisher, Chief Investment Officer

Lenin is often credited with saying that "there are decades where nothing happens; and there are weeks where decades happen." It is beginning to feel like the culmination of the 2016 presidential election has brought on this type of inflection.

As one that stayed up all night watching the results—and the markets—it seems that the investing universe came to this conclusion over a 16-hour period. Starting at 8:00 p.m. EST, the U.S. markets collapsed by 6% (more than 950 points on the Dow) only to rebound all the way back by Wednesday market open and then adding 250 points by the close. The total swing across that single night and day was nearly 1,200 points, and by Thursday the Dow was at a new all-time record close.

Other markets moved in similar whipsaw motions. The yield on 10-year Treasuries initially collapsed by 18 basis points (a basis point, or bp, is 1/100 of a percent) before moving higher by 37 basis points. Gold surged higher by $70 an ounce only to give all that back in regular trading.

Before the election results were tallied, most analysts projected that the stock market would see material declines in the event of a Trump victory. Thus the initial drop was violent but not a surprise. But the forceful recovery *was* a surprise. So what caused the collective change of opinion in such a short period of time? In our opinion, it was not actually Donald Trump's victory that came as a surprise but rather the definitive sweep of elections that went in the favor of the Republican Party. Investors concluded that we weren't dealing with a Trump White House intent

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There is, of course, much work to be done before this view can be seen as reality, but the trends in the market have persisted, and for now investors are optimistic that positive economic results will follow.

It is important to recognize that half of the country did not vote for Mr. Trump and that many are disappointed in the election results. Government, the media and the country remain highly polarized. But it is our job to assess the landscape and ensure that client portfolios are in sync with current fundamentals and future changes that may arise from policy change. As investors, we must set our personal bias aside and focus on where the data and markets take us.

What Comes Next?

Over the next several weeks, the news will shift from elections to leadership. As the new administration builds a team of advisors and appoints key positions, policy priorities will become clearer. At present, it appears that President-elect Trump is using the "team of rivals" model. He began by naming key Republican insider, and GOP Chair, Reince Priebus as Chief of Staff while at the same time naming the divisive and consummate outsider Steve Bannon as Chief Strategist. Other key appointments may follow this pattern of a potentially volatile mix of traditional insiders paired with nonconventional firebrands.

The team-of-rivals concept comes from the book by Doris Kearns Goodwin that studied the unique mix of personalities that made up Abraham Lincoln's Cabinet. Only time will tell if Trump's version of this exercise will have a similarly successful outcome or if it will devolve into a chaotic group of individuals unable to coalesce around a common vision.

What is clear is that predictions of a divided Republican party splitting into traditional and extreme factions now seem misplaced. Within a week of the election, Speaker of the House Paul Ryan—a vocal critic of Trump during the campaign—partnered with the President-elect and was unanimously approved to serve again as Speaker. After a highly emotional campaign with personal attacks over more than a year, it is impressive to see how Trump has pulled almost all of his party back under the tent.

Just as important for the markets, it will be key to see how the policy priorities start to line up. Trump has already outlined his top three issues as (1) immigration, (2) health care and (3) tax reform. It will be critical to see how his first major policy change plays out. If he is able to get broad, including bipartisan, support for a major bill, then his political capital could grow. If things get bogged down, then the optimism for major change could fade. Of course, it is way too early to make prognostications.

It is worth remembering that even though the Republicans maintained control of the Senate, they did give up seats and now hold only a slight majority. Much of the legislation will take Democratic support to get past the 60% cloture rules. Early news stories about challenges within the transition selection process underscore the fact that the process of leading an

organization as unwieldy as the U.S. executive branch of government is complex and fraught with challenges.

Investment Implications of a New Regime

Even though many questions remain, the fact that we are operating with a new regime is undeniable. The policies that have been in place since the financial crisis will be materially changed. The market has thus far taken this as a reorientation toward growth policies, but how quickly and, ultimately, how effectively these changes will be made matters for future market performance.

We will consider each major segment of the market in more detail below, but at the highest level the changes are likely to remain more bullish for stocks over bonds, and for tangible assets over financial assets. The initial sharp adjustments are likely behind us, and we will now settle into a period of slower moves. We would be even more bullish if not for the fact that we are in the later innings of a muted yet elongated business cycle with assets generally at the higher end of reasonable valuations.

- **Domestic stocks:** The week of the election saw the strongest U.S. stock market returns in over two years. Yet digging under the surface and observing individual sectors, one discovers even more dramatic moves. The difference between sectors like banking and renewable energy widened by 20% or more.

  The clear winners from this election were several of the traditional value sectors such as energy, industrials and financials. The weaker parts of the market have been the big technology companies such as Facebook, Amazon and Netflix, which are down between 2 and 8% since the election. Worries about protectionist policies and selling winners to buy the new hot areas are likely both reasons for the move. Smaller stocks with a domestic focus are now higher-conviction picks, in our opinion. International sales represent nearly 50% of the S&P 500, and the stronger dollar and concerns about global trade policies could restrain appreciation in these stocks.

  - *Bottom line:* It is prudent to now be biased toward stocks with a domestic focus. The election is extremely positive for financials, especially banks. It is somewhat helpful for industrials, energy and portions of health care stocks. It is positive for domestic-oriented stocks, and less-clear for companies with large global sales. We added to smaller companies and traditional value strategies earlier this year, and these moves have helped client portfolios. We will look to add further to these same positions on any market pullbacks. Our additions would be even more aggressive if not for the fact that U.S. stocks are at levels near the high end of reasonable, in our opinion.

