

## Making Volatility Great Again-Augmenting the 4 D's<sup>1</sup> with the 4 P's.

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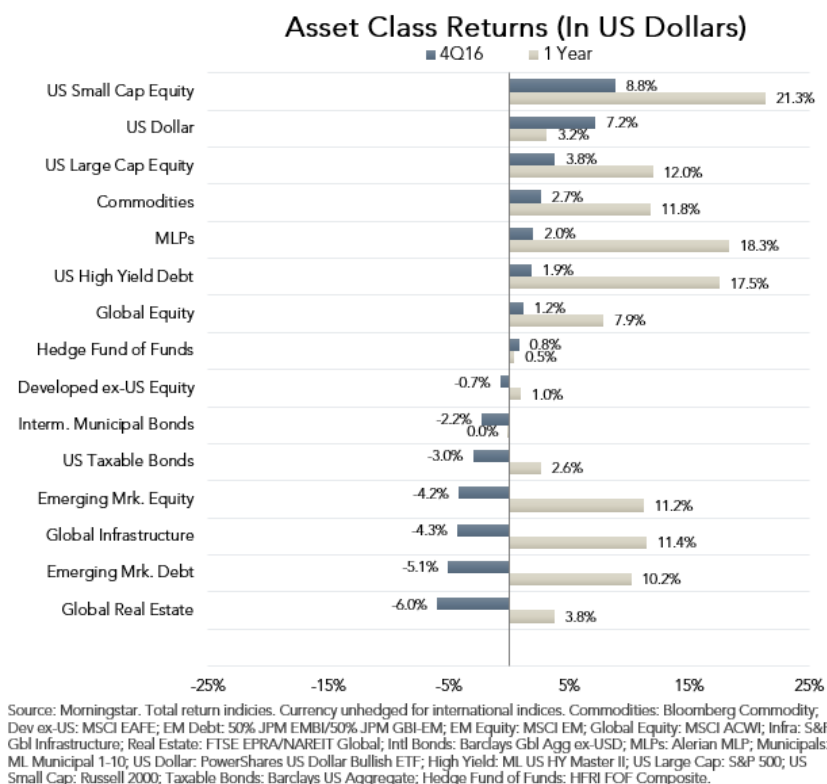
One of my traditions during the year-end holiday break is to write this “beginning of the new year” commentary. To be honest...I find myself struggling as we usher in 2017 given the 15 round, Rocky-like bout we experienced last year in terms of the political environment—both domestically and internationally.

I think most of us would agree that the acrimony of our election cycle has worn us out, yet we may only be at the beginning of a market regime where headlines are dominated by politicians and political unrest. As much as it pains me, I am compelled to define 2017 by 4 P's: Presidency, Politics, Populism and Protectionism. The actions of our new President and his administration coupled with the rise of populist movements both here and abroad should dominate investment themes or at least catalyze sub-strategies throughout 2017. I believe that the product of this combination will be the return of volatility as a constant companion not the occasional visitor we have seen of late. Admittedly, we have been calling for the return of sustained volatility for some time now, but its artificial suppression (by excessive monetary easing) can only last so long.

As you spend a few minutes reading this piece, I remind you of the following: as an investment strategist I am expected to formulate an economic and market mosaic, not to render a political opinion or judgment and that is what you will get from me. My intentions are apolitical.

### Reflections on 2016

To sum up, 2016 was a year full of unanticipated outcomes. As such expecting the unexpected would have been a winning strategy ranging from the failure of the January barometer on U.S. markets (i.e. January's stock market performance tends to presage the tone and performance for the year), the wide adoption of NIRP (negative interest rate policy) by central banks from around the world, U.S. equity volatility reaching record lows, Brexit, a substantial rise in U.S. Treasury bond yields, strong rebounds in oil and other commodity prices, an



<sup>1</sup> As a reminder, the 4 D's are Debts, Deficits, Demographics (aging), and Dearth of Leadership (a reference to weak policymakers)

extension of the U.S. bull market, and the capstone, PEOTUS—Mr. Donald J. Trump. Despite the market rout experienced last year from January through mid-February, risk assets made a comeback almost across the board leading to healthy market returns for most portfolios except for those dominated by core fixed income and, as a result, subject to interest rate risk.

