"ANGRY IS THE NEW HOPE"

Dan Clifton, Strategas Conference NYC 3/2/2017

Nancy Tengler
SVP, CHIEF INVESTMENT OFFICER

For many of us, in this new world navigated at the speed of tweet, it is difficult to remember (was it really less than a year ago?) that Bernie Sanders received 42% of the vote in the Democratic primary against Hillary Clinton. Senator Sanders is a lot of things: remarkably energetic for a 70+ year old politician, determined, and focused in his message, but it would be difficult to ignore the anger. He believed what he said about the problems we face and his integrity to his message…well, it just made him mad. Enter now President Donald Trump. The name-calling, scowling, unabashed, uninhibited business man who doesn't seem all that happy either. We've entered a new phase in American politics. The optimistic vision put forth by Ronald Reagan, and the call for hope and change advocated by Barack Obama, have been replaced. Angry is the new hope.

The keynote speaker at the recent Strategas Conference in NYC was Nigel Farage of Brexit fame. Farage, a former trader at Drexel Burnham Lambert, subsequent politician, and long-time advocate for Britain to leave the European Union, believes the EU is doomed no matter the result of the upcoming French election. He believes that Prime Minister May will trigger Article 50 this week and Great Britain will begin the two-year process of a hard exit from the EU. This event and the pending test of the EU's unity has profound implications for investors. Just what the ongoing impact will be is hard to predict. Not only did the pundits and bookies get Brexit wrong, investors did too.

Britain is the largest export market in the European Union. A civil and well-managed exit matters as much, or more, to the remaining EU countries as it does to G.B. Just listen to what the Bavarian economic minister, Isle Aigner said, "post Brexit poses a "high risk" to the economy," and, "the UK is one of the "most important trading partners for Bavaria," which is one of Germany's most prosperous states (*The Telegraph*). Additionally, despite the warnings of economic Armageddon post-Brexit referendum to leave, in 2016 foreign direct investment in the UK doubled over 2015. That is contrary to the predictions. And, it is important to note that since Brexit the FTSE (UK stock market) is up 19.4% in the local currency versus 14.5% for the S&P 500. (In dollars, the FTSE is down 1.2%.) It is difficult to handicap the political machinations in the developed international markets. The same investors who thought Brexit would be bad for U.S. stocks assured a massive sell-off would follow if President Trump were elected.

Farage asserts, "every pub is a parliament." And he would know since he spends a good deal of his free time in pubs. In "Lunch with the FT: Nigel Farage" the sub-head reads "'I am what I am' over six pints, a bottle of wine and two glasses of port." Based on his everyman approach to politics, Farage is convinced that Brexit and the Trump election are not anomalies, rather, they are indicative of a world-wide "re-birth of the nation state." It is easy to believe that the world and the new administration, in particular, is a chaotic vortex. Though it may be true, the media would not have it otherwise. As my mother (and yours, too, I suppose) said, there are two sides to every story. During the election, I met with an economic advisor to candidate Trump who admitted the campaign was the most decentralized and, perhaps, the most disorganized, this person had ever experienced. But others argue they are getting things done. Knocking off the campaign promises one by one. Despite what the media presents, amazingly, the market seems to be looking through the muck. Or, at the very least, *has* been looking through. We will see what the coming weeks reveal. As the investment sage Warren Buffett avers, it never pays to invest your politics.

Dan Clifton, Head of Washington Office for Strategas believes that tax reform, or at the very least, tax cuts, will get done this year. "Republicans don't know how to do anything other than tax cuts" he suggests. He also believes we will see ACA (health care) reform this year. It will get messy to be sure. There will be fits and starts. Defeats. The Republicans, according to Clifton, are more divided on the ACA issue than any other. He also believes the opposition to Trump is real. Prior to the President's speech, polls showed the Republicans losing 50 seats in the house. In his words: "The speech was that important."

Continued on next page

Infrastructure will happen ($1 trillion) and the repatriation tax holiday is a fixture in all four tax cut/reform proposals. We believe that the repatriation tax is important to jobs and economic growth. Many worry that the repatriation will do no such thing, rather companies will simply spend on stock buy backs and dividend increases, but according to Clifton, all four tax proposals include capital expense tax credits and less interest rate deductibility (which encourages the use of debt to buy back stock). If that is the case, repatriated cash will – at least somewhat go to CapEx. Lastly, deregulation presents an opportunity for growth at the margin.

