

The "I" Word

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"Any bull market covers a multitude of sins." -RON CHERNOW, American writer, journalist, historian and biographer

INTRODUCTION

The "I" word. The word "impeachment" has been thrown around several times in the history of American politics. The first sitting president to be formally impeached was Andrew Johnson, in 1868, for abuse of power. Over a century later, Bill Clinton was the second US president impeached for perjury and obstruction of justice. Both were acquitted in the Senate, but their names will be forever associated with that long, humiliating "I" word.

Another name infamous for impeachment is Richard Nixon. While never formally impeached (the House made three failed attempts), the Watergate scandal indelibly stigmatized Mr. Nixon as the only US president to resign from office.

More recently, headlines relaying Trump's missteps and potential collusions have created chatter around the possibility of a third US presidential impeachment. Leading up to last Wednesday, all those headlines seemed to be background noise created by a media obsessed with breaking the next political scandal. However, the firing of former FBI Director James Comey on May 9th immediately sparked questions about Trump's motives and, one week later, reports came out alleging that Trump asked Comey to halt the investigation into former National Security Advisor Michael Flynn.

In the biggest market pullback of 2017, the Dow Jones and S&P retraced -1.8% on May 17th in reaction to the report. The Nasdaq fared even worse, dropping -2.6%. While this pales in comparison to Brazil's May 18th drop of -9% over its president's corruption scandal, this sudden air-pocket was the first tangible indication that the stock market is losing faith in the growth-catalyzing power of Trumponomics. As regular EVA readers know, Evergreen has been warning for months that the hope of Mr. Trump's policies were likely to fall far short of the reality.

One person advocating that we should look past the speculation about a potential Trump impeachment is Tan Kai Xian at our partner firm Gavekal. In his article presented below, he admits that, while the chance of an impeachment has jumped from improbable to possible, there are four reasons why investors shouldn't worry too much about Trump's trials (and potential trial!). I won't spoil his conclusions in the introduction, but he makes some compelling points related to "Trump trade" winners, the Fed's tightening path, economic and political conditions in Europe, and the presidential line of succession.

Assuming Trump avoids impeachment, the question (and focus) will quickly become, "how effective can he be at passing pro-growth policies through Congress?" This was a main topic at the Milken Global Conference earlier this month, where politicians, bankers, technology billionaires and other elites from the United States met to discuss how Trump's policies will benefit certain industries and sectors of the economy.

In the second article presented in this week's EVA, Gavekal co-founder Anatole Kaletsky

outlines his takeaways from this event, which includes commentary on whether we can still expect an infrastructure boost and deregulation, as well as health care and tax reform. It's quite a fascinating take based on the on- and off-record comments made at what Bloomberg News described as a "peer review of President Trump's first 100 days in office".

Shifting focus away from American politics, Charles Gave outlines his views on China's recent "copy-and-paste" version of the Marshall Plan in the final article presented. Charles notes that if the plan proves as successful as George Marshall's did for Europe, it could spell long-term growth for Asian markets. Is this where investors should focus more of their attention – and funds? Find out more in the pages below...



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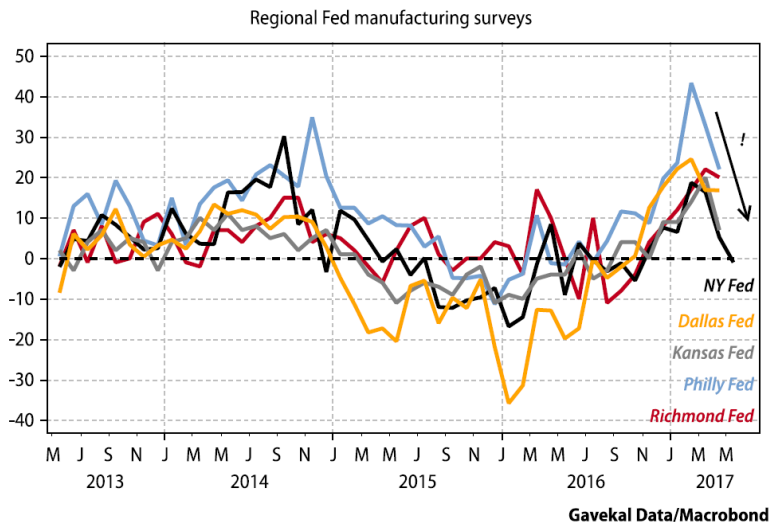
DON'T SWEAT AN IMPEACHMENT

By Tan Kai Xian

After weeks of ignoring ever wackier White House shenanigans, on May 17th investors focused on US political risk. The revelation of memos that seem to offer *prima facie* evidence of the president obstructing justice means the chance of an impeachment has jumped from improbable to possible. As the government's investigative machinery cranked up a notch yesterday, US equities experienced their worst day since last September and treasury yields fell 11bp. But far from running for the hills, there are four reasons why investors should not fret overly about Donald J Trump's travails.

