MORNINGSIDE HILL
CAPITAL MANAGEMENT

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TRUMP, STOCKS AND THE ECONOMY

We have questioned the health of the US economy for some time. Consensus views on the other hand stated that the economy is in a great shape and because of that people would vote for "more of the same" in the face of Clinton. Now that the US presidential election is behind us, recession odds have greatly increased. This is not to say that Clinton would have necessarily been a better option. Here we wish to underline our non-partisan stance regarding American politics – this is not a political piece.

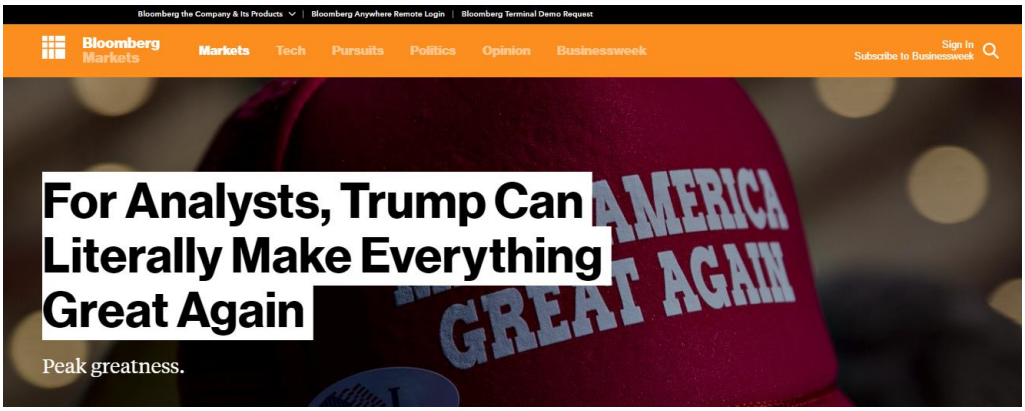
What surprised us most was the sudden change in the narrative. During the elections Trump was described as a buffoon, a clown, with inconsistent views, vague and contradictory policies, a racist, sexist, both inexperienced and unqualified for the position. Conversely, Clinton was presented as the sounder choice for the economy and hence the stock market. This narrative was not only touted by the mainstream media. Business leaders, CEOs, investors, Wall-Street and numerous respectable market commentators and analysts fervently defended it. A significant portion of the US electorate used the ballot box to voice their discontent with the economy. Rather than provoking a thorough examination of the root causes for the imbalances that lead to this surge in populism, the consensus view took the easy way out, yet again. The narrative immediately shifted and rallied under a new banner: 'Whatever economic woes beleaguered us, Trump will fix it all' (and the solution is just a tweet away).

Trump is no longer a buffoon. Instead, he is now portrayed as the new Ronald Reagan under whose presidency the US economy improved, inflation was reigned in and the markets prospered. Trump is depicted as a strong, pro-growth leader (was there ever an anti-growth one?) who suddenly turned out to be the better option for business and the economy. The Dow Jones stock index hit a new all-time high a mere 2 days after the elections. Wall Street, vehemently against Trump during the campaign (Goldman Sachs explicitly barred employees from donating to Donald Trump's campaign[1]) insisted that a Trump win will lead to an immediate market crash and a recession. Now these same banks are sending notes to clients saying that Trump is actually great news for the economy. We tend to disagree.

First of all Trump is no Reagan. While Trump is a divisive figure, Reagan was a consensus builder and his tenure heralded a realignment towards conservative policies. When Reagan took the reins in the 80s, the stock market was at a cyclical low, inflation and interest rates were near all-time highs – the polar opposite of today's environment. In addition national debt was at 30% of GDP unlike today's ratio surpassing 100%.

Despite the facts, the new hope (hype) is here and there is purportedly no limit to all the good things Trump can suddenly do. To provide some color, we included a snapshot of an article encapsulating the prevailing spirit of exuberant expectations.[2]

[1] http://www.cnbc.com/2016/09/07/goldman-sachs-bans-top-employees-from-donating-to-trump-report.html
[2] http://www.bloomberg.com/news/articles/2016-11-21/for-analysts-trump-can-literally-make-everything-great-again



> *"Sell-side analysts believe Trump can make everything from **securitized bundles of home loans**, to **the U.S. dollar**, to **mergers and acquisitions "great again,"** according to a recent rush of research notes borrowing the President-elect's catchphrase… The emerging consensus holds that Trump will boost the **U.S. dollar, interest rates and inflation** as he embarks on a mix of trade protectionism and fiscal stimulus financed through debt. "**Trump win makes reflation trades great again**," read a Nov. 9 headline from Citigroup Inc.'s Asia research team that is characteristic of the new oeuvre. "Trump's win should provide a further catalyst for inflation expectations and the inflation risk premium," Barclays Plc analysts wrote in a Nov. 9 note titled "**Making TIPS great again**." … Energy analysts at Morgan Stanley added a caveat to their thesis that Trump could provide a boost for oil refiners in the form of a question mark, in their note titled: "**Make Refining Great Again?**"… Citigroup's analysts for residential mortgage-backed securities (RMBS) that aren't backed by the U.S. government's housing agencies titled their 2017 outlook: "**Making RMBS Great Again**," … Other things that analysts suggest Trump could make good — if not necessarily great, again — include **materials, engineering stocks, metals, U.S. coal production, the biotech sector, term premiums, small-cap equities, retail spending — and Wall Street itself**."*

It seems as if in Wall Street reports the adjective "populist" suddenly gave way to a string of obsequious outlooks.

