



# Investors: Goodbye Convention, Hello Threaded Tweets?

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With tweet three out of four on August 1, President Trump rocked markets by publicly escalating trade war rhetoric with China. Traditional conventions—whether they be predictable diplomacy or even minimum levels of civility—have gone out the White House window. With the standard protocols of foreign relations and domestic political communication shattered, investors have to deal with more frequent and unpredictable political interludes than seemingly ever before.



**Donald J. Trump**  @realDonaldTrump · Aug 1

Our representatives have just returned from China where they had constructive talks having to do with a future Trade Deal. We thought we had a deal with China three months ago, but sadly, China decided to re-negotiate the deal prior to signing. More recently, China agreed to...

 8.4K    17K    81.2K   



**Donald J. Trump**  @realDonaldTrump · Aug 1

...buy agricultural product from the U.S. in large quantities, but did not do so. Additionally, my friend President Xi said that he would stop the sale of Fentanyl to the United States – this never happened, and many Americans continue to die! Trade talks are continuing, and...

 1.8K    6.7K    27.1K   



**Donald J. Trump**  @realDonaldTrump · Aug 1

...during the talks the U.S. will start, on September 1st, putting a small additional Tariff of 10% on the remaining 300 Billion Dollars of goods and products coming from China into our Country. This does not include the 250 Billion Dollars already Tariffed at 25%...

 5.3K    14.7K    70.5K   



**Donald J. Trump**  @realDonaldTrump · Aug 1

...We look forward to continuing our positive dialogue with China on a comprehensive Trade Deal, and feel that the future between our two countries will be a very bright one!

 7.3K    13.2K    70K   

Financial assets carry value, and normally fundamental analysis can assess that value within a reasonable range. Market participants may move those prices up and down based on varying forecasts and the like, but generally there is a connection between the market price and what we would call intrinsic value. On the equity side, we know well that an extreme at one side of the price range can happen for longer than might be warranted. Ergo, John Maynard Keynes encapsulated these long-term extremes in his famous quote that, "The market can stay irrational longer than you can stay solvent."

However, what "feels" different at the moment is that the political environment has joined the market in the

extremes of its irrationality. In the current market environment, it certainly seems that "feelings" seem to often be outweighing facts at times. How are portfolio managers, analysts, and clients to respond if this assessment is correct?

On the equity side, participants are perhaps used to these extremes—at least somewhat. After all, in most years we have market corrections, and every equity investor knows the history of 25-50% declines in the stock market. Losing money, outperformance and underperformance, styles being in and out of favor—none of these are foreign concepts to equity investors. Given the proper timeframe and the extensive history of equity market performance, it's easier for participants to accept irrationality and randomness.

However, this level and persistence of volatility and extremely rich valuations may be relatively new to bond investors. Fixed income investors should therefore get used to more volatility, which may be an uncomfortable notion. For bond market participants—and I'm writing this from the perspective of an equity investor—it may seem that market sentiment has become completely irrational. Fixed income markets have historically enjoyed much lower levels of volatility, but those days may be gone—at least in the medium term—as tremendous amounts of risk have been introduced into debt markets by government actors. Low and negative rates on some of these "high-quality" European and Japanese bonds essentially provide no compensation for the increased risks. An environment much like a low-key PBS documentary has suddenly become a reality-show boardroom, with yields getting whipped around.

Getting back to the question, what are the options for managing portfolios in this kind of environment?

First, it seems like a strong violation of process to abandon an investment philosophy focused on identifying underlying value and opportunity. Trying to predict the next move in a game of 4-D chess is a loser's battle.

Second, emotion is likely to be a formidable and tempting enemy. Even if it takes a while for rationality to carry the day from a policy perspective, underlying valuations do not change quickly, and market participants often overshoot fair value out of fear or greed, creating opportunity. Note that this may require that all participants "trust the process," something we are used to in Philadelphia! This level of trust also requires investors to accept higher volatility and underperformance in the short term. The alternative—capitulating to fear despite underlying fundamentals—is almost certainly an objectively bad outcome.

Third, chasing lower volatility is unlikely to be a good course of action for long-term investors. Studies of investor behavior, most recently with exchange-traded funds, continue to show that what investors pour money into often underperforms in subsequent time periods.

When thinking about this conventional wisdom as it relates to current market fundamentals, "defensive" sectors are at historic extremes from a valuation standpoint and may ultimately be a terrible place to hide. Perhaps defensive stocks will be a good place to seek refuge if momentum and a blind run to traditional areas holds form, but they've never traded at such extremes. At some point, valuations do get too high, and the incremental buyer disappears.

One step worthy of consideration is keeping dry powder on hand, possibly by not going "all-in" on assets that are likely to be highly correlated in one direction. This is true within portfolios as well as in asset allocation. As an example of the latter, private equity allocations may avoid short-term volatility through lock-ups and longer timeframes, but an overallocation to private equity—or any other asset class—might end up with tremendous exposure to a large change in the economy, regulatory rules, new legislation targeted at the industry, or other factors.

The "new normal" right now almost certainly is increased political divisiveness in the U.S., and for at least the next 16 months, we will likely have policy-by-tweet and diplomacy-by-tweet as a regular occurrence. In that environment, the balance between underlying fundamentals and unpredictable events is likely to be shaken. This shift in the policy paradigm means that all participants—including investment managers and clients—may have to accept more uncertainty and market movement than they'd ordinarily like.

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