Investment Insights

2016 Elections: First Thoughts

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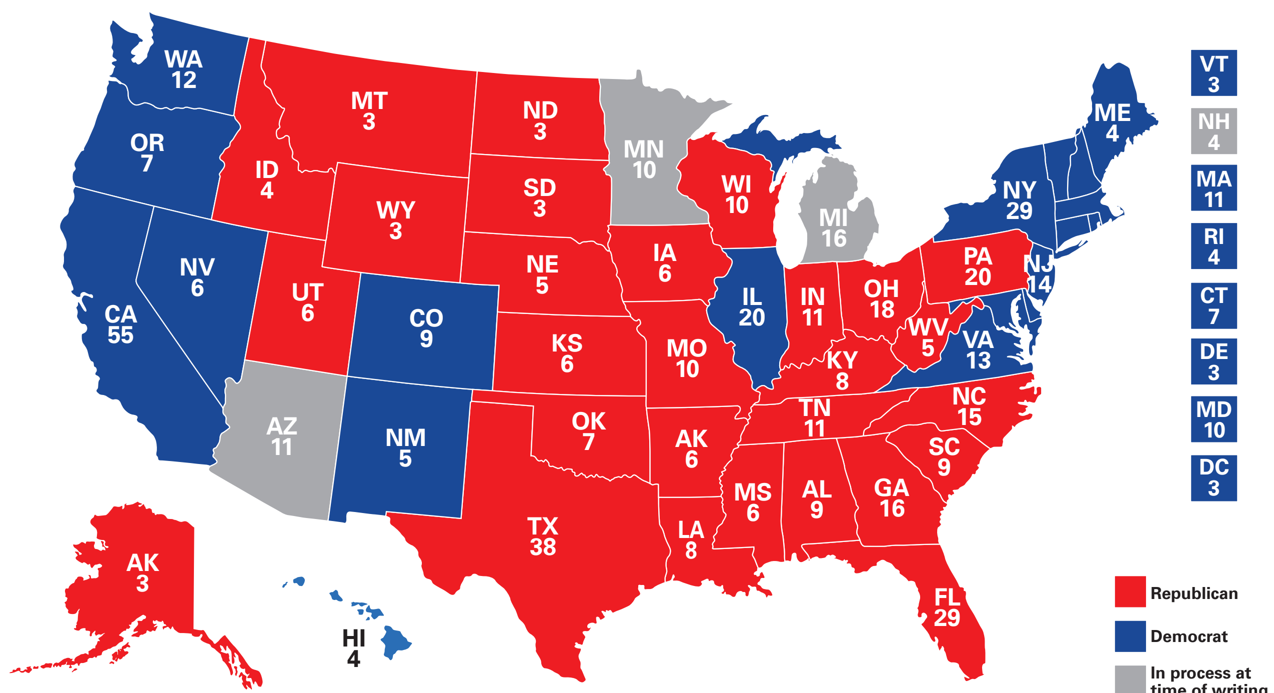
Highlights

One of the most unconventional and tense U.S. presidential election seasons in recent memory finally came to a close Wednesday morning, when Donald Trump, businessman, television celebrity, and political outsider, pulled off a dramatic upset to become the 45th American president, with an estimated electoral vote count of 279 (according to RealClear Politics) and several states still outstanding at the time of writing early Wednesday morning (Exhibit 1; 270 electoral votes needed to win); at this point, the popular vote is very close with both major candidates receiving approximately 48%, and it is possible Clinton wins the popular vote despite losing the Electoral College.

Republicans will continue to hold majorities in both houses of Congress. Democrats picked up one seat in the Senate (Illinois), with the race in New Hampshire still too close to call and a runoff in Louisiana scheduled for December. In the House of Representatives, Republicans gave up 7 seats, now outnumbering Democrats by 44 (with some states still outstanding).

Exhibit 1: Shakeout of the Electoral Map



Source: RealClear Politics

Initial Market Reaction

On Wednesday morning, global stocks resumed their pre-election slide (coincident with the closing gap in many election polls), with Asian and European stock markets falling between two and five percent immediately after the U.S. election was called in Trump's favor, and Dow futures down as much as 900 points before rebounding to flat at the time of writing. The U.S. dollar is modestly weaker versus developed-market currencies, in particular the euro and yen. At the same time, the dollar is stronger versus many emerging market currencies, as they could suffer from renegotiation of U.S. trade agreements.

