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After his experience of the past two weeks, you can bet that Donald Trump wishes that he had been elected King rather than President, as he is learning, in no uncertain terms, that it is much easier to issue executive decrees than it is to pass legislation, even with the President's own party in control of both houses of Congress, and that the "art of the deal", which Trump is the self-proclaimed master of, does not work nearly as well in Washington politics as it does in commercial real estate negotiations.

Indeed, the markets are viewing the ill-fated attempt to repeal and replace the Affordable Care Act (a.k.a. the ACA or "Obamacare") as far more than just an aborted piece of legislation.

At minimum, it was an important lost opportunity to vindicate investor optimism in the ability of Trump to push through his pro-growth, pro-capital markets agenda. At worst, it is an indication that Trump really has only one management "skill", which is to be a bully and that, while that trait served him well on the campaign trail, it is just not going to work with Congress, and not even within his own party.

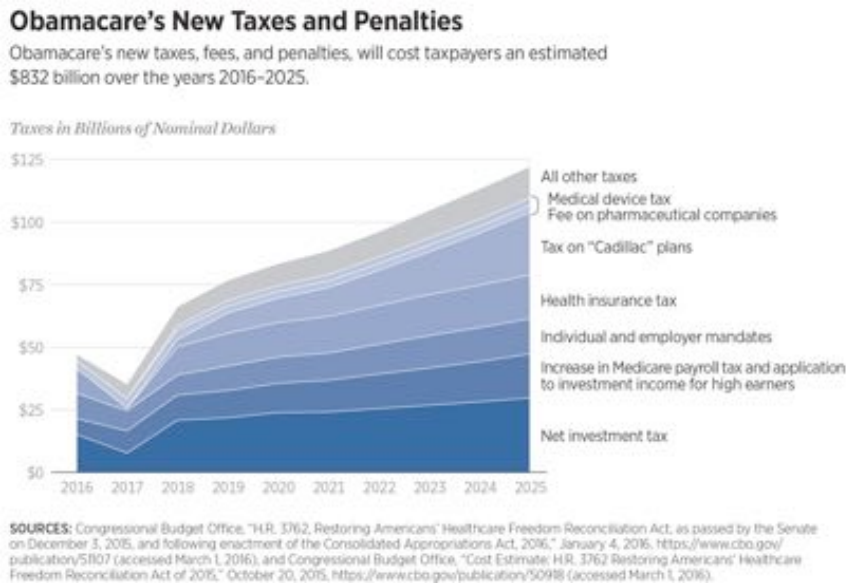
For example, Trump reportedly had Steve Bannon present the leaders of the Republican "Freedom Caucus" with the following ultimatum: "Guys, look. This is not a discussion. This is not a debate. You have no choice but to vote for this bill." By doing so, Trump nullified almost any chance of this caucus voting for repeal, due to the risk of relegating themselves to political irrelevance. Moreover, rather than learn from his mistake, Trump has instead threatened to campaign against members of the "Freedom Caucus" prior to the mid-term elections. The irony is that the Republican-controlled House already voted for repeal and replace several times over recent years, when they knew that Obama would veto the bill.

This lack of political awareness on Trump's part calls into question his ability to successfully navigate his political agenda through a disjointed Republican majority and a Democratic contingent that is solidly unified against it.

Moreover, the aborted American Health Care Act was the "gateway" legislation that opened the door to the remainder of the Trump agenda. To explain, Obamacare is not only a healthcare bill. It is also a tax bill that created 21 different taxes on everything from insurance companies and employers to insurance consumers and more-affluent tax payers.

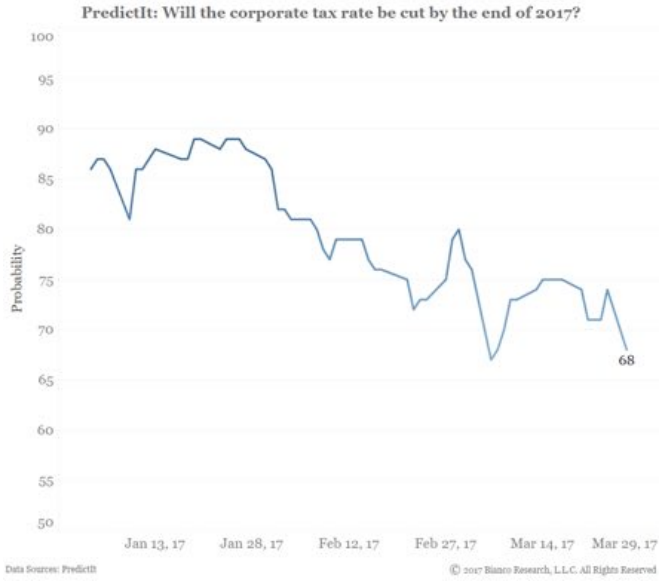
Unfortunately, it is inextricably interwoven with the overall tax system like a "Gordian knot", and many political talking heads are increasingly speculating that it will be very challenging to pursue significant tax reform (the foundation of the Trump platform) without first "cutting the knot" that ties these pieces of legislation together.

