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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Trump's In - What Now?

By Casey Clarke

As we've hopefully made pretty clear over the years in these letters, our job as financial advisors and asset managers isn't to grind a political axe. We all have our views on issues, and to a large extent, those views determine how we identify politically in terms of party. For some of us, those views on issues change over time, or how the party we've felt most aligned with changes its stance on those views, and so we remain flexible with our votes. For others of us, that party identity can dominate and shape how we feel about certain issues, which leaves us in essence, trusting the tribe. Although most of us would like to believe we're in the former group, we all tend to feel more at home in one group than the other, for a host of complex reasons. The important thing to remember when it comes to identity politics, is that both sides are capable of virtuosity as well as depravity, and just like everything else, the extent to which they engage in it is cyclical. If we go back in history far enough, most would agree that both Republicans and Democrats had their eras of enlightenment and moral blindness. Unfortunately, like market bubbles, the line between the two is nearly impossible to spot in the moment. It's a slow creep, so the objects in our field of view look normal from one day to the next; all while that field of view gets increasingly narrow. The best defense against this myopia is, in my opinion, a commitment to objectivity where one seeks out opposing viewpoints, contradictions, and discomfort. The more we can put ourselves in challenging positions, take risks, and embrace uncomfortable situations, the more likely we are to grow intellectually and spiritually. In addition, like we discussed last month, knowing what drives human behavior is also crucial; incentives, conflicts, and capture. Understanding that these forces act on everyone makes it possible to question things we otherwise wouldn't think to. In the end, all of us, and both political parties, are better off if we focus on truth, honesty, and objectivity. As points of view widen and the fog of obfuscation lifts, we find we agree on more things than not; especially those things that can be quantified and are less abstract. All that said, and with those principles front and center, let's discuss what a Trump presidency means for the economy and markets, and ultimately, your portfolio.

Trump Policies - All Else Being Equal

Just like in 2016, Wall Street quickly found a way to celebrate Trump's election win with the Dow Industrials up 1500 points on November 6. As we know, Wall Street always looks for a reason to keep markets rising and profits flowing. The question really is, how will Trump's policies affect the economy and markets over time assuming he has the ability to fully implement them? Let's tackle the big ones first, looking at both pros and cons, since no policy is exclusively one or the other.

Tariffs – The goal of tariffs is to protect domestic industries from foreign competition, so if one feels we could benefit from bringing more of our production and manufacturing back home, then tariffs would be a means of accomplishing that. If there's one thing that we were reminded of when Covid response measures hit global supply chains in 2020, it was that we have become far too dependent on imports for critical products and components. Self-sufficiency comes at a cost, however. It requires that we essentially undo some of the offshoring that has taken place over the last 30 years in pursuit of higher corporate profit margins and cheaper consumer goods. This offshoring of cheap products and labor has both hidden the pernicious effect of rising costs (inflation) here at home and eliminated swaths of jobs for American workers. If you've found yourself lamenting those good old days where Americans made quality products that served our everyday needs, tariffs should be a policy option worthy of debate. The argument for them is that they would make the cost of imported goods more expensive, therefore leveling the playing field for domestically produced goods. If other countries are using them against us, then it's only reasonable to balance that out by imposing tariffs on those countries' goods. Of course, for tariffs to be beneficial over time, we would need to concurrently bolster our domestic markets for those newly tariffed goods in a way where innovation, efficiencies, and competition could keep prices as low as possible over time. Part of this would be to make business formation less cumbersome and do whatever is necessary to reasonably incentivize efforts to bring quality manufacturing back to the U.S.

The cost of getting back to those good old days would likely be significant in the short term at least. Until domestic market formations and efficiencies kick in, tariffs will raise the cost of goods to consumers not only on those imported goods that are more expensive, but also on competitors' goods that would raise theirs in tandem. Technically, this isn't inflation, as the supply of money in the system doesn't change, but it certainly means more expensive products in certain industries and markets. This is an important distinction as it relates to the economic impact. In the short term, if there isn't an increase in the amount of money floating around in the financial system/economy, the ability for consumers to absorb price increases is limited. In a scenario where growth and employment are both tepid, that could be a net negative in the coming quarters if other policies aren't able to offset it.

