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FREE REPORT

My out of-the-box call for 2017: Trump accidentally engineers a return to the disinflation trade

Dear Readers,

I shared this story with our paying subscribers earlier this week, but I wanted all of you to read it so I'm pleased to now share it as a Free edition. Feel free to share it with your friends and colleagues.

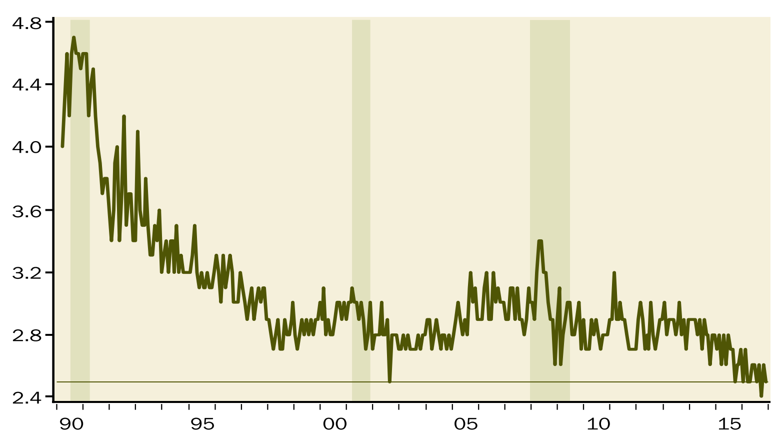
Yes, I say this with the knowledge that 10-year TIPS inflation breakeven levels have surged to over 200 basis points.

Somehow, inflation expectations among households and even businesses have not exactly moved quite as quickly as what financial market participants have priced in.

At last count, the University of Michigan survey showed consumer inflation expectations, as short as one-year out to as long as 5-to-10 years, just 10 basis points above their all-time lows — and that includes a doubling in oil prices off their lows and a 20% bounce in base metal prices.

CHART 1: 5-TO-10 YEAR CONSUMER INFLATION EXPECTATIONS

United States: University of Michigan *Survey of Consumers*
(percent)

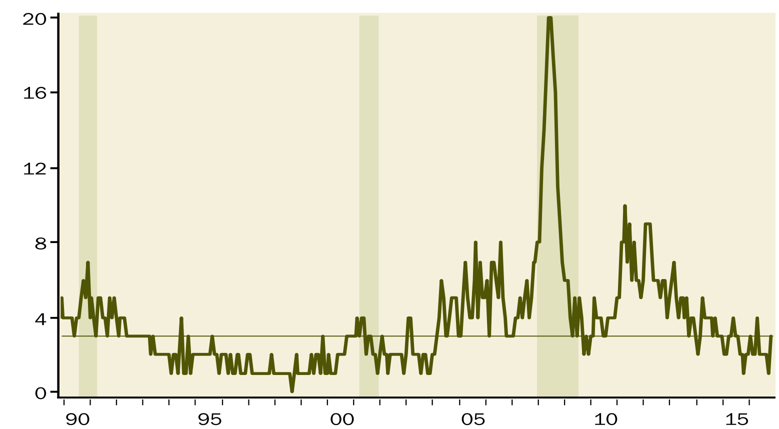


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Not just that, but in the National Federation of Independent Business' small business survey, the grand total of a 3% share stated inflation as their number-one concern.

CHART 2: INFLATION SINGLE MOST IMPORTANT PROBLEM

United States: NFIB Small Business Economic Trends
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Yet I did a BNN interview on Monday on the market outlook and the conclusion (not from me, mind you) was that 2017 was going to be defined by what inflation was going to do.

Well, beyond base effects caused by the dramatic plunge in oil prices at the start of the year and the more recent bounce towards year-end, I don't see a whole lot of upside to inflation.

In fact, despite base effects taking the year-over-year trends higher near-term, I think we will close 2017 with consumer inflation, headline and core, below 1.5% (though both will peak in the opening months of the year at 2.6% and 2.3% respectively).

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The question is what sort of growth we get, and as we saw with all the promises from "hope and change" in 2008, what you see isn't always what you get.

