MAKENA STRATEGY INSIGHTS – September 30, 2016

Policy and Rhetoric: Are The President-Elect's Campaign Promises Achievable?

Q3
PERIOD ENDING
September 30, 2016

Portfolio Strategy

The inescapable topic of this quarter is, of course, the election of Donald Trump as the 45th president of the United States. In the pages that follow, we will focus on the economic and investing implications of some of the putative policies that President-elect Trump may follow based on his commentary during the election process. At the highest level, it is easy to argue that a Trump presidency is a pro-inflation presidency, all three pillars of his platform point to increased inflation. On the demand side, fiscal stimulus taking the form of additional federal government purchases of goods and services would contribute positively to inflation, as would tax cuts putting more disposable income in consumers' pockets. On the supply side, limiting immigration should provide upward pressure on wages, and limiting imports should provide upward pressure on prices of goods, thereby also contributing positively to inflation.

Importantly, from a portfolio perspective, Makena is well-positioned to take advantage of the situation. Regular readers will know that one of our mantras is to construct well-balanced portfolios across all risk factors. Indeed, we have always kept a substantial allocation to Natural Resources and commodities, both of which are significant inflation hedges. Furthermore, our focus on smaller capitalization equities in Private Equity and on non-core/non-yield assets in the Real Estate portfolio implies that our private assets are relatively insensitive to inflation. Finally, in our listed equity portfolio (GPE and T/HE), as we have discussed in our Q1 and Q2 letters, significant risk exists in growth stocks as it relates to P/E ratios – again, our exposure mitigates this risk, as we are in general value-biased in our listed portfolios.

In the pages that follow, we will take a deeper look at the economic realities that many voters face, the potential effectiveness of various stimulus measures, and the outcome/benefits that might derive from a reindustrialization of the United States. In short, the range of potential outcomes is very wide and very dependent on the actual details of the policy implementation. As a result, we cannot and will not forecast a particular outcome but rather equip you, our reader, with the tools required to assess policies and actions as they are taken during the next 6 to 12 months.

The difficult reality of the typical American household

Having large numbers of people earning less than an "acceptable" income level (as defined shortly) creates insufficient investment in human capital, lowers aggregate demand, and therefore contributes to insufficient business investment. Said differently, if even the poorest American earned more than enough to ensure a relatively comfortable standard of living, low wages would not harm growth. Unfortunately, that is not the situation today. Figure 1 below illustrates the situation for the U.S., based on the Department of Health and Human Services estimate of the minimum amount of income required to be able to pay for shelter, food, healthcare, childcare, and education. For the typical household of four, with two working adults and two children, the minimum income required is estimated at $63,744. Compared with the median household income of $50,000 a year[1], the implication is that ~50% of U.S. households probably do not earn enough to properly invest in developing family members' skills, and "under consume" relative to their needs. Similar conclusions can be drawn for other household types. These shocking numbers are no doubt a significant driver of Trump's appeal. To the extent Trump's policies can improve the welfare of this group, the U.S. will benefit greatly, but the question is whether these policies will elicit the promised results.