Regulation – This one's pretty clear cut and depends largely on one's perspective. Almost anyone who's attempted to start a business and/or currently runs a business will tell you that many of the current regulations are onerous and financially burdensome. As nice and responsible as they sound to all of us when it comes to an industry that we aren't personally running a business in, the reality is that even well-intentioned regulations add cost and expense that trickles through the economic system and results in less competition and more expensive products and services. We all know the argument for regulation; protect the consumer against corporate greed, fraud, or safety oversights. As valid as this argument might be, the downsides to regulation are the aforementioned cost and price increases, lack of competition (small companies have a harder time absorbing the costs of regulatory compliance), as well as the potential for regulatory capture as we discussed last month, which ultimately is detrimental to the consumers and serves to incentivize more and more regulation through corrupt quid pro quo arrangements. Another side effect of overregulation is a reduction in the overall level of personal responsibility and accountability individuals are capable of taking on for their day-to-day decisions. The "hot coffee" warnings are a prime example of this. The potential for a local coffee shop to get sued out of business for failing to treat it's patron like a two-year old is in no way helpful in creating a thriving local economy. Trump has stated his intention to roll back burdensome regulations. Most business owners would agree that this is something that is sorely needed and it would certainly help to offset some of the cost increases associated with the imposition of tariffs. It should be no surprise to anybody why most Washington politicians aren't big on the idea. We shouldn't expect them to be.

Government cuts – Which brings us to this idea of government (budget) cuts. To frame this one, it might be helpful to visualize living in any number of nations where the government makes up a large percentage of its economic activity, and therefore where government jobs are the most sought-after ones. These nations tend to either be authoritarian-led socialist or communist systems, where economic activity is centrally planned, or simply late-stage democratic ones. The former is fairly easy to conceptualize as the United States has been railing on communism and its ills since World War II, and for good reason. Any iteration of it where a government has substantially more power and a bigger voice than its populace seems equally problematic. The latter concept of old-aged democratic societies taking on similar characteristics is more foreign to most, but no less troublesome. When democracy shifts from representing the people to representing institutions (larger, wealthier, more powerful, greater influence), which is mostly a function of time, something subtle happens. Not only is the idea of government as a voice of the people more distant, but government becomes more interested in self-preservation and protecting the status quo. Over time, this manifests in capture, creep, and growth well beyond what was originally intended. At ~125% debt to GDP currently, the highest in U.S. history, federal spending of ~$6 trillion per year, and interest payments on the $36 trillion of government debt making up more than $1 trillion of that $6 trillion spending budget - Houston, we have a problem. If you're wondering why the officially reported government numbers for the economy and employment seemed a lot better than what you're observing with your own eyes over the last few years, it's because they were. Not only were the non-farm employment numbers reported consistently too high, which there have been and will continue to be downward adjustments for, but the majority of what strength exists in these economic numbers has come from the government sector, which produces very little in terms of innovation and real wealth. There is no way out of this without cuts, or without shrinking the federal budget; which is to say, without shrinking government itself. Tax increases won't fix a spending problem. It would simply further impair the productive side of the economy (private) while enabling further profligacy on the unproductive side (public). This need not be political. It's really that simple.