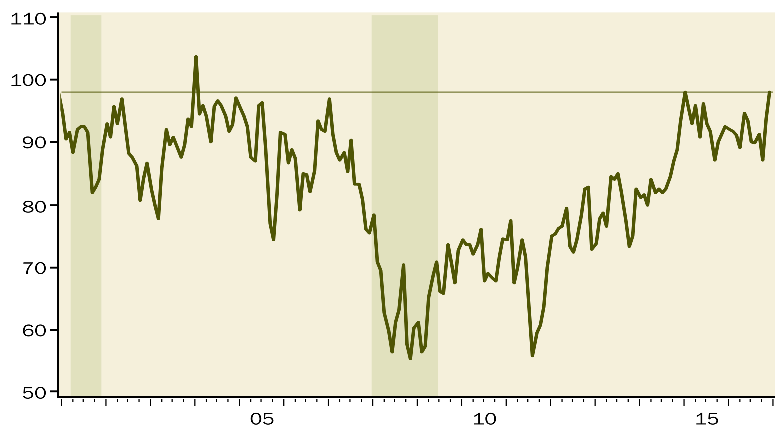
What followed the 1980 election of Reagan (recession in the next 18 months), George H. W. Bush in 1988 (recession within two years), Clinton in 1992 (a near double-dip recession), George W. Bush in 2000 (recession within months) and Obama in 2008 (the worst recovery of all time) shows one thing and one thing only when it comes to elections (keeping in mind that it is completely normal to have a market bounce between election day and inauguration day).

There are strong grounds to fade this current rally, which has more to do with sentiment, market positioning and technicals than anything that can be construed as real or fundamental.

There is perception and then there is reality. Perception is unequivocally bullish. For example, the University of Michigan consumer sentiment index jumped to 98.0 in December from 93.8 in November and 87.2 in October — this was the best since January 2015 and second best of the cycle. But spending intentions on both autos and housing actually both fell a point. Go figure.

CHART 3: CONSUMER SENTIMENT INDEX

United States: University of Michigan *Survey of Consumers*
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

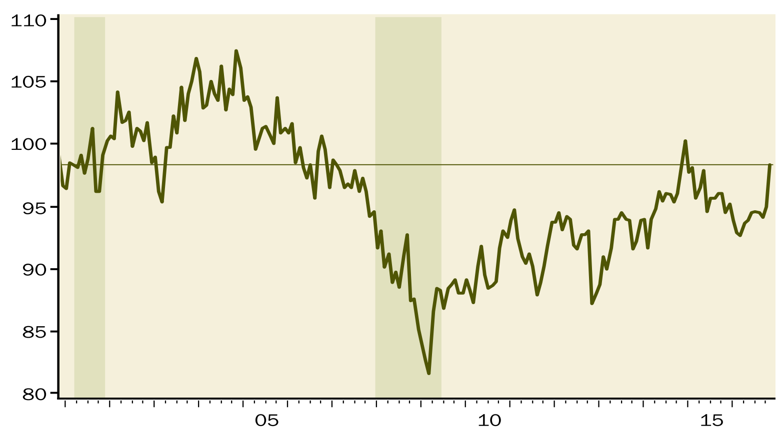
So people are basically saying I feel a lot better for whatever reason out of the election — maybe because the stock market is telling me to feel more bullish — but sorry, no, I'm not changing my spending plans because of it.

And look at the NFIB small business sentiment index. Similar story. The headline optimism index shot up to 98.4 in November from 94.9 (the consensus was 96.7), the highest level since December 2014. The monthly gain of 3.5 points also is the best run up since April 2009.

The headline optimism index shot up to 98.4 in November from 94.9

CHART 4: SMALL BUSINESS OPTIMISM INDEX

United States: NFIB Small Business Economic Trends
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

And yet, the index assessing whether these companies intend to boost their own capital spending in the next three to six months fell to a six-month low of 24 from 27. This is where surveys reveal how you feel and at the same time how little you're going to react!

The markets are indeed forward-looking but this latest leg of the risk rally has a certain speculative feel to it.