Emerging markets — both equities and currencies — are likely to be one of the most bruised and battered regions, at least in the short term, as they were seen as a proxy for the election, given Trump's harsher trade rhetoric than Clinton's. In particular, immediately after the election was called in Trump's favor, the U.S. dollar spiked versus the Mexican peso before settling at around 10% stronger on the day and making the peso one of the worst-performing currencies year-to-date with a return of -13%. Even in the medium term, the risk premium within emerging market equities could stay elevated, as anti-trade rhetoric was such a central part of his candidacy.

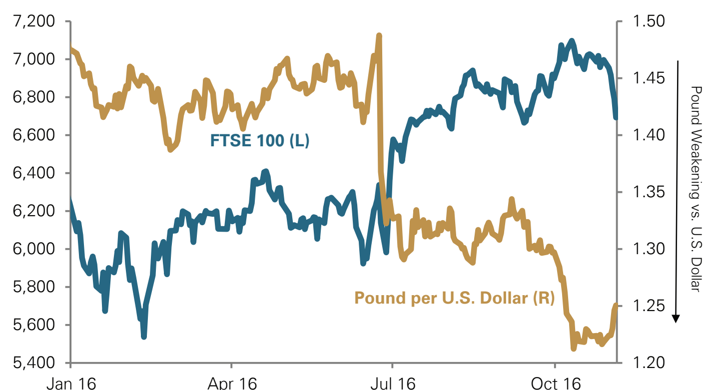
America's Brexit Moment

Some have drawn parallels between this election and Brexit, the June decision by the U.K. to exit the European Union. We admit that it's an appealing analogy, especially to U.S. investors hoping to see the S&P 500 Index post similar returns as U.K. stocks post Brexit. (The FTSE 100 Index is up 14% in local-currency terms since the post-Brexit trough; though for U.S. investors converting to U.S. dollars, after factoring in the weaker pound, U.K. stocks are down -5% total return year-to-date). The choice between Clinton, representative of the "status quo," and Trump, the "wild card," is similar to the U.K.'s decision to remain or leave the European Union (E.U.). Still, there are notable differences that make the U.S. election quite different from Brexit:

1. From an economic perspective, Brexit created uncertainty regarding the future of two distinct trading groups: the U.K. and E.U. Though the Brexit negotiations involve the 27 other countries within the E.U., which will surely complicate the process, Trump's anti-trade rhetoric has called into question many of the U.S.'s trade relationships, including those with China, Mexico, Canada, and others, elevating the uncertainty facing many corporations. For perspective, U.S. exports are almost 3.5 times as much as those of the U.K., in U.S. dollar terms, but exports as a percentage of GDP for the U.S. are about half those of the U.K.
2. The bounce in U.K. stocks after Brexit was largely due to the rapid depreciation of the British pound (Exhibit 2). Given the divergence of global monetary policy, the Fed's likelihood to remain on the path of gradually raising interest rates, and the U.S.'s status as a safe-haven asset and global trading currency, we think the dollar is unlikely to weaken even close to as much as the pound.
3. Unlike the Bank of England, which eased monetary policy and reinstated asset purchases following the Brexit vote, the Fed is unlikely, in our view, to

Exhibit 2: FTSE 100 and Pound Sterling per U.S. Dollar

Year-to-Date Performance



As of November 4, 2016. FTSE 100 represents the price level and is in local currency (Pound Sterling).

Source: Bloomberg

ease policy outside of an economic recession, though post-election volatility may cause the Fed to put its rate-hike plans on hold until financial conditions loosen.

4. Brexit is going to be a long process, and the U.K. government made it clear it would take its time before invoking Article 50, which would then start a two-year negotiation between the U.K. and E.U. For many investors (not ourselves), two years is beyond their investment horizon. As it pertains to uncertainty around Trump's policy changes, these could be quick and somewhat unilateral (especially since Republicans swept the House and Senate).

What Now?

