F&V Capital Management, LLC
805 Third Avenue, 12th Floor
New York, NY 10022

H. Terrence Riley III, CFA
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Contact: Karin Mueller-Paris
+1(212) 326 9533 kmm@fvcm.us

The Polls Were Wrong: Trump Wins

The election of Donald Trump has a rather surreal quality to it because he was not expected to win the Republican nomination back in the primaries, and after he became the Republican candidate for president, he was not expected to win the election. The comparison to Brexit was sometimes made, but no one seemed to really believe that Trump could defeat Hillary Clinton in the end. But it is so. The shock could be seen on nearly every face during the election returns on U.S. TV. It seems that maybe Trump was right about forgotten people when he said the following:

"I have visited the laid-off factory workers, and the communities crushed by our horrible and unfair trade deals. These are the forgotten men and women of our country."
— Donald Trump, July 21, 2016

Shock to the System

The Trump victory is expected to lead to greater volatility in the short run, but it's a buying opportunity. S&P 500 stock futures were down 5% overnight as the surprise election results were reported. By morning, when the markets opened, the real cash index was down only 1%. It's hard to know if there will be additional downside, but investors should recall that stocks in London only suffered a one day loss before recovering after Brexit. We used the morning weakness to make some minor additions to equity portfolios.

We do not have a clear understanding which Trump policies will be enacted into law, but we expect growth to accelerate. Here are a few of the major issues:

Positive:

1. **Corporate Tax Reform –** At 35%, the U.S. has the highest statutory tax rate in the industrialized world. It is a near certainty that there will now be tax reform that will lower that rate. This is very positive. All the big U.S. multinationals have been sheltering hundreds of billions of dollars overseas to avoid the high U.S. tax rate. These funds will now be able to come back to the U.S. for investment. Also, there will be much less reason for U.S. businesses to move their headquarters to the Bahamas, Ireland and other tax havens.
2. **Regulations –** the Obama administration has increased the Federal Register of business regulations at the fastest rate in U.S. history. Many have argued that the slow rate of growth in the U.S., compared to the historical average of 3%+, was partly due to the high costs and incentive depressing effects of these regulations. A Trump administration is expected to remove many of the high costs rules.

Negative:

1. **International Trade –** Trump has threatened to renegotiate important trade deals such as the North American Free Trade Agreement (NAFTA). Points have been made, for example, that Mexico has a VAT tax but that the U.S. does not. So U.S. exports to Mexico are taxed through the VAT, but Mexican exports to the U.S. are not. Whether this is a legitimate problem or not, nearly all economist agree that free trade is positive for nations as a whole (although perhaps not some specific "forgotten men and women"). Any reduction in trade is a net negative.

2. **Foreign Labor –** Trump has threatened to deport millions of Mexicans illegally living in the U.S. This is a clear negative for the economy. The U.S. unemployment rate is only 4.9% and the building industry is already reporting shortages of skilled labor. Mexicans living in the U.S. make up a substantial portion of the building trades and labor shortages may become acute if mass deportations were to actually occur. Maybe we are too cynical, but we believe Trump will change his opinions now that he is elected. He is a real estate developer and it is a fact that his buildings have been built with a substantial amount of Mexican labor.

Effects:

1. **Equities –** economic growth and corporate profitability is likely to increase at an accelerating pace in 2017 because of the Trump election. Valuations remain attractive and we anticipate a substantial increase in stock prices during the year ahead;
2. **Bonds** – the fiscal policies supported by Trump (lower taxes / higher spending) are negative for the fixed income markets. Bond yield are up significantly this morning and we would look to reduce exposure in the weeks ahead;
3. **The dollar** – faster U.S. growth and higher interest rates are likely to keep upward pressure on the dollar's f/x value during the year ahead.

Summary

There is too much emotion in there air and it has created a buying opportunity. Trump's trade and immigration policies present long term challenges, but the new government's fiscal policy is a positive. By attempting to separate emotional response from policy changes, the outlook is positive for equities and the dollar, and more negative for bonds. There is one caveat: It is nearly impossible to predict what the second derivative effects will be on China and other emerging markets. Some exposure to U.S. Treasury bonds may continue to be desirable as a hedge.