

The Absolute Return Letter



November 2016 Trump – another Brexit moment?

“In Donald Trump, Americans have finally found a man too stupid even for them.”

David Millward, Daily Telegraph

Given the highly provocative nature of the quote I have chosen to open this month's Absolute Return Letter with, I should probably make a comment or two. My colleagues immediately accused me of sarcasm, but I am the least sarcastic person in the Western hemisphere – can't even spell the word correctly. Of course I am not saying that all Americans are stupid – only that one of the presidential candidates is! How can you take a man, who plans to build a 2,000 mile (3,200 km) long wall between Mexico and the US, seriously?

From a European point of view, the election campaign has certainly been highly entertaining so far, but perhaps not quite as reassuring as one would have liked. Most of us have spent the last few months preoccupied with the profoundly important question: Will Hilary Clinton take the ultimate prize, or will Donald Trump play one of his (in)famous jokers at the 11th hour, bringing him back into contention?

On a related note, there has been surprisingly scarce mention of the Congress elections – at least here in Europe. Both chambers have a substantial number of seats up for grabs. To be more precise, 34 of the 100 seats in the Senate are up for election on the 8th, and so are all 435 seats in the House of Representatives.

The Republicans have controlled both chambers of Congress in recent years to the detriment of the US economy. I am not at all saying that the Republicans are any worse than the Democrats in terms of playing silly games; however, when two political parties are jointly in power, as they currently are in the US, the political process often comes to a virtual standstill. Annoying the other side becomes more important than making the necessary compromises. We only know too well here in Europe.

When that happens, there is only one loser – the country. For that reason, it is almost more important who takes the majority in Congress. Should Hilary Clinton win, as the opinion polls still suggest she will, and should the Republican party keep the power in both chambers of Congress, we are most likely in for another few years of open hostility between the President and Congress. It could quite possibly turn even worse under Clinton's stewardship than it ever was under Obama, considering

how disliked she is. The most likely outcome? Another few years of do-nothing, leading to continued slow economic growth.

That said, before I go any further, I should probably point out that presidents' (and prime ministers') impact on economic growth is diminutive relative to the impact they think they have. Yes, they can move the needle a little bit by building a new motorway here and there, or expand the number of runways at the local airport (think London Heathrow), but they cannot affect any of the truly seismic factors, such as demographics. The biggest impact lawmakers can ever expect to have on economic growth is through the rules and regulations they put in place (or remove).

As the US economy already benefits immensely from very business-friendly laws when compared to other developed markets, one shouldn't really expect it to make a massive difference, whether Clinton or Trump wins. That said, there is a once-in-a-lifetime opportunity to upgrade a dilapidated US infrastructure.

The Brexit moment

As I began to prepare for this month's Absolute Return Letter, I couldn't stop comparing the Trump moment (as I call it) to the Brexit moment in the UK. Rapidly rising anti-establishment emotions combined with growing nationalism gave us an outcome of the EU referendum that took the political leadership in the UK by surprise. What they thought was a winnable battle turned out to be anything but, and what was supposed to be a referendum about continued EU membership turned into a referendum for or against the establishment.

Likewise, the inclination amongst many US voters to vote for Trump looks to me to be a vote against the establishment over there. People have simply had enough of the elite, who continue to grab whatever they can get away with. One example: 95% of the increase in US income since 2008 has ended up in the pockets of the top 1% of earners¹.

Selecting Trump as the next US president would be a cry for change, just like the Brexit referendum was a plea for change in the UK, but will things really change, should he win? I honestly don't know, and have no intentions of turning the Absolute Return Letter into a political manifesto, so let's stick to things that I do know about – how would his political programme affect the US economic landscape, should he come out as a winner on the 8th November?

What has Donald Trump actually promised the Americans?

Trump's programme is a colourful mix of socially responsible policies, such as his childcare programme, mixed up with largely meaningless promises (such as declaring American energy dominance a goal) and a few pies in the sky (e.g. promising at least 3.5% annual GDP growth) so, in that respect, he isn't any different from other politicians. Where he differs is on his promise to deliver the preposterous, such as the already mentioned wall, designed to appeal to the uninformed.

At this point, I should probably stress that the following 13 policy points have been taken out of context so to speak. They are part of a broader political programme, and they are by no means all preposterous. Some of them make a great deal of sense, actually. Nevertheless, I am sure I will still be accused of being biased (which I am), but here we go:

1. Child care

Provide six weeks of paid leave to new mothers before returning to work.

