May 13, 2016

Thinking About a Trump Bull Market

With June quickly approaching, we'd like to update our stock and political outlooks.

Year-to-date, equity markets have behaved how we generally outlined in our 2016 Outlook on January 5th. We were bearish on stocks, forecasting the S&P 500 to sell off close to 10% because of excessive Fed hawkishness, and then rebound strongly as Fed members cave to the selling pressure and fear of slowing economies and tail risks around the world.

Of course, the low in stocks on February 11 coincided with Janet Yellen's testimony before Congress that made the case for two to four rate increases this year. But soon thereafter, as we highlighted in our client letter on February 19, Fed officials including Jim Bullard, William Dudley, and Eric Rosengren began to back off that hawkish telegraph to the market, setting the stage for the nearly 15% rally between mid-February and mid-April.

As of our April 6 client letter, we have been neutral in the near-term on U.S. equities because, with the Fed being the primary driver of stocks at the moment, we are concerned that hawkish Fed comments will resurface.

In January, we were also bullish on Treasuries and oil, believing the 10-year was a great buy around 2.10-2.20% and predicted oil, which started the year at $37, would trade above $50 at year-end. Today, with the 10-year Treasury at 1.78%, we aren't as bullish but are comfortable with owning Treasuries.

As for oil, we are even more bullish than at the beginning of the year. With gold now trading at $1275, compared to $1065 in early January, the weaker dollar creates even more support for oil.

Of course, the historical ratio between oil and gold is 15 to 20 barrels per ounce of gold. In February, that ratio reached an extraordinary 48+ intraday; the most extreme level in the ratio that we've seen in the data since 1860. The oil-gold ratio is mean-reverting, so we are convinced that it is only a matter of time before the ratio reaches 20 again, likely within the next 12 months. The ratio now trades at 28; a 20 ratio with gold trading at $1275 would push oil to $63.75. Bottom line: we still like oil very much.

So today, we find ourselves in a generally neutral equity market environment. Conventional wisdom leans toward a cautious view of 2017, where value stocks are favored over growth, U.S. equity returns are relatively in-line with international equities, and fears of a market downturn remain elevated. Few are contemplating an energized bull market for next year

But we believe that the U.S. stock market is very likely on the verge of a strong bull market for one crucial reason: Donald J. Trump. We expect Trump will be elected President in November, and will usher in a powerful bull market, which stocks may begin to sense and start discounting later this year. Remember Bartley's "Seven Fat Years?" We're going to see them again.

Trump's positioning to the left of Hillary on foreign policy, right on economic policy, and left on trade and immigration is the winning policy combination this year.

Even more, we view Trump to be a more astute politician than anyone really gives him credit for. The conventional view holds that Trump is a big personality or ego-maniac, ad-libbing a presidential campaign, capturing most Americans for its entertainment value more than anything. This view is dead wrong. Trump is a brilliantly calculating leader using the powers of persuasion we haven't seen in years, making seasoned politicians look like amateurs.

Trump's attacks -- such "low energy Jeb," "Little Marco," "Lyin' Ted," and "Crooked Hillary" – are framing the perceptions of voters and devastating his opponents. These are carefully conceived caricatures that Trump has A-B tested on the campaign trail.

Today, in the subconscious of the American electorate, the race for the next President of the United States is between "Make American Great Again" and "Crooked Hillary." Trump wins that contest, and during his first 100 days as President, he will marshal in a wave of policy changes.

Every new Administration in the modern era has leveraged the momentum of an election to implement sweeping changes in its first 100 days; for example, Reagan after Carter, Bush 41 after Reagan, Clinton after Bush, Bush 43 after Clinton, and Obama after Bush. The next White House will be no different.

The primary policy change a Trump White House will demand early next year will be major corporate tax reform that sees the corporate tax rate slashed from 35%. 15% is goal; but even 20% will do. And Chuck Schumer, whom we expect will be Senate Majority Leader if Democrats regain the Senate, will look to make a deal. Certainly, Trump recently polling even with Hillary in three key swing states – Ohio, Pennsylvania, and Florida – suggests that if more Senate Republicans join the Trump bandwagon, Republican odds of retaining the Senate improve.

With a dramatically reduced corporate tax rate, the after-tax returns on corporate projects sitting on shelves will sky-rocket, and those plans will be put to work, igniting job creation. Even more, we expect income tax rates on all levels of income will be slashed, as will the capital gains tax.

