Strategy Thoughts

November 2016

Trump wins

Should we still be worried?

Introduction

I was always going to title this edition of Strategy Thoughts 'Should we still be worried?' following on from last month's title 'I've been concerned for a few years'. However, in the wake of Donald Trump's historic victory it seemed sensible to add 'Trump wins' to the question in the title, it is a very important question. This month's Strategy Thoughts looks at where expectations were ahead of Trump's upset victory, how they changed after and what his victory may lead to over both the near term and, far more importantly, over the longer term. Also this month I look into the probability of increasing volatility and what that may do to investors' levels of worry and finally I reiterate the importance of discipline to help any investor deal with worry.

Trump wins

In June last year punters could get odds of more than 50-1 on Donald Trump winning the presidency, and as recently as Tuesday of this week his odds were still 5-1. In what by then was clearly a two horse race these were very long odds indeed but some (either very smart or very lucky) gamblers made the most of them. One collected two million pounds after having staked a total of two hundred thousand pounds at various stages through the campaign and a British hotel owner was reported to have backed Trump immediately he announced his candidacy, and placed additional bets as the campaign progressed, turning five thousand pounds into one hundred thousand pounds along the way. These are wonderful stories but they also really highlight just how unlikely a Trump presidency was viewed as being. As does the case of one British bookmaker that actually paid out five million pounds on bets that Clinton would win last month, so certain were they of her victory.

In addition to the few lucky punters there was one much more widely followed prognosticator that seems to have known that an upset lay in the future; the stock market!

At the end of October CNBC ran the following story;

This stock market metric says the likely winner is...Trump

The article pointed out that since World War II if the S&P500 had declined between the end of July and the end of October then the challenger had won the election 86% of the time. However, if the market rose over this three month period then the incumbent party retained the presidency. The article concluded that given the overwhelming favourite status that Hillary Clinton had attained then investors should 'prepare to be surprised'. Clearly this was excellent advice, in fact it is sound advice at all times, investors should continually be questioning where and how the majority are most likely to be surprised. The value of this discipline can also be seen in the immediate after effect of Trump's victory.

Ahead of the election commentators and pundits seemed not only to have agreed on the inevitability of a Clinton victory, but also that if by some incredible miracle Trump were to win then all hell would break lose. CNBC reported that J P Morgan forecast that the markets would continue to decline if

Trump were to win; Barclays forecast a (remarkably precise) 11-13% fall and Citi a five percent fall. On the 1st November, a week ahead of the election Market Watch published an opinion piece from an MIT professor predicting a Trump victory would likely cause the stock market to crash and to plunge the world into a recession and a week earlier Politico ran the headline:

Economists: A Trump win would tank the markets

At the same time CNN reported the opinions of two forecasting firms, Macroeconomic Advisors and the Brookings Institute, who were calling for an 8% and a 10-15% 'nosedive' in the stock market if Trump were to win.

Finally, the day before the election I received a lengthy email detailing why all the polling was wrong and that in fact Trump would defy the odds and win the election. This forecast was obviously remarkably prescient; however, the author went on to detail how I should position myself ahead of this 'surprise'. The US dollar would fall, the stock market would collapse and gold would rocket higher.

With hindsight we now know that things did not quite pan out as he expected. Despite an initial kneejerk reaction in the direction most expected, as a Trump victory appeared increasingly possible and then likely, the expected disaster as a result of a Trump victory did not eventuate, at least not in the immediate aftermath.

The day after the election the US stock market rallied between 1.1% for the NASDAQ and more than 3% for the Russell 2000, Gold, despite a dramatic rally as election result started to come in, ended $5 **below** where it had traded the day before the election, having fallen more than $60 during the post-election trading day, and the US dollar, which fell more than 2% while gold was rallying on election night, reversed the next day recouping all it had lost an more to end up 0.67%.

It is amazing what a difference a day can make, so much of the doom laden commentary if Trump should win ahead of the election has now reversed.

One chief investment officer interviewed by CNBC calmly stated with the Dow soaring 300 points that;

> "Like with BREXIT, investors and traders are realising that this is a process, not an event. What you're seeing now is a pretty predictable repositioning of portfolios."

