

## Investing Around Trumponomics

Financials markets have moved materially since Donald Trump managed to pull off an upset in the U.S. presidential race and the Republicans maintained control of Congress. His win was surprising to most, and we were not betting on the outcome. However, it is consistent with our work on political instability, which highlighted that the perfect storm was building within the U.S. (**table 1** on page 3). Specifically, the sluggish economic expansion since 2009 has created chronic frustration for many (widening the intolerance gap), excessive inequality is fueling resentment, and the lack of education and unskilled jobs is limiting social mobility. Together these forces create a sense of desperation and willingness of voters to try something extreme, at a point when the battle among “elites” is polarizing political views. Europe faces similar challenges (albeit to a lesser extent), with important elections on the horizon.

Now that U.S. voters have elected Trump, investors are looking for an appropriate framework to judge risk and reward. Today’s **MRB Strategic Trader Report** makes an initial attempt on this front. In short, we anticipated that markets would have suffered a few days of risk-off upon a Trump victory, but that solid underlying economic and policy conditions would ultimately prove supportive. Although Clinton was a lower risk bet, Trump could prove to be more supportive of **cyclical** growth conditions, provided he backs away from protectionist policies. The longer-term outlook is more clouded under Trump.

### MRB TradeBook

p.2

- A Trump presidency creates more political, economic and financial market uncertainty over the long haul than had Clinton won. However, the outcome is likely to be stronger near-term growth, at the expense of longer-term sustainability.
- Trump’s economic proposals are largely designed around bringing forward economic and profit growth. This is cyclically constructive for stocks over bonds.
- Protectionist or isolationist policies would be a mistake that would detract or derail the pro-growth elements of his economic plan. While Trump will likely seek symbolic wins to appease his voter base, it will be important for equity markets that he largely mutes or shelves these policies.
- Being President provides ample media attention and Trump is taking over a solid and improving economy that will be credited to him. Thus, his need for controversy **may** be easing, causing this tail risks to recede (until the next economic downturn).
- Maintain a mild pro-growth investment stance, and favor stocks over government bonds.
- Stay long U.S. bank stocks and look to add exposure in global construction materials on a pullback. Do not chase coal and energy stocks.
- Remain long the U.S. dollar on expectations for firm growth and gradually higher interest rates.
- Expect G7 bond yields to move up slowly, but keep tight stops on yield plays.

## MRB TradeBook

View print version with reference charts (pdf format)

Current Trades	Initiation Date	Gain/Loss (%)	Exit Point <sup>1</sup>
<b>Equities</b>			
Global: Short Consumer Discretionary/Long Benchmark	11-Feb-16	2.97	-4.0%
U.S.: Long Banks/Short Benchmark	11-Feb-16	21.11	-4.0%
<b>CLOSED</b> Long U.S. Telecom Services	11-Feb-16	<b>10%</b>	10.0%
Long Global Capital Goods and Software & Services	17-Feb-16	17.40	10.0%
U.K.: Short Small Caps/Long Large Caps	23-Jun-16	8.07	<b>5.0%</b>
U.K.: Short Consumer Discretionary/Long Benchmark	23-Jun-16	11.37	<b>5.0%</b>
Banks: Long US and Euro Area/Short Canada	11-Aug-16	15.43	-7.0%
<b>CLOSED</b> Long India & Indonesia/Short Russia	11-Aug-16	<b>-7.0</b>	-7.0%
<b>Foreign Exchange</b>			
<b>UPDATE</b> Long SEK/EUR	11-Feb-16	<b>-6.56</b>	<b>0.10</b>
Long U.S. Dollar Index (DXY)	06-Nov-15	2.34	92.0
Short CAD/USD	22-Jul-16	2.41	-
<b>Fixed Income</b>			
Long EM U.S. Dollar-Denominated Debt/Short 10-Year U.S. Treasuries	10-Oct-13	4.46	Spread: 4.2%
Long U.S. High-Yield Corporate Debt	08-Oct-15	10.11	Yield: <b>7.0%</b>
<b>Alternatives</b>			
Long German Real Estate <sup>2</sup>	23-Nov-10	32.26	-
<b>NEW</b> Short Gold	<b>11-Nov-16</b>	<b>1.98</b>	<b>\$1,250/oz</b>
<b>NEW</b> Long Global Stocks/Short G7 10-Year Government Bonds	<b>17-Nov-16</b>	-	<b>-5.0%</b>
<b>Shadow Trades</b>			
Bank Stocks: Long Euro Area/Short U.K.	06-Jul-16	-	-
Emerging Market Stocks: Long Asia/Short Commodity Producers <sup>3</sup>	11-Aug-16	-	-
U.S. Stocks: Long Financials/Short Real Estate	08-Sep-16	-	-
<b>NEW</b> Long Global Construction Materials Stocks/Short Global Benchmark	<b>17-Nov-16</b>	-	-

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<sup>1</sup> Exit points for equities and stock/bond ratios are expressed as the % gain/loss generated if trade is stopped out. See reference charts for details.

<sup>2</sup> Proxied by German house prices

<sup>3</sup> Market cap-weighted; commodity producers: Brazil, Chile, Colombia, Peru, Russia and South Africa (i.e. we omitted the commodity producers in emerging Asia)

Note: Gain/losses are based on daily closing values. Gain/loss is calculated in U.S. dollars unless otherwise stated; recommended trades are intended to be held for a minimum of three months, and may last more than a year. Nevertheless, we use exit points in order to control risk. *Shadow Trades* are investment opportunities that we plan to implement once timing is appropriate.

Investment Theme

**Macro Framework For Trump**

All politicians have distinctive personalities that form their policy biases. Independent of one’s political views, most investors can agree that Trump has many extreme character traits (including many faults), which were well documented during the presidential race, as well as during decades of media appearances and business deals. These personality traits often make him volatile and will undoubtedly periodically cause heightened market anxiety over the next few years. However, they also make Trump *somewhat* predictable, allowing for at least a crude economic and investment framework.

Such a framework provides insight into how conditions are likely to evolve if Trump was unrestrained. In practice, it will indicate more of the direction that policy is heading, with the need for investors to overlay their expectations of the extent to which mainstream political realities will constrain him. Although Trump has many extreme traits, we will focus on those that are most notable for shaping his economic policies and top-down investment strategy.

On balance, we conclude that a Trump Administration certainly brings with it some major tail risks. However, the U.S. economy was already in solid shape and his efforts to promote fiscal stimulus and deregulation will add to the cyclical economic and profit expansion, provided he backs away from isolationist policies. His initiatives may well darken the outlook for the next generation, but financial markets will not look that far into the future.

***Trump’s Pro-Growth Traits & Policies***

- 1) **Make Aggressive Leveraged Bets:** Trump has a long history of making aggressive bets that are debt-financed. This often goes with the territory of real estate development, and it can work in the business sector due to the limited liability of corporations. Although overly generalized, those with a portfolio of independent businesses funded by borrowing money can effectively walk away from losses while reaping rewards of the successes. This approach skews the risk/reward profile and incentivizes aggressive bets, provided you can continue to borrow. In contrast, the U.S. government (and ultimately taxpayers) cannot simply walk away from losing bets. Trump has previously suggested that he could restructure the U.S. government debt if needed, but such statements fail to grasp the adverse impact this would have on the U.S. (and global) economy and financial markets and the dollar.
- 2) **Fixated On Short-Term Gains:** Consistent with betting aggressively, Trump’s focus is predominantly on obtaining immediate payoffs. This is probably the most critical

**Table 1 Forces Driving Political Instability**

Large Intolerance Gap = Frustration
Excessive Income Inequality = Resentment
Lack Of Social Mobility = Desperation
Elite Overproduction = Battle For Power
Collectively = A Perfect Storm

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Trump's extreme character traits provide for at least a crude economic and investment framework

Trump makes big bets focused on short-term gains

observation for investment strategy, since much of his economic plan revolves around short-term gains at the expense of future generations.

3) **Prioritizes Personal Interests:** Trump is fairly blunt about looking after his own financial interests above all else. He prides himself on getting away with bending rules (including tax policy) and regularly battles in court to do so. Proponents of Trump hope that this means he will fight hard for their interests and/or those of the country, which may be true *if* interests are aligned. Regardless, investors should expect the order and importance of Trump’s policies to fit with his personal interests.

**Tax Cuts:** Trump is calling for substantial personal and corporate tax cuts. Clearly, this aligns with his interests, but also with many other wealthy individuals, business owners and investors that would disproportionately benefit. Equity markets will generally like this policy. However, it should be expected to only create modest economic growth, rather than a substantial boost. Trump’s fixation on supply-side economics is merely an attempt to justify a policy that is not in the long-term best interest of the country, and most economists would discredit its application to the current U.S. economy.

