CROSSBRIDGE CAPITAL

Market Viewpoints

Manish Singh

October 2016

> **In our personal ambitions we are individualists. But in our seeking for economic and political progress as a nation, we all go up or else all go down as one people.**
>
> - Franklin D. Roosevelt

Hillary Clinton is now favourite to win the US election. If the US economy continues to grow at a pace of +1 to +2% per year (instead of the historical +3% to +4%), then the current economic and political problems will only worsen. Clinton will be acutely aware of this. A growth deficit should be a bigger worry than a budget deficit. Fiscal austerity has to give way to fiscal spending that induces growth. With 30y US Treasurys yielding 2.5%, borrowing to invest should be the mantra. The current economic expansion in the US, which began in June 2009, is now in its 88th month, which means that Trump or Clinton is likely to face a recession early in his or her administration. Equity Bull markets tend to have an expiration date as well: On average every 4.5 years. However, like the economic expansion, this Bull Run is also past its due date and is now seven years old. Does that mean one should sell? Not at all. Seasonally, we are entering the best period for equity markets. November to April is when equities tend to do well, before the May to October swoon. Since 1950, the S&P 500 Index has gained +7.1%, on average from November through April, versus +1.4% from May through October. Monetary accommodation is set to continue. These markets will not be broken by central banks. In many respects the central banks "own" these markets. If anything breaks the market, it will be the upheaval that only politics can cause – the US election, the Austrian election, and the Italian constitution referendum amongst others.

Gaslight

In the psychological thriller *Gaslight,* husband (Charles Boyer), in an attempt to convince his wife (Ingrid Bergman) that she is going insane, secretly turns the gaslights in the house up and down, making the light brighter or darker to confuse her, cloud her perceptions of reality and ultimately control her at will. Similarly, in politics, for years now, depending on the interests of the political elite - reality has been illuminated or dimmed. The benefits of globalization, immigration, home-ownership, austerity et al. have all been touted or condemned, as it suits the narrative of the day. This has resulted in modern politics being littered with professional politicians ready to turn on a dime and use the manipulative "gaslighting" techniques to alter the perceptions of the gullible electorate. As in the movie, reality doesn't have to be real. It just needs to seem that way to voters. However, people have woken up and are ready to reclaim reality. UK's Brexit vote (Brexit Special newsletter) earlier this year is one such instance, when a huge coalition of the establishment was given a proper reality check.

Angry, anxious or populist; one or all of these adjectives can describe the current political mood in Europe and the US. If political experience at the highest level and preparedness for the job were the only yardsticks, Hillary Clinton should be miles ahead in the Clinton v Trump race. Yet until two weeks ago, Trump, with no political experience, or indeed preparedness for the top job, was narrowly ahead in the Presidential race. Trump's campaign has survived behaviour by him that would have ended a candidate's chances at the primary stage. It is anger and populism that have made Donald Trump - a billionaire who has changed his party registration five times - the Republican Presidential candidate. The Republican primaries looked like a bonus season of *The Apprentice* with each week Trump "firing" one of his sixteen Republican rivals, most of whom had more political experience than him.

It is no surprise that Trump finds a large, receptive audience to messages of economic stagnation and a bleak future for the average American. After decades of life becoming better:

- The US median income of full-time male employees is lower than it was 42 years ago
- Real (inflation-adjusted) wages at the bottom of the income distribution are roughly where they were 60 years ago. Yet GDP has grown nearly six-fold over that time period i.e. the benefits of growth have trickled up, not down

This is not to say that there isn't enough government spending in the US. Social expenditure in the US amounts to 28% of GDP, second only to France, with 31%. The US is well on its way to becoming France (some would argue without the good wine or the weather) if successive administrations, including the incoming one, target tax and government spending as a panacea for all ailments that the US economy suffers from. Inequality and the despondency of labour are real issues, but big government, higher taxes, higher social spending and more regulation make things worse. Without a fair and efficient way to transfer income from capital to labour, the middle-class democracies of the West will not survive. The Republican party, champion of small government and so desperate to win the White House, is unfortunately lumped with a very bad messenger. Therefore it is very unlikely that Trump will win this election.

