SeaBridge Core Global Strategy

Fourth Quarter 2016
Commentary

In his book, *The General Theory of Employment, Interest and Money* published in 1936, John Maynard Keynes popularized the phrase “animal spirits.” Although the phrase was widely used in English literature over the centuries, Keynes applied the term to the field of economics. Essentially, Keynes was describing human behavior that was best explained as spontaneous optimism. In an unanticipated twist of fate, U.S. equity markets moved sharply higher following the Presidential election. Despite losing the popular vote, the States, as represented by the Electoral College, chose Donald Trump to be the 45th President of the United States of America, and animal spirits appear to have been unleashed.

Aside from an enormous amount of equity value that was created out of thin air subsequent to the Presidential election, what exactly are animal spirits in an economic context? Perhaps the most vivid illustration of animal spirits came from the National Association of Home Builders (NAHB). In conjunction with Wells Fargo, the NAHB publishes a monthly Housing Market Index (HMI), which is designed to measure builders’ sentiment. On December 15, 2016, the NAHB noted that their HMI had jumped an impressive 7 points to a level of 70. The NAHB noted that this was the highest reading since July 2005 and the biggest sequential monthly increase in 20 years. Their press release indicated that “This notable rise in builder sentiment is largely attributable to a post-election bounce, as builders are hopeful that President-elect Trump will follow through on his pledge to cut burdensome regulations that are harming small business and housing affordability.” This sentiment is understandable in that a recent NAHB study showed that “regulatory costs for home building have increased 29 percent in the last five years.”

Corroborating the NAHBs sentiment, Brian Moynihan, CEO of the Bank of America, recently told Bloomberg in an interview that mid-sized companies “are friskier, they’re more active.” By friskier, Moynihan was referring to a recent increase in companies drawing on their credit lines. Moynihan further noted that “they feel better about the prospects of the regulatory environment and their business.” Perhaps more important, Moynihan said “they feel better about the possibility of final demand.” The absence of robust growth in final demand for goods and services has, ostensibly, been the proximate cause of anemic growth in capital spending and, therefore, substandard GDP growth in recent years.

Based on the apparent increase in business sentiment subsequent to the presidential election, it seems reasonable to assume that U.S. economic activity should accelerate in the early part of 2017. Thus far in the current economic recovery, the U.S. has grown at a rate of 2.2% per year, which is well below the post-war average of 3.4%. Nonetheless, the paltry growth experienced since 2010 has been enough to tighten the job market to the point at which wage growth is showing signs of accelerating. Since President-elect Trump’s rhetoric has been all about stimulating the economy and creating jobs in America, the issue that will preoccupy investors in the coming years is the impact of Mr. Trump’s policy initiatives on inflation. Normally, economic stimulus is introduced into economies that are in recession, rather than near full employment as the U.S. economy is at present. If Trump’s stimulus package has more of an effect on labor, rather than capital, then we could experience inflation above the Federal Open Market Committee’s (FOMC) target zone. Such an outcome has the potential to shorten the economic recovery. A stimulus package that incentivizes capital investment, however, could lead to an extended period of high growth with low to moderate inflation.

Investors will have a difficult time handicapping the policy initiatives that Mr. Trump is likely to pursue because the only thing the President-elect has demonstrated with clarity is that he changes his mind as frequently as political expedience requires. We'll know what he plans to do when, as, or if we see proposed legislation. Even then we won't be sure what the final policy outcomes will be because the Republican Congress is anything but unified. Although the Republicans nominally control both chambers of Congress, the party is as fractured as the American public.

Some of the topics for major policy initiatives articulated during the Presidential campaign have the potential to be very stimulative to the U.S. economy. Others could be outright destructive. The growth enhancing issues that could be pursued by Trump include: tax reform that stimulates final demand and increases capital investment; repatriating corporate capital stranded abroad, which could increase capital investment; and easing business regulations that lower the cost of doing business and stimulates business formation. On the destructive side of Trump's campaign rhetoric are: protectionist trade legislation that slows world growth, or immigration reform that leaves the U.S without a sufficient supply of skilled labor to fuel growth.

So, what does all this mean for equity investors? There are a lot of permutations of policy outcomes, and a range of potential outcomes for the economy and corporate profits. In the short term, we expect that the animal spirits unleashed by the election will stimulate economic activity. If we use the rate of 2.2% growth experienced since the last recession as a base, then perhaps animal spirits lift growth closer to 3% in the first half of 2017. Some of the policy proposals mentioned by President-elect Trump have the potential to lift growth to a rate that more closely approximates the historical 3.4% long-term average. Protectionism, on the other hand, is a growth attenuator at a minimum, and potentially something much worse. As the politics and rhetoric that accompany the legislative process play-out in the media over the early months of the new Presidential administration, the stock market could be more volatile than normal. Moreover, the FOMC has engineered two quarter point increases in interest rates thus far and has suggested that three more could occur in 2017. The pace at which interest rates increase could also increase equity market volatility.

If Trump's policy initiatives are successful in engineering an increase in economic activity, then corporate earnings have the potential to be higher than current equity valuations imply. If so, then stocks, which currently seem to be priced in a fair value range, could enjoy a substantial leg higher. Moreover, if interest rates rise at a moderate pace, our value style of investing could continue to perform better than investing in high growth, high valuation equities. Indeed, we noted in our commentary in April of 2016 that the rising trajectory of interest rates that began in December 2015 would swing the odds in favor of value over growth. This was the driving force behind our strong portfolio performance in 2016, and, hopefully, it will continue into 2017 as interest rates continue to regress to a normal level.

Alas, as is typically the case, along with opportunity comes risk. If President Trump over-plays his hand, we may have to deal with legislation that could disrupt commerce and cause the economy to slow. Conversely, public policy could overly stimulate the economy and produce inflation due to the already tight labor market. The latter outcome would incite a more aggressive FOMC, which could reduce equity valuations. After Trump takes office in January, we will assess the efficacy of his policy initiatives, and make the appropriate adjustments to our portfolio strategy.

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