This latest leg of the risk rally has a certain speculative feel to it

Now, some full disclosure. I actually find it senseless to provide a forecast for the entire year ahead at this time.

We are not in normal, more stable time periods.

We have been in a heightened state of volatility and that will intensify in 2017 because of the political dynamics in the U.S. as well as in Europe.

We have a president who tweets the first thing that comes to his head, has appointed a cabinet filled with billionaires even though it was rural blue-collar voters that pushed him over the top, and every pro-growth promise was met with an anti-growth measure.

We go into the New Year with investor optimism and equity market valuations running at extremely high levels so initially the risk is that disappointment sets in, but that may not happen until we are well into 2017.

I will go on record to say that sentiment and market positioning are so radically negative on Treasuries that it wouldn't take much to elicit a countertrend bond market rally. We are way oversold here.

It wouldn't take much to elicit a countertrend bond market rally

The economy isn't that strong and anyone who thinks one man can reverse on his own the structural forces that led to the multi-year disinflation trend — and I'm talking about excessive debt, globalization, aging demographics and technology — needs to go back to economics school right away.

I think it is very dangerous to be basing investment decisions on expectations of government policy. What is done and when it is done is far too uncertain, and uncertainty is inherently difficult to price.

I look back to the Obama "hope and change" enthusiasm — also apparently following a failed presidency.

Barrack Obama said he would renegotiate NAFTA, that he would cut income taxes for low and middle income earners, that he would create five million green energy jobs, that he would sharply reduce the power of lobby groups in Washington, that he would embark in an $830 billion, 10-year infrastructure stimulus plan, and that he would not bail out Wall Street.

Well, none of this happened, right?

And yes, the stock market tripled, but that was almost exclusively due to TARP, ZIRP, and QE.

Obama did not fully live up to half his initial pledges, even with the Democrats taking the House and Senate in his first two years in office, not to mention the fact that he secured 53% of the vote and 365 electoral college votes in November 2008 (it is not lost on Senate Democrats that this was a far tighter race with no clear mandate outside of "making America great again" which is nothing more than apple pie rhetoric).

In fact, even the mighty Ronald Reagan, despite all the great things he did, fulfilled barely over 50% of his campaign promises. Looking at data compiled by FiveThirtyEight, U.S. presidents historically keep little better than 60% of their promises.

So as I said, it is too early to handicap what Trump will or will not do, especially since nothing "big" can really happen without 60 votes in the Senate (needed to circumvent any filibusters).

It is too early to handicap what Trump will or will not do

And yes, I am aware that Mr. Market is not exactly taking my advice, but it's not the first time and I doubt will be the last.

Back to the coming year. Look for extreme volatility. That will breed recurring trading opportunities on both the long and short side, and across the asset classes.

This means holding a higher level of cash than is normal at all times for optionality purposes.

Be mindful of how quickly things are getting priced in and be willing to take profits on positions early — more than normal.

Pay more attention to market positioning, sentiment and valuations — moving against the herd mentality will be more important than is usually the case; trades are going to become very crowded as we saw repeatedly in 2016.

Which is why 2016 is so instructive in terms of making big bold predictions at the end of a given year, especially the one we are about to head into given the extremely wide range of outcomes.

We started off the year at 2.27% on the 10-year U.S. Treasury note yield; went down to 1.63% in February; up to 1.98% in March; then down to 1.37% in July; and closing the year near 2.5%.

We had a cumulative 397 basis points of declines on the rally days and 419 basis points of cumulative increases in yield on the selloff sessions.

Look for even wilder moves this year — a year that could well see a test of technical support at 3% before heading down to close the year at 2%.

At the end of 2015, the calls were for 3% yields on the 10-year T-note and then by the summer, there were many calls for 1%.

And look at the Fed: the consensus for 2016 was four rate hikes and instead we will see but one (today).

So again, why would anyone plan around some analyst's year-ahead forecast? What happens when, even if proven right, all those forecasts come to fruition by the end of January?

Why would anyone plan around some analyst's year-ahead forecast?