1) Some of the worst performers on Wednesday of last week were "Trump trade" winners like banks and infrastructure stocks. The point, however, is that political inaction is largely in the price. Break-even inflation rates, for example, are back at pre-election levels, while the yield curve steepening that unfolded after Trump's win has been fully reversed. This reassessment extends to metal bashers who got excited about an industrial revival after Trump won, but judging by softening survey data such as the ISM manufacturing PMI, now expect political inaction.

The bet on political inaction spreads to business surveys



2) The Federal Reserve's tightening path depends on fiscal stimulus going ahead. After all, its hawkish tone hardened after Trump convinced investors that a huge fiscal expansion was coming. If those hopes fade, then an alternative scenario of stable US growth and moderate inflation pressure should allow the Fed to adopt a more gradual monetary tightening. Such a "Goldilocks" outcome is bearish for the US dollar and so it was unsurprising that the DXY index fell -0.5% on Wednesday, May 17th. The good news for the rest of the world is that a weaker US dollar improves financial conditions, supports capital formation and ultimately boosts growth.

3) Political and economic conditions in Europe have greatly improved, which should provide support for global markets. With Germany and France seemingly moving toward increased cooperation over economic policy and institutional development, the chances are rising that the EU becomes a source of stability rather than a worrying tail risk. Moreover, the battered EU economy has coiled spring potential that should allow a sustained reflation driven by domestic demand, decent credit growth and an improving international outlook.

4) A Trump impeachment need not be such a debilitating political event. Next in line for the Oval Office would be Vice President Mike Pence and House Speaker Paul Ryan. Both are mainstream Republicans who may be opposed by Trump's base, but are widely respected within the party. Each would likely follow Trumpian policies of deregulation, tax reform and enhanced infrastructure spending. The pace of implementation would likely slow, but markets may quickly focus on "Trump without the bad stuff".

The situation in Washington is too febrile to make any meaningful assessment of how Trump's Russia scandal plays out. In the event that a full impeachment materializes, upending all plans for fiscal expansion, I think the US can still dodge a recession. This is because US fundamentals and monetary aggregates are robust enough to resist a shock, while the "Fed put" remains in place. As such, investors should use any Trump-induced sell-off in risk assets to build positions, especially in non-US markets.

WHAT TRUMP WILL AND WON'T DO

By Anatole Kaletsky

After President Trump's shock firing of his top law enforcement official, the White House has scrambled to keep some semblance of control over the news agenda. Trump's problem is that press attention has quickly moved off policy matters and on to the more exciting business of chasing down a purported Watergate-type scandal linked to Russia. This means that an administration that was already dialing back the radical parts of its reform agenda will have even less room to drive change.

Depending on your interests in the American firmament, this could be a welcome relief or a disappointment. Earlier this month, the hopes and fears of American elites got a full hearing at the Milken Global Conference—a Davos-like event for 4,000 guests including globalist politicians, central bankers, financiers and technology billionaires. The bash epitomizes the rootless cosmopolitan elitism that Charles loves to hate, but does attract more important Americans who would not waste time going to Davos. It's a more businesslike gathering, where speakers tend to get to the point.

This year the American elite showed up to conduct what *Bloomberg News* aptly described as a "peer review of President Trump's first 100 days in office". In particular, the focus was on how much they and their businesses could hope to gain from the new administration's tax cuts, deregulation and public investment projects.

The answer, to judge by comments, both on and off the record, from Trump cabinet members, politicians of both parties and Congressional staffers and lobbyists, is much less than the markets expected when Trump was elected and some investors even today seem to expect. Here are the main impressions that I came away with, in descending order of certainty (that is, with my most confident conclusions first):

Infrastructure: We should forget about any significant stimulus to the US economy or the construction industry from the \$1trn of new investment promised by the Trump campaign. Elaine Chow, Trump's Transport Secretary, said three times in the course of a 20-minute presentation, that the Federal government accounts for only 16% of US infrastructure spending—and that meant, in her view, that less than \$200bn of Federal money would "leverage" \$1trn of spending. How state governments would be induced to raise the rest of this money seems not to have been considered, except insofar as more public-private partnerships would be good news.

