

CLEARVIEW

WEALTH SOLUTIONS

Our Thoughts on the Presidential Election



Investors are confident in this year's Presidential election results with a Clinton victory already discounted (expected) in share prices. But unexpected outcomes always pose a risk to investment portfolios and this year's election season may also hold surprises, including the FBI's announcement on October 28 that they have resumed their probe into Clinton's emails and email server.

Let's start with an assumed Clinton victory and how certain market segments might be affected. From a macroeconomic perspective, GDP growth would be expected by analysts to plod along like it has this cycle thereby eliminating the need for many interest rate increases. This could be a huge benefit to both high dividend and dividend growth stocks, including our own dividend growth equity strategy. In addition, fewer interest rate hikes could lower the market's assumed discount rate, support higher P/E ratios, or even both. Appreciated stocks could remain competitive with bonds.

requirements both slowing earnings growth. Our bank exposure is limited and we plan to keep it that way for now. Drug stocks are more of a concern. We own a handful of world class pharmaceutical companies that rely on unit volume increases to grow, not steep price hikes. But any (successful) attempt to control drug prices would hurt profit margins and increase today's already negative sentiment towards the group. Valuations, however, are very compelling at these levels and we are likely to hold our current weighting of drug stocks. One example is Allergan whose share price has been declining due to industry pricing concerns. The company holds one-third of its market value in cash.

A Trump victory, on the other hand, would still be a surprise to most and thus could ratchet-up uncertainty in the stock market. A Trump victory has been considered a tail risk event—something investors place a low probability on occurring but would matter greatly once realized. It is hard to say how the market would react under this scenario. Many Wall Street analysts think a Trump victory would spark a correction in share prices, yet when Trump was tied in the polls this past summer, the market was hitting new highs.

Another tail risk event would occur if the Democrats captured both the Senate and the House, an outcome now considered a possibility but certainly not the consensus as we write this. Under that scenario, Secretary Clinton would face few roadblocks to enacting her agenda. Since investors normally prefer gridlock in Washington, this outcome would likely spook investors.

Regardless of this year's Presidential election outcome, the day after Election Day should be interesting.

High Yield Bonds: Priced to Perfection

As QE (quantitative easing) unwinds in the United States, along with QE, ZIRP (zero interest rate policy) and NIRP (negative interest rate policy) in other developed countries, fixed income markets are growing more fragile. And while financial stability appears to have been restored, high and growing worldwide debt levels along with dismal growth prospects remain challenging in the aftermath of last decade's housing collapse.

"Moral hazard," investor presumption that risky bets are protected by central banks, becomes ever more concerning as pricing distortions created by central bank intervention (tapering) begins. While we remain convinced that the policy unwind is a positive step for markets overall, there remain pockets of the bond market detached from reality. Namely, credit spreads of emerging market corporate and sovereign debtors that remain priced to perfection. These credit spreads have tightened to record levels (prices to record highs) while high grade bond prices have risen to record levels. **We believe the QE tsunami of liquidity has separated valuations from fundamentals providing lesser quality corporate and sovereign borrowers the opportunity to issue unlimited amounts of debt at irrational prices.**

Much of this excess liquidity will dry up as central bank policy is wound down, and with it spreads are sure to return to more normal, wider levels (lower prices) that are more sustainable and better reflect the inherent risk in the credit markets. One of the more unfortunate consequences of this liquidity contraction will be rising defaults among questionable issuers. The post-housing collapse regulatory environment requires that large banks and brokerages limit securities trading so liquidity in the fixed income markets is now thin. This is not a problem in orderly markets but could be a significant disadvantage for investors during a liquidity event (as occurred early in 2016).

For the first time, we have witnessed, bond market valuations have become disconnected from fundamentals. While valuations have fallen modestly over the past month they remain near peak levels at a time when debt loads are among the highest in history. Therefore, we view the credit risk associated with lesser quality debt as a loser's game offering high risk bets with little prospect of reward. And this is particularly the case with H-N-W investors where a buy-and-hold approach is essential and significant credit losses unacceptable. We do not believe credit risk is a viable way to add value in core portfolio – especially now.

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