¹ Source: *The Credit Strategy*

2. Constitution and second amendment

Protect and defend freedom of religion, speech, press and right to bear arms.

3. Economy

Boost growth to 3.5% per year on average, with the potential to reach a 4% growth rate.

4. Education

Immediately add an additional federal investment of \$20 billion towards school choice.

5. Energy

Declare American energy dominance a strategic, economic and foreign policy goal of the United States.

6. Foreign policy and defeating ISIS.

Rebuild our military, enhance and improve intelligence and cyber capabilities.

7. Health care

Work with Congress to create a patient-centered health care system that promotes choice, quality and affordability.

8. Immigration

Begin working on an impenetrable physical wall on the southern border, on day one. Mexico will pay for the wall.

9. National defence

Increase the size of the US army to 540,000 active duty soldiers, which the army Chief of Staff says he needs to execute current missions.

10. Regulations

Put the job-killing regulation industry out of business.

11. Tax plan

Ensure the rich will pay their fair share, but no one will pay so much that it destroys jobs or undermines our ability to compete.

12. Trade

Instruct the Trade Secretary to label China a currency manipulator.

13. Veterans Affairs Reform

Ask that Congress pass legislation that empowers the Secretary of Veterans Affairs to discipline or terminate any employee who has jeopardised the health, safety or well-being of a veteran.

Source: <https://www.donaldjtrump.com/policies/>

The true cost of Trump's policy programme

Assuming his current policy programme is implemented, debt-to-GDP will rise quite dramatically under Trump's leadership, but Clinton's programme isn't exactly inexpensive either so, in that respect, the two candidates don't really offer anything meaningfully different.

That said, the actual cost of Trump's policy programme appears to be a great deal higher than he is prepared to admit. The Mexican wall is a good example. When he first proposed it, he said the cost of building the wall would be in the neighbourhood of \$4 billion. He subsequently raised the cost to \$7 billion, then to \$10 billion, only to go \$12 billion eventually.

Non-partisan sources say that the wall *cannot* be constructed for anything less than \$25 billion, with at least an extra \$25 billion to be spent on repairs and maintenance after the first seven years².

And that is only the beginning. Other parts of Trump's immigration plan would be far more expensive than erecting the silly wall. Deporting the 11 million of illegal immigrants (mostly Mexican workers that keep an ailing agricultural industry alive), and subsequently keeping them out, would run into the many hundreds of billions, possibly even trillions, of dollars³.

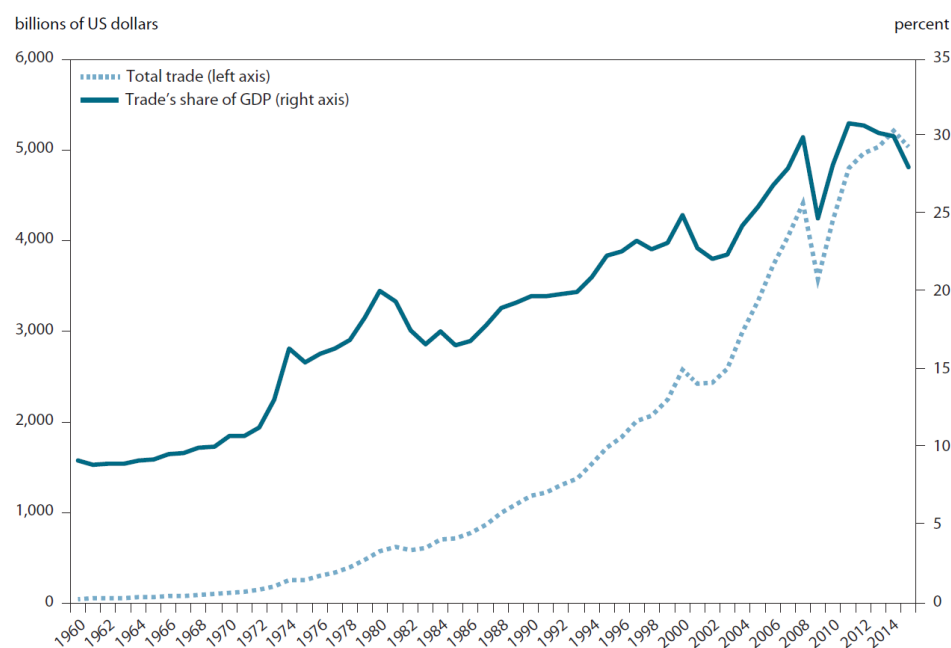
The significance of international trade to economic growth

And it gets worse. The Petersen Institute for International Economics – a private, non-profit, non-partisan research institute – has taken a closer look at Trump's trade plan.

