Memo to: Oaktree Clients

From: Howard Marks

Re: Go Figure!

Think back to just before last week's election. What did we know?

- The polls were almost unanimous in saying Hillary Clinton would win the popular vote by about 3%.
- FiveThirtyEight, an analytical website whose forecasts had proved quite accurate in the two prior presidential elections, gave Clinton a 71% probability of winning, and almost everyone else was between 80% and 90%.
- Clinton was favored in most of the "swing states" that would make the difference in the Electoral College. Thus she was expected to win more than 290 electoral votes, leaving just 250 or so for Donald Trump.
- Clinton was the obvious choice of the people who move the markets. This could be seen in the fact that the markets went up when Clinton's odds improved in late October (recovering from some unpleasant Wikileaks disclosures), and then they fell after the FBI's James Comey announced the discovery of an additional cache of Clinton emails on October 28, lifting Trump's chances.
- Thus there was a near-universal belief that a Trump victory – as unlikely as it was – would be bad for the markets.

So what happened? **First Clinton didn't win.** There's much soul-searching, particularly among the forecasting fraternity. Everyone knew intellectually that Trump had a non-zero chance of winning, but few people thought it could actually happen.

And second, the U.S. stock market had its best week since 2014! The Dow Jones Industrials rose almost 5% for the week, taking them to a new all-time high. The Dow was up every day last week. It rose on Monday and Tuesday, when Clinton was expected to win. And then it rose Wednesday, Thursday and Friday, after she had lost.

That behavior calls to mind my January memo, "On the Couch," on the subject of the market's irrationality. Clearly, the election was the biggest event last week, so it must have been the main influence behind the changes in stock prices. But how could the expectation of a Clinton victory make stock prices rise, and then the reality of her defeat make them rise further?

In that memo, I included a cartoon showing a newscaster saying, "Everything that was good for the market yesterday was no good for it today." In the case of the election, it might have been, "Whatever was good for the market yesterday, its polar opposite was good for it today." It just doesn't make sense.

While people search the market's behavior for logic, there really doesn't have to be any. In "On the Couch," I mentioned that sometimes the market interprets everything positively, and sometimes it interprets everything negatively. The market often fails to act rationally in the short run, primarily because of the role played by people in determining its course.

Thus two key observations can be made based on last week's developments:

- First, no one really knows what events are going to transpire.
- And second, no one knows what the market's reaction to those events will be.

These observations reinforce my belief that it's a mistake to base investment decisions on macro forecasts. But you knew that.

<u>Impact on the Markets</u>

Of course there's logic to the market's rise last week, just a logic different from that which would have made it go up if Clinton had won. The reasons one might cite are these:

- **As a businessman, Trump doubtless intends to be a pro-business president.** In fact, he'll probably make more of an effort to nurture business than Clinton would have (especially when being pushed to the left by Sanders and Elizabeth Warren), and more than I think characterized the Obama administration.
- Trump's campaign promises have included tax reform; reduced income tax rates on corporations and big earners; some form of tax holiday to enable corporations to bring in profits stranded abroad; a reduction of business regulation (Carl Icahn tells me this will be huge); a big infrastructure program ($1 trillion announced); an end to bank-bashing; less pressure on pharmaceutical and health care companies to cut prices; and an end to the estate tax. That's quite a pro-business agenda.
- The populist power of Sen. Warren will be reduced.
- Businessmen and Wall Streeters will be welcome to serve in the administration, not verboten as in recent years.

At the bottom line – if everything works as promised – there will be massive fiscal stimulus; big increases in GDP growth, corporate profits and jobs; higher inflation than otherwise would have been the case; a big increase in the national debt; and more of everything for everybody.

> Writing in the Financial Times, Anthony Scaramucci, a member of Mr. Trump's economic advisory council, said the president-elect would finance the new spending plan with "historically-cheap debt and public-private partnerships" and said it would cut deficits by stimulating economic growth. "Economies around the world are fighting deflation largely because of a post-crisis move toward fiscal austerity. We can close the wealth gap in America by replacing emergency-level interest rates with fiscal stimulus." (*Financial Times*, November 12-13)

No austerity here!

Trump's statements regarding business and the economy contain some real positives and are the best part of his platform . . . if he and his administration are up to the task of putting them into practice.

However, some of his promises may test the limits of what can be accomplished under the limitations imposed by economic reality.

And there are negatives, including:

- Trump's express disdain for Janet Yellen, and the resulting possibility that Fed independence will be reduced,
- his stance on international trade pacts (an area in which a president has unusually broad power to take unilateral action), his threat of imposing import duties on goods made in China and Mexico, and the resulting possibility of trade wars, and
- the possibility that this plus his unconventional positions on things such as climate change and defense treaties bode ill for international relations in general.