Trump's brand of populism is not that different from its antecedents and its current European cousins, all aiming for quasi-universal appeal (especially on the campaign trail), only to fail to deliver the conflicting and even mutually exclusive promises.

That's the beauty of a populist message – there is something in it for everyone. The bottom percenters expect Trump will bring jobs back home by rejecting business-friendly policies favored by elites of all stripes. At the same time the top percenters gleefully expect him to deliver estate and personal income tax cuts. Both Wall Street and Main Street rejoice at his "pro-growth" agenda, promising to cut corporate tax rates and remove regulations. We don't see how he could possibly satisfy all of the above-mentioned parties.

To say the least, Mr. Trump's pre-election plans have been ambiguous and unspecific. Whether he will "build that wall" and scrap international trade agreements is anyone's guess. Because his plans lack specifics, the level of uncertainty is much higher than under previous executive transitions. However, this is not what markets imply.

On the next few pages we explain why Trump will fail to reignite growth and how he will upset the fragile balance between central banks and financial markets ushering a recession this year.

Does Trump really have congressional support?

After the republicans swept both chambers of congress and the presidency, a popular thesis evolved claiming it will make it easier for Trump to pass his agenda, whatever it may be. Rather than broad-based republican support, Trump's candidacy was derided and criticized as most prominent republicans opposed him, including house speaker Paul Ryan. Trump received absolutely no campaign financing from the party. For comparison Mitt Romney received $42 million in 2012.

Anti-establishment

Political division in these elections reflects a new fault line. Not one between republicans and democrats but one between establishment and anti-establishment. Republicans in Congress are career politicians looking past Trump's four years in the White House. Most have had long political careers and all are looking forward to many more years in office. There is no pressure for Washington to cater to Trump's agenda especially if it doesn't serve their interest. Some might even say that a semi-independent, owe-no-favors, take-no-prisoners president is an unwelcome change in Washington. Should Trump make the wrong move, Washington would gladly feed him to the dogs.

Fiscally conservative Congress

The US president doesn't have the power to cut taxes or increase deficit spending directly. He can propose changes while the legislative institutions choose whether to enact them or not. Several republican congressmen have already stated that they are against bigger government and more spending. Instead, they hold that they have been elected on the promise to reign in government spending and demolish the mounting wall of debt.

Infrastructure spending

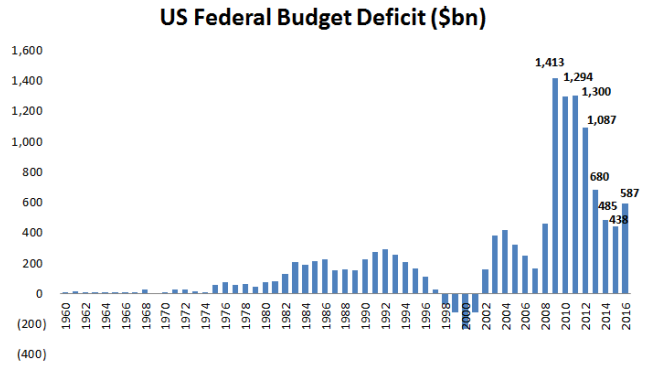
Trump has been vague in his proposal for a new infrastructure spending program. His website and some of his speeches state he would at least double Hillary Clinton's proposed spending of $275 billion to a total of $550 billion. However other speeches call for up to $1 trillion of new infrastructure spending over 10 years or about $100 billion per year. The trillion dollar infrastructure plan is hardly a new idea. President Obama proposed the exact same thing when he was running for office and the plan was voted down by Congress in 2009.

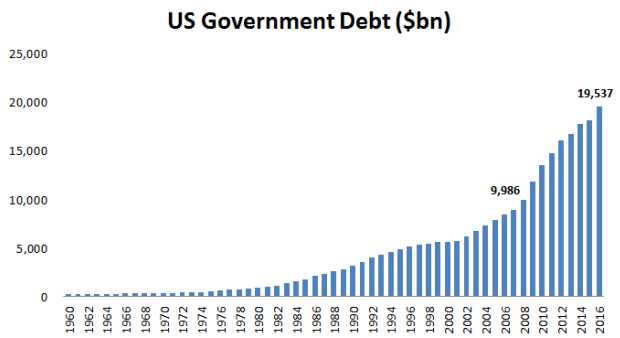
The financing of this infrastructure plan is as of yet unclear. Trump has mentioned several different schemes – a direct government financing through new bonds, the creation of an infrastructure bank or private financing through the use of tax credits. Financing it by issuing new debt remains the most probable option and yet the most difficult to pass through a republican Congress.