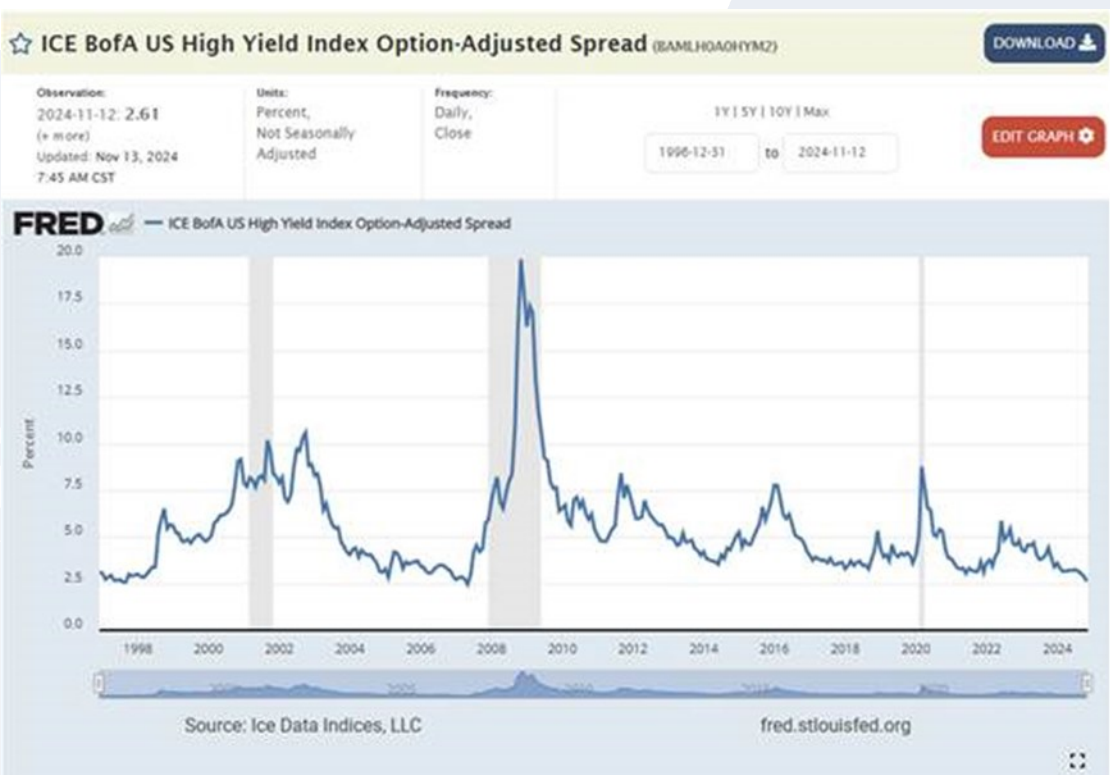
Now, as it relates to Trump's plan to cut government, like tariffs, it would hurt initially. A hit to the sector of the economy that has been contributing most to the economy (debt fueled and unsustainable), would expose the underlying general weakness. It's hard to envision this not leading to recession in the near-term unless it was carried out in phases or with some sort of safety-net for those out of a job. The argument for this would be similar to that for tariffs. Over time, our economy would be freer of public sector inefficiencies, which could add vibrancy and efficiency to the private economy, boost growth, and ultimately reduce the burden on every tax-payer. The argument against deep government cuts would of course be the immediate hardship to those employees affected, as well as effects on those downstream of government spending. These are valid concerns. There's no perfect way to remove a band-aid, but ultimately when the body's motion and function is restricted due to being covered in them, you have to start somewhere. Unless we want an economy where our grandchildren's best hope for a job is in the government sector, where they have to hope some still remain after friends, family, and cronies have all gotten their allocations, we should welcome the idea of a much more reasonable government footprint. To the degree we do that intelligently, the economic impact should ultimately be positive.

But All Else is Not Equal

Regardless of how one feels about Trump, his policies, and the impact both could have on the country, economy, and financial markets, there are some pretty serious realities that can't be ignored. If all else were equal, would

