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FROM THE DESK OF DAN VERU, CHIEF INVESTMENT OFFICER

Pro-growth Economic Policies and the Case for Small Cap Investing

Pragmatist: A pragmatist is someone who has a practical approach to problems and affairs tried to strike a balance between principles and pragmatism.

Ideologue: An ideologue is an impractical idealist or one who is often a blindly partisan advocate of a particular ideology.
(Merriam-Webster)

The election of Donald J. Trump will be remembered as one of the most unique and historic elections in the history of our republic. We will let the political pundits and commentators focus on the stylistic aspects of the President Elect, but with regard to the equity and bond markets, Mr. Trump's election has been and will continue to be good for stocks and ***very*** good for small cap stocks. Conversely, the multi-decade period of strong fixed income total returns is, by and large, over as artificially low interest rates come to an end. From market close on Tuesday, November 8th through Thursday, December 1st, the S&P 500® appreciated by 2.59%, while the Russell 2000® gained an astonishing 10.05%. By contrast, the ten year treasury yield has risen from 1.88% to 2.45% over the same period of time. We expect the current rally to continue for the following reasons:

- ***The President Elect is a pragmatist:*** Mr. Trump will be the first president that has never held political office or served in the military. He is a tenacious business man who is goal-oriented and not beholden to any political ideology; though he does need to gain better control of his emotions because they have distracted him at times. It is understandable that the Democratic establishment did not support his candidacy but neither did most of the Republican establishment with the exception of a few hearty souls, some of whom will be members of his cabinet. While Mr. Trump did receive some money from the Republican National Committee, he did not obtain the monetary support of unions or any other groups that are now looking for payback. As a result, Mr. Trump can take the best ideas from Republicans and Democrats. With Republican majorities in Congress and the Senate, the likelihood of enactment of pro-growth policies, such as less regulation, lower corporate and individual tax rates, and "fixing" the Affordable Care Act, has increased. Additionally, a repatriation tax holiday for companies could bring back a significant portion of their more than two trillion dollars of cash held overseas.

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- ***Rising rates and a stronger dollar are good for small cap stocks:*** In April 2015, we published a white paper on small cap stocks in a rising rate environment. Four months later, the Chinese central bank devalued the yuan, setting off a global sell off in risk assets that didn't ultimately bottom until February 11, 2016. Financials, Industrials, and Technology shares dropped the most while Utilities, Consumer Staples, and certain parts of Health Care did better. The global nature of the sell-off sent government debt yields to zero or even negative. U.S. Treasury yields returned to levels not seen since the financial crisis. The U.S. dollar rose sharply during this period but did not have the effect of supporting small cap shares because the dollar was merely the cleanest shirt in a world of dirty laundry. The prospects of lower regulation, lower taxes, and increased U.S. energy drilling could drive investment capital to this country. Investors buying the dollar believe that may become a reality once new policies are put into place. This dollar strength is a positive for equities, notably small cap stocks, because small cap earnings growth should accelerate. However, not all sectors will have similar performance, particularly in an environment where new capital will be generated from lower corporate taxes and less regulation while being spent on business investment and domestic infrastructure. Passive strategies have been the focus of allocations and now may be the time to shift towards active management.

- ***The great rotation out of bonds may be under way:*** Over the last ten years, we have had only one paltry twenty five basis point increase in interest rates - that occurred a year ago. Bond funds have done very well and investors have not seen a significant decline in the value of individual bonds or bond mutual funds for at least the last eight years. As a result, the flow of funds into bond mutual funds has not stopped during the post-financial crisis period while equity mutual fund flows have consistently been negative during that same period. As I stated earlier, the ten year treasury yield has risen from 1.88% to 2.4%. Obviously this move is off of a very low yield but a move of that magnitude in only a little more than three weeks is historic. Individual investors are about to receive their first account statements since the election and, if they only owned bond funds, they lost money during a period of sharp appreciation for equities. So far Financials, namely banks, Industrials, and Materials have led the rally, but it's been at the expense of Utilities, Consumer Staples, Technology and dividend paying stocks like REITS which have done poorly as money flows moved to sectors that are more pro-cyclical. For now, there is too much water in the bond bathtub and not enough in the equity bathtub. As money finds places where it will be treated the best, the trends of the last 10 years may be reversing.

In summary, the markets have reacted dramatically to the surprising election of Donald J. Trump. Professional and individual investors were clearly set up for a different result and a slower growth environment. If the policies contemplated by the incoming administration become a reality over the next year, we are looking at higher US GDP, increasing corporate profits, and higher stock prices. However, the stocks that led in the previous uptrend will be very different. Small cap stocks with domestic exposure will out-perform the index. The dollar will likely remain elevated, and bond yields may normalize to levels that don't necessarily harm equity valuations. Also, passive strategies are likely going to under-perform active managers who can allocate to the sectors and the underlying stocks that have the best upside potential. The Federal Reserve is likely to raise rates shortly but only as the economy continues to gather strength, which should keep equities, notably small cap stocks, in an upward trend.