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The Unexpected Outcome

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"No-one is so brave that he is not disturbed by something unexpected"
Julius Caesar

"There is only one kind of shock worse than the totally unexpected: the expected for which one has refused to prepare"
Mary Renault

"Sometimes the best investments are the ones you don't make"
Donald Trump

"Because they're stupid, that's why. That's why everybody does everything"
Homer Simpson

Well what a year! As it started we had low expectations of investment returns and that's what we got. Markets across the board were lacklustre at best, no disasters, just a long slow grind. We had a few really solid winners in most portfolios but on the whole uninspiring is the word that springs to mind. Unfortunately, with my crystal ball and sages hat on, I see pretty much the same for the coming 12 months.

After that we got some rather unexpected outcomes. Not many saw Brexit coming, even though it was close in the polling. No-one almost, not even the bookies, saw the result for Donald Trump. We also had the terror attacks in Brussels, the further destruction of Syria and its people, Zika virus etc. To be fair you could make a list like this every year although one in particular stands out, Donald Trump of course; and perhaps NOT for the reasons you might imagine.

Watching the results with incredulousness I struggled to come to terms with the concept. As it is now a given I have tried to be objective and look for an upside with Trump, as it's easy to focus on the downside. Now I'm going to steer clear of the misogyny, the personal insults and focus on the key economic and political outcomes of Donald's success.

Background

Before I explore the implications of Trump's victory, lets identify a few keys factors that I believe are relevant.

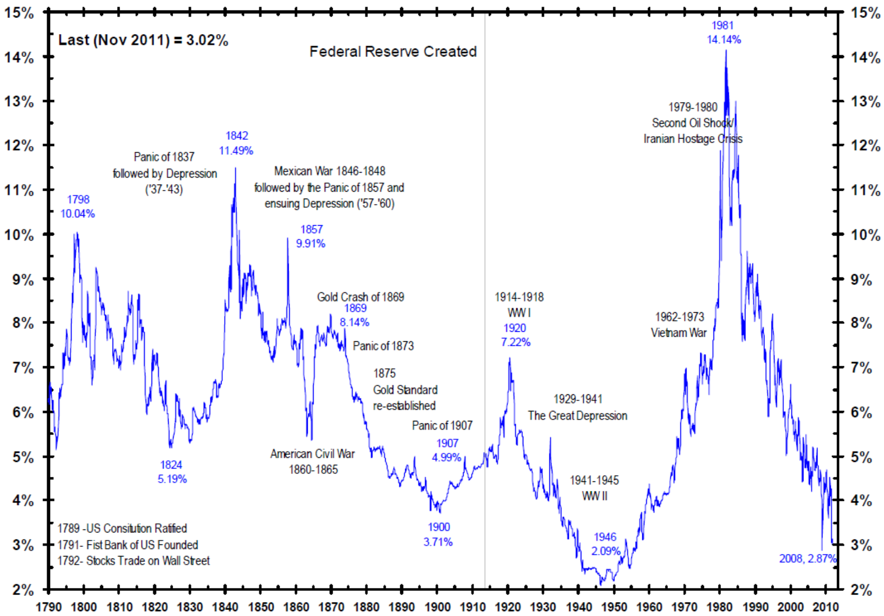
Firstly, as I cited in my Brexit newsletter some 6 months ago here, I suggested much of the political outcomes around the world are a protest vote against the status quo and 'The Establishment'.

This voice and commentary has since become more pronounced. This will buy Trump quite a bit of time and leniency although I expect certain sections of the media and commentators will pounce on every perceived mistake or miss step, simply because they hate Donald so much. To be fair to them to say he's a divisive figure is somewhat of an understatement.

The political climate is therefore more unpredictable than has been the case in decades past. Coupled with that I feel we are at the turning point in a long cycle.

I'm talking about interest rates, Bond yields, not term deposits.