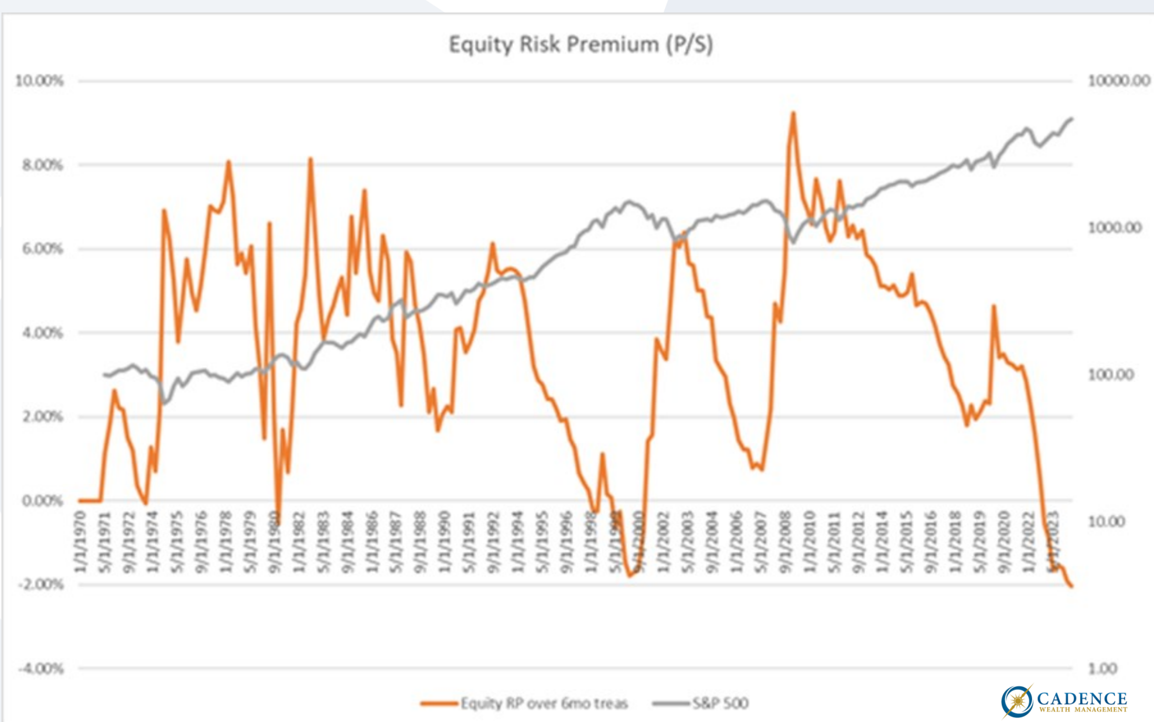
Trump be good for the economy? Our thinking is that over time, yes, his policies could help restore American production and manufacturing, innovation, and a more dynamic private sector. There are legitimate downsides to tariffs, so we're skeptical of their long-term effectiveness. After all, frustrations associated with tariffs in the early 20th century are what led to the establishment of the individual income tax in 1913. These things are nuanced, and it's likely that certain policies work better in some situations than others and for a limited period of time. The diagnosis dictates the medicine. In the short term however, achieving that longer-term vision will require a bit of pain from an economic and market standpoint. In addition, all else is not equal. The economy is already weak from both an activity and employment perspective, and the bubble in the stock market still hasn't popped. In many ways, it seems as though the hope of some miraculous escape from gravity has been enough to keep markets in orbit. It's our inclination to focus solely on the "when", not the "if" part of the question as to whether markets return to Earth, because there has never been bubble in history from which there's been a miraculous escape. Even though we're convinced it's a matter of when, it's a fool's errand to try to get too cute predicting it. What we can do, however, is ascertain whether conditions are ripe for the complex system we call financial markets to break. Let's have a look at a few data points.

First, we look at the bond market and the rate of interest on corporate bonds that are below investment grade (BB or below) compared to the interest rate on U.S. Treasury bonds with similar maturities. What we can see in the chart below is that investors are currently getting an extra 2.61% for taking the risk associated with these corporate bonds over and above what they could get from a "safe" treasury bond. The important takeaway here is how that 2.61% compares to prior credit spreads and what it says about where we might be in the business and investment cycle. What it says to us is that it's about as small as spreads have been in the last 30 years, and small spreads tend to occur prior to economic and market downturns, not after.



The next data point that suggests the same condition is the yield curve; the difference between the ten and two-year U.S. Treasury interest rates. When the ten-year rate drops to or below that of the 2-year, when the latter comes up to meet the 10-year, or any combination of the two, the economy and stock market tend to stall out and get into trouble. The black line in the chart below represents this yield curve, while the red line illustrates the S&P 500. The green and gold lines are treasury bonds and gold respectively. What we observe here is that as the yield curve rises from a low or negative position, stocks tend to be the worst performing of the three asset categories. Again, this interest rate setup tends to precede economic weakness, not strength.