That brings us to the outlook for bonds. Just as the U.S. stock market has celebrated Trump's election, the bond markets have been discouraged. Interest rates rose very rapidly last week following Trump's election, bringing big losses to bond holders. The *FT* wrote the following, citing Henry Kaufman, the Salomon Brothers chief economist who correctly called the bond bear market in the 1970s:

> "It's a tectonic shift" . . . the end of a three-decade bond bull market, because of the likelihood of unfunded tax cuts, infrastructure spending and a radically reshaped Federal Reserve. "I would say the secular trend is going to be upwards now," he told the FT. "Secular swings are hard to forecast, but the secular sweep downwards in interest rates is over, and we are about to have a gentle swing upwards."

I always feel it takes a degree of innate optimism to be a devotee of stocks (with their reliance on conjectural returns awarded by the market) as opposed to bonds (which bring contractual returns guaranteed by their issuers). Thus U.S. equity investors have exhibited an optimism regarding the Trump administration that virtually no one foresaw a week ago.

Equity investors like inflation because it pumps up profits. Bond investors dislike it because it raises interest rates, reducing the value of the bonds they hold. But the two can't go in opposite directions forever. At some distant point, higher interest rates can cause bonds to offer stiffer competition against highly appreciated stocks.

Finally on the subject of the market outlook, I'll pass on some observations from Stanley Druckenmiller – the owner of one of the very best investment records in history, and certainly not someone congenitally biased to optimism (or anything else):

> Billionaire investor Stanley Druckenmiller told CNBC on Thursday he's "quite, quite optimistic" about the U.S. economy following the election of Donald Trump.
>
> "I sold all my gold on the night of the election," the founder and former chairman of Duquesne Capital said in a "Squawk Box" interview.

He said he's betting on growth by shorting bonds globally, and he likes stocks that respond to growth. He also likes prospects for the dollar, especially against the euro.

This rosier outlook is in sharp contrast to what Druckenmiller said at the Sohn Investment Conference in New York in May. At the time, he told attendees they should sell their stock holdings. He also had said gold was his "largest currency allocation."

Despite Druckenmiller's past negativity, he said Thursday: "It's as hopeful as I've been in a long time." He added, "I would not be surprised if we're not looking at the peak of the divisiveness."

"[But] I hope economic policy is deferred to Mike Pence and Paul Ryan," he said, referring to the vice president-elect and the speaker of the House. He pointed out he did not support Hillary Clinton. (Druckenmiller had supported John Kasich for the Republican nomination and said he's philosophically in favor of Ryan's economic policies.)

"I don't think Donald Trump is Ronald Reagan," he added.

Since Republicans maintained control of the House and Senate while winning the White House, Druckenmiller said "this is the greatest chance" to get tax reform and deregulation passed.

"If it wasn't for the messy conflict of rates rising with the stronger economic growth through [fiscal] policy, I would think there's so much low-hanging fruit in terms of deregulation and tax reform, we could get a jolt of 4 percent [growth] for about 18 months," he said.

"I do think interest rates could cut that back into the high 2s, low 3s [percent]," he continued, adding markets are pointing to the cost of borrowing money going up a lot. "I think the market is going to force this. The market is going to push them to raise interest rates if my hopeful scenario turns out to be right." (CNBC on-line)

I usually inveigh against macro forecasting and macro investing, but Stan is the exception who proves I'm far from 100% right. I supply his words unabridged. No one should ignore them.

Why Were the Forecasters So Wrong?

Trump won in 30 states, whereas Clinton won in 20 states and the District of Columbia. Trump won in three states that were expected to go for Clinton plus the two largest of the three states rated "toss-ups," while Clinton didn't upset Trump in any of the states people expected him to win. Trump won vastly more counties than Clinton (although not the most populated, obviously), including those populated by both below-average and above-average incomes. Many of these things came as surprises.

The amalgamation of Trump voters that I described in "Implications of the Election" came together as expected, but in greater quantity than expected. His supporters were moved by great fervor, and while they may not have admitted to the pollsters that they favored the candidate derided by most of the media and intelligentsia, they voted for him in surprising numbers. The surprises included some college-educated whites, people with higher incomes, and even Hispanics, the vast majority of whom were expected to vote for Clinton.

And in the end, the "enthusiasm deficit" people had talked about all campaign came home to haunt Clinton. While more people had told pollsters they would vote for her than for Trump, many of them were probably motivated by aversion to Trump rather than any great love of Clinton. In the end, her voters' lack of enthusiasm seems to have kept enough from the polls to make the difference. Turnout was below expectations in Florida, Michigan, Pennsylvania and Wisconsin, and the results in these states were largely responsible for the election surprise.

The *Financial Times* of November 12-13 made a telling observation:

> In Michigan and Wisconsin, the two states that arguably swung the election, [Mrs. Clinton] received roughly 300,000 fewer votes than Mr. Obama did, suggesting his supporters either stayed home, or cast their votes for Mr. Trump or a third-party candidate.

