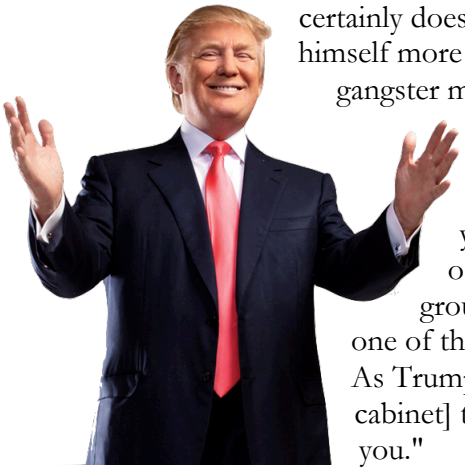
Volume 75

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

January 2017

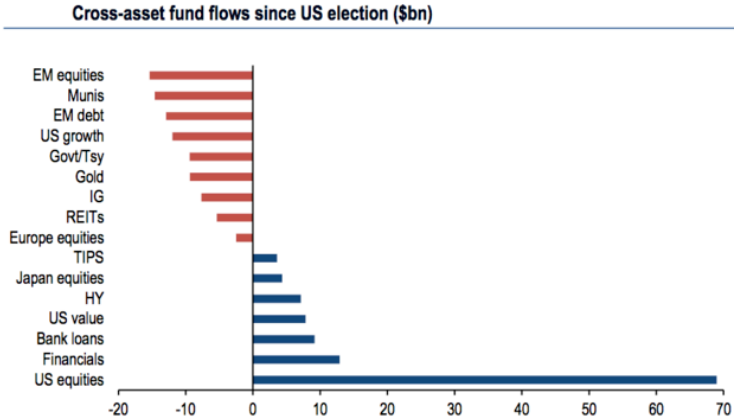
To state the obvious, Donald Trump is not your average President, or even your average politician. He doesn't look like a politician. He doesn't act like a politician and he most certainly doesn't think like a politician. If anything, he seems to view himself more as a corporate raider engaging in hostile takeovers or as a gangster making offers that one dares not refuse.



It is no wonder that his cabinet looks more like a board of directors for a U.S. multinational corporation (where you endeavor to build a prestigious and experienced body of highly successful business executives) than it does a group of government department heads. Significantly, it is one of the wealthiest cabinets in U.S. history, and that is by design. As Trump himself said on December 8th, "I want people [for my cabinet] that made a fortune because now they're negotiating with you."

Another differentiator has been Donald Trump's commitment to his campaign promises, which are, for most politicians, normally little more than pipe dreams and meaningless rhetoric. However, Trump is proceeding as if they were instead corporate objectives, and he appears to be systematically checking them off one at a time. This fact is simultaneously remarkable, exciting and frightening because, while some of his ideas have great potential, others seem so extreme and even bizarre that their potential implementation seems virtually incredible. Even so, Trump has the authority and/or the political capital to proceed with many of them on his own initiative. Further, many Republicans in Congress now seem to be warming to the Trump agenda, which should help to expedite legislative changes.

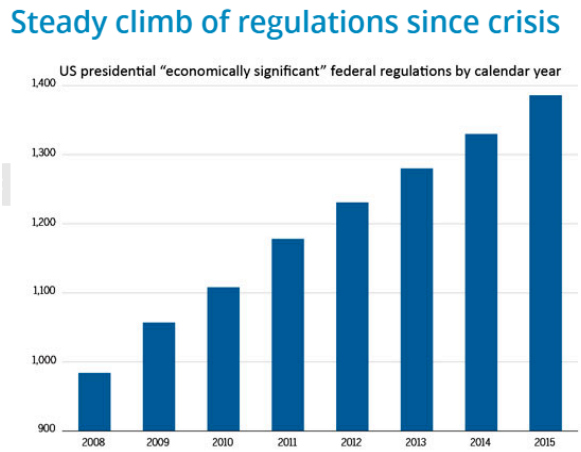
Importantly, unlike almost any other president in the modern era, Trump came to power with his own unique agenda that was separate and distinct from that of any party. Moreover, while most presidents have historically been content to use their time in office to use traditional political methods to shift the American political agenda modestly in one direction or the other, Trump seems to have a grand vision of restructuring the basic world order that has prevailed since the end of World War II.