To begin with, allow me to share some thoughts as to the role of international trade. As the Great Depression of the 1930s deepened, governments all over the world established trade barriers in a misunderstood attempt to protect their local industry. It didn't take long for everyone to realise that it had exactly the opposite effect of what was intended. *Everything* got worse.

International trade is very important to economic growth and has always been so. In the US alone, the increased openness of the global economy has tripled the share of trade in national income in the last 50 years (chart 1).

Chart 1: US trade and GDP (1960-2015)



Source: *Assessing Trade Agendas in the US Presidential Campaign*, Petersen Institute, Sept. 2016.

The Petersen Institute concluded that, should Trump win, and should he go ahead with his trade plan, assuming that the trading counterparties of the US act in kind, the US economy will, all other things being equal, be so badly affected that a (mild) recession is inevitable – most likely in 2019, where GDP is expected to drop to -0.1% (chart 2).

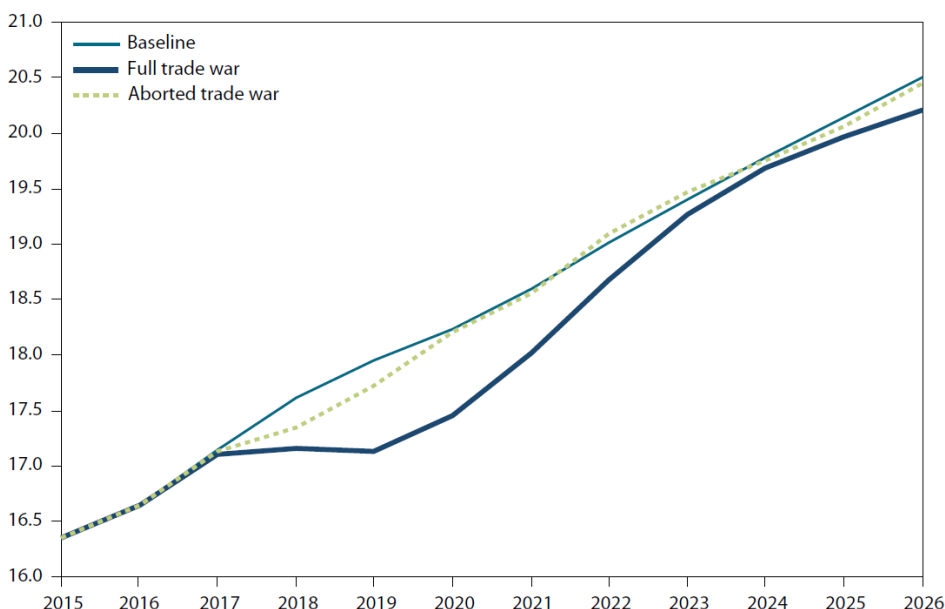
² Source: <http://www.independent.co.uk/news/people/john-oliver-breaks-down-the-true-cost-of-donald-trump-s-mexico-border-wall-a6944271.html>

³ Source: <http://uk.businessinsider.com/how-much-does-donald-trumps-immigration-plan-cost-2015-8?r=US&IR=T>

Let me explain. Trump has said that, under his stewardship, China will be subject to a 45% tariff and Mexico to 35%. The Petersen Institute then assume that those two countries would apply the same tariff when importing from the US, which is what they have labelled 'full trade war' in chart 2.

Chart 2: Projected US GDP under different scenarios (2015-2026)

trillions of 2009 US dollars



Source: *Assessing Trade Agendas in the US Presidential Campaign*, Petersen Institute, Sept. 2016.

Trump vis-à-vis Brexit

The British chose to leave the EU because of a rising sense of nationalism, and because many believed – and continue to believe – that life outside will be better. Meanwhile, the British media has gone from being moderately optimistic to outright gung-ho, because the negative effects of Brexit are nowhere to be seen yet, unless you have just booked your next holiday outside Britain, in which case you have found that it is about 20% more expensive than last year due to the fall in the value of the British currency. The British media are (in my opinion) guilty of conveniently ignoring the fact that the full implications of Brexit could quite possibly take many years to manifest themselves.