[1] See www.census.gov/hhes/www/income/

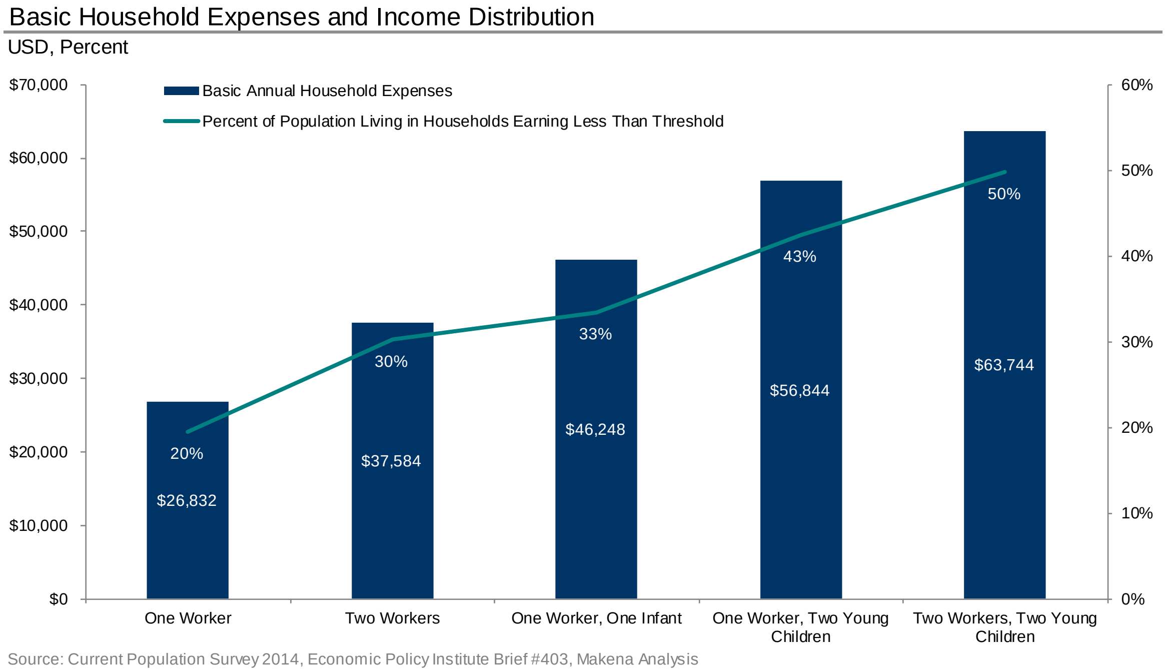


Figure 1: Minimum Income Requirements for Various Household Types vs U.S. Income Distribution

Stimulus: the importance of the "multiplier" effect

A summary measure of the potency of fiscal stimulus is called the "multiplier." As the Trump presidency gets underway, we expect the term "multiplier" to become part of the vernacular and therefore it is worth spending a moment to define it. The cost-benefit trade-off with any government action depends on whether the amount spent in the economy by the government generates more value than its cost of implementation. If, by taking one dollar away from the economy through increased taxes, the government then initiates a policy that generates more than one dollar worth of GDP, then the multiplier is said to be greater than one. Generally speaking, the higher the multiplier the better, and a multiplier above one is required for the government to add value on a net basis. An example may help: increasing tax on a high net worth individual who most likely would have saved rather than spent the money, and then spending that money to buy goods and services would generally lead to a high multiplier. On the other hand, increasing taxes on minimum wage earners who tend to spend their entire aggregate after-tax income, and then spending that increased revenue on goods and services would likely be a wash if not a net detraction to the overall economy, leading to a low multiplier.

There have been numerous studies on the multiplier effect of various government actions, the summary of which we present in Figure 2 below. Note how wide the ranges are for many of these actions, reflecting the fact that it is difficult to assess the multiplier without the necessary details around the implementation of the government action. That said, there are many actions that are unambiguously positive to the economy as we highlight in the red box. On the other hand, there are some actions that even under optimistic scenarios generate a multiplier below one. Nonetheless, the range of potential policies and actions is so wide that we remain optimistic that an effective stimulus can be put into place, especially now that both the executive and legislative branches of the government are, nominally, under Republican control.

Note that in order to calculate the fiscal multiplier one needs to understand both the source and the use of government funds. Given that the U.S. is a low tax jurisdiction relative to almost every other developed economy, one way to finance a stimulus would be through tax increases. This brings us to the next proposed Trump policy – a reduction of the corporate tax rate.