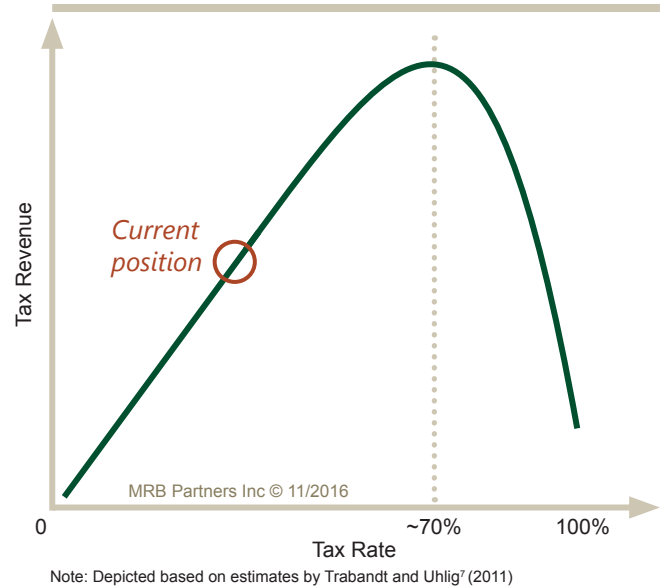
The starting point of personal tax rates in the U.S. is already low on the Laffer Curve<sup>1</sup> and cutting further will largely lead to wider deficits, rather than an offset associated with increased economic activity (**chart 1**). Also, the effective corporate tax rate is not much higher than what Trump has proposed (**chart 2**). Regardless, the U.S. is too large to competitively lower tax rates and steal enough market share from other economies to materially shift its domestic economic needle. Businesses are already located in the U.S. for other competitive reasons. Instead, cutting taxes will largely transfer wealth from the nation (present and future) to businesses and the wealthy today, and the latter have a low propensity to consume.

*In short, the net result of tax cuts will be modest near-term growth at a disproportionate expense to public coffers and future taxpayers. Nonetheless, this policy is bullish for earnings and P/E ratios over the next couple of years.*

**Infrastructure:** Spending on infrastructure does create a boost to the economy that aligns well with the business interest of the Trump family and friends, making this likely

<sup>1</sup> The Laffer Curve explains the relationship between economic activity and the rate of taxation. It suggests the existence of an optimum tax rate that maximizes tax revenue. In short, when tax rates are lifted too high, economic activity becomes restrained and aggregate tax revenues are reduced. In contrast, when tax rates are already low, cutting them further does not boost economic activity materially and overall tax revenues fall. The U.S. is currently on this part of the curve according to most studies.

Chart 1 The U.S. Laffer Curve: Cutting Taxes Will Lead To Larger Deficits




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Tax cuts are a gain for the wealthy and business owners, but will not create much growth

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to be a top priority. It could also be an additional catalyst to encourage a pickup in corporate spending (**chart 3**). The offset is that there is a lack of “shovel ready” projects to absorb the funds suggested, so investor optimism may be premature.

From a longer-term perspective, infrastructure spending will also increase government debt. Trump has floated the idea of public/private financing schemes. Although we agree with the appeal of an infrastructure bank, these schemes have largely failed everywhere in the world, even in China which owns the companies that it is trying to incentivize. The problem is that the role of infrastructure in an economy is to generate positive spillovers to other sectors, not to generate revenue (which is why governments almost always end up financing the whole project). In the case of the U.S. proposal, the returns assumed are extremely high for long-term assets. Also, Trump has suggested that infrastructure will be revenue neutral for the government because of the growth it creates. This is merely supply-side wishful thinking.

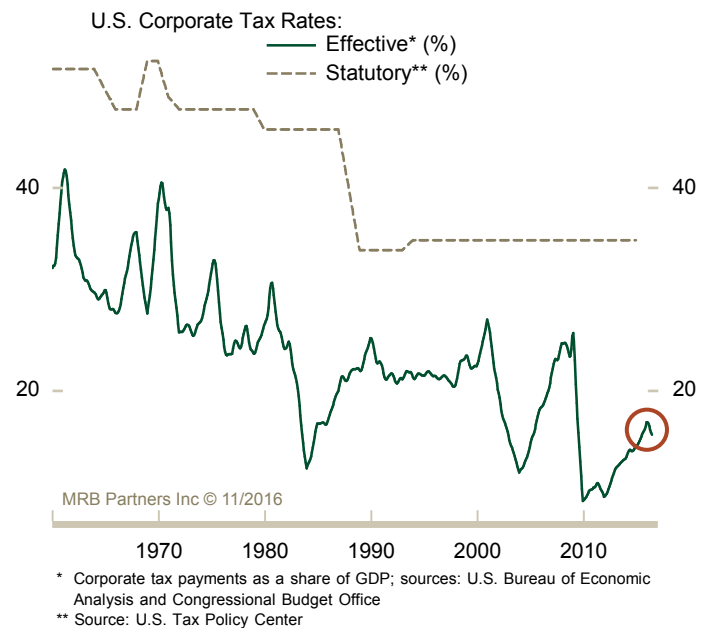
*The U.S. will undertake an infrastructure spending program. Much of this will end up being government debt financed, which may restrain the ultimate size of the program. Nonetheless, it should provide a boost to economic growth over the next couple of years, which is constructive for equities.*

**Deregulation:** Efforts to deregulate businesses is a key element of the Republican platform. Reduced regulations is supportive of corporate profits, and can help economic growth. The offset and longer-term policy challenge is that the corporate sector and capital markets (in the U.S. and around the world) have repeatedly proven not to self-regulate, as former Fed Chairman Greenspan painfully learned. Intense competition, shorter-term shareholder demands, and the structure of executive compensations all work against long-term objectives. Arguably these longer-term societal objectives are not the corporate sector’s responsibility, but rather the role of government. Thus, while the current regulations may not be appropriate, if left to its own devices, the corporate sector will (continue to) create economic boom/bust cycles.

*The U.S. government will attempt to deregulate parts of the corporate sector, or at least limit further regulations. This is bullish for equities and risk-taking, especially for industries affected, including financials and drug companies.*

**Environment:** Trump has suggested that climate change is a hoax. It is unlikely that he is that uninformed, but rather dismissing global warming allows for policies that capture

**Chart 2 U.S. Corporate Tax Rate Is Already Low**



Infrastructure spending will boost growth, but will be more debt financed than proposed

growth now at the expense of future generations, consistent with his focus on short-term gains. By removing environmental costs and restraints from business decisions, it will increase drilling and other commodity-related extraction activities. That said, much of the cyclical and structural outlook for these stocks will still be capped by the global price of commodities and the substantial supply overhang.

*Relaxing environmental restraints will provide a near-term boost to growth and benefit traditional commodity stocks over alternative energies.*

**Trump’s Negative-Growth Traits & Policies**

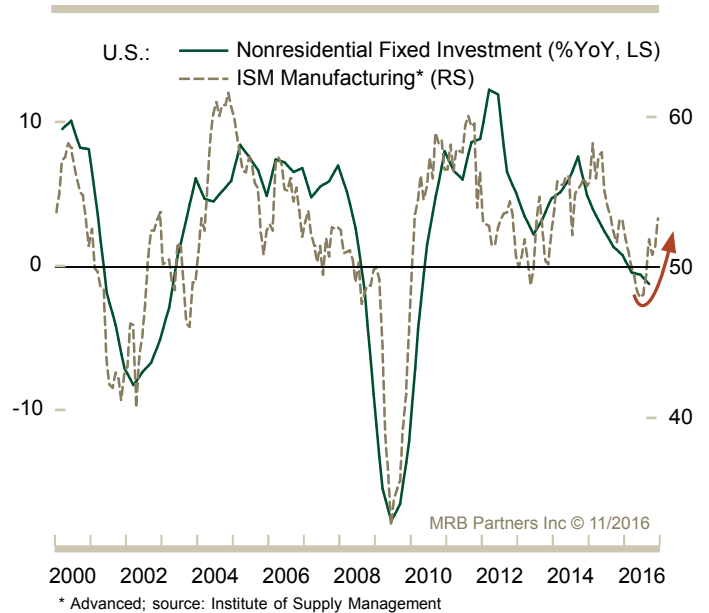
**4) Debatable Batting Average:** Whether you are a fan of Trump’s aggregate business track record or not, he often strikes out, and at times on what (at least from an outside perspective) appear to be questionable business models. It is well documented that he has had a handful of business bankruptcies and a host of other failures and/or disappointments, including an airline, magazine, university, mortgage company, vodka, etc. Whether this is bad luck, a lack of prior homework, overestimation of his brand’s value, etc. is up for debate. What is important for investment strategy, is that he does not *always* make sound judgements, including on a few components of his current economic plan. A major role of his cabinet and advisors will be to steer him away from such policy mistakes.

**5) Prides Himself On Deal Negotiations:** Whether or not this should be a source of pride for Trump, it is clear he wants to be known for being an expert in negotiations. The problem is that he may be determined to renegotiate policies that will be detrimental to the U.S. (and global) economy, such as trade agreements with other nations.

**Protectionism & Immigration:** Much of Trump’s economic plan is designed around boosting near-term growth at the expense of the future. However, his anti-trade and anti-immigration rhetoric works counter to his agenda by raising long-term and short-term risks. His suggestion that isolationist policies would recapture manufacturing jobs is naïve, as we pointed out in a recent two-part **MRB Theme Report**<sup>2</sup>.

