December 5, 2016

Consilience Market Notes:

Trump-onomics!

First, an update: Our *Global Macro Indicators** are as follows for the 7 asset classes we invest in for our clients:

Global Equities – **Positive,**
Global Bonds – Negative,
Commodities – **Positive,**
Gold – Negative,
Hedge Fund Strategies – Negative,
U.S. Dollar – Neutral,
Real Estate – Negative.

Now to this week's report:

Who would have thought that a Trump presidency would be the best thing for the U.S stock market? Certainly not Wall Street experts… all of whom warned of a severe decline should Trump be elected.

What a change in the market's perception: At one point investors were expecting markets would go down as much as 80 percent if Trump won… and now he's an economic wizard!

Whether or not Trump's pro-growth agenda is enacted or succeeds is beside-the-point, right now investors are clearly expecting it.

For example, last week, *Institutional Investor* surveys projected that the S&P 500 would rise to 2425 from its current 2191 level by the end of next year. A similar survey conducted just before the election on November 3rd put the S&P at 2087.

What is the driving force behind this changed perception on the part of investors?

It appears that the markets are pricing in the assumption that lower taxes, less regulation and higher deficit spending will accelerate economic growth and provide a positive demand for stocks.

The most potentially dynamic component of the Trump plan is the reduction in tax rates. The plan calls for a $500 billion decrease in taxes over the next ten years which is estimated to add economic growth of $1 trillion over this same period.

The result: Both stocks and yields have risen dramatically in just a couple of weeks since the election.

Here is a summary of the main themes that have emerged:

1. As mentioned above, lower taxes which should be good for earnings and will stimulate the economy,

2. A large infrastructure bill and increased military spending which should benefit corporations that supply such services and hence are good for employment,

3. Inflation due to economic demand which will likely be good for banks and hence good for stocks.

Many point to the Reagan tax cuts of the early 1980s as a precedent for the current optimism. However, it is important to put the current proposals in perspective. The Reagan tax cuts were far larger in relative terms than what is being proposed, and the federal debt was much less than it is currently.

Additionally, the Reagan tax cuts were being implemented while interest rates were falling sharply. But this is not the case today.

While stocks have been rising, so have interest rates.

Just a few months ago, the yield on the 10-year U.S. Treasury yield was at a historic low of 1.32%... down from its peak in 1981 of 15.68%!

But in the past few months, the 10-year Treasury yield has almost doubled from that historic low of 1.32% to almost 2.40%

Rising interest rates can still be favorable for stocks if they are rising due to an expectation of an acceleration in economic growth. And this appears to be exactly what investors are banking on!

But, what if the consensus is wrong: what if rates are rising due to the end of Quantitative Easing (QE) and not because of a reflation of economic growth?

Such a scenario would not be good for equities.

Even assuming the market's expectations are correct, a transition from "Full QE mode" into "Fiscal Expansion mode" would not necessarily result in a smooth ride for markets.

In contrast to QE, Fiscal expansion has:

1. Execution risks (longer time to delivery, uncertainties over resource (mis)-allocation across industries & population cohorts),

2. Headwinds as rates and wages rise (thus squeezing corporate margins from all-time highs).

Or what if this recent rally in stocks occurred coincidentally after trump's victory, but was really the result of a final and possibly temporary surge in QE and not the Trump victory?

Is the market wrong? Did the rally have ***anything*** to do with Trump after all?

As shown below, **U.S. money growth is more than 8% higher than it was a year ago, or almost an incredible +$1trillion… This money growth is the result of the very same QE forces that have propelled the markets higher during the past 8 years!**