The Obamacare-related taxes that most directly affect our readership are the 3.8% additional tax on investment income and capital gains, and the additional 0.9% Medicare hospital tax on income and self-employment profits. These apply if one makes more than $200,000 a year ($250,000 for married couples filing jointly, and $125,000 for married couples filing separately).



As Speaker of the House Paul Ryan noted just after cancelling the vote on H.R. 1628 (the repeal and replace bill), "This does make tax reform more difficult, but it does not in any way make it impossible…the Obamacare taxes stay with Obamacare…We're going to fix the rest of the tax code." However, the survival of Obamacare, in addition to greatly complicating tax reform, removes one of the major sources of revenue that was going to be used to pay for tax cuts.

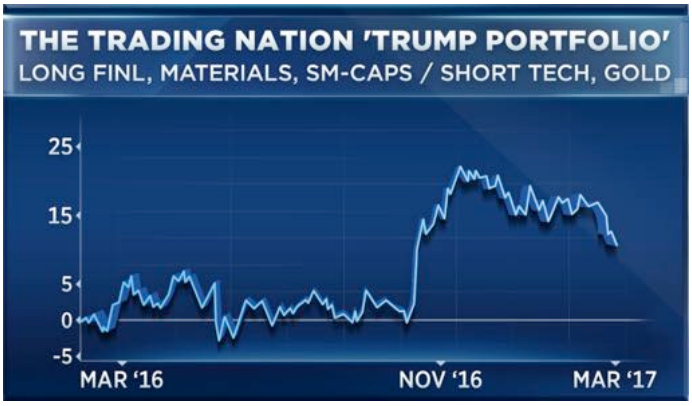
That loss of an estimated $1 trillion of revenue, when combined with an increasing likelihood that Republicans in the Senate will not agree to a border-adjustment tax (BAT) has the potential to significantly limit the size of any tax cuts. Further, any tax reform that is not deficit-neutral will require Democratic votes to pass which, as things currently stand, is improbable at best.



It is also increasingly likely that it may be at least 2018 before we see any substantive tax reform, which would likely be a disappointment for equity investors who seem to have already priced in both tax reform and broad deregulation as 2017 outcomes.

You can see changes in the perceived likelihood of corporate tax reform in 2017 by looking at the PredictIt markets, where people wager money on political and other outcomes. Of important note, this source increasingly needs to be taken with a "grain of salt", as speculators used this same service to wager both that Britain would vote to remain in the European Union and that Hillary Clinton would win the U.S. presidency.

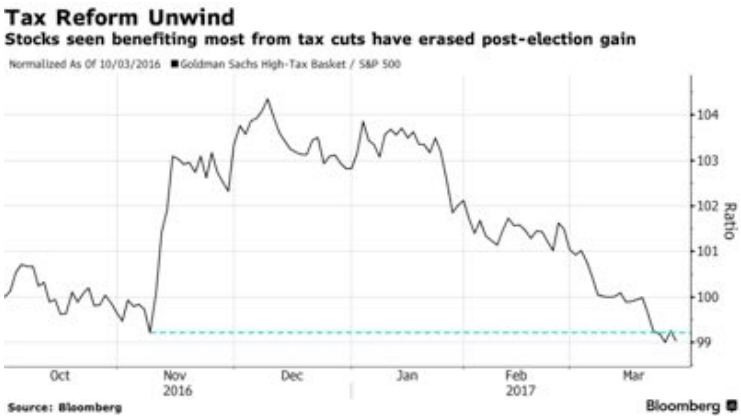
Given the recent unreliability of these prediction markets, we will turn to a much more broad-based and better established sentiment poll. We are speaking specifically of the domestic equity markets, which seem to reflect a similar concern about Trump's potential inability to pass through his agenda, which has recently been manifested by significant declines in the sectors that should benefit most from an economic acceleration (small capitalization stocks), from deregulation (bank stocks), and from a large infrastructure-building program (basic materials stocks).



