CROSSBRIDGE CAPITAL

Market Viewpoints

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Too many of us are not living our dreams because we are living our fears.

- Les Brown

On Wednesday, the US Federal Reserve raised the Federal-Funds rate by +0.25%, yet didn't alter its growth and inflation projections much. Like everyone, the Fed is in wait-and-see mode as to the reflationary promises of the incoming Trump administration. If we look at the recent history of US recessions, on average, the US economy has experienced a recession every eight years. The current economic expansion, which started in June 2009, is now in its ominous eighth year. Almost everyone is of the view that Trump will have to deal with a recession or a financial crisis, at some stage during his term in office. The Fed knows that it needs to hike as much as it can in order to prepare for the next crisis. I would not be surprised if we saw another rate hike at the next meeting in January. As we look back at 2016, the big event was certainly Brexit. It signalled the rise of “populism,” which is now firmly entrenched in the UK, the US and across Europe. The post-Second World War principles of Social democracy (particularly in Europe) are having an existential moment and populist nationalism is in ascendance. President-elect Trump’s policies are largely a “basket of unknowables." However, on the issue of trade, Trump has held a consistent view for a long time. At the core, Trump is a mercantilist, who believes trade deficits are bad for workers and the economy and that trade tariffs are one way to overcome them. My biggest fear for 2017 is that protectionism gains ground, first in the US, and then everywhere else in response. Much like the 1930's, when the signing of the Smoot-Hawley Act by another Republican President, Herbert Hoover, unleashed protectionism and the collapse of global trade. The well-being of the American people, and indeed the world, are predicated on the smooth flow of global trade and capital.

The (dot) plot thickens

The Dow Jones Industrial Average (DJIA) is within touching distance of 20,000. While all major US equity indices, the S&P 500 (SPX), DJIA, and NASDAQ are at record highs, equities in the rest of the world: The Nikkei 225 (NKY), Shanghai Composite (SHCOMP), Eurostoxx 50 (SX5E), and MSCI Emerging Market (EEM) indices are -50%, -43%, -38% and -28% respectively below their record levels. President-elect Donald Trump only promised to "make America great again" and the performance of equity markets around the world seems to reflect that.

On Wednesday, the US Federal Reserve (Fed) raised the Federal-Funds rate by +0.25% taking it to +0.75%. This increase comes exactly a year after the last hike, which lifted interest rates above zero, where they had been since December 2008. Then, the Fed indicated it would raise rates four times in 2016. Regular readers of this newsletter will know my reaction to this was one of disbelief and in the December 2015 Market Viewpoints, I wrote - "The Fed may have raised rates and projected four additional +0.25% rate increases next year, but in my view, they will be lucky to pull off two increases."

This time around, the Fed has indicated that it envisages raising rates three times during 2017, which I entirely agree with. Perhaps it may even go one better, should it be lucky and a recession or crisis not strike sooner. Almost everyone is of the view that Trump will have to deal with a recession or a financial crisis, at some stage during his term in office.

If we look at the recent history of US recessions, there were recessions in 1960, 1969, 1973, 1981, 1990, 2001 and 2008. On average, the economy experienced a recession every eight years. If you think eight years is too soon, consider this. Between 1836 - 1928, the US economy averaged a recession every 2.1 years. This included seven depressions that led to an average GDP contraction of -29%. The US was on the gold standard at the time, and much like in Emerging Markets (EM) today, the full development of its financial system took many decades and the US didn’t establish a central bank until 1913.

The current economic expansion in the US, which started in June 2009, is in its ominous eighth year. The Fed certainly knows that it needs to hike as much as it can in order to prepare for the next crisis. I would not be surprised if we see another rate hike at the next meeting in January.