- **International stocks:** Just as the election is likely to impact sectors in the U.S. differently, it could have mixed results regionally around the world. On the margin, a strong U.S. helps the overall global economy, as we remain the biggest and most dynamic economy in the world. A rising dollar and higher interest rates here also make the U.S. less competitive compared with other countries. This coupled with strong evidence that stocks outside the U.S. are available at much more attractive values means that a wholesale shift seems inappropriate.

Since the post-Brexit-vote lows, we have seen Japanese equities outperform those in the U.S. by more than 10%. The significant policy shifts by the Bank of Japan in September have fueled this outperformance and pushed all of our key research partners to hold overweight opinions on Japan. Europe is less clear. The continuation of concerns over Brexit and elections over the next 12 months (Italian referendum, French presidential and German Chancellor) add risk.

The European Central Bank remains on the offensive, and bank stocks have been outperforming, both positives for asset valuation increases. Emerging markets are the biggest unknown. Our core emerging market manager remains up midteens this year but has pulled back by 6% since the election. Until clarity around global trade emerges, these markets may remain volatile.

- *Bottom line:* International equities provide a larger margin of safety compared with those in the U.S. while most economies around the world are earlier in the business cycle than the U.S. Economic data before the election were showing the strongest period of synchronized expansion since 2010. That said, risks remain elevated in most of these regions, and an inability to address their challenges could continue. We will watch developments closely in the coming weeks. In the near term we would be inclined to hold or even add slightly to Japan while reducing exposure on moves higher in Europe. Emerging markets have had a convincing move since we added exposure in early 2016, and we are inclined to hold current positions but want to see confirmation of a ”soft Trump” approach to global trade.

- **Real assets:** We mentioned that the future appears brighter for tangible assets compared with financial assets. What are tangible assets? Basically anything you can see and touch, including energy and commodities, real estate, infrastructure, precious metals and even collectibles like art and antiques. Though many of these assets have done well in recent years, broadly, tangible assets are valued near multi-decade lows compared with financial assets. This is largely due to the ultra-low interest rates and relative high prices assigned to financial assets as a result.

  Real estate fundamentals remain solid, and interest rate increases should remain mostly benign unless the U.S. 10-year moves north of 4%, which we believe is unlikely over the next few years. Commodities have rallied sharply since February, which could mark a significant low. We especially like energy markets and energy infrastructure given the change in regulation around these industries. Precious metals have sold off as political uncertainty within the U.S. has retreated. Geopolitical shocks will continue to provide upside potential to gold and silver, but the timing of these events is not possible.

  - *Bottom line:* Inflation expectations have shifted higher by nearly 0.5% since the election, accounting for a significant portion of the moves in bond markets and leading to the shifts within equity sectors. That said, the past week could prove to be a long-term secular shift for tangible assets. Our favored areas remain real estate and energy, especially pipelines. We will continue to hold and potentially add to these markets on pullbacks.

- **Alternative assets:** Anticipating the impact of the election on hedge funds and private equities is difficult. Two positive shifts in recent trading have helped. First, the market has become more differentiated, meaning the performance of individual stocks has been more varied. As opposed to an environment where a majority of stocks move in parallel, this is an environment that so-called active management can make a bigger difference. This is critically important for hedge funds.

  Second, many alternative strategies will benefit if interest rates drift higher due to the high levels of cash they often hold as collateral against trades. Historically, this could provide several percent per year to returns, but has clearly not been available in recent years. Other strategies use leverage and are harmed in a proportionate way from higher rates.

  - *Bottom line:* By definition, alternative strategies are designed to take advantage of idiosyncratic opportunities. As such, it is impossible to make broad statements about how they will be impacted by the election. A move to higher rates and more dispersion of returns will aid a lot of long/short strategies. In a renewed bull market, we would be inclined to use the alternative portion of our portfolio allocations to fund higher-risk investments like equities.

- **Fixed income:** The clearest market signal over the past weeks seems to be the belief that rates have hit a historic low. Legendary investor Henry Kaufman was quoted in the *FT* last week as saying, "[The election] is a tectonic shift … the end of a three-decade bond bull market. … Secular swings are hard to forecast, but the secular sweep downwards in interest rates is over, and we are about to have a gentle sweep upwards." A key word in that quote is "gentle." The move thus far has been violent, but it is likely to settle down from here. That said, the rewards for holding fixed income look even less enticing than before. We have continued to hold the majority of our fixed income holdings in positions that have limited impact from rates moving up.

  - *Bottom line:* For most investors with long-term goals, fixed income allocations should be on the low end of what is appropriate. We have had that positioning over the past few years; thus we would anticipate limited changes from here. We will continue to hold the maximum amount that we feel is prudent in shorter-term strategies that tend to have more credit risk. A growing economy and modestly higher inflation, all else equal, are positive for these strategies.

As stated above, events of the past week will likely be seen as a major inflection, not only for politics and geopolitics, but possibly for the global economy as well. Investors' initial take is mostly positive, but we still have more questions than answers. The team at SignatureFD will watch developments very closely over the next several weeks, and we look forward to updating our thoughts with our 2017 overview in January. Thank you for your business and continued trust.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.