CYCLES • TRENDS • FORECASTS

US ELECTION SPECIAL: ISSUE NO. 1

"Trump effect" good for property and banks, but look for new stockmarket low next year

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> *Dodd-Frank [the banking reforms put in place after the global financial crisis] has made it impossible for bankers to function. It makes it very hard for bankers to loan money for people to create jobs, for people with businesses to create jobs. And that has to stop... [The changes I will make] will be close to [the] dismantling of Dodd-Frank.*

Presidential candidate Donald J Trump, 17 May 2016

> *These reforms [proposals to reduce taxes "across the board"] will offer the biggest tax revolution since the Reagan Tax Reform, which unleashed years of continued economic growth and job creation.*

Presidential candidate Donald J Trump, 8 August 2016

> *We are going to fix our inner cities and rebuild our highways, bridges, tunnels, airports, schools, hospitals. We're going to rebuild our infrastructure, which will become, by the way, second to none. And we will put millions of our people to work as we rebuild it.*

President-elect Donald J Trump, 9 November 2016

The quotations above from US President-elect Donald Trump may prove to be some of the most significant statements you will hear in the next ten years, from an investment point of view. Let me tell you up front what I am going to argue below: **Trump is going to make the boom during this cycle, which I had already forecast to be the biggest in history, even bigger**.

The fool who became a king

The Shakespearean fool plays a big role in many of the Bard's comedies – a tradition he continued from medieval plays. We see the

IN THIS ISSUE…

- This election of Donald J Trump will not alter the 18-year Grand Cycle one bit. His election will merely reinforce it.
- Trump will embark on a programme of deregulation of the financial system, tax cuts and infrastructure building. This will create an even bigger boom than would otherwise have happened. The stimulus package this entails will be measured in the trillions. Ultimately, land will take the gains.
- Expect greater volatility as the market adjusts to a new reality (fiscal stimulus, rising bond yields, strengthening US dollar). We remain on the lookout for a low in stockmarkets in 2017. The outlook for property remains the same – expect prices to rise into the mid-cycle slowdown around 2019.

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archetype of the fool popping up even in modern culture, such as Disney movies. The fool is the rude and uncouth character, who speaks in prose whereas others speak in verse; his behaviour and speech always go well beyond norms of acceptability and speech. They speak from instinct and not culture and appear in the plays as buffoons.

In the drama that was the US election, Trump was cast as the fool. And he played it well. We were amused. We were shocked. We indulged his mocking of minorities. But we are not laughing any more.

As far as I know, there are not many plays where the fool becomes the king. Maybe that scenario was too strange even for Shakespeare to contemplate. Maybe that was the point at which a comedy might have turned into a tragedy.

But my job here is not to give you my personal feelings about Trump. It's to analyse what his presidency means for your bottom line, through the lens of my research on economic cycles.

Why the US presidential election matters to UK investors

In the free reports I provided to you when you signed up, I noted that UK investors needed to follow what was going on in the US, because of its relative size. What happens in the US impacts the rest of the world.

But even more important than this is that the US *leads the world into and out of every real estate cycle*. It has done so since at least the Second World War, but arguably even longer (the US became the world's largest economy in the late 19th century, a position it has held ever since).

This means that, even as UK investors, we need to watch things closely over there. It also provides a substantial advantage to investors outside the US. **If we follow what's happening there, we can anticipate what will happen in the UK and then get ready**.

"If we follow what's happening there, we can anticipate what will happen in the UK and then get ready"

I covered this in more detail in the report "The current cycle explained: where we are now and what happens next". But the policy implications of the US election has to be watched in terms of its impact on the US real estate cycle. Let's review.

Since the result on 8 November, there has been a rather strange fascination with almost everything Trump has done, or hasn't done, or said, or hasn't said. Is he going to build a wall? Is he going to prosecute Hillary Clinton? Will Muslims be banned? Will he pull the US out of Nato? Is he going to pal up with Vladimir Putin? Is he going to create a (trade) war with China?

Part of the problem for people is that he was so light on policy detail during the campaign that no one really knows what to expect. Even fellow world leaders are in the dark. Witness the scramble by the UK government to appease Trump (someone it had criticised during the campaign) and claim he's going to be good for the post-Brexit UK.

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Suddenly, according to Boris Johnson, Trump is a bona fide New York liberal. It's rather embarrassing, no?

While the overall policy mix is yet to emerge, I think we have already seen enough to know what the main impact is going to be. I'll show you what I mean below.

