HarborView Capital Management LLC

Global Investment Advisors

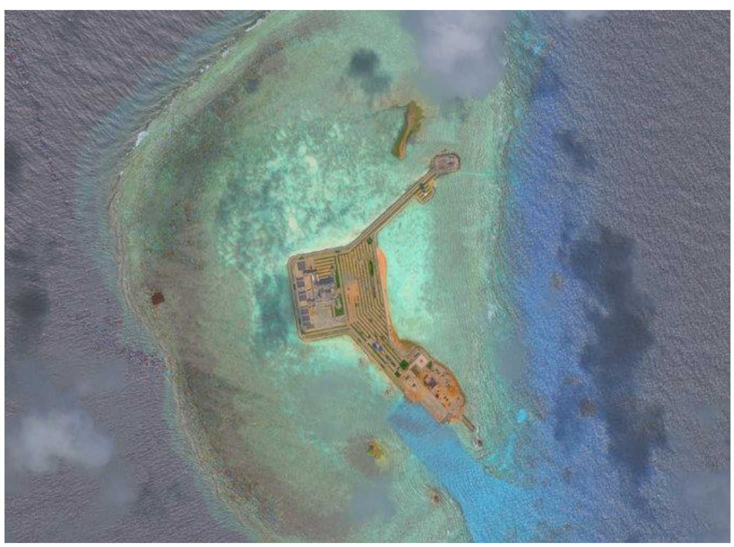
Investor Letter, 1st Quarter 2017 January 22, 2017

- Policy by Tweet
- The power of optimism
- Trump may be lucky!
- The "Impossible Trinity"

Last year was full of surprises. Populism made for great politics, though whether it makes for good economics remains to be seen.

In fact populism is one of the major threats to global markets in 2017, along with geopolitical risk, with five major European elections this year and a new Trump Administration. There seems to be a dangerous global trend towards authoritarian populism, best personified by Trump, with others close behind (Putin, Xi, Modi and Duterte to name a few).

Geo-political risk? Trump's Secretary of State nominee, Rex Tillerson, perhaps set the tone of Trump's foreign policy when he said during nomination hearings that *"We're going to have to send China a clear signal that, first, the island-building stops, and second, your access to those islands also is not going to be allowed."* January 11, 2017 https://www.youtube.com/watch?v=bgXz8W9tHwo



One of China's newly constructed artificial islands in the Gaven Reefs in the South China Sea.

For the two years ending early the morning of November 9th the S&P500 was flat, showing no gain for investors. The "surprise" Trump victory broke the logjam of uncertainty as investors clamored to invest in what seemed the winners of a Trump presidency. This led to the 5th best post-election rally on record (as measured by the DOW), and a great rotation from bonds to stocks, from deflation to reflation, from growth to value, from large cap to small cap, from tech & healthcare to financials & materials.

While the Nasdaq 100, a classic growth index, barely participated in the post-election rally, the DOW, price weighted toward the "Trump winners" like financials and materials (both sectors that severely underperformed the last few years), reached all-time highs. Bonds sold off hard in the 4th quarter with the benchmark bond index down 3% while the $ soared. Since mid-December, however, the stock market has flatlined once again, with buyers below the market and sellers above, as investors wait for clarification on actual policy from the new administration. The lack of volatility is reflected by the fact that the S&P has not had a 1%+ up or down day since October 2016.

As President-elect, Trump took to communicating whatever is on his mind directly with the world, bypassing the usual channels of communication, scolding countries, companies and individuals that conduct business in ways he doesn't like (and quickly take credit for any movement toward his view of the world). Unfortunately President Trump continues this behavior, by Tweeting daily, including Tweets resembling broad "policy" pronouncements.

How are CEO's, heads of state, and markets supposed to respond to these populist Tweets? It doesn't help that facts don't seem to get in the way of many of Trump's Tweets. (One is reminded of Daniel Patrick Moynihan's famous line "one is entitled to one's own opinion but not to one's own facts"). We find this potentially very dangerous. But it could be, as some suggest, that these are merely starting positions (however untraditional) for negotiations – we hope so!

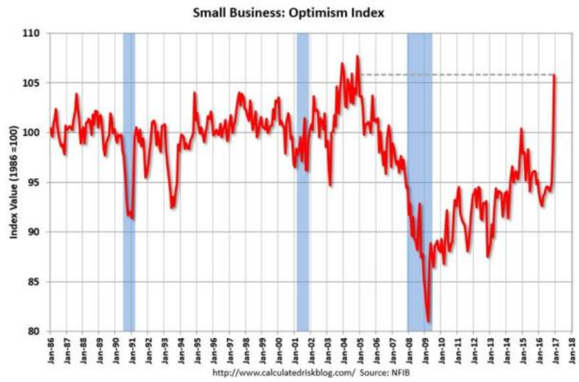
".. and will to the best of my ability, which is terrific ability, by the way. Everyone agrees, I have fantastic ability. So there's no problem with my ability, believe me…."