I am not sure on what basis he thought it 'pretty predictable' as I couldn't find anyone forecasting anything of the sort, but it seems the generally conciliatory nature of Trump's acceptance speech helped calm many commentators fears and most strategists have maintained their pre-election targets for markets, even though those targets were set on the basis of a strong expectation of a Clinton victory.

There have clearly been two major surprises over the last couple of days. First Trump won the election and second fear did not reign in the aftermath and the forecast collapse never occurred. Both these surprises reinforce a view that I have repeated many times over the years, that is that in markets what the majority forecast rarely happens and even if it does then the result is rarely the one that a neat cause and effect relationship would have suggested. Markets are driven by surprises and disappointments. This raises the important question of where the next major surprise or disappointment may lie and what they may mean for the stock market over both the near term and the longer term.

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Near term

Fears over just what president Trump may do have obviously begun to soften, at least that seems to be one of the reasons markets didn't deliver the widely anticipated collapse. Over the coming days, and possibly weeks, that softening of fear and improvement in expectations may continue and as a result see analysts and economists begin to ratchet up their own forecasts and expectations. Probably to reflect the outlook succinctly put by legendary GE CEO Jack Welch on CNBC soon after Trump's victory:

"His economic plan - the opportunities are unlimited"

This will likely result in some, albeit volatile, continuation of the post-election trends but will ultimately lay the foundation for a larger disappointment.

There was much discussion ahead of the election as to whether investors should 'buy the dip' and the general consensus seemed to be that one should. Obviously that 'dip' was never made available but in an environment of increasing volatility there will be dips, and many will be encouraged and tempted to buy them. I will not be and would urge investors still exposed to equity markets to use post-election strength to become more defensively positioned.

Longer term – a deteriorating social mood

In chapter four of Investing: The Expectations Game I showed the historic relationship between both hemlines, and the heights of skyscrapers, with the long term history of the stock market. I wrote:

> Obviously building tall buildings does not push the stock market higher, any more than lowering hemlines does, but there is clearly a relationship, it's just not a causal relationship. All three, the heights of skyscrapers, the shortness of skirts and the level of the stock market are indications of the underlying level of social mood, the underlying confidence, enthusiasm and hope of the public. And social mood ebbs and flows, but it is not driven by the economy, rather the economy is a lagging reflection of those ebbs and flows. It takes a long time for the effects of a rising social mood to be obvious in economic data whereas in the stock market, dress lengths, and to some extent skyscraper plans, this ebb and flow is much more current. That is why the stock market is a substantially better forecaster of the economy than the other way around.
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> The Socionomic Institute defines social mood as follows;
>
>> Social mood is a shared mental state among humans that arises from social interaction. Social mood predisposes individuals in the group toward emotions, beliefs and actions. It fluctuates constantly in a fractal pattern. It is unconscious, unremembered and endogenously regulated.
>>
>> Socionomic theory proposes that social mood governs the character of social events.
>>
>> Social mood waxes and wanes positively and negatively. Periods of positive social mood tend to be associated with a host of social phenomena, such as rising stock prices, re-election of incumbents, peace, increasing deregulation,

> and the popularity of brighter colors and shorter skirts. Periods of negative social mood also tend to be associated with a host of social phenomena, such as falling stock prices, rejection of incumbents, discord, increasing regulation, and the popularity of darker colors and longer skirts.
>
> Although social mood governs social events, it fluctuates independently of such events. In other words, wherever mood goes, the character of events will follow. But the events themselves have no impact on the direction of social mood; there is no feedback loop.

This is obviously contrary to what the vast majority believe, however, the evidence, particularly as presented by perhaps the most immediate barometer of social mood, the stock market, clearly supports this contention. Particularly when compared with the more favoured, but clearly flawed idea, that somehow it is the economy that drives the stock market.

From a longer term perspective there are a growing number of indications of a deteriorating social mood. BREXIT was one and the anti-establishment rebelliousness of Trump's election is another.

