A Narrative for Every Season

11/29/2016

"All is for the best in the best of all possible worlds" – Voltaire (Candide/The Optimist)

Consider the media headlines and stories published before and after the presidential election.

Before the election:

- *"The conventional wisdom is that, right off the bat, the stock market would fall precipitously. Simon Johnson, the Massachusetts Institute of Technology economist, posited that Mr. Trump's presidency would "**likely cause the stock market to crash and plunge the world into recession**." He predicted that Mr. Trump's "anti-trade policies would cause a sharp slowdown, much like the British are experiencing" after their vote to exit the European Union."* - The New York Times – "What Happens to the Markets if Donald Trump Wins?" by Andrew Ross Sorkin

- "The stock market doesn't like the idea of a Trump Presidency"- PBS Newshour

- "Economists: A Trump win would tank the market" – Politico

- "Stock Markets will freak out if Trump wins, but you probably shouldn't"- Boston Globe

After:

- Wall Street welcomes Trump with a bang" –CNN Money

- Stock Market Slingshots Higher After Trump Victory Sparked Overnight Plunge" Forbes

- Dow Surges to Fresh All-Time High on Trump-Fueled Momentum" –Fox Business

Following Donald Trump's surprise victory and the violent market reactions, many investors are left scratching their heads. As shown above, the consensus narrative warned that a Trump victory would spell doom for the markets. Days later, the narrative flipped and Trump's economic policies, all of which were known prior to the election, are deemed beneficial for share prices.

In this article we evaluate the narratives we see day-to-day and how they not only tell a story, true or false, but provide comfort and, importantly, a sense of control. We then explore the current market narrative calling Trump's victory bullish for share prices. We hope to provide cognizance of the influence of narratives and to offer a basis to help investors judge whether the markets' reaction is justified.

The Narrative

nar·ra·tive

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A spoken or written account of connected events; a story.

A narrative is a story or a line of reasoning that helps explain an event. Sometimes a narrative is factual, sometimes it is fabricated and quite often it lies somewhere in between. A great example can be found when your favorite newspaper proclaims that the market was up or down yesterday due to a specific event or piece of data. Trying to encapsulate the hundreds of millions of investment decisions into one story line is not only ridiculous, but grossly misleading. Human nature demands narratives, as they give us a sense of control and the comfort of understanding, valid or not, why something has occurred.

Global warming provides a good example of a popular narrative. The narrative states that humans are the overwhelming cause for the increase in global temperatures and the problems it causes. There is no doubt human actions have a big impact on the earth's climate, but there are millions of other variables, many of which are not understood at all. By assigning blame on humans, rightly or wrongly, we are provided a sense of control over the problem. Humans find it comforting to believe that if we caused the problem then we can certainly control the problem and possibly even reverse it.

Over the last few years, investors have relied heavily on narratives to help justify extended valuations. A great example is the "bad news is good news" mantra. The stock market has seen more than its fair share of days when weak economic data was the impetus to buy stocks. This storyline causes investors to ignore the fact that weaker economic growth leads to weaker earnings and inevitably declining prices. Instead, investors have taken comfort in a belief that the Federal Reserve will counteract weak economic data with monetary stimulus and thus influence prices higher regardless of economic fundamentals. The narrative provides investors comfort and rationalization at a time when valuations are extreme and economic growth is stagnating. The harm of this narrative, and any narrative for that matter, occurs if it is proven wrong.

Panic Narrative

The market volatility on the presidential election night was stunning. Prior to the election, many concerned investors had shorted equities, hedged positions and/or moved to greater cash positions. As a Trump victory looked more and more viable, the markets plunged and at first proved the concerned investors correct. Early Wednesday morning, however, the markets reversed sharply. At that point, it is likely that a perfect technical storm formed.

With S&P 500 equity futures limit down 5%, computer algorithms, trained to "buy the dip" were staring at a dip of monstrous proportions. The exchange limits that halted trading provided a floor to the market downfall. Once the downside was capped some investors began covering shorts and even outright buying. The market started rising and likely triggered signals for the algorithms to buy. Keep in mind, the blueprint for this reaction was recently affirmed by the BREXIT vote.

The race was on. Not only were the computers buying, but investors, well trained to buy the dip, jumped in as well. Adding fuel to the fire were those investors that were short the market or hedged as a defense against the low probability of a Trump victory. By 9:30 am, the S&P 500 was down 8 points, having gained 92 points from the nights lows. It closed the day up 24 points and the week 76 points or 3.6% higher. **Shortly after the media declared Trump victorious in Pennsylvania and Wisconsin, a <u>panic-born narrative</u> was created**.