In any case, there seems to be no urgency about starting any of this work. The \$1trn infrastructure promise, even if it could be financed, is supposed to be spread over 10 years. Moreover, Chow said that the phrase "shovel-ready projects" has been banned from the Transport Department's lexicon. Meanwhile, the concept of "infrastructure investment" has been stretched to include "workforce development" organized by Trump's daughter Ivanka, according to Reed Cordish, the White House official responsible for industrial initiatives.

Deregulation: This is the aspect of Trump's economic rhetoric that should be taken most seriously. His key economic appointees—Steve Mnuchin and Wilbur Ross—both of whom spoke at the conference seem determined to deregulate whatever and wherever they can. Even if the Congressional Democrats manage to block legislative changes, for example in Dodd-Frank or the Clean Air acts, the administration has scope to weaken energy, environmental and financial regulations, simply by re-interpreting existing laws. "You don't have to change the regulations, if you can change the regulators," seems to be the watchword.

As a result, the prospect of less regulation is a much better reason for the upsurge in business

confidence, than the hope of big tax cuts or public investment programs. There are, however, two problems. Small businesses that complain most about regulation may get less benefit than they expect as so much red tape comes from states rather than Federal agencies. At the other end of the size spectrum, business such as energy and utilities could suffer from deregulation, since lifting controls on oil and gas exploration will add to the downward pressure on prices.

The one major industry that seems guaranteed to gain from deregulation is finance, especially small business and mortgage banking. The tightening of credit standards after the financial crisis locked many middle-income families out of the housing market and sometimes even denied them the opportunity to benefit from low interest rates by refinancing. This is an injustice Trump seems determined to redress, while trying to avoid the excesses of the sub-prime bubble, to judge by comments from Steve Mnuchin and Steven Schwartzman.

Protectionism and border-adjusted taxes: Although there will be some further escalation of protectionist rhetoric and some minor tweaks to antidumping duties and other targeted tariffs, large scale changes in trade policy, including the introduction of border-adjusted taxes are extremely unlikely. Wilbur Ross, Trump's supposedly protectionist Commerce Secretary admitted that he has changed his views about the incompetence of trade negotiators and other government officials. "I've been heartened," he said, "to find the quality of people in the government was very high— they were just trapped in a dysfunctional system".

He expressed satisfaction with the improvements already achieved in trade relations with China during the first 100 days, with the implication that further change was not likely. As for border adjustment taxes, the Senate Finance Committee's staff director noted: "Big import companies and especially the large retailers have certainly done a good job of educating our members" about the costs of border adjustment to consumers and potential voters.

Health care reform: Obamacare is very unlikely to be abolished as the Republicans unanimously promised. So many Americans have now enjoyed benefits from state-subsidized health care that Obamacare has started to develop the political untouchability of other "entitlements" such as Social Security and Medicare. As a result, full-scale repeal is almost out of the question. The objective of repeal has morphed into "replace" and soon it will change into "repair". As this shape-shifting occurs, hopes are fading that healthcare reform will generate large reductions in public spending that can finance tax cuts.

Taxes: With savings from Obamacare repeal and windfalls from border adjustment taxes vanishing like desert mirages, the last major economic question is what sort of tax reform Trump can achieve. The answer will depend on how much deficit financing the fiscal conservatives in Congress will accept. Trump's announcement three weeks ago of "the biggest tax cut in the history of our country" accompanied by the flimsiest two-page account of how it might be financed, was not taken seriously even by his own Treasury Secretary. As Mnuchin said, the tax proposal was "purposely vague" so that the President could work with legislators to craft something that "Congress will pass".

The problem with this approach is that fitting any version of Trump's tax cuts into the deficit limits required to circumvent the filibuster rules in the Senate will require "dynamic budget scoring" with very ambitious growth assumptions. Mnuchin insists that the US economy will grow by at least 3% annually from now on, and he pointed out that the difference between 2% and 3% growth for the Congressional deficit accounting would be \$3-\$4trn. But it is far from clear that fiscally conservative Senate Republicans would accept such speculative growth accounting,

while the Democrats would surely vote against whatever the Republicans propose.

The most likely outcome seems to be a temporary tax cut, resulting in a fairly small budget deficit rise and modest Keynesian stimulus, combined with a redistribution of tax burdens from companies and high earners to middle-income personal tax payers. Whether Trump's voters will welcome this reverse-Robin Hood income distribution remains to be seen.

Conclusion. Overall, Trump will have less effect on US macroeconomic performance or on the world economy, for better or worse, than was widely expected when he won the election. This is indeed what markets have come to believe in the four months since the inauguration. But Trump's sectoral impact will nevertheless be substantial.

