Trump's election as US President – has the world really changed that much?

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On November 8 Donald Trump won the US Presidential election that made him the 45th President of the United States. The victory seemed highly unlikely leading up to the election. Instead of the large correction that many experts predicted on Trump becoming President, developed equity markets and commodities have staged a strong rally on predictions that the new President's economic policies will be the panacea to the low growth world we have been muddling through in the wake of the Global Financial Crisis (GFC).

Most economists and forecasters (many are the same people who had predicted the large correction only a few months ago) are now confidently lifting their economic growth expectations in the wake of the unexpected election result. Most investors seem to have readily accepted these forecasters' wisdom and are comfortable with their predictions. Probably because most investors feel more comfortable welcoming a forecast of sorts, particularly a rosy one, instead of continuing to live with the uncertainty of the last few years. As opposed to many other market participants, Investors Mutual (IML) will readily admit that we cannot with any great accuracy forecast the performance of the economy over the next year or two.

"I'm not an economist and we all know economists were created to make weather forecasters look good."

Rupert Murdoch

What we are certain of is that the future remains uncertain. While many economists often like to make confident predictions about the future, we would rather invest clients' money using our tried and tested investment philosophy of identifying undervalued quality companies that our detailed analysis shows can grow their earnings and dividends in the years ahead, as opposed to making investment decisions based on bold forecasts or predictions on what will transpire under a Trump Presidency.

At IML, we base our investment philosophy on buying good quality companies at the right price. Over short periods many stocks can perform well as investors exuberantly chase stocks based on the latest 'accurate' bold economic forecasts. However, it is our experience that over the longer term it pays off to buy quality companies that can deliver healthy long term capital growth, coupled with a reliable income stream rather than chase the latest fad or theme.

At the beginning of 2016 IML reflected on the weak state of global growth and indebtedness in the years following the GFC in a piece entitled 'Sustained Sluggishness'. We believe that despite the many new economic forecasts and predictions of a renewed economic upswing courtesy of President Trump's fabled magic wand, the global economy appears to be set to remain in a period of relatively low growth for the reasons, discussed in this paper.

Weak underpinnings: ineffectual Central Bank policy

As we noted last year, global growth remains delicately poised. Deflationary forces throughout the world continue to impede growth, despite the many efforts of Central Banks. Aggressive monetary policy has been tried repeatedly without leading to much tangible real economic benefit. Keynesianism holds sway amongst the financial authorities with the ingrained belief that low interest rates are always the tonic for investment and growth. Alas, credit growth in most places around the world has remained anaemic despite record low interest rates and global growth has barely budged.

One of the most noticeable outcomes of quantitative easing (QE) and ultra-low interest rates has been a sharp rise in financial asset prices, equities, commodities and property. The impact of Central banks policies is that many asset owners around the world are very satisfied with their actions as the prices of assets in the developed world hover at record highs. In truth unfortunately, this aggressive monetary policy has created great social disharmony in many countries between the 'haves' and the 'have nots', which has only served to exacerbate rising inequality. The impact of this has seen the rise of populist politics and increased nationalism in many countries, with the votes for Trump and Brexit surprising an "out of touch" elite, including Central Banks. The forthcoming elections in major European countries in 2017 in places like Holland and France may also prove interesting and also raise more concerns regarding the direction of global growth.

'Trumpflation'

Trump's pro-growth rhetoric and proposed stimulatory policies have led to predictions of higher inflation in the US, with the implication of further US interest rate increases through 2017. Federal Reserve Officials have already readied the markets to expect three interest rate increases throughout 2017.

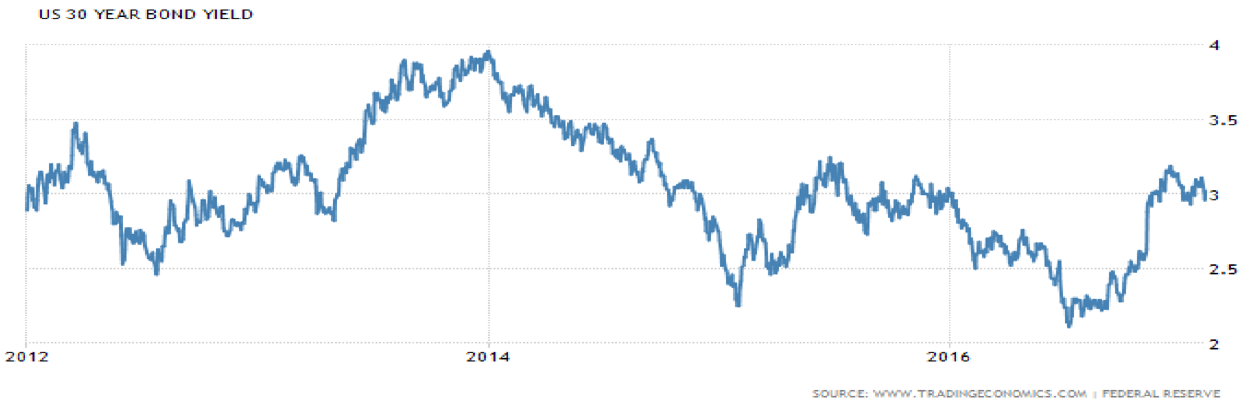
"The Federal Reserve is not currently forecasting a recession."

