Tiburon Capital Management

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Long Trumps Short or the Trump and Dump?

The Trump Trades Setting Up for 2017

Coming into the new year, I historically write what we call the "Tiburon Panorama" – a look at what would appear to us to be ways to make money long and short in the new year, as well as new and evolving risks. With this recent US Presidential election and transition to a Donald Trump presidency, the *transition*, unlike any time in my experience, is anything but *status quo*. Because of the checks and balances in the US system of government, the president typically has limited direct impact on the economy. However, President-elect Donald Trump is arguably likely to be different, not just because some of his policy stances (especially on trade) depart from Republican orthodoxy, but also because his party now controls both branches of Congress (US electorates rarely award the Presidency as well as all of Congress to one party). Consequently, we think his policies could have a considerable impact – both positive and negative – on the US economy and markets consequently, in the months and years ahead. Therefore, this year we frame the opportunities and risks in the context of this new moment and new administration.

The Trump *economic agenda* has two main elements. One concerns trade-related tariffs and the possible "re-negotiation" of existing trade agreements. The other is an economic stimulus composed of tax cuts (and tax reform) as well as fiscal spending. While we as managers, dynamically shifts the lens to focus in real time, on the changing landscape that gives us evolving opportunities and risks, a lot of what is to follow is a reasoned best guess, a supposition. Therefore, probabilities are more widely distributed than a typical "status quo" transition of power in Washington. **Nothing in what is discussed below is meant to be political in nature. There is no room for such personal biases in how we allocate capital.** With our caveats, here is our best sense for present positioning for future positive outcomes in securities markets:

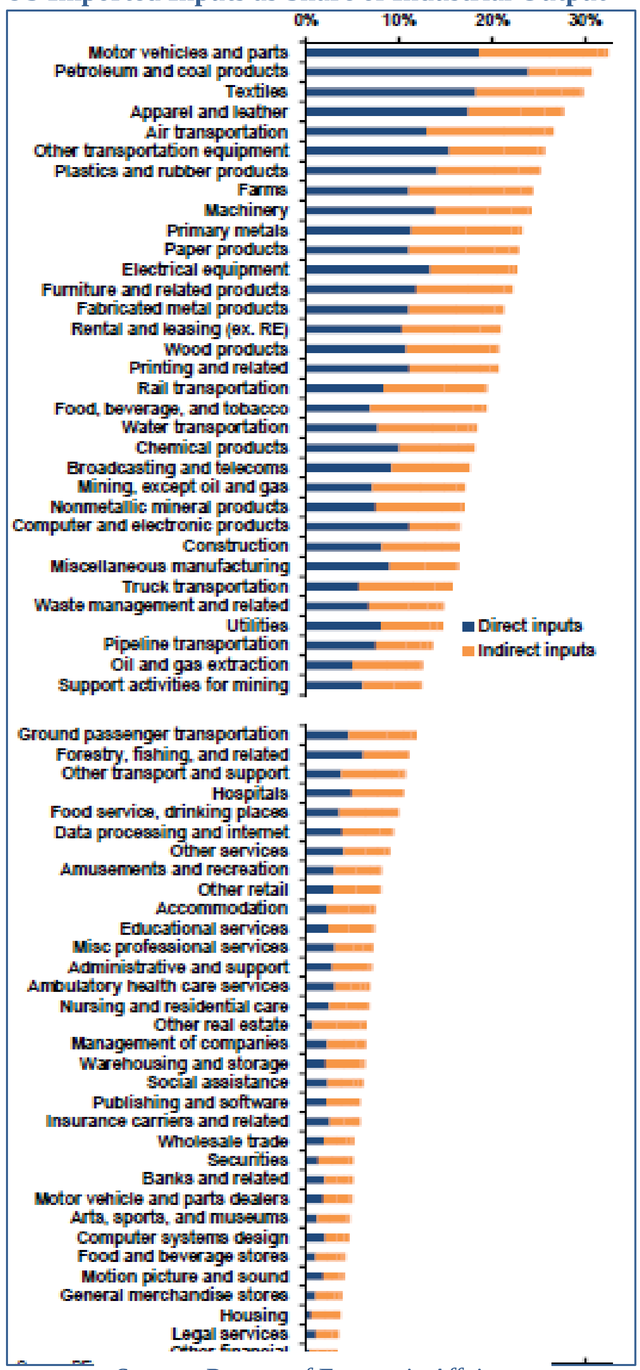
Perceived Reduced Regulatory Logjams

To take the prospect of Trump *the business man* as President-elect at face value, markets may, and probably should assume much of past regulatory logjam, in fact, in many instances, objections, will be curtailed. Certainly, sectors such as energy (particularly coal), banking and finance, real estate, healthcare (regarding combinations), telecom (witness the discussion of the replacement of Chairman Tom Wheeler at the FCC, who was adamant about maintaining 4 strong carriers) are beneficiaries. What remains to be seen is if, Trump, the *populist*, can navigate the more incendiary regulatory matters, for example, Drug Pricing and foreign purchasers of US companies and assets. Simply put, however, reduced Regulatory Logjam likely contributes to increased business combinations – events – in the US.

Trade Policies Likely Favor (Long) US Domestic-Focused Companies, Hurt (Short) Those with Overseas Currency (Yuan, etc) International Sales and Cost Exposure

It is our present base case scenario that trade policies will increase conflicts with our overseas trading partners and that such conflicts manifest in higher costs for US companies with any overseas business exposure (buying inputs, selling goods). If US trade policies are renegotiated, causing friction with China, others, US manufacturers will face larger tariffs on products shipped overseas and will likely see higher costs on imported goods and inputs (from overseas suppliers). With China, it is plausible to see the Yuan depreciated deliberately against the US$, with ramifications for companies doing business in China. The coming potential protectionist trade policies is a tax on the domestic economy through higher prices designed to induce reallocation of activity and commerce back to the US and US manufacturers. Initially, this will simply create costs for US companies, potentially with benefits to come. Outright, some economists think a full-on trade war brought about by Trump's trade agenda could cost as much as -2% of US GDP[1] (before potentially offset by other fiscal policies discussed below).

US Imported Inputs as Share of Industrial Output



Source: Bureau of Economic Affairs

This is a political gambit fraught with other risks as well. China appears to be transitioning to a consumer-based economy with more ease than doomsday scenarists suggested a few years back. If the US and other Domestic Markets ("DM") sovereigns are in a condition of *Oversupply*[2] (products, labor,

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[1] *J.P. Morgan Global Data Watch*, Economic Research, November, 11, 2016

[2] We have written at length, mostly in monthly letters, about the nature of global *Oversupply*. Contact us if you would like to discuss further. Read *The Age of Oversupply, Overcoming the Greatest Challenge to the Global Economy*, by Daniel Alpert, Penguin Group, 2013

commodities), alienating the only growing and largest potential consumer economic sovereign poses hazard. Further, there is argument (not suited for this current discussion) that trade deals (such as TPP) are equally *global security deals*. That is, if we are economically aligned with community of interest, we are likely to support each other militarily (more directly, not attack one another).

Immigration Policies Perceived to Hinder Technology Sector

If you can no longer hire the best and brightest regardless of nationality, there is the supposition in markets presently that this will retard innovation. This remains to be seen but presumably, all things being equal, technology companies, which are now the largest component of the S&P 500 at approximately 20%, would be hiring more US nationals for openings if they were most qualified (the all things equal goes to cost of salaries). Implementation of restrictions on Trade and Immigration would damage global supply chains, leading to higher tariffs. While the negative supply shock and potentially positive demand shock might offset each other regarding growth, they both promote higher inflation as well and the Technology Sector will argue that it will put them and the US in a less competitive position globally.

Higher Interest Rates (Costs of Borrowing Escalates)

On the matter of Interest Rates, the reasonably sanguine US economic engine continued to produce enough new jobs that absent a shocking jobs number surprise in early December (below 100,000) or any exogenous world event, we should presume the first of as many as three .25% rate hikes coming in December. The combination of the imminence of rate hikes in the US and costs of either Clinton's or Trump's stated plans helped drive the 10 year US treasury rate from 1.40% pre-election to over 2.33% as of this writing. About the only item seemingly unanimously believed by market participants, is increasing interest rates. While this means borrowing costs escalate, with its concomitant potential impact on deals and deal financings, rates in the US remain low by any historical measure. Further, imminent rate hikes like recessions as the adage goes, have been successfully predicted 9 out of the last 4 times.

It is also possible that some of China's trade retaliation could come in the form of refusal to participate in future US Treasury auctions, further, China may potentially threaten to sell Chinese held US Treasuries, which could have a destabilizing effect on credit (and equity) markets, increasing borrowing costs for the US government and all US borrowers.