The key takeaways from this week's Fed meeting are as follows:

- The Fed, like everyone, is in a wait-and-see mode as to the reflationary promises of the incoming Trump administration. It does not seem ready to alter economic forecasts significantly yet, until it has a clearer idea what President Trump will do
- Fed Chair Janet Yellen refrained from taking the bait on offering any critique of Trump's economic proposals. She emphasised the importance of the Fed's independence several times, a possible signal that she would be happy to leave President Trump alone, so long as he returns the favour
- Yellen emphasised that she considers the move in the Fed's "dot plot" (part of the Fed's Summary of Economic Projections released along with its policy decision) statement, from two hikes to three hikes in 2017, a "very modest adjustment." This puts even more emphasis on the next economic projection the Fed will release in March. By then, the committee will have a much better idea how changes in the Trump economy are shaping up
- Yellen didn't mention any particular downside risks to the economy at this time. There was no repeat of the usual suspects that often creep into statements such as China's slowdown or Europe's debt crisis. It just goes to show how much the emphasis has shifted

Yellen made two interesting statements about the US economy

- Firstly, she highlighted that the US economy does not need a fiscal stimulus in order to hit full employment. Perhaps she meant that not all fiscal stimuli are created equal, and that there is little point in spending unwisely, if it only accelerates asset price inflation without the associated growth
- Secondly, Yellen seemed to back away from the idea that the Fed should let the economy “run hot” to let discouraged job hunters re-join the labour force, before getting concerned about inflation. After raising this point in October, on Wednesday, she was quick to highlight that she had never recommended running the economy “hot”, but rather had simply noted this was an interesting intellectual question worth exploring. Very nifty footwork there. A true master class in how to gracefully back away from something one had previously recommended!

Trumpeting in 2017: Lessons from the 1930's trade war

It’s been a year of confounding outcomes: A Trump victory, *Brexit,* unreliable polls, exploding Samsung Galaxy S7s, more Technology Unicorns (the number of private technology companies valued at over $1 billion now stands at 141 compared to 8 in 2010) and a US equity market that seems to take every negative in its stride and carry on higher.

As we look back at 2016, the big event was certainly *Brexit*. It signalled the rise of “populism” which is now firmly entrenched in the UK, the US and across Europe. The post-Second World War principles of Social democracy (particularly in Europe) are having an existential moment and populist nationalism is in ascendance.

My biggest fear for 2017 is that protectionism gains ground, first in the US, and then everywhere else in response. Much like the 1930's, when the signing of the Smoot-Hawley Act by another Republican President, Herbert Hoover, unleashed protectionism and the collapse of global trade. Popular legend has it that the Great Depression was caused by the 1929 stock market crash. In fact, the stock market was recovering well in 1930. It was the global trade war that put the “Great” in the Great Depression.

As I noted in last month’s newsletter, President-elect Trump’s policies are largely a “basket of unknowables." However, on the issue of trade, Trump has held a consistent view for a long time. As far back as 1988, Trump, in an interview with Oprah Winfrey had this to say about trade with Japan: "They come over here, they sell their cars, their VCRs. They knock the hell out of our companies." At the core, Trump is a mercantilist, who believes trade deficits are bad for workers and the economy and that trade tariffs are one way to overcome them.

Much like Trump’s promise to manufacturing workers during the recent campaign, when campaigning for President in 1928, one of Hoover's promises to help beleaguered farmers, had been to increase tariffs on agricultural imports. Hoover won, and Republicans maintained comfortable majorities in both the House and the Senate. The Tariff Act they wrote was initially meant to benefit farmers. But after the shock of 1929, industry and labour demanded protection as well. Both Hoover and the Republican Congress complied. In its final form, the Smoot-Hawley Act covered some 20,000 items. The average tariff on dutiable goods jumped to 50% from an already high 25%. The trading partners of the US responded in kind and world trade began to shut down. Between 1929 - 1933 world trade collapsed by -66%. US GDP collapsed by more than -50% during that period.

Trump has been called the most protectionist President since Hoover, and there are certain resemblances. Hoover, like Trump, came late to politics. He had never held elected office before winning the Presidency. Hoover scouted the world for promising mineral deposits and opened mines to exploit them; much like Trump has done with real estate projects.

