A New Paradigm

Since 2009, we have seen little fiscal policy change and extremely low interest rates. As a result, the optimal investment has been to passively and indiscriminately buy the stock market. With the election of Donald Trump, we see a new paradigm. We have spent the last few months analyzing the various "Trump Trades" prevalent since November 8th, and believe the dots are increasingly converging around an environment of higher interest rates, rising inflation, and increased volatility. As a result, the new path of safety lies in active versus passive management. While we don't know the specifics of the Trump policies, we do know that things will not remain the same. Despite the recent failure of healthcare reform, change is inevitable. And that change will not reward all equally.

President Trump will attempt to deliver on his campaign promises. What does this mean for our investments? Below is a chart that breaks down his major policy proposals and how they would likely effect the economy:

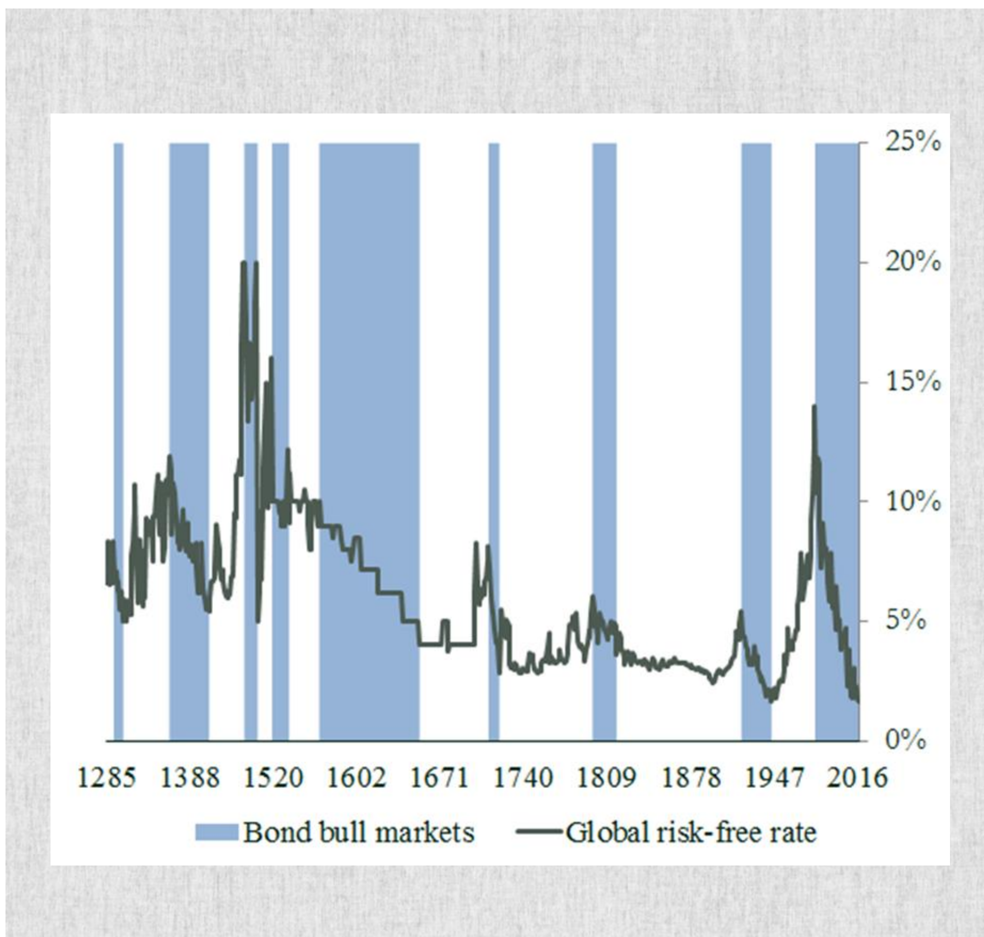
Policy Proposal	Inflation/Deflation	Economic Growth/Drag
Immigration Reform	Labor supply will tighten: Inflation	A shrinking population: Drag
Comprehensive Tax Reform	Simpler, lower rates: Inflation	Incentive for reinvestment: Growth
Corporate Deregulation	Freeing of capital: Inflation	Profit incentive: Growth
New Trade Policy	Higher cost of goods: Inflation	Less consumption: Drag
Infrastructure Spending	Multiplier effect: Inflation	Capital spending: Growth
Repatriation of Capital	Increased hiring: Inflation	Domestic capital spending: Growth

All of what President Trump proposes is potentially inflationary. Everything. Even if he only accomplishes a small part of his agenda, the results of those accomplishments will be inflationary. While we are not predicting rapid inflation will occur, we do see a systematic shift of risk from deflation to inflation.