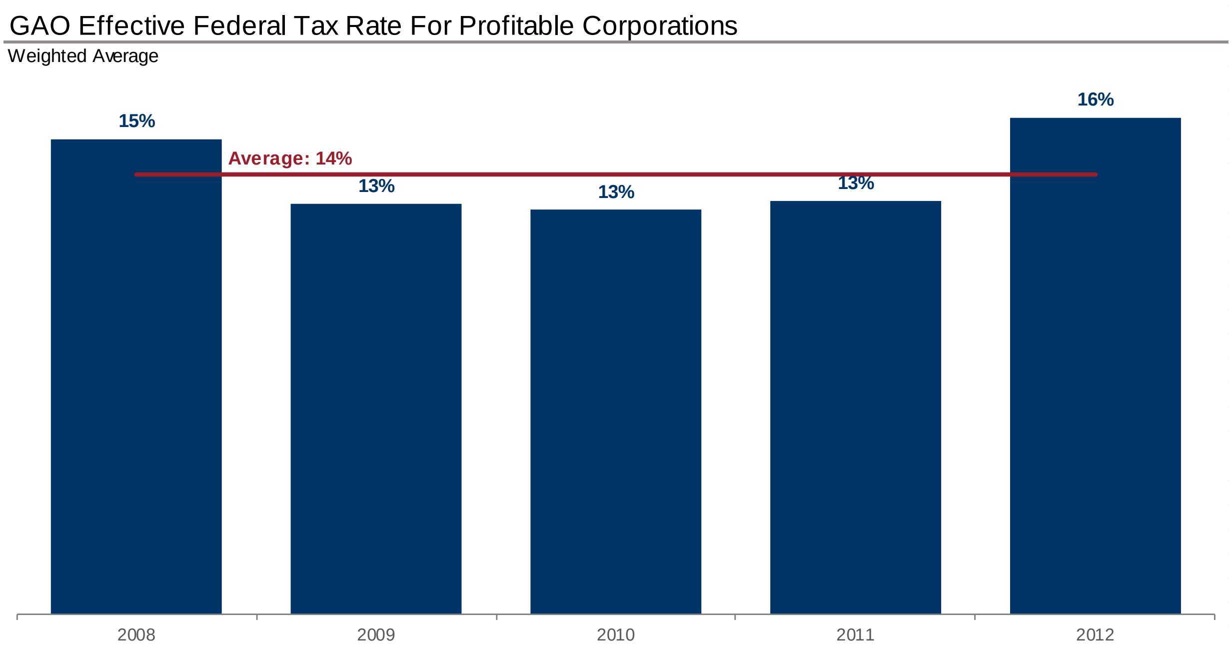
Activity	Average[1]	Range
Purchases of Goods and Services by Fed. Gov.	1.5	0.5 - 2.5
Transfer to State/Local Gov for Infrastructure	1.3	0.4 - 2.2
Transfer to Individuals	1.3	0.4 - 2.1
Transfer to State/Local Gov for Services	1.1	0.4 - 1.8
Two-Year Tax Cut for Low/Middle-Income Individual	0.9	0.3 - 1.5
One-Time Payment to Retirees	0.6	0.2 - 1.0
Extension of First-Time Homebuyer Credit	0.5	0.2 - 0.8
One-Year Tax Cut for Higher-Income Individuals	0.4	0.1 - 0.6
Corporate Tax Provisions Affecting Cash Flow	0.2	0.0 - 0.4

Source: Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output, CBO, 2015
[1]CBO published ranges and average is inferred

Figure 2: Estimated Fiscal Multipliers for Various Stimulus Programs

Corporate taxes – a nuanced story

It is important to bear in mind that very few, if any, U.S. corporations actually pay the statutory 35% tax rate on corporate income. Corporations do not systematically report the breakdown of their tax liability between federal, state, local, and foreign governments. As a result, short of reading through the footnotes of every 10-K filing, it is difficult to fully ascertain what U.S. corporations effectively pay as federal corporate income tax. The GAO (Government Accountability Office) has helpfully issued an in-depth analysis of the ETR (effective tax rate) that U.S. corporations pay by going through IRS filings. The results (shown in Figure 3 below) are somewhat surprising. Relative to the rhetoric around how high corporate taxes are in the U.S., the fact is that U.S. corporations pay very low federal taxes: on the order of 13% to 16% of income once all tax avoidance strategies are taken into account (e.g., net operating loss carryforwards, accelerated depreciation schedules, foreign/state/local tax credits, etc.).



Source: United States Government Accountability Office - 16-363

Figure 3: Federal Taxes Paid Differ Meaningfully From Headline Rate

Therefore we find ourselves in somewhat of a conundrum. If the statutory headline tax rate were dropped to, say, 25%, but all tax avoidance loopholes were to be closed, then most U.S. corporations would see a dramatic *increase* in their total tax bill. Whether the new administration takes advantage of this conundrum to reduce headline tax rates while actually increasing cash tax receipts in order to fund a fiscal stimulus remains to be seen.

The picture gets more interesting when we look at the U.S. on a sector-by-sector basis. Perhaps not surprisingly, those corporations with significant international activities (e.g., multinational companies) are better able to optimize their tax structure and therefore pay lower taxes, whereas companies with predominantly domestic operations (e.g., energy or small cap companies) have less ability to minimize their taxes. As a result, those who stand to benefit the most from a tax cut are domestically-focused companies, which is mostly synonymous with service sector companies. This is a risk for growth/tech companies that traditionally used international subsidiaries to shelter significant amounts of income from U.S. taxation; the benefits that tech companies derive from their offshore activities in terms of lowered taxes would be less important under a lower U.S. tax regime relative to other sectors of the stock market. Viewed from this perspective, the rally in domestically-oriented companies after the election of Trump is not surprising and reflects this nuanced corporate income tax situation.

