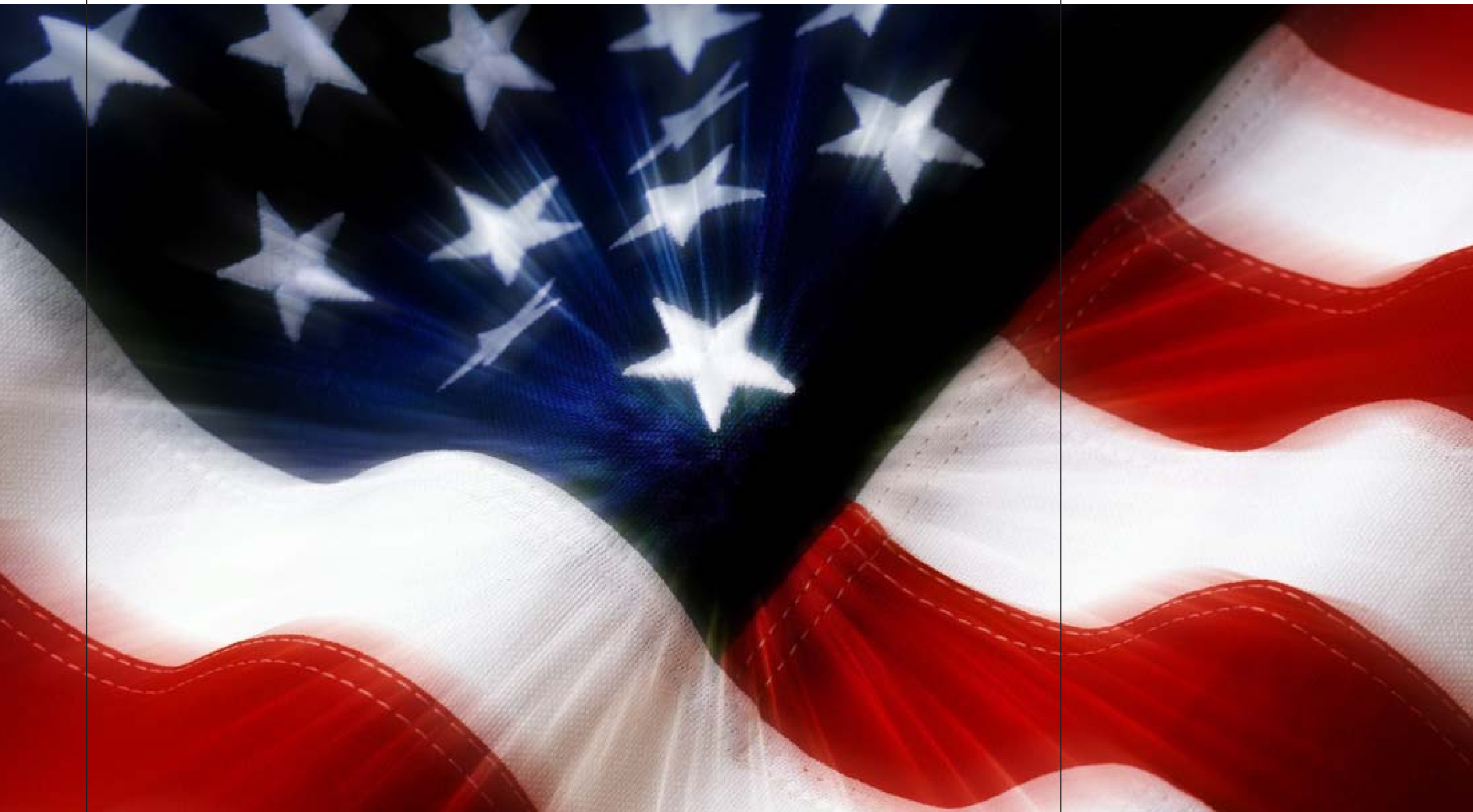
William Blair

November 2016
Market Update
Dynamic Allocation Strategies

Commentary:
U.S. Election Cycle Ends With a Bang

Dynamic Allocation Strategies Team

With an early morning concession call to Donald Trump, Hillary Clinton brought to a close an election cycle unlike any in recent memory. The cycle was characterized by an unusual degree of animosity between candidates and even within parties and witnessed by an increasingly angry, dissatisfied, polarized, and divided American electorate. This latest surge of populism, which has been a major macro-thematic influence for the Dynamic Allocation Strategies (DAS) team for several years now, was again vastly underestimated by both pollsters and the betting markets.



What Happened?

While we witnessed a somewhat similar lead-up and outcome early this summer with Brexit, in that case the polls indicated a close outcome but leaning toward "remain" while the betting markets heavily favored the same outcome.