The last time the United States experienced inflation over 3% was 1993[1]. Interest rates have been in a state of secular decline for over 35 years[2]. This has resulted in the largest bull market in bonds in 500 years and the third largest bull market in 800 years[3].

Source: 1, 2: Bloomberg; 3:"Venetians, Volcker and Value-at Risk: 8 centuries of bond market reversals," Paul Schmelzing, Harvard University, 1/4/2017

While the Trump-policy fueled growth spurt in the US economy would be welcome to many Americans, the resulting increase in interest rates could be disruptive. Very few of today's market participants have any experience in dealing with a rising rate environment. Retail consumers have little or no memory of inflation. Few capital market participants have any real experience trading or analyzing securities while interest rates systematically increase.



Americans have grown complacent. Complicating matters, the last five years have been the most tranquil equity markets since the 1950's. The size of modern debt markets doesn't resemble anything in history. In the past 35 years, debt markets have grown by nearly 12 times[4]. With the Trump policy changes, there will be winners and losers. As a result, we expect to see a significant pick up in market volatility.

It's a scary and uncertain future. So, how best to protect our capital? How would we take advantage of the new fiscal and monetary policies? We are shifting portfolios away from passive market investment and towards active managers. Fixed income portfolios will shift away from the risk posed by higher interest rates and towards specific company credit risk. We've identified several themes that should experience the upside of this secular change. Risk portfolios will tilt more towards investments in regional banks and real assets: real estate, energy, & precious metals.

While we anticipate more thematic investment opportunities as we gain clarity on Trump policies, several have emerged already. As an example, we see a multi-year investment opportunity in regional & community banks. Four factors provide tailwinds to this theme. First, the potential deregulation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The law resulted in US banks dramatically increasing reporting obligations, adopting a variety of global standards, implementing an array of consumer protections, and following a host of new accounting rules. Dodd Frank was a massive law spanning 848 pages of the Federal Register and requiring bureaucrats to write 390 rules. As a result, banks' compliance budgets soared from 3% to as much as 15% of total operating costs. The new U.S. administration has put Dodd-Frank in its cross-hairs, promising to repeal the (still growing) morass of regulations. Second, a backdrop of rising interest rates will be a boon to banks. With core business models that "borrow short" and "lend long," an increase in interest rates presents a long awaited tailwind of profitability. Third, any corporate tax reform would benefit domestic banks. As a group, they pay a 30% aggregate effective tax rate, the highest of any sector[5]. Any tax reform resulting in a lowering of the corporate rate would result in a tremendous boost to earnings.

Source: 4 Federal Reserve; 5 Stern NY University

Finally, we see a continuation and even an increase in the merger wave running through regional and community banks. When interstate banking became legal in the mid-1980's, the United States had over 18,000 banks, many of them operating in a single county or even with single branches. Since then, the number has shrunk to just over 6,000. While some banks failed along the way, many others combined. For growth-seeking banks based in economically challenged parts of the country, buying another institution in a vibrant market was the most efficient way to build shareholder value. In the last three years, consolidation pressure has only increased. According to the Federal Reserve, 2014 - 2016 were three of the busiest years for bank mergers since 1991. Small banks, still challenged by economies of scale, will remain pressured to consolidate. The run up in share prices equips acquirers with stronger currency for purchases at higher acquisition prices. We believe the ability to structure deals accretive to both parties is as strong as ever. Twenty deals were announced in January, two more than the previous year. This may portend growing merger activity in 2017.

It's over two months into the new administration. We have seen a lot of rhetoric and a lot of action, including the attempt to repeal and replace Obamacare. So far, we have not yet seen significant volatility. We believe that volatility will come. In advance, we are asking for your patience and bravery. We see the impending volatility as opportunity. Paraphrasing Warren Buffet, at times of fear, we must be greedy. At those times, we will seek to pick up assets at valuations below their inherent value. Thank you for entrusting us to protect your wealth. We all look forward to speaking with each of you over the coming months.

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