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THE PER STIRLING CAPITAL OUTLOOK

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The most insightful comment from this year's presidential election campaign may have come from the September 23rd edition of *The Atlantic* magazine, which said of President-Elect Trump, "The press takes him literally, but not seriously; his supporters take him seriously, but not literally."

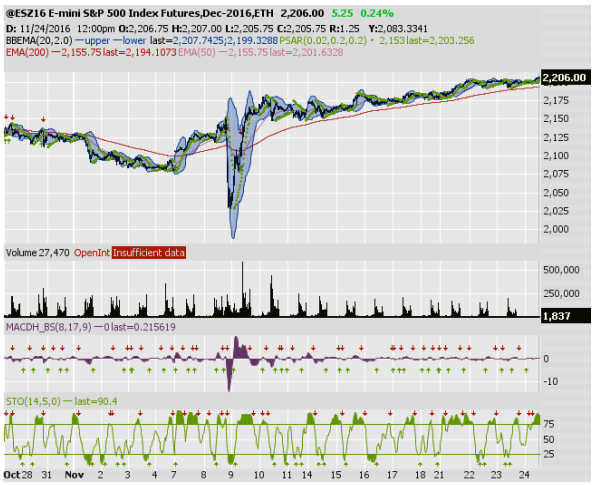
Throughout the campaign, Trump was the ultimate enigma. From an investor's perspective, some of his proposals would be extraordinarily bullish for risk assets. Others would be exceptionally bearish. Some make perfect sense, while others suggest an absolute ignorance of the interworking of the global economy and global financial system.

Until the evening of the election, investors seemed entirely indifferent to the enigmatic Trump, as virtually no one, particularly the pollsters and the odds-makers, gave him any possibility of winning. The complete and utter surprise of his victory caused an immediate "black swan" reaction in the markets (see last month's report), which ultimately only lasted a few hours.

It was an amazing thing to watch unfold on election night, as it became apparent that a Trump presidency was a growing possibility, and the selling in both the global equity markets and the U.S. equity futures markets became so severe (down 5% to 7% in many global equity markets) that the U.S. futures contracts hit "lock-limit-down" levels of minus 5%, which caused trading to be halted.

However, with the benefit of hindsight, it seems that the only thing more surprising than Trump becoming President was his ability to act "presidential", which manifested itself in his victory speech.

It was as if someone had flipped a switch. The brash and bullying Trump was replaced by someone who seemed more rational and reasonable and, perhaps most importantly, someone who would not actually follow through on some of his most extreme and controversial campaign promises.



Suddenly, the selling turned into buying and a dramatic reversal ensued. It was the first time in history that the futures markets were "lock-limit-down" at night, only to have the cash equity markets close higher the following day. Over that 24-hour period, the Dow Jones Industrial Average traded in a range of over 1,000 points.

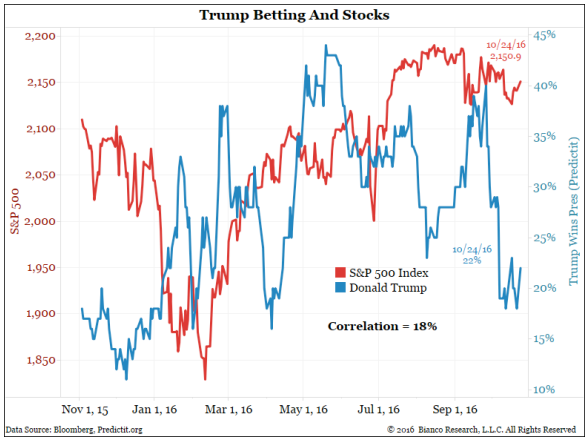
The inflection point appeared to take place when, as opposed to continuing with his threats to appoint a special prosecutor to put Secretary Clinton in jail, he congratulated her on a hard-fought campaign and then went on to say, "Hillary has worked very long and very hard over a long period of time, and we owe her a major debt of gratitude for her service to our country. I mean that very sincerely."

If that were not enough, Trump the divider became Trump the unifier when he said, "Now it is time for America to bind the wounds of division... To all Republicans and Democrats and independents across this nation, I say it is time for us to come together as one united people."

The prospect of having a full Republican sweep, with a President and Congress that both favor very pro-business, pro-investor policies proved to be incredibly bullish for the equity markets (and extraordinarily bearish for the bond markets). That initial reaction is seemingly justified, but only if one assumes that Trump was only kidding when he proposed a variety of potentially very dangerous ideas during the heat of the campaign.