Finally, a tax holiday for the repatriation of offshore capital back to the U.S. will most likely have limited impact on U.S. investment and growth. Indeed, with record amounts of cash on their balance sheets, capital has not been the binding constraint on corporate investing. Furthermore, as we discussed in our Q2 letter, with internal hurdle rates at all-time lows, companies still prefer to redistribute cash to shareholders rather than invest it in capital expenditure programs. So with rates now higher than they were before, and therefore internal hurdle rates also higher, the implication is that corporations will invest *less* than in the recent past.

Imports / immigration and the reindustrialization of the U.S.

While fiscal stimulus and corporate income taxation are nuanced stories, once a policy is announced it should be fairly straightforward to assess what that policy's impact would be on companies and therefore the market. Much more difficult are the issues surrounding imports and the reindustrialization of the United States. One of the main reasons why the United States has deindustrialized is not necessarily because of foreign competition, but rather because the U.S. economy itself has evolved significantly since the manufacturing heyday of the 50s and 60s. Indeed, back in the 60s, manufacturing, relative to other sectors in the U.S. economy, was a highly productive and highly value-added sector, and therefore it commanded higher than median wage income, as shown in Figure 4 below. However, the economy has evolved dramatically, and today most activities in the economy are higher value-added than manufacturing. Current manufacturing wages reflect this reality; manufacturing wages are now below average income occupations. This begs the question of whether adding many manufacturing jobs is a "win" for the United States.

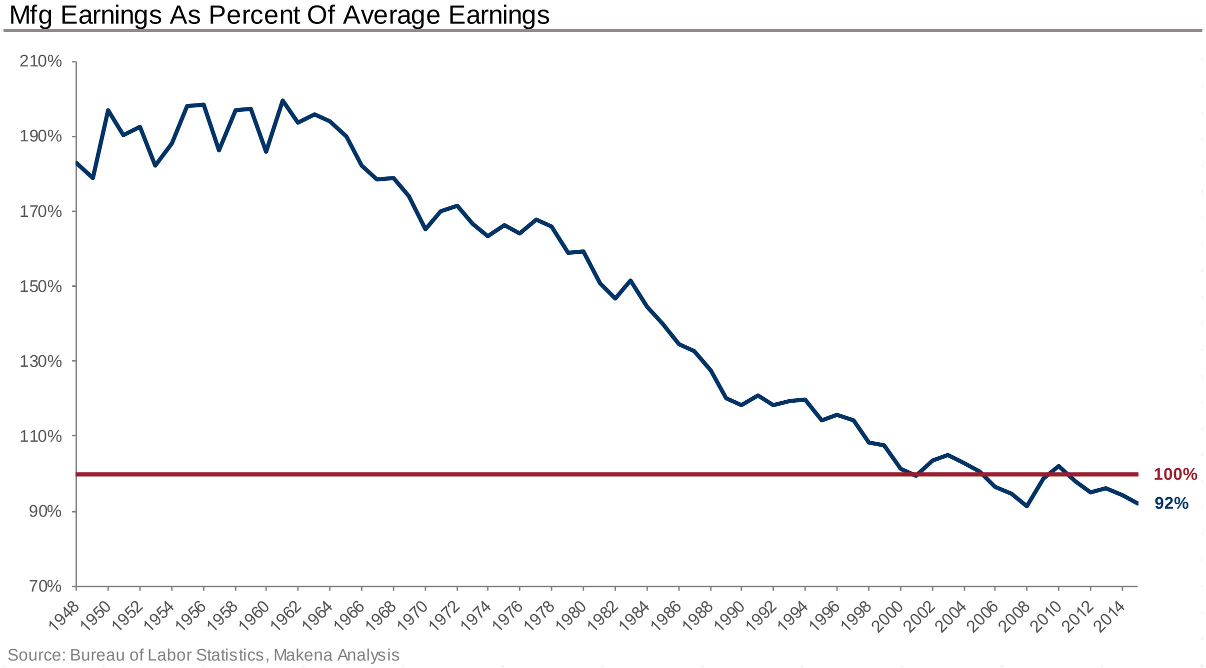


Figure 4: Relative Wages Reflect Declining Value-Added in Manufacturing

Let us sidestep this important question, however, and imagine that we find ourselves in a future where, as a combination of tax, immigration, and import substitution policy, the Trump administration has a reindustrialization process underway in the United States. For this thought exercise, it is useful to bifurcate the world into high value-added manufacturing and low value-added manufacturing.

