Brexit, now Trump: Why a System Based Approach is Better

"I'm neither smart enough nor dumb enough to forecast the future." - Mike Nash

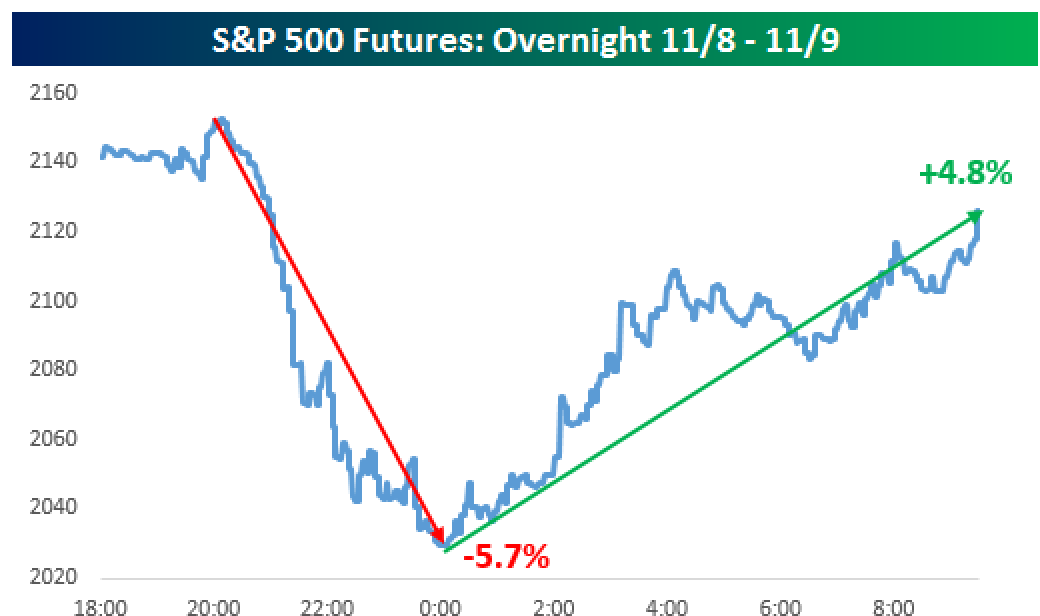
Peter Berezin, Managing Editor of BCA Research's Global Investment Strategy, spent most of Friday's issue, titled *The Trumpenproletariat Strikes Back*, congratulating himself on predicting a Trump victory: "I spent the last few days meeting clients in New York City. The expression on the faces of people while walking down the streets in Manhattan - which went 87%-to-10% for Clinton over Trump - said it all. Most people seemed dazed and confused by what happened on November 8th.

Trump did not win because of his personality. He won in spite of it. As I have emphasized over the past 18 months - starting with my presentation at the *2015 BCA New York Conference*, which featured the prediction that "The Trumpists Will Win" - Trumpism is a lot more popular than Trump. How else can someone with a 62% unfavorability rating become the next president of the United States?

The reason that Trump won is because he addressed many of the legitimate grievances of blue collar workers in swing states that establishment politicians had long ignored. ..."

As we have previously shared, one of Berezin's rationales for being underweight U.S. stocks was his Trump prediction. So, despite being right about the election, he was forced to conclude on Friday:

"We must admit that we are surprised that global equities were so quick to shrug off their (over-night) losses (Bespoke chart added). Our expectation had been that stocks would weaken somewhat in the wake of a Trump victory. (He was in fact predicting a 10% correction.) What happened? A few things come to mind. First, there has probably been a fair amount of short-covering from investors who had bought insurance against a Trump win.



Second, investors, like all humans, tend to draw on analogies in making their decisions. The best analogy for what happened on November 8th is what occurred after the Brexit vote. The lesson from that episode is that one should buy stocks after a supposedly negative voting outcome. That is exactly what investors did Wednesday morning.

Third, there are in fact some legitimate reasons why President Trump may be good for stocks. In addition to the prospect of lower corporate tax rates and fiscal stimulus, a Trump administration is likely to go soft on financial regulation. This, in tandem with a steeper yield curve, could prove to be a positive development for banks. A

Trump administration is also good news for energy companies, particularly coal. Defense contractors should benefit from increased military expenditures.

The implications for health care stocks is harder to gauge. While the potential repeal of the Affordable Care Act could hurt some companies, it may benefit others. Our hunch is that the net effect for health care earnings will be positive. Even if Obamacare is repealed, it is likely to be replaced with something that looks a lot like the existing legislation, just with more subsidies and giveaways for health care providers and drugmakers (think of Medicare Part D).