One of the reasons for the initial sell-off of risk assets is because the policies and priorities of Trump are less clear than those of Clinton (whether you agreed with hers or not, investors more or less knew what they were getting with Clinton). Will Trump spark a trade war or negotiate with other countries in a business-like manner? Will Trump hold a grudge against Republicans who did not support him, effectively creating a divided government despite a Republican sweep of the Senate and House, or will he work with Paul Ryan to enact policy change? Volatility could remain high in the first few months of a Trump presidency as he clarifies policy priorities.

If Trump's administration emphasizes the trade and immigration aspects of his campaign, volatility may remain elevated. The challenge of new tariffs and changing trade deals would cause disruption across global supply chains and likely weigh on investor perceptions of aggregate growth (we note that the president has several avenues for using executive orders to invoke tariffs).

If, on the other hand, Trump focuses on his tax and repatriation plans, specifically lowering corporate tax rates and encouraging corporate cash held abroad to return to the U.S., the market is likely to view this positively. A fiscal spending package would also be supportive of the market in the coming months. Importantly, congressional approval is needed for tax changes and any fiscal spending package; Trump's ability to enact major tax and fiscal change has increased greatly given the Republication majority in the House and Senate.

Another risk that could emerge early on is whether Federal Reserve Chair Janet Yellen decides to step down in the wake of a Trump win. Trump has made his disapproval of Yellen quite clear, and while it is our base case that Yellen finishes her term and is not reappointed in 2018, when her four-year term expires, it is a possibility that she'll choose not to remain in her seat. This scenario would be a big negative for risk assets.

The days leading up to the January 20 inauguration should reveal more details about the most actionable priorities and makeup of Trump's administration. We expect speculation around cabinet nominees to ramp up quickly; Presidents George H.W. Bush and Barack Obama began the process of vetting and naming cabinet members just weeks after the election. Some of the names frequently mentioned in the press include Bob Corker (Tennessee senator), Ben Carson (retired neurosurgeon), Rudy Giuliani (former New York City mayor), and Newt Gingrich (former speaker of the House).

Trump's First 100 Days

Many investors and the media may draw conclusions (rightly or wrongly) quickly after the election, in terms of how they think policy may evolve under Trump. That said, any real policy shifts are likely to occur only after inauguration on January 20. The term "First 100 Days" was coined in 1933 when President Franklin D. Roosevelt took office and spent the first 100 days of his administration meeting with Congress and passing major legislation, including fiscal stimulus, monetary and banking reform, and even repealing prohibition. Since then, a president's first 100 days following inauguration have been watched closely for an indication of the tone and priorities for the term.

Exhibit 3: Post-election Calendar

	Date	Significance
Cabinet Appointments	Nov. 2016-Jan. 2017	Who is named to Trump's cabinet will shape investor perceptions over his policy priorities; we would be more constructive on risk assets should we see more experienced, centrist names.
Election for Speaker of House	Week of Nov. 14, 2016	Paul Ryan is likely to remain House speaker; near-term interactions with Trump could heavily shape market sentiment about how the two government branches may work together going forward.
Federal Reserve Meeting	Dec. 14, 2016	December hike will depend in large part on post-election market reaction; investors will also focus on Fed Chair Yellen and her relationship with Trump.
Inauguration Day	Jan. 20, 2017	Trump becomes the 45th president of the United States.
State of the Union	Late Jan./early Feb. 2017	We expect Trump to outline his key priorities for his "First 100 Days," which may include business tax reform, an infrastructure spending bill, and immigration reform.

Trump has made his priorities fairly clear, though details of some of his policies have changed throughout his campaign. Based on Trump's website, we would highlight four issues we expect to remain in focus:

1. Comprehensive immigration reform, including building a physical wall, ending catch-and-release, and removing criminal illegal aliens.
2. Passage of a large infrastructure spending bill with maximum flexibility given to the states.
3. Repeal and replacement of the Affordable Care Act (ACA).
4. Revision and update of individual and corporate tax codes.

(In addition, we would highlight the potential for Trump to use executive order or action to roll back some of his predecessor's executive actions as well as push ahead on a Supreme Court nominee, which in turn could influence markets.)