For high value-added manufacturing, which is the bulk of current manufacturing in the United States, industry has migrated to highly automated and highly productive manufacturing processes. Indeed, Figure 5 below shows just how productive the average manufacturing employee is today, aided by software, computers, and robots. Should reindustrialization occur only with economically viable projects, most likely all manufacturing expansion would be high value-added and highly automated. In that context, a large 20% increase in the share of manufacturing in GDP, i.e. approximately 2% of GDP, would amount to adding approximately 2 million jobs in the United States. Put into context, while 2 million jobs may sound substantial, it represents approximately one year of job growth (using recent growth rates which themselves are weak relative to the past). Since such a substantial expansion of the manufacturing sector would take several years to occur, the boost to employment would be even less noticeable on a monthly basis. As such, we emphasize a cautious approach to promises of a large manufacturing boom, avoiding the rush into the sector, and maintaining a balanced portfolio positioning.

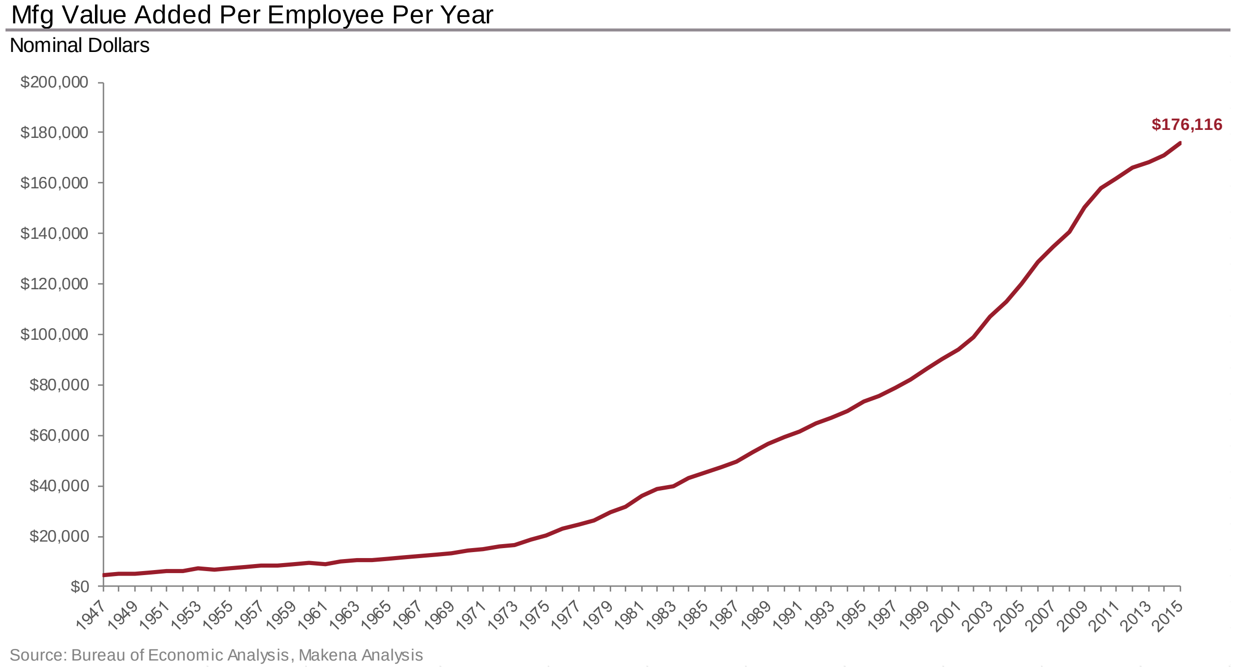


Figure 5: Impressive Growth in Productivity in Manufacturing

If on the other hand, reindustrialization is achieved by taxing imports and/or favoring domestic manufacturing through the tax code, then some of the industrialization would most likely occur via lower value-added activities. This would imply a higher level of employment relative to the high value-added scenario we just discussed. Given that the United States is a relatively high cost economy, participating in these lower value-added activities would imply an increase in the general price level for the goods produced out of these U.S. factories. Higher prices would then be borne by the entire U.S. population and the impact on aggregate consumer spending would be an offset to the increased employment. Seen in this light, "forced" reindustrialization that would not make sense in a free market environment would in effect be a form of income transfer. We would be "taxing" all U.S. consumers via higher prices for the goods and services they consume, in exchange for support to a less productive and lower value-added industrial workforce. It will be interesting to see whether households will be happy with slightly better job prospects juxtaposed with more expensive cars and television sets.

