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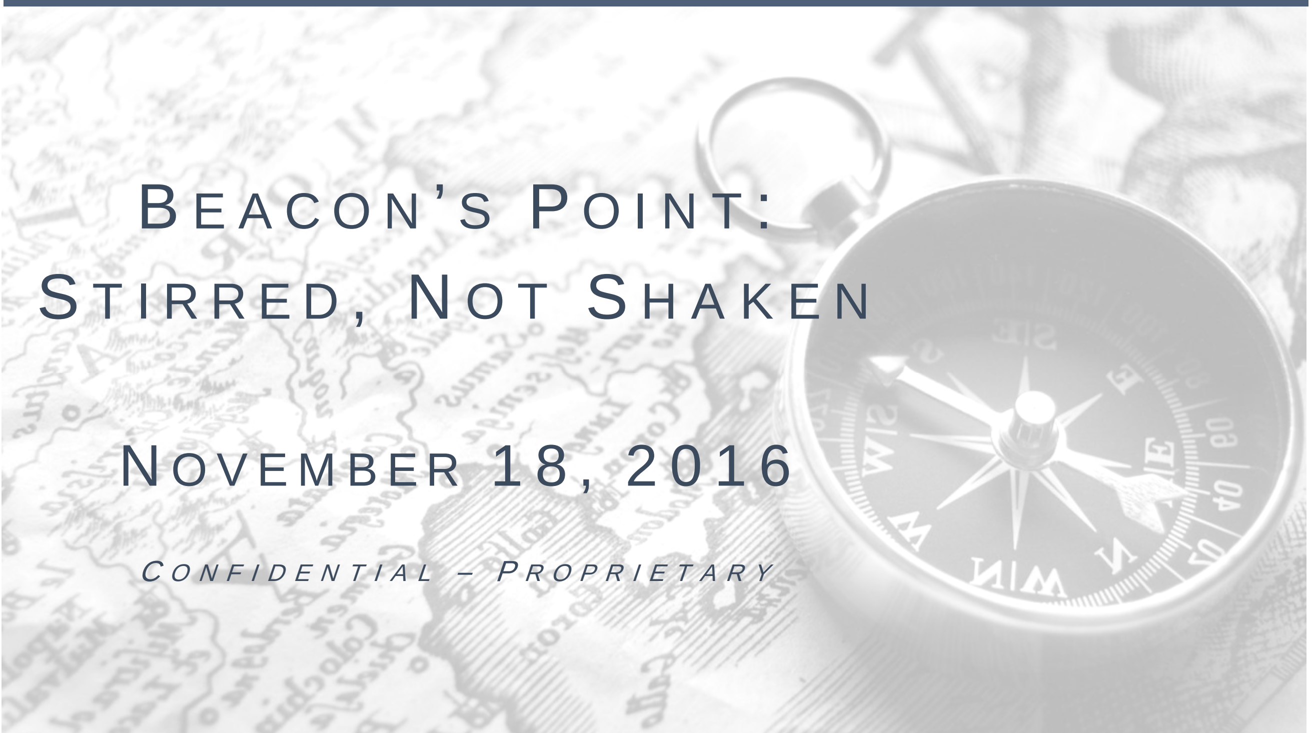


Beacon's Point: Stirred, Not Shaken

November 18, 2016

Confidential – Proprietary

Stirred, Not Shaken

In the early morning hours of November 9th, we learned that Donald Trump's promise to "Make America Great Again" resonated with voters. The important transition from campaign slogans to political reality is already in full swing. Much will happen between now and President-Elect Trump's inauguration in January. Cabinet appointments will be announced, party leadership will be selected, and policy initiatives will be proposed and debated. We will also give thanks for the many fortunes we have been blessed with – including the end of a fiercely-contested election campaign – and usher in the New Year. Our world has certainly been stirred by President-Elect Trump's surprising victory, but our confidence has not been shaken. We, at Beacon Pointe, see clearly the value we bring to our clients in the form of unbiased advice, a focus on each client's long term goals, and a thoughtful and balanced approach to risks and opportunities in all market environments.