Adopting protectionism gives up the net benefits increased global trade has created, including economic/profit growth, disinflation and lower borrowing rates (**chart 4**). In the end, protecting uncompetitive domestic industries comes at a hefty and persistent cost to taxpayers and/or consumers. Also, retaliation from trading partners could crush corporate

**Chart 3 U.S. Business Investment Is Set To Improve**



Trump's economic plan has some clear policy mistakes

<sup>2</sup> MRB Theme Reports, *“Forced De-Globalization (Part I): Benefits And Costs Of Trade”*, November 8, 2016 and *“Forced De-Globalization (Part II): Blame Technology Not Trade”*, November 10, 2016

profits in domestic industries that are competitive, costing more wealth and job losses than those salvaged by anti-trade policies. It is also worth noting that global trade has taken an unfair amount of the blame for manufacturing job losses. Technology advancements have also played a major role around the world (chart 5). Politicians cannot stop this trend and protectionism does not recoup these jobs. The risk is Trump believes otherwise and becomes determined to negotiate.

That said, Trump may not understand the problem of higher consumer prices on the average household, but he appreciates the corporate profit impact of global trade. Trump's businesses regularly outsource manufacturing and buy cheaper inputs from abroad. Thus, most likely he will merely agree with foreign leaders on something symbolic so that he can claim it as a win. An example would be on Chinese steel, as China's government already wants to reduce capacity.

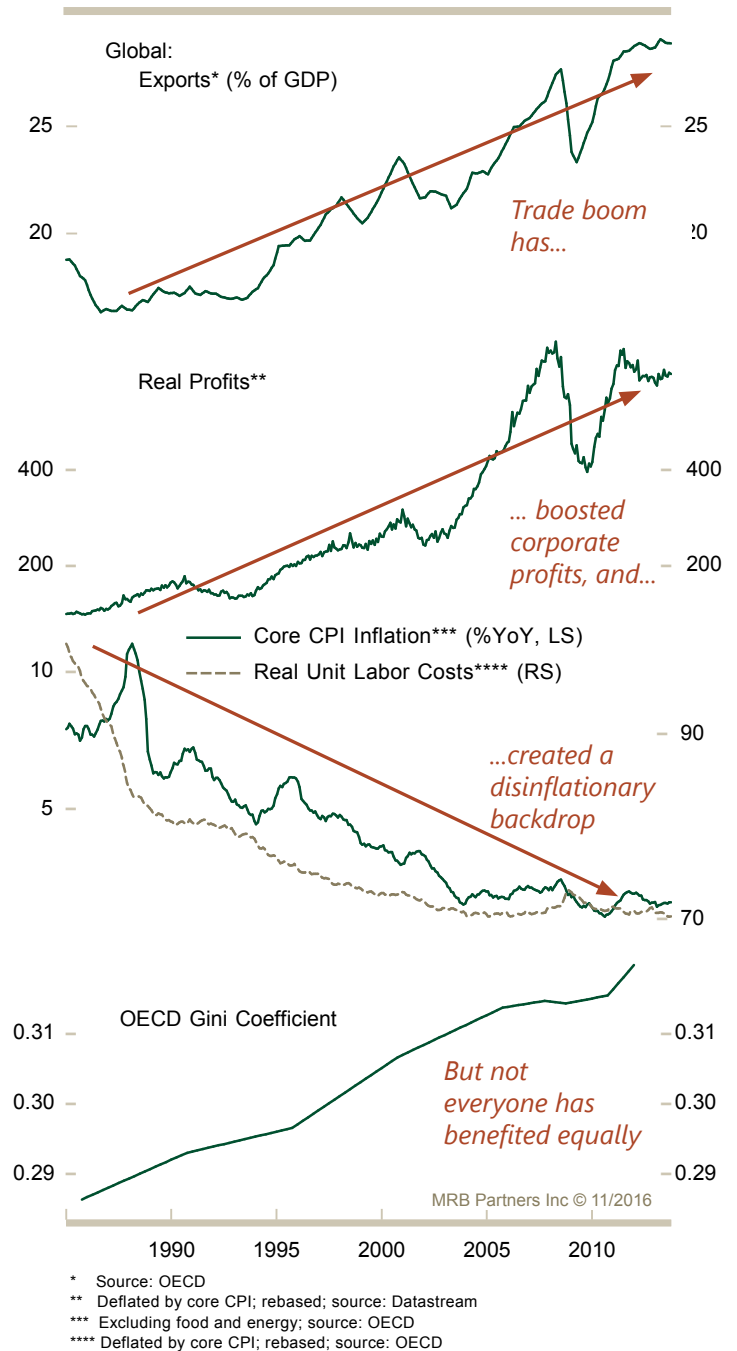
Anti-immigration has a huge domestic social impact, but less potential for global economic retaliation. Still, the outcome would be higher inflation and lower longer-term growth, which would also make asset prices vulnerable and debt sustainability more difficult. Fortunately, Trump's latest statements have basically diluted his stance in the matter to largely the existing status quo. While he is likely to sound tough, actions will likely be limited for now.

*Isolationist policies work against Trump's larger objectives for short-term economic and wealth gains, so he is likely to back away. If not, this will present a major threat for risk assets as it will lead to stagflation (at best) and eventually deflation.*

**Trump's Tail Risk Traits & Policies**

**6) Wants To Be Admired:** This is not unique to Trump, but in some ways it overrides everything else he does, as many have pointed out in recent months. Those that feared a Trump presidency often noted that his desperation to be admired and inability to take criticism (or acknowledge weaknesses) makes his personality exceptionally volatile and

**Chart 4 Increased Global Trade Has Been Beneficial**



Protectionism will be damaging

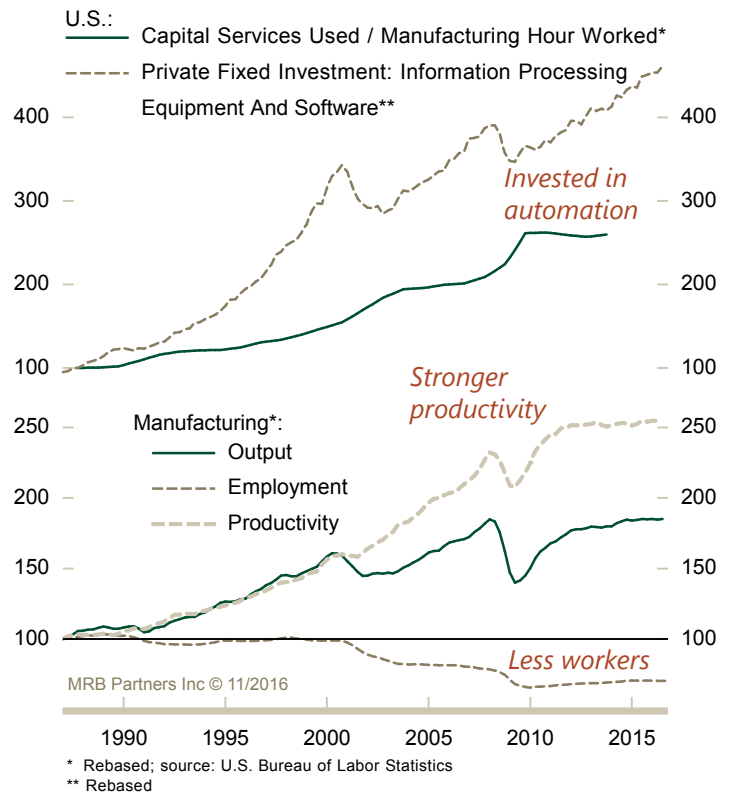
potentially disruptive. Also, Trump’s desire to remain a top news story, often encourages him to express his views in unconventional and extreme ways.

**Tail Risk:** This is a huge tail risk for the U.S. (and global) economy and financial markets, although one that is likely to be contained in the near run. Being President will keep Trump in the news over at least the first year or two. While he will undoubtedly seek to be controversial, his need to be over the top to gain attention (which would cause extreme financial market volatility) should diminish somewhat. Also, he is being handed a U.S. economy that is already on a solid expansion path and he plans to add fiscal stimulus. Thus, he will be able to receive praise for economic growth and job gains.

Instead, this tail risk becomes more relevant in periods when Trump is taking intense criticism, likely during the next U.S. and global recession. His history suggests that he will look for distractions and scapegoats, which his biases suggest will impact geopolitics, immigrants and the Federal Reserve. These all have the potential to cause market panic and amplify downturns, although (again) this is likely *not* a near-term story.