While markets were generally benign prior to the U.S. election, investors reacted to the outcome as if they were at the starting line of the Indy 500—buying stocks as if we had entered the First Turning overnight (see my October blog [“Turning the Page”](#) for an explanation). While I would agree with investors’ assessment that the U.S. Presidential election could have marked a major turning point (pun intended) in the global macroeconomic and geopolitical landscape, I continue to feel that markets have inadequately accounted for the many risks still plaguing global economies.

During 2016 we maintained conservative positioning and emphasized risk management. While the markets ended the year differently than we had expected (i.e. with a strongly positive bent across most risk asset exposures), we are generally comfortable with the results within our client portfolios when viewed on a risk-adjusted basis relative to client goals and risk tolerance. Instead of leaning into the momentum trade induced by the tsunami of monetary easing in response to and since the Great Financial Crisis (GFC), we chose to reinforce our defensive positions. Our position was predicated on the risks identified across the macroeconomic landscape and our view that the efficacy of said policy would be questioned and likely weaken as desperate central banks dipped into negative yield territory to jumpstart their economies. Despite the treacherous and uncharted nature of that policy shift, investors apparently shrugged off this uncertainty mixed with lofty valuations, and instead chased returns.

### ***The Year Ahead***

You may recall the 4 D’s have been the core tenets of our secular thematic underpinning—debts, deficits, demographics (aging), and a dearth of leadership—for the last five years. We are not abandoning the 4 D’s as those trends have only been reinforced. The last “D” in particular has just begun making headlines via the most recent elections and referenda given the effects of weak policymaking leadership. To add some color and contrast to our palate, we thought we would add another letter of the alphabet, P, to our mosaic. So, at the risk of being perceived as trite, let’s try on the 4 P’s for size—Politics, Presidents, Populism and Protectionism. The 4 P’s, coupled with the 4 D’s, should define the shape and tenor of the global macroeconomic, geopolitical and capital market environments in 2017.

- *Politics.* A spate of elections is scheduled for this coming year—Dutch, French, and German—to name a few. All of these could have far reaching implications related to the future of the Eurozone, the second largest economy in the world after the U.S. (if treated like one country). Additionally, on this side of the Atlantic, we will have a front row seat at one of the most interesting political dramas as the Republican party and its many factions try to create some form of unity not only amongst themselves but with an apolitical, unpredictable and seemingly uncontrollable President and his cabinet staffed with ex-military and Washington outsider (aka Wall Street) billionaires. There is one thing you can count on – the unexpected will be the norm. In line with the idea of the Fourth Turning involving a tearing down of the governing bodies that haven’t served the populace well, we are witnessing not only a shift in policy but, likely, a much more dramatic change – like a new approach to governing writ large (i.e. just think “tweets” instead of press conferences as just one small example).