Immigration reform is complex, requiring analysis of many factors to determine the impact on the economy. We also note that comprehensive reform, even with a Republican Congress, would take time. On the other hand, infrastructure investment is an issue that receives bipartisan support, and the "fiscal multiplier" (the amount of spillover to other areas of the economy for each dollar spent on infrastructure) will likely be greater if Trump can pass a bill funded from deficit spending rather than one that is deficit neutral. This would increase inflation expectations and steepen the U.S. yield curve over time; inflation could also pick up if restrictions on U.S. imports increase prices within U.S. corporate supply chains, all of which are negative for bonds. However, House Republicans, especially if led by Ryan, may be hesitant to increase the federal budget deficit, which has plateaued of late at around 3% of GDP. Also, historically, the benefit of federal spending has been greatest when the Fed is not tightening monetary policy.

A big part of Trump's campaign (and that of Republicans more generally) was to repeal and replace the Affordable Care Act (ACA), with greater emphasis on health savings accounts, flexibility for states, and insurance competition across state lines. This could be done through a budget reconciliation bill for fiscal year 2017 that would not fully repeal the ACA but could propose many fundamental changes, including elimination of the individual and employer mandates, repeal of the medical device and health insurer taxes, and elimination of the 3.8% tax on investment income. Elevated uncertainty could weigh on healthcare broadly but, over time, would likely be positive for biotechnology and negative for hospitals/facilities. A lesser focus for Trump has been price controls for pharmaceuticals (with the greatest downside for companies with concentrated product lines), but drug pricing is pretty strongly opposed by Republicans.

Corporate tax rates in the U.S. are among the highest in the developed world. If Trump can lower the business tax rate from 35% to 15% as promised on the campaign trail, this could significantly halt the wave of corporate inversions we have seen over the past few years and may prove low enough to incentivize companies to bring back foreign earnings (a great deal of undistributed foreign earnings are concentrated in the tech and energy sectors). The implications for multinationals are unclear, as they would benefit from corporate tax reform but would be hurt if a Trump administration pulls back from trade deals.

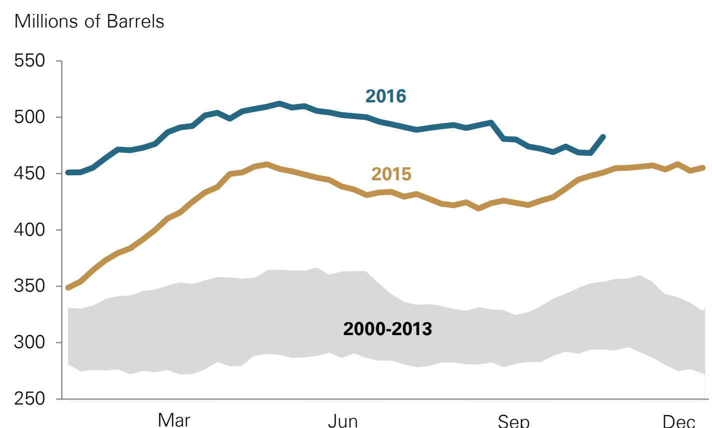
Other Market Implications

Several priorities of the Trump administration have implications for certain market sectors. While a full analysis of each is beyond the scope of this note, and any meaningful progress will depend heavily on the details that unfold, we outline three of the key issues for investors based on the information Trump's team has provided thus far.

- **Regulation.** Trump has pledged to eliminate intrusive government regulations, including overhauling the 2010 financial regulatory law known as Dodd-Frank. The impact could be most felt by the financial sector with a boost to regional banks; however, if elevated volatility encourages the Fed to move even slower than its already-glacial pace of rate hikes, banks could continue to feel pressure. As it stands, the S&P 500 Financials Sector Index has been roughly flat for the past two years in the face of tighter regulations, rock-bottom interest rates, and a flattening yield curve. Bessemer equity portfolios are underweight financials but, within the financial sector, have a bit more exposure than the MSCI ACWI Investable Market Index (MSCI ACWI) to banks and diversified financial services.

- **Energy.** A Trump administration would likely prioritize conventional energy production so as to make the U.S. energy sector independent (removing the need to import energy from OPEC). Trump has also pledged to rescind energy regulations, which would likely hurt "clean energy" companies. However, any upside to conventional energy is limited given the supply overhang that currently exists in the U.S. oil market (Exhibit 4). Any additional production from U.S. oil companies will likely prolong the rebalancing cycle, keeping oil prices capped and energy companies' balance sheets under pressure.

