KANAWHA
CAPITAL MANAGEMENT

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IRRATIONAL REALITY

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So the wordsmiths over at Merriam-Webster selected the term *surreal* as the word of the year for 2016. Their dictionary defines *surreal* as “marked by the intense irrational reality of a dream.” Synonyms include *unbelievable* and *fantastic*. It was chosen on the basis of several major and sustained spikes in interest.

Not surprisingly, the largest spike in lookups followed the U.S. election. The presidential race had dominated the news cycle for over eighteen months. The electorate has become increasingly polarized with much of the media amplifying the partisanship. And virtually every political pro and pollster misjudged the outcome. For many, it *was* like a dream and for some, a nightmare.

The mood today ranges from elation to despair. For those in the latter camp, it is worth recalling that many voters were pretty unhappy following the election of George Bush in 2000 and Barack Obama in 2008 and yet the country muddled through. The satirist Jon Stewart — speaking seriously — provided some insightful context after the latest election:

> *“I don’t believe we are a fundamentally different country today than we were two weeks ago. The same country with all its grace and flaws, and volatility, and insecurity, and strength, and resilience exists today as existed two weeks ago.” — Interview with Charlie Rose, November 16, 2016*

Fiscal pivot

Shifting political appetites are not uncommon following a two-term presidency. Some observers are drawing parallels with the magnitude of the ideological pivot of the Reagan years. Ronald Reagan was obviously much more of a mainstream Republican and had an excellent relationship with Tip O’Neill, the Democratic Speaker of the House. But like Trump today, Reagan advocated large-scale tax cuts, deregulation, and more defense spending, a big departure from the status quo.

The first hundred days of the new administration will provide a much better sense of concrete policy action. Based on the rhetoric so far, a paradigm shift seems in order. Bridgewater Associates fund manager Ray Dalio posits that while the current period has been characterized by 1) increasing globalization and free trade, 2) limited fiscal policy, and 3) sluggish growth, low inflation and falling bond yields, we will enter a new regime of 1) decreasing globalization and connectedness, 2) aggressively stimulative fiscal policies, and 3) faster growth, higher inflation, and rising bond yields.

Ignore the gurus

As with the political arena, there has also been a surreal aspect to financial markets over the past year. And like their political counterparts, market gurus tended to miss the boat with their prognostications. Over the first four trading days of 2016, the S&P 500 dropped 5%, the worst start on record. By January 11, the strategists at RBS had seen enough. They advised investors to "sell everything" a call that was widely disseminated by major media outlets. Anxiety abounded and by early February, stocks were down 10.5%. If only this were a dream.

But as they are wont to do, investors overreacted — the mood too pessimistic, the selling too pronounced — setting the stage for a rally. At that point, bond king Bill Gross helpfully suggested that investors use the rally to "de-risk" (sell stocks). Needless to say, by mid-April, the stock market hit an all-time high.

And of course, 2016 was a year in which politics and geopolitics had a meaningful impact on financial markets. Donald Trump's election as our 45th president was not the only major shock. Another had occurred nearly five months earlier, also courtesy of voters, but in the United Kingdom. In a heated referendum, the Brits decided to pull out of the European Union.

Although divided by an ocean, Trump's ascendency and Britain's exit were tipped by similar forces. Both constituencies felt left behind by global integration with the benefits accruing to the elites. Market pundits issued dire warnings prior to both votes and initially, most asset markets did sell off sharply on the unexpected outcomes. Nevertheless, stocks quickly reversed course and rallied — again, counter to what the pundits had predicted.

Trump bump

Prior to the election, markets appeared stuck in a trading range, unable to break through to new highs. Sentiment has since shifted with investors now presuming that the new administration's initiatives will boost growth.

On the surface, a set of policies targeting lower tax rates, tax reform, regulatory relief, and infrastructure spending should be pro-growth. Indeed, multinational institutions like the World Bank and International Monetary Fund have been pressing OECD nations for more aggressive fiscal policy for years. The rub will be in the "cost" of such policies, primarily in the form of mounting government debt and higher interest rates.

