COMMENTARY

November 10, 2016

Dear clients and colleagues,

Another stunning event this week: the unexpected election of Donald Trump as 45th president of the United States. Is it a surprise? Earlier this summer, few would have predicted the UK would vote to leave the European Union. And going back a few years, the Arab Spring and the rise of the New Russia were just the prelude.

What is happening?

We have written in previous comments about how the rise of inequalities is leaving the middle class behind. What are the culprits: globalization? automation? central bank experiments with low or negative rates? Whatever the causes, there are seismic shifts happening, and this is just the beginning.

What now?

In the next few months there will be an Italian referendum on December 4, which we already discussed in a prior comment; Scotland may have a second referendum on independence as a result of the Brexit vote, and Northern Ireland is contemplating an independence referendum too; the UK will start negotiations to leave the EU in March 2017; French presidential elections will take place in April and May 2017, with the Front National, an isolationist, anti-EU party, expected to make it to the second round; and Germany will have its federal election in August 2017 with Angela Merkel at risk of losing power. The outcome of these and other events over the next few years will have important consequences. There will be risks for markets, but also opportunities.

But before we look into the future, let's look back in time.

Following the First World War, which ended 98 years ago, we saw the rise of fascism, in Italy with the election of Mussolini in 1922 and in Germany with the election of Hitler in 1933. On the other hand we saw communism established in Russia in 1917 and Japan embarked on an imperialistic vision of expansion. From 1929 to 1934, we had the greatest financial crisis of the twentieth century, and we all know that these events led to the most devastating war the world ever witnessed.

What is not lost on students of history is that a possible cause of all these events was the dramatic increase in inequality experienced in first few decades of the twentieth century leading up to the financial crises of 1929-1934.

Karl Marx saw that the new nation states were characterized by intensified inequality between the Capital and the working class. He predicted that if these inequalities continued to rise, there would be a breaking point and the Capital would be overthrown.

At the other end of the spectrum, fascism was a rejection of liberal democracy and advocated a totalitarian one-party state to prepare a country to respond to economic difficulties, often through protectionist and interventionist economic policies.

After WWII, Western democracies established social programs in areas of education, health and welfare that allowed a prosperous middle class to emerge. But since the beginning of the 1980s, these programs have been scaled back or eliminated. This combined with a rapidly aging population created a negative feedback loop. In addition, the rise of globalization, with poorly conceived multilateral agreements and weak dispute resolution mechanisms, has led to a hollowing out of the middle class.

The rise of the multinational company, a stateless economic actor, has created more imbalances.

Finally, the deregulation of the financial industry and the rise of financial engineering and speculation have created an explosive mix.

In summary, the decades between 1991 and 2008 saw inequalities rise to a level last seen in the 1920s. The result was the Global Financial Crisis of 2008 and central banks trying unorthodox policies such as quantitative easing and negative interest rates.

Although the economy seems to have recovered since 2008, globally unemployment remains high, particularly for young people, and the quality of jobs that have been created since then does not match those lost during the crisis. And the 1% captured even more of the wealth created.

So it is no surprise to see protest votes, a desire for change and a rejection of the current ruling class.

Where do we go from here? Uncertainty is a constant in financial markets. But even in the worst crisis, there is no lack of opportunities for investors.

Capital Market Performance During Times of War

	Large-Cap Stocks	Small-Cap Stocks	Long-Term Bonds	Five-Year Notes	Long-Term Credit	Cash	Inflation
1926-2013							
Return	10.0%	11.6%	5.6%	5.3%	5.9%	3.5%	3.0%
Risk	19.0%	27.2%	8.4%	4.4%	7.6%	0.9%	
World War II							
Return	16.9%	32.8%	3.2%	1.8%	3.0%	0.3%	5.2%
Risk	13.8%	21.0%	1.9%	0.8%	1.1%	0.0%	

Sources: The indices used for each asset class are as follows: the S&P 500 Index for large-Cap stocks; CRSP Deciles 6-10 for small-cap stocks; long-term US government bonds for long-term bonds; five-year US Treasury notes for five-year notes; long-term US corporate bonds for long-term credit; one-month Treasury bills for cash; and the Consumer Price Index for inflation. All index returns are total returns for that index. Returns for a war-time period are calculated as the returns of the index four months before the war and during the entire war itself. Returns for “All Wars” are the annualized geometric return of the index over all “war-time periods.” Risk is the annualized standard deviation of the index over the given period. Past performance is not indicative of future results.

Among the main proposals in Donald Trump's economic program are a reduction of taxes, increased infrastructure spending and protectionist measures to encourage US job creation. All three will have an impact on the deficit (increase) and inflation (rise).

There will be opportunities available. Companies exposed to infrastructure spending, in the US but also in the rest of the world, should benefit.

Rising inflation may have a negative effect on US bonds. However, rising inflation historically has led to outperformance of smaller companies.

The US dollar may weaken, but this should be a positive for the materials sector.

Donald Trump favours more traditional energy sources and advocates a rescinding of the Climate Action Plan and the Waters of the US rule, which would effectively allow drilling for oil and other fossil fuels in currently protected areas. He has also promised to invest heavily in the coal industry.

For health care, Trump has promised to repeal the Affordable Care Act (ACA), proposing state-level Medicaid for citizens instead. He has promised to fight to keep drug costs down by netotiating aggressively with drug companies and by removing barriers to entry for generic, non-patent alternative products.

The US may enact protectionist measures and more trade barriers. This may lead to outperformance of domestically focused companies, but may also lead European and Asian companies to pivot to faster growing economies in China and South East Asia.

Have a good weekend.

The Global Alpha Team