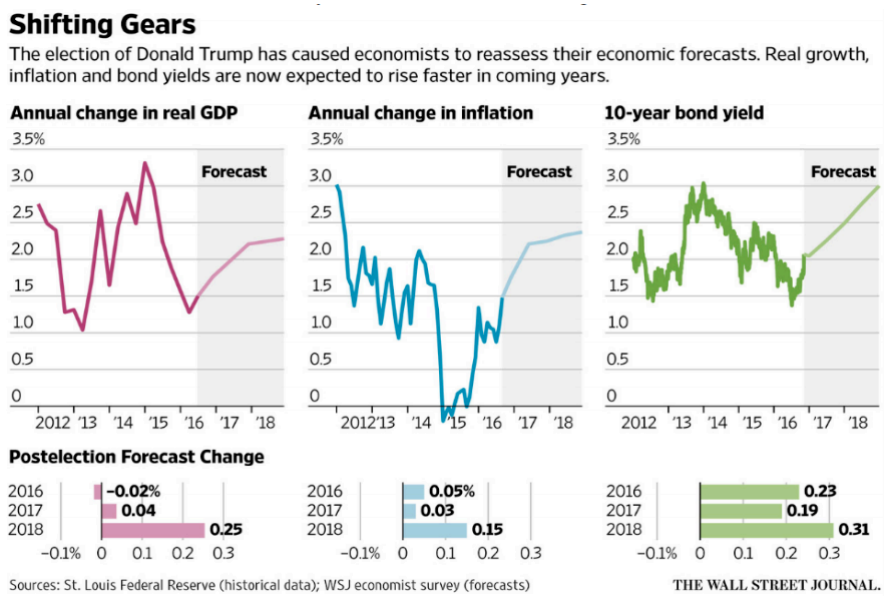
These would include engaging in a globally disruptive trade war with China, deporting 11 million illegal immigrants (which would cause shockwaves across the U.S. economy), revoking NAFTA, and "renegotiating" (i.e. technically defaulting on) America's sovereign debt, which would likely cause another global financial crisis. He has even proposed forcing the Fed to set future monetary policy based on a rules-based formula and even raised the idea of returning to the gold standard, which was one of the elements that caused the Great Depression to be so deep and so long-lasting. What of the above is actually part of his platform versus what are simply trial balloons or election rhetoric remains to be seen.

We are of the opinion that this process of investors differentiating between when Trump should be taken "seriously" versus when he should be taken "literally" will be a primary driver of the domestic capital markets for the foreseeable future. To illustrate just how little investors know about Trump's future agenda, we will turn to a chart that we actually used in last month's report. It shows that there was only an 18% correlation between the value of stocks and Trump's political prospects. In contrast, the correlation between Clinton and the equity markets was 86%.



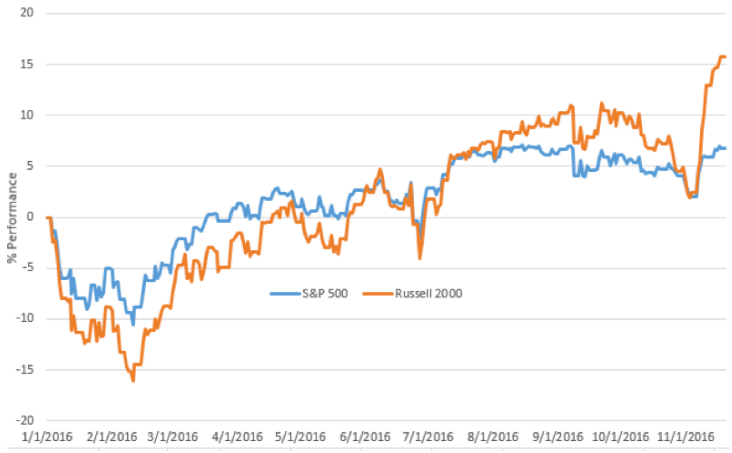
While there is no doubt that Wall Street marginalized Trump's chance of winning, that fact alone cannot explain the virtual lack of correlation between the markets and Trump. We believe that it is instead indicative of the fact that Trump had provided so little substantive detail about his platform during the campaign that investors had no way of anticipating what kind of impact a Trump presidency would have on the capital markets.