On November 8, we witnessed polls and betting markets—both very heavily leaning toward a Clinton victory (despite some recent hiccups around her emails)—being turned upside down. Clinton's choice to avoid several Midwest states (in the middle of the so-called "Rust Belt"), thinking them locked up, came back to haunt her as Trump continued to pound away and carried Wisconsin, Michigan (likely), Ohio, and Pennsylvania. That, along with big victories in Florida and Arizona, propelled him to a surprising victory.

Trump's appeal as an outsider resonated with middle America, and his continued promises to focus on fixing the internal problems of the country and espouse the type of nationalistic tenets that have become a fixture of populist movements gained great traction among more than enough people not typically on the radar screen of the major media outlets. Trump successfully positioned himself as this cycle's "change agent" (albeit quite differently from Obama's efforts eight years ago), contrasting his outsider status with that of Clinton's 30 years of public service.

While our most recent election probability matrix put a Republican sweep at 20%—a relatively slim chance even with recent upticks—our sense was that if Trump did find a "path to 270," he would likely bring the Senate with him. We anticipated the potential for a large downside event in the case of a Trump victory and were able to rest relatively easy last night as the tide turned to Trump.

> **"We were appropriately protected for a large downside event in the case of a Trump victory and were able to rest relatively easy last night as the tide turned to Trump."**
>
> — DAS Team

Now What?

Uncertainty now reigns (versus the gridlock we expected would come from a Clinton victory and a divided legislature) and will likely remain to some extent through early next year as Trump's cabinet appointees and path forward on issues such as immigration, trade, foreign relations, healthcare, and fiscal and monetary policy are clarified.

It remains to be seen whether (and how) the way in which Trump ran this campaign will have a lasting impact on how future election cycles evolve and/or how political parties in the United States coalesce around their chosen candidate. But of utmost near-term importance is how Trump will spend his time during the next couple of months—with whom will he meet, how will he refine and message his intended policies and goals, and whether he will truly work on the "unification" aspect that he emphasized in his acceptance speech early Wednesday morning.

> **"Of utmost near-term importance is how Trump will spend his time during the next couple of months."**
>
> — DAS Team

Forward-Looking Implications

Equity markets began to sell off the evening of November 8 as early exit polling indicated an unexpectedly strong early showing by Trump. Most (equity) futures markets, and a number of emerging market and Asian currencies, continued to sell off to overnight lows. The Mexican peso was down by as much as 13%, U.S. equity futures down more than 5%, and Japan equity futures down more than 6%.

However, as evening turned to morning in the United States, a marked rebound off lows was noted almost uniformly as investors began to digest the news and wrestle with the removal of one large uncertainty (that of the result) but face a forward-looking environment filled with even more and unexpected uncertainty. In this way, investors appear to be acting on the message learned from Brexit; however, it remains to be seen as to whether this immediate reaction proves appropriate.

> **"Investors appear to be acting on the message learned from Brexit."**
>
> — DAS Team

Some aspects of our initial thinking revolve around:

- A Republican sweep equates to a pro-business environment.
- Market gyrations (especially November 9's rebound from the overnight downturn) are likely a near-term overreaction to relief of removal of election uncertainty but, in our view, perhaps overlook policy and institutional uncertainty in the months ahead.
- The result strengthens the United Kingdom's hand and weakens European Union's hand in the Brexit negotiations.
- Italy's Prime Minister Matteo Renzi faces a large uphill battle in next month's referendum.
- Chancellor of Germany Angela Merkel also now faces a headwinds in Germany.
- France's Marine Le Pen, whose far-right National Front party has been building support for anti-immigration, anti-EU policies, has gained momentum in France.
- The probability of U.S. secular stagnation has dropped a bit.
- The next election cycle (the 2018 midterm) presents favorable tailwind in terms of further cementing or expanding Republican control of the Senate.

We will be monitoring a number of "milestones" for Trump:

- With which foreign leaders will Trump first meet?
- Who will be considered for presidential appointments and/or cabinet considerations?
- Will Trump's first efforts be along easier paths, designed to generate quick wins and utilize the Republican sweep (such as tax reform)? Or will they be longer, more time-intensive, and more difficult pursuits (such as repealing Obamacare)?

In terms of trade:

- Trump will likely more free-trade-oriented than he was during his campaign posturing.
- Trump can remove the North American Free Trade Agreement (NAFTA) with less effort than the Trans-Pacific Partnership (TPP).
- Regarding the TPP, a fast-track already granted by Congress provides guidelines in regard to what can be (re) negotiated by a president. It is possible that Trump reworks it or kills it altogether. ■

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