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Asset Allocation in a Trump Market

Key Points

- The global capital markets were delivered another "Brexit-type" surprise in November with the election of Donald Trump and the Republican sweep of Congress.
- The capital markets swiftly made adjustments based on a preliminary understanding of the Trump legislative agenda. Some asset classes have been deemed "winners," others as "losers" in the post-election stock market rally, as investors attempt to sort out the investment implications of a Trump presidency.
- Although certain U.S. equity market indexes moved to all-time highs, global markets have not necessarily moved to the same degree.
- A fully diversified, balanced portfolio that includes equities (both U.S. and international), fixed income and alternative investments has generally increased in value, post-election, but not to the degree of a portfolio invested 100% in U.S. equities.
- An effective asset-allocation strategy can help you grow your investments without exposing you to unnecessary risk.

While it may be tempting to rebalance in the wake of the recent market performance, it is important to tune out the noise and sharpen your long-term perspective, which we believe is the best way to navigate volatile markets.

DONALD TRUMP'S SURPRISE ELECTION victory, as well as the Republicans gaining control of Congress, has generated an initial positive response in the U.S. equity markets, leading to measurable gains in several indexes, including the Dow Jones Industrial Average, which has gained 8.4% since the election*, and the Russell 2000 and S&P 500, which are up 14.3% and 7% since the election*, respectively. In addition, all of the major U.S. indexes, including the S&P 500 and Nasdaq Composite, set new record highs in 2016.

We believe the strength of these markets results from investors believing that the combination of a pro-business Trump presidency and a Republican-controlled Congress would lead to an era of less regulatory oversight, lower corporate and personal taxes, and increased federal infrastructure spending that, among other policies, bode well for businesses and the economy.

**Through January 31, 2017*

U.S. Equity Market Returns Post-Election

SINCE THE ELECTION, certain sectors have been big winners, while others have not fared as well. For example, stocks in the financial services/banking sector have surged since the election, as investors anticipate less regulatory oversight and lower corporate taxes for companies in this sector. Bank stocks, which have significantly lagged the broad equity market indexes since the 2008 financial crisis, have led the equity market's post-election rally, reflecting investor belief that U.S. interest rates will be moving significantly higher, which tends to benefit banks who stand to gain from the improved spread between deposit and lending rates (See Figures 1 and 2).

On the other hand, the sectors that were the best performers pre-election (such as energy and utilities) have not fared as well post-election (See Figures 1 and 2). The stocks in these sectors are often seen as "bond proxies" because of their attractive dividend yield and were the primary beneficiaries of investors' search for yield in a low interest rate environment. As interest rates have risen post-election, these stocks have been used as a source of funds for investors who rebalanced their portfolio into those asset classes perceived to be beneficiaries in the Trump legislative agenda.

When analyzing the post-election "winners and losers," it is clear that the U.S. equity market is performing as if it is in an "early cycle" phase, which is typical when the economy is emerging from a recession. In this phase, the stocks of companies in the more cyclical sectors of the economy (financials, industrials, materials) are the early leaders in equity market performance, while more consistent growth sectors (consumer staples, technology, health care) have had a more muted response relative to their more cyclical counterparts.

Given that the U.S. economy is in the seventh year of an economic expansion, and essentially at "full employment" with unemployment hovering near 5%, this dramatic post-election move by investors into "early cycle" winners is very unusual. It reflects the belief that a strong fiscal stimulus will be applied to an economy that is already growing (albeit slowly) through the reduction of corporate and individual tax rates, less regulation and significant increases in infrastructure spending.