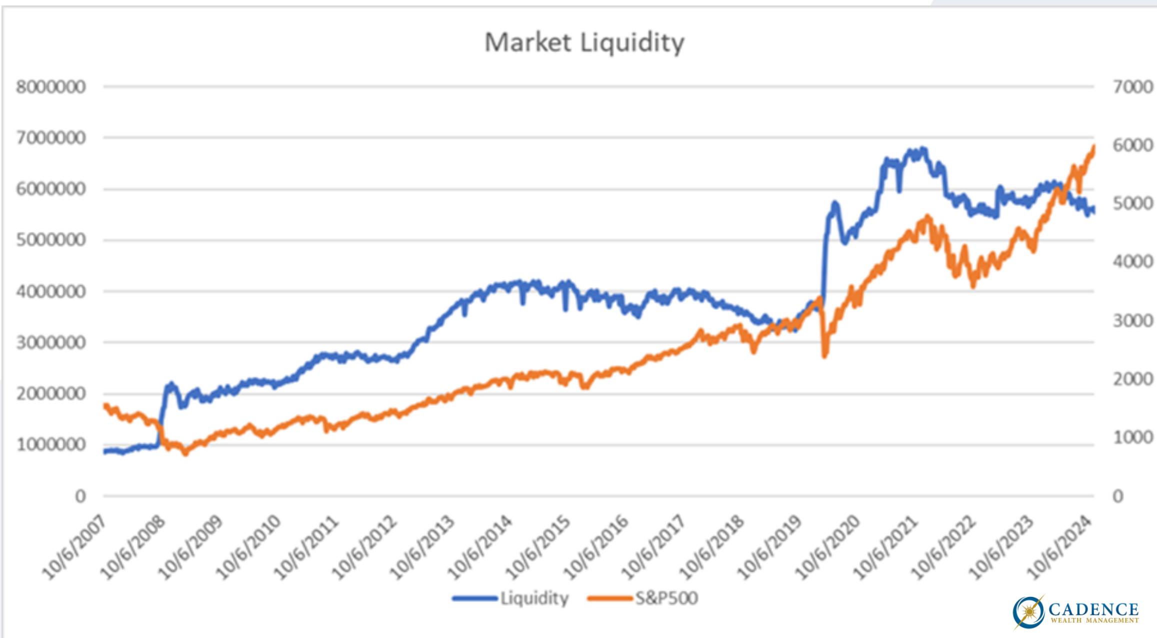
Next, when we look at the valuation of U.S. corporations relative to U.S. Treasury bonds, we see similar warning signs; signs that tend to occur before weak economic and market periods. The chart below looks at the amount of "stuff" U.S. corporations produce and ultimately sell (corporate gross value added) relative to the price of like corporations (S&P 500), then compares that to what could be earned on government bonds. When the orange line is low, it suggests little or no additional value over and above what could be earned in a risk-free government bond. You can clearly see that when these "risk premiums" have been low in the past, downturns in the stock market tended to follow. In other words, a low risk premium suggests to investors that stock prices are too high and that returns on bonds will be a better bet once markets turn the other way and revert back to more normal pricing.

