<u>Monthly Outlook, November, 2016: A "Tsunami" election</u>

The American electorate delivered an election result that can only be described as a ***"Tsunami"*** given the precisely wrong statistics espoused by all manner of pollsters ahead of the elections. While the "smart" consensus had pretty much thought the result was a foregone conclusion, voters acted differently: Indeed, President-Elect Trump was able to cobble together a coalition of like-minded voters much to the chagrin of the pollsters, the media and the intelligentsia.

Not since the election of Herbert Hoover in 1928, has an incoming Republican President enjoyed the luxury of having both the House of Representatives as well as the Senate controlled by his own party. It is abundantly clear that President-Elect Trump will likely spend his early days dismantling the Obama legacy of ***dirigisme*** (much of it accomplished through the use of Executive Orders rather than Legislation) when it comes to healthcare as well as a number of other sectors of the US economy.

US financial markets have accepted the Trump victory with ***equanimity*** (again confounding the "experts") who were calling for significant declines. Some of President Trump's policies like reforming the tax code to make it much simpler (a bane for tax accountants, we are sure!) and a repatriation holiday for corporations' balances held abroad are quite positive. But the threat of an all-out ***trade war with China and Mexico*** are worrisome – given the experience of the Hoover Administration and the Smoot-Hawley tariffs from the 1930s.

US economic data posted ***mixed results*** recently: The labor market added 161,000 jobs during the month of October, with the unemployment rate posting a decline of one-tenths to 4.9%. Private payrolls posted a gain of 148k for the month, while the manufacturing sector reported a decline of -9k jobs. Average Hourly Earnings rose 0.4% (m/m; y/y: 2.8%) during the month, while the participation rate declined one-tenth to 62.8%. The U-6 measure of under-employment (in our opinion, a more robust measure of the labor market), also posted a decline of two-tenths to 9.5%.

The Institute of Supply Management's Purchasing Manager's Report on manufacturing activity showed some promise (gaining from 51.5 in September to 51.9 in October), but the innards of the report did show some ***cause for concern***: New Orders posted a sizable decline (from 55.1 to 52.1), prices rose (from 53.0 to 54.5) and the backlog of orders also fell (from 49.5 to 45.5). The same organization's Non-Manufacturing Report also showed some weakness with the Non-Manufacturing Index declining (from 57.1 to 54.8), new orders posting a loss (from 60.0 to 57.1) and prices rising (from 54.0 to 56.6) as well.

The Bureau of Economic Analysis of the Department of Commerce pegged ***US GDP growth*** for 3Q2016 at a surprising 2.9% (quarter-on-quarter, seasonally adjusted annual rate) relative to 2Q2016's pace of a damp 1.4% gain (also, q/q saar). In looking at the details of the release, it appears that soybean exports accounted for a large part of the gain, without which the gain would have been closer to 2.1% for 3Q2016. It turns out that the total exports of soybeans during the quarter were equivalent to the entire exports for 2015. (A hat–tip to Edward Guay for pointing this out!).

Overseas data has been ***mixed as well***: Industrial Production in Germany declined -1.8% (m/m; y/y: 1.2%) during September and Industrial Production in the UK also posted a decline of -0.4% (m/m; y/y: +0.3%) for the same period. Machine tool orders in Japan (granted, a fairly volatile data series) also declined for the month of October -0.7% (m/m; y/y: -8.9%). Housing starts declined from 219.4k units in September to 192.9k units in October in Canada, while building permits posted a sizable decline of -7.0% (y/y) for the month of September.

The Federal Open Market Committee of the US Federal Reserve demurred (again!) at its meeting in early November suggesting that the ***"case for a tightening of monetary policy has strengthened"***. The FOMC

Statement also suggested that they decided "for the time being, to wait for further evidence of continued progress towards its objectives". In other words, despite all the data that seems to suggest they are already behind the curve, the FOMC is going to take their time in increasing interest rates. The consensus is however coalescing around the idea that a rate hike at the FOMC meeting in December is quite likely.

Speaking of the curve, the US yield curve has ***steepened ominously*** since the elections: The difference between the yield on the ten year US Treasury and the two year US Treasury – which was around 80bp in early October is now around 125bp! Such a steepening of the curve is being interpreted as a positive for banks, but could also be as a result of ***rising inflation expectations*** getting embedded in the pricing of Treasury instruments.

Market participants demand greater compensation (or a higher yield to maturity) for investing in longer dated debt instruments **-** which have a ***longer duration* -** and are therefore, by definition, more sensitive to smaller changes in interest rates. Such sensitivity to changes in interest rates also brings home the point that bonds are vulnerable to a loss of principal in the event of an unexpected change in growth or inflation expectations.

Recent increases in Treasury yields in the long end of the curve ***bear watching*** (pun intended!). Higher economic growth is not necessarily inflationary (which is blasphemy to bond vigilantes), but with the US economy pretty much at full employment, a "go-for-broke" growth strategy could lead to unintended consequences in terms of punishingly higher interest rates. We would file this idea under the category of "be careful what you wish for, as you might just get it".

A steepening yield curve also has implications for the ***value of the US Dollar.*** If the steepening is as a result of expectations of Fed policy (rising interest rates and more confidence in the Federal Reserve) it could well be ***positive*** for the Greenback. If however, the steepening is as a result of rising inflation expectations (and by implication declining confidence in the Federal Reserve), then it could be ***quite negative*** for the Greenback. Regardless, the shape of the yield curve (and the term structure of interest rates) does play a big role in determining future equity returns.

The ***stunning Trump victory*** at the hustings has clearly brought into focus the terrible job that pollsters and prognosticators have performed in the past few months: Not only did they miss the angst among US voters by a country mile, but also missed a call on a ceasefire referendum in Colombia (October) as well as the Brexit vote in the UK (June). While some of this can be directly attributed to a media-bias, we think there is something more subtle going on. Voters in general, are rebelling against being told "what to think", and would much rather vote for change even if such a change takes them into the ***vast unknown***.

With control of both houses of Congress, President Trump does have an opportunity to put the good old US of A on a ***significantly higher growth trajectory***: However, this would involve changes in a number of areas including regulatory reform (Obamacare and Dodd-Frank to name a couple), tax reform (simplifying the tax code), a sensible energy policy, incentives for investment spending as well as shrinking the size of a bloated Federal Government. Much of the ***euphoria*** in the financial markets in the immediate aftermath of the election is due to market participants dreaming about these possibilities.

It will be interesting to see how President-Elect Trump choses to govern once he and his team take office in late January. We will know more about this as his cabinet takes shape and his legislative agenda for the early part of the term are announced. We remain skeptical (we are analysts after all!) that he will be able to wave a magic wand and remove some of the impediments to progress over the next four years. The laws of supply and demand are yet to be repealed as the ***fundamentals*** of earnings growth (expectations still too high) and valuations (a little stretched at this point) are applicable even more now – especially if financial markets are to return to some ***modicum of reality***.

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