In purely economic terms, the US wouldn’t hurt (at least initially) if Trump adopted protectionist policies. The US is a relatively closed economy, with exports totalling approximately 10% of its GDP. Exports to China and Mexico amount to approximately 1% and 1.8% of GDP, respectively. Yet, as the world learnt in the 1930's, politics is just as important as economics. The well-being of the American people, and indeed the world, are predicated on the smooth flow of global trade and capital. Trump can likely make America "good" but not necessarily "great" again, as the gap between the US and other nations continues to shrink. Yet, the US is and will remain the dominant super power for many years to come. There are three key metrics to attaining superpower status: High population, high GDP, and high per capita GDP. Low per capita GDP means that China (and to a lesser extent India) is still a long way from having that extra capital a superpower needs to spend on defence, diplomacy, infrastructure, investments, foreign aid and the cultivation of soft power (the ability to attract and co-opt without coercion).

Where to invest?

A strong USD, US inflation and a steeper yield curve will all help US equities at first before they begin to hurt. Therefore, I recommend staying long US equities for now. My sector preferences are Financials (XLF) and Industrials (XLI).

My views on EM equities haven't changed. A strong USD and steeper yield curve are a risk for EM bonds and equities alike. However, the medium-term fundamentals of an equity bull remain intact and any market declines due to the “Trump factor” will present good buying opportunities, if you can remain patient.

Turning to Europe, in one swoop, the European Central Bank (ECB) both increased (extending the end date to December 2017) and decreased (reducing the size from €90bn to €60bn per month) it's Quantitative easing (QE) program. The key point is that the ECB wants to keep flexibility in its bond buying programme, in what will be a crucial period in Europe with Dutch, French and German elections during the first half of 2017. European financials are still a good buy and so are industrial stocks. Eurozone valuations look attractive and sentiment is already negative, owing to stresses in Italy and Greece. With the Italian referendum behind us and no likelihood of new elections in Italy in the short term, the risk has receded for now. If the Dutch election results prove that political risk has been overplayed, I would expect a sustained rally in European equities in Q2 2017. Japanese equities should continue to rally in the wake of a weak Yen vis-à-vis the USD.

Stocks I hold/recommend holding: JP Morgan (JPM US), Bank of America (BAC US), Allergen (AGN UN), Celgene (CELG UW), General Electric (GE), General Dynamics (GD US), United Rentals (URI), Raytheon (RTN US), Northrop (NOC US), BAE Systems (BA/ LN), Boeing (BA UN), Google (GOOG US), Microsoft (MSFT US), Amazon(AMZN UW), Daimler (DAI GY), AECOM (ACM US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Gilead Sciences (GILD US), Societe Generale (GLE US), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRM US), Estee Lauder (EL US), Johnson & Johnson (JNJ), Freeport McMoran (FCX US), Glencore (GLEN UN), Rio Tinto (RIO LN).

As for bonds, we have seen the yield on 10Y US Treasury vault to over 2.5% and it may go higher still. However, my view is that the US economy cannot take higher yields and that something will happen which will see yields drop again back to the 2% level. The increase in yields is driven not by higher real yields, but by inflation expectations in anticipation of new inflationary policies.The Fed predicts that the US economy will expand at an annual pace of +1.9% this year and +2.1% in 2017. Both lacklustre numbers. Therefore, bonds are a buy to lock, despite the recent increase in yields.

Turning to currencies, the theme of a strong USD, weaker Euro and weaker EM currencies, will continue into 2017 as the yield differential in favour of the USD keeps getting better. Of course, the USD rally will have its consequences, creating a further headwind for the US economy, as the Fed tightens further. Going into Q1 2017, I would expect EUR/USD to trade close to parity, but it will recover and stay at the 1.05 level by the end of the quarter.

The USD/JPY rally is likely to hit a wall if it gets to 120. At 120, USD/JPY is a sell with a target of 110 by end of Q1. USD/CAD should continue to rally taking it as high as the 1.40 level by the end of Q1. It’s very likely we see a peak in USD before the end of Q2, but much depends on how fiscal and monetary policies interact under a Trump administration.

Best wishes,

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