The S&P 500 started the year at 2,044. As of June 28th, it was sitting at 2,036 and the legion of bulls looked foolish. Even by November 4th, just before the election, the S&P 500 was 2,085 or up marginally for the year. And here we are, with a Trump Rally taking the index to 2,256.

And if you were long the rate-defensives and out of the cyclicals, Energy and Financials in the opening months of the year, you were golden. But if you stayed in that position in the last four months, you look like a dope.

The up days saw a cumulative 13,288 rally points this year on the Dow; and the bear-days had a combined 10,917 down points. Expect even wider swings in the year ahead.

Expect even wider swings in the year ahead

And look at the sector shifts: as of August, the two S&P 500 leaders were Utilities and Telecom as they had been with near consistency all year along until then. As of September, the worst was Financials and to the end of October, was still ranked 8th. To think by now it would be #2 for the year here in mid-December, let alone Energy as the top sector, at the start of the year, would have been unthinkable.

TABLE 1: S&P 500 MONTHLY SECTOR PERFORMANCE RANKS, 2016

United States

Rank	January	February	March	April	May	June	July	August	September	October	November	December
1	Telecom	Materials	Real Estate	Energy	Tech	Telecom	Tech	Financials	Energy	Financials	Financials	Telecom
2	Utilities	Industrials	Energy	Materials	Health Care	Utilities	Materials	Tech	Tech	Utilities	Industrials	Utilities
3	Staples	Telecom	Tech	Financials	Financials	Real Estate	Health Care	Energy	Utilities	Tech	Energy	Financials
4	Energy	Utilities	Utilities	Health Care	Real Estate	Staples	Discretionary	Industrials	Industrials	Staples	Materials	Real Estate
5	Real Estate	Discretionary	Materials	Industrials	Utilities	Energy	Financials	Materials	Discretionary	Industrials	Discretionary	Staples
6	Tech	Staples	Financials	Discretionary	Staples	Health Care	Industrials	Staples	Health Care	Materials	Telecom	Energy
7	Discretionary	Health Care	Industrials	Staples	Discretionary	Industrials	Real Estate	Discretionary	Telecom	Discretionary	Health Care	Tech
8	Industrials	Real Estate	Discretionary	Real Estate	Telecom	Materials	Telecom	Health Care	Materials	Energy	Tech	Discretionary
9	Health Care	Tech	Telecom	Utilities	Materials	Discretionary	Utilities	Real Estate	Staples	Real Estate	Real Estate	Industrials
10	Financials	Energy	Staples	Telecom	Industrials	Tech	Staples	Telecom	Real Estate	Health Care	Staples	Materials
11	Materials	Financials	Health Care	Tech	Energy	Financials	Energy	Utilities	Financials	Telecom	Utilities	Health Care

Source: Bloomberg, Gluskin Sheff

TABLE 1: S&P 500 YEAR-TO-DATE SECTOR PERFORMANCE RANKS, 2016

United States

Rank	January	February	March	April	May	June	July	August	September	October	November	December
1	Telecom	Telecom	Telecom	Energy	Utilities	Telecom	Telecom	Telecom	Energy	Utilities	Energy	Energy
2	Utilities	Utilities	Utilities	Utilities	Telecom	Utilities	Utilities	Utilities	Telecom	Energy	Financials	Financials
3	Staples	Staples	Staples	Telecom	Energy	Energy	Energy	Energy	Utilities	Tech	Industrials	Industrials
4	Energy	Industrials	Industrials	Materials	Materials	Staples	Real Estate	Materials	Tech	Materials	Materials	Materials
5	Real Estate	Materials	Real Estate	Industrials	Industrials	Real Estate	Materials	Industrials	Materials	Industrials	Tech	Telecom
6	Tech	Discretionary	Energy	Staples	Staples	Materials	Industrials	Tech	Industrials	Telecom	Telecom	Tech
7	Discretionary	Energy	Materials	Real Estate	Real Estate	Industrials	Staples	Real Estate	Real Estate	Staples	Utilities	Utilities
8	Industrials	Real Estate	Tech	Discretionary	Tech	Discretionary	Tech	Staples	Staples	Financials	Discretionary	Discretionary
9	Health Care	Tech	Discretionary	Financials	Discretionary	Health Care	Health Care	Discretionary	Discretionary	Discretionary	Staples	Staples
10	Financials	Health Care	Financials	Health Care	Financials	Tech	Discretionary	Financials	Health Care	Real Estate	Real Estate	Real Estate
11	Materials	Financials	Health Care	Tech	Health Care	Financials	Financials	Health Care	Financials	Health Care	Health Care	Health Care