When asked just two months ago whether he would support Trump's infrastructure spending, republican leader and House speaker Paul Ryan laughed loudly while slapping his hand on the arm-rest of his chair. "That's not in the 'Better Way' agenda" he said, referring to the republican campaign platform. Please follow the link below to the interview's 16th minute mark.[3]

Even if some form of infrastructure spending were to be passed by Congress, how would that differ from the trillions in budget deficit, spent by the Obama administration? Below is a chart that shows the US federal budget deficits and total US government debt from 1960 to the present.

[3] https://www.youtube.com/watch?v=K9dm_6f-88g&list=PLwj46yNDLyTV5rP1fcagO7pPNIJOGuWYR&index=23





Cumulative US budget deficits (1960-2016) in billions	$12,375
Cumulative Obama deficits (2009-2016) in billions	$7,284
Obama deficits as percent of total	58.9%

US total public debt in 2016	$19,537
US total public debt in 2008	$9,986
Increase in public debt since 2008	$9,551

Sources: US Government Spending, Morningside Hill

The chart above to the left shows the stunning federal budget deficits accumulated under the Obama administration which amounted to $7.3 trillion dollars or almost 60% of the total cumulative deficits since 1960. The chart above to the right shows these deficits were financed with massive issuance of new debt. Bush Jr. doubled the government debt from $5 trillion to $10 trillion and then Obama doubled it again to $20 trillion.

The US had $7.3 trillion in fiscal deficits over the past 8 years and the result is the weakest output growth in history. We fail to see why Trump's proposed $0.5-$1 trillion in infrastructure spending is so exciting.

Indeed, the architects of Trump's infrastructure plan, UC Irvine economist Peter Navarro and private equity investor Wilbur Ross, took a jab at Keynes in their paper outlining the program.[4]

> *"All we have gotten from tilting at Keynesian windmills is a doubling of our national debt from $10 trillion to $20 trillion under Obama-Clinton and the weakest economic recovery since World War II – combined with depleted infrastructure and a shrunken military."*

Well it seems that even Trump's advisors seem to agree that fiscal stimulus' effectiveness in boosting the economy is highly questionable in the first place. Yet the consensus view changed to thinking more fiscal spending is the panacea for all setbacks in the economy.

Trump's deregulation pledge

Another campaign promise has been to reduce business regulations. From his tenuous commitment to repeal Dodd-Frank to his dithering claim to remove Obamacare, Trump has been incredibly vague on policy proposals. On regulation he has so far offered the following: "for every new regulation enacted, two others have to be scrapped." Questions like how significant the scrapped regulations need to be in comparison to the new ones, do they all need to be in the same field or industry and how they will be prioritized abound.

Shifting through regulations does not necessarily lead to growth. For instance we fail to see how repealing Dodd-Frank and hence allowing investment banks to trade for their own proprietary accounts will bolster the US economy. In the immediate aftermath of the elections, Trump backed away from repealing the entire Dodd-Frank, as he backtracked on other campaign promises. We believe that like most populist agendas, there will not be any significant follow-throughs.

[4] https://assets.donaldjtrump.com/Trump_Economic_Plan.pdf

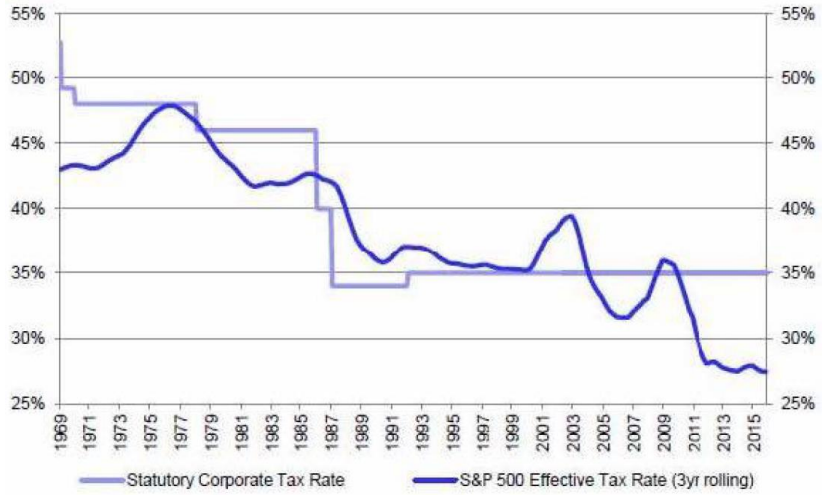
Trump's proposed tax reform

Trump's comments on potential tax cuts have been erratic and lacking in critical detail. He has mentioned reducing the corporate tax rate to 15% which is unrealistic. Small countries like Ireland and Bulgaria with tiny budgets can afford to offer a flat corporate tax rate of 10% in order to lure foreign businesses in what is known as relative tax havens. The largest economy with trillion dollar deficits cannot begin to compete with the likes of Ireland on low tax rates. In addition to cutting corporate taxes, Trump has proposed unspecified cuts in personal and estate taxes.

There has been a misconception that republicans in Congress support Trump's proposed tax cuts unequivocally. Instead, they have vowed to go for a tax overhaul which will be revenue-neutral. Any tax cuts have to be offset by a proportional cut in government spending. Thus, they will not add to any fiscal stimulus and avoid increasing the national debt. Republicans also seek to simplify the tax code and remove the numerous loopholes, so that the effective taxes paid get closer to the statutory tax rates.

