Infomail
February 13, 2017

The Reflation Trade is Back

"No government can create wealth. A government can get away with the illusion that paper is wealth, but in the end, too much paper is always created and with that action, the illusion falls apart".

Famed Market Watcher Richard Russell

When Ronald Reagan was elected 36 years ago as the 40th President of the United States, the US 10-year Treasury Bond was yielding around 15%. As I write, it sits at about 2.40% (after bottoming late summer at around 1.40%).

No one would have believed rates would fall like they have (and stay down at these levels).

But there is a change happening. We've had a swift change in sentiment and where US GDP seemed locked in at a lethargic subpar 2%, there is a growing feeling 3-4% GDP is once again possible.

The Reflation trade is back.

There are many reasons why I think that is beginning to happen and what is causing it, so let's go through them:

1. US Corporate Taxes are set to Fall

President Trump campaigned on cutting corporate taxes from 35% to 15%. Not sure he can get all the way to 15% early on, but even if he could get them down to 20-25%, it would be a huge catalyst. Markets have been craving for some form of fiscal stimulus for about 10 years.

If they can combine a corporate tax cut with lower personal taxes, and allow all those trillions of US corporate capital held offshore to be repatriated…..wow.

2. Revitalization of Consumer Spending

If the economy heats up, it will lead to higher wages. Higher wages combined with lower income taxes will create a wealth effect. Add higher equity markets and you get a huge wealth effect.

3. The US Federal Reserve

I believe the Fed will be more fully engaged than the market is currently discounting, but Chair Yellen is in somewhat of a box. She faced criticism from then candidate Donald Trump, held off raising rates until AFTER the election which Trump won. Her term is up at the end of this year, and there's a good chance she will not be reappointed.

So does it now come down to her worrying about her legacy?

4. Volatility

Let's face it, volatility will be higher under a Trump Presidency:

- Because of his rhetoric
- His views on immigration/trade
- If economy speeds up, will create more volatility
- If Fed becomes more vigilant because of heating market or economy, we will also have increased volatility.

5. Change in Market Asset Allocations

The last few years, a lot of the "crowd" investing moved towards ETF's and "low volatility" strategies. I believe it will be at the worst time possible and we've written many times over the years how wrong the consensus tends to be at the worst times possible and at major inflection points.

I think this will be one of those times, and "passive" strategies will regret it. Stick with proactive managers.

So what are the portfolio implications?

A. If inflation rises, so will rates, bad for bonds, good for credit

B. Emerging markets (except maybe commodity exporters) may have a tough time either way
C. Should be very positive for cyclicals, materials, business services
D. Not so good for defensive, consumer, non-discretionary, utilities
E. Value > Growth
F. Interest rates will rise, but maybe not has much as some think as technology will keep inflation somewhat passive
G. Investors need to keep realistic return expectations

We've seen several markets reflect what I am saying already:

- Bond yields have risen
- Oil prices are up 100% in last 12 months
- Gold sneaking higher
- Material stocks have had huge moves higher
- Copper prices have been strong & zinc supposedly has "zero" inventory
- Even some "soft" commodities (like cotton) are exploding higher

So let's see how it plays out….

Stay tuned,

Vito Finucci, B.COMM, CIM, FCSI
Vice President and Director, Investment Advisor
Associate Portfolio Manager