Lower Individual and Corporate Taxes, Repatriation of Overseas Cash of US Multinationals

Trump's most recent tax plan hews quite close to the one proposed by House Speaker Paul Ryan. A principal element of this plan is reducing the current seven individual income tax brackets to three, and at most income levels the tax rate is lower than under the current system. There are several other aspects of the individual income tax plan, including increasing the standard deduction, capping itemized deductions, increasing the earned income tax credit, and repealing the alternative minimum tax. All told, the tax burden on the household sector would be reduced by around $250 billion per year. Theoretically, this "tax windfall" could create more disposable income for consumers to spend. However, the massive decline in gasoline prices similarly was to create such a "windfall" for consumers since the fall of 2014 and has yet to materialize. There are arguments about the need humans have to believe such "windfalls" are not one time in nature, but ongoing. This may be more feasible and confidence-causing with a change in tax law than with a change in energy prices.

Single Filer Tax Rates, Current Law vs Trump

Adjusted gross income ($)		Marginal rate (%)	
Over	But not over	Current	Trump plan
0	10,350	0	0
10,350	15,000	10	0
15,000	19,625	10	12
19,625	48,000	15	12
48,000	52,500	25	12
52,500	101,500	25	25
101,500	127,500	28	25
127,500	200,500	28	33
200,500	423,700	33	33
423,700	425,400	35	33
425,400	and over	39.6	33

Source: Brookings Institute

The tax plan put forth by President-elect Trump during his campaign proposed lowering the statutory federal corporate tax rate to 15% from 35%. The plan authored by House Republicans in June 2016 proposed a 20% statutory rate. Among major developed nations, the current US statutory rate of 35% ranks highest. The Trump rate of 15%, adjusted slightly higher to include state and local taxes, would rank among the lowest in the world. The House Republican proposal would also rank below the average statutory rate of 25%. Mr. Trump has also proposed adopting a full territorial system, which would reduce effective tax rates even further by excluding foreign revenues. The median S&P 500 company pays an effective tax rate of 28%, more than 10 percentage points lower than the combined federal and state/local statutory corporate tax rate of 39%. Many pundits believe that Tax Reform has a good chance of passing in 2017. *Goldman Sachs* estimates that each percentage point change in the effective US Corporate Tax Rate is worth about $1.50/share in 2017 EPS. They estimate this could produce nearly +20% EPS growth in 2017 (assuming effected and retroactive for all 2017).[3]

Theoretically, industries and select companies within them, laboring under higher average tax rates can reap a windfall relative to those with lower effective tax rates, but to a degree, its somewhat of a *zero-sum game* as all public US tax paying companies are beneficiaries. More succinctly put, a lower tax burden is part of our base case, suggesting a preference for DM equities over Emerging Markets ("EM") and within DM, US over Europe.

[3] *The Potential Impact of Corporate Tax Reform on US Equity Earnings and Performance*. Goldman Sachs Portfolio Strategy Research, November 10, 2016.

Tax Rate by Industry: Telecom and Transport Top the List

Industry	Median	Mean
Wireless Telecommunication Services	38.9%	38.9%
Transportation Infrastructure	38.7%	38.7%
Professional Services	37.6%	36.8%
Marine	37.3%	37.3%
Construction & Engineering	37.2%	34.1%
Road & Rail	37.1%	35.0%
Airlines	36.8%	35.8%
Specialty Retail	36.8%	36.8%
Distributors	36.7%	35.7%
Health Care Providers & Services	36.7%	39.1%
Diversified Financial Services	36.6%	36.6%
Tobacco	36.6%	34.6%
Water Utilities	36.5%	29.4%
Gas Utilities	36.5%	33.7%
Multiline Retail	36.3%	35.7%
Diversified Consumer Services	36.3%	35.7%
Air Freight & Logistics	35.7%	35.7%
Trading Companies & Distributors	35.5%	34.7%
Diversified Telecom. Services	35.0%	31.8%
Commercial Services & Supplies	34.7%	57.6%
Consumer Finance	34.7%	34.8%
Food & Staples Retailing	34.3%	34.5%
Building Products	33.9%	41.8%
Thrifts & Mortgage Finance	33.3%	32.4%
Capital Markets	32.8%	30.9%
Automobiles	32.7%	30.5%
Metals & Mining	32.6%	53.3%
Food Products	32.4%	29.7%
Multi-Utilities	32.2%	28.2%
Auto Components	32.1%	30.7%
Electric Utilities	32.0%	29.4%
Media	31.9%	33.2%
Real Estate Mgmt. & Development	31.8%	31.7%
Banks	31.4%	30.7%