His policies should continue to be bullish for US banks, especially smaller banks, and for homebuilders. But they will be less helpful than expected for manufacturing exporters and businesses involved in infrastructure. His tax changes will probably have less effect than expected on US tech companies and cash-rich multinationals. And his deregulatory policies are unequivocally bad news for energy businesses exposed to falling prices of oil, gas or coal.

Only one thing about Trump's economic policies is certain. The prosperous elites whom Trump and other populists attack will continue to gather every year for mutual admiration at the Milken Conference and Davos—and the populists' policies will not hurt these prosperous elites.

BACK TO THE FUTURE

By Charles Gave

Back in 1947, war was over but a ruined European economy needed full-scale reconstruction. The US government was in the driver's seat and a remarkable generation of public servants rose to the occasion. Their macroeconomic challenge lay in the beggar-thy-neighbor dynamic racking the continent. A systemic shortage of capital meant that the more go-ahead European economies were struggling to fund external deficits being run with their neighbors, while the most badly off could not import the capital needed to rebuild their ruined infrastructure.

My history lesson has a modern day point, but first consider how the US authorities responded to this dilemma back in the late 1940s:

- 1) The current account deficit of all European economies was backstopped through funds provided under an economic plan championed by US Secretary of State George Marshall.
- 2) Any nation that chose a protectionist path would be cut off from fund disbursements made under the Marshall Plan.
- 3) To ameliorate structural problems, the newly formed Bretton Woods institutions stepped up. The International Monetary Fund eased funding crises, while the World Bank offered long-term capital in a world bereft of long-term savings.

The result was a fairly swift European recovery made possible by local currencies seeing a sharp decline in both long- and short-rates. In the early 1950s a European risk premium was warranted by the very real possibility of Communists taking power in France or Italy, or Russian tanks rolling into Berlin. Yet by 1965, the situation had greatly stabilized such that German long-rates had declined to US levels.

The result was outperformance by European longer duration assets like growth-stocks and real

estate. Hence, viewed simply in financial terms, the impact of the Marshall Plan was to facilitate a sustained decline in the cost of money, leading to a long period of capital formation and growth.

Now fast forward to the 21st century. In the last two decades the world's most important emerging economic region has seen two great crisis periods, which in large part stemmed from vagaries associated with the global reserve currency, the US dollar. In 1998, all Asian economies were settling their external accounts in the US currency. Hence, when there were excess dollars, Asia boomed and when there were not enough dollars, Asia faced a bust. As such, the region was really a warrant on the US dollar.

Then came the 2008-09 crisis, which produced a spectacular and instant collapse in Asian imports and exports due only to the US dollar funding squeeze that followed Lehman Brothers' collapse. As a result, the People's Bank of China sought to strike a new bargain with its regional counterparts, with a pitch that went something like this: "In the future we should all stop settling accounts in US dollars, and instead do so in our local currencies. We will extend renminbi swaps if you need them, and so, in fact, we will underwrite your current account deficit. The proviso is that you must buy Chinese capital goods. Moreover, let's establish our own version of the IMF and the World Bank, which we will fund and oversee so that it supports all of our liquidity needs."

This is, of course, the bargain that the US offered Europe in the 1950s. As I look at the way China is wooing its neighbors through its Belt and Road strategy and other economic and financial linkages, the approach looks like a remarkably effective "copy-and-paste" operation.

Let's assume that Beijing's big plan works like Marshall's did for Europe 70 years ago. What should follow is a sharp fall in Asian risk premiums. As such, the big question that will determine the size and scope of the next Asian bull market will be: what is the appropriate risk premium for Russian or Emerging Asian bonds versus their Chinese equivalents?

Consider that 10-year bonds in Indonesia currently yield 7.8%, in India 7.2% and in Russia 8%. China, meanwhile, is at 3.7 %, which leaves plenty of room for the kind of convergence observed in Europe in the 1960s.

But it also means that economic volatility in Asia should collapse (no more dollar crises). The market impact should be a huge rerating of high-quality growth stocks and lower bond yields. The odd thing, as I see it, is the continued belief in the US dollar's might as an axiom of Asian investing. Ironically, I see evidence of this "peak dollar" moment in Chinese firms acting to resume US dollar debt in the expectation that its value will likely decline over time versus the renminbi.

The reality is that the US dollar is much less important today than it was ten years ago, but much more important than it will be five years hence. Buy long-dated assets in Asia.

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE

- Large-cap growth (during a correction)

- International developed markets (during a correction)
- Canadian REITs
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12%
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Select blue chip oil stocks
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Mexican stocks
- Solar Yield Cos on a pull-back
- Long-term municipal bonds

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Floating-rate bank debt (junk)
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Large-cap value

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