2017-2018 is shaping up to be a strong bull market.

For years, monetary policy makers, from the Fed to the ECB to the BOJ, have clamored for fiscal stimulus to support economies. It comes next year.

What will this mean for Fed policy? The Fed clearly realizes that it has been the primary driver of the weakness and fear in financial markets and economies during the last year, as well as their rebound since February. St. Louis Fed President Bullard expressed his astonishment in March at how markets priced in all of the expected Fed rate hikes rather than incrementally discounting future data-dependent quarter point increases. We expect the Fed to be timid in raising the funds rate this year given its recent experience, the June Brexit vote, and the November elections. However, just as the June 2003 tax cuts ignited a stock market boom and set the stage for the Greenspan rate hikes in 2004, the 2017 bull market will give Fed officials more comfort, and breathing space, to raise the funds rate. Treasuries may not be your best friend next year.

Frankly, the error acknowledged by Bullard is silly one for the Fed to have made, and it must be carefully reviewed in its communications research. The 2004-2006 rate hiking cycle is a case in point. Even though Alan Greenspan telegraphed a relatively vague "prolonged, measured rate hiking cycle," the 10-year Treasury yield sky-rocketed to a peak of 4.85% during the second quarter of 2004, which turned out to be only 40 basis points below its peak in June 2006, just before the conclusion of that policy cycle. In the face of uncertainty, financial markets typically discount the worst initially, then float to a more "equilibrium level" as uncertainty becomes more quantifiable and known (i.e. uncertainty evolves into risk).

Importantly, Donald Trump is attuned to the implications and power of monetary policy. More than anyone on the campaign trail, he has warned about the precariousness of financial markets and the economy, and cautioned the Fed on raising interest rates any further for fear that it will severely harm growth and risk assets. Of course, he is correct.

Note that Trump has already put Yellen on notice: "I think she's done a serviceable job… I don't want to comment on reappointment, but I would be more inclined to put other people in." Most of us (BWR and clients) would say something quite similar if we were in the same position at this point in the campaign.

Even more importantly, though, Trump has highlighted the practical weaknesses of free trade deals that have no mechanism to adjudicate competitive devaluations by routinely lambasting China's monetary authority for manipulating the yuan, which is 8% weaker against the dollar since January 2014. At its heart, Trump is espousing a Mundellian foreign exchange policy of fixed exchange rates. Unlike Ted Cruz who was comfortable on national television talking about anchoring the dollar's value to gold, Trump can talk about trade deals in terms of their practical flaws, which put U.S. industry and jobs at risk. In our view, Trump has the chops to assess monetary policy developments in his presidency better than any President since Reagan.

The risk is real that if Trump succeeds with his fiscal agenda, the Yellen Fed will work at cross purposes and try to raise rates quickly. This evokes the monetary/fiscal split following the 2003 tax cuts and the cross-purposes that brought on the 1980-1982 recession of Reagan-Volcker. If Trump wants to protect his legacy, he will work carefully with classically-minded advisers to craft a monetary policy reform program that mandates the Federal Reserve to target gold or the general commodity-price level rather than interest rates. Almost certainly, an interest-rate hiking cycle in conjunction with dollar instability will ultimately suppress or nullify the power of the Trump tax cuts, just as the 2004-2006 rate cycle did for the Bush tax cuts with the 2008 financial crisis.

We are fortunate to have some of the world's brightest portfolio managers as clients, and the most popular concern raised in recent months with our Trump bull market scenario is the prospect of a trade war, where tariff barriers are erected, Smoot Hawley-style. It's certainly a fair, legitimate worry. But we do not believe it is cause for major concern.

Trump's promises that "Mexico will pay for that wall," "we'll renegotiate with China," and "those companies won't leave the U.S. anymore," these are all negotiating tactics by the man who wrote *Art of the Deal*. Trump is taking an extreme position that will move the middle in favor of the United States in future compromises with trading partners. We don't see Trump to be a Herbert Hoover, but rather a pragmatic businessman. Therefore, in our model, competing tariff battles in coming years is a low probability scenario.

This is, of course, a strongly outside-the-box scenario. Needless to say, however, we are very constructive about the fiscal and stock market possibilities for investors if Donald Trump is elected the 45th President of the United States.

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