*In short, Trump’s intense desire to be admired and his volatile personality present major tail risks, albeit ones that are likely to recede in the near term.*

Chart 5 Technology Has Displaced Manufacturing Jobs



**Economic Outlook**

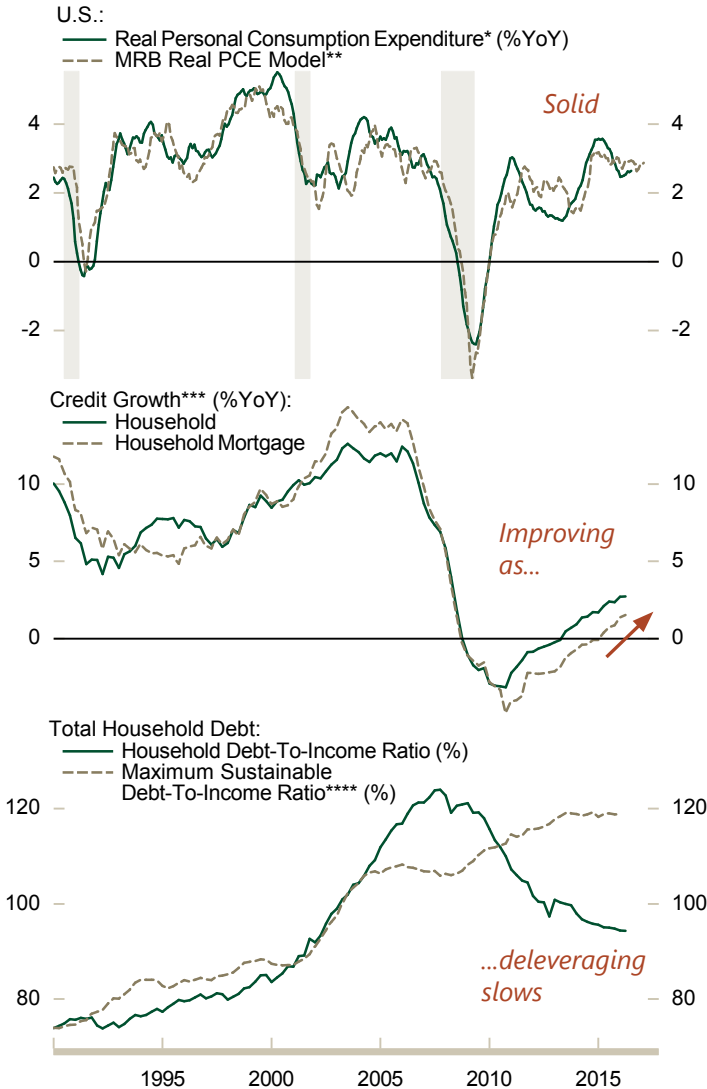
The cyclical outlook for the U.S. economy is constructive. The economy was already enjoying a durable economic expansion. Consumer spending is solid and will be reinforced as deleveraging pressures continue to fade and household credit growth renormalizes (chart 6). At the same time, the job engine has proven to be robust and wages are creeping up (chart 7). Business confidence has been tempered this cycle, but generally positive and any political clarity is likely to help encourage a rebound in investment spending (chart 3 on page 5).

That said, Trump’s policies will likely further boost cyclical growth prospects. In fact, he could create a mini-economic boom if he focuses on infrastructure spending, tax cuts and deregulation, while shelving his anti-trade and anti-immigration initiatives. The reverse policy mix would cause domestic and global economic damage and defeat his larger objectives. Thus, he will likely pander to his populous supporters through rhetoric rather than actions. This judgement call will be key for investment strategy.

Trump's volatile personality should recede a bit, for now

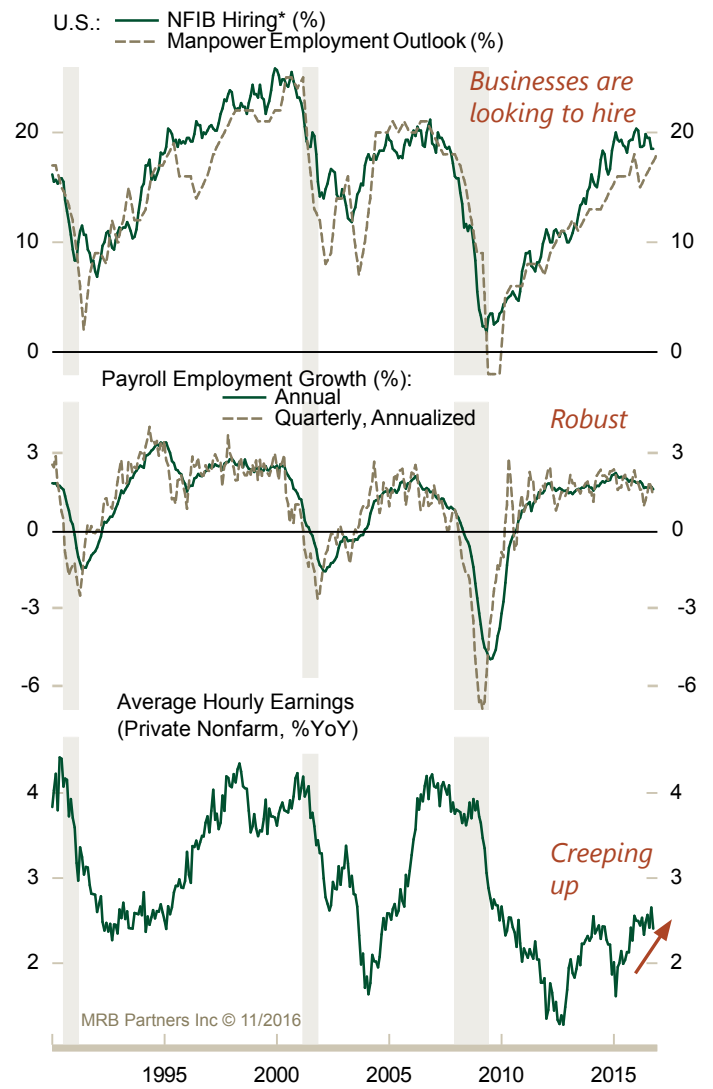


Chart 6 U.S. Household Sector Is In Great Shape



\* Smoothed  
 \*\* Includes economic variables  
 \*\*\* Sum of credit market instruments for the household and non-financial corporate business sectors; source: Financial Accounts of the United States  
 \*\*\*\* MRB calculation based on a maximum 6% debt service ratio for mortgage

Chart 7 U.S. Job Engine Continues To Stay Resilient



\* Smoothed average of hiring plans and job openings; source: National Federation of Independent Business  
 Note: Shade for NBER-designated U.S. recessions

The dominant cyclical risk to leverage-induced growth is that borrowing rates (largely driven by bond yields) become restrictive and choke out the expansion, although the starting point is very supportive (**chart 8**). Trump has been critical of the Fed in recent years, suggesting that it was supportive of Obama by keeping rates anchored. This was likely merely that he desired a premature lifting in interest rates as the economic damage would have hurt the chances of Democrats in the presidential race. Investors should expect his tone to change now as he adopts a pro-growth mandate and desires continued low funding costs. Regardless, bond yields themselves will be the greater determinant. Even if Trump discourages the Fed from hiking (which is unlikely) while undertaking fiscal stimulus, the bond market may still riot. This is a risk that will need to be monitored.

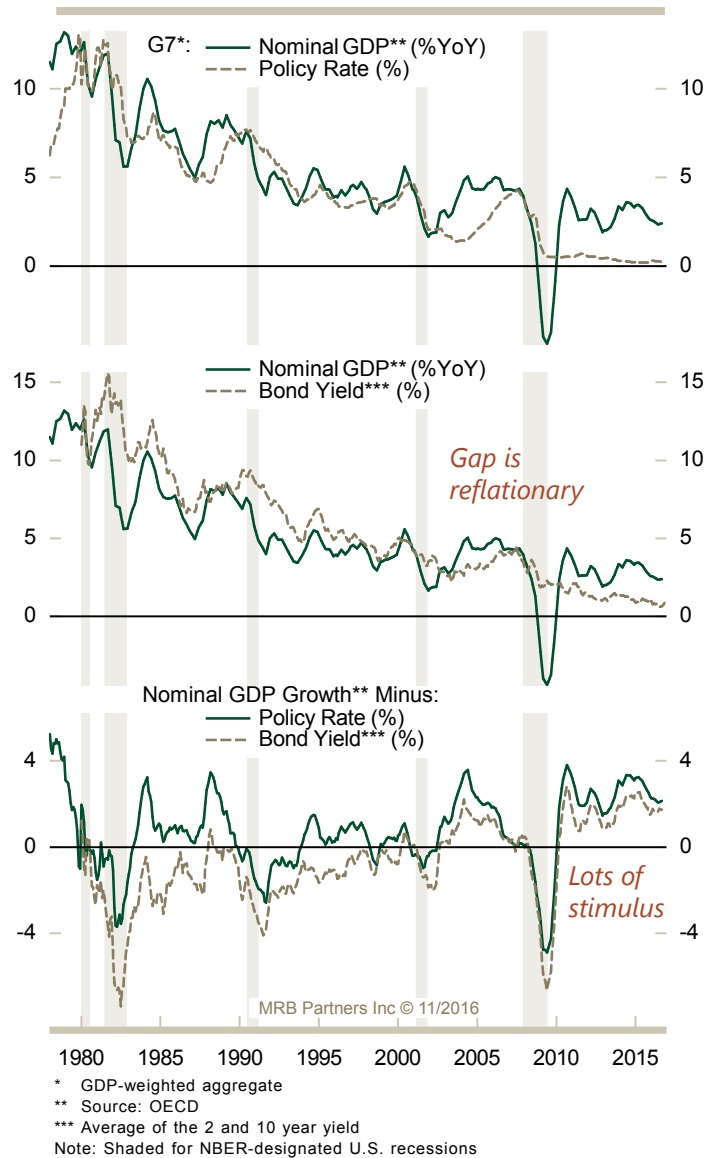
The U.S. economy should remain in solid shape

The longer-term outlook for the U.S. is less comforting. Trump’s policies are all designed around unsustainable ways to capture economic growth, including rising government debt, greater imbalances and environmental degradation. The U.S. economy has spent this decade delevering and rebalancing after reaching the household sector debt ceiling. If left unconstrained, Trump will likely try to test the debt threshold of the government over the next several years: it is estimated that his policies would increase government debt by about 40% of GDP over 10 years<sup>3</sup>, even if there is no sizable recession.