The leading storyline of the current environment is the undeniable shift in the balance of political power at multiple levels of government in favor of the Republican Party. Last week's election results were the exclamation point at the end of a process that has been underway for several years. According to AMG Funds' summary of the post-election state of the union:

- 2017 will have a Republican in the White House and Republicans controlling both the House and the Senate. Over the last 80 years, the S&P 500 has gained +11.7% per year (total return) when the White House and Congress were controlled by the same political party. (Source: BTN Research)
- Using voting results through Friday 11/11/16, the House is now controlled by the Republicans 239-193 with 3 races still to be determined. The Republicans controlled the House 246-186 (with 3 vacancies) prior to the 11/08/16 elections. (Source: House of Representatives)
- Using voting results through Friday 11/11/16, the Senate is now controlled by the Republicans 51-46-2 with 1 race still to be determined (Louisiana). The Republicans controlled the Senate 54-44-2 prior to the 11/08/16 elections. (Source: Senate)
- Using voting results through Friday 11/11/16, the governorships across the country are now controlled by the Republicans 33-15-1 with 1 race still to be determined (North Carolina). The Republicans controlled the governorships 31-18-1 prior to the 11/08/16 elections. (Source: Washington Examiner)
- 126.1 million Americans voted in the 11/08/16 presidential election, 3 million less than the number of voters in the 2012 election. The 126.1 million voters represent 56.8% of Americans that were eligible to vote, indicating that 96 million Americans that could have voted choose not to do so. The highest voter participation in the last 100 years was the 62.8% that voted in the 1960 election. (Source: BTN Research)
- The state of Ohio has correctly backed the winner of the US presidential election in the last 14 races, i.e., 1964-2016, including last week's upset. (Source: PresidentElect.org)

Source: AMG Funds

Emotions always run high around presidential elections, especially when the popular vote and Electoral College results differ. Once the outcome is known, some feel elated, others deflated. The reality of the next four years will likely be neither as hoped by the former, nor as feared by the latter. The political road from words to actions is very long, indeed. Even with a united government – both chambers of the 115th Congress and the Presidency will be controlled by the Republican Party – there are no guarantees that the proposed legislature will gain sufficient support without multiple rounds of amendments. Congressional Republicans have not always agreed with President-Elect Trump's positions on key matters, so consensus and unity within the majority party itself will be a process of compromise and consensus-building. Nevertheless, we expect a busy Washington, DC agenda in the first two years of the new presidential cycle with a focus on the following key issues:

- <u>Fiscal policy and taxation</u> – President-Elect Trump's highest priority initiatives seem to be his tax cut proposal and an infrastructure spending plan. The President-Elect has called for lower personal income tax rates, a simplified system (consolidating the current seven tax brackets into three, 12%, 25%, and 33%), and the repeal of the estate or "death" tax. He has also vowed to reduce the corporate tax rate from 35% to 15% and eliminate the corporate alternative minimum tax. Finally, he will seek an agreement regarding the repatriation of overseas corporate cash at a one-time tax rate of 10%.

  In terms of infrastructure spending, although it is still unclear what the potential size of the proposed package will be (according to campaign speeches, the amount could exceed $500 billion), it is likely to provide a meaningful boost to GDP growth. Specific areas in need of investment, according to the plan, are transportation, clean water, a modern and reliable electricity grid, telecommunications, and security. Both Republicans and Democrats are likely to lend their support to projects that create jobs and improve business prospects. Some projects will require federal outlays, but others may be more geared towards state and local governments as well as the private sector. Nevertheless, President-Elect Trump's fiscal stimulus proposals, if they come to pass, will result in a widening of the budget deficit.

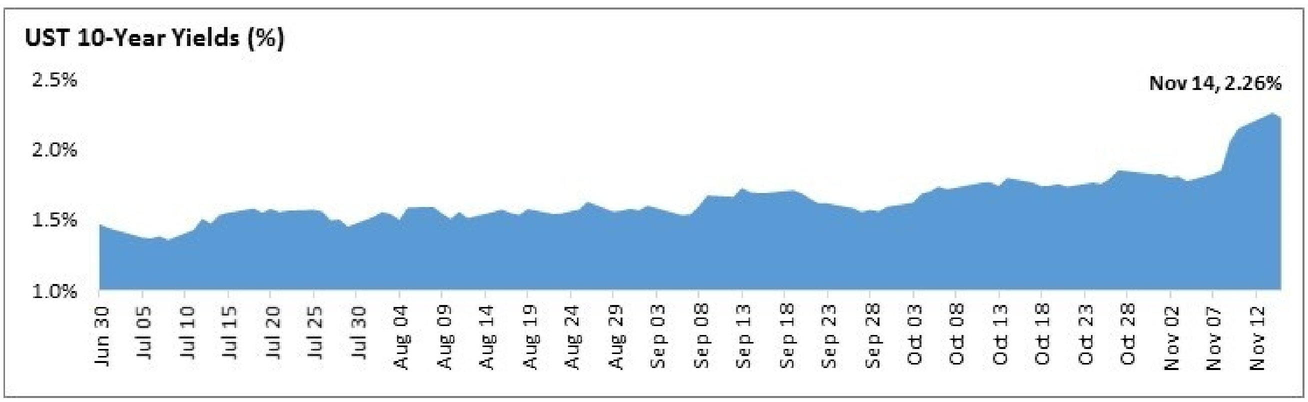
- <u>Regulation</u> – another area of focus will be regulatory reform. There is a recognition that increased regulation has hindered new business formation and productivity growth in recent years. Areas that may be favorably impacted by a move toward easing regulatory requirements include the energy, financial, and health care sectors. (President-Elect Trump frequently argued that the Affordable Care Act should be repealed as soon as possible, but he may take a more measured and practical approach to this issue, perhaps choosing to work on an alternative solution first or amending/improving the law instead of creating a vacuum in its absence.)