Radio personality Garrison Keillor wrote a brilliant essay in the Washington Post immediately after Trump's victory, **'Trump voters will not like what happens next'**. Towards the end Keillor wrote:

> Mr. Trump was the cruelest candidate since George Wallace. How he won on fear and bile is for political pathologists to study. The country is already tired of his noise, even his own voters. He is likely to become the most intensely disliked president since Hoover. His children will carry the burden of his name. He will never be happy in his own skin. But the damage he will do to our country — who knows? His supporters voted for change, and boy, are they going to get it.

Social mood has been rolling over at different rates and at different times all over the world. Obviously the peak in mood was seen in parts of Europe and the emerging markets several years ago. Trump's victory seems to be a clear symptom of a similar reversal in mood in the US. As social mood declines expectations get dashed and the stock market is hit by disappointment after disappointment. Eventually this sets up the possibility of a positive surprise, but I fear that such a surprise is still some time in the future, and from stock markets levels well below where the US market is now.

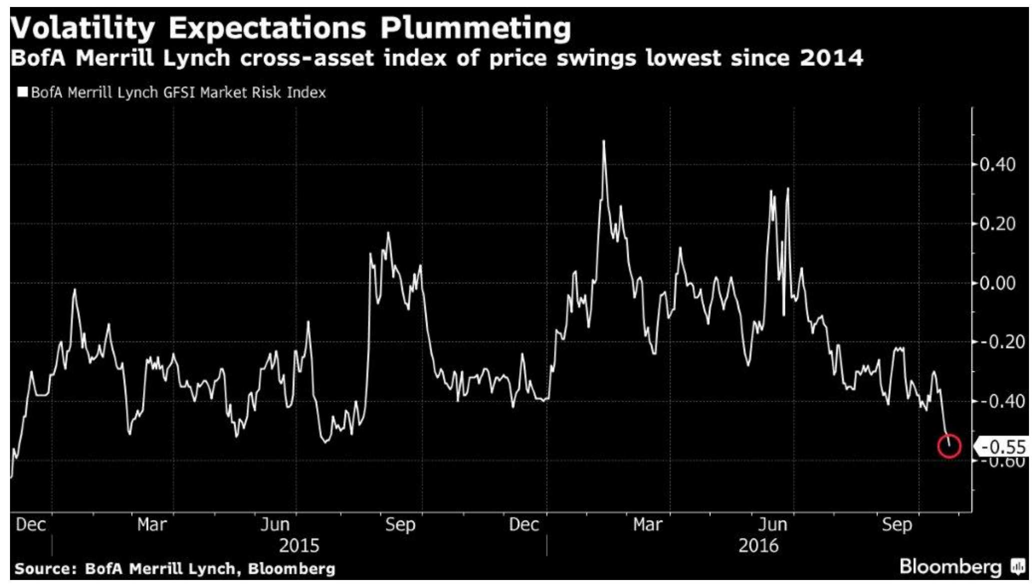
Why Worry?

Prior to the election there had been a remarkable calmness about most investment markets. Bloomberg highlighted this in late October with the headline;

Uneasy Calm Grips Markets

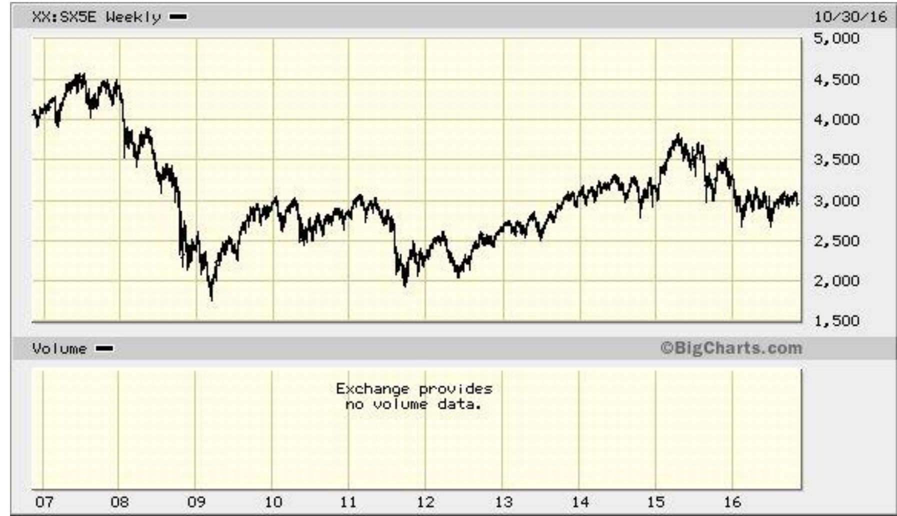
> Markets around the world, from stocks to metals and bonds, have slowed to a crawl, revisiting lows in volatility that have stood for two years. Muted moves just sent a cross-asset gauge of price swings in equities, rates, currency and commodities to the lowest since 2014.