The bottom line is that Trump won virtually all the counties that Romney won in 2016 plus a fair number of the ones Obama won. Clinton lost Pennsylvania by 1.4%, whereas two weeks ago she was thought to be ahead by double digits; Wisconsin by 1.5%, a state she was expected to win; and Michigan by 0.3%, a state Obama carried in 2012.

Obama's supporters were passionate, often because of his stirring oratory and/or his potential to be/remain the first black president. Despite the possibility of her being the first woman in the White House, Clinton ran into trouble relating to her difficulty connecting with the "common man," in addition to the controversies relating to her private email server and the Clinton Foundation. Finally, she never picked up some of the Democrats, especially young ones, who had coalesced behind Bernie Sanders's more liberal agenda. Thus her vote count fell short of expectations.

A combined shortfall of just 113,000 votes in Pennsylvania, Wisconsin and Michigan made Clinton the loser. If she had won just 57,000 of those votes (or 0.4% of the 13.6 million total votes cast there), she would be the president-elect.

For whatever reason, Trump, who almost everyone thought had no significant chance, was the surprise winner. After this and the Brexit vote – which also ran counter to forecasts – prognosticators are likely to be followed less assiduously in the future than in the past.

I keep saying "almost everyone" thought Clinton would win. That's because there was one prominent exception: the USC Dornslife/Los Angeles Times Presidential Election Poll consistently predicted a Trump victory in the popular vote. They had him up by 3% at the end.

Now the USC poll's Arie Kapteyn is being lauded for having gotten the outcome right, and Bloomberg reports that he employed "what experts called a unique and more complex weighting model." Does his success redeem the forecasting profession?

Not really. Trump didn't win the popular vote as USC predicted; he lost it (by just under half a percent). Thus you can't say USC had it right. They were wrong. Or rather, they were right about a Trump victory, but for the wrong reason. (How often do we see that in the investment world?) In the end, who was more right: USC (which said he would win the popular vote) or the others (who were correct in saying Clinton would win it – only to see her lose the election)? That's what I would call a Talebian question.

The bottom line is that popular vote polls get headlines, but the presidency is determined in the Electoral College. The latter made Trump the winner – as USC had said, but not for the reason it had predicted. (More on the Electoral College later.)

Outlook for the Trump Presidency

I was in Australia on Election Day, and right away I was asked what the future holds. First, I said, there's far too much we don't know to permit any conclusions. Here are a few of the key open questions:

- How much of what Trump said while campaigning did he mean?
- How much of what he actually meant will he try to implement?
- And how much of what he tries to implement will he be able to effect?

- Will he seek advice? (While campaigning he gave the impression he thinks he knows best.)
- Will he appoint expert, experienced advisors?
- Will he heed their advice?

Second, I'd look for some initial signs.

- Would his acceptance speech be conciliatory or vindictive? Certainly it was the former.
- Will his first appointments be constructive or less so? Will they primarily reward loyalty or expertise and experience?
  - We can take some encouragement from the mainstream choice of Mike Pence to head his transition team.
  - Less cheering is his appointment of Myron Ebell, an outspoken climate change denier, to lead the transition at the Environmental Protection Agency.
  - I had thought that Trump's selection of his chief of staff would be somewhat telling, given the rumored choice between the controversial campaign adviser Steve Bannon, formerly head of the alt-right Breitbart News, and Republican National Committee Chair Reince Priebus, who is respected in Washington and has an insider's understanding of how it works. Sunday's appointment of Priebus as chief of staff and Bannon as chief strategist/senior counselor leaves the question unanswered and suggests there's room in the Trump administration for both traditionalists and outsiders.
  - One of the things we have yet to see is whether experienced and respected veterans of government will join an unpredictable and potentially controversial administration.
- Will Trump's early behavior indicate that the man we saw on the stump was the real Trump, or that the fiery populist and outside-the-box persona was exaggerated for effect? I am

somewhat encouraged that, so far, he's appearing about as "presidential" as we could have thought possible.

Third, it will be interesting to see the extent to which Trump is supported in Congress. Republicans lost a net of six seats in the House of Representatives, but they still enjoy a solid majority of 45 seats out of the 435 there.

But they lost some ground in the Senate and thus now hold only a bare majority of the 100 seats. Here are some of the key considerations there:

- The Senate has a special role, as its approval is required for treaties (a two-thirds majority) and for appointments such as those of cabinet members, ambassadors, and judges of the Supreme Court.
- Certainly some candidates ran for the Senate this year – and won – explicitly rejecting Trump and saying they would vote for Clinton. Thus not all of the Republican senators are sure to support Trump's initiatives; his majority isn't bulletproof.
- Further, the tradition of filibuster in the Senate allows a member to prevent action on a bill (other than a budget) unless the filibuster is lifted through the invocation of "cloture" Cloture requires support from 3/5 of the senators voting (usually 60), with the very new exception of certain executive and judicial appointments (but not Supreme Court nominees), when a simple majority is sufficient. Thus the Republicans' small majority isn't enough to ensure smooth sailing in most cases.