Fortunately the founding fathers limited the ability of a President to act unilaterally (just ask Obama!). So the most important question really is what will Congress allow Trump to do? With both a Republican majority in Congress and a "Republican" President there is much optimism that long held and universally supported changes to government policy can now be accomplished. These include tax reform, foreign profit repatriation, regulatory relief, infrastructure spending and ACA modification/replacement. **Eight years of obstructionist politics looks to be over – America should be happy to give Trump the credit if there is success, and of course, he will be happy to take that credit.**

Based upon the early rhetoric from cabinet picks and the administration we remain cautiously optimistic – ex Tweets of course. A large part the cabinet is filled with successful businessmen (vs only 8% of Obama's cabinet), who have real world experience managing major business's. While there is always room for conflicts, these people have agreed to serve in the Trump cabinet because they believe they can help make a positive impact on the country.

What about the markets? The current 2017 consensus for S&P 500 operating earnings is $132. If 2016's P/E ratio of 18.5 remains constant, this suggests a 2017 year-end S&P value of 2,453 or a roughly 8% appreciation. While certain valuation measures show a stock market that is significantly overvalued the fact is the earnings recession of the last six quarters is history. If indeed we get positive policy moves the markets could easily see upside from the current

$132 earnings estimate – or conversely a decline if we experience a serious policy mistake or a major geo-political event.



Animal spirits! Consumer confidence, CEO confidence and even small business confidence is at new multi-year highs.

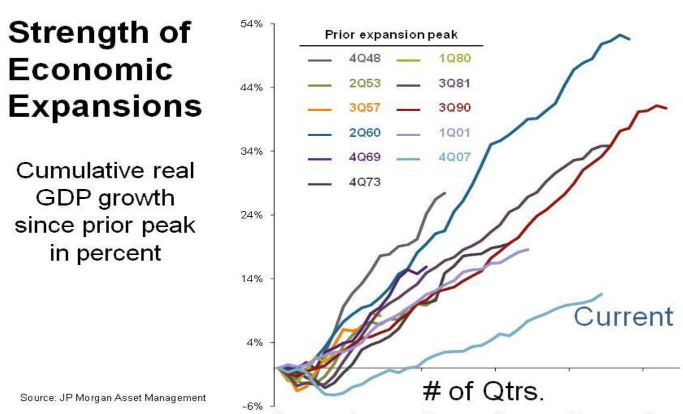
Both the IMF and the World Bank recently raised their estimates of U.S. GDP growth, confidence indices are all multi-year highs as are leading indicators, and the 4th quarter corporate earnings calls have been quite constructive:

> *"Well, I just want to echo what you just said that we are starting to have conversations with clients that are indicating they are more optimistic business owners around possibilities of increased economic growth and maybe some tax relief or other things that might come with the new administration yet to be determined." -Comerica, January 17, 2017*

> *"I think when you say indirect and direct, you mean direct, obviously, we've been a relatively high taxpayer. And so to the extent to which tax rates come down, we're a beneficiary. But obviously, changes in tax policy can be a huge catalyst for how all of our clients think about deploying their capital, strategic decisions." –Goldman Sachs, January 18, 2017*

Long time readers know HarborView Capital views recessions as major sources of risk, and major drawdowns in the stock market. For now there looks to be no recession on the immediate horizon, and as long as this is the case any stock market corrections will be, and should be, bought.

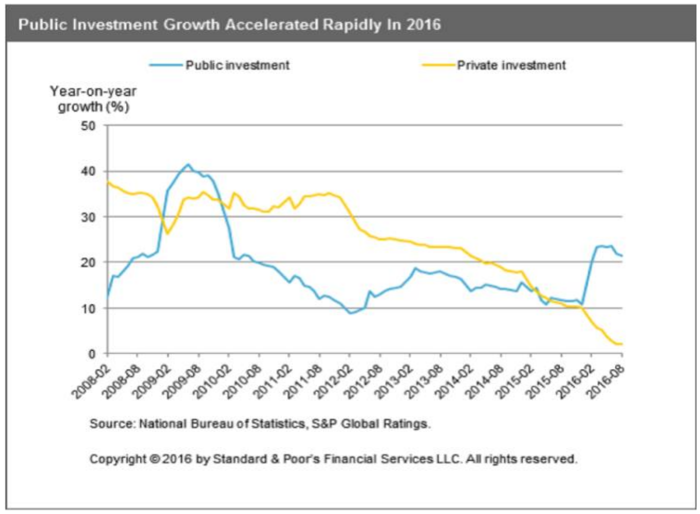
While the current post recession GDP expansion has endured for 90 months (the average expansion is 47 months) the total cumulative growth in GDP is just 11% (vs an average of 23%). The graph below suggests there is a reasonable probability that the economy has room to expand further before becoming unsustainably inflated and breaking down into the next recession. At the end of Trump's presidency, we may look back over the Obama/Trump years and say they were the good-old-days.