For example instead of paying the statutory tax rate of 35%, S&P 500 companies use many loopholes to reduce their tax bill to 27%. Below is a chart by Deutsche Bank showing the effective versus statutory tax rates.

Figure 5: US statutory corporate tax rate vs. S&P 500 effective tax rate



Source: Compustat, Deutsche Bank

Even if corporate taxes were to decrease a full 10% (from 35% to 25%), S&P500 companies will only see a 2% increase in net income.

Any tax reform will be subject to fierce debate in Congress and results, if any, will be slow to come by. It took Reagan five years to pass his tax overhaul – he took office in 1981 while the tax bill cleared Congress in 1986.

Protectionist policies (import tariffs, trade wars, dismantling NAFTA, etc.)

The stock market is behaving as if Trump will fulfill only the campaign promises it likes but conveniently break all those promises it doesn't like. We view all of the proposed protectionist policies as unequivocally bad for growth. Any sort of trade protectionism will hurt corporate margins which were inflated by globalization and outsourcing. Trying to protect jobs at home comes at a cost – lower corporate profits. How much would an iPhone cost if all components have to be manufactured in the US instead of Asia? Apple Inc. would probably be able to transfer a fraction of this added cost to its customers, but some of it will come out of its profits.

Populism tends to exacerbate rather than solve problems

Up until this point, Americans had been blessed with limited experience with the new breed of populism. Europeans, on the other hand, have recently had quite a few populist leaders. Italy's Berlusconi, Greece's Tsipras and Bulgaria's Borisov are but a few examples of the populist wave sweeping across the EU.

Italy's Silvio Berlusconi was a prime minister for 9 years and left the country in today's wrecked state. Not only did he damage the democratic institutions with his numerous scandals and lawsuits, but he significantly increased government debt and impaired the economy through erratic actions and dubious reforms. The pillars of his election platform were tax reform, jobs growth and fiscal stimulus. He undertook a simplification of the tax code by introducing only 2 tax brackets depending on income – 33% and 23%. He also vowed to reduce the unemployment rate by bringing jobs back to Italy and keeping them there. Lastly he wanted to undertake a massive new public works program i.e. infrastructure spending. Unfortunately all he achieved was to leave the country in a worse state.

In 2015, Greece's Tsipras rose to power on similar promises. He vowed to decrease taxes, reduce the austerity measures (to provide relative fiscal stimulus) and diminish the high unemployment rate through "pro-growth" policies. None of the promises materialized and few will dispute Greece's unenviable state today as the crisis deepened.

Lower unemployment, lower taxes and more spending are universally pleasing to any electorate and universally instrumentalized by mainstream politicians and populists alike. For example Bush ran on a platform to overhaul and reduce taxes and the $1 trillion infrastructure spending plan was originally put forward by Obama in his 2008 bid. In his election platform, Trump was simply using what has worked for decades.

Contrary to the consensus view, economic, financial and political risks are increasing

There is a general misconception that 2016 was a volatile year for US equities. In fact the realized volatility on the S&P 500 was amongst the lowest on record. This is generally manifested in the popular saying that stocks have "climbed a wall of worry," yet last year there seemed to be no worries. After the January correction there was almost no equity volatility. There were less than 10 days the market fell more than 1% for the rest of the year. As many commentators noticed, the markets shrugged off Brexit in a matter of days, Trump's victory in a matter of hours and the Italian referendum in a matter of minutes.

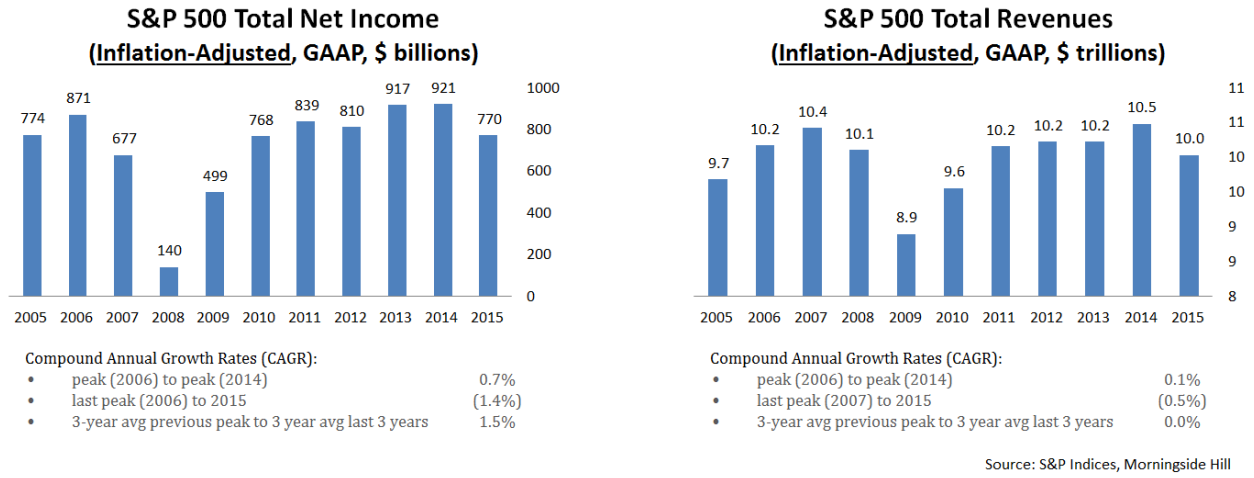
Like at every market top, risks simply cease to exist. Everything seems like a buying opportunity. Bad news are rapidly absorbed by buying any potential dip, while good news are cited as reasons for the markets to go even higher. For anyone who remembers previous market tops this behavior is not abnormal.