Note: week ending on Nov 9 2016 to present

In this new world order, the U.S. would no longer act as a force for good, for justice, or for democracy. Instead, it will be "America first," and the country will only be concerned about anyone else when it is in its own self-interest to care.

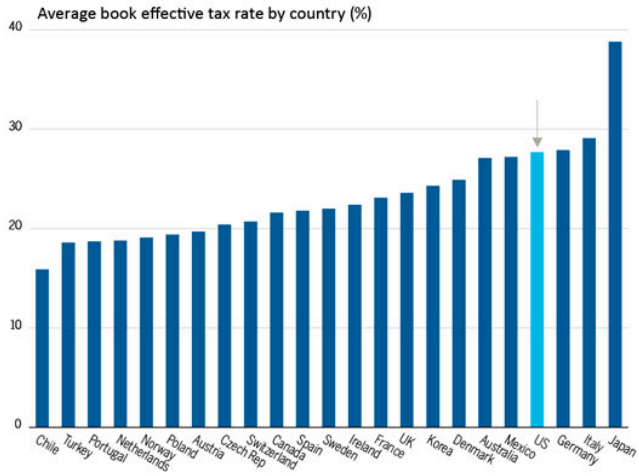
This perspective was very well summarized on January 26th, by British Prime Minister Theresa May in her speech to the Republican "Congress of Tomorrow" conference, when she said, "This cannot mean a return to the failed policies of the past. The days of Britain and America intervening in sovereign countries in an attempt to remake the world in our own image are over. But nor can we afford to stand idly by when the threat is real and when **it is in our own interests** to intervene. We must be strong, smart and hardheaded. And we must demonstrate the resolve necessary to stand up for **our interests** *[emphasis added]*."



Such an egocentric perspective is gravely concerning from a moral, ethical and humanitarian perspective. However, such value judgments are generally outside of the purview of this report, where we will instead consider the economic and capital markets implications of this political sea change, where this revised set of priorities may prove to be particularly beneficial to the domestic economy and equity markets…at least in the short to intermediate term.

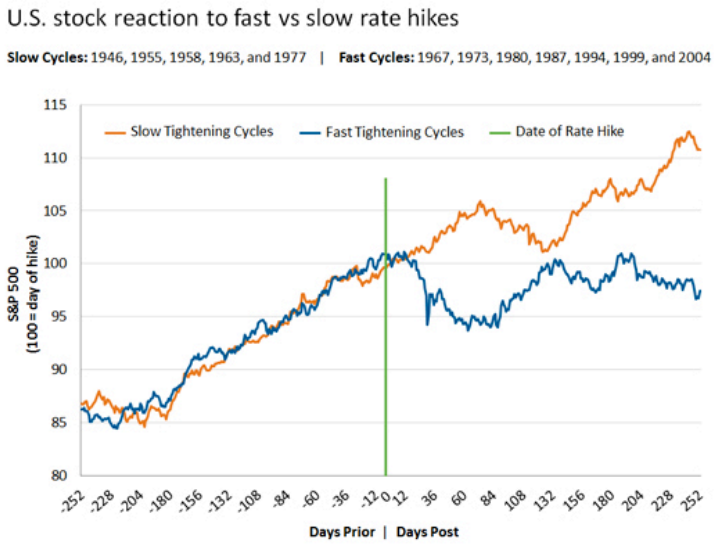
In the long term, Trump's policies of deregulation, an unbridled financial system, and a reduced social safety net is akin to adding a really fast engine to a car, while simultaneously replacing the steel frame with an aluminum one and disconnecting the air bags. The car will perform much better and travel much faster (due to a targeted 75% reduction in government regulations, less bureaucratic red tape and reduced taxes), but any accident that takes place in the future will likely be much more damaging, and have more far-reaching consequences.

This dilemma illustrates the pros and cons of "animal spirits" and the role that they play in the economy and the markets. This is an issue that we addressed in great detail in the December edition of this report (http://perstirling.com/per-stirling-capital-outlook-december-2016/), which we would encourage you to read, if you have not already done so, as we believe that having an understanding of the role of "animal spirits" in the current environment is essential, if one is to understand the developing dynamic between the economy, the markets and the Trump agenda.



