Market Update

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The financial markets began the fourth quarter of the year on a sour note, reflecting uncertainty and national frustration surrounding the most dispiriting and divisive election in memory. The S&P 500 Index dropped 1.9%, while the Dow Industrials trimmed 0.9%, and small cap stocks lost 2.3%. The decline was broad based, with nine of eleven sectors in the S&P posting negative returns. Only utilities and financials were higher at month end. Interestingly, bond investors also shared in the pain, as U.S. Treasury Bonds sold off, lifting yields on the 10-year UST from 1.6% to 1.8% by month end. Even international stocks got in on the action, with the EAFE Index falling 2.0%.

It is a relatively unusual and disconcerting occurrence for stock and bond prices to trade lower in tandem, as expectations for slower growth and lower corporate profits are coupled with higher inflation expectations. Many of our readers will recall the term "stagflation" and shudder at the thought; we are not predicting a return to the 1970's, but we do see economic growth moderating and interest rates moving higher with price pressures building modestly throughout the global economy (just about everywhere but Japan). Perhaps "secular stagnation" is a more appropriate term in the current context.

We see three possible causes, which are not mutually exclusive:

Inflation

With all the noise from the election and global economic uncertainty, it's even more challenging than usual to read market signals. While price gains are just starting to tick upward from very low levels, the current consensus among economists is for U.S. inflation to exceed the Fed's target of 2.0% in each and every quarter next year. Inflation in the U.K. is expected to exceed 2.0% and even the euro zone is anticipating inflation above 1.0% in 2017. Consumer prices are on the move, and except for Japan, they're trending higher across the developed markets.

Tightening Monetary Policy

Central banks such as the European Central Bank and the Federal Reserve are also antagonizing markets as they change their respective courses. The ECB is under pressure to begin tapering its monthly 80 billion euro ($90 billion) purchase program, and the Fed seems ready to raise rates in December. The futures market is pricing in a roughly 70 percent chance of a rate hike next month, which will be just the second time in more than a decade that the Fed has done so. The unwinding of quantitative easing on the continent and the end of ultra-loose monetary policy at home puts downward pressure on the prices of financial assets, both stocks and bonds alike.

The U.S. Election

Uncertainty regarding the outcome of our presidential election is not helping matters. Financial markets don't "think" or "feel", despite the common tendency to ascribe human attributes to them. But markets do serve to aggregate and process economic data, and the interpretations of those outputs are often subject to human perception and bias. If financial markets "hate" uncertainty, the probability of a Trump presidency (along with its inherent ambiguity and unpredictability regarding future policy decisions) is a driver of volatility.

Let's examine the potential implications of the two presidential election outcomes more closely, with a few caveats: accepting proposed policy shifts at face value is a fool's game. No one can predict what the final version(s) will look like under the best of circumstances, even less so with an impaired executive trying to advance his or her initiatives through an instransigent and evenly split Senate. *Most importantly, the following represents our analysis of the economic implications of the election. As our client, rest assured that yours is the only side we take in the stewardship and management of your assets.*

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IF CLINTON WINS

Clinton's agenda and its attendant policy implications are far easier to gauge than Trump's. She is viewed as an extension of President Obama's initiatives and the status quo. Both candidates are proposing fiscal stimulus in the form of infrastructure spending. Hillary's spending is more modest, targeting $250 billion over five years, plus a $25 billion "infrastructure" bank to leverage private spending on infrastructure projects. The projects would be paid for with higher corporate taxes.

With respect to trade, Hillary has renounced her early support of the Trans-Pacific Partnership (which she helped negotiate) and promises to oppose it if elected. To be sure, Bernie Sanders and Trump have both pulled Clinton away from her earlier pro-trade posture. Sadly, the populist rhetoric of this political season have put the U.S. economy on on a lower trajectory as America becomes more protectionist and retreats on global trade. If there's a silver lining with respect to trade under a Clinton presidency, it is that renegotiating trade deals would probably not be an immediate priority for her administration.

Regarding taxes, Hillary has indicated that she would raise income taxes on the wealthy and increase both tax rates and holding periods for capital gains. These initiatives, while generating revenues for the Treasury, would have a negative impact on many of our clients. Additionally, Mrs. Clinton has proposed (as has Mr. Trump) to temporarily cut taxes on U.S. corporate profits held abroad in an effort to repatriate those funds and stimulate the economy. Both candidates' repatriation plans would be stimulative to the economy, we believe, as the infusion of revenue could improve capital investment and lead to further job creation. It should also allow some companies to pay off debt or return cash to shareholders, both of which we generally view positively. While repatriation of corporate profits is unambiguously positive, changes to personal and investment-related tax rates will have significant hurdles to clear in Congress.

