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Agincourt Capital Management, LLC

INVESTMENT UPDATE

There will be plenty of time in the weeks ahead for the pundits to pick over the hows and whys of what was a pretty stunning finish to the 2016 presidential race. We're not political experts, and will leave that analysis to others. What we are most interested in is how the results of this year's election will impact the capital markets, and especially the high grade US bond market. We will share our "first impression" analysis, with the caveat that whatever we write today is certainly subject to change.

What makes this analysis even more preliminary than usual is that Donald Trump didn't give us a lot of specifics about what his administration's policies would be if elected president; as a candidate, he simply had to be effective at tapping into the dissatisfaction and alienation of voters who felt that they had been left behind.

Nevertheless, there are some major themes that Trump championed, which, if implemented, could have a measurable impact on the US bond market.

<u>Infrastructure Spending</u>

In their campaigns, both major candidates pointed to the need for more infrastructure spending, but Trump went big—proposing $1 trillion in new spending over ten years. Details are somewhat sketchy, but the money would be borrowed (at least in part by municipal bond issuance) and the projects themselves would be revenue-generating to pay off the debt (think toll bridges and airport fees). There would also be tax credits for companies who take on infrastructure investments.

If this rings a bell, it should, as a similar program was implemented in 2009's stimulus bill, which brought about infrastructure-funding Build America Bonds. That program was short-lived, however, as the US economy's relatively rapid turnaround (and burgeoning debt) put an end to additional fiscal stimulus. Likewise, these new proposals will be scrutinized heavily by the Republican-led Congress, despite what is certain to be a real push by the head of their party.

If large increases in infrastructure spending do pass Congress, the impact on the bond market would be significant, with the potential for hundreds of billions in new Treasury and quasi-governmental/municipal bonds hitting the market. Interest rates would likely get pushed higher in order for all this new supply to find a home.

<u>The Yield Curve</u>

As detailed above, a major thrust of Trump's "Make America Great Again" agenda is to increase government spending by up to a trillion dollars while also proposing "across the board" tax cuts for individuals and a reduction in the corporate tax rate from 35% to 15%. That is not, to coin a phrase, what the fiscally-conservative doctor ordered. Investors have reacted quickly, driving down the prices on benchmark US Treasury bonds, particularly those with longer maturities. In the first few trading days after the election, yields on 10- and 30- year maturity Treasury bonds rose by 50 basis points (0.50%)—the biggest selloff in more than three years.

What's behind this move in rates is the fear of inflation—the mortal enemy of long-maturity bonds. The non-partisan Committee for a Responsible Federal Budget analyzed Trump's fiscal policies in September and concluded that they would, if implemented, result in a huge increase in the US budget deficit. How huge? Over five years, Trump's plan would add $4.6 trillion to the federal debt, approximately 2.5% of US GDP per year. Their estimates show that US debt would grow from its current level of 75% of US GDP to 105% by 2026. Baseline projections (under current policies) show US debt as a percent of GDP growing to approximately 85% over the same period.

More spending, less taxing—that's the prescription for faster economic growth, but at the cost of fiscal imprudence and higher inflation. Bond investors are highly sensitive to this, and have run for the hills, dumping longer maturity Treasury bonds and moving into other assets; it's no coincidence that the stock market has rallied strongly for the same reasons—stock investors love economic growth, even if it means having to deal with a higher level of price inflation. Likewise, most high-grade corporate bonds have outperformed Treasuries since the election; credit investors like the idea of lower taxes and are hoping that a little inflation will further boost profits.

<u>Regulation</u>

With Republican control of the House and Senate locked down, we expect to see a coordinated effort to roll back regulations that are viewed as "anti-business." Chief among these are certain banking regulations in the Dodd-Frank financial reform package. In addition to financial regulations, we expect to see steps taken to review certain environmental regulations, including those in the oil and gas and coal industries.

Unlike the infrastructure proposals, regulatory reform should be relatively smooth sailing for the new administration, as Congressional Republicans march in virtual lockstep on this issue. And while Dodd-Frank is not likely to be repealed in its entirety (the more stringent capital requirements passed in the wake of the financial crisis are important for the US' financial stability), the banking industry is expected to prevail at rolling back the so-called "Volker Rule" which prohibits banks from taking risky bets for their own benefit.