Net government debt in the U.S. is around 90% of GDP (chart 9). The old rule of thumb before running into strains is around 100% of GDP, but it is higher for the U.S. (perhaps 25 percentage points) since the country still maintains the world reserve currency. However, the U.S. is not Japan, which got away with excessive debt because it had huge domestic savings (albeit the BoJ has also played an important role in recent years). Regardless, the U.S. government balance sheet is not at a breaking point and has room to be levered up. This is typically frowned upon by the Republican party and especially by its Tea Party wing, but time will tell if they are able or wish to restrain Trump. If they act to restrain, then the cyclical tailwinds to growth will be dampened somewhat, but the structural outlook will not be as bleak.

Ironically, there are no direct initiatives to rebalance income inequality under Trump’s economic plan, despite what his voter base may have perceived. This undercurrent of social unrest that helped put him in the White House will not be addressed and will undoubtedly rear its head again in the future (chart 10). That said, employment and wage growth were already starting to broaden under the Obama administration due to the prolonged expansion and stronger growth prospects. This trend will be reinforced by infrastructure spending. Thus, even though income equality will remain poor, everyone should benefit somewhat from stronger growth, helping to temper social unrest until the next recession. Also, this disgruntled voter base has thrown their “Hail Mary pass” and will likely look for signs that they made the right choice. Of course, other social instability could intensify due to discrimination against women and minorities.

Chart 8 Global Monetary Policy Setting Is Pro-Growth



Structural imbalances will increase

<sup>3</sup> Estimates according to the Committee for a Responsible Federal Budget.

**Final Word:** *Isolationist policies aside, Trump's proposals are designed around bringing future growth forward. This should provide further cyclical support to an already healthy U.S. economy. The longer-term outlook will be much weaker, but this is beyond the investment horizon of most market participants and is unlikely to drive financial markets over the next year or two.*

### Investment Strategy

The October **MRB Strategic Trader Report**<sup>4</sup> highlighted that the unique nature of U.S. Presidential election cycle would result in several important ramifications for financial assets, particularly among U.S. equity sub-groups. Clinton would have provided a much less risky investment landscape, based on stronger but sustainable growth policies. Still, U.S. equities have rallied since November 8, as Trump offers an even larger boost to **cyclical** economic and profit growth provided he dampens his anti-trade rhetoric.

In fairness, we had been anticipating at least a few days of risk-off following a Trump victory due to heightened uncertainty. However, we maintained a mild pro-growth cyclical investment stance with a preference towards equities over bonds, which has largely been rewarded.

### Equities & Risk Assets

The October 5 **MRB Theme Report**<sup>5</sup> noted that policy conditions are supportive, global growth indicators show encouraging signs and there is room for positive surprises. At the same time, the major price shocks from late-2014 until early-2016 (namely the surge in the U.S. dollar and plunge in commodity prices) is wearing off and revealing a firmer economic growth and profit trend (**chart 11**). This provides a supportive environment for equities over bonds, albeit risk-taking has been held back due to uncertainty about U.S. and European politics. A Clinton victory would have likely provided greater comfort for investors, but the macro landscape will still be constructive under Trump provided he does not pursue

Chart 9 U.S. Public Finances Will Deteriorate

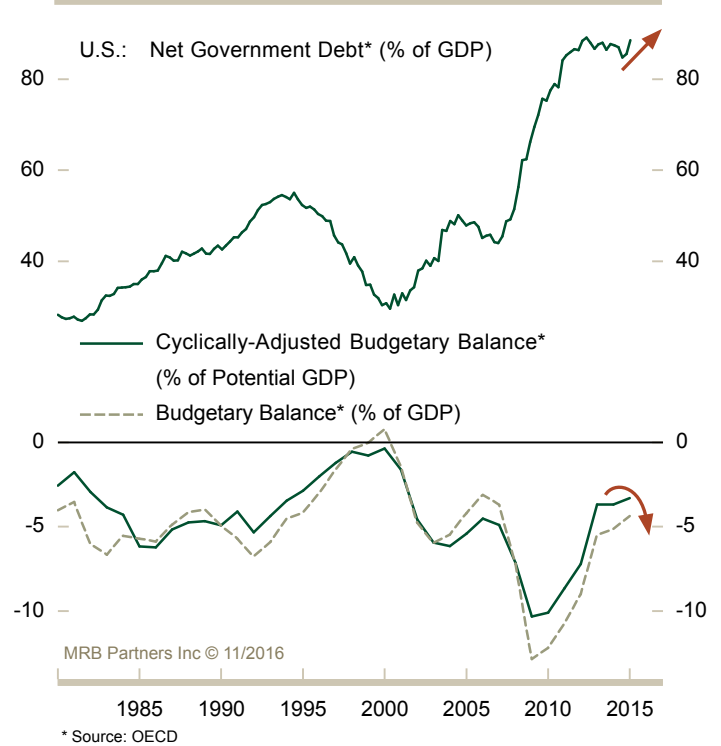
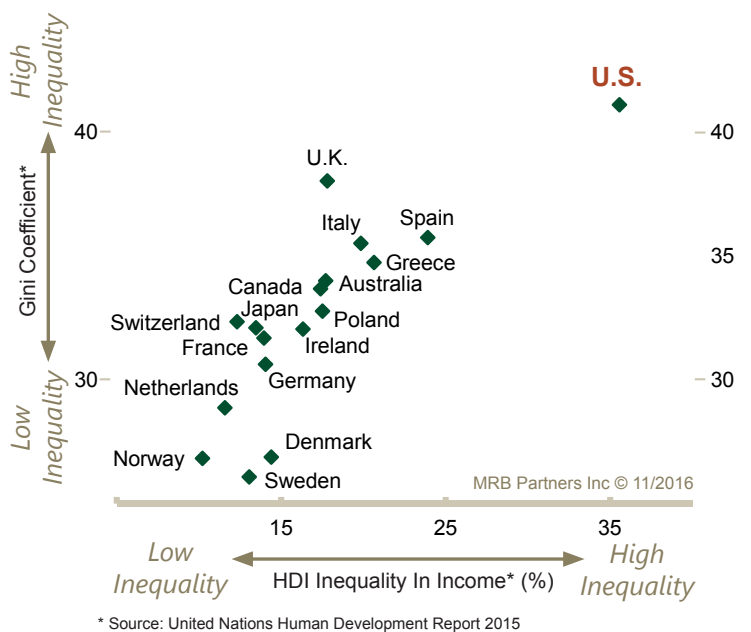


Chart 10 U.S. Has Extreme Income Inequality



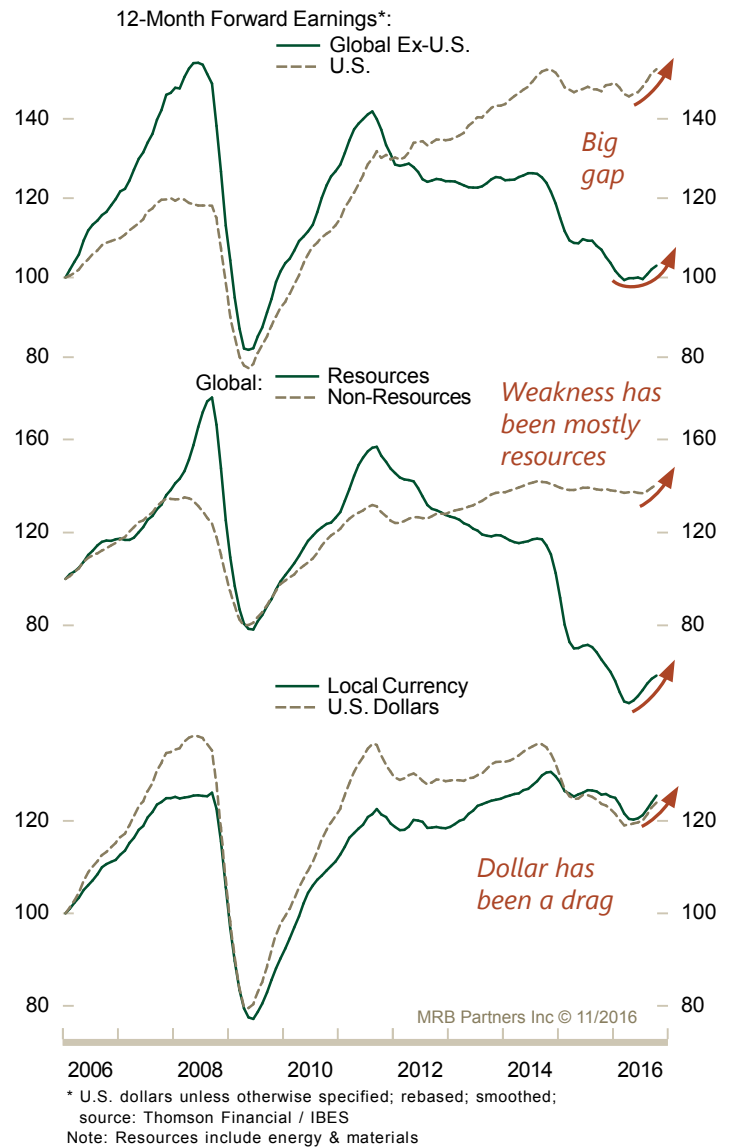
<sup>4</sup> MRB Strategic Trader Report, "All About Politics", October 13, 2016

protectionism or cause geopolitical turmoil. Our bias is to stay pro-growth, although we would trim exposure if U.S. or European policies become disruptive.