FIGURE 1: S&P SECTOR PERFORMANCE PRE-ELECTION
January 1, 2016 to November 8, 2016

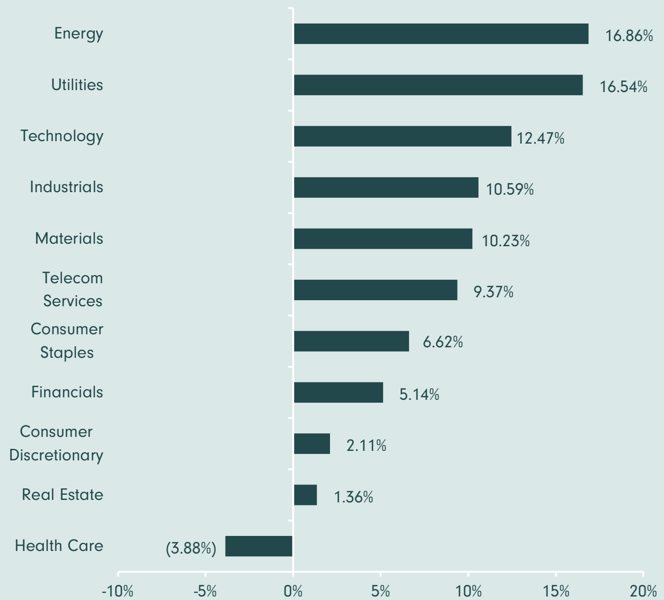
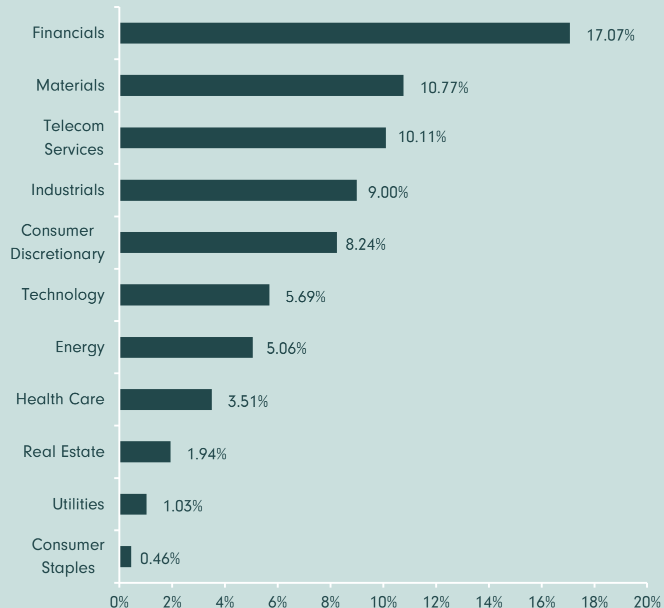


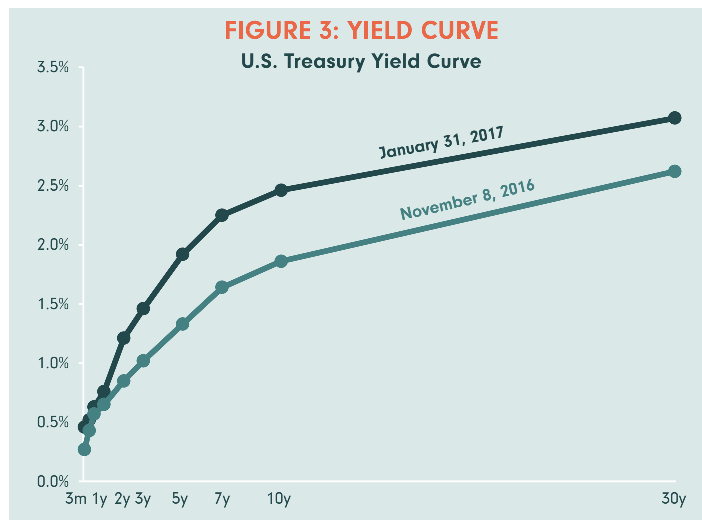
FIGURE 2: S&P SECTOR PERFORMANCE POST-ELECTION
November 9, 2016 to January 31, 2017



Returns are total returns and are not annualized. Sector returns are for the S&P 500® Index. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

The Recent Stock Market Rally and Your Portfolio

DESPITE THE STRONG RETURNS IN THE U.S. equity markets, a well-diversified portfolio, which includes some combination of U.S. and international equities, fixed income and alternative investments, has not kept pace with an all equity portfolio due to exposure to the fixed income market, as bond prices have declined as interest rates have increased—post-election (see Figure 3).



