Financial Market Landscape
Changes in Wake of Historic Election

Hamilton-Bates
Market Update

November 20, 2016

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One of the Biggest 'Upsets' in Political History causes Tectonic Shifts in the Financial Markets Overnight

To many it seemed clear Hillary Clinton would win, and the shocking result of the election seems to have caught many media and political experts off-guard, seeming to have come out of nowhere. But that really isn't true. In our opinion this Election was all about the Economy; and not the awesome growth story the government peddles, but the hard reality that Wall St may be doing well but Main St. has been woefully neglected. The Election result was as much a referendum on that as anything else.

I personally thought Trump could win because of my thoughts on the weakness of the economy and my own observations of large numbers of 'Trump' signs in my historically 'blue' home state of PA. I think the Trump/Hillary sign ratio was 30-1. That told me that the public wanted change.

Now the GOP controls the Presidency, the House, and the Senate. For a market that historically likes 'gridlock', the positive response to an electoral sweep is something different.

Financial Market and Investment Outlook

The futures market was down nearly 1000 Dow points the night of the Election as it seemed Trump could win. But once it was clear he would win, the market began to change as investors positioned money on how they thought President Trump would enact policy. The market reacted positively to certainty.

The market's general conclusion post-election is a focus on U.S. domestic growth. Rotation into small-caps and banks in particular happened really quickly. We had been planning a move increasing exposure in these areas prior to the Election, and the outcome only confirms our intentions. Small-Caps and domestic centric stories, along with the financials, makes total sense if you believe the Trump government will decrease regulations and increase fiscal spending. On a sector basis a Trump presidency is bullish for Financials, Health Care, Industrials, and Energy, basically the most-regulated sectors of the economy. This is a big switch from the near total focus on tech stocks, along with low-volatility dividend payers like utilities that existed prior to the election.

Is it all rainbows and unicorns now? The Market seems happy, what could go wrong?

The big risk to both the financial markets and the economy is a rise in interest rates that occurs too rapidly. Rising rates can reflect health and growth, but a spike in rates that results from a 'crash' in the bond market would end up causing spillover damage to the equity markets and the economy.

So much money has flowed into bonds over the past few years because of Central Bank Policy, that should this flow unwind too quickly, the resulting illiquidity in credit markets and spike in rates would serve to DEPRESS economic activity and thwart any benefits from fiscal policy.

Rising rates also boost the Dollar, and a stronger dollar hurts most commodities as well as the value of overseas earnings as they are repatriated. If the dollar strengthens too much, large-cap earnings from overseas could be eviscerated. The Fed has been trying to stoke inflation and 'scare' the bond market for years to no avail. They wanted fixed income assets to flow into riskier assets and support the economy via the 'wealth affect'. But investors continued to flock to

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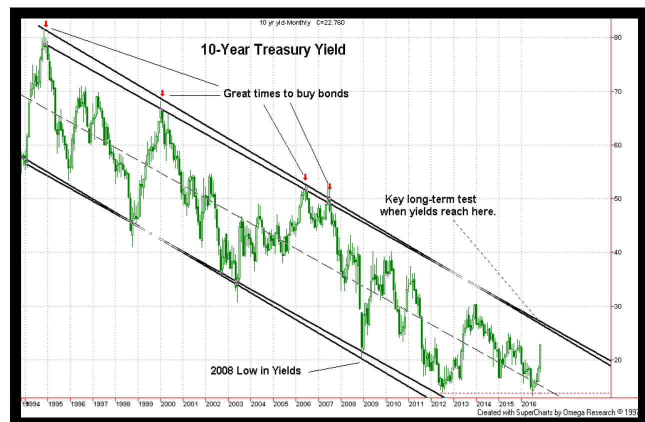
bonds. Trading in the bond market has been violent since the Election, with Treasury yields spiking 65 basis points in about a week. That is the biggest move in years. Yields have also risen over 1% since the Summer low. The yield-curve steepened massively. Trump did in a week what the Fed has been trying to do for years. The chance of a rate hike in December has to be close to 100%. The market is now believing in rate hikes. As long as rates in the credit market do not continue to spike, the move away from fixed income toward equity and cyclically sensitive assets can continue in a healthy way. Getting the Central Banks out of the interest rate suppression business can only help the economy long-term. Interest rate suppression only ends up strangling the economy.

Investment Strategy

The equity market likes the idea of growth. Cutting marginal income tax rates, cutting corporate tax rates, repatriating overseas earnings, and rolling back regulations (Obamacare, Dodd-Frank) are all actions that would stimulate domestic growth rates.

We will focus equity exposure on domestic-centric names set to benefit from Trump's expected policy, while looking to modify fixed income exposure to be more flexible and less sensitive to rising rates. We continue to under-weight Treasuries, and we will look to increase holdings of flexible bond funds and floating rate funds, as Central Bank interest rate suppression looks to be on the way out.

Market Charts—Election Rocks Credit Markets & Interest Rate Expectations



To give you an idea of how violent the reaction was in the bond market over the past week and a half, consider the intermediate Treasury ETF (TLT). It has fallen 6% since the Election, and 15% since its peak in the Summer. Once the top-performing investment for 2016, this asset class has now given up all of its gains for the year. At some point Government Bonds will become attractive, we are not there yet.

The long-term trend of falling rates has supported the financial markets for decades. The 10-year Treasury yield went from 8% in 2000 down to 1.3% in July of 2016. The downtrend is still technically intact but that trend is for the first time in some time at risk. <u>And this would have huge ramifications for all assets</u>. Treasuries have a little more room before the trend is 'broken' but this chart should be noted by all investors with fixed income assets.

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