Such a lack of insight is hardly surprising as, over the 511 days of his campaign, Trump took 141 distinct policy positions on only 23 issues. Trump has since justified this as simply being "flexible." Nonetheless, it is not surprising that, prior to Election Day, investors had expressed a strong preference for Clinton whose policies, while undesirable, where at least knowable. One thing that you can always count on is that investors hate uncertainty above almost everything else.

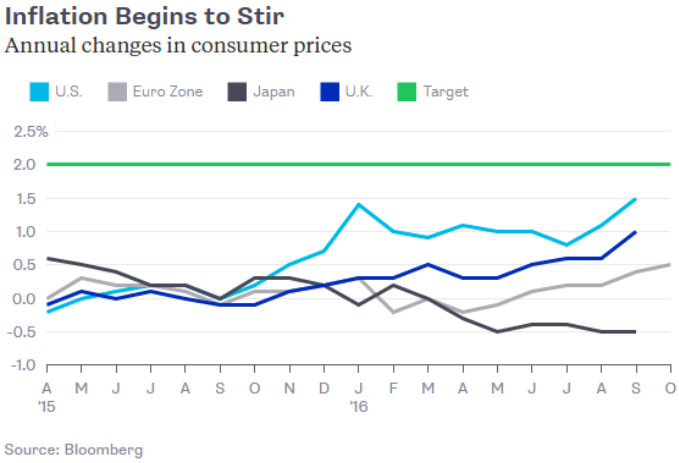


As investors learn more about Trump's platform, uncertainty is slowly being replaced with relative certainty and, in general, the equity markets increasingly like what they hear, which is a very pro-business and very stimulative economic platform. For the time being, this is the only thing that investors, analysts and economists seem to be concerned about, while they ignore in their entirety both the disastrous long-rang implications of Trump's economic platform (if it were to be passed as proposed) and the risk that Trump will actually follow through on one of his more extremist campaign promises.

In the meantime, analysts and economists are taking Trump's more reasonable proposals at face value, and are significantly increasing their forecasts for economic growth, inflation and interest rates. The very same phenomenon is going on in the capital markets, where there is a massive reallocation underway away from bonds, commercial real estate, gold, and defensive equity sectors like utilities, consumer staples companies, and stodgy old blue-chip exporting companies, to economically sensitive and domestically oriented companies. Stocks of small and mid-capitalization U.S. companies have seen the greatest gains via this global portfolio reallocation, as they should benefit the most from the anticipated unwinding of the massive and burdensome regulatory structure that has been put in place over the past decade or so. Smaller, U.S.-centric companies are also less susceptible to the impact of trade wars and a soaring dollar. You can see this post-election relative outperformance reflected in the chart with smaller company stocks represented by the Russell 200 Index and large-capitalization stocks represented by the S&P 500 Index.



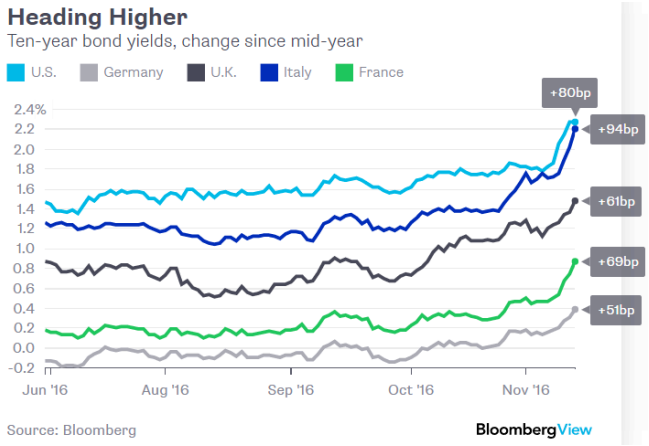
A large part of what is going on is that economic stimulus is moving from quantitative easing (monetary stimulus) to fiscal stimulus. To explain, quantitative easing is the practice of the Federal Reserve creating trillions of dollars of money out of thin air (via an accounting measure) and using that newly created money to buy bonds in the open market, which pushes debt prices higher and interest rates in the economy lower. Since America's elected officials were unable to work together to pass any reasonable post-crisis fiscal stimulus, it left the Federal Reserve (and other central banks around the world) as the only game in town, and they were both very aggressive and very creative in their efforts to facilitate a recovery from the financial crisis.



While these strategies helped to avert the next Great Depression and created an investment nirvana for bond investors, monetary policy has reached its limits (at least in the U.S.) and it is time to pass the baton on to fiscal stimulus (government spending and tax policies). We have been writing about this inevitability for months, and we believe that the transition would have happened regardless of who won the White House. The fact that Trump was the victor is not insignificant though as, with Republican control of both the House and the Senate; the fiscal stimulus should be both larger and more immediate than would have been the case under Clinton.