Let’s hope the political class are ready to give up on ”gaslighting” and govern honestly. Otherwise, I am afraid the anger and revolt could take disturbing proportions, ones that could easily get out of control.

What does a Clinton victory bring?

Hillary Clinton is now favourite to win the election. If the US economy continues to grow at a pace of +1-2% a year (instead of the historical +3% to 4%), then the current economic and political problems will only worsen. Clinton will be acutely aware of this. A growth deficit should be a bigger worry than a budget deficit. Fiscal austerity has to give way to fiscal spending that induces growth.

Democrats may be able to flip the majority in the Senate, but the House of Representatives is likely to remain Republican. The Republicans currently hold a 4 seat majority in the Senate. Having said that, more voters are “splitting the ticket” i.e. not necessary voting for the same party for President and Congress. In such a scenario, if the Republicans maintain control of the Senate, Clinton may face legislative opposition in both Houses of Congress. However, I would expect Clinton to learn from the failings of the Obama White House and develop good relations with Republicans in the Congress.

- Hillary Clinton will look to deliver fiscal spending using a combination of tax rises and a higher budget deficit. The US Budget deficit fell from $1.3 trillion in 2011 to $438 billion in 2015 and is expected to hit $600 billion in the fiscal year ending September 2016. With 30y US Treasurys yielding 2.5%, borrowing to invest should be the mantra
- One area where all sides should be able to quickly agree on is an infrastructure spending initiative. At least $100 billion could be raised from taxing repatriated corporate earnings and that money, along with more borrowing, could go towards funding $1 trillion worth of infrastructure. Clinton herself, along with Senator Chuck Schumer, Congressman Paul Ryan, Senator Mitch McConnell and Congresswoman Nancy Pelosi have all spoken favourably on this subject
- With Clinton in the White House, markets will feel more comfortable and I don’t mean her closeness to the Wall Street. Clinton is the predictable choice and Trump is the surprise package
- There will however be more regulation. The financial sector will be more tightly regulated with Senator Elizabeth Warren, particularly on the attack having just secured the prized scalp of the CEO of Wells Fargo
- Healthcare companies may be subject to price control. Clinton has proposed numerous ideas to curb the pricing power of drug manufacturers. If she doesn’t get her way through Congress, she may try executive powers to achieve this
- Clinton has also talked about raising the minimum wage. She is unlikely to receive much sympathy on this from a Republican controlled house. A proposal by Democrats to raise the federal minimum wage from $8 to $16 is dead on arrival. However, if they can get it to $10 or more, it should be welcome news for consumer spending
- Clinton has also talked about boosting women’s workforce participation, by backing efforts to improve paid leave and access to child care. This will have a long term and very positive impact, if she were to achieve it
- Immigration reform will be key, as it will bring highly skilled tech workers, and release workers from the shadow economy into the mainstream economy. This should be stimulative for consumer spending and growth
- Income tax will go up for those earnings more than $250,000 a year. Since this will be focused on the wealthy, it won’t hurt overall consumption much

Clinton will have one year to do as much as possible before gridlock returns with the next mid-term Congressional elections, when, hopefully, the shadow of Trump on the Republican party will be long gone.

Where to invest?

When it comes to equity investing it is safe to ignore any investment commentary that starts off with “If Trump wins …” or “If Clinton wins …”

The “if Obama wins ...” narrative has been completely debunked. The narrative was that Obama would put gun makers out of business, Obamacare would hit Healthcare stocks hard, and the Presidency would usher in a clean and green energy revolution. Gun makers have done well (Smith & Wesson has outperformed the Russell 2000 Index by 9 to 1), Healthcare stocks have boomed and outperformed the S&P 500 (SPX) index by as much as 3 times and clean energy stocks have cratered. President Obama wanted to cut the country’s reliance on fossil fuels, yet cheap money led to major advancements in technology to extract petroleum from shale formations. Oil price crashed, renewables became unprofitable vis-à-vis crude and the US became the largest producer of crude oil under his watch. Just because a President wants something, it does not mean he or she will get it.

Therefore, I will not opine on single stocks or sectors in the context of this election. As an investor, the focus should always be on the medium to long term and not on short term issues as you are investing for a lifetime and not for a President’s time in office.

