

Market Comments November 9, 2016