Anecdotally, confidence is picking up. The National Federation of Independent Business recently reported that small business sentiment had jumped sharply, reaching its most optimistic level since 2005. Small firms anticipate higher sales. Meanwhile, Duke University's CFO survey indicated that optimism about the economy is now at levels not seen since 2007.

Although at times fickle and fleeting, confidence can be a powerful tailwind once it gains force. A surge in investor and business confidence could help lift the economy. John Maynard Keynes suggested that individuals often act on "animal spirits — a spontaneous urge to action" born of optimism, rather than some quantitative assessment of the future. Animal spirits lead to risk taking, encouraging businesses to expand and individuals to invest. Up to a point, this can be healthy for the economy; at other times, such sentiment may lead to hubris and speculation.

Hoover's folly

It is in the area of foreign trade and international relations where we see the greatest downside risk to the new administration's economic policies — and most potential to burst the current optimism about a step-up in U.S. growth.

Motivated by a desire to protect American jobs, Herbert Hoover signed the Smoot-Hawley Tariff Act into law in 1930. The legislation placed tariffs on imported goods which then triggered retaliatory tariffs on U.S. exports to other countries. Within several years, global trade volumes had collapsed more than 50%. Many scholars believe U.S. trade policy significantly amplified the depth and duration of the Great Depression.

Donald Trump has made protecting and restoring American manufacturing jobs a focal point of his movement. In his view, unfair trading practices and skewed trade pacts represent the primary villains. And his success in the upper Midwest, and the margin for his Electoral College win, was propelled by voters who feel harmed by globalization.

Make manufacturing great again

It is widely presumed that U.S. manufacturing has been in a long-term tailspin. But policymakers must draw a distinction between manufacturing *output* and *jobs*. Since the mid-1980s, the output of U.S. factories has *doubled* with one-third fewer workers. Many research studies actually view technology improvements and the ensuing productivity gains as the primary cause of the structural decline in manufacturing jobs, not foreign trade.

Among other things, Trump has announced his intention to renegotiate or withdraw from NAFTA, withdraw from the Trans-Pacific Partnership, and label China a currency manipulator. He has berated domestic manufacturers with plants outside our borders. The president-elect has also tweeted support for taxes on imports.

Since the 1970s, there have been numerous examples of administrations using trade restrictions to protect U.S. manufacturing. These policies saved jobs in the targeted areas but typically at great cost. They significantly increased costs for consumers and at times, for other manufacturers. In many instances, the total "cost" per job saved amounted to several hundred thousand dollars.

The rhetoric has been heightened but it remains to be seen how protectionist an agenda the Trump trade team will pursue. The group should certainly target those specific areas where U.S. companies are at an unfair disadvantage. Securing intellectual property rights represents one obvious example.

Trump dump?

Stocks have rallied in anticipation of an accelerating economy and rising corporate profits. Markets seem to be buying the narrative of fiscal reflation (from tax cuts, deregulation, and infrastructure spending) combining with benign monetary policy to ramp up the U.S. growth rate.

Investors should remain cognizant of the unintended consequences of policy initiatives. Encouraged by the Fed, inflation expectations had already begun to creep up; they have advanced further since the election. And we have likely seen the 30-year low in interest rates. There could be tension between growth and yields.

As stocks have marched to all-time highs, valuations have climbed above historic averages. Higher valuations tend to resolve themselves in one of two ways. They normalize due to either growth in earnings or declines in stock prices. The former, of course, is the preferred path. It is too early to determine whether the markets have over- or under-reacted to potential policy shifts. But hopefully for stocks, a healthier economy and stronger corporate earnings can prevent the Trump *bump* from turning into the Trump *dump*.

— Christopher J. Singleton, CFA, Managing Director

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