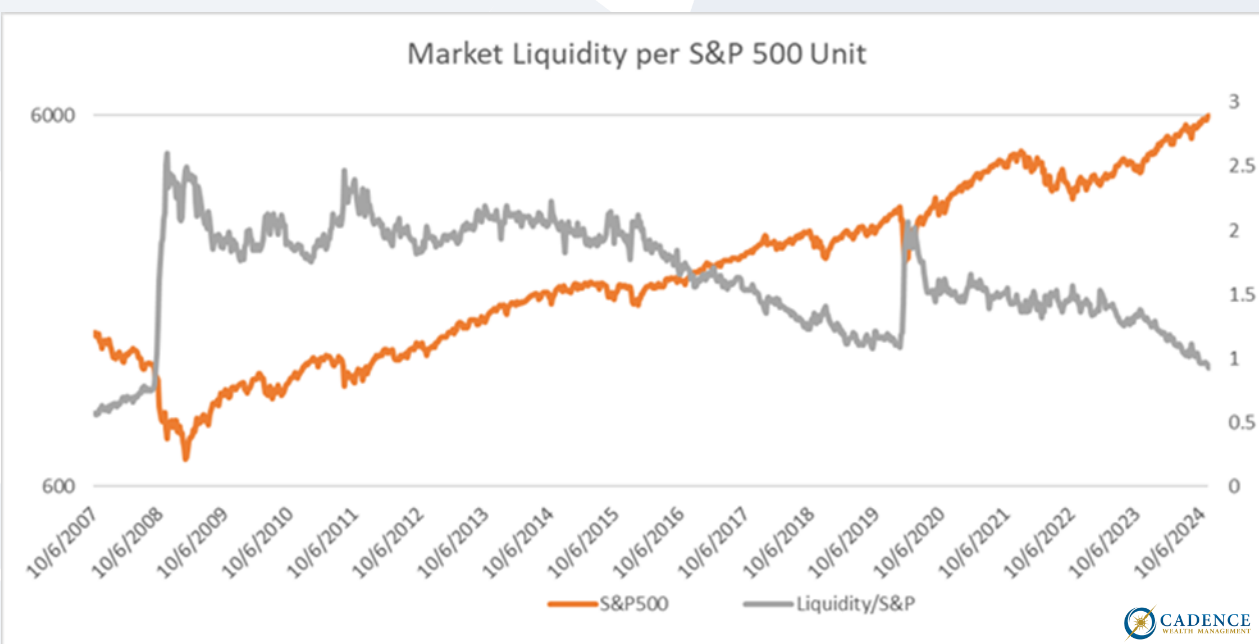


Now let's move to market liquidity – which we'll define as Fed balance sheet, plus repurchase agreements, plus Bank Term Loan Program balances, minus Treasury General Account balances, minus reverse repurchase agreements. Basically, this all means money the Fed credits to banks minus the money taken (debited) from banks. The idea here is that the more reserves the banking system has, the more fuel exists for asset purchases in the public markets. Same being true in reverse; the less money (reserves) banks have on hand, the less buying of financial assets.

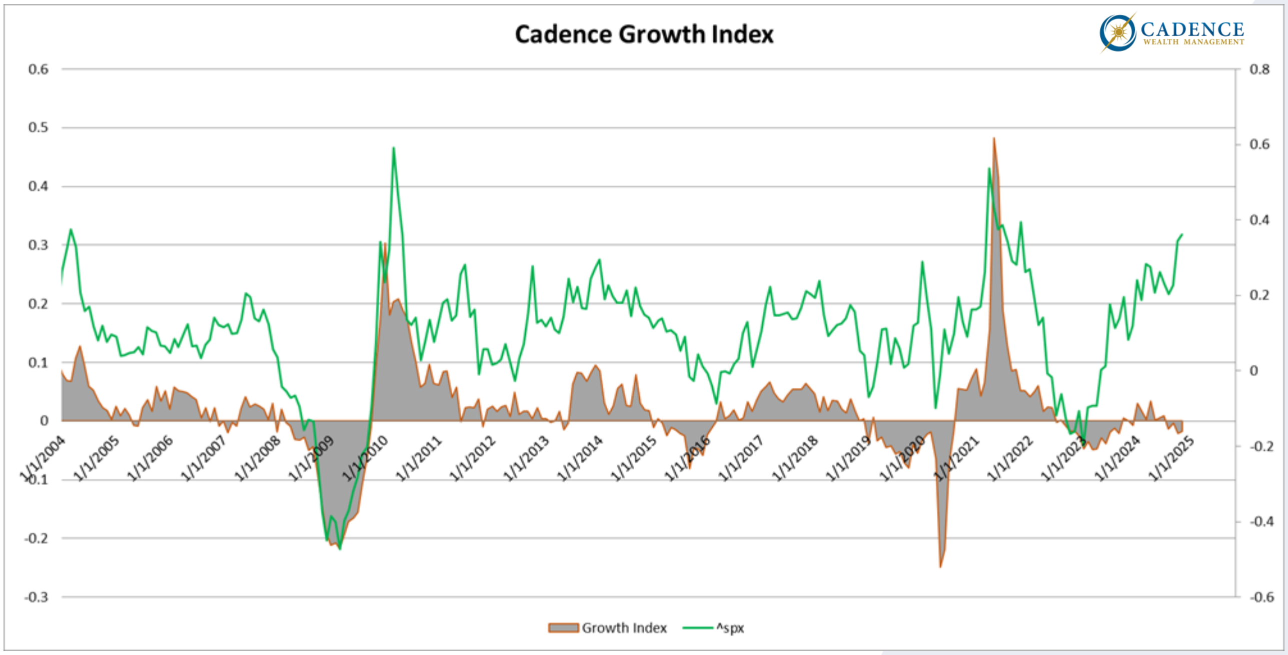
The first chart below shows total bank liquidity, and the second, liquidity per unit of stock market. The latter may be more relevant given the theory that it takes more and more liquidity to prop up an increasingly large market system. Of note, we have less liquidity per market unit now than we did prior to the Covid crash, and it appears to be falling. Also, we're currently at the lowest levels since the Fed made printing money its new addiction.