Did the market know who would win the election?

The markets themselves appear to have decided that Trump's not going to be as bad as we feared and have had a strong showing immediately after the election. The Dow Jones Industrial Average (comprising the 30 largest US industrial stocks) has crossed 19,000 for the first time ever. But as ever, don't trust the front-page news story. What do I mean?

The Trump rally will probably not be all that long-lived or will be accompanied by significant market volatility next year. I cover the outlook for US markets a little later in this newsletter. Indeed, the rally we have had this year was predictable – had anyone bothered to understand the cycle and then look at the markets.

"Indeed, the rally we have had this year was predictable"

In the report "The four cycles to help investors and traders" I showed you how the US Presidential Cycle determines some of the broad moves in the market. This year has been no different.

The last two years of the Presidential Cycle tend to be bullish. The incumbent party does everything it can to stimulate the economy and to ensure that people are feeling good (and therefore likely to vote for the status quo). Note that this was carried out against the backdrop of a thriving US economy (despite what the papers will have you believe: people being misled by the financial news is a feature of the cycle).

Clearly this did not work in this election, though it appears that efforts were made. The markets responded from lows in January; they were up into August, but then moved sideways with a slight downward bias as the campaign got close after the formal nominations of both Trump and Clinton towards the end of August.

Did the market know something was up and that the anticipated election of Clinton was not going to happen? Bloomberg ran a story a month ago on this very subject. It showed that over 80% of the time, the movement of the S&P 500 during the August to October period of an election year correctly *anticipated* the result.

"Did the market know something was up"

- If the S&P 500 finished higher at the end of October, then the incumbent party would win (in this case it would have been a victory for Clinton).
- If it fell during this period, the incumbent party would lose and Trump would win.
- There have been only three misses in 19 election cycles since 1944,

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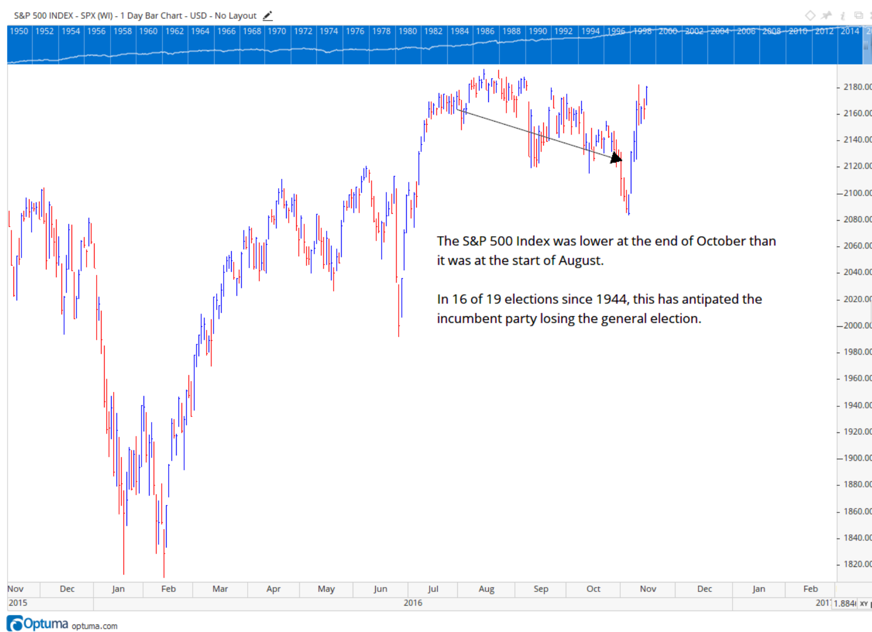
where the S&P 500's behaviour did not correctly predict the winner.

S&P 500 predicts Trump victory



Source: Optuma

On 1 August the S&P 500 opened at 2173.15. On 31 October it closed at 2126.16, almost 50 points lower – pointing to (if this pattern were to repeat) a Trump victory. Which is of course what happened. See the chart below.

Scientific this may not be. But remember, the US government did what it could to stimulate the economy and make markets go up. The market still ran out of steam before the election. It's surely not beyond the realm of possibility that the market anticipated a change in political fortunes.

Food for thought for those who thought the market "mispriced" a Trump victory.

Analysis like this is useful *and* interesting. Anyone curious about history and cycles should pay attention to stockmarket charts. A stock chart is an efficient way to process information. This information can provide you with many clues as to what is going to happen – if you know how to interpret them correctly. I am going to demonstrate this to you in newsletters and updates in the future.

