FRONTIER FOCUS
November 2016

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The Election and Capital Markets

On November 8th, U.S. voters hidden in plain sight came out to vote for Donald Trump. Just as with Brexit, this populist result was unexpected, and has left many feeling puzzled as to how to absorb the result. The stated policies of the incoming Republican Party differ greatly from those of the existing Democrat Party. Capital markets do not like large and unpredictable changes; unknowns create fear. However, since November 8th, U.S. equity markets have risen. It is the bond market which has experienced a significant sell off, indicating investors' initial fears are more centered on rising interest rates than on a poor economic outcome. Is this a short-term reactionary response or are the capital markets telling us something?

President-elect Donald Trump campaigned for abrupt changes to economic policies, including increasing fiscal spending, lowering taxes, and revising trade policies. Given that the Republican Party retained control of both the house and senate, it is probable that some of these policy changes are likely to occur. The biggest policy change that has the potential to benefit the U.S. economy is what looks like massive fiscal expansion. Lower taxes for consumers and corporations combined with increased infrastructure and defense spending will create more jobs and put more money in consumers' pockets. Fiscal expansion at a time when interest rates are low and when the economy appears to be gaining steam could be a huge shot of adrenaline to the economy. A stronger economy implies higher inflation is around the corner.

Of course, there are no free lunches. The money to pay for fiscal expansion must come from somewhere. Any induced economic expansion requires either debt or the printing of money. When fiscal policy is tight, taxes remain high and government spending is low, and consumers and businesses are enticed to take on debt through easy monetary policy to keep the economy growing. Under this kind of austerity policy, the economy can grow, but often at a slow rate and inflation and interest rates usually remain low. Under a policy of fiscal expansion, taxes are low and government spending is high, which then creates a deficit and leads to higher government debt. Consumers are rewarded with lower taxes and possibly a stronger labor market, which is a direct stimulant for the economy. In the short-run, fiscal expansion and lower taxes should lead to economic growth, reflation and higher interest rates.

Economic Policy Table

How fiscal spending and monetary policy work together.

Party	Taxes	Regulation	Fiscal Spending	Social Spending	Growth From Fiscal	Who takes on Debt?	Monetary Policy	Interest Rates	Growth From Monetary
Current	Higher	Higher	Lower	Higher	Lower	Consumer	Easier	Lower	Higher
New	Lower	Lower	Higher	Lower	Higher	Government	Tighter	Higher	Lower

In theory, the longer-term cost of fiscal induced economic expansion is higher government debt and higher interest rates. However, capital markets have a long history of proving economic theories wrong. While fiscal spending and lower taxes are a direct positive force to help the economy, it is not a foregone conclusion that interest rates should rise materially. Foremost, rising interest rates are a vicious circle, creating higher borrowing costs and in turn slowing the economy the higher they go. Furthermore, U.S. interest rates across the maturity spectrum are significantly higher than almost every other first world trading partner, which is an imbalance that shouldn't remain long-term. Thirdly, we are still operating in a global slow growth and low inflation environment, where massive monetary and fiscal stimulus have had very little effect on economic outcomes. Finally, there are all the unknown factors. It is unclear what impact all the policies that are up for change will have on the economy.

In hindsight, the initial market reaction to the election seems in line with stated policies; U.S. stocks held strong due to fiscal stimulus, and the U.S. bond market sold off due to inflation fears and possibly foreign investors' perception of U.S. credit quality. Emerging markets also fell victim to campaign rhetoric, and sold off sharply based on fears of trade restrictions and tariffs. Of course, we will have to wait and see what the real longer term impact on capital markets will be, if any. It has only been a week, and capital markets will eventually settle down. The Frontier Asset Management team has managed investment strategies through many political and economic events before and we know that in the short-run capital markets movements can be unpredictable or just normal random volatility. However, the long-run characteristics of capital markets rarely change, and each asset classes' role in a strategy remains relevant. Stocks like a good economy, bonds like a bad economy, and real assets perform well during times of inflation. A well-balanced strategy should always hold some combination of these assets, regardless of what is happening in the short-term.

On a final note. When fixed income assets are the poorest performer of the asset classes, conservative strategies, which are dominated by fixed income allocations, tend to perform the worst. That has been true within Frontier's Globally Diversified strategies since the election. But even Frontier's Capital Preservation strategy has some balance among all the asset classes. That has kept its losses small in comparison to the losses that high-quality bonds have experienced, and well within its downside risk target.

As always, we will continue to run through our entire process monthly and will continue to focus on managing risk, providing growth, and looking for opportunities to consistently add value.

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