If regular administration of a drug keeps the addict calm, this seems problematic.

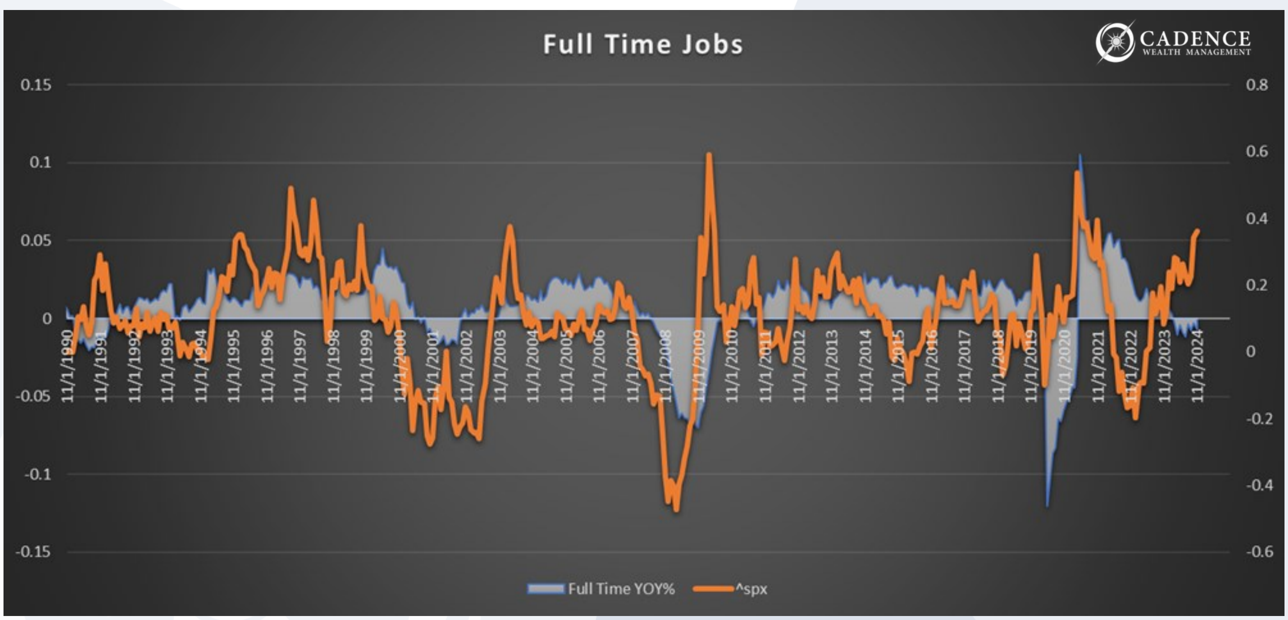




In terms of current economic growth, our index shows a weakening since the anemic bounce that took us into the summer. As you can see, the year over year stock market gains in green, which are typically in line with the direction of economic growth, is doing its own thing. It's not economic activity that's driving it.



Below, we see full-time employment also in negative territory. This is consistent with prior recessionary periods and again, the stock market is disconnected from this reality.