The Harvard study that tells us where we are in the cycle

One of the most important reports that came out this year was a fairly unheralded Harvard University study "The State of the Nation's Housing 2016".

It may not sound important. But contained within it are nuggets of information demonstrating *very clearly* that the real estate cycle is

"Scientific this may not be. But remember, the US government did what it could to stimulate the economy and make markets go up."

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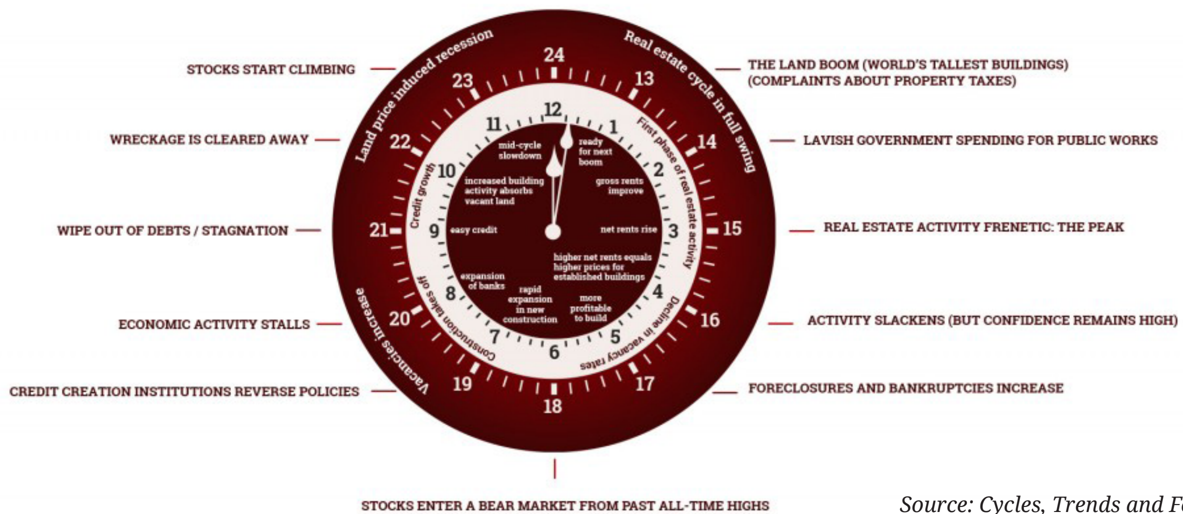
perfectly on track and that there is plenty of room to go upwards. It noted that since the financial crisis (emphasis added is mine):

- The housing recovery to date has been driven by the rental market – with demand for rental properties increasing across all age and income groups.
- House prices have started to rise (admittedly not uniformly in every city).
- Housing starts are now picking up (from a low base post-crisis), though are well below 2006 levels.
- The number of underwater mortgages continues to decline and therefore household balance sheets are recovering (though still overall, not where they were before the global crisis).
- Demand for owning property is picking up again after falling in the wake of the crisis – but is constrained by tight credit conditions.

If you're familiar with the 18-year real estate clock, these key highlights are almost identical to the first few stages of the cycle.



Source: Cycles, Trends and Forecasts

Note what I said in the free report you received "The current cycle explained" (referring to the real estate clock) about how the cycle gets underway:

> First, following the crash (around 1:00 to 2:00 on the diagram), rents rise. This seems counterintuitive – the economy is a mess, how can people afford higher rents? But the weak economy, rising unemployment and lack of credit availability also means most people can't buy property, driving them back to the rental market.
>
> Over time, higher rents push up prices for established buildings. In turn, that makes it attractive to start new projects. This process started in London in 2010 but has now spread to a number of other major cities.

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Is this not *exactly* what is described in the Harvard report?

Going by the clock, we are now at the point where credit conditions should become easier, banks start expanding their balance sheets and return to normal (8:00). **This requires a normalisation of interest rates and a loosening of credit restrictions.**

Easier credit and housebuilding leads to higher growth, which in turn supports higher real estate prices. And on it goes. In the stockmarket, historically, you've started to see the sectors that have so far lagged the recovery, take the lead. Principally those to do with construction, lending and the like.

Note, these conditions were prevalent ***before*** the US voters went to the polls. But with the surprise victory, and an unpredictable president-elect, might this not change things? Might the cycle get derailed? Let's look at the three main ways in which Trump may drive us to the biggest cycle in history.

The $10 trillion question: what does Trump mean for the 18-year cycle?