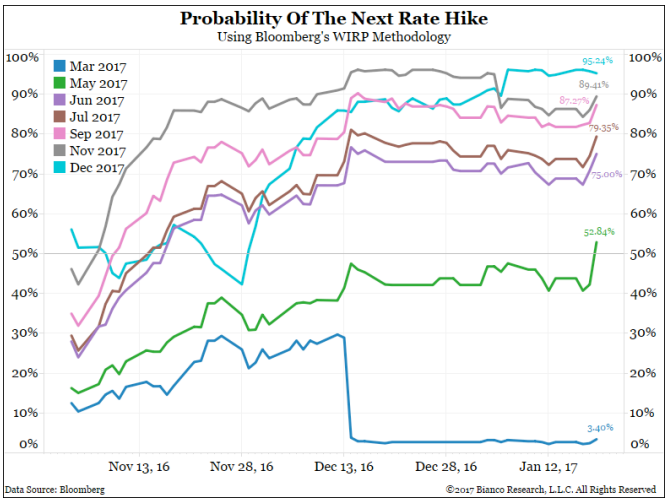
Trump's initial actions have been all about deal-making, leveraging market position and improving operational efficiencies, which is a further confirmation that he intends to run the country the same way in which you would run a multi-national company. This further suggests to us that decisions will be increasingly profit-driven (albeit for the economy as a whole), and that Trump will want to use federal debt to accelerate U.S. economic growth in the same way that a corporation would use debt to leverage its profit potential, and this has significant implications for the Fed.

As Federal Reserve Chairwoman Janet Yellen recently stated, "I and most of my colleagues" expect to raise interest rates "a few times a year" through the end of 2019, which is not a particularly notable increase in the pace of monetary tightening. In the past, it has not been unusual for the Fed to increase rates at every one of its eight meetings per year from the start of the tightening cycle to its conclusion (and oftentimes in increments of greater than 0.25%, as has been the case in this cycle). This is a very important point for equity investors, as the stock market has historically weathered slow, methodical tightening cycles quite well, while performing very poorly during periods of aggressive Fed tightening.



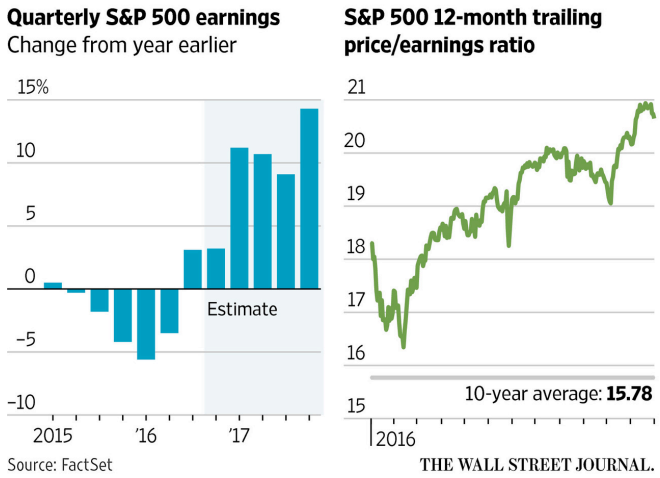
Perhaps equally noteworthy is the fact that several Fed Governors have recently floated "trial balloons" about the Fed actually shrinking the size of its balance sheet, which means that the Fed would not only be raising rates, but would also be increasing the supply of bonds that need to be absorbed by the market. This should, in turn, push market-set rates higher along with the short-term rates that are set by the Fed.

The bottom line is that the Trump administration wants to inject massive fiscal stimulus into an economy that is already in its eighth year of expansion, and which is already at full employment and which has little slack in its industrial capacity. This, in and of itself, should be a recipe for higher inflation which, when combined with additional deficit spending, should drive interest rates higher. As interest rates rise, the deficit gets bigger and the supply of new debt increases, which pushes interest rates higher, which grows the debt that needs to be financed, and so on and so on.