In reality the world is in a worse state today than it was 12 months ago. US growth is slower, trailing corporate earnings are lower, China is rapidly decelerating, political risks are increasing. A year ago we did not have many of the problems we have today, while none of the existing issues were resolved.

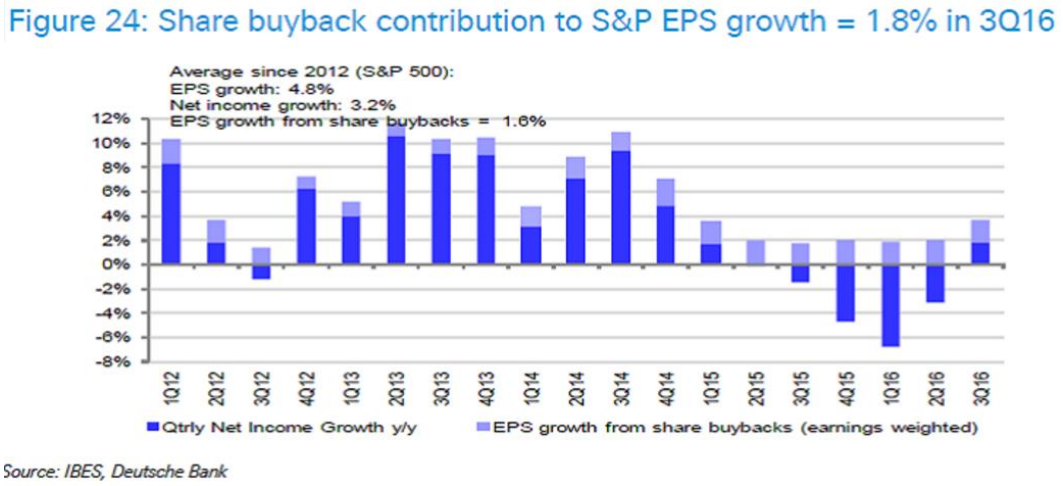
The powerful albeit misleading narrative that "everything is great"

Virtually all media praised the "improving" economy and lead us to believe the promised acceleration in growth is just around the corner. Last year saw real GDP growth in the US of 1.7% in comparison to 2.4% in 2015. For the S&P 500 companies real corporate profits, even the adjusted non-GAAP numbers, are down in 2016 versus 2015, which were lower than 2014.

In the paper titled "S&P 500's lost decade" (available here) we demonstrate that the index companies have not achieved a lot in the last 10 years once we exclude the effects of inflation and buybacks. The chart below shows that total net income and revenue barely grew from the previous cycle's peak to the current one.



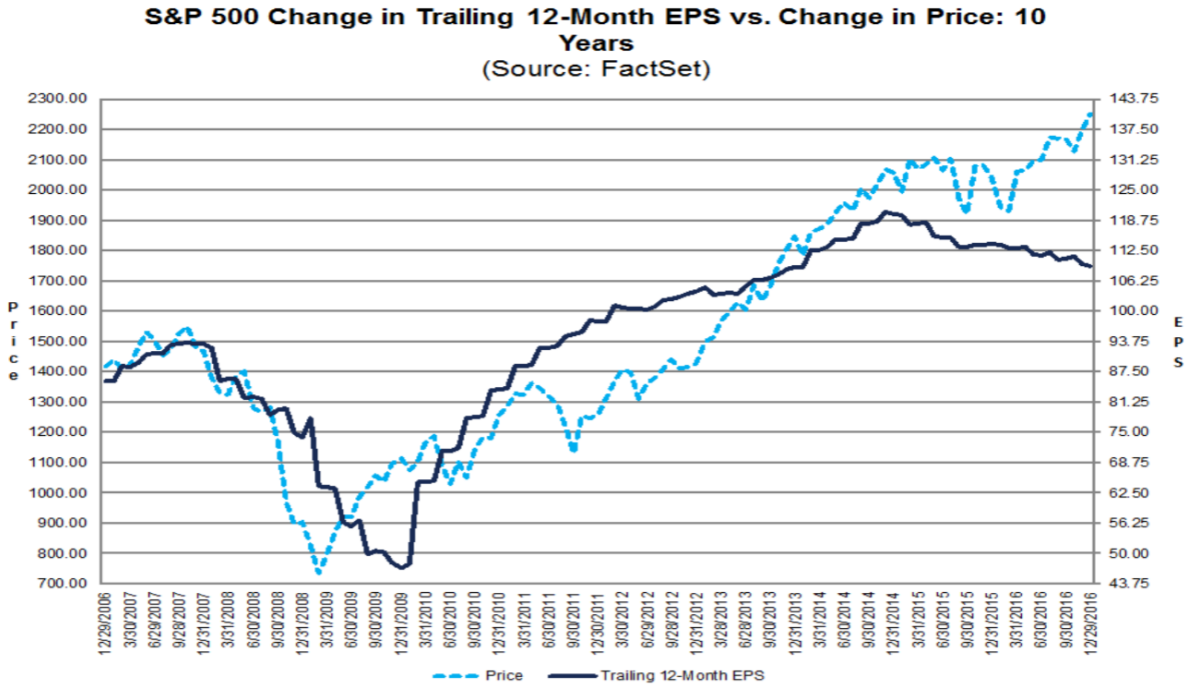
Let's take for example the latest S&P 500 quarterly earnings for Q3 of 2016 – touted as a great success and growth reacceleration. According to Factset the adjusted non-GAAP earnings growth was 3.1%. With positive earnings growth everyone proclaimed the end of the earnings recession. However, with inflation at 1.7% real earnings grew at only 1.4%. To account for the effect of buybacks let's look at the following chart from Deutsche Bank. It demonstrates the quarterly improvement in earnings due to companies buying back their own stock, most often with borrowed money.