Long Term Interest Rates Back to 1790



Almost all our clients, no matter their age, have derived their investment experience in an environment of falling interest rates. Some will say they remember rising rates since the late 1980's but these were blips in a longer and stronger downtrend. I personally remember paying 19.25% on our investment mortgage. If your memory extends prior to the 1980's you could ask yourself how much investment experience did I have prior to this time, so how much experience do you really have in any environment which is not an interest rate downtrend?

In an environment of falling interest rates almost everything else goes up. Bonds make capital gains, shares, property, and almost everything else for that matter, rises. This makes everyone look like an investment genius. It also breeds a degree of confidence that you may develop the idea that you "know how things work". Hubris, by anyone, in investment market decision making process is very dangerous.

We try to position portfolios to protect capital, reduce risk and make some gains. In order to do this we use a vast array of information sources, expert opinion and experience to make these decisions, they will however not always be right. This is a fundamental tenet investing.

The danger right now is relying too heavily on personal experience. If all you have ever experienced in developing your investment expertise is falling interest rates, you actually understand half of the market cycle. Combine this with hubris and you are in dangerous territory indeed!

What does this have to do with Donald Trump you may ask?

Whether it's the chicken or the egg I don't really know but the end of the great bond bull market may have finally happened. Whether this is caused by Donald's accession or just a coincidence is not known, nor does it matter. Rise to power

Donald's policies are likely to be quite inflationary, if you can believe what he says. If this results in rising interest rates then the game rules have been changed.

Did you notice?

Bond yields are up almost a full percent in the US for the 10year note. Not much you say, this is an increase of over 50% such is the laws of mathematics and small numbers. If it stays here the changes will be ripples, however this change is built on expectation of policy direction by Trump, not the actual implementation of policy. If this continues then we could see the opposite impact of falling rates. Capital losses on bonds, falling share and property prices etc.

It is for this reason we are conservatively positioned for all portfolios.

Also, don't expect your term deposits to match the increase in rates in the bond market, at least not in magnitude nor quickly. It's called the steepening of the yield curve for anyone interested, it has been very flat for too long for a healthy market to endure.

All bad news then?

Well not really no. As many of you will know we have been lamenting the state of the markets, the central bank decision making, especially the global binge on printing money in the trillions. (NB: we used to only use trillions to describe stars in the universe or the number of cells in a human body).

Markets are like mother nature. You can control the course of a river, build a sea wall, pollute your local area, eventually mother nature yells 'ENOUGH!!'. A cyclone, storm or collapse of your local ecosystem results and we start again.

Well, markets are similar. You can only abuse markets, distort valuations and attempt to control prices for so long. When you are a government and print lots of money you can do it for a long time. I suspect that time might be approaching where the current status quo is changing.

We have reduced exposures to shares, especially US shares, have been very short listed property, long unlisted property where possible, short duration in our bond portfolios and long cash. Not all of these calls have been the best possible solution over a short period of hindsight, but over the longer term? We will need to wait and see. Again such is the nature of investing. Nevertheless we are happy with the aggregate outcome in a very difficult climate.

As we are typically positioned conservatively to respective benchmarks, we have reduced the higher risk elements of the portfolio for now, and have extra cash to deploy if we do see any price corrections. This provides us with the capacity to make money when others may be losing money.

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Making Sense of it all

We have potentially hit a turning point in investment markets that is outside the experience of almost all investors, no matter your age. Like or loathe him, Donald Trump could be the catalyst in a market rebalancing. Whilst this will be painful in the short term it will be beneficial in the longer term in our view.

We remain vigilant, cautious and careful but also remain invested. We can't afford to be out of the markets as that too can be extraordinarily costly. We are managing the risks posed by a very challenging investment environment, one that will continue, whilst driving as much income and growth as possible into portfolios.

Wishing everyone a very Happy New Year, may it bring you and family peace, prosperity, health and happiness.

If you would like to discuss this paper or any other matter please do not hesitate to contact us at fpadmin@nac.com.au or (02) 9984 7774.

Kind Regards

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