Exhibit 4: U.S. Oil Markets Remain Oversupplied



As of October 28, 2016. Inventories exclude stocks held in the Strategic Petroleum Reserve (SPR).

Source: Bloomberg, U.S. Department of Energy

- **Defense.** Trump has pledged to repeal the defense sequester and submit a new budget with increased defense spending, which would result in a meaningful boost for defense companies (though their performance is a function of many factors, including perceived security threats). In particular, cyber-defense companies could benefit, as a comprehensive review of U.S. cyber defenses and vulnerabilities is also a priority of a Trump administration and would likely receive funding from a Republican Congress.

A Little Economic Perspective

As president of the United States, Trump will have a tremendous influence on the shape and direction of U.S. and global policy. That said, we believe financial markets are driven by much more than just one person. Public-sector policy is influenced as well by Congress, while the Federal Reserve drives monetary policy. Corporate profits are also influenced by internal management decisions. Market valuations and investor sentiment matter. And perhaps most important of all, at least in our view, is the state of the global economy, and in particular the U.S. economy. As we have noted on many other occasions, we see the outlook for the economic cycle as fundamental to our view on equities. The election results matter, but mainly for how they may, or may not, change that basic economic view.

The good news here is that going into Election Day, the U.S. economy appeared to be in decent shape — expanding, albeit at a moderate pace, with signs that we are in the later stages of the economic cycle. Large, sustained drawdowns in the stock market are rare outside of recessions, and while inevitable at some point, we believe we are still one to three years away from the next recession, barring some large, unexpected shock. The manufacturing sector seems to be picking up as headwinds from a stronger U.S. dollar and lower oil prices have receded, and business confidence for the service sector has been quite good of late. Despite a vicious election season, consumer confidence is hovering around cycle highs but not overly euphoric (overly confident consumers have historically been a contrarian indicator for the stock market). The labor market is creating jobs at an average rate of 180,000 jobs per month, compared to 229,000 per month on average during 2015, and wages are rising at a modest pace.

One economic indicator we continue to monitor closely is corporate profit margins. For the majority of businesses in the U.S.'s service-based economy, wages are the biggest cost component of their bottom line. A tighter labor market and rising wages will inevitably weigh on corporate profits, and historically, once profit margins start to decline, it is unlikely that they reverse that trend without the economy first going through a recession.

What Does This Mean for Bessemer Portfolios?

At this time, we are monitoring financial market developments closely but are not changing our overall allocation to equities (a Balanced Growth portfolio with a 70/30 stock/bond risk profile currently holds approximately 70% in equities). Over the course of this year, we have reduced volatility in equity portfolios, as the market is more vulnerable given where we are in the economic cycle and current valuation levels. This has been accomplished through a modest reduction of equity exposure early in the year, as well as through equity strategies that target lower volatility than the broader market, and a slightly higher allocation to high-quality fixed income (but still underweight versus the Balanced Growth benchmark).

In light of the election results, Bessemer mandates are evaluating emerging market (EM) holdings with an eye toward reducing exposure, given EM reliance on global and U.S. trade. Many of our managers' EM holdings have some built-in immunities to currency and trade (many have a domestic focus or revenues in U.S. dollars, for example), but we could still reduce our exposure at a broad level (Bessemer equity portfolios are currently modestly underweight versus the MSCI ACWI).

Beyond trade, we will watch developments around specific policy areas to see how we may need to further adjust portfolios — both from an asset-class as well as

an equity-sector perspective. The current correction may create attractive entry points to increase exposure to certain assets via the Strategic Opportunities mandate.

Ultimately, the economic cycle should remain the biggest factor, and we are likely to take further steps to reduce risk in portfolios over the next year (as the U.S. economy continues to mature), all else equal.

We continue to believe the fundamental backdrop for the U.S. is more favorable than other areas of the developed world, the latter still mired in disinflation and challenged by much-needed structural reforms, so Bessemer equity portfolios are meaningfully overweight the U.S. versus the MSCI ACWI.

Overall, we are trying to strike a balance: we want enough cyclical exposure so that portfolios can participate in the event that the expansion continues a few years longer, or even accelerates (maybe thanks to U.S. policy). That said, we do not want to be “over our skis” with risk given the considerations noted earlier. We know our clients’ capital is irreplaceable, and we need to do all we can to protect it.

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