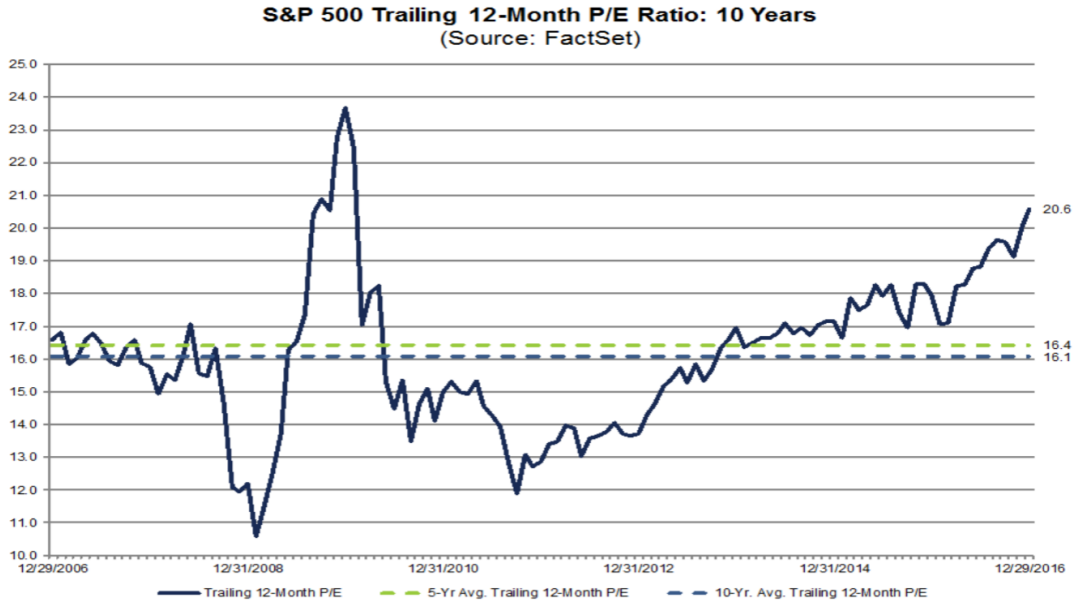
It turns out that in Q3 of 2016 buybacks contributed 1.8% to earnings growth. Therefore excluding the effect of inflation and buybacks, Q3 earnings were at -0.4% versus the already weak Q3 of 2015 (3.1%-1.7%-1.8% = -0.4%).

No wonder that market commentators and analysts always insist on valuing the market at forward earnings rather than trailing ones. They want us to base market valuations on their optimistic forward projections instead of

currently reported earnings. The trailing 12 month earnings are ugly indeed. The following is a chart pictured on the last page of Factset's Q3 report showing the price of the S&P 500 index and its trailing 12-month EPS.[5]



The divergence is so significant that either earnings need to increase by 30% or the index must drop by 20% just to bring the valuation down to its level at the previous peak in 2007. If earnings are decreasing while the index is constantly achieving new all-time highs than the price to earnings ratio (P/E) must be increasing. The chart below shows that the current adjusted non-GAAP earnings ratio is at 20.5x significantly above historical averages (during last cycle it peaked at 17x in 2007). The GAAP price to earnings ratio is even higher at 26x.



High expectations for economic activity in 2017 are as unfounded as they were for 2016. Economists and analysts expect 15.6% earnings growth and 2.5% GDP growth in 2017. Their expectations were quite similar for 2016 and we had negative real earnings growth and a mere 1.6% GDP growth.