**U.S. Equities:** Table 2 reiterates our U.S. equity picks for a Trump victory, based on our various research reports heading into the election<sup>6</sup>. Chart 12 shows that many of these have indeed bounced strongly in recent days. Looking ahead, our preference remains U.S. banks (or financials more generally), which still have attractive valuations and will benefit from increased credit growth and a steeper yield curve. We also find value in pharmaceuticals and aggregate health care and would recommend this for investors looking to balance their portfolio with a historically defensive holding. Construction materials (and industrials to a lesser extent) are appealing infrastructure spending plays, but the recent bounce may be overdone in the near run since it will take time to get these projects underway. Finally, we would not chase coal or energy stocks as commodity prices will remain the dominant driver, and these markets will remain oversupplied.

**Regional Equities & Risk Assets:** Trump’s policy mix matters for regional equity allocations. Our preference for now is the U.S. market, which will benefit from solid *domestic* growth conditions and investor concerns about U.S.-led protectionism (domestically-focused U.S. equities will be better sheltered from the latter). That said, if there is clarity that Trump will push forward with fiscal spending and shelve his anti-trade policies, then there will be a case for a rotation into cheaper and more pro-growth equities elsewhere, including the euro area and emerging Asia. In the interim, our preference is to focus our non-U.S. exposure in risk assets of economies with solid domestic growth drivers. These include domestically-focused assets in Germany, India and Indonesia . We have a long position in Germany real estate (up 32%), while our long position in India and Indonesia stocks was stopped out recently and we will look for an opportunity to reinstate (see below).

Chart 11 Global Earnings Are Improving



Favor U.S. equities for now

<sup>5</sup> MRB Theme Report "[Stylized Investment Cycle Update: A Fairly Unique Cycle](#)", October 5, 2016

<sup>6</sup> MRB Equity Sectors Research Highlights, "[U.S. Health Care Stocks: Campaign Rhetoric Vs Political Realities](#)", September 27, 2016, "[U.S. Energy And Utility Stocks: The Politics Of Climate Change](#)", October 11, 2016, "[Clinton Vs Trump: How The Candidates Would Regulate Wall Street](#)", October 24, 2016 and "[U.S. Industrial Stocks: The Politics Of Better Infrastructure And Defense](#)", November 1, 2016

Table 2 Trump's Impact On U.S. Equities

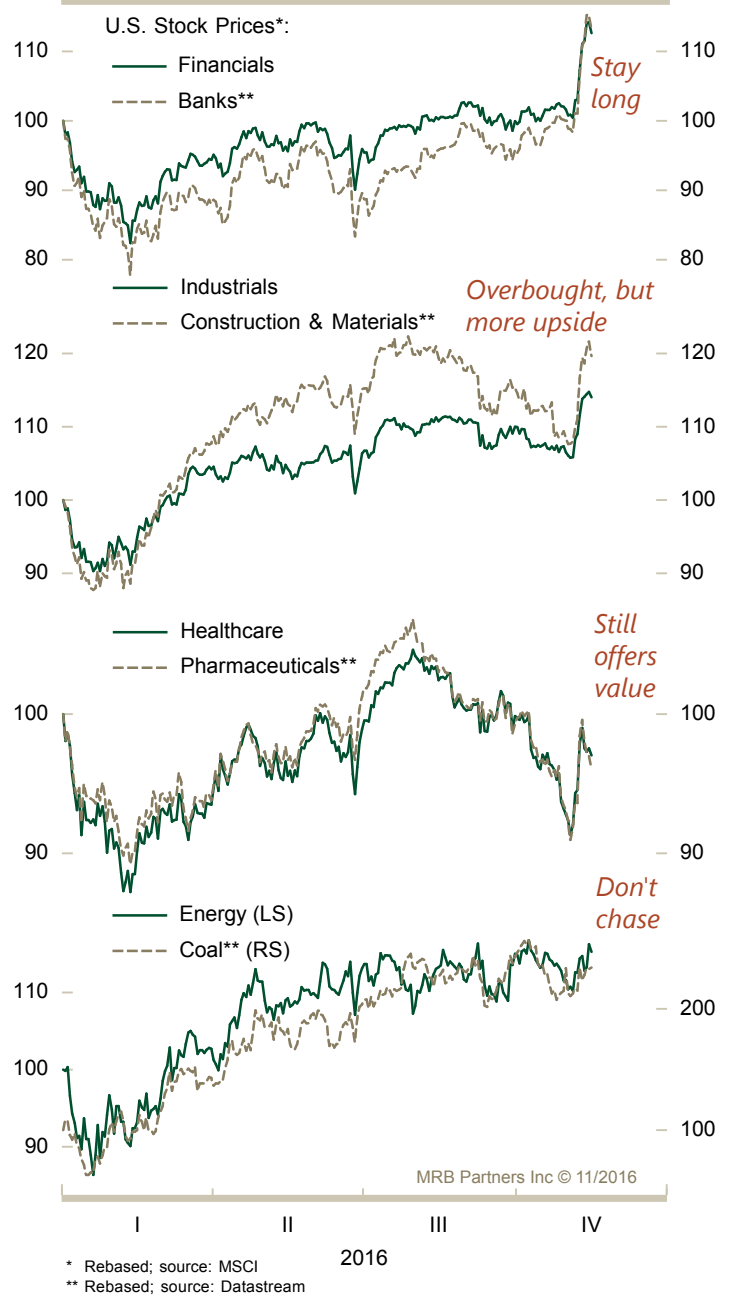
Sector/Issue	Positive For	Negative For
Health Care	Pharma, biotech, specialty pharma companies, and PBMs	Managed care companies and hospitals
Energy & Utilities	Conventional E&P, companies, coal miners, oil services, pipelines, and utilities with large coal-fired assets	Renewable energy companies (wind & solar)
Financials	Large banks, large insurers, investment banks	
Infrastructure	Construction materials, machinery, and engineering companies	

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The related **MRB TradeBook** positions include (chart 13):

- **Long U.S. Banks:** We hold U.S. bank stocks versus the U.S. equity benchmark (up 21%), and have a position in U.S. and euro area banks versus their Canadian counterparts (up 15%). U.S. bank stocks have been shunned by investors since the global financial crisis, due to mistrust, fears of punitive financial regulations, and a lack of confidence in the sustainability of credit growth. That said, the sector is relatively cheap and has healthy balance sheets, at a point when U.S. policy reflation has worked. At the same time, real home prices have rebounded materially in recent years, bolstering underlying collateral values and gradually encouraging credit growth. We noted that the key for unlocking value was an upward drift in bond yields (i.e. boosting net interest margins) and ideally clarity on regulatory reforms. The Trump win provided both, benefiting our positions.
- **Long U.S. Financials/Short Real Estate Stocks:** We kept this as a *Shadow Trade* to avoid having too much exposure to U.S. banks. Nonetheless, the position is designed to benefit from a backup in bond yields and still has legs. Banks benefit from an improving economy, stronger trading volumes, M&A activity, and higher bond yields

Chart 12 U.S. Equity Trump Trades



Stay long  
U.S. banks

(provided the latter lags improving growth). In contrast, real estate stocks are much more (negatively) sensitive to higher interest rates.