- <u>Monetary policy</u> – leading up to the election, Donald Trump was a vocal critic of Fed Chair Janet Yellen for keeping rates artificially low. While removing her from the position would be difficult for him, it seems clear that Ms. Yellen will be replaced after her current term expires in February 2018. Importantly, the President-Elect has an opportunity to reshape the Fed's Board of Governance ahead of that date as there are currently two vacancies awaiting nominations. Near term, the Fed is still expected to raise rates by 25 basis points during its December meeting, but the outlook for 2017 is less certain.

- <u>Trade and international relations</u> – de-globalization played an important role in President-Elect Trump's message to voters during the campaign. He repeatedly signaled a commitment to more restrictive policies on international trade. There is a high probability that President-Elect Trump will label China a currency manipulator, which will create tensions between the two largest economies in the world. He is also likely to dispute certain issues with the World Trade Organization, raise tariffs on imports, and look to renegotiate NAFTA (North American Free Trade Agreement). It seems almost certain that the Trump presidency puts an end to the TPP (Trans-Pacific Partnership) and TTIP (Transatlantic Trade and Investment Partnership), two trade deals that were often the subject of harsh criticism on his behalf during the presidential campaign. One area of concern for geopolitical observers is President-Elect Trump's questioning of NATO's role and the potentially destabilizing effect of such rhetoric on international relations and global world order.

There are certainly other issues – including the new administration's social, immigration, energy, and environmental policies as well as his Supreme Court appointments – that will shape the 45th Presidency but are beyond the scope of a single commentary.

With this many moving parts, it is interesting to note how different financial markets have reacted. The following chart shows a meaningful move in 10-Year Treasury yields in the days since the election. Hovering around the 1.50% level at mid-year, yields had very gradually trended up until November 8th but spiked to 2.26% at the start of this week. From a long-term perspective, bond yields are still low, yet the recent step up, if sustained, may be the long-awaited first sign of a new interest rate regime.



Source: First Western Capital Management

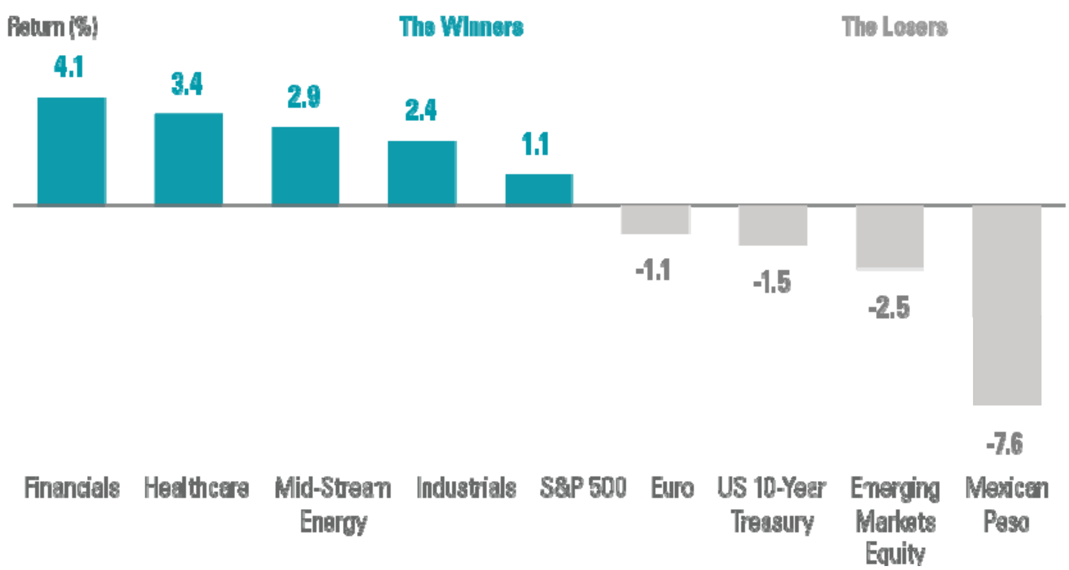
Although market uncertainty is often supportive of bond prices, U.S. Treasury yields increased (prices declined) as investors evaluated the possibility of larger deficits and rising inflation under a Trump administration. While increasing yields led to negative bond returns in the days following the election, the 10-year Treasury yield is now at the level it was at the beginning of the year, and fixed income returns remain firmly in positive territory for the year-to-date period. In the last few trading days, bond yields have stabilized as investors continue to evaluate whether the recent sell-off was overdone.