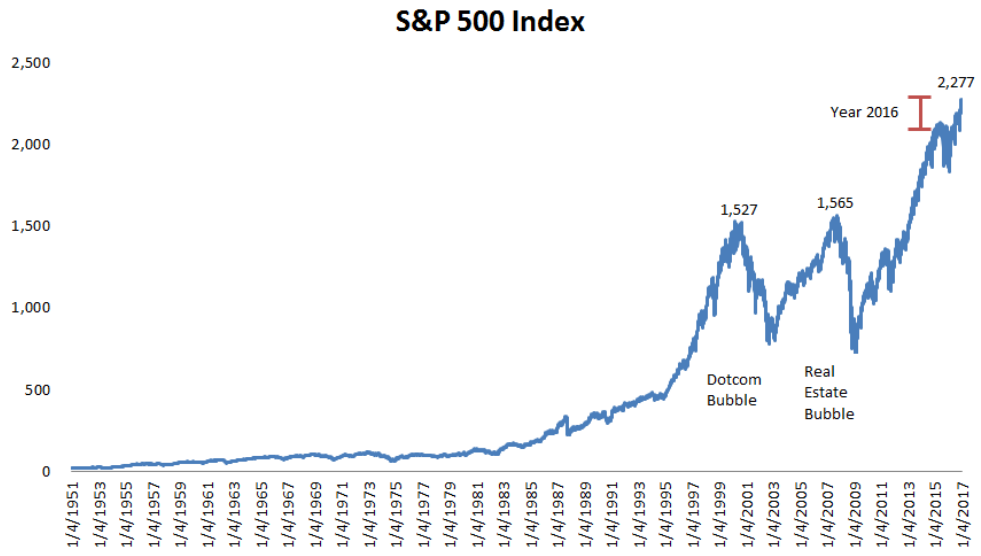
[5] http://insight.factset.com/hubfs/Earnings%20Insight/Earnings_Insight_123016.pdf

In the absence of any real catalysts, what could lead to a reacceleration in growth and earnings? Just as analysts assumed that central banks would provide a panacea to stagnant growth, they have now chosen a new savior – Donald Trump.

We do not expect any growth reacceleration 8 years into the current cycle. This new ubiquitous "theme" is truly astounding. Protracted weakness in the US economy is here to stay and will give way to a more serious downturn. A more critical look at the US economic data would explain the popular discontent that brought about Trump's ascension and a surge of populism on the American political arena. Signs of strain are visible in a web of interconnected elements. Most new jobs created are lower paying and part-time, while there was no real wage growth for the bottom 85% of US employees since 2009 (a detailed employment analysis will be provided separately). Real wage growth is lacking since companies have not been able to grow real earnings as demonstrated above.

After Trump's election, markets were excited by a sudden jump in many survey-based metrics like purchasing manager's surveys and consumer confidence surveys. The rise in this survey-based data contradicts hard economic data and we believe is the direct result of a post-election hype. Sentiment-driven data is fickle and unreliable in assessing long-term trends.

As we mentioned earlier, markets are only pricing in blue sky scenarios while completely ignoring the risks. To visualize the massive equity bubble, here is a simple daily chart of the S&P 500 over the past 70 years. The year 2016 represents a nearly vertical ramp up.



More negative on equities, expecting a recession in the very near future

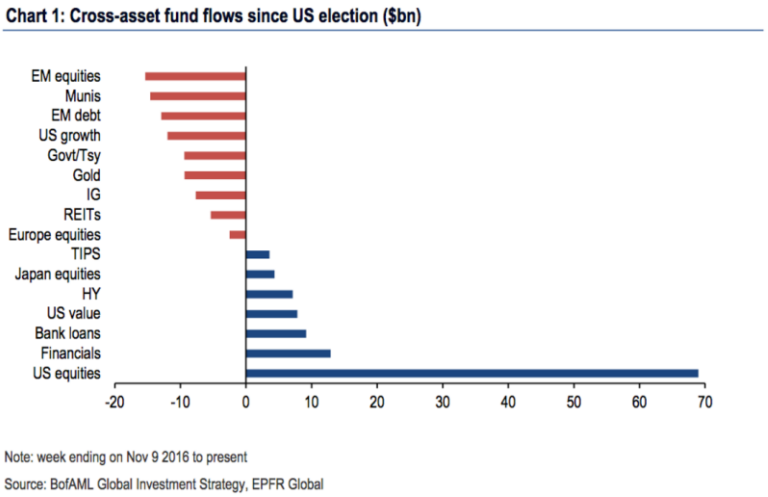
Last year's Jan-Feb market correction felt wrong. Everyone was cautious and Wall Street banks were sending notes to "sell everything," "reduce risk" and called the end of the equity bull market. If the markets really did crash back then, this would have been the first time Wall Street and mainstream economists saw it coming.

Today everyone is bullish and most bears have capitulated. We have witnessed a renewed wave of irrational exuberance which was the missing ingredient in what has become a textbook setup for a market crash.