While it is hard to know where Trump stands on most things, his campaign was pretty clear on three main things:

1. He is going to roll back bank regulations put in place in the aftermath of the financial crisis in an effort to get banks lending again.

2. He is going to cut taxes by trillions.

3. He is going to massively scale up infrastructure spending and put people back to work.

In the aftermath of every cycle, bank regulations are enacted to attempt to prevent another financial crisis. During the cycle, banks do what they can (through the political system or exploiting loopholes) to get them wound back or bypassed, and the next financial crisis takes place right on cue.

A study of history shows this dynamic at play cycle after cycle. My friend and business partner, Phil Anderson, has documented this process over the course of 200 years in the US in *The Secret Life of Real Estate and Banking*. Others have shown it working elsewhere.

This cycle will be no different.

During the campaign, Trump was already challenging the regulations enacted in 2009 under the Dodd-Frank Act. This is the act brought in after 2008 to better regulate the banks and ensure "another financial panic would never happen again". It did this through increased oversight of banks (and systemically important non-banks), higher capital adequacy ratios, limitations on commercial banks engaging in speculative activities and consumer protections.

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Obviously these things are not popular with banks. They reduce profits. But they also inhibit recovery in the sense that banks are repairing balance sheets and have to meet stricter requirements, and so cannot lend as much. This is particularly true of lending to small and medium-sized enterprises (SMEs), which would be regarded as riskier loans during a recovery. However, SME growth drives an economic expansion.

Secretary Hensarling (the man who will demolish bank regulations)

Trump said he would repeal Dodd-Frank, a policy position shared by the Republican Party. With the Republicans in control of Congress, the chances of repeal have gone up significantly. Also, earlier this year, Jeb Hensarling, chairman of the US House Financial Services Committee, put together measures to specifically help US banks by dismantling the Dodd-Frank Act. Currently, Hensarling is in the running to be treasury secretary. So it's likely that his plan will become a reality.

This is how history repeats and how the new real estate cycle builds into the future. I will report back to you as this issue develops.

Banks fund supportive politicians to their cause, and those politicians usually end up winning. When I saw Trump's comments on bank reforms in May, that was the first time I thought he might have a chance of winning.

Investors in bank stocks were, it seems, quite pleased with the outcome of the election. The Financial Select Sector SPDR fund (an exchange-traded fund that tracks the S&P 500 financial sector, consisting of commercial banks; insurance companies; mortgage and consumer finance providers; and other real estate-related companies) broke a key resistance level above $20 (see chart below).

Financial stocks break out

Source: Yahoo Finance

It's important to address a myth that has been perpetuated in the media over the last few years. People think that central banks have

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printed money "loosely" since the financial crisis and that we are in danger of a hyperinflationary episode.

We can all debate the merits of quantitative easing and whether it has had any benefit (other than to raise property prices in large cities). **But if anything, not *enough* money has been printed**. I realise this may be a controversial statement to you. Let me explain.

Around 90% of the money supply is *created* out of nothing by private banks through their lending activities. Banks do not "lend out" your deposits. As banks have stopped creating credit in the wake of the crisis, central banks have tried to fill the gap (which they have not managed to do). The tools central banks use to get banks to lend have not had an effect. So, in fact, there has been a shortage of money in the economy.

(As an aside, I appreciate that this view of money creation may be new to you or sound fantastical. I assure you it is not, and I will soon cover this in depth because it is one of the most misunderstood concepts in economics and finance. Even Nobel Prize-winning economists don't really get it.)

This is why growth has been low. US money supply would be several trillion dollars larger if it had followed normal trends since the crisis. But this may change soon.

If regulations are rolled back, you can expect lending to begin again. The money supply will grow, via bank lending, to make up this gap. And it will make banks more profitable – which is reflected in higher share prices. This should generate even higher growth.

Here's the important point: **it also ultimately goes into the real estate market**. And it eventually drives the cycle to a peak. And then it all comes crashing down again. And the cycle begins again.

In addition to this, this cycle has new modes of financing coming up (crowdfunding, online banking, ever increasing cross-border banking, etc) to look at. Regulations – the ones that remain – won't keep up.

And even if they could, they can't prevent the real estate cycle. This is why you have to focus on land first. This is the structure of the economy. If you permit the enclosure of the economic rent you *must* get a real estate cycle. The credit issue sits on top of that and then determines how large the cycle will be.