By historical standards, interest rates have remained low for a prolonged period of time as the Fed has taken unprecedented steps to continue to hold rates low in an effort to spur economic growth. As illustrated in the chart above, Treasury yields had already been gradually moving higher prior to the election as the market responded to an improving economy, signs of increasing inflation, and expectations for the Fed to raise interest rates. While a continued increase in bond yields is far from certain in the near term, it is reasonable to expect that the tailwind provided from a secular decline in interest rates over the past 30 plus years would come to an end.

Despite the many unknowns about the future direction of policy and markets, bonds continue to play an important role in clients' portfolios regardless of the direction of interest rates. Occasional periods of negative price movements are to be expected, and while future bond returns may be somewhat muted, a strategic allocation to fixed income remains a critical component of portfolio diversification. In flight-to-quality market environments, an allocation to bonds has historically helped mitigate losses due to the asset class's relatively low volatility and low correlation to equities. Exposure to interest-rate movements through high quality bonds is a powerful diversifier that can smooth overall portfolio performance over time.

Additionally, active managers have many tools at their disposal to navigate various interest rate environments. For example, managers may shorten the duration of the portfolio, diversify into bonds that are less susceptible to rate changes, or find opportunities in undervalued bonds or sectors through differentiated security selection. By pursuing some or all of these strategies, managers can potentially enhance the returns and diversification benefits of a fixed income portfolio. It is also important to remember that, although an increase in rates initially leads to a decline in bond prices, it also enables investors to reinvest at higher yields and earn more income over time. As long as an investor has a multi-year investment horizon, this reinvestment effect means that the investor can ultimately be better off if rates rise than if they fall.

Looking beyond the world of fixed income, markets cast their own votes regarding the winners and losers from the events of November 8th. Investor expectations for regulatory relief has lifted financial and health care stocks, while the prospect of energy-friendly policies and increased infrastructure spending served as a boost to the energy and industrial sectors. According to Mr. Market, emerging market equities and the Mexican currency were most negatively affected by the election outcome.



Source: Goldman Sachs Market Monitor

These performance trends may continue and strengthen or they may reverse, depending on the political, economic, and financial market developments – some expected, others unexpected – in the months and quarters to come. When asked to comment on the outcome of the elections, the incomparable Howard Marks of Oaktree Capital stated: "[T]here's far too much we don't know to permit any conclusions. Here are a few of the key open questions:

- How much of what Trump said while campaigning did he mean?
- How much of what he actually meant will he try to implement?
- [H]ow much of what he tries to implement will he be able to effect?
- Will he seek advice? (While campaigning he gave the impression he thinks he knows best.)
- Will he appoint expert, experienced advisors?
- Will he heed their advice?" (Source: "Go Figure" by Howard Markets, November 14, 2016)

For this reason and as always, we advocate discipline and patience, rather than complacency. Investors should certainly not ignore developments in Washington, DC, but neither should they overreact by making wholesale changes to their portfolios based on prognostications and opinions. As last week unequivocally proved, no one really knows what will happen or how the market will react to it. Our commitment to clients remains the same – to help guide them through the ups and downs of market cycles and execute on a prudent investment strategy designed around each client's investment and financial goals.

Please feel free to call Beacon Pointe should you need additional information or have any questions.