- Presidents.* President Donald J. Trump should continue to be a headline making personality with his unconventional views, actions, and use of social media. Given the very generous welcome equity markets have granted him upon becoming the President-elect, combined with a historically low approval rating prior to inauguration for a new president, one has to wonder whether the bloom will fade from that rose rather quickly. After all, there is the practical reality of getting cabinet nominees approved, nominating a Supreme Court justice and driving change within the regulatory, healthcare, tax, and trade frameworks through D.C.'s byzantine machine while it flexes its muscles. I am relatively certain about one observation. Equity markets have not appropriately accounted for the elevated volatility levels associated with a President with an atypical communication style and thin skin that reacts by tweeting instead of adopting a more deliberate, consultative, and thoughtful approach to governing. Not to mention, he still needs to adequately navigate his broad personal interests both here and abroad, both from an ethical and security standpoint. We can hope the enormity of his responsibility will cause him to rely more on his advisors, as wise Presidents have before him. With that said, while we are not privy to his inner circle, I suspect his autocratic management style will result in at least one if not more than one resignation within his cabinet.
- Populism.* What unexpected outcomes led by those feeling left behind by open borders, global trade, technology advancements phasing out labor, and the out-of-touch ruling, elitist bureaucrats will be presented to us in 2017? Could we see more protests? Could former President Obama decide to take up the mantle of rebuilding the Democratic party and act as its voice speaking against the current administration? While past Presidents have generally avoided commenting on their successor's performance, President Obama has implied he may break with tradition. And, why not? We seem to be in a new political era where old traditions are being cast aside. Could populist movements in Europe lead to the beginning of the end for the Eurozone as large cohorts of people attempt to wrest control over their national socioeconomic and political destinies? Where else in the world might this movement continue and to what aim?
- Protectionism.* While the global economy has avoided a coordinated downturn and has generally grown since the Great Financial Crisis, the inflation of financial assets has masked the lack of economic progress. A substantial cohort of the world's population has been feeling left behind while corporations and the wealthy continued to enjoy the gifts of easy money. As such, isolationism and protectionism are growing in popularity across the world. In the U.S., Trump ran on a platform promising to renegotiate or withdraw from "terrible" trade deals as well as to reward exporters and punish importers via various tax changes or even tariffs. While Trump's ability to pass these measures is far from known, the big risks here would be any retaliatory reaction by other countries, possible further strengthening of the U.S. dollar (both of which would hurt our exporters and reduce GDP), and the potential for higher inflation due to increased costs of production passing through to consumers. Markets have already started pricing some expectation of protectionism into U.S. equity markets, as small- and mid-cap companies outpaced larger ones due to their more insulated positioning relative to foreign trade. We can hope Mr. Trump's more extreme positions are simply negotiating stakes in the ground designed to drive toward more moderate and fair outcomes for all parties.

All four P's have something to do with sociopolitical issues leading to the conclusion that the future for the global economy is highly dependent on the volatile and changing political currents. If the rising swell of populism does lead to economic and social barriers between countries, we are likely to witness a destructive process take place in the global economy. However, we can also hope the leaders replacing the pusillanimous incumbents could be emboldened to make positive, albeit difficult, changes to their respective regulatory, economic and fiscal frameworks. There is hope that comes with the disruptive changes being driven by the unexpected strength of the populist movements.

In the U.S., based on Trump's history and the complexion of his cabinet comprised of extremely experienced and successful business people, we are likely to witness a seismic shift in how we are governed and the overarching tone of the next four years from vilifying some of the key tenets of capitalism to celebrating them. At this point it appears this administration will be honed in on streamlining government, removing obstacles to economic growth, and creating an environment designed to enhance productivity through updating our infrastructure, creating a pro-business environment attractive to local and foreign entrepreneurs alike, incentivize the deployment of capital toward productive ends and, ultimately, to create jobs and put more after-tax capital in the hands of the middle class. If successful, it is not too difficult to imagine the creation of a virtuous cycle of economic growth. If this scenario plays out, we can also hope the administration does not sacrifice a focus on the acute environmental and social issues facing our country (and the world) for the benefit of short term economic growth.

On the other hand, we can easily paint a scenario less optimistic based on the daunting challenges that we may face, some that are well beyond the control of even the most capable leaders.