Tax cuts and economic booms

Another area of President Trump's focus is cutting taxes. We've been here before – most recently, George W Bush was elected on a platform of tax cuts (having been handed a budget surplus by his predecessor, he had plenty of room to cut taxes and borrow more).

We know what happened. When people's tax expenses go down, they can spend more – **but ultimately this ends up in the price of land** – and then there is a land boom and then a major collapse, followed by

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the next cycle. The Bush tax cuts took place after 2001 and drove the boom into 2006.

Bush's tax cuts were not the cause of the boom and the bust – this would have happened anyway. But they contributed to it being higher than it might otherwise have been.

The major tax cutting exercise before that was carried out under the Ronald Reagan administration during the previous 18-year cycle. That tax bonanza led to a boom during the 1980s, which ultimately resulted in the crash and recession of the early 1990s. In the cycle before that, John F Kennedy enacted a major tax cutting programme in 1961, which pushed the boom during the 1960s and into the early 1970s peak.

Estimates differ on how much tax Trump is going to cut. But the *lower* of the estimates is in the range of $2 to $3 trillion, to go alongside the trillions that will enter the money supply through higher bank lending.

You should also look beyond the headlines; the size of the tax cuts will grab all of the attention but you also need to pay attention to where the tax burden is shifted. Trump has already said he wants to slash taxes on corporations. (As a major business owner this is no surprise – his businesses will benefit hugely.) What hasn't been talked about as much will be where the tax falls. In particular, watch out for a shift away from property taxes towards taxes on sales or consumption. Many economists have been advocating a national sales tax, similar to the one we have in the EU (VAT).

Politicians like this. The sales tax is general and generally not visible. People forget they are paying it. If this is accompanied by a cut in visible taxes such as corporation or property taxes, people are happy.

But this manoeuvre is *highly* regressive as it falls mainly on lower-income households. The property tax is not perfect, but it is much better than other taxes and much better for the economy. But the problem is it falls more on the wealthy – on people like Trump.

The US collects more in property taxes than most countries, but the trend has been away from the property taxes over the last half century. A real estate mogul is going to accelerate this process. He's not suddenly going to change his spots.

Lower taxes and lower taxes on property. This is going to feed into an even bigger land boom and then bust.

The boom in infrastructure

The final piece of the Trumpian puzzle is his proposal to invest in infrastructure. There are some uncertainties about how to pay for this. But a renewal of infrastructure in the US is an urgent priority (the American Society of Civil Engineers graded US infrastructure as D+ grade – in other words, not good and close to failing) and it has the support of both parties. However, the Republicans in Congress refused

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to work with Barack Obama on this issue.

With Trump it will be a different story. The Republican Congress will have no choice but to support the new president, not least because he has caused one of the biggest upsets in modern election history. And because he lacks credibility with a large part of the electorate, both Trump and Congress will want to get a deal soon so they can be seen to do something the American people perceive as constructive (unlike the last several years of congressional nay-saying).

Again, estimates are hazy currently. But Trump is considering a stimulus on the order of $600 billion. That is a lot of money. It's going to cause a construction boom and create jobs. Construction represents a large segment of the economy and so economic growth is going to be higher than it has been in the recent years.

And it will push real estate prices up further.

Bankers are probably rubbing their hands with glee at the possibility of lending money to pay for this. As are pension funds and other major institutions which are looking for assets that deliver long-term yield.

It is really not surprising that this is where Trump wants to start out.

He understands the system. Better infrastructure improves locational values. Lower costs, in the form of lower taxes, means that people can afford to pay more for sites. Looser regulations increase the amount of available credit, which supports people bidding up prices for property.

He may even believe he is doing it in the public interest because as infrastructure is put in place and the economy grows, house prices rise, people feel wealthier and spend more. This feeds back on itself – enabling banks to create more loans for house purchases, earn more profits, etc.

As Trump said in his victory speech, "It's gonna be beautiful".

So, back to the question: how will Trump affect the cycle?

Well, could anything be more obvious? He's a real estate developer, and if someone in his profession could choose the top three things for Christmas to support his activities he would choose:

- To make it easier to borrow from the bank.
- To reduce taxes on his earnings.
- Get taxpayers to pay for infrastructure, which raises land prices in the best locations.

We know where it will end, though. An economic boom, rising inequality, an increase in debt, very high property prices, and then a major collapse. And then it begins again. Many people in this election were rightly concerned about the influence the "one percent" had on politics. Well, they've now just handed over the keys to the kingdom.

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This will become clear in the next decade.