Steve Eisman (Steve Carrell play Eisman's character in *The Big Short*) addressed the conference over dinner and suggested that the banking system was in great shape thanks to Dodd-Frank. He is, however, not worried about the proposed changes to Dodd-Frank by the Trump Administration. A much less focused-on and much more powerful change agent is the unfilled Dodd-Frank position as Vice Chair in charge of bank regulation—a position left open by the Obama Administration that carries sweeping authority and only requires 51 votes in the Senate for approval. Deregulation without all the hoopla. Expect to see an easier curve for stress tests, the ability for banks to buy back more stock, and rising leverage. But none of this rivals the leverage or risk the banks were taking in the early 2000s. Eisman believes that bank stocks, in particular, will continue to outperform as the earnings leverage from here is remarkable. Many of those stocks are approaching our sell ranges. They have had quite a run already.

Our response: stay the course, own great companies and remain focused on the fundamentals. (Earnings are improving. And the consumer and CEOs are as optimistic as they've been in decades.) Economic growth is implied in the President's policies. Tax reform, or at the very least, tax cuts, are already factored into the stock market, so beware a disappointment. Since the legislative process is anything but razor sharp, expect twists and turns in stocks in the coming months but the long-term trend is optimistic.

From the desk of Paul Dickson, Director of Fixed Income

This week, Federal Reserve Chairwoman Janet Yellen further opened the door on a rate hike on March 15. In her prepared remarks she stated, ***"At our meeting later this month, the Committee will evaluate whether employment and inflation are continuing to evolve in line with our expectations, in which case a further adjustment of the federal funds rate would likely be appropriate . . . With the job market strengthening and inflation rising toward our target, the median assessment of FOMC participants as of last December was that a cumulative 3/4 percentage point increase in the target range for the federal funds rate would likely be appropriate over the course of this year . . . The economy has essentially met the employment portion of our mandate and inflation is moving closer to our 2 percent objective."*** Prior to the remarks, the market was looking for the next hike to take place in June, but in the aftermath of her speech, and based on comments from other Fed officials, the probability of a hike has moved to greater than 80%. At one time, the lack of a pre-scheduled press conference following the March meeting might have reduced those odds. Now that the meeting is "live" as we opined it would be a few weeks ago simply due to the economic data coming in stronger, the odds of a rate hike are much greater.

The market consensus has moved into a pro-hike attitude increasing the likelihood of a rate increase, especially if you are of the opinion that the Fed has begun making its rate setting decisions based on market expectations rather than on objective facts on the ground. That was the opinion of one of the speakers at a conference we attended this week in New York. Kevin Warsh, former member of the Board of Governors, Federal Reserve (2006-2011), was a keynote speaker at the Annual Stone Ridge Conference. He expressed his worry that the Fed was overly concerned with market expectations rather than with the real economy. There may be some truth to that opinion as we all know the Fed does not want to surprise the market as they did in 2013, and have been careful to provide additional guidance wherever they can. Could it be that it's gone so far as the Fed waiting for consensus before a move? That would be terrible. But Warsh certainly has a point.

Continued on next page

Speaking of the Stone Ridge Conference, there were a great number of insights, but a couple of takeaways seem particularly relevant. The firms that source the loans in the Alternative Lending Fund, in which we participate for our fixed income clients, seem to be employing very rigorous rules for loan making and rely on a tremendous amount of data heretofore unavailable. They also cover a much broader lending universe that includes lending to franchises, a very large market for small business lending, as well as what we believe is the bread and butter of the fund: direct to consumer personal loans. In terms of insurance and reinsurance investing (which includes our other Stone Ridge fund) the opportunities to grow into that marketplace are enormous. And, as with the lending sector, insurance is also undergoing enormous changes driven by data and apps. Door-to-door insurance sales are being replaced by proactive apps that help design policies for the individual based on reams of data.

Both Stone Ridge funds have been excellent investments in our fixed income strategies. We continue to search for others.

In summary. The world is changing. We may face years of rising interest rates, but our fixed income team, led by Paul Dickson, has proven adept at finding ways to generate excess return (witness the Stone Ridge investments discussed above) in a rising interest rate environment. Though passive equity investing seems to be a fait-accompli-ad-infinitum, there are many indications that active investing is poised to return. Witness active managers have begun to outperform their passive benchmarks and correlations of returns for S&P companies are at multi-year lows – a signal that active equity management will outperform in the coming years. Investors live in interesting times. Stay tuned. Watch for emerging policies, like tax cuts, that generate economic growth. But investors must see through the noise. Change comes difficult to Washington. Power brokers don't like letting go. Politics is a convoluted, fickle business. Investors need to focus on the intermediate and long-term. And, that is exactly what we are doing.