Like Obama, Trump may have gotten lucky with his timing.

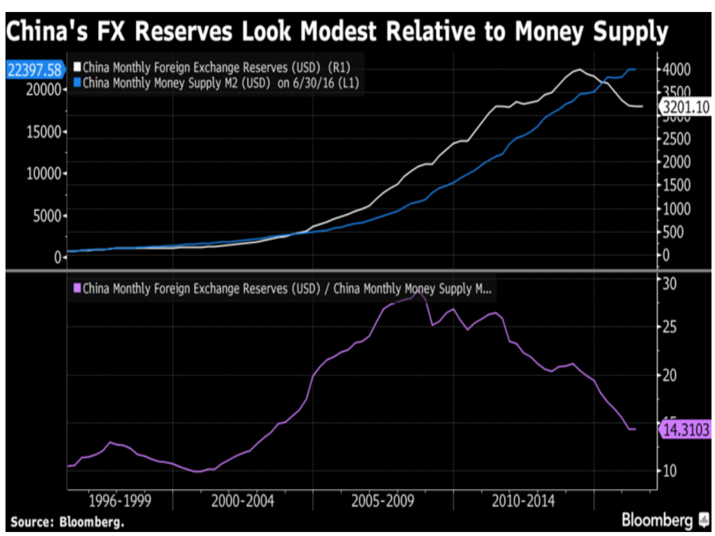
Of course problems remain, and as usual the biggest problem, besides unforeseen geo-political events or major policy mistakes, is debt. While improved growth and higher inflation will help, growth in global debt continues unabated – led by China.

China's 2016 GDP came in at 6.7%. Its credit market growth, however, exploded higher, with China adding trillions of $'s of new debt as the Chinese continue to rely on credit as a key source of economic growth. Zhou Xiaochuan, governor of the People's Bank of China (PBoC), recently said that the ratio of lending to GDP was becoming excessive. *"Lending and other debt as a share of GDP, especially corporate lending, is on the high side,"* he said, adding that a ***"highly leveraged economy was more prone to macroeconomic risk"*** - *y*ou think?



While public sector "investment" growth is exploding higher private sector investment is declining rapidly as capital leaves the country.

At the same time capital is leaving China at an unsustainable rate. With Chinese foreign reserves now down $1trillion in the last 18 months and reserves being drained at a ~$100mm monthly pace China's fiscal and monetary policy have very little flexibility. The ratio of FX Reserves to money supply, at 27% in 2014, is now well below the IMF's suggested 20% threshold, at just 14%, and continues to decline. (Money supply represents the amount of money that could potentially leave the country.)



The Chinese will soon run out of FX reserves to defend the currency at the current pace of depletion.

The fact is having a fixed exchange rate with an independent monetary policy AND a free flow of capital in and out of China is unsustainable. https://en.wikipedia.org/wiki/Mundell%E2%80%93Fleming_model Historically this "Impossible Trinity" has led to severe financial crisis, including the Asian crisis in the 90's, itself precipitated by China's 35% currency devaluation in 1994.

While the timing of any such event is difficult President Trump may provide the trigger for another such devaluation of the Chinese currency. (Markets can, for now, take some solace in the fact that ~90% of both Chinese and Japanese debt is internally financed.) HarborView Capital is, as always, on the lookout for macro events which have the potential of destabilizing a historically leveraged and unstable financial system, such as a major devaluation by the Chinese. Meantime the super credit cycle continues to expand.

Some in Silicon Valley suggest Trump will either be a "one or eight" year President. That is, he will either be impeached or quit within a year (President Pence anyone?) or be wildly successful and win a second term. **We wish President Trump and his administration the best of luck – if they succeed America succeeds, something every American, and the world, should want.**

We wish everyone a Happy New Year, and as always if you have any questions regarding the markets or your accounts, please let us know.

Best Regards,

Paul Brian Gibson
Partner, HarborView Capital Management LLC