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There’s No Morning-After Pill

By Kerry Pechter *Wed, Nov 16, 2016*

Along with millions of other Americans, I was glued to the news channels on election night, watching with disbelief and puzzlement as polls closed and the electoral map turned into a sea of red. I did not give Donald Trump’s take-no-prisoners campaign style a reasonable chance for victory. His win reminds me very much of[... Read more »]

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- We are blind to our blind spots. In this election, the mainstream media and elite observers consistently underestimated the degree of frustration and discontentment of mid-America and the impact of an uneven recovery since 2008 on the average citizen. A growing portion of American workers felt left behind.
- When we offer our “educated” and “independent” view about the future, or establish a base case regarding an outcome, is our view truly objective? Is our analysis skewed by the destination we visualize? Do we unknowingly promote the factors that favor our desired conclusion? The we-have-never-seen-a-back test-we-didn’t-like phenomenon that validates an investment strategy is evident in politics as well. Even many Trump supporters did not count on a Trump victory, let alone a shut out.
- Behavioral finance shows how, after the fact, people selectively recall that they anticipated the outcome. In retrospect, they quickly identify the factors that were “obvious” all along. In reality, we only think that we know the reasons, factors and behaviors for an outcome after the fact. We will soon hear post-mortem analyses of the election results. Pundits will revise reality to fit their narratives. Many will maintain that they privately believed that Trump’s “path to 270” was much wider than it seemed. They are not liars; rather, everything seems so much clearer after the fact.

The question now is: how quickly can we, as the stewards of our client assets, abandon our own biases (extreme optimism on the part of Trump supporters and pessimism on the part of Clinton supporters) to act (and not react) to re-position our client portfolios for the future. For now, the markets seem to predict an economic revival, with much needed fiscal stimulus, deregulation, and tax reform.

Expansion would naturally lead to inflation. This could mean a faster pace for interest rate hikes (both FOMC and the market driven long rates) and bad news for bonds. Internationally, U.S.-dependent emerging markets may be hurt. But this is just speculation. The markets may have temporarily forgotten that the GOP is as fractured as the electorate and that change is not a slam dunk.

In managing investments, before we tactically allocate our clients’ portfolios to pursue opportunity or to mitigate risk, we first develop a *view*—our base case, in which we have the greatest conviction about the global economic and political environment going forward. But conviction isn’t certainty. In the case of this election, the popular base case was a Hillary win. Her supporters discounted conflicting evidence as outliers and counter-signals as noise. But in politics, as in finance, every base case contains uncertainty.

After eight years of unconventional monetary policy in the U.S. and globally, investors and savers embraced risk in search of income and return. This compressed risk premia and term premia, but did not reduce the variance of return (i.e., the range of possible returns). Consequently, financial assets have more potential for risk and less for return. And, in a low return world, there is less room to absorb normal losses.

In his 1921 book, “Risk, Uncertainty, and Profit,” American economist Frank Knight distinguished risk from uncertainty. Risk, he wrote, applies to situations where one can assign probabilities to specific outcomes—based on “known knowns”—without being certain about any of them. Uncertainty, on the other hand, applies to situations where one can’t identify a range of outcomes. There are too many “known unknowns” and “unknowables.”

With no governing history, Trump is a known unknown. The stark difference between his behavior and temperament during the campaign and after his victory forces us to wonder: Who is the real Trump? We can attempt to guess his potential policy positions on trade, immigration, the environment, on our global alliances and treaties, or on our fiscal policy, but as citizens (and stewards of client assets) our biggest concern is uncertainty about Trump’s positions. Our country, its people, and the investment world face uncertainty about the next four years without any clear method for assessing the risks.

In the end, I am reassured by the sturdiness of our electoral process. It speaks loudly and favorably about America that an outsider can run a low budget campaign without the support of his own party and still win the highest office in the land. It speaks loudly about the strength of our democracy and respect for the rule of law that power has transitioned peacefully from one administration to the next.