The analysts on CNBC's *Trading Nation* show put together a hypothetical "Trump Portfolio" that is "long" the aforementioned types of companies that should do well if the Trump platform is adopted in its entirety and "short" (making bets against) sectors that should do poorly if the Trump agenda is adopted. This includes gold stocks, which should be hurt by Trump's strong dollar policies and technology stocks, which should be negatively affected by any trade wars or anti-trade policies.

You can see that the "Trump Portfolio" performed spectacularly well immediately after the election, but has been losing ground with each and every one of Trump's political missteps. Indeed, while the recent decline in the broad domestic equity market has been only modest, energy stocks fell by 11%, bank stocks by 7%, and small capitalization stocks fell by 3%.

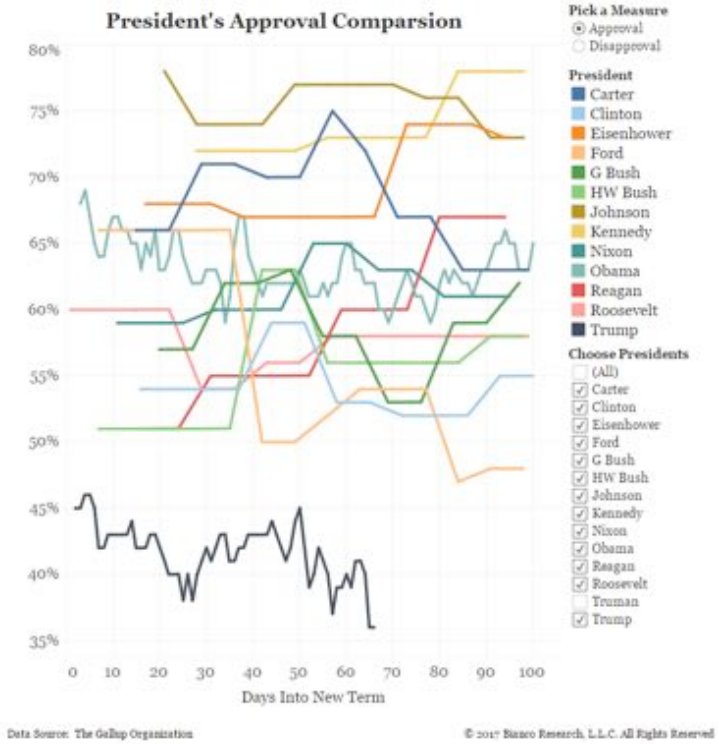
A very similar analysis can be done to illustrate the lessening confidence that significant, and much-needed, tax reform can be achieved over the near term. Included below is the Goldman Sachs High-Tax Basket, which includes stocks from many of the most highly-taxed companies in America (i.e. those companies that would benefit most from the passage of Trump's major corporate tax overhaul).



Just as was the case regarding the above-noted "Trump Portfolio", this basket of stocks roared higher immediately after the election, only to give back all of their post-election gains, as investors increasingly question President Trump's ability to ultimately push through comprehensive tax reform, which is the cornerstone of his agenda.

Indeed, according to a just-concluded Bank of America/Merrill Lynch survey of fund managers, only 10% of them believe that a tax reform bill will be passed by Trump's target date, which is the start of the August congressional recess. This growing pessimism is probably a good thing for equity investors, as it suggests that the prospects for ongoing gridlock are already increasingly being discounted into equity prices.

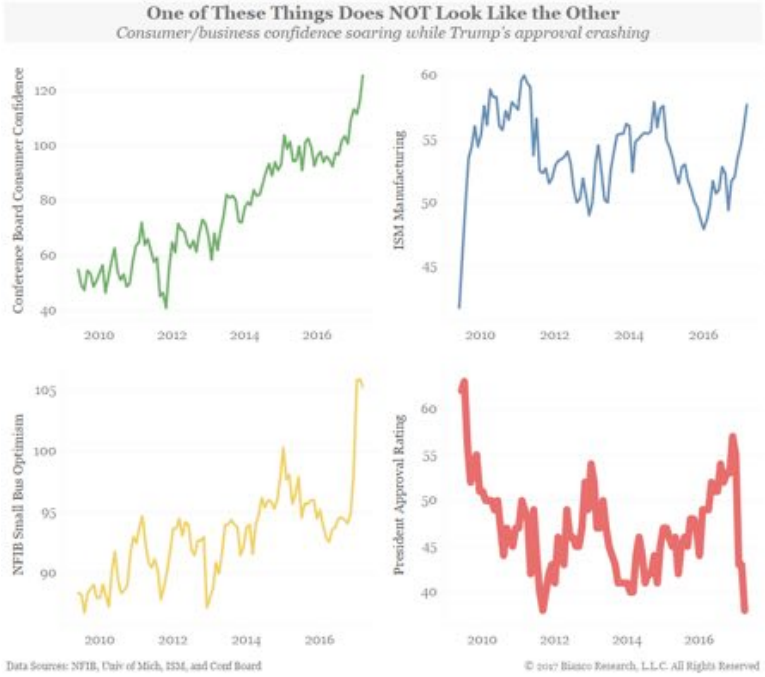
This increasing caution has recently been catalyzing a change in investor preferences from smaller, more highly-valued, Trump-related stocks to stocks of larger companies with high-quality balance sheets. As evidence, during the month of March, the largest fifty domestic stocks outperformed the smallest fifty domestic stocks by a whopping 3.6%!