The article included the following chart from Bank of America Merrill Lynch:



The interesting question that such low volatility raises is whether it is a sign of potentially dangerous complacency, or just a sign that no one has a strong idea about what to do next. What can be said is that all periods of low volatility have been followed by periods of high volatility, the problem is that this could mean asset prices rise in a volatile fashion, they fall in a volatile fashion, or they go nowhere but swing about a lot. Given that, as I wrote last month, I have been concerned for some time, my fear is that what follows may be uncomfortable and unrewarding volatility. The relative calm of recent months may well be looked back upon as having been the calm before the storm, or even the eye of the storm in markets that are already well below their previous highs, such as much of Europe and Australia.

The chart below shows the Euro Stoxx 50 index over the last ten years. The relative calm of much of the last twelve months is very obvious with the index at the same level it was at in January down 17% from its high more than eighteen months ago.



Back in May 2008 I titled a monthly Strategy Conclusions paper 'The Calm Before The Storm' and stated that the low seen in March of that year was highly unlikely to be THE low, and that the relative calm that was evident in most markets at that time was something to be concerned, or worried, about. Then, as can be seen in the chart above, European stocks were down about 17% from their high more

than a year earlier, and what would become known as the Global Financial Crisis had not even been named, but it had certainly begun. I concluded that paper with:

> It is very hard to argue that now is a low risk entry point for any markets.

I believe the same to be true now.

The cure for worry – Discipline!

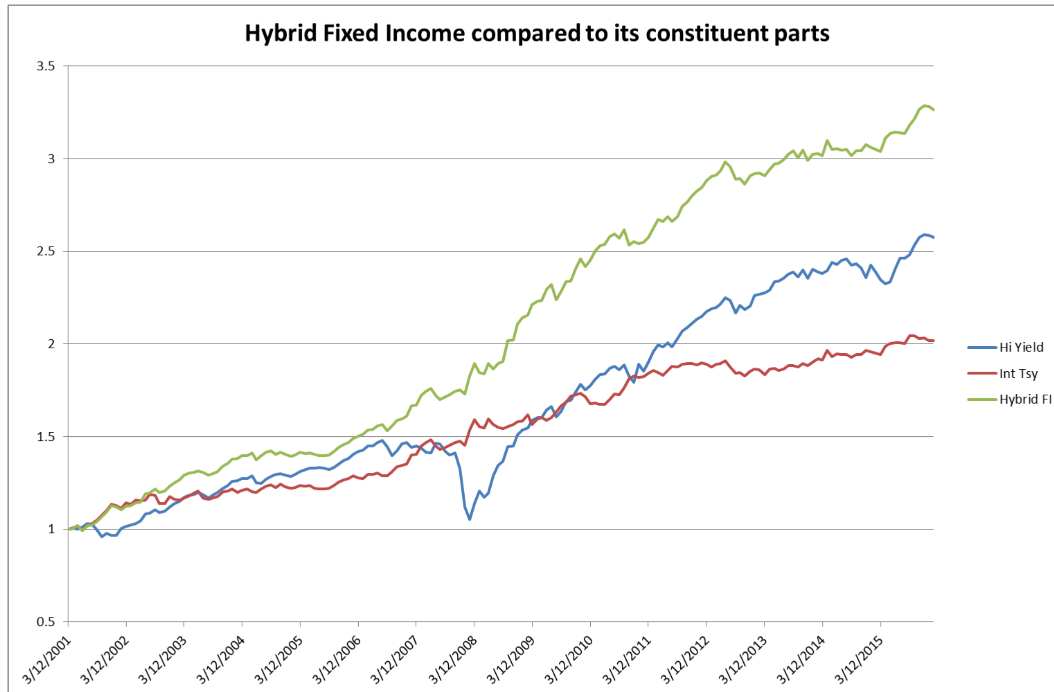
Chapter six and seven of my new book 'Investing: The Expectations Game' focus on the one trait that all successful investors share and outline a pathway available to all investors that want to avoid the emotional traps that markets always present and so reduce their periods of worry. That trait is DISCIPLINE.