Further exacerbating the challenges for the bond market (and ultimately the stock market) is that the Fed, which has controlling inflation as one of its two primary objectives, will have little choice but to offset Trump's proposed fiscal stimulus (infrastructure spending and tax cuts) with increasingly restrictive monetary policy (higher interest rates and reduced money supply). Importantly, monetary policy has historically had a much bigger influence on stock, bond, and real estate prices than has fiscal policy. Indeed, higher interest rates have historically compressed price-to-earnings multiples, which is particularly important in the current environment, when price-to-earnings multiples in both the stock and bond markets are already in nose*bleed territory.

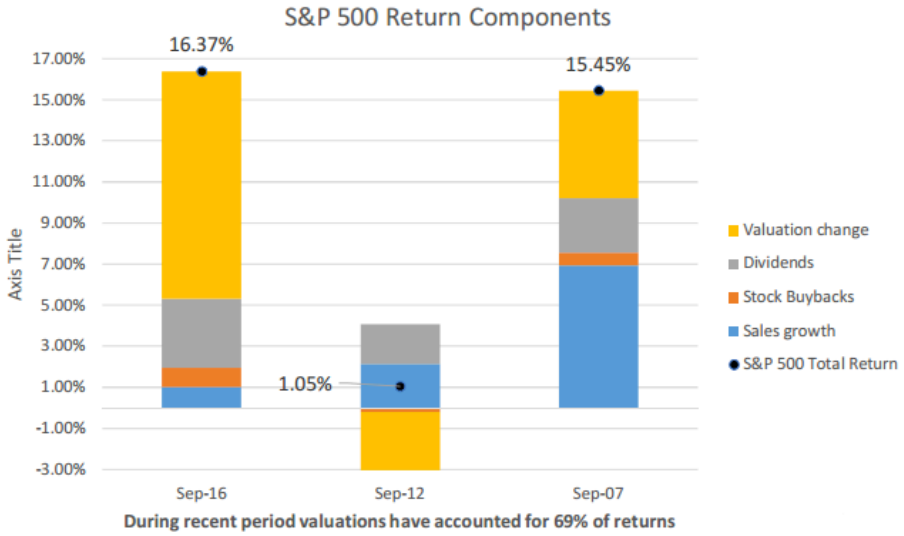
Indeed, President Trump comes to office with the second highest equity valuations of any president in history. However, his proposed corporate tax cuts (from a top rate of 35% to either 15% or 20%) may do much to help alleviate this overvalued condition. Equity markets are priced as if U.S. companies are going to average 30% profit growth in 2017.



While such growth rates are normally unheard of, particularly in the later stages of a business cycle, it is estimated that Trump's proposed tax cuts alone would be sufficient to boost profit growth by as much as 20%. Moreover, if Trump can simultaneously increase efficiency and decrease operating costs via deregulation, increase corporate share buy-backs (as a result of the tax-preferenced repatriation of foreign profits), stimulate the economy through infrastructure spending, and protect domestic industries through an increasingly protectionist agenda, a 30% profit target starts to at least look more achievable.

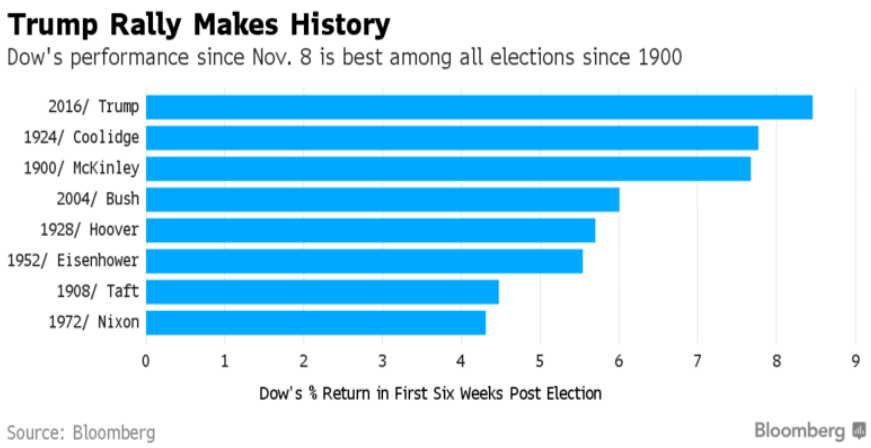
As President Trump stated most succinctly during his inaugural speech, "We will follow two simple rules: Buy American and hire American… Every decision on trade, on taxes, on immigration, on foreign affairs will be made to benefit American workers and American families."