Source: Bloomberg, Gluskin Sheff

Look at what oil did: the WTI price started the year at $37 per barrel, then plunged to nearly $26 by February — and now closing the year above $50 on this OPEC/non-OPEC supply cut deal.

Commodities in general, started the year extremely weak and closed the year very strong (gold the opposite). Recall all the calls in the first quarter for WTI to retreat to $20 per barrel or lower.

The Canadian dollar had a wild year

The Canadian dollar had a similar wild year, starting 2016 at C$1.3840, then hitting C$1.46 in January, rallying to C$1.25 in April, to then sell off to C$1.35 in November and now closing the year with a bullish run back to C$1.31. At the early-year lows, there were calls for the loonie to break to C$1.60. Remember that.

I don't really have much confidence in how much Donald Trump ends up getting accomplished. But I am respectful on what history has to say on the matter, and I sense that far too much reflationary optimism is priced in at the moment.

The CNN "fear and greed" index is now at 87%, up from 75% a week ago and 48% a month ago

The CNN "fear and greed" index is now at 87%, up from 75% a week ago and 48% a month ago. Only two other times in the past three years has this index has this index been this high and both times proved to be a classic case of chasing nickels in front of a steamroller for those following the herd.

Look at the just released BAML global fund manager survey:

- Expectations of "above trend" growth and inflation have surged to five-year highs
- Global growth expectations are at a 19-month high (net 57% from 35% in November)
- Inflation expectations have only been as high as they are today just one other time in the past 20 years — a net 84% see inflation accelerating
- Global profit expectations are at six-year highs
- Only 6% of portfolio managers see lower bond yields in the coming year
- Cash ratios have dropped to 4.8% from 5.0% in November and 5.8% in October; only coming out of the 2001 recession did cash ratios come down this quickly (and then we had the double-dip in 2002)
- Net exposure to global banks soared to 31% from 25% in November, two standard deviations above normal levels
- Net percent of those who think the U.S. dollar is now a "crowded trade" is at the third highest level of the past decade
- Nothing has been done and yet — and yet a net 37% believe fiscal policy is too restrictive, down from 56% in November
- A net 58% of asset allocators are underweight bonds, up from 48% in November

- Allocation to equities rose to a net 31% from an 8% overweight position last month
- Net overweight in commodities rose to a five-year high this month
- Only a net 7% (record low) believe large-caps will outperform small caps, despite the move we already have seen
- Allocation to Emerging Market equities has fallen to seven-month lows; investors in the survey are underweight Eurozone equities for the first time in five months; U.S. overweight exposure up to a two-year high (15% from 4% in November); bullishness on Japanese equities has risen to a 10-month high (21% overweight from 5%)
- Relative Emerging Market versus Developed Market positioning is down to eight-month lows (now at –8.7 percentage points versus +1.7 in November)
- Net overweight positions in Industrials (2½-year high), Materials (two-year high), Energy (two-year high); Tech exposure down to 2½ year lows and Consumer Staples to 18-month lows

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In addition to knowing how investors are positioned, and the BAML survey confirms the data from the Commodity Futures Trading Commission's *Commitment of Traders* report, we also know that the surprise this year will be the opposite of what the surprise was last year which is that the Fed tightens more than what is currently being discounted.

Of course, Janet Yellen is likely a lame-duck Chairperson and she may well give Donald Trump exactly what he was clamouring for during the election campaign — higher rates.

