

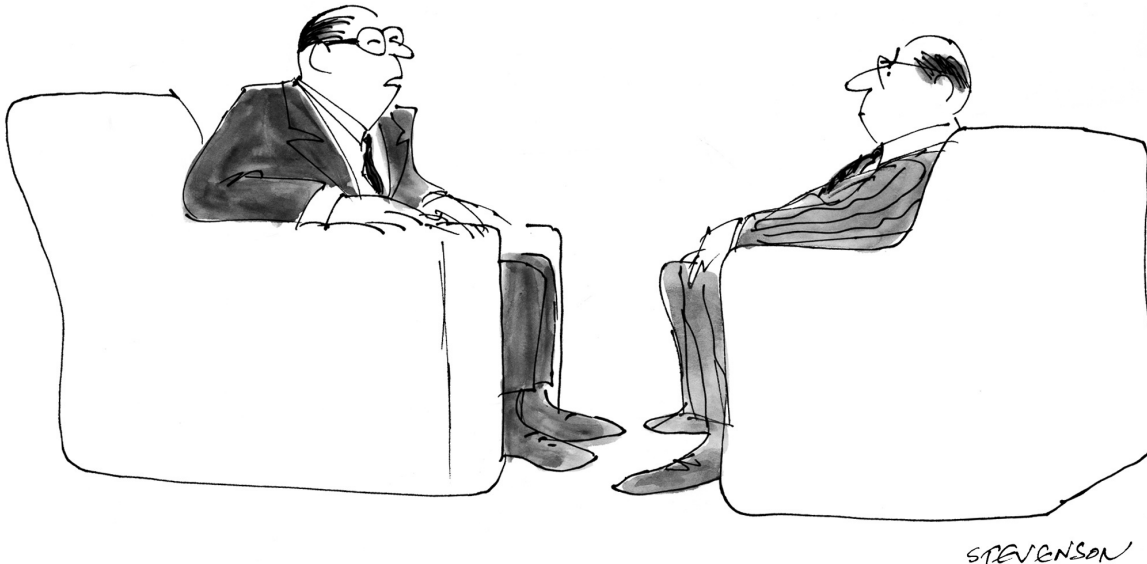


**PACIFICUS**  
CAPITAL MANAGEMENT

INVESTMENT OUTLOOK — JUNE 2019

## Politics and Markets

*“A paranoid is someone who knows a little of what's going on.”*  
— William S. Burroughs



*“To be completely frank, we have now discovered all your country's secrets, except how to make a million dollars in one's spare time at home with no personal investment.”*

CartoonStock.com

How many people during the Autumn of 2016 thought the U.S. stock market and/or the economy would crash if Donald Trump won the presidential election? I can admit, I did not subscribe to the market collapse view (I'm not an outlier type of guy), but I also did not envision the positive reaction that emerged over the subsequent months. Back then, most publications I read, and the majority of people I communicated with appeared to have a higher degree of confidence the market could collapse should Trump prevail over Clinton. Aside from political operators, virtually no one admitted to, or expressed any positive sentiment at that time.

To the investors who were swept up in the emotional ping pong back then – you shouldn't feel bad or embarrassed. You were in good company. Post-election night, a number of clients were concerned about their investment portfolios, with a few suggesting we pare back their risk allocation or divest from stocks completely. At the time, our response was to not allow political beliefs or emotions infect their judgement. "Stick to the long-term investment plan." "Stay with the risk and return objectives laid out in our investment policy statement." Most clients agreed to wait and see how things played out, while a small number asked that their risk be dialed down a bit.

In the investment management field, there are two main schools of thought. The first group are the fundamental bottom-up managers. These investment managers generally focus on picking securities through their analysis of corporate financial statements and are less concerned with the broader economy. The second and competing school of thought are the top-down macro investment managers. These managers engage in "macro" analysis where both the economy and political developments play a prominent role. In practice, most managers incorporate both disciplines to some degree. At Pacificus, I'd guesstimate we incorporate 70% macro/top-down analysis and 30% fundamental/bottom-up analysis in our investment decision making process. The macro analysis guides our asset allocation decisions while fundamental analysis determines our security selection.

Today, as opposed to the Autumn of 2016 we need not ignore the current political climate. After a long period of hibernation post the global financial crisis, macro is back! President Trump frequently announces his thinking/policy to the world over Twitter and does so with haste. Lately his tweets have focused on implementing trade tariffs with both Mexico and China and he does not appear to be bluffing. His disagreement with Mexico seems to have been resolved for the time being. However, the trade war with China is real and does not appear to be near any sort of resolution. Both sides are digging in. The political developments of today will have an effect on the corporate profitability of tomorrow. To the pure fundamental bottom-up investment managers I'd like to say - *Corporate profitability does not exist in a bubble in our globalized world. Less trade translates to less future profits.*

Fortunately the Fed, led by Chairman Jay Powell has woken up to the near term risks, which include a protracted trade war with China. This acknowledgement has been a relief to stock market bulls. Initially Powell's dovish tilt was a reaction to the market decline that occurred during the fourth quarter of 2018. Since then, both corporate profitability and economic statistics, which measure the health of the U.S. economy have decelerated. As a result, the market is pricing in about 0.75% of interest rate cuts to the Fed Funds rate through 2019. Usually once the Fed gets going in one direction, the trajectory of policy adjustments tends to go beyond what markets currently have priced in. Why would this time be any different?

Regarding financial markets, this means prices of asset classes that are positively affected or tied to easier U.S. monetary policy will likely go higher over the coming months. Although corporate profitability is decelerating, discount rates are also declining which in turn suggests Price/Earnings multiples for stocks could increase going forward. In the near to medium term, lower interest rates, an end to quantitative tightening, and increased liquidity should more than offset the warning signals coming from a deceleration in corporate profitability and decreased trade. However, given the political risks it would be prudent to keep some powder dry in case things don't play out as expected. Our client asset allocations are generally at target with regard to equities and will remain so as things become more apparent.

<b>ASSET CLASS &amp; SECTOR OPINIONS</b>		
<b>OVERWEIGHT</b>	<b>NEUTRAL</b>	<b>UNDERWEIGHT</b>
U.S. Real Estate Equities	Materials Sector	International Developed Market Equities
Large Capitalization Technology	Communication Services Sector	Financial Services Sector
Emerging Markets Equities	Healthcare Biotech & Pharmaceuticals	Consumer Discretionary Sector
Healthcare Equipment	Consumer Staples	High Yield Corporate Bonds
Aerospace & Defense	Investment Grade Corporate Bonds	Leverage Loans (Floating Rate Debt)
U.S. Treasury Notes & Bonds	Mortgage Backed Securities	Treasury Inflation Protection Securities
Gold	Local Currency EMG Bonds	
	Energy Related Equities	

Sincerely,

Justin Kobe, CFA  
 Founder, Portfolio Manager & Adviser  
 Pacificus Capital Management



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