However, despite a growing litany of concerns about Trump's ability to push his agenda through Congress, there is no doubt that both investors and business owners generally view President Trump as a massive improvement to the decidedly anti-business/anti-investor class administration of former President Obama.

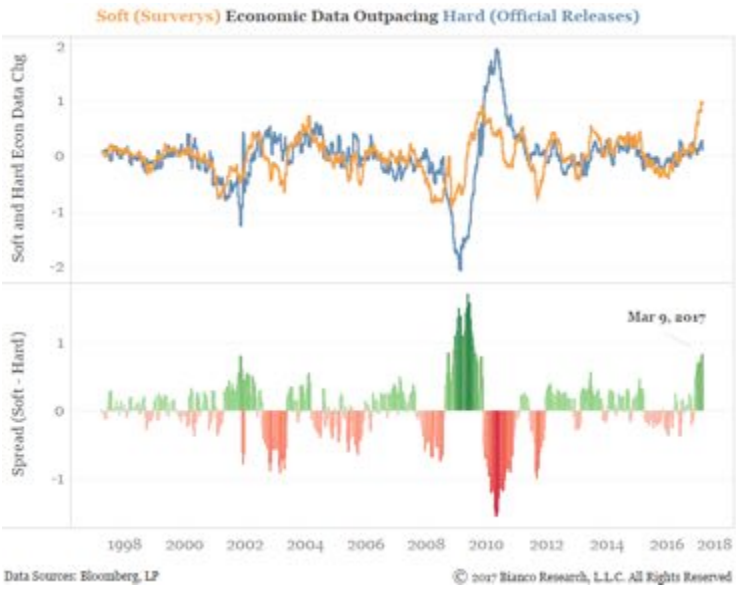
As such, it is likely to drag on the equity markets whenever Trump looks un-presidential, or when anything happens that might jeopardize either his presidency or his agenda.

Interestingly, while Trump's popularity ratings have steadily declined from a historically low starting point (black line above), the impact that Trump has had on consumer confidence (green line right), small business owners (yellow line right), and manufacturing sector executives (blue line right) has been simply spectacular to the upside.



This is just more evidence of the "animal spirits" that we have been writing about over recent months. Confidence is soaring across major components of the U.S. economy, and this can be a "good" thing, as increased confidence can often be a precursor to increased consumer spending, increased business hiring, increased investment into capital equipment, etc., each of which would add fuel to the current economic recovery.

However, it can also be a "bad" thing, if these improvements in sentiment do not lead to improvements in actual "hard" economic data, and this is a real risk if the Trump agenda generally, and tax-reform, deregulation, and repatriation of foreign profits specifically, stall in Congress.



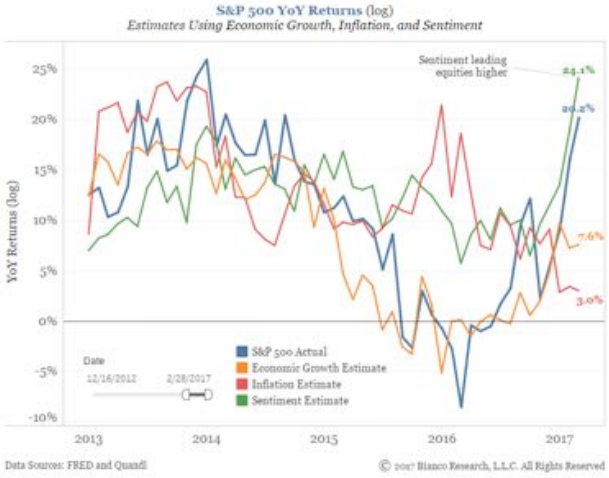
In the meantime, you can see the divergence between confidence/expectations and actual hard economic data by comparing confidence surveys (in gold) with actual economic data (in blue).