Janet Yellen is likely a lame-duck Chairperson

CHART 5: TRUMP SCREAMIN' ON YELLEN

Source: Wall Street Journal (November 9, 2016) Gluskin Sheff

As my good pal Peter Boockvar published, and this is a crude estimate but likely a good working assumption, America is so heavily indebted that every 100 basis points increase in market rates causes interest charges to soar $470 billion or 2.5% of GDP. It will be interesting to see how this plays out.

And we know that we are that much more late cycle than we were this time a year ago and that we are just six months away from this expansion celebrating its eighth birthday.

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It is true that no cycle dies of old age, but they do die nonetheless, and usually at the hands of the Fed, who have engineered 10 recessions in the post-WWII era but only three "soft landings" and those soft landings (mid-1960s, mid-1980s and mid-1990s) occurred when the cycle was roughly three years old, not eight.

Most important is to look at what is priced in with price-to-earnings multiples of 20x on trailing and 18.5x on forward — multiples we have not seen in 15 years and two standard deviations above the norm.

Using ultra-low interest rates as rationale for multiples this high no longer make much sense. What has to happen for these multiples to make any sense is for earnings in the coming year to soar more than 30% — which means that Trump does all the good stuff, none of the bad stuff, interest expense does not rise that much and profit margins are not affected by rising wage growth and a stronger dollar.

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If we get an earnings profile that is more befitting of a late-cycle backdrop, it is tough to get an estimate for the S&P 500 much above 1,950.

Again, that is an estimate, but assumes that Trump ends up getting the 60% of what presidents generally squeeze out of Congress — nobody ever got 100% but maybe this President will merely use the bully pulpit more aggressively. Then again, for someone who is resisting having to be briefed daily, the potential for a mistake or two can't be underestimated either, though this is not on Mr. Market's radar screen at the current time.

So if I have a year-ahead crystal ball (and I don't), I will lean back on three of Bob Farrell's *10 Market Rules to Remember*:

> *#2. Excesses in one direction will lead to an opposite excess in the other direction.*
>
> *#4. Exponentially rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.*
>
> *#9. When all the experts and forecasts agree, something else is going to happen.*

So I strongly think we will be seeing a ton of volatility in an even more politically charged year. I think that there is a risk as per #4 that we could well see an early-year melt up in bond yields and equity prices that will then leave us with a #2 situation where the excessive move up in long-dated rates and stock prices reverse course.

So I strongly think we will be seeing a ton of volatility in an even more politically charged year

The market is not at all discounting any chance of there being a disappointment on growth — sort of like December 2015 but less extreme and look what happened when first quarter growth collapsed to a 0.8% annual rate.

If I do agree with the consensus it is that the bullish U.S. dollar trade is a bit of an overcrowded trade, and if that proves to be the case, then Emerging Market equities, which are so under-owned, could well be an upside surprise. I also agree with the consensus on Japan.

But there is too much emphasis on the U.S. market for my liking and it has become the most overvalued equity region.

If Angela Merkel can survive in Germany and anyone but Marine le Pen win in the French elections, we could see some positive political rerating in Europe; and there is always the chance that Brexit is delayed even further.

We could see some positive political rerating in Europe

The fact that the far-right did not emerge victorious in Austria last week was a very positive signpost that we have seen a peak in this anti-establishment momentum that has swept much of the global political landscape over the past year.

Valuations in Europe are more compelling and like Japan, liquidity conditions remain flush and currencies are acting as a tailwind for earnings revision ratios, which have much greater upside now compared to the U.S.

The Financials were looking best when things were darkest but a lot of good news has been priced into this sector. The cyclicals for the most part now look overvalued and overdone, including Materials and Energy which have received a lift from supply adjustments but will need much better global demand growth to usher in a full-fledged bull phase.

The bond proxies which have been hard hit of late are now under-owned and will benefit from any unwinding in this bond market selloff, but we will soon have to see the run up in mortgage rates and auto financing rates dampen the credit-sensitive sectors of the economy before this happens — but to be successful in 2017, we will have to be willing to move against the herd and accept Bob's rule #9.