Despite this ultimately populist statement, it apparently does not, in Trump's eyes, suggest an anti-business policy. In the past, this would have seemed like an oxymoron, as the relationship between labor and capital has traditionally been viewed as adversarial. Indeed, negotiations between the two sides have traditionally been viewed as a zero sum game, where any gain by one side comes at the expense of an equal loss to the other side.



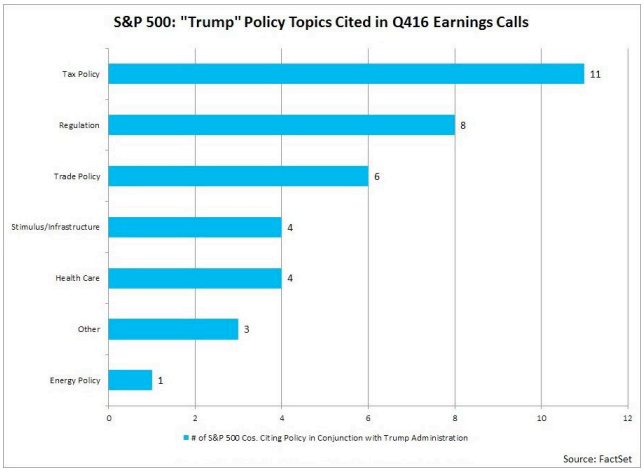
Trump's goal seems to be to benefit both domestic labor and domestic businesses, but at the expense of America's trading partners, and any domestic companies that dare to move operations or production outside of the U.S. This novel approach is making for some strange bedfellows, and is increasingly being endorsed by both U.S. business leaders and labor union leaders.

For all of the pro-business, pro-equity market components of the Trump economic platform (as we understand it at present), there is the ever-present risk of punitive tariffs, embargos, and trade wars, which would likely hurt bond prices, because trade restrictions are inherently inflationary, and almost certainly hurt the equity markets in general, and large-cap, multinational companies in particular, because protectionism interferes with the efficient allocation of resources (which drives productivity and profits) and limits the ability of America's largest companies to do business overseas, where they derive approximately 50% of their profits.



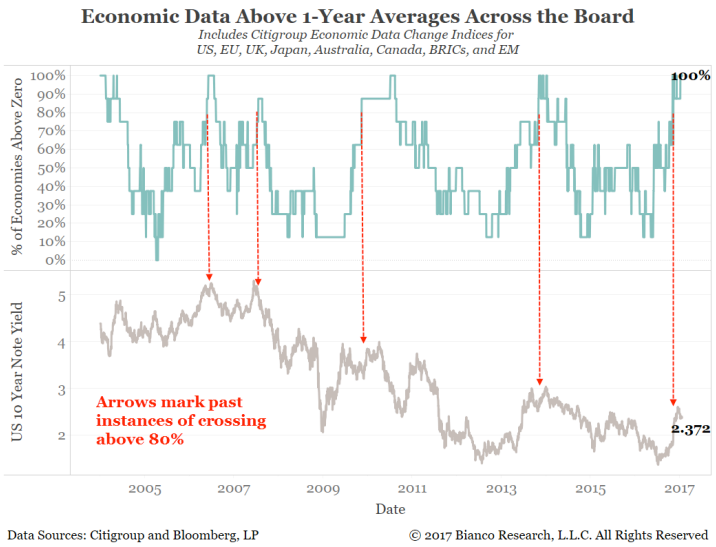
Fortunately, Trump is starting to look a little less protectionist than he appeared during the campaign, and it appears that he is not so much against trade as he is against multilateral (multi-country) trade agreements like NAFTA and the Trans-Pacific Partnership. He instead favors unilateral (one-on-one) trade agreements. His point, which we believe is correct, is that, when you are the biggest economy in the world, you can leverage your strengths and thus probably get much better terms in one-on-one negotiations versus multi-party negotiations.