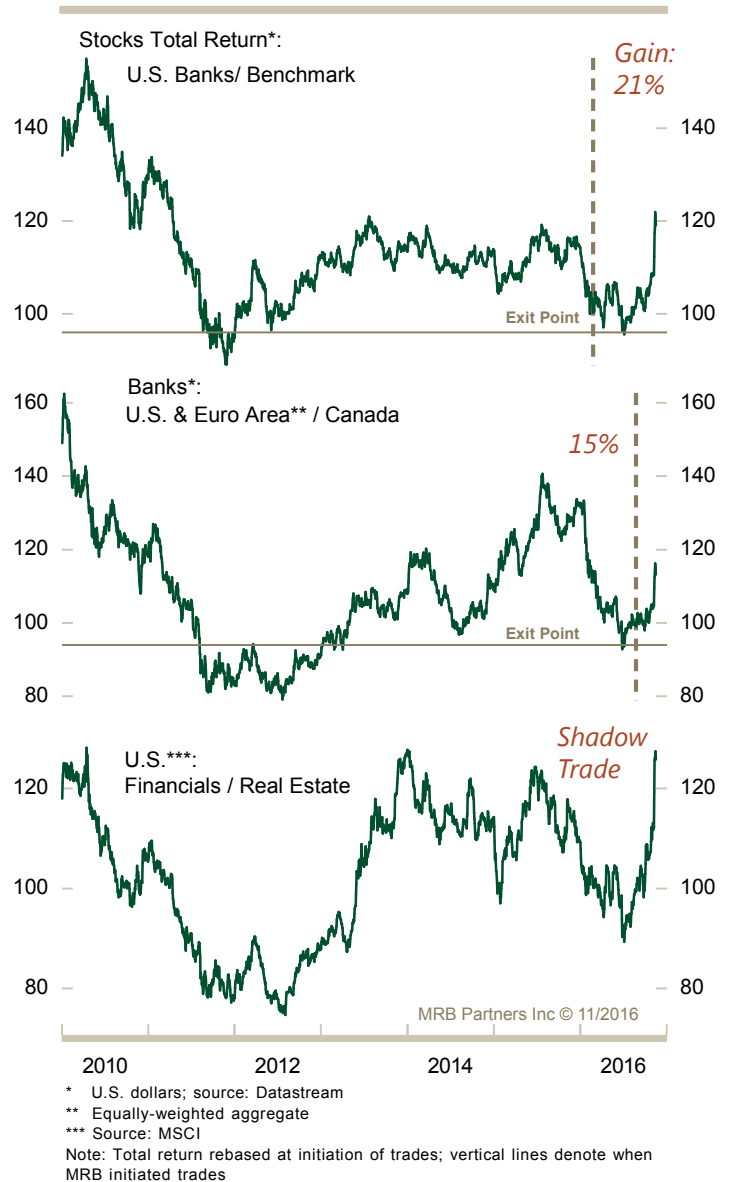
- **Global Construction Materials Stocks:** We identified this as our preferred infrastructure bet in recent weeks, although never formally pulled the trigger. We are hesitant to chase the recent bounce which looks overdone, but expect longer-term upside. Thus, we will add the position versus the broad market to our *Shadow Trades* and look to buy after a brief consolidation.
- **Long Global Stock/Bond Ratio:** We scaled back our pro-growth exposure somewhat earlier this year and focused on “safe beta” positions. While this is still appropriate given the elevated policy uncertainty, we will add back a bit of risk exposure via buying global equities versus 10-year G7 government bonds. This is consistent with our existing asset allocation recommendations and our take on current positioning within the investment cycle<sup>7</sup>. Nonetheless, we will set a stop to limit downside risk to a 7% loss.

**Government Bonds & Yield Plays**

U.S. Treasuries have faced selling pressure since Trump won the presidential election (**chart 14**). European yields have also risen in response, although partially because investors are now also pricing in the potential for a populous outcome in key upcoming elections (i.e. sovereign debt risks have risen). Finally, search for yield trades (including spread product and high dividend-yielding stocks) have also faced selling pressure since the U.S. election.

Although there was potential for a near-term flight-to-safety, a Trump presidency is generally bearish for government bonds, which remain overvalued (**chart 15**). That said, the uptrend is likely to be more gradual than has been observed in the past week or two. Fiscal stimulus will take time to impact growth, but should provide a boost to an already strengthening domestic economy, putting upward pressure on real yields and inflation expectations. Likewise, easy fiscal policy makes a less accommodative monetary policy

**Chart 13 MRB TradeBook: U.S. Financial Positions**



Buy the global stock/bond ratio

<sup>7</sup> MRB Emerging Market Equities Report, “Domestic Growth: Worth A Premium?”, November 15, 2016

more appropriate. If the Fed lags, inflation expectations will rise instead.

Higher government debt levels could cause an upward drift for the underlying trend in yields, but this will be overridden by cyclical dynamics until the U.S. government's balance sheet becomes extended, which is unlikely in the next couple of years. Even in the opposite extreme where protectionist policies are adopted and fiscal stimulus is shelved, the outcome would likely be stagflation before deflation.

The related **MRB TradeBook** positions include (charts 16 and 17):

- **Short U.S. Treasurys:** We do not currently have a formal position, but have regularly expressed comfort with cyclical short positions in the 10-year U.S. Treasury. That said, in the current environment of gradually higher bond yields, our preferred play on a steeper yields curve has been U.S. bank stocks (see above). There is a risk that bond investors rush for the exits and exacerbate what should be a gradual uptrend in yields, or that protectionist policies create more inflation than growth. Either scenario is not great for bank stocks, so investors may wish to also hold a short Treasury position as insurance.

- **Long U.S. High-Yield Corporate Debt:** Despite the recent selloff in spread product, this trade has generated 10% gains this year (note that we previously booked a 26% profit on this position). We will reiterate our constructive view on corporate debt in tomorrow's **MRB Weekly Macro Strategy Report**, while maintaining stops in the **MRB TradeBook** to protect against a general unwinding of search for yield plays. We already lowered the exit point to a yield of 7% early this month (the current yield is at 6.7%).

- **Long EM U.S. Dollar-Denominated Debt/Short 10-Year U.S. Treasurys:** This pair trade is up 4%, but is also vulnerable in the near run. Thus, we will tighten stops to a spread of 4% (currently at 3.8%).

Chart 14 Abrupt Bond Selloff

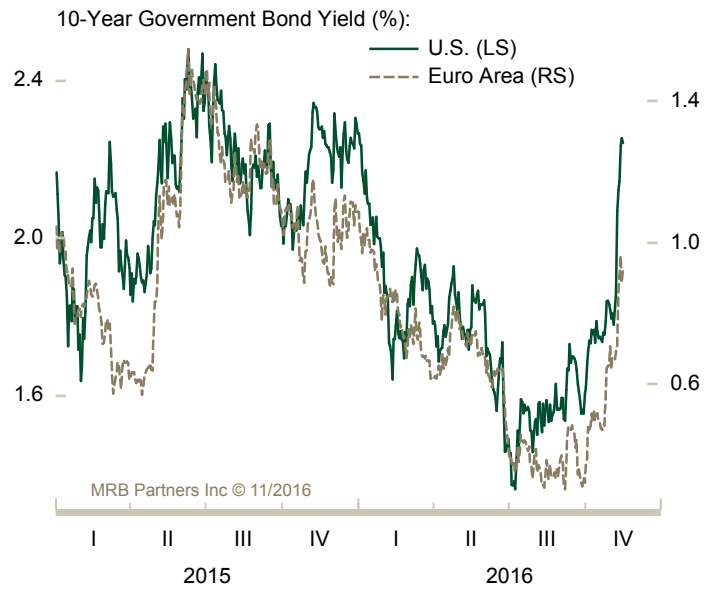
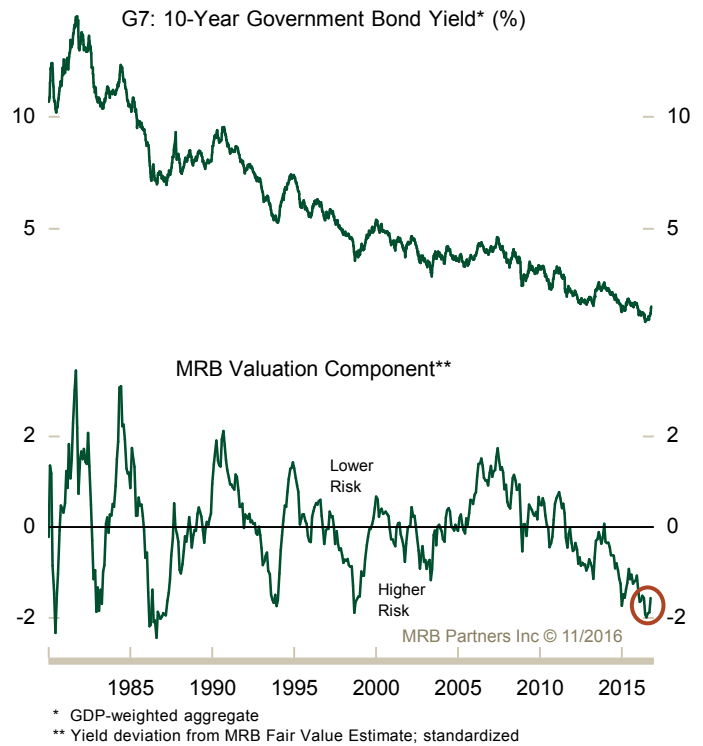
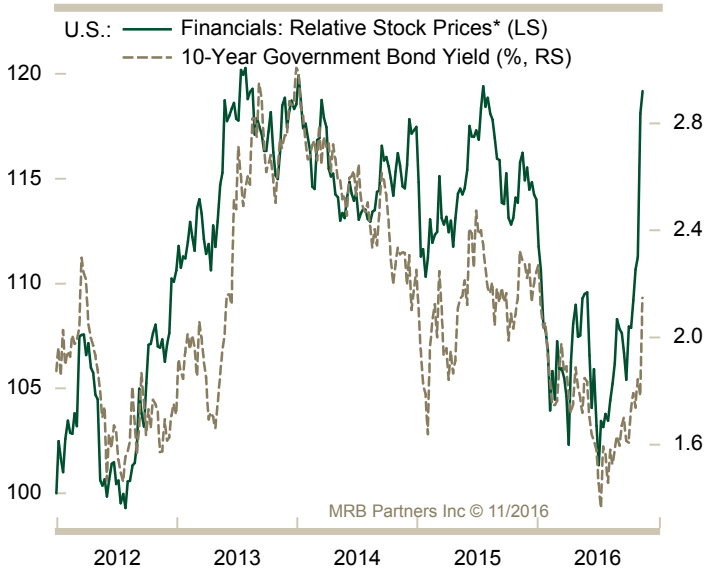


Chart 15 G7 Bonds Are Still Expensive



\* GDP-weighted aggregate  
 \*\* Yield deviation from MRB Fair Value Estimate; standardized