Source: ClariFi, Morgan Stanley Research

Repatriation of Overseas Cash without Conditions May Drive Share Buybacks, EPS

US corporates currently pay no US tax on profits earned and “permanently-reinvested” overseas. S&P 500 companies have $2.4 trillion of overseas profits, of which cash likely accounts for roughly $1 trillion. President-elect Trump has suggested a repatriation tax holiday during which a 10% one-time tax would be levied on cash brought back to the US. House Republicans have proposed an 8.75% tax, and the Obama administration proposed a 14% one-time tax in the FY17 budget proposal. Assuming the incoming administration makes no requirements on uses (capital expenditure, infrastructure, job creation – all highly unlikely), the 2004 precedent suggests a large amount of repatriated cash would be used for buybacks, likely boosting stock performance and per share earnings.

The obvious beneficiaries are technology and pharma companies – both industries have large active fund manager ownership, and are de facto "crowded."[4] So some finesse around this theme with knowledge aforethought of what can go wrong (technicals) is required. This is a list we've monitored dating back to 2012 when the notion of repatriation first became a potential theme for us. Here's a recent screen:

Repatriation Beneficiaries

Ticker	Company Name	Sector	For. Earnings Deemed Perm Reinvested ($B)	Foreign Cash ($B)	Consol. Market Cap
MSFT	Microsoft Corporation	Info Tech	124,000	108,900	470,175.5
AAPL	Apple Inc.	Info Tech	109,800	216,000	592,206.7
GE	General Electric Co	Industrials	104,000	50,100	260,260.8
PFE	Pfizer Inc.	Health Care	80,000	"Signif Portions"	181,969.6
IBM	Int'l Bus Mach	Info Tech	68,100	ND	147,544.2
CSCO	Cisco Systems, Inc.	Info Tech	65,600	59,800	155,814.8
MRK	Merck & Co., Inc.	Health Care	59,200	22,525	166,834.4
GOOGL	Alphabet Inc. Class A	Info Tech	58,300	42,900	551,024.7
JNJ	Johnson & Johnson	Health Care	58,000	38,200	318,438.3
XOM	Exxon Mobil Corp	Energy	51,000	ND	353,754.3
PG	Procter & Gamble Co	Cons Staples	49,000	11,000	234,042.3
HPQ	HP Inc.	Info Tech	47,200	"Substantially All"	26,142.2
CVX	Chevron Corporation	Energy	45,400	ND	202,538.8
C	Citigroup Inc	Financials	45,200	NM	142,230.0
ORCL	Oracle Corporation	Info Tech	42,600	48,200	160,653.9
PEP	PepsiCo, Inc.	Cons Staples	40,200	11,100	155,924.4
JPM	JPMorgan Chase	Financials	34,600	NM	250,585.8
AMGN	Amgen Inc.	Health Care	32,600	29,000	102,996.0
QCOM	QUALCOMM Inc.	Info Tech	32,500	29,600	100,827.1
KO	Coca-Cola Company	Cons Staples	31,900	17,900	184,939.7

Source: Tiburon Capital Management

Infrastructure (Fiscal Policy) Spending, Other (Defense) Spending Beneficiaries but Interest Rates Rise

While the Trump campaign put forth several detailed tax plans, the incoming Administration's spending plans are vaguer. Trump has called for greater infrastructure spending, a priority he reiterated in his victory speech. During his campaign, he pledged to double Clinton's call for $250 billion in infrastructure spending over the next five years.

[4] As an investment manager, we overtly avoid what we deem to be "crowded" trades as best we can, to limit exposure to other's technical selling, a function of large fund herd mentality. See Tiburon White Paper, *Far from the Madding Crowd – Averting Underperformance (and Profiting) from Crowded Hedge Fund Trades*. Lupoff. Share Bites Vol 6, Article 1. April, 2016 http://nebula.wsimg.com/900f19380e76894cd68447a4a98fc482?AccessKeyId=ED7655C1814E263BA776&disposition=0&alloworigin=1

(He subsequently upped that to $1 trillion over 10 years). Such Fiscal Policy will cost money that would likely come in the form of increased US borrowing via Treasuries auction. This also would drive up borrowing costs. Trump's planned Infrastructure spend will likely get push back, causing both delay and smaller expenditure. Any likely GDP impact is plausibly no earlier than 2018. Interest sensitive bonds remain at risk.

