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To: TIFF Members and Friends
From: CIO Jay Willoughby
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What Next

In the first few days after the US presidential election, many of our colleagues in the investment industry dashed off notes to their clients analyzing the surprising results and immediately prognosticating about what a Trump presidency would mean for capital markets. As is our custom, we chose to wait a bit, observe the emerging evidence, and try to think through the longer-term implications of the election through what we hope is a neutral political lens. This would have been our approach regardless of the outcome; the unexpected result makes it all the more essential. Today, we'll offer you our sense of how capital markets in general and our portfolios specifically might be affected by some of the key economic policies of the new administration and its potential supporters in Congress.

Most investors seem in agreement that President-Elect Trump's policies are likely to support a strong US dollar and are likely to be good for US-focused stocks; bad for emerging markets stocks; bad for bonds as inflation, debt levels, and interest rates rise; and good for sectors where the level of regulation could decline. We base these observations on returns from the first week or so after the election, when US stocks led developed markets by substantial margins (measured in US dollars); yields on the 10-year Treasury rose by roughly 40 basis points; and the trade-weighted US dollar rose by about 2.5%.

Our goal here is to take a little longer view of what the next four years might hold. We don't view what follows as firm predictions and hope you won't either. What we will discuss is <u>not</u> what we want to happen, but rather how we think our portfolios might be impacted by changing US policies that clear-eyed, long-term observers of the US economy and markets identify.

In 1824, Andrew Jackson won a plurality of both the popular and electoral votes in the presidential election against three other candidates, John Quincy Adams, William Crawford, and Henry Clay. But no candidate had won a majority, so the House of Representatives chose the next President. The House selected Adams, then Secretary of State, after Clay, the House Speaker, threw his support to Adams. Adams then picked Clay to be the new Secretary of State, prompting Jackson to denounce the whole thing as a "corrupt bargain." Many voters believed Jackson had indeed been robbed of the Presidency by corrupt Eastern aristocrats. Four years later, Jackson was elected President and worked to transfer political power from established elites to rank-and-file voters. To be sure, not all of Jackson's qualities were admirable, but in this he seemed to stay the course. Today, nearly 200 years later, Donald Trump is about to take office on the back of a campaign that claimed it would upend the establishment elite and give voice and power to average, middle-class Americans who feel forgotten.

The 2016 election has proven more divisive than most and so will likely require a careful hand to lead a divided country. That said, America has, in our view, proven quite resilient to all past Presidents, good and bad. The scope of the job Mr. Trump just won is massive, and with some 4,000 positions to fill in the early days, it is clear that a President's role is to lead, not micro-manage. In many ways, the next four years will help us understand how important the role of the President really is. Will Congress work with the President? Will the President work with Congress? Are America's political institutions too polarized to coalesce around what is best for the nation? Do we have enough financial flexibility to pursue policies that are collectively deemed worth pursuing? And, in the end, what will all this mean for capital markets?

To begin, we highlight the "broader cone of potential outcomes" possible with a Trump presidency than would likely have been the case with a Clinton presidency. Mr. Trump does not have a clear track record for advancing the priorities he says he will pursue. He does not have a clearly articulated process for pursuing his priorities. And he does not have a history of galvanizing political support for his programs. During the campaign, he seemed to fight with Republicans almost as much as with Democrats. Do either support him? All of this leads to uncertainty, which capital markets generally do not like. This is not to say that a Trump administration will do poorly, just that the cone of potential outcomes is quite wide.

Mr. Trump will be the first President with no government or military experience. He will need to assemble a team to run the government. His long experience in the private sector should be helpful. If he chooses the best people from different walks of life and puts together an inclusive group to lead our nation, the outcome should be much better than what an insular group of cronies might achieve. Selecting competent colleagues would be a first step to heal the divide that exists today in America and help us to think more constructively about our collective future. If he proves to be exclusive, then our more optimistic view of the future may need to be tempered.

During the campaign, Mr. Trump issued declarations on a very broad range of topics, and policy shifts in any one of these areas could certainly impact capital markets. They include health care, immigration and border protection, anti-terror efforts, and America's role in world affairs. We have chosen to focus initially on areas with a direct linkage to the economy. Later in this letter, we'll briefly address global politics.

The three main economic policy pillars we expect Mr. Trump to pursue are infrastructure spending, tax cuts, and tweaks to trade agreements. Starting with infrastructure, we do expect a broad infrastructure program to be enacted. The targeted scale is likely to be somewhere between $500 billion and $1 trillion over the next 10 years. Funding sources are not yet clear (tax credits may come into play) but will certainly include government backing. This may add to the deficit and generate some pushback from fiscal conservatives. We all recall that in 2009 Congress passed a stimulus bill in an effort to pull the US out of the great financial crisis. Of the $787 billion authorized for a broad range of programs, including everything from child-care assistance to "shovel ready" construction projects, only about $150 billion was earmarked for roads, public transport, rail, bridges, airports, and water systems. Infrastructure programs are much easier to imagine than they are to fund. In the end, we do expect to see some success in this area, as few will argue that improving the nation's infrastructure is bad for America and our people. Most agree that our roads, bridges, tunnels and airports need a refresh. To the extent this does play out, we are likely to see increased <u>fiscal</u> policy supplant what has been, to our mind, extreme <u>monetary</u> policy. Because fiscal policy does not have the same levers that monetary policy has, it takes longer to turn up and down, creating a wider cone of potential outcomes.