Past administrations (and Republicans in particular) have traditionally viewed global trade as a good thing from a philosophical perspective, because it redistributes wealth around the world and helps to pull the world's emerging economies out of poverty. In Trump's world however, a trade deal is only good if it is to the benefit of the United States. It is a surprisingly reasonable approach, if you are only concerned about your own self-interest.



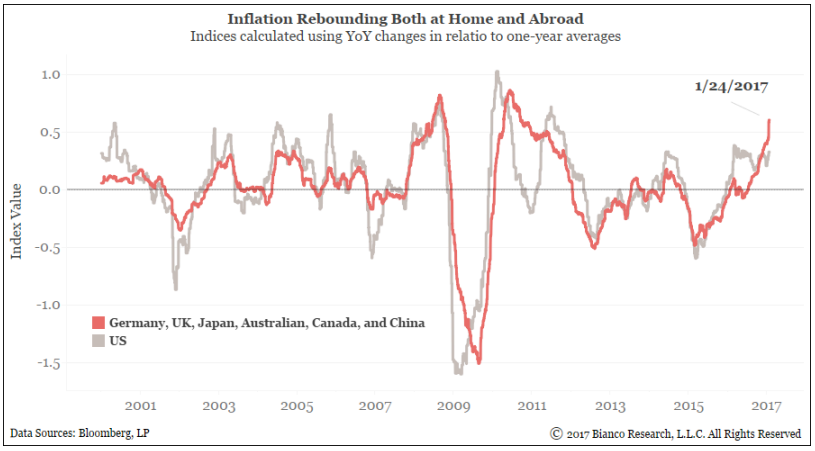
We are also somewhat encouraged that Trump is proving (at least thus far) to be rather pragmatic on the trade front. While he did take President Enrique Peña Nieto of Mexico to the proverbial "woodshed" last week and, by doing so, sent a message to all U.S. trading partners, he has to-date refrained from implementing two of his most extreme trade-related proposals, which he had suggested that he might enact on day one of his administration. They are 1) accusing China of being a currency manipulator and 2) imposing massive tariffs on imports from Mexico and China. A full-blown trade war between the world's two largest economies (the U.S. and China) would not be good for anyone, and would almost certainly roil the equity markets, while benefitting high quality bonds, as investors seek a safe haven.

While there is much about Trump's agenda that causes some angst in the financial markets, concerns about protectionism and trade policies almost certainly top the list. This is not without justification, as there has historically been a remarkably consistent 85% to 88% correlation between global trade flows and global growth rates. In fact, the increased global trade that resulted from the 1973 Tokyo round of the General Agreement on Trade and Tariffs (GATT) has increased global economic growth by an average of over one-half percent per annum.



While unimpressive on a nominal basis, it is enough to increase the global growth rate from an average 3% per year to 3.75% per year, which is quite significant on a relative basis. At a time when the global economy is finally showing signs of emerging from the Global Financial Crisis and the resulting deflation, this would be a terrible time to implement protectionist policies that will hamper global growth.

Ralph Acampora, who is know globally as "the father of technical market analysis" has called the Trump platform "the rebirth of capitalism." While that is probably a bit extreme, the idea of running the country using traditional business principals is actually a very interesting and novel concept, and it will be fascinating to see it unfold, as it has the potential to produce results that could be really good or really bad. Only time will tell, as this approach is virtually unprecedented in the United States.



It is noteworthy, however, that government-directed capitalism has been tried in other countries (like Japan in the 1980s and China in the new millennium), and it usually produces very impressive growth it its early stages, before failing over the longer term, primarily because the markets are ultimately a much more efficient allocator of capital than are governments.

As we noted last week in a Reuters interview, "Wall Street's already figured out that the recovery is in place, and that the Fed is going to start getting aggressive. What they haven't figured out yet is, exactly who is Donald Trump." Since the markets believe that they already understand the outlook for the economy and monetary policy, and because markets almost never react to the same news twice, we believe that investors' attention will continue to be dominated by the words and deeds of the always-enigmatic President Trump.