For all these reasons, even though Republicans control both houses of Congress, I don't think Trump necessarily has a blank check. Hopefully circumstances in the Senate will push him toward moderation.

I felt during the campaign that, as opposed to Hillary Clinton, the range of possible actions and outcomes in a Trump administration was far too broad to be predicted. I'm still convinced that's the only thing we know for certain.

<u>Majority Doesn't Rule</u>

In "The Implications of the Election" last week, I talked about the shortcomings of the Electoral College. Now they have been made clear. As mentioned earlier, even though Hillary Clinton won the popular vote by about 0.5%, Donald Trump is projected to win in the Electoral College by a big margin, 306 to 232, when it votes officially next month. Thus his 47.3% of the popular vote (Clinton got 47.8%, and 4.9% voted for the candidates of so-called "third parties") translated into 57.9% of the Electoral votes.

This alchemy is attributable primarily to the fact that all of the states other than Maine and Nebraska allocate their electoral votes not in proportion to the candidates' popular votes in the state, but rather on a winner-take-all basis.

Clinton won a few big states by huge margins – like NY's 29 electoral votes by 58% to 37%, and the top prize, California with its 55 electoral votes, by 62% to 33%. But since all the electoral votes go to the person with the most popular votes, anything in excess of a simple majority is "wasted." In these two states combined, with 15.2 million votes cast, Clinton got 9.6 million, which was 2 million more than she needed to win. Those extra votes padded her popular vote total, but they could do nothing to help her win the presidency.

Trump, on the other hand, won a larger number of states – many of them small to mid-sized – and in six cases by less than 5%. But, as I said above, 51/49 produces the same outcome as 70/30. So even though Trump received fewer popular votes in total than Clinton, he used them much more efficiently (meaning his average margin of victory was smaller). He got 5.1 electoral votes per million popular votes, whereas Clinton got only 3.8. Of course that's basically undemocratic.

This process translates into outcomes that can deny the election to the candidate for whom more people voted. Last week's election was the fourth time that has happened in our nation's history, but also the second time in the last 16 years.

Here's what CBS reports one astute observer to have said about this arrangement in 2012:

> The phoney [sic] electoral college made a laughing stock out of our nation. The loser one!
>
> He lost the popular vote by a lot and won the election. We should have a revolution in this country!

That observer was Donald Trump, responding erroneously to Obama's 2012 reelection (Obama actually won the popular vote). For some odd reason, those tweets have now been taken down.

There have been unsuccessful efforts to change the process so that future presidents will be chosen on the basis of the national popular vote, including one as recently as 1969. Another is currently underway, but the road is long and arduous. I hope the situation will be revised . . . and that I live to see it.

But in the meantime, the vote in the Electoral College is the vote that counts. Thus candidates allocate their time, effort and resources to maximize those votes, rather than popular votes. Although I'd prefer a different system, it's the one we've got, and complaints about the legitimacy of a victory that isn't accompanied by a popular vote majority don't resonate with me.

As an aside, a very similar phenomenon impacted the battle for this year's Republican nomination. A few years ago, the party changed the system to winner-take-all in the early primary races. The purpose was to quickly winnow the field to focus the contest on candidates capable of garnering significant support.

Thus when Trump was up against 16 other candidates in the primaries, he distinguished himself from the others and was able to win 100% of the delegates at stake with vote percentages generally in the twenties. This enabled him to take a commanding lead before the Republican establishment was able to respond to his insurgent candidacy. Here too, winner-take-all voting may come under examination.

The Outlook for the Parties Revisited

In "The Implications of the Election," I mentioned the uncertain future of the Republican party – with a schism possible between Trump's followers and the unsupportive party establishment. (Now that Trump has won, it's possible all will be forgiven.)

Now I want to point out the possibility of a schism among Democrats.

- There was a clear divide during the primaries between Clinton's centrist supporters and Bernie Sanders's considerably more liberal backers.
- Many of the latter became disgruntled when Clinton received the nomination, and some are likely to have abstained from voting in the general election.
- It's possible some will attribute Clinton's loss to an easily-beatable Republican candidate to her less liberal agenda and membership in the party's old guard. This may cause the liberal faction to try to exert more effort next time to ensure that their kind of candidate is nominated.

Thus I think the 2016 presidential election – and Trump's catalyzing role in it – will have implications on both sides of our political process for years to come. These too, however, are unpredictable.

* * *

This is the last memo on politics for a while, I hope (as may you).

November 14, 2016

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