This is certainly not a new idea and has been tried in many geographies over time. In particular, Europe historically relied on "national champions" to service their domestic markets – this is why one would see, for example, a predominance of German cars in Germany, French cars in France, and Italian cars in Italy. Prices for such goods were, and remain, higher in Europe than in the United States. In exchange for those higher prices, a larger share of the population is kept employed in the manufacturing sectors and ostensibly a higher proportion of employment in the economy as a whole. We are not passing a value judgment on this approach to running an economy; it is simply a matter of choice whether one prefers consumers to achieve the lowest prices possible in exchange for potentially higher unemployment / lower wages for less productive members of society, versus higher employment and higher cost levels in general. With the election of President Trump, it seems as though the United States has opted to take the European route and go with the latter solution.

Summary of Investment Strategy

In our Q2 2016 letter, we outlined a series of investment recommendations. Many of those themes remain unchanged, though we introduce some new themes based on an expectation of higher inflation going forward.

i. *Caution over growth companies during the run-up to and immediate aftermath of Fed rate hikes*
Growth companies will likely exhibit sensitivity to the effects of a rate hike via the P/E multiple. However, in a world of scarce growth, they may be able to attract and sustain higher valuation multiples than they have attracted historically, suggesting that risk is perhaps somewhat muted.

ii. *Similar to (i) above, buy into long-term growth via EM equities*
Growth *countries* will also likely exhibit heightened sensitivity to the effects of a rate hike. Indeed, many EM markets seem to have already priced-in the effect of rate rises. Moreover, in a world of scarce growth, they should be able to attract and sustain higher valuation multiples than they have historically. Said differently, some EM countries currently represent “growth at a reasonable price.”

iii. *Prefer inflation linked bonds to nominal bonds*
Evidence of inflationary pressures are mounting from a tighter labor market, with a likely boost by government policy as we outlined above. Real rates are likely to rise at the front end due to Fed policy but the impact at greater tenors is unclear at best.

iv. *Similar to (iii) above, buy real assets and commodities*
Many real assets and commodities respond with positive beta to inflation and to surprise inflation, making them helpful investments to protect the buying power of a portfolio. The implicit assumption is that real rates do not rise significantly from here, which given the growth outlook, seems reasonable.

v. *Longer duration vs. shorter duration in Fixed Income portfolios*
Uncertainty over the timing and pace of the coming Fed hiking cycle is likely to continue to generate substantial volatility in the short end of the curve and potentially less volatility in the longer end. Additionally, should market expectations price a lower growth rate and a lower inflation outlook following a rate hike, we could actually see a rally in the long end.

vi. *Neutral positioning for U.S. dollar in currency portfolios*
Real rate rises would push a currency upward due to improved carry dynamics. However, the current outlook appears more inflationary which has a mixed impact on currency: carry improves but the buying power for the currency is reduced.

vii. *U.S. small and medium enterprises (including Private Equity) vs. large-caps*
With a strong dollar and weaker commodity prices, the U.S. consumer has more disposable income, thereby favoring smaller domestically-oriented services companies. Potential tax code changes will only accentuate our preference for smaller capitalization domestically-oriented companies.

viii. *Long Europe exporters and periphery intra-Europe exporters*
Thanks to internal deflation across most of Europe, European exporters should see margins continuing to improve. The weak Euro will continue to bolster exports to outside the Eurozone and imports from peripheral Europe to the core as a substitute for imports from outside the Eurozone.

ix. *Long EM reformers vs. laggards (across asset classes)*
Some countries have embraced reforms since the last few crises, implementing flexible exchange rates, minimizing interventions in their domestic economies, and in general fostering an environment where private industry can thrive. These countries should be able to navigate volatility driven by exchange rates and the Fed’s moves more successfully than the laggards that have not reformed.

The Partners of Makena Capital Management

Analysis by Michel Del Buono, Global Investment Strategist

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