Early in Chapter seven I wrote:

> All successful investors, and there are many ways and approaches that can result in success, share one trait that can allow them to avoid the siren call of the herd, and that is discipline. Whether that is an exceptionally long term discipline, such as displayed by Warren Buffett, or a much more mechanical and possibly shorter term discipline, like that described in the previous chapter from the Zurich Axioms, is largely irrelevant. The important thing is to establish a discipline and stick to it. Unfortunately the loose discipline offered by typical financial planners of regularly rebalancing to a set asset allocation, whilst better than nothing and being blown around by every changing wind that comes along, does not consistently deliver the long term real return required over the long term by investors. It may perform satisfactorily compared to whatever benchmark has been set, but invariably those benchmarks are related to underlying investment markets and so the satisfactory return that may be delivered will only ever be a relative return. This is fine when underlying markets are rising, but, as has already been discussed at length, is of very little comfort when markets are declining.
>
> For most investors victory in the 'Expectations game' would not be a relative measure compared to markets, not even fixed income markets which can also fall for extended periods. For most investors victory would be seeing their invested capital achieve a satisfactory real, inflation adjusted, return. Or as Ben Graham put it;
>
> > "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return."
>
> Any investment operation that has relative returns as its principle objective, particularly when it sees its primary risk as being its own reputation rather than the risk to the investors' capital, is unable to offer any comfort when it comes to safety of principal.
>
> All investors must endeavour to overcome and avoid behavioural biases, such as herding, that undermine the pursuit and achievement of a disciplined investment approach. The simplest way to achieve this is to write down and adhere to a number of rules.

Last month I showed the results of a disciplined 'All Seasons Portfolio' that follows the very simple set of rules outlined in chapter six and seven of Investing: The Expectations Game. Rules which only require an investor to monitor their portfolio of low cost funds representing high and low grade fixed income, international REITs, Natural Resource stocks, emerging market stocks, international

developed market stocks, gold and the S&P 500 once a month. At the heart of that portfolio is the hybrid fixed income portfolio as that is where anything is invested if any of the underlying markets are in lengthy downtrends. This hybrid fixed income portfolio is made up of the Vanguard High Yield Corporate Bond Fund and the Vanguard Intermediate Treasury Bond Fund. Over the last fifteen years this hybrid approach has delivered very healthy returns.



The hybrid fixed income portfolio has been invested in high yield 51% of the time and intermediate treasuries 49% of the time and has delivered:

- Average rolling twelve month returns of 8.4%
- Compound average annual returns of 8.24%
- Positive rolling twelve month returns more than 96% of the time and standard deviation of rolling twelve month returns of just 5.5%

The comparable numbers for the high yield fund would be:

- Average rolling twelve month returns of 7.2%
- CAGR 6.5%
- Positive rolling twelve month returns 88% of the time and a standard deviation of rolling twelve month returns of 9.8%