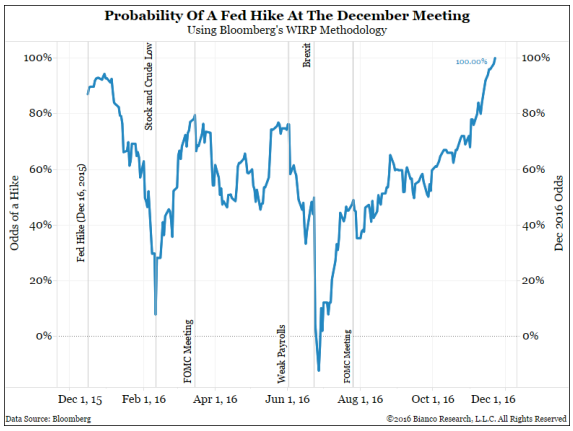
Unlike monetary stimulus, which has been very bullish for bond prices as it reduced the supply of bonds in the markets by trillions of dollars, fiscal stimulus should have the exact opposite effect on the debt markets, as it will dramatically increase the supply of new federal debt by trillions of dollars and thus push rates higher and bond prices lower.

Such stimulus is normally utilized very early in economic cycles when the economy is just starting to emerge from recession, when there is plenty of excess industrial capacity in the economy, and when there is great slack in the labor market.



This time, it is going to be introduced eight years into an economic expansion, when there is little industrial capacity remaining and the nation is approaching full employment. This is like pouring gasoline onto a fire, and should catalyze both wage push and demand pull inflation. This combination of stronger growth, increasing inflation, an increased supply of debt and a tightening Federal Reserve creates a terrible environment for bond prices, which will likely need to come down over time to accommodate the prospects for higher inflation. Of note, in the very near term, bonds are technically over-sold and could be due for a temporary bounce. The opposite can be said of the equity markets.

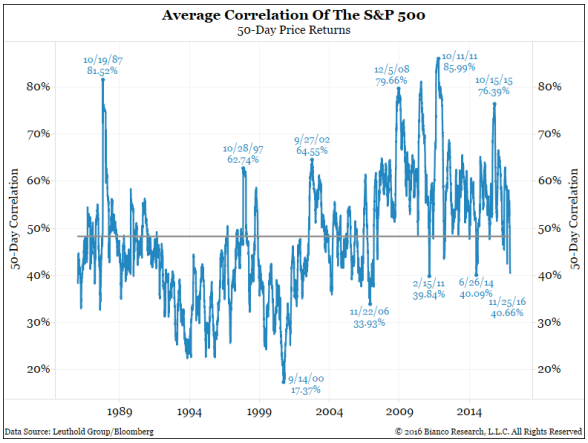
The Federal Reserve is well aware of these inflationary risks, and will almost certainly raise rates in December. Further, if fiscal stimulus comes through in anywhere near the size that President-Elect Trump has proposed, we would actually expect to see at least two or three rate hikes next year. Importantly, while higher rates should be quite a headwind for the bond markets, there are two reasons why we believe that the equity markets may remain relatively indifferent over the near term. First of all, the Fed Funds Futures Market is already pricing in a 100% chance of a December rate increase, and markets rarely sell off on the same news twice. Indeed, we suspect that the equity markets might actually fall if the Fed does not increase rates in December, as it will raise concerns that the Fed thinks that the economy is worse off than investors believe.



In addition, we actually think that equities may celebrate an increasingly normal interest rate structure as a sign that the economy and markets no longer need the Fed's emergency measures. Moreover, recent experiences with ultra-low and negative interest rates have taught the markets that interest rates being below certain levels are actually deflationary rather than stimulative.

It is really quite ironic that it appears that, after bashing the Fed and Chairwoman Yellen throughout the campaign for keeping interest rates so low, it is actually Trump that is coming to their rescue by doing in two weeks what the Fed has been unable to do in two years. He pushed the markets' inflationary expectations right up to the Fed's 2% target rate and made the risk markets comfortable with the prospect of higher short-term interest rates. In essence, Trump managed to get the markets to give the Fed permission to raise rates, which the Fed itself has been trying to accomplish via jawboning for the past two years.