Ben Bernanke, 2008

The truth is that Trump's reflation rally could run out of steam before it begins, with the impact that higher borrowing costs courtesy of higher bond yields could weigh on the US economic recovery. We have already seen this with the US 10-year bond yield moving from its all-time low of 1.4% in July 2016 to around 2.5% as of December 2016. This strong rise in interest rates has already significantly impacted on the affordability of new houses for borrowers in the US.

During the 'taper tantrum' of 2013 we saw the US housing market's recovery come under increasing pressure as US 30-year bond rates spiked higher. If rates continue to increase, the US housing recovery, already in its seventh year, may begin to seriously sputter. Defaults could spike and higher mortgage repayments could weigh on other areas of economic activity, such as personal consumption.

US Government 30 Year Bond Yield – yields moving steadily higher



The rise in US interest rates has also sent the USD to its strongest level in over 13 years against its major trading partners. The strength in the USD is another obstacle that Trump will have to overcome as he looks to rebalance the economy in favour of US manufacturing and US exports. We have already seen the strong rhetoric coming out of the White House toward supposed "currency manipulators", namely China and Germany, as the new administration attempts to talk down the US Dollar.

Trump's much anticipated growth policies

Now in its 8th year of expansion since the GFC, the US economic recovery is fairly mature and is already running at close to full capacity in certain areas. Removing regulatory burdens, as proposed by the new President, will undoubtedly be favourable for businesses, but extra spending on areas such as infrastructure could put further pressure on labour markets and the supply of materials.

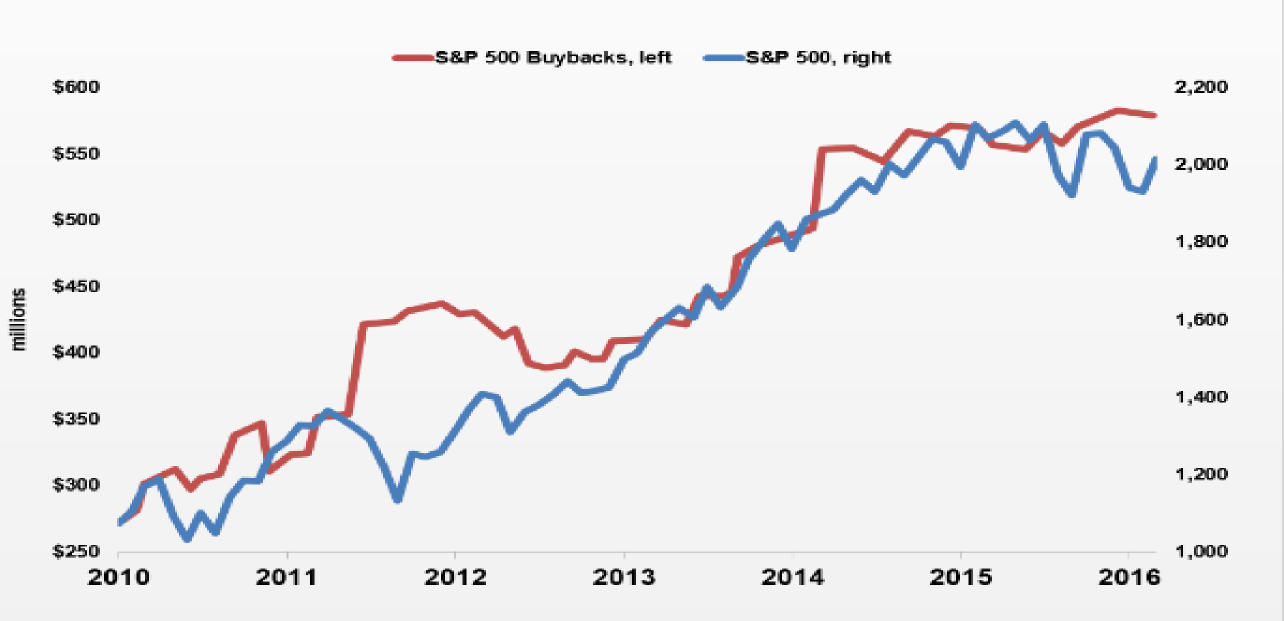
"I don't read economic forecasts. I don't read the funny papers."