This is a positive for certain industries, including the aforementioned energy and banking sectors; we have already seen bonds in these industries rallying in anticipation of regulatory changes. Coal-dependent electric utilities are another beneficiary, as Trump campaigned heavily in the industrial Midwest for the easing of carbon controls on coal-fired power plants.

Obamacare

Candidate Trump promised to "repeal and replace" the Affordable Care Act. Since the election, his rhetoric has softened, as he and his advisors are realizing how difficult it will be to untangle the ACA (after six years of integration) from the US healthcare system. The focus instead will be to try to eliminate the most controversial provisions of the ACA, including the individual and employer mandates, as well as the expansion of Medicaid. But even this will be difficult, as the Democrats are likely to use every procedural tool they have to block changes to the law.

There are too many moving parts to the health care situation to make sensible predictions at this point. Our best guess is that there will be some changes to the law, but the impact on both the economy and even the healthcare, insurance and pharma industries (all of which have extremely powerful lobbies) should be fairly minimal. A complete repeal of Obamacare is highly unlikely, especially since there are certain provisions (e.g., the preexisting condition protections) that have bipartisan support. And, legislatively, it's far easier to modify than to repeal.

Immigration and Protectionism

Candidate Trump promised to take quick action on deporting illegal aliens and on putting in place protectionist policies to combat what he considered unfair trade deals. Once again, saying is easier than doing, but we suspect that President Trump will, for starters, roll back much of Obama's immigration policies, including the executive action that gave a path to citizenship to an estimated 800,000 undocumented immigrants who came to the US as children. Deportation, and steps to delay and decrease the flow of immigrants (in a system that is already backlogged), could have long-term demographic effects on the US economy, as immigrants typically have a higher birth rate than the established US population. While that impact will play out over many years, the immediate impact will be felt most in agriculture and in small businesses who depend on immigrant labor, many of which fly under the radar of the Federal authorities.

We suspect that the pro-business arm of the Republican party, which overwhelmingly supports free trade, will not allow protectionism to be codified in law. President Trump is far more likely to use the threat of protectionist legislation in negotiating for better deals. Clearly, the proposed Trans Pacific Partnership is dead in the water, having never made it to the floors of Congress for a vote. NAFTA, which was pushed through by the efforts of both George H.W. Bush and Bill Clinton, could be used as a bargaining chip to negotiate trade concessions in certain industries, especially with Mexico, but is highly unlikely to be repealed, as it (once again) has the clear support of powerful lobbying groups and Congress.

Taken together, we expect little in the way of protective legislation (or executive orders) that would have a significant impact on the US macroeconomic picture, at least in the short run. A major trade war is not in the best interests of the US, and there are powerful stakeholders to remind the new president of that fact. There could be selective deals for individual industries (commodities, such as steel and paper products, come to mind), but we wouldn't place any bets on that happening at this point. More important would be the impact of tough immigration laws on the long-term growth prospects of the US economy, which needs a growing labor force in order to fuel a healthy and expanding economy; immigrants represent an important component of that growth.

Fed Policy

Although he will have the power to make appointments to its Board, President Trump will have no direct control over the Federal Reserve's policies. But it would be a grave mistake to think that the Fed isn't watching his every move—just as they are watching the markets' reaction to Trump's victory. Even before the election, the market was already anticipating that the Fed would push up the overnight Fed funds rate by 25 basis points (0.25%) in mid-December; so what changes should we expect as a result of this election?

Honestly, it could go either way. On the one hand, as previously discussed, Trump's proposals (especially the infrastructure spending) are highly expansionary. If the Fed believes that these policies will fuel inflation, they will have little choice but to raise rates next month and signal that future hikes will be forthcoming, to "get out ahead" of incipient inflationary pressures. The Fed will find it difficult, with a massive spending program in the offing, to wait for inflation to begin to rise.

On the other hand, with rates already up by close to 50 basis points for longer-dated bonds (as well as home mortgage rates), some of the Fed's heavy lifting is being done for them by the capital markets. This recovery has been characterized by a historically weak demand for credit as consumers and businesses have been reluctant to borrow, even at record low interest rates. How much weaker will credit demand be when rates rise by 50 or 75 basis points, and how much will that put the brakes on economic growth? Those are the questions the Fed will have to answer in the coming weeks and months.