Data is obtained from FactSet Research Systems and is assumed to be reliable.

- Municipal bond investors experienced a decline in portfolio values due to a combination of the general rise in U.S. interest rates, post-election, and concerns regarding the impact of declining tax revenues if both corporate and individual tax rate legislation is enacted.
- For the most part, stocks and bonds have rallied together since the stock market bottomed in early 2009. However, the most recent stock market rally was not accompanied by falling interest rates for first time in the last several years.
- Typically, stocks and bonds tend to diverge in the latter stages of a bull market when the economy tends to be accelerating and gaining strongly. In the current environment, a well-diversified portfolio will have difficulty keeping up with all-equity indexes.
- It is important to remember that a portfolio composed entirely of stocks will generate a higher return during a bull market than a portfolio composed of stocks, bonds and alternative investments, or a 100% bond portfolio. However, the diversified portfolio will likely be less volatile than a portfolio containing all stocks. So while investors with diversified portfolios may not be gaining in lockstep with the overall equity market, they are, however, shielding their portfolios from significant losses in the event of a major equity market correction.

Figure 4 reminds us of how a "balanced" portfolio typically performs over a long time period. A balanced portfolio is designed to provide consistent long-term returns, forgoing the "top position" return in any single year in exchange for avoidance of being in the "bottom position" caused by a significant drawdown of account value.

Despite the record year in the U.S. equity markets, a well-diversified portfolio, which includes some combination of U.S. and international equities, fixed income and alternative investments, has not kept pace with an all equity portfolio.

FIGURE 4: ASSET CLASS RETURNS

As of December 31, 2016

															2002-2016	
2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Ann.	Vol.
Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	REITs 10.8%	EM Equity 23.8%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	EM Equity 9.8%	REITs 22.6%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	High Yield 9.2%	Small Cap 20.1%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 8.5%	DM Equity 19.2%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 6.9%	Comdty. 19.0%
Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	Large Cap 6.7%	Large Cap 15.9%
EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	DM Equity 5.8%	High Yield 11.7%
DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 4.6%	Asset Alloc. 11.0%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Cash 1.3%	Fixed Income 3.5%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Comdty. 1.2%	Cash 0.8%

Data is obtained from FactSet Research Systems, J.P. Morgan Asset Management, Barclays, Bloomberg, MSCI, NAREIT, Russell and Standard & Poor's and is assumed to be reliable. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/01 – 12/31/16. All data represents total return for stated period. Past performance is no guarantee of future results.

Our View

THERE IS A "HUGE" DIFFERENCE between proposals on the campaign trail and the timing and structure of actual legislation. Further, President Trump is not a traditional Republican president, and it remains to be seen how well he can work with Congress to meet the goals of his legislative agenda. For now, investors have focused on the positive aspects of the Trump legislative agenda, rather than the uncertainties. We would not be surprised to see, after this initial positive response by the capital markets, periods of heightened uncertainty as investors sort through the implications of the economic outcomes when tax, trade and regulatory legislation is formed and passed by Congress.

We believe there are real, structural changes in fiscal, tax and regulatory policies headed our way that will have important implications for global equity, fixed income and real asset classes. Further, investors should not underestimate the positive implications of the transition from monetary policy to fiscal policy as the primary driver of global growth.

We are in the very early stages of these important changes. The global capital markets quickly made their initial assessment of the "winners and losers" in this new environment. However, these adjustments in global pricing of asset classes are just beginning.

KEY TAKEAWAY

There are winners and losers in every market, as some assets gain during periods when others decline. It is important to tune out the noise and sharpen your long-term perspective, which we believe is the best way to navigate volatile markets.