History teaches us that these two lines will converge, which means that the economic data either needs to improve or sentiment will worsen, and that change in sentiment would be reflected in the prices of securities.

Another way of looking at this divergence between current fact and future expectations is by comparing two of the most basic elements of the actual economy: inflation (in red) and economic growth rates (in orange) to two of the most basic anticipatory indicators, consumer and business confidence in green and the S&P stock index in blue (see below).

The result of this divergence is that both confidence, which is at a sixteen-year high, and stock prices, which are selling at historically high multiples relative to earnings, are very expensive when compared to the underlying economic fundamentals.

Importantly, as we have noted in the past, valuation has historically proven to be a terrible timing tool. However, it has historically been a great indicator of probable future returns. For example, when U.S. equities have historically traded at current levels (a forward-looking price-to-earnings multiple of between 18X and 20X), returns for the following year have averaged 1.1% and average returns over the following five years have averaged 4.5%.

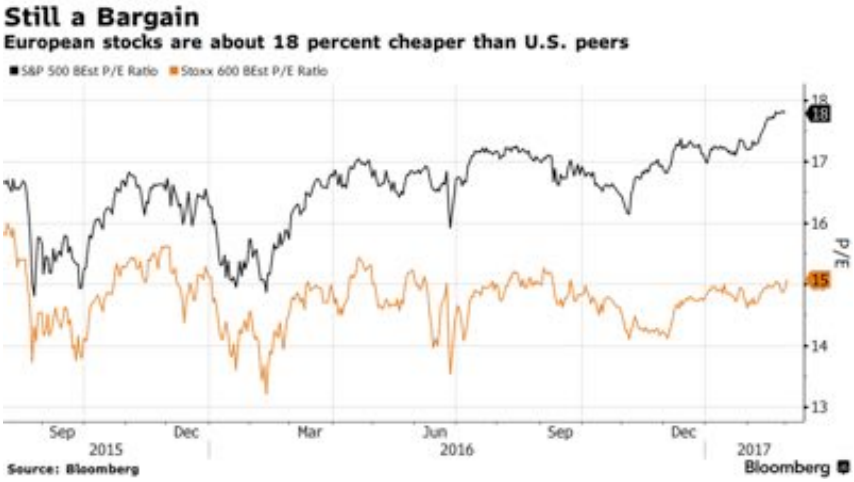


In contrast, when the market is selling at a forward-looking price-to earnings multiple of between 10X and 12X, the average return for the following year has been 17.0% and the five-year average return has been 10.8%. In short, U.S. equities are selling at multiples that are hard to justify unless we see a major paradigm shift in the economy and markets. <u>We believe that the passage of the Trump agenda would likely represent such a paradigm shift, but obviously only if it passes.</u>

There is no doubt that domestic equities are quite expensive on a historical basis, and that they are likely to disappoint many investors if much of the Trump agenda fails to become law. However, this is not a call to avoid equities. To the contrary, we suspect that equities will prove to be the best performing of the major asset classes over the intermediate term.

Despite concerns over U.S. equity valuations, and all of the uncertainty coming out of Washington D.C., we believe that equities will nonetheless benefit from one massive, macro-economic and redeeming factor, which is that the rest of the world is finally emerging from the global financial crisis, and that foreign markets are likely to play "catch-up" with the domestic economy and markets, which already reflect so much of the economic recovery.

Indeed, it makes sense to us to 1) maintain a healthy exposure to domestic equities, while being careful not to over-emphasize trades that rely too much on the passage of the Trump agenda, and 2) add to your foreign equity allocations. You will see much of the justification for this comment in the above chart that shows which global markets professional money managers consider to be over and undervalued. While there is a consensus opinion that the U.S. markets are egregiously overvalued, there is a similarly strong consensus that Britain, continental Europe, Japan, and the world's emerging markets are compellingly undervalued.



Europe is probably the most compelling market of all, as attractive valuations are being paired with decreased political uncertainty, with recent elections in Austria, Spain, Bulgaria, and The Netherlands producing very pro-European Union results, the polls in Germany showing a resurgence in the popularity of Angela Merkel, and a decreasing potential for a Le Pen victory in France. On top of everything else, the European economy is really starting to surprise on the upside. We think that it is time to update your passport.