Chart 16 Financial Stock Benefit From Higher Yields



\* Rebased; relative to U.S. equity benchmark; source: MSCI

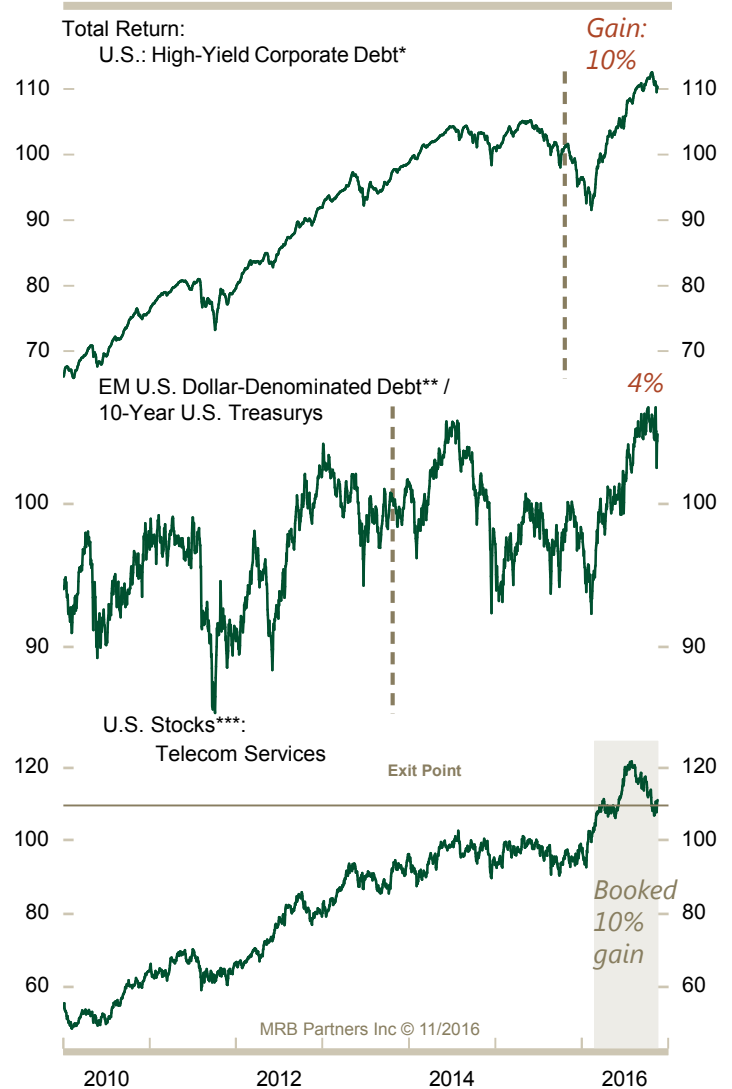
○ **Long U.S. Telecom Services Stocks:** The selloff in U.S. telecoms triggered our stop early this month, causing us to book the 10% gain. We are replacing this “safe beta” yield play with a position in the global stock/bond ratio (see above).

**U.S. Dollar**

Our view has been that the U.S. dollar would be a win/win bet from the U.S. election on a 6-12 month horizon. In the case of a Trump victory, the rally would in part be the flipside of deflationary forces elsewhere, given potential U.S. trade restrictions. These initial tailwinds for the U.S. dollar could persist on a one-year horizon assuming Trump focuses on fiscal spending (rather than just tax cuts) ensuring that recent economic momentum persists (or even improves). This, in turn, will add to pressure on the Fed to hike rates.

Over the long term, Trump’s proposed policies (if passed by Congress) would be structurally bearish for the U.S. dollar. U.S. government debt levels will move up substantially and his anti-immigration and anti-trade policies, *if enacted*, are bearish over the long haul for the currency. They would be stagflationary and the erosion of competitiveness of the nation and long-term potential growth will make the U.S. dollar less attractive. Still, it will take considerable time before investors focus on these outcomes.

Chart 17 MRB TradeBook: Yield Plays



\* Source: BofA Merrill Lynch  
 \*\* Source: J.P. Morgan Chase & Co.  
 \*\*\* Rebased; source: MSCI

Note: Total return rebased at initiation of trade; shading denotes when MRB previously held trade

Stay long the U.S. dollar



The related **MRB TradeBook** position is (**chart 18**):

- **Long DXY Index:** The U.S. dollar has rallied in recent days, benefiting our position which is now up 2% (note that previously booked 18% gains on this trade). We expect further gains ahead.

**Trade Updates**      **MRB TradeBook Houskeeping**

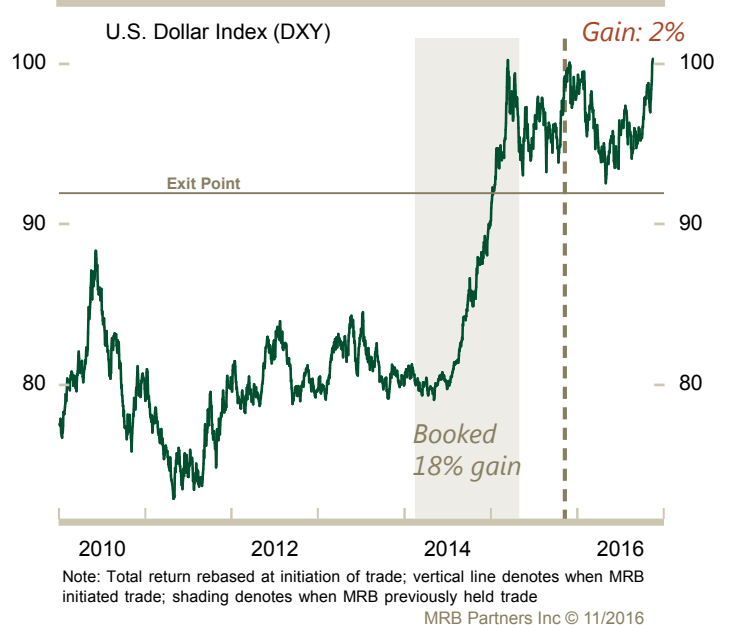
The market swings following the U.S. election outcome triggered stops on two of our recommendations (**chart 19**):

- **Short Gold:** The recent decline in gold prices triggered the stop-short at \$1250/oz on this **Shadow Trade** (currently up 2%, note that we previous booked 24% gains shorting gold). This position was added to bet on a stronger U.S. dollar and higher bond yields following the U.S. election, which has panned out. That said, a Trump victory is not as bearish for gold, as the latter provides insurance against policy uncertainty, geopolitical risks and higher inflation expectations (see last week's **MRB Weekly Macro Strategy**). Thus, we recommend adding a stop at the entry level.
- **Long India & Indonesia/Short Russia:** The stop was triggered on this pair trade early this week, causing us to book a 7% loss. This position is aligned with our preferences for emerging Asian stocks versus their counterparts in EM commodity-based economies. Nonetheless, we will wait for further details on U.S. policies before adding back exposure.

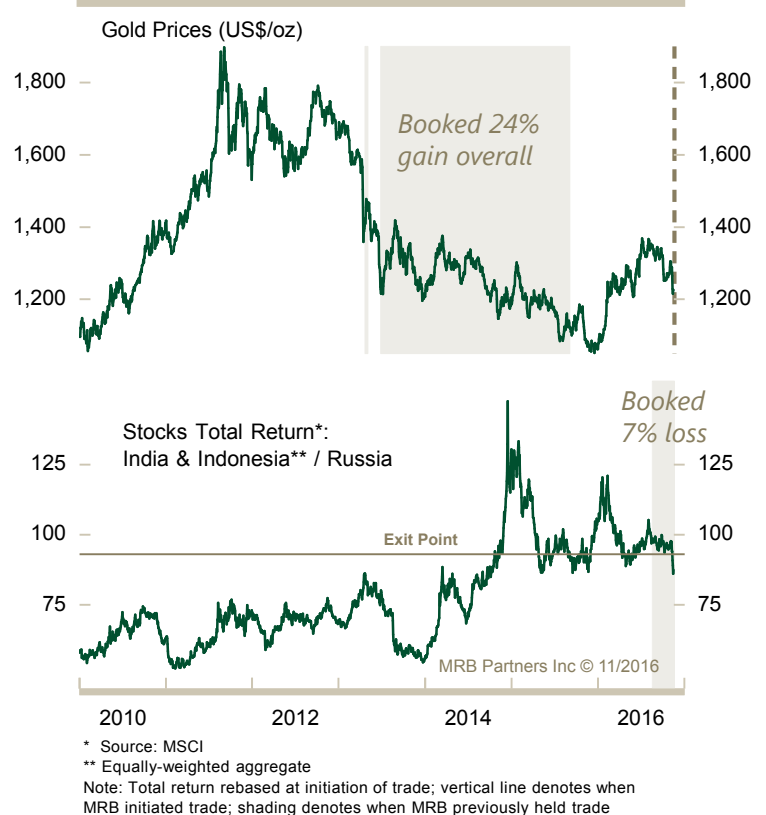
**Phillip Colmar**

**Santiago Espinosa**

**Chart 18 MRB TradeBook: U.S. Dollar Position**



**Chart 19 MRB TradeBook Changes**



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