The investment outlook

So how will this play out in relation to one's investment portfolio?

Stocks

In your welcome pack, you received a free report on four key investor cycles. The first one was the US Presidential Cycle.

It set out a strong case that US presidential politics has a strong impact on the performance of the economy and therefore the stockmarket. In the run-up to elections, particularly where an incumbent is running for re-election, the economy is managed in a way that stimulates growth. They tend to be good years for the stockmarket.

By contrast, the first couple of years tend to be where the harder actions are taken. Despite the glee with which the market has reacted to the idea of massive fiscal stimulus, there are some difficult decisions to take, including interest rates.

For that reason, expect stocks to be volatile in 2017 as the market, globally, adjusts to rising yields in the US and a strong dollar (the two are linked). In addition, with many questions surrounding the new administration's policy agenda, **be on the lookout for a market low next year**. (There is also a decade cycle at play in US stocks, which also points to a low next year. But I will cover that in more detail in a later newsletter.)

Bank stocks should feature more prominently within a bull run should Trump loosen bank regulations and should interest rates rise (see below).

Interest rates and bonds

At the same time we are looking closely at the Federal Reserve. It started raising rates at the end of 2015 but stopped. It appears that policymakers wanted to do the same, but the normal story during election years is that they hold off.

Recently, the tone has become notably more "hawkish". Investors are widely expecting an interest rate rise in December. Janet Yellen, the Federal Reserve chairwoman, confirmed as much in recent remarks.

But more important than that is the rally in bond yields since Trump was elected. The market appears to have decided that fiscal stimulus (which will be largely debt funded) will be inflationary and interest rates are rising to compensate.

Expect that this will continue more or less into 2019.

The rising yields on the longer-date bonds will steepen the yield curve. This is good for banks, whose business model is based on "borrowing short and lending long" – ie, borrowing short term in the interbank

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market and extending loans for a longer period (particularly for property). At some point, the central bank will look to flatten the yield curve by raising short-term interest rates.

Prior to the mid-cycle slowdown, which is expected around 2019, expect the yield curve to invert, where the short-term rate is above the longer-term rate. This is as reliable an indicator as you are going to get of a coming recession.

Nevertheless, the economy will continue to build. Expanding bank balance sheets and higher volumes of house building, plus infrastructure development, drive the cycle forward. The cycle is building towards the end of the decade quite nicely.

Commodities

Despite strength in the US dollar (commodities are priced in dollars so a strong dollar means lower commodity prices, other things being equal), I expect commodity prices to start (or continue) rising from lows this year and the general trend should be up into 2018/19. A key market to watch is the Australian dollar against the US dollar – as a commodity exporting nation, a stronger Australian dollar (AUD) means that commodity prices are rising. Note the lows in the AUD at the start of the year.

If governments around the world are going to enact fiscal stimulus through infrastructure development (the US is joined by the UK, EU, Japan and China) then this produces higher demand for raw materials, which feeds into higher commodity prices.

As a major commodity producer, rising commodity prices will support US growth and will contribute to inflationary pressures within the UK. Rising inflation will mean central banks look to raise interest rates. This will encourage more lending and higher growth.

A flight to the dollar caused by major market turmoil would interrupt this outlook. However, as noted in the “Four cycles” report (on the Kondratiev Wave), we are on the upswing of the wave and this should continue into at least the mid-2020s.

Property

The outlook for the US was covered above. The developments taking place under Trump will support this trend and house prices will continue rising. The gains will be more broadly based.

The same dynamic is at work in the UK, with growth taking place outside of London (in some cases at a higher rate). While prime central London has fallen for the time being, otherwise house prices are continuing their upward march across the country. Am I surprised, given Brexit? Not a bit, this is the cycle in action. Brexit and its impact on the cycle will be covered in the next newsletter.

Stay tuned for the Brexit Report

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From one major news piece that has been running for the past two years… to another that will dominate the news for the next two.

Yes, I am talking about the B-word… BREXIT.

A number of people have come up to me and asked what Brexit means for the 18-year cycle.

Key questions I have been asked:

- Will Brexit kill the cycle?
- Is UK/London property going to crash?
- We may be ok for now, but is it going to get worse?
- Should I be in gold now?

Surely cutting ourselves off from a market consisting of half a billion people is going to have an impact on the way the cycle operates?

Rather than cram my thoughts, I am going to examine this issue in more detail in the next edition.

I think you will find my views surprising.

Until next time,

Akhil Patel
Editor, *Cycles, Trends and Forecasts*

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