Could the Americans be about to make the same mistake? Could the Americans possibly go for Trump, not because they think he is the best thing since sliced bread, but because Clinton – if at all possible – is even less popular, and because they (mistakenly?) think that a life with Trump will be better?

It certainly looks like it. Growing nationalism, and not the least growing populism, is not a particular British phenomenon. It has been unfolding in Japan for years; it is now manifesting itself in the US, and it is happening all over Europe (chart 3). With general elections around the corner in France and Germany, we could be in for more Brexit moments in the months to come.

At the end of the day, it is about people feeling increasingly insecure and feeling that they have lost control of their own livelihoods and, until governments address that issue, it will only get worse.

Chart 3: Key populist parties in EU countries

Country	Political Party	Political Orientation	May Polling	Anti-EU	Anti-euro	Anti-austerity	Anti-bailouts	Anti-immigration
Austria	FPO	Right	33.7%	Ambivalent	Yes			Yes
Finland	True Finns	Right	9.1%		Ambivalent		Yes	Yes
France	FN	Left	27.0%	Yes	Yes	Yes		Yes
Germany	AfD	Right	13.3%	Ambivalent	Yes	No	Yes	Yes
Greece	Syriza Golden Dawn	Left Right	22.0% 11.2%		Ambivalent	Ambivalent		
Ireland	Sinn Fein	Left	15.7%	No	Ambivalent	Yes	Yes	No
Italy	M5S LN	Left Right	27.5% 14.0%	Ambivalent Yes	Ambivalent Yes	Yes Yes	Ambivalent	Ambivalent Yes
Netherlands	PVV	Right	35.4%	Yes	Yes		Yes	Yes
Portugal	BE PCP	Left Left	9.6% 7.5%		Ambivalent Ambivalent	Yes Yes		
Spain	UP	Left	24.1%		Ambivalent	Yes		
Denmark	DF	Right	19.1%					Yes
Hungary	Fidesz Jobbik	Right Right	42.7% 24.3%	No Ambivalent				Yes Yes
Poland	PiS	Right	34.0%	No				Yes
Sweden	SD	Right	18.3%	Yes				Yes

Source: Goldman Sachs Int'l Limited, Eurasia Group, Wall Street Journal, October 2016.

The impact on financial markets

As far as financial markets are concerned, the repercussions could be dramatically different depending on who wins. A Trump victory would almost certainly lead to rising interest rates and a falling US dollar, with the currency probably taking the brunt of the impact, just as it did in the UK after the EU referendum. I am not so sure about equities, though. US investors, being the perma-bulls they are, may be able to invent a reason why Trump is actually good news for the US equity market. I simply don't know.

Should Clinton win, the reaction in financial markets will depend entirely on who takes control of Congress. An outright victory for the Democrats will probably lead to the best response from financial markets, whereas a continuation of Republican supremacy in Congress will result in a more subdued reaction (I think). More importantly, though, such an outcome will most likely lead to few new policy initiatives initiated by Washington, resulting in several more years of subdued economic growth.

Concluding remarks

The title of this month's Absolute Return Letter is '*Trump - another Brexit moment?*', and my answer to that is a qualified yes.

The electorate all over the world appears to be rather fed up with things as they are and, considering the relatively modest lead Clinton holds over Trump in the opinion polls, it won't take much for him to suddenly be in power.

The relatively high number of voters who say that they have not yet decided who to support, only makes it more likely for Trump to run away with the laurels. I would assign at least a 33% probability of him snatching victory at the very last minute, and I am not convinced financial markets are prepared for that.

The most likely outcome, I think, is still Hilary and Bill moving back into the White House, but the general apathy with the political establishment will probably ensure that it will be without the necessary support in Congress to make more than modest

changes. In other words, I see murky waters ahead, regardless of who wins the presidential election.

One final note before I wrap it up for this month. We have recently hired a new senior research analyst, and his name is Mark Moloney. Mark comes from Saguenay Strathmore Capital, where he has gained a wealth of experience in the alternative investment space, and he will unquestionably be a source of interesting investment opportunities going forward. Welcome Mark!

Niels C. Jensen
1 November 2016

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