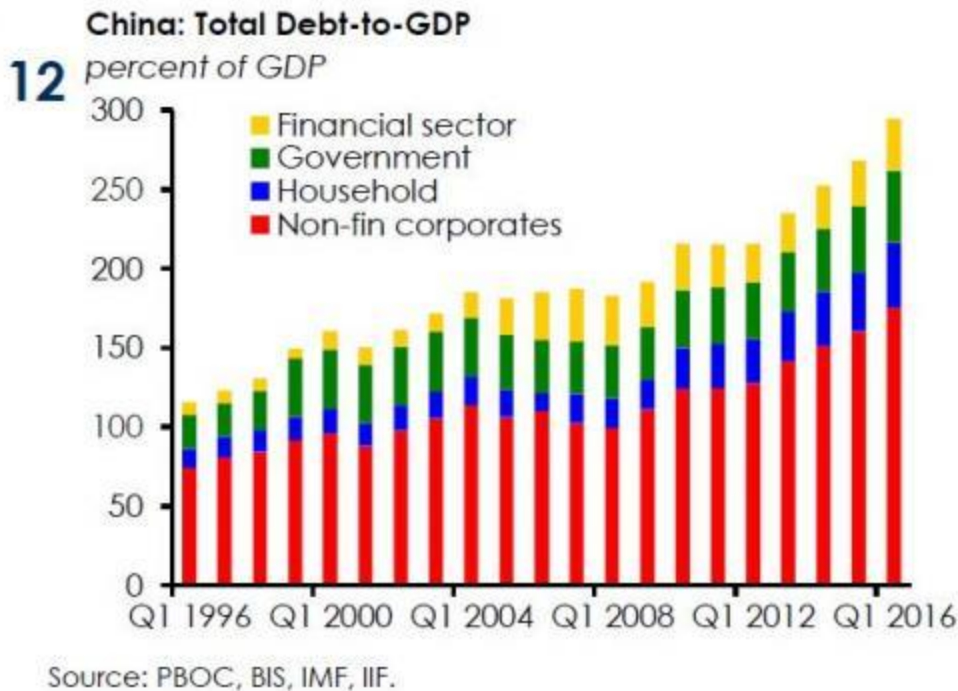
If so, after riding the Trump-onomics stock rally of the past 4 weeks, is it now time to take a less-exuberant stance?

But, it's not just U.S. money growth. More tangibly there has been a resurgence in Chinese stimulative money supply growth.

Keep in mind, all the QE/money growth has been accompanied by a corresponding increase in **debt** as it is being accomplished via a "fiat" monetary system*2.

Thus, debt in China has grown by $4.5 trillion over the past 12 months, by far the highest amount of debt creation globally as compared to $2.2 trillion in the US, $870 billion in Japan and $550 billion in the euro area.

Indeed, China has added more debt/stimulus than the U.S., Japan and the Eurozone combined**.**



Has this been the real driving force behind the recent stock market rally? Yes and no.

I think the additional money printing has been the fundamental force behind the market's move… but it was the Trump victory that provided the psychological drive to ignite the markets.

If this is so, then a reversal of this monetary expansion would spell trouble for the stock market.

Whether China's recent debt-fueled growth fades soon is also a material issue for the U.S. Federal Reserve, which is set to hike rates later this month.

With debt/GDP is now at or above 300%, should China feel compelled to slow down its debt creation, it's not just the U.S., but the entire world that will feel the consequences.

If this were to occur, would the projected monetary expansion under a Trump administration, be enough to offset such a contraction in China? It is uncertain that it would. Thus, any possibility of a slowdown, particularly in China's debt-creation must be carefully watched.

Although we are currently over-weight equities and under-weight bonds in our managed portfolios, I believe a degree of caution is warranted.

As we navigate through these volatile times, our admonition remains: Stay vigilant and nimble.

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*Our *Global Macro Tactical Strategy* seeks to identify favorable investment opportunities among seven primary asset classes. Capital is rotated to the specific markets in an effort to control risk by underweighting or eliminating exposure to markets that exhibit elevated risk.

Our *Relative Capital Flow Model* is the cornerstone of our tactical allocation decisions and is augmented by our Behavior, Economic, Monetary and Stability indicators.

*[2] ***Fiat money*** *is currency that a government has declared to be legal tender, but it is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material that the money is made of. Historically, most currencies were based on physical commodities such as gold or silver, but fiat money is based solely on the faith and credit of the economy. - Investopedia*