- Many of those feeling left behind should blame automation and not globalization—a trend likely to develop momentum thereby compelling people to learn new skills or risk being left behind permanently. Just ask yourself—how successful were the switchboard operators from the 20's and 30's in stopping the evolution of the telecommunications industry?
- Debt levels are much higher globally than they were prior to the GFC—levels that act as a major impediment to growth and increase the risk of yet another global crisis caused by unsustainable debt. And, unfortunately, we have not seen much of that debt put to productive use. At the aggregate debt level, the numbers, while overly simplistic, tell the story. This past year the U.S. debt (household, federal, state and corporate) has increased more than \$2 trillion, yet the economy only grew by a fraction of that at approximately \$450 billion.<sup>2</sup> I'm sorry but I don't think 22 ½ cents of growth for every dollar of debt is a good deal. Companies, inspired by low rates, issued a substantial amount of debt solely to buy back their stock and, as a result, improve the per share optics for earnings, at the expense of investing those dollars in innovation, capital expenditures and job creation.
- In the Eurozone, there are a multitude of failing banks in Italy, a country with the distinction of ranking fifth on the list of total government debt outstanding<sup>3</sup> yet it has not experienced economic growth in gross domestic product greater than 2% in over 30 years!<sup>4</sup> Italian debt is like a widespread virus that, in the case of a default, could have far reaching implications to the Eurozone. French banks, alone, have a total exposure to Italian debt that exceeds €250 billion,

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<sup>2</sup> "My Outlook for 2017," Lawrence Fuller, Seeking Alpha, December 30, 2016

<sup>3</sup> [https://en.wikipedia.org/wiki/Government\\_debt](https://en.wikipedia.org/wiki/Government_debt)

<sup>4</sup> <http://www.tradingeconomics.com/italy/gdp-growth>

while Spain, the UK and German banks hold another +€150 billion, yet investors do not seem to be worried and, from my perspective, they should be<sup>5</sup>.

- Aging demographics in the developed world should continue to act as a major deflationary force and, as a result, provide a ceiling to economic growth as aging populations are less productive and consume less.
- Fiscal spending (e.g. think infrastructure) is not necessarily the panacea to the anemic growth rates we have seen since the GFC. If careful consideration and planning is done to figure out where to spend to generate the highest return to society -- both economically, environmentally and socially -- yes, fiscal spending can help. However, politicians globally do not have a good track record of doing so. If they had, a country like Japan could have emerged from its generation-long economic slump a long time ago, U.S. bridges and water lines would be in better shape, and citizens of Delhi and Beijing could breathe easier.

## **The Fed**

While I have lamented the omnipresence of the Federal Reserve (and its global counterparts) and its commensurately sizable influence on market psychology and dynamics, I am compelled to mention them yet again and much to my dismay. During its latest meeting the Fed seems to have conceded that its zero-interest rate policy (ZIRP) may not have been effective at generating economic growth. While I applaud their intent to normalize interest rates (with three planned rate hikes in 2017), I am worried about the market's reaction to a departure from ZIRP as well as the impact of a strengthening dollar on corporate earnings (i.e. a stronger dollar hurts the earnings of companies generating much of their revenues from exports) AND, not to mention, the potential for a substantial increase in debt servicing costs that could severely crimp economic growth. One pivotal issue in 2017 will be the tug of war that would likely ensue between growth generated from fiscal stimulus, and its corresponding negative by-product, inflation. In an environment when the Fed is raising interest rates, credit expansion, and, as a result, growth could be constrained in the process. This is the ultimate known unknown, a "catch-22" wrapped up in an enigma surrounded by a conundrum, and it makes my head spin.

## **Concluding Remarks**

What does all of this mean for our investment strategy? Not only are changes in governance going to be different – but the proposed policy battles could be the impetus for investment strategy change as issues such as banking deregulation could lead to the rebirth of proprietary trading desks and too-big-to-fail risks again; repealing and replacing the Affordable Care Act and its implications on healthcare; the breadth and depth of corporate and individual tax reform, etc.

As we evaluate the potential for positive economic and market effects, we need to be prepared to add risk to our portfolios if fundamentals and the potential for a virtuous cycle in the U.S and spreading globally may begin to justify a further surge upward in risk assets. To some extent, given our caution in recent years, stretched valuations and the excessive optimism pervading markets today, I have surprised myself in placing a higher probability on some positive economic and capital market outcomes. If we end up pivoting toward a more risk-seeking posture, I feel we need to do so opportunistically by taking

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<sup>5</sup> "Year End Outlook: Will Investors Get Hustled By the Pros? [dimartinobooth.com/latest-weekly-newsletter/](http://dimartinobooth.com/latest-weekly-newsletter/)

advantage of the volatility coming from our new unpredictable President and his impact on the domestic and global stages. With that said, this is just one of many possible outcomes and it comes with many risks that can jeopardize its realization. Thus, as always, we need to infuse portfolios with exposures that can either enhance return or mitigate risk based on other possible scenarios.