Trump also has vowed to increase defense spending, though he has not offered a specific dollar cost. The spending caps imposed by the Budget Control Act that went into force in early 2013 has reduced defense spending relative to what most military planners believe to be prudent levels. Simply reversing the limitations of this legislation would increase defense spending by between $50 billion and $75 billion per year. Increased defense spending of this magnitude could add around 0.3% to aggregate demand. Determined increased defense spending, likely saber-rattling and lessened international economic ties all suggest Defense industry exposure.

Preferring DM Over EM, US>Europe. Preferring Financials, Cyclicals, Defense, Healthcare Over Defensives, Consumer Staples

We continue to favor DM equities over EM and then within DM, the US over Europe. We will prefer US industrials, financials and certain healthcare. Rising inflation and interest rates, possible faster economic growth, and potentially reduced regulation all contributed to the rally in Financials and other Cyclicals over the Defensive Utilities and Consumer Staples post-election and is likely to persist. Tax and trade reform appear to be high priorities for President-elect Trump. Cyclical stocks that should benefit most will have high domestic sales, sizeable profits held overseas that may be repatriated, and/or high corporate tax rates. Industrials and Defense appear to be favored given infrastructure spend and an inevitable increase in Defense spending given heightened distrust of foreign sovereign counter-parts. Healthcare companies are sitting on large amounts of cash with improved M&A odds under the incoming administration. Before any debate of the repeal of Glass-Steagall and/or (unlikely) changes in bank capital requirements, financials simply benefit from higher interest rates.

All that Cash for All the Wrong Reasons (But Even a Broken Clock is Right Twice a Day)

Most of the professional buyside is sitting on larger cash positions than they, perhaps, ever have. This feels right but for different reasons than most of the Street would articulate. Probably most came into the election with larger cash positions given their fears of an overpriced equity markets in the States (this is debatable, but okay). Others might point out the increased risks of European break-up given BREXIT and the rise of global Populism, particularly in DM. Another reason might be the risks caused by the imminent rate hikes in the US and perhaps Europe, as the punchbowl of Quantitative Easing gets yanked at the end of happy hour. I don't know, de-stabilizing terrorist attacks? Anything else? Cyber-terrorism? All probably defensible arguments solely and in combination, but none which protected anyone from the choking under-performance of most managers, particularly in these "late innings" of the greatest and most unloved bull market in history. No, these myriad reasons turned out to be all wrong regarding large cash positions (and hedges for that matter) coming into this US Presidential election. But probably now, cash matters, but for reasons the Street underestimates presently. The market's current ascent post-election significantly over-weights favorable outcomes as a function of Presidential transition.

Overestimation by the Street – A Function of Bias, Myopia and Narrowness of Interest, Experiences

We've focused on President-elect Trump's *economic agenda* thus far. This is simple, it is the business we are in. Less simple is the President-elect's *social agenda* and it's potential for creating *societal anxiety*, and how this anxiety can manifest in exogenous events and impact the economy and markets (the topic of another paper I've been asked to write). The Street knows a narrow demographic as their core client constituency, and many them and their clients do not face any first derivative societal anxiety. Market decision makers and participants are largely this same demographic. However, there are American men and women that are surprised, angry and/or frightened now that there is a Trump presidency. Perhaps they cried when they saw the results of the election or have children that said that they are now scared or dealt with their first, firsthand experience or knowledge of a hate crime. *The problem with the Street's biases regarding markets is that they are largely tone-deaf to social matters that can weigh on transition, confidence and economic decision-making given their principally narrow, insulated existence*. The *Ceterus paribus – all things equal* - aspects of presidential transition of the past is now gone and this is new terrain. It is my view that this is very much underestimated by the Street. This is not to say that there are not high probabilities of tax cuts, of fiscal stimulus, and trade agreement changes and concomitant ramifications. It is that any probability weightings regarding the *economic agenda* miss – for the first time in years, the notion of *lost social ground* – the impact that a new *social agenda* can have on consumers, market anxieties, etc., regardless of the narrow black box of the unfeeling policies impacting markets and economy.

The cash component should be larger given that fatter tails exist both ways on growth, more upside risk on inflation, greater macro and market volatility, policy rotation to fiscal, a return to negative bond-equity correlations, and a twilight of globalization. These seismic changes in the US political landscape have a new, untested dimension in potential *societal angst*. Fatter tails suggest more cash.

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