The Japanese Yen

One of the things we think bears close monitoring is what's happening in Japan, and more specifically, the Japanese yen. Over the last three years, the purchasing power of the yen in dollar terms has fallen roughly -30%. Beyond being bad for Japanese tourists and an economy that imports much of its energy, the weakening yen has fueled carry trades where (large) investors borrow in yen, convert to dollars, buy dollar denominated assets that have done well, and ultimately sell and convert back to yen at a lower price. We discussed this concept in a prior Clips; the carry trade works until the factors that allow it to work change. One of those factors has been a weakening yen. As with most developed nations that are mired in public sector debt, Japan has structured its policy around intentionally generating inflation, and set its target for it at 2%. The hope of course is that mild inflation nudges consumers and businesses to spend and keep economic activity moving, while also increasing government revenue with which to more easily pay off government debt. It's a delicate balance of course, and with October Core CPI increasing 2.3% and corporate services inflation rising 2.9% versus one year ago, there's a good chance the Bank of Japan will have to intervene to arrest any unwanted upward momentum in inflation. That intervention could take the form of raising key policy interest rates or other steps to defend the yen and bolster its value. Either way, a stronger yen, as we can see from the chart below, would likely be very good for U.S. Treasury bonds as the two have been tightly correlated over the last few years. In addition, a recovery in the Japanese yen has the potential to unwind outstanding carry trades, which could have broader market implications. In short, if Japan has to react to nascent inflationary issues, that could impact U.S. stock and bond markets here at home – stocks negatively, government bonds favorably would be our current assessment. We're keeping an eye on this one.

All of these data points suggest current weakness in the economy and that the path of least resistance will be continued weakness. They also suggest a stock market that hasn't gotten the memo for one reason or another. Is it possible that the economy quickly improves and supports markets at current levels? Sure, but given the near-term downsides to Trump's policy proposals and the current setup with respect to interest rates, market signals, and valuations, it's unlikely we'll get the rapid growth needed to grow into the current extremes. What's more likely in our opinion is that we see weakness early in Trump's term, a corresponding market correction, then with any luck, some traction with which to move forward in a more sustainable way.

What happens when the biggest stock market bubble in history pops? In short, a lot. The passive investment flows into index funds and ETFs reverse, margin calls ramp up, and everything that created the imbalances and extremes we now take for granted gets thrown into reverse. Many investors today haven't experienced the back side of the mountain; they will. What we're fully expecting as stock market losses on the most popular and crowded stocks of the last decade pile up, is monetary and fiscal intervention on a massive scale. That flooding of the system with money to arrest the pain will further support gold and other precious metals, along with commodities, more broadly. Eventually, it will probably also support a renewed uptrend in the economy and stocks more generally, but not necessarily right away. History is pretty clear about the fact that pain trumps promise when it comes to the prospect of government action staunching acute losses. Our best guess is that this is about the time government bond risk increases dramatically. The role of safe-haven assets through the worst period of economic weakness and stock declines could end with re-emerging and increasingly serious uncertainty around inflation and government solvency. Until then, we view U.S. Treasury bonds as a reasonable investment given the relative attractiveness versus stocks and the likely economic weakening ahead. Beyond that, we're much less optimistic on treasuries.

So, to wrap, the market is reacting well to a Trump presidency, but we're not sure that will last. In the end, one man can't change all the conditions that exist at the moment, most of which aren't trending at all in the right direction. Holding up the economy and markets in recent years has required such a Herculean effort, that we're now in a position where valuations for many assets are historically rich (unaffordable for most), our government has grown burdensomely large, and our dependence on increasingly large amounts of liquidity from central banks and government spending will eventually kill the patient. To keep the system afloat much longer is akin to Sisyphus pushing the boulder up the hill. He'll never achieve rest because there is no achievable top. The story for mortal men ends in Sisyphus growing tired and frustrated with the lack of progress, and the realization that fighting gravity is not only futile, but an enormous waste of time and physical resources. The boulder will fall. Whether that happens soon or not isn't entirely relevant. What is, is making sure we don't get rolled over when it does. It's times like these, when risk of sharp, lasting losses is dangerously high, that we focus on investment rather than speculation. In our opinion, there are plenty of the former in the commodity and natural resources space, as well as U.S. Government bonds being a shorter-term opportunity for portfolio ballast. That will change at some point, but probably not before the broad stock market finds a pin.

We wish our new president the best, because if he and his team succeed, we all succeed. That doesn't mean, however, that we shouldn't plan our portfolio for the worst. The two aren't mutually exclusive.

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