These factors are coming together to generate a reallocation of assets of historic proportions. Since the election, the global bond market has suffered its biggest two-week (4%) loss in at least 26 years. In the first week after the election, equity ETFs and mutual funds saw net inflows of $25.4 billion, while bond ETFs and mutual funds saw outflows of $9.1 billion. Last week was even more dramatic. Equity funds had inflows of $28 billion and bond fund outflows were $18 billion. That was the biggest weekly disparity between inflows and outflows in history.

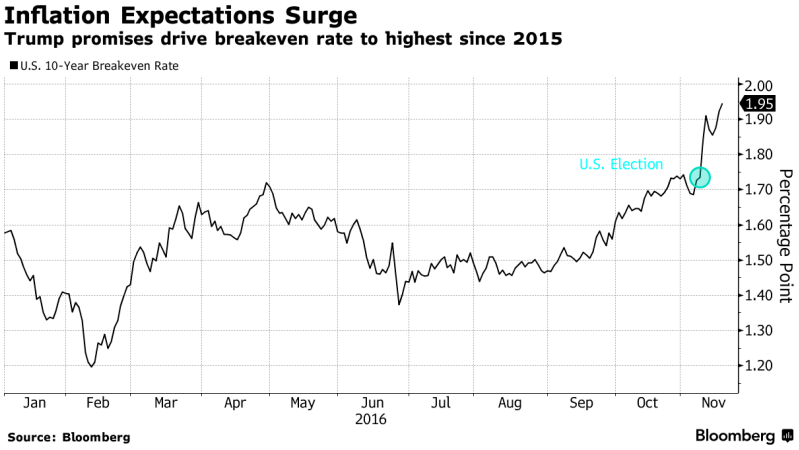


It is noteworthy that the VIX equity market "fear index" has collapsed by 30% since the election, while the MOVE bond market "fear index" has soared by 19%. These two volatility indexes measure fear based upon the prices that investors are willing to pay for protective options. It is also important to note that this move from monetary stimulus to fiscal stimulus is significantly lowering the correlation between equities, which is great news for equity managers who employ tactical strategies and stock-picking.

Importantly, the sell-off in the bond markets started even before the election. From their recent highs, long-term government bond prices have declined by 14% and long-term domestic debt in general has declined in price by over 8%. The global bond market has already lost $2 trillion of value in November alone, and we expect for this to get worse over time as the economy, inflation and the size of the national debt all grow. This is despite the fact that Trump is not going to get approval for his full economic platform.

If Trump were to get his entire fiscal plan approved, the debt would jump from 77% of the size of the economy (GDP) today to 100% of GDP within a decade. Further, by the year 2020, the cost of servicing the national debt would grow from 7% of federal revenues to 25% of all federal revenues. As interest rates move higher, the debt burden will increase exponentially. That would put the U.S. on par with several peripheral European countries, which we do not believe that the House Republicans, in particular, will tolerate.

Paul Ryan stated that the Republicans have a mandate to reshape healthcare, taxes, regulation and border security. In an 11/22/16 YouTube video, Trump laid out an agenda including trade, immigration, energy, regulation, national security and ethics reform (i.e. "draining the swamp"). We expect for the two sides to meet somewhere in the middle.



In any event, we do expect that the new political regime will pursue inward-looking, nationalistic, and relatively isolationist policies (i.e. anti-free-trade and anti-immigration). We expect for the new political agenda to also include a fairly massive fiscal stimulus program to help fill the void being left by the inevitable, albeit prolonged, unwinding of the Federal Reserve's historic monetary stimulus programs.

In our opinion, these policies are likely to lead to increasing inflation, higher interest rates, a stronger dollar and the potential for tariffs and other trade restrictions. Each of these influences would introduce a potentially significant headwind in the face of America's major multi-national companies that rely on exports and foreign operations for approximately 50% of their annual profits. At the same time, these policies should help to jumpstart the domestic economy which, along with a greatly reduced regulatory burden and lower taxes, should be highly beneficial to stocks in general and small and mid-capitalization U.S. companies in particular, as they cater primarily to domestic consumers and are less dollar-sensitive. In addition, this new "America first" philosophy has the potential to be particularly challenging for many foreign stock and bond markets.

According to a recent Bank of America/Merrill Lynch report, 2016 saw "peak liquidity, peak inequality, peak globalization, peak deflation, and the end of the biggest bull market ever in bonds. That all starts to reverse next year." From our perspective, that is not a bad macro thesis. However, over the near term, it remains all about differentiating between what should be taken "literally" versus what should be taken "seriously."