Having said all this, investors now seem to be a bit too complacent about what a Trump presidency means for stocks. The risk of a trade war is still present. And even if Trump pulls in his protectionist horns, a tighter labor market, exacerbated by a potential shortage of immigrant workers, is likely to eat into corporate profit margins. Higher rates and a stronger dollar will also hurt. As such, we are maintaining our tactically cautious stance on global equities."

While not predicting a Trump win, BCA Research's Geopolitical Strategy team also believed that the Markets were over estimating Clinton's chances and were therefore recommending a series of Hedges against a Trump victory. However, on election day they reversed course in anticipation of a narrow Clinton win by closing their Trump hedges and going Long S&P 500/Short Gold Futures. At one point that night S&P 500 Futures were limit down 5% while the Dow's Futures plunged 800 points as the Trump victory unfolded.

Our thoughts

In our August 1st letter to clients we wrote: "As we touched on in last month's letter, the Brexit shock was June's dominate story. Despite our incessant warnings about the rise of populism, I thought the vote to remain would prevail. The panic in the markets on June 24th & 27th was a typical overreaction, as we pointed out last month. What was surprising was the strength of the subsequent rally to new highs in the U.S. Suppose that you had a premonition on the vote, and hedged accordingly. You would have been right for exactly 2 days, and, without another premonition, missed a historic rally." In the words of Yogi Berra, "**It's deja vu all over again."**, except this time those betting on a Trump win slamming stocks were only right for a night. One of the headlines from this weekend's WSJ: **Dow's Best Week in 5 Years**.

B.K. Hughes & Associates, the Managing Member of Quest Opportunity Fund, has been a BCA client since 1992. Today, BCA Research is widely regarded within the financial industry as providing the best independent investment analysis available. As for Geopolitical analysts, our favorite is Ian Bremmer. He is a foreign affairs columnist and editor-at-large at TIME, the president of Eurasia Group, a political-risk consultancy, and a Global Research Professor at New York University. Bremmer's Mea Culpa, http://us12.campaign-archive1.com/?u=7404e6dcdc8018f49c82e941d&id=a94d4cd3f9&e=0111d07705 , over the election consumed most of his 23 minute video from last week's briefing.

In 2008 we attended the Democratic Convention as major donors to the Obama campaign. The finance group met with Campaign Manager David Plouffe, who detailed state by state how we were going to win, provided we came up with enough money. We came out of that meeting in awe, and we don't awe easily. It was not a surprise when he subsequently became chief adviser and a member of the board of Uber. In a Friday NYT op-ed titled **David Plouffe: What I Got Wrong About the Election** he confessed:

"Like many people around the world, I expected a comfortable Hillary Clinton victory on Tuesday. But I’m not a random pundit when it comes to understanding presidential races and the electorate — I managed one Obama

presidential campaign and oversaw another from the White House. So of all the forecasts that got it wrong, my prediction that Mrs. Clinton was a 100 percent favorite was a glaring miss.

My confidence was not partisan spin. It was based on public data, voting history and some sense of the Clinton campaign's own models. I played with various state scenarios, and even in the most generous outcomes, could not get Donald J. Trump to 270 electoral votes."

So, as Investment Managers, do we start a search for better experts? If we knew of any, they would probably already be part of our daily consumption of analysis. Perhaps J. Scott Armstrong got it right in his classic economic paper from 1980, *The Seer-Sucker Theory: The Value of Experts in Forecasting:* **"Don't hire the best expert, hire the cheapest expert."**

Is there a better approach? Grove et al. (2000) did a meta-analysis, or study of studies, on 136 published papers across a wide range of professions in which they analyzed the accuracy of quantitative models versus expert judgment. Models beat experts 94% of the time. Human judgment prevailed over quantitative models in only eight studies, and all of these had access to information not available to the quantitative models.

Keynes described the action of rational agents in a market by using an analogy of a beauty contest, in which to win you must pick what the average opinion of the judges will be: **"It is not a case of choosing those that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."** (Keynes, General Theory of Employment Interest and Money, 1936). While we consider ourselves Keynesians, a topic for another time, we readily admit that as Quantitative investors we don't even attempt to judge how pretty a stock is, let alone attempt to anticipate what other investors are anticipating. While we are obviously willing to express our opinion, in this case that Hillary would win, it had no bearing on our investment process. If we had believed that the Donald would triumph, it wouldn't have made a difference. Our IVE Stock Selection System, which was developed over 20 years ago, dictates that we follow Buffett's admonition: **"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful."**