The new narrative goes as follows: Donald Trump will cut taxes, increase infrastructure spending, reduce regulation, allow for the repatriation of foreign profits, and be a proponent of a host of other business friendly ideas. All of these proposals were public weeks before the election, when the market discounted equity prices on concerns that Trump could win and such policies would be enacted.

Out of desperation for answers, this new business friendly narrative was born. Investors, desperately seeking an explanation for the sharp rally, were placated. While such proposed actions taken at face value may benefit stock prices, it is incumbent upon investors to understand the efficacy and ramifications of the proposals as well as the political and economic environment.

Trump's Plan

Donald Trump does not have a magic wand that allows him to instantly enact his wishes. Consider the following:

- **Legislative**- Trump must deal with Democrats in Congress that abhor the thought of him as President. There are quite a few Republicans who harbor similar views.

- **Tax cuts**- While positive for the economy, will they result in more productive investments? If not, they do little more than provide a short-term economic spark and increase the budget deficit and already gargantuan national debt.

- **Infrastructure spending**- Infrastructure projects can be productive, like the Hoover Dam, or unproductive like a bridge to nowhere. Unproductive projects, as is fairly typical, provide little more than a temporary burst of growth and higher debt levels. Many economists believe the fiscal multiplier to be negative. In other words, the amount spent on fiscal projects actually <u>reduces</u> economic growth. Typically, we fail to consider the money that could have been invested in more productive growth that instead is used to fund unproductive projects. Expenditures on new infrastructure are very different from revitalization projects on existing structures, akin to remodeling a home.

- **Interest rates**- If Trump is successful in generating economic growth and inflation, interest rates will rise. The government, corporations and individuals of this country are already burdened with a heavy debt load in large part masked by historically low interest rates.

- **Dollar**- The U.S. Dollar may continue to appreciate versus the respective currencies of many of our trade partners as growth and higher interest rates are factored into currency prices. If this occurs, U.S. exports and corporate earnings will be pressured. Additionally, a stronger U.S. Dollar creates, deflationary pressures and destabilizes countries heavily reliant on dollar funding, such as China and other emerging market economies. These countries are a very big part of the U.S. economic supply chain.

- **Trade deals**- Renegotiating trade deals may be beneficial in the long run, but in the short term such actions can produce hostility from other nations and may result in a reduction in global trade.

Our point is not to say Trump's proposals will or will not work. Without more details, which will emerge over the next few years, we are only able to speculate on their effectiveness. We summarized a few of Trump's proposals above to help you better understand that there are many factors to consider before bluntly claiming them positive as the market has done.

Many investors are suddenly comparing Trump's economic policy proposals to those of Ronald Reagan. For those that deem that bullish, we remind you that the economic environment and potential growth of 1982 was vastly different than it is today. Consider the following table:

	1982	Today		1982	Today
Fed Funds Rate	18.00%	0.50%	Annual Inflation Rate (CPI)	8.00%	1.60%
10 Year Treasury Yield	15.00%	2.30%	Personal Savings Rate	10.00%	5.00%
Mortgage Rate	16.25%	3.87%	Labor Force Participation	64.00%	63.00%
Household Debt to Income	62.00%	130.00%	S&P 500 - CAPE10	7	26
U.S. Government Debt to GDP Ratio	30.00%	105.00%	S&P 500 - Median Price to Sales Ratio	.50x	2.20x
Total U.S. Debt to GDP Ratio	.90x	3.60x	Median Age Baby Boomers	26	60
Productivity Growth	2.00%	0.25%	Global Trade Barriers	Falling	Rising

Data Courtesy: St. Louis Federal Reserve (FRED), Bloomberg, Bureau of Economic Analysis

Summary

As investors, we must understand the popular narrative and respect it as it is a formidable short- term force driving the market. That said, we also must understand whether there is logic and truth behind the narrative. In the late 1990's, investors bought into the new economy narrative. By 2002, the market reminded them that the narrative was borne of greed not reality. Similarly, in the early to mid-2000's real estate investors were lead to believe that real-estate prices never decline.

The bottom line is that one should respect the narrative and its ability to propel the market higher. However, think for yourself and truly understand the pros and cons of Trumps proposals as well as the daunting odds of enacting them. Your investing success is dependent on determining whether the narrative is the truth or simply a rationalization to provide comfort and control when desperately needed.

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