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Upside Down You Turn Me

It has been a mild fall so far here in Ohio, with shorts and a t-shirt sufficing on many days. Last week, the Chicago Cubs overcame history and won their first World Series since 1908, defeating our beloved Cleveland Indians in the most-watched baseball game in 25 years. The upside-down events continued this week when underdog Donald Trump defeated Hillary Clinton for the presidency of the United States, shocking the country.

Such a significant event, when unexpected, can disrupt the financial markets, as it certainly has this time. As Trump's chances of victory rose Tuesday night, Dow futures fell – at one point by 4%. But as the opening of trading approached, futures recovered much of their losses, and the Dow actually finished 1.4% higher Wednesday, reaching an all-time high. The S&P 500 rose 1.1%. But this wild ride and these numbers obscure the more interesting story, which is the divergence among sectors. Some of the formerly popular areas of the market have sold off hard in the two days since the election, while investors have scrambled to gain exposure to other sectors. This is another way of saying that various companies have been dramatically repriced as a consequence of the federal government being under Republican control.

For the two days, the NYSE Pharmaceutical Index rose 6% and the Nasdaq Biotech Index gained 11%, as the market deduced that President-elect Trump and the Republicans will be less aggressive on price controls than Mrs. Clinton might have been. Hospital stocks suffered severe losses on fears that the Affordable Care Act may be repealed.

Before we get to other sectors, we would like to note the volatility in the bond market, as the market is pricing in higher inflation and, seemingly at odds, a tighter Fed. Since the day of the election, the bellwether 10-year Treasury bond has fallen about 3% in price (rates have risen), which, given the prevailing yield of about 2%, wipes out a year and a half of return. We have talked repeatedly about the bubble in bonds and the effect it has had on various segments of the stock market. The stock market cousins of bonds in recent years have been the utilities, real estate investment trusts, and consumer staples; their price action has been highly correlated with bonds, as investors have reached for yield and stability. Since the election, with the selloff in bonds, utilities are down 6%, REITs have fallen 3%, and staples are down 4%. These areas were highly popular given their yields and their supposed low volatility, but these are significant losses, especially in an up market, and they continue an unwinding (i.e. price correction) that has been in place since July.

The anti-bond or anti-utilities/REITs/staples play has been the financials. In the first half of the year these stocks languished, due to concern about China, Brexit and low/negative interest rates. Once it was determined that Brexit was going to be manageable, the financials started their ascent, and then this week they ripped higher on the Trump victory, likely because of both the interest rate effect as well as the perception that the regulatory environment will be more favorable for banks. The greater factor in the move is more than likely the former. For the two trading days since the election, Charles Schwab is up 9%, JP Morgan 9.5%, and Wells Fargo 14%. These are massive moves in such a short time.

Our portfolios were positioned counter-trend, meaning we were heavy in the (unpopular) financials and light in the yield sectors. This has paid off handsomely the past few months and especially this week. We didn't know Mr. Trump was going to win the election or when interest rates would rise, but we believed that eventually market conditions would change and that stock prices would gravitate toward their true value.

Stepping back, one of the interesting things about the positive market reaction is that the market also rallied on Monday when Clinton's chances of winning increased. It makes us a little nervous when the market rallies on each of two opposing events.

In addition, our greatest concern with a Trump presidency is the risk of a trade war, and we would have expected a selloff for that reason. But the market, at least so far, has given more weight to the positive effects of a potentially more friendly tax and regulatory environment. Trump has called the NAFTA and TPP trade deals a disaster, and we will watch to see if his bite matches his campaign bark.

Investors that flocked to low-volatility or yield products have suffered losses as the market has been turned upside down. In 1980 "Upside Down" by Diana Ross reached number 1. The same year, Ronald Reagan, whom some have compared to Donald Trump, was elected President and brought about major change. Now Mr. Trump too aims to turn Washington upside down.

Best regards,

Mark

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