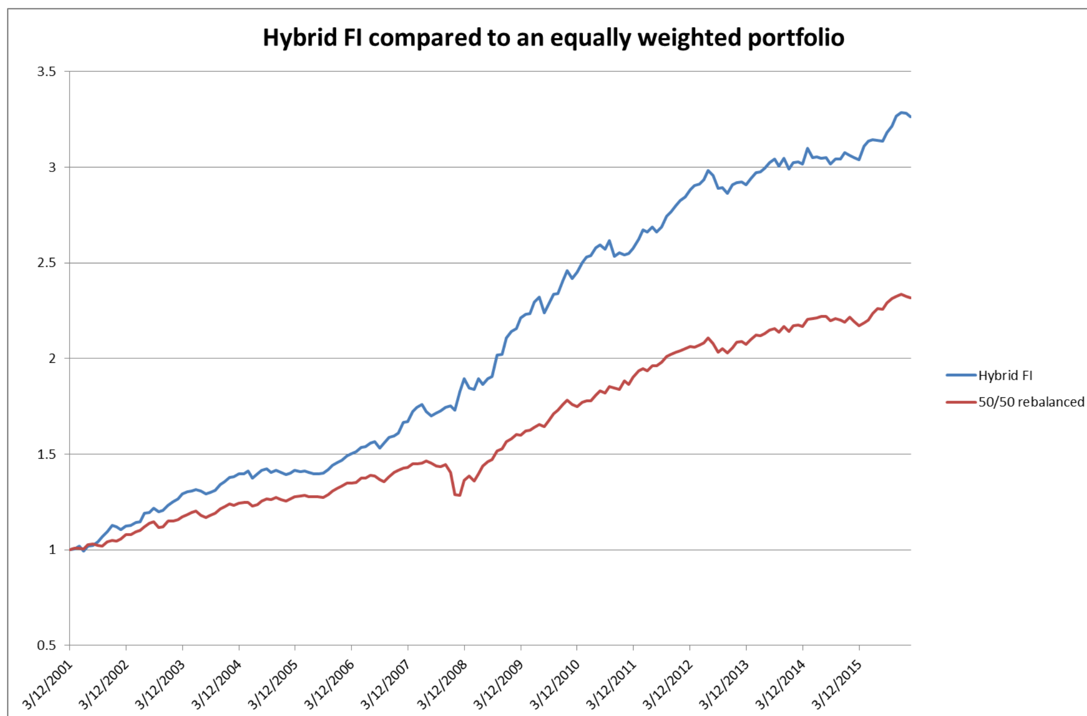
Intermediate treasuries delivered:

- Average rolling twelve month returns of 4.8%
- CAGR 4.8%
- Positive rolling twelve month returns 88% of the time and a standard deviation of rolling twelve month returns of 4.1%

Obviously an investment in intermediate treasuries would have delivered the least volatility and so the least reason to worry, although it is a little surprising that the hybrid delivers a higher average return with a lower likelihood of negative returns, however, the standard deviation of returns is a little

higher. More importantly, the disciplined rules based approach that drives the hybrids performance delivers a greater return with much lower volatility and lower chance of a loss than the high yield fund, primarily through avoiding those periods when worries would have been most extreme, at the tail end of the tech bust and through the latter stages of the GFC.

It is also worth noting that simply taking a balanced approach to these two fixed income assets and rebalancing each month would not have delivered anything like the return of the hybrid or avoided all of the most painful periods.



Conclusions

Trump's victory is of absolute historic significance and it has sent a number of clear messages; firstly that whatever the majority expects (at least when it comes to investment markets) rarely happens and when it does the outcome for the market is rarely what a neat cause and effect would have suggested would happen, and secondly, and most importantly, that as with the BREXIT vote, social mood is in the process of rolling over. Over the long term this heightens the risk of disappointment for investors.

Two months ago A Gary Shilling began one of his Bloomberg articles with:

> Global growth is weak, and will be eroded further by Brexit. Oil prices are low, and likely to plunge further. The world has excess capacity and a wage-depressing labor surplus. Corporate profits are shaky. And deflation is laying bare the impotence of central banks. So where would you logically expect financial markets to be going, given that economic, financial and political environment?
>
> You'd expect to see increased demand for safe-haven U.S. Treasuries, a soaring dollar, falling commodity prices, and increasing investor aversion to junk bonds, emerging market debt and equities and other low-quality securities. But that's not the case.

That wasn't the case back then, but perhaps the 'calm' is beginning to end and the 'storm' may just be starting. Or for those markets that had already been falling perhaps the 'eye' has now passed over. The next few months are likely to be far more volatile than any we have been through for some time. It is important that investors don't get lulled into a false sense of security just because markets seem eerily calm. As I concluded last month:

> I have been concerned for some time, and the lack of anything really bad having happened only makes me more concerned, certainly not less concerned.

This is still very much remains the case.

Kevin Armstrong

11th November 2016

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