For example, we are partnering with a third party to design and create a bespoke vehicle containing special, quasi-liquid idiosyncratic ingredients (i.e. strategies) designed to take advantage of normal and elevated market volatility with the added ability to provide liquidity when most others are demanding it. This will be designed to benefit from disruptive yet attractive price dislocations that may occur if the dark side of the populist movements bring with it destructive isolationist and protectionist policies.

Additionally, we need to watch for signs of cracking in the Eurozone. While anemic growth numbers have improved somewhat as of late, the region's unified framework will be tested by each election, by the continued challenges it faces addressing the refugee crisis, massive unemployment amongst their youngest workers, the unknown implications of seemingly endless monetary easing, the Italian banking crisis and the likely execution of Article 50 by the United Kingdom - their formal declaration of withdrawal from the European Union. One data point we plan on watching is the spread between Italian bonds and their German and French counterparts for any signs of panic. A meaningful destabilization in Europe could send us into a global recession calling upon our risk management tools to mitigate the drawdown. Conversely, if we believe a recession is imminent or has already started, it is incumbent upon us to map out our strategy for deploying capital into those assets experiencing dislocation.

Signs that dollar strengthening will continue would be a reason to consider the implications to sectors, regions and other exposures that could be negatively affected by that trend. As the Fed moves forward with interest rate normalization, savers and retirees should begin to cheer, but multinational corporations with a major share of earnings coming from exports will not. Also, as mentioned earlier, we will need to be vigilant about assessing how U.S. Treasury interest servicing costs increasing as a percentage of the overall federal budget will affect growth prospects in general as well as the risk of a spike in interest rates to our core fixed portfolio.

On the impact front, we believe even more opportunities will arise in 2017 to infuse portfolios with exposures that have the ability to generate both compelling financial and non-financial outcomes. Despite the nervousness associated with the Trump Administration picks that may threaten some of the major environmental and social initiative important to impact investors, I would argue that the investment merits of environmental and socially responsible strategies have reached a point in 2017 that could help drive even more private capital toward those challenges and issues, thereby overcoming any policy shift at the federal level. For example, according to Lazard Limited's Global Power, Energy and Infrastructure Group [Levelized Cost of Energy \(LCOE\) analysis](#) (that's a mouthful!), the costs of solar and wind can now compete against fossil fuels, including natural gas, without subsidies.<sup>6</sup> This is an exciting area, and one that we'll continue to focus on. Also, we should not forget about the substantial power at the state level to continue moving the wheels of progress forward.

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<sup>6</sup> Lazard's Levelized Cost of Energy Analysis – Version 10.0. December 2016. <https://www.lazard.com/media/438038/levelized-cost-of-energy-v100.pdf>

While it is difficult to imagine that impact investing will be on the political agenda as it was under President Obama, we can also envision a new set of project-specific Social Impact Bonds growing in more states (education, homelessness, recidivism). Internationally, we expect more growth of the Green Bond sector and of International Development Bonds being issued by bilateral and multilateral agencies to eradicate diseases as well as structured products developed to finance prevention over remediation. Lastly, we have been seeing Refugee Camp-specific impact investments - basically, Microfinance to enable refugees to start micro and small businesses while residing in host countries. Given our concern regarding the social instability in Europe caused by the influx of refugees, we are optimistic regarding the development of solutions geared toward displaced populations.

While there is nothing magical about a change in the calendar, there is something to be said about the perception of a new palate to paint on from a macroeconomic perspective. As 2017 makes volatility great again, I expect we will be chatting quite often as events unfold.

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