The direction of the overall market, however, seems to differ widely depending on which party controls the White House. Numbers crunched by staff at *Fortune* magazine suggest that the average compound annual growth rate for equities since 1945 has been +9.7% under Democratic Presidents and +6.7% under Republicans. So that should cheer Clinton supporters, but there is a twist. It turns out that the absolute best market returns were generated under Republican Presidents working with a Republican-controlled Congress. In that scenario, the SPX has gained +15.1% annually.

So there you have it. Trump as President anyone? A +15% per annum return on the SPX is at stake!

The current economic expansion in the US, which began in June 2009, is now in its 88th month (the average duration of US economic expansion over last 100 years is 39 months), which means that Trump or Clinton are likely to face a recession early in his or her administration. Equity bull markets tend to have an expiration date as well. On average every 4.5 years. However, like the economic expansion, this bull run is also past its due date and is now seven years old. Does that mean one should sell? Not at all. Seasonally, we are entering the best period for equity markets. November to April is when equities tend to do well, before the May to October swoon. Since 1950, the SPX has gained +7.1%, on average from November through April versus +1.4% from May through October.

In the US, we are within touching distance of the Federal Reserve (Fed) raising interest rates. However, no one should harbour thoughts that the Fed is on to a clockwork-like increase - one every quarter. Productivity growth remains poor, which certainly isn't supportive of GDP growth or earnings growth. With US GDP growth in the range +1-2%, and global growth on a downward slide, there is little inflationary fear to alarm the Fed. No wonder then, that despite various Fed speakers talking up the probability of a rate rise at its December meeting, Fed Chairwoman Janet Yellen continues to offer a narrative for running the US economy hot for a period, to ensure moribund growth doesn't become an entrenched feature of the economy. That would mean letting unemployment fall lower, raising rates only very gradually and spurring faster growth to boost consumer spending and business investments.

The US unemployment rate stands at 5%. I can very well see it falling to as low as 4% before we see any alarm on the inflation front that gets the Fed worried. The Fed needs to maintain the accommodative policy and pursue an "aggregate demand" policy to stimulate GDP growth to at least +3-4%. In this effort, it will need a lot of help from fiscal measures that the incoming President will have to enact. Financial markets expect the Fed to increase rates by +0.25% at its December meeting. I concur with that view, although it would not surprise me in the least if the Fed decided to hold fire.

Monetary accommodation is set to continue. The European Central Bank (ECB) will do more Quantitative Easing (QE) and GDP growth and inflation expectations in the developed world are still muted. Bond yields therefore will remain low until such time as the global economy is back to its normal growth rate. If that takes another decade, then so be it. Emerging Markets (EM) assets and High yield bonds will experience volatility every time the Fed rate rise expectations build up. However the USD is unlikely to strengthen much vis-a-vis the EM currencies. Over the last two quarters, the covenant quality of high-yield bonds has improved greatly. Oil has seen a good rally but we know that the oversupply remains and US shale gas tap can be turned on if price inches higher. Upside to Oil looks capped at $60, barring a geopolitical event of importance that effect supply and demand.

These markets will not be broken by central banks. In many respects the central banks "own" these markets. If anything breaks the market, it will be the upheaval that only politics can cause - the US election, the Austrian election, and the Italian constitution referendum amongst others.

I continue to prefer USD and US Equities, My sector biases are Technology (XLK), Healthcare (XLV), Financials (XLF) and to some extent Utilities (XLU) and Telecom (XTL) as we move late cycle into the recovery. I am underweight Energy (XLE) and Materials (XLB).

I hold/recommend holding: Starbucks (SBUX US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), Biogen (BIIB), Amgen (AMGN), General Electric (GE), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Pepsi (PEP US), McDonalds (MCD US), Daimler (DAI GY), Airbus (AIR FP), Walgreen Boots (WBA US), CVS Healthcare (CVS US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRMUS), Estee Lauder (EL US), American electric power company (AEP US), AT&T (T US), Southwest airlines (LUV US), Johnson & Johnson (JNJ), eBay (EBAY US).

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom
9 South Street
London W1K 2XA
United Kingdom

Singapore
One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Monaco
Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:
crossbridgecapital.com

CROSSBRIDGE CAPITAL