In sum, a Clinton victory would very likely be well received by the markets in the short term. Her proposals to raise revenues (about $1 trillion over ten years) should help improve long term deficits, although the concurrent impacts of reduced spending by those paying higher taxes are almost impossible to estimate. Growth will probably suffer at some level. The greater predictibility of her policy path and less negative impact on the federal deficit would give market participants and trade partners some confidence around which to build projections.

IF TRUMP WINS

The gap between Mr. Trump's campaign rhetoric and what he can accomplish as president is exceedingly difficult to assess. That makes us – and other market participants – nervous. So we must attempt to analyze his stated plans and extrapolate forward… while still holding out hope that he self moderates (or is constrained by Congress) should he win the oval office. As mentioned earlier, both candidates have made much of infrastructure investment on the campaign trail. Trump's plan is to spend "at least double" what Hillary is proposing on infrastructre projects, which is expected to climb to almost $1 trillion over ten years. Rather than government lending and corporate taxes, Trump would rely on tax credits and private lending as the sources of funds.

He has been harshly critical of existing trade deals, famously referring to the North American Free Trade Agreement (NAFTA) as the "single worst trade agreement ever approved in the country," and promising to slap a 45% tariff on imported Chinese goods. Since this issue has been a pillar of his campaign, we would expect Trump to make it a high priority, possibly going so far as to appoint a U.S. trade representative who would quickly declare unfair trade practices and thereby allow Trump to exercise executive privilege and circumvent Congress. A tariff would immediately drive up the cost of many consumer goods, which could easily become a consumer-led recession, as imports of good and services into the U.S. (according to the Bureau of Economic Analysis) were $2.7 trillion in 2015. That's about 15% of our $18.2 trillion GDP measure for last year. And retaliation is practially a foregone conclusion if Trump moves aggressively. We can easily envision trading partners successfully petitioning the World Trade Organization seeking permission to retaliate against the U.S., damaging our exports. Since exports make up about 12% of GDP ($2.1T in 2015), the combined impacts of Trump's trade proposals would almost certainly be negative for the domestic economy.

With respect to taxes, the aforementioned reptriation of corporate profits would be stimulative. Less clear is the overall effect of Trump's plan to reduce the number of personal tax brackets from seven to three, while lowering the highest marginal rate from 39.6% to 33%. Combined with a reduction in the corporate tax rate from 35% to 15%, revenues into federal coffers would likely decrease by $5.8 trillion over the next ten years (per estimates from the non-partisan Committee for a Responsible Budget). Mr. Trump's corresponding spending cuts of $1.2 trillion are grossly insufficient to cover the revenue shortfall, so the federal deficit will expand significantly.

Interestingly, Mr. Trump's tax plan is not far off the plan that Republicans in the House of Representatives have already proposed. But that is not to suggest that either will gain enough support from Congress, as the ballooning deficit is projected to add an additional $700 billion to interest payments over the ten year period.

Regulatory reform is one area where President Trump could provide a meaningful improvement, at least in the short term, to the domestic economy. Environmental regulations have hampered some domestic industries, particularly in the energy sector, and a Trump rollback would help those companies. Similarly, Donald has been highly critical of the mountain of new financial regulations pursuant to the Dodd-Frank bill of 2010. Investment in the sector (and therefore productivity gains) have been impaired as a result of the regulatory overhang. And of course, Trump has reserved a special kind of venom for Obamacare, which he views as having decimated the healthcare system. Although it's difficult to quantify the true costs of regulation, we think it's fair to suggest that pulling back on regulatory overreach is an excellent way to stimulate business investment – and that a lack of business investment has been one of the reasons this recovery hasn't taken off as briskly as we'd hoped.

In sum, a Trump victory in the presidential election is unlikely to be favorably received by the markets, at least initially. Given his unpredictable and unsettling behavior, his anti-trade stance and his deficit-exploding proposals, it is difficult to see – in economic terms – how detractors outweigh the positive aspects of his platform.

What does all this mean for our clients?

August, September and October have been volatile months for financial assets in recent years, and 2016 was no exception. A Clinton victory on election day will likely be a boon for investors, after trading lower in recent weeks as the odds of a Trump victory improved somewhat. Conversely, anxiety and pessimism are likely to assail the markets, at least in the short term, if Donald is elected – leading to a further decline in equity values. Bonds may also come under pressure, as the prospects for massive defict spending weigh on the value of already issued fixed income securities.

We remain committed to you – first and foremost – and look forward to a measure of clarity and visibility once the election results are finalized. We earnestly hope that, as a nation, we can turn the page and look forward together with a new sense of unity and purpose.

Reminder

If you haven't verified your attendance at our client reception on Wednesday, November 30th at the Country Club of Harrisburg, please RSVP at your earliest opportunity. As a reminder, participants will enjoy a fascinating presentation on behavioral finance by Dimensional Fund Advisors (the firm founded by Nobel laureate Eugene Fama) and an economic brief by FMA Advisory. The event begins at 5:30 p.m. and you may confirm your attendance directly with us at:

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