That in turn means to own anything that can benefit if this rampant pro-growth/pro-inflation market psychology doesn't take hold, which I expect to unfold.

Timing is never easy, but these markets are so manic today that we could well end up seeing this retracement taking place by the end of the first quarter. And who knows? By then when everyone has turned bearish and that CNN "fear and greed index" is back to 30%, I will be the one turning optimistic.

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Every football game has four quarters. As the Giants/Cowboys game showed you on Monday night, how the game goes in the first quarter isn't necessarily how it ends. So let's take it one quarter at a time.

And my call for the coming quarter is to be cognizant that "something else is going to happen" with respect to what is currently being discounted by stocks, bonds and commodities.

While it is extremely difficult to predict what the markets are going to do when it comes to inflation expectations, or how the Fed responds, I do have as strong view that inflation very much is going to be the non-event it has for the past several decades.

Donald Trump has no influence on aging demographics. He can try to reverse globalization, but I think he will not be very successful. If he is successful on the deregulation front, that will reduce business costs and as such will be disinflationary.

Donald Trump has no influence on aging demographics

His choice of energy secretary will be in favour of more drilling which means more supply and hence lower prices.

His labor secretary is in favour of abolishing minimum wages.

And of course, the strong dollar will continue to depress import costs as the November data just highlighted.

Even if Trump does engage in trade wars, the reality is that manufacturing employment was falling just about as fast in the 15 years after China joined World Trade Organization (WTO) as was the case the 15 years prior. And manufacturing productivity in the U.S. over the past 15 years at over a 3% annual rate is identical to what it was in the 15 years before China gained WTO membership.

We are just starting what is called the Fourth Revolution which is going to involve the advent and proliferation of industrial robot manufacturing and this promises to be intensely deflationary — but at least is a response to a shrinking workforce in the industrialized world (and now in China).

There truly is very little that Donald Trump will be able to do in the realm of technological advancement — these deflationary factors, like aging demographics, are unstoppable.

There truly is very little that Donald Trump will be able to do in the realm of technological advancement

Trump's pledges to roll back regulations and lower health care costs are just icing on the cake for the return to the disinflation view … which is what I think will win out in 2017 and beyond.

Be that as it may, while some planks of the Trump plan will likely be effective (such as deregulation and corporate tax cuts financed in part by induced repatriation of locked-up retained earnings abroad), one of the big surprises to the market will be how limited fiscal policy will be given a record debt ratio for a peace time economy. The bang for the buck from fiscal stimulus is much more powerful at low levels of government debt, which is why the FDR and Regan stimuli worked so well.

As Janet Yellen said recently, *"with the debt-to-GDP ratio at around 77%, there's not a lot of fiscal space, should a shock to the economy occur, an adverse shock, that did require fiscal stimulus."*

So this may well be the Year of the Rooster in China, but as far as the U.S. is concerned it will be the Year of Ricardian Equivalence where fiscal policy proves to be just about as tapped out as monetary policy has been at the zero-bound on interest rates.

Investing in an equity market that is priced for perfection will prove to be a very big challenge in 2017.

Fading the inflation psychology

To reiterate, I believe that fading the inflation psychology and identifying equity sectors and areas of the capital market more generally that are not priced for excessive optimism and not currently experiencing a crowded trade, in other words moving against the herd mentality, will likely bear fruit in what is probably going to be an even more intense roller coaster ride than what we witnessed in 2016.

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and serving high net worth private clients and institutional investors, we are dedicated to providing our clients with strong risk-adjusted returns together with the highest level of personalized client service.

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Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively among the largest clients of the Firm. Our clients are our partners, through performance-based fees that are earned only when pre-specified performance benchmarks for clients' investments are exceeded.

PROVEN[1]

$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $5.4 million[2] on April 30, 2016 versus $2.6 million for the S&P/TSX Total Return Index[3] over the same period.

Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively among the largest clients of the Firm.

$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $5.8million[2] on October 31, 2016 versus $2.6 million for the S&P/TSX Total Return Index[3] over the same period.

For further information, please contact research@gluskinshe .com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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