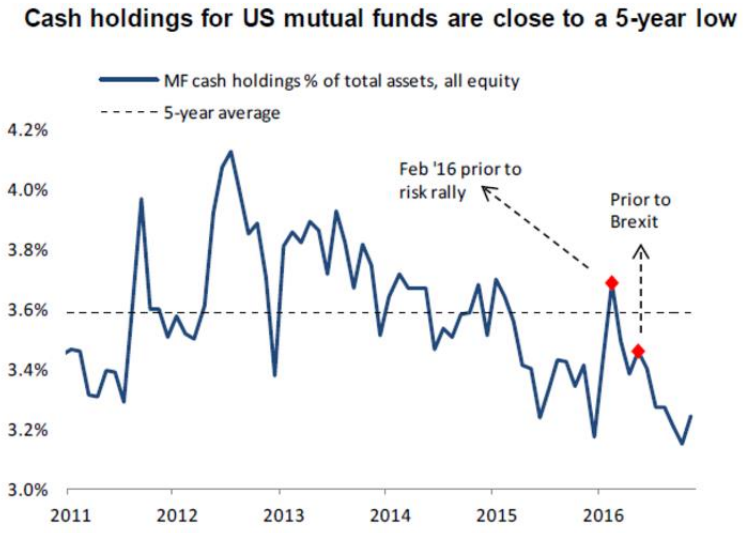
Risk no longer exists. Wall Street banks have aligned their projections expecting results within a very narrow band. Herding behavior is apparent in the very tight range of expectations for market returns. The only question is whether equity markets will be up 10% or more.

There is no need to pay for active management anymore. This past year saw a record switch into passive ETFs since it doesn't matter which stock you pick – the markets will simply go higher and higher and one cannot lose. In 2016 alone, ETFs saw a record inflow of $280 billion.[5] As smart money is underperforming, the other end cannot seem to buy the dips fast enough. The biggest bear on Wall Street sees the market going up only 5%. Buying downside protection for equities or shorting anything is at its most unprofitable since 1999.

The chart below shows the staggering $70 billion inflow into US equities since the elections. One can imagine what happens once this overcrowded trade is reversed.[6]



The following chart shows the mutual fund cash levels are at 5-year lows.[7] This is a very strong contrarian signal.



Who needs improving fundamentals when there is more hope just around the corner? Last year it was the central banks, today it is Trump. However, if any of Trump's "pro-growth" policies materialize at all, it will take a few years. On the other hand financial tightening, a strong dollar and higher inflation expectations are already here and they all have adverse effects on earnings.

[6,7] https://www.bloomberg.com/news/articles/2017-01-06/wall-street-is-starting-to-get-nervous-about-all-the-money-pouring-into-u-s-stocks

The Bloomberg chart below to the left illustrates the jump in yield on the 10-year US government bond after Trump's election in November. The one to the right, depicts the rise in the US dollar index (that represents the USD exchange rate against a basket of currencies).

As the yield on the 10-year US treasury bond rate suggests, since Trump's election borrowing costs have increased some 30-50%. As the bond selloff continues, a Fed hike becomes irrelevant – the markets are tightening financial conditions on their own. By selling government bonds they increase borrowing costs for everyone in the real economy. At the same the US dollar reached a 14 year high and this bodes ill for both US corporate earnings and output.

In 2016 global debt continued to increase at an exponential rate. The Institute for International Finance just reported that it has reached $217 trillion or a full 325% of global GDP and in 2016 alone it increased by a stunning 20% of global output.[8] The world has been experiencing slowing growth despite continued leveraging, the repercussions of which we leave for you to judge.

US companies are facing additional headwinds from steeper borrowing costs, higher fuel input costs and a stronger dollar which weighs on their international sales (currently at 30% of S&P 500 revenues). We fail to see the case for improved earnings in the near future.

As Trump fails to deliver throughout the year, sentiment-driven metrics (i.e. confidence and PMI surveys) will follow suit. We view Trump's actions as erratic, reactive, impulsive and superficial; he is unlikely to follow through on lofty promises with hard-fought reforms and feasible strategies. The moment the markets recognize this, they will realize that they are stuck with him for a full four years. At this point the last pillar of hope will disappear.

External risks have intensified as well. China is at a very dangerous point in the debt cycle where about $200 billion in additional debt monthly is needed just to keep the system from imploding while real growth is crashing. The topic should be addressed separately, and we will share our research piece on China soon. Europe is distinctly worse off and yet its stock markets are soaring. Italy is struggling to keep its banking system afloat and is patching a €380 billion capital deficit with what it refuses to admit are bailouts of €20 billion or less at a time. The EU's second-largest economy just opted out of the bloc, revealing a rising specter of populism across the continent.

The difference between inflation and growth is that unlike growth, higher inflation can be wished into existence. After years of monetary stimulus resulting in $13 trillion of new money printed that failed to produce inflation, mere expectations of what a Trump presidency might bring are sufficient to fuel its current rapid increase. Unlike what many economists believe, inflation seems to be more of a psychological than a purely monetary phenomenon. Rising inflationary pressures will undoubtedly hamper the already weak consumer worldwide.

[8] https://www.iif.com/publication/global-debt-monitor/global-debt-monitor-january-2017

We believe that the probability of a recession in 2017 has markedly increased over the past few months. Most economic indicators are at or below levels historically associated with the start of recessions. A drop in equities and consumer confidence, both at record highs, would be enough to tip the economy into a recession. If the equity rally continues, the bond selloff will worsen which will in turn hamper the equity rally. The massive amounts of debt worldwide will not withstand even slightly higher borrowing costs and the unraveling will ensue. Even if equities take a pause and trail sideways, the increasing inflation expectations will force higher bond yields. The markets have pushed themselves into a corner with their prevalent high expectations; disappointing this fickle sentiment is more probable than not and may give way to a serious downturn.