Warren Buffett

Trump's team has not placed much emphasis on infrastructure spending since the election and little in substance has been provided to date. Naturally, the new President also has to get his policies through Congress. Although dominated by Republicans, many of these are unwilling to watch the US deficit balloon any further and they may well demand spending cuts to match any such spending initiatives. Trump's answer to this is that stronger levels of economic growth will provide the plank to pay for the additional stimulus. This is political rhetoric at its best in our view.

Trump's proposed tax cuts for corporate America, while very encouraging on the surface, also need to translate into higher investment spending by companies that will actually boost economic growth. In the last few years, rather than build new plants many US companies have used the low interest rate environment to focus on capital management via share buybacks, which have soared to record levels in recent years as seen in the chart below.

A close correlation: US company share buybacks and the S&P500



Source: S&P, Haver Analytics, Barclays Research; Reposted in *Business Insider* 03/12/2016 www.dentresearch.com

Share buybacks may be good for companies' earnings per share (EPS) and help increase the value of CEO's stock options, but they do not create many new jobs except possibly at investment banks and legal firms!

When one looks closely at the US economic recovery, the truth is that the low interest rate environment has not actually meaningfully boosted investment but it has instead boosted leverage as companies have opted for financial engineering to boost their share prices. Trump's mooted corporate tax cuts have the potential to increase company earnings by up to 10-15%, but unless corporate behaviour changes as a result, real economic growth will not necessarily jump as high as many economists are now predicting.

"Forecasts usually tell us more of the forecaster than of the future."

Warren Buffet

Needless to say, both Australia's fortunes and global growth are sensitive to several economies outside the US. Trump's intention of raising taxes on foreign sourced production and effectively favouring domestic US production may lift US output, but it will do so via the substitution of overseas manufacturing. Consequently, global growth might be little changed as companies shift production in response to changing tax regimes rather than produce more overall.

China

In our opinion, despite numerous experts making forecasts on China's GDP, it remains almost impossible to predict with any certainty whatsoever.

Besides the fact that the Chinese economy is almost totally controlled by Government and hence at the total discretion of Government policies, in the last decade China's economic growth has continued to be boosted by a heavy emphasis on fixed asset investment. China's construction pace has been so hectic that a recent statistic showed that the country used more cement in three recent years (2011-13) than the US did for the whole of the twentieth century. An incredible statistic.

Much of the investment in infrastructure and construction post GFC was not necessarily required and was put in place ahead of expected demand to stimulate economic growth to a level that ensured social stability and low unemployment. China's economy remains heavily dependent on stimulus measures to keep its GDP growth in the high single digits whilst the authorities attempt to engineer a transition to a more consumer based economy.

"We have two classes of forecasters: Those who don't know and those who don't know they don't know."

John Kenneth Galbraith

In the past two years fears of a potential hard landing for the Chinese economy have escalated from time to time. These fears made headlines throughout the world, most notably in early 2016 when the Chinese stockmarket was in freefall, as many expert economists at the time made all sorts of dire predictions about what this collapse in Chinese stocks meant for the global economy. The Chinese authorities reacted to this stockmarket collapse by placing a ban on selling as well as suspending many stocks in a bid to prop up the market. These measures proved unsuccessful initially with a fall in the market from peak to trough (from June 2015 to February 2016) of approximately 50%. Whilst the Chinese stock market is not mature or deep enough to reflect China's domestic economy, it did bring to the surface many concerns surrounding the true health of the economy.

As the Yuan continues to devalue against its major trading partners, capital outflows from China persist, as more and more Chinese look to deploy their wealth outside of China. These outflows put further pressure on banks' liquidity ratios that are already highly dependent on liquidity injections from the People's Bank of China. As capital continues to exit and the Yuan faces ongoing devaluation, there is the potential for a banking crisis, although the authorities are likely to do all in their power to prevent or defer such an event.

Arguably the exodus of Chinese capital has fostered property bubbles in several Australian, New Zealand, Canadian and US cities. Authorities in China have recently tightened capital controls as the foreign exchange reserves of the country have fallen quite steeply in the past couple of years.

The ongoing bubble like nature of Chinese property adds further risk to the health of the banking system given the leverage deployed. Officials are hamstrung between trying to end the exuberance for property, yet at the same time stimulate the economy which is very dependent on construction. As noted above, policy makers are not always able to achieve the outcomes they seek despite aggressive measures and intervention.

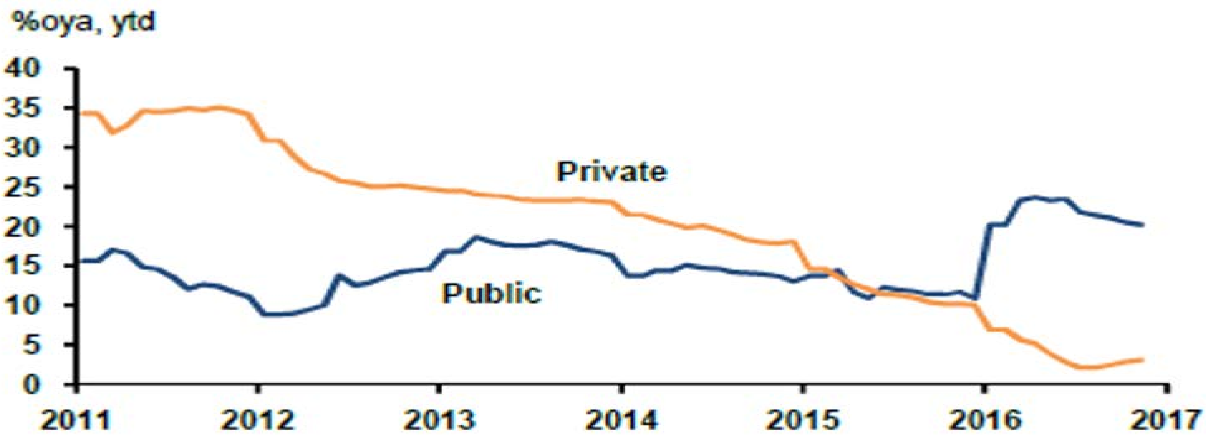
"What do you call an economist with a prediction? Wrong."

Robert Kuttner

Australia

The health of the Chinese economy remains crucial to the Australian economy, as witnessed at the beginning of 2016. Commodity prices, including our most significant exports, coal and iron ore, sold off heavily on concerns of a hard landing in China as the Chinese stockmarket collapsed and as spending on fixed asset investment declined. Chinese policy makers responded to this by loosening bank lending requirements and increasing infrastructure spending that helped doubled the price of iron ore and coal through the remainder of 2016.

China Fixed Asset Investment (FAI) growth in Public (State) v Private sectors



Source: NBS

Chinese state and private investment percentage change year to year: 2011– 2016. China continues to be driven by rapidly rising state investment. The dramatic increase in state led FAI was one of the major factors driving the commodities rally through 2016.

The performance of Australia's Resource sector remains heavily dependent on the strength in demand from China. The commodities rally of 2016, boosted directly by Chinese Government intervention, helped propel Australia's income and will provide some respite to the Federal Government's growing Budget Deficit, which is coming under closer scrutiny by the ratings agencies as to whether our AAA rating is still warranted.

The success of Chinese policymakers in navigating an overleveraged country through the transition from an economy that has been very asset investment dependent to one that is a consumption based remains a major economic uncertainty, with or without Donald Trump.

IML's positioning in a low growth environment

At IML, we are well conditioned to the mindset of investing without overreliance on strong world growth to deliver our results. Our selective stock picking style has always focussed on the quality and value of the underlying companies we own in our portfolios.

In the current continued uncertain economic environment and with so many potential uncertainties still facing the global economy, we continue to favour companies that our research shows can grow from their own initiatives rather than relying on higher GDP growth.

Our portfolios focus remains to identify companies that can grow through initiatives such as:

- **market share gains**
- **cost outs**
- **restructuring**
- **contracted growth**
- **accretive bolt on acquisitions**

Where our bottom up research shows that management have the capability to execute on their strategies effectively, we are confident earnings can grow despite much help from the economy.

Sentiment amongst many sharemarket investors has significantly improved since the election of Trump after many economists recently upgraded their GDP forecasts. This is the complete opposite to where we were only 12 months ago when China's sharemarket was crashing and many leading economists were making dire warnings of what it all meant to global growth.

We believe a cautious approach is still warranted given the points mentioned in this paper. While sentiment may carry the stockmarket higher in the short term, we believe it is important for long term investors to continue to remain disciplined and positioned in defensive, quality stocks where the earnings and dividend outlooks are sustainable in the years ahead rather than get too carried away with whatever is being forecast by many market 'experts' at this particular moment in time.