Tax reform, including tax cuts for businesses and individuals, seems set to arrive in America. Both sides of the aisle agree on some of the components of tax reform -- one example is a likely effort to provide an incentive for US corporations to repatriate profits sitting overseas. The entire area of tax reform will no doubt be contentious and raise the possibility of a filibuster in the Senate. Regardless of whether one believes in "trickle-down economics," the repatriation of $2-$5 trillion in capital from abroad will surely boost the US economy either through increased M&A, share buybacks, or heightened investment in plant and equipment. Taxes seem like an area with low-hanging fruit for the new administration.

On trade, we expect moderation when compared to stark campaign rhetoric. The broad imposition of tariffs under the Smoot-Hawley Act of 1930 and the subsequent retaliation by other nations almost certainly exacerbated the challenges America faced in the 1930s. In today's more interconnected world, we would expect a similar sort of reaction by our trading partners to any aggressive trade barriers that a Trump administration might consider pursuing. Around the edges, he will claim victories, but big broad trade sanctions are unlikely. This is an area of great concern, as the repercussions of a mistake could be large. Here the cone of potential outcomes becomes very wide indeed.

Pulling these themes together, a Trump administration could have a positive economic impact on US GDP growth if the President-Elect's plans materialize as currently articulated. Increased spending on infrastructure could result in more jobs and higher wages. More capital coming back to America could lead to greater investment and more job growth. Reduced taxes could increase the amplitude of this potential investment cycle. Some tweaks to trade policy that make it "fairer" without causing retaliation could further spur job growth.

Even if all of the above comes to pass, there would be associated problems. Increased government spending would result in higher budget deficits, at least in the short term. Higher deficits mean greater issuance of debt. Inflation would also likely rise along with wages as any slack in the job market would get eaten up. Finally, if the U.S. is supplying more of our own materials to carry out work aimed at boosting jobs, goods prices might also rise. All of these increases should work their way into interest rates, pushing them higher. Higher interest rates increase the cost of projects and in a rational world reduce the number of projects that make the cut.

Timing is the other key element of implementing programs like these. It will take many months and probably several years to know if any or all of these programs work as hoped and benefit the people and economy of America. Yet we see stock and bond markets already doing their job, attempting to discount these future events. As we write, the mere prospect of these programs becoming reality has pushed interest rates on 10-year Treasuries up some 40 basis points. That is before anything has actually happened. The recent rise in rates will have ripple effects across the economy and, for example, could cause a slowdown in housing before any new infrastructure jobs are actually available to be filled. The result may be pockets of economic weakness that impact different geographic regions and companies differently. Again, the cone of potential outcomes widens.

Lastly, let's touch on the indirect global impact of Mr. Trump's victory. The Brexit vote in the UK surprised global investors. Surprise came again with the US election. Going forward, many worry that the world may be heading into a more polarized time. The Brexit and US election results may lend credence to heretofore fringe candidates in Europe and may increase the odds of a European country voting to leave the EU or the euro. Such an outcome would increase uncertainty around the viability of both and would seriously widen the cone of potential outcomes. Today, the euro is the second-most important currency in the world. Its demise could be very unsettling. The list of important European elections in the next year is long. Turmoil in Europe could be good for China, as countries would likely turn to China for currency diversification vs. the US dollar that they currently obtain via the euro. Lastly, USD strength could negatively impact US-domiciled companies generating earnings from abroad and emerging market countries with USD-denominated sovereign debt, pushing their GDP and stock markets lower.

Of course, there will continue to be a myriad of other important global and local drivers of capital markets. US political policy is one very important, but certainly not a unilaterally determinative, factor in capital market behavior.

So how does our analysis of US and global conditions impact TIFF's current portfolio positioning? Honestly, not very much. At the margin, equities are relative beneficiaries, and we maintain approximately a 65% weight to this asset class in our core endowment strategies – in line with our policy portfolio when taking into account cash held by managers. Our equity tilts are already away from Europe and Canada and toward Asia. Our managers' tilts are generally larger and currently result in an underweight (vs. global indices) to US equities. We will watch to see if this changes as underlying managers reassess prospects in coming weeks and weigh the valuation discrepancies. Rising interest rates will reduce returns in fixed income and could lead to losses. We have anticipated such an outcome for quite a while and maintain a roughly 15% exposure to US Treasury debt/cash (again, in line with our policy portfolio) with significantly below-benchmark duration. In the remainder of our portfolios, dominated by such diversifying assets as hedge funds, we have incorporated a number of return streams that have low correlations to equities and to each other; these are designed to provide ballast and better returns, regardless of the direction in which stocks and bonds move.

As the calendar turns and we inaugurate a new President, we will be rooting for positive economic results, just as we have done for all who came before. Extrapolating from initial trends, the environment could generally be favorable for equities but is likely to be worse for fixed income. Our portfolios are broadly positioned for such an environment. Additionally, we like our manager roster and believe it is now about where we want it. The job of improving our roster never ends, but as we have said before, we believe most of the hard work of upgrading is behind us.

How did the Jackson term end, you ask? Despite his many flaws, he was re-elected in 1832, defeating Henry Clay. Jackson was the only President to ever completely pay off <u>all</u> of America's debt. In his eight years he made many strong friends and enemies, as he governed with a consistent and firm set of principles, and he did not hesitate to speak his mind. On his last day in office, he admitted that one of his only regrets was that he "had been unable to shoot Henry Clay." His Vice President, Martin Van Buren, succeeded him. Let's all hope that when his time as President ends, Mr. Trump has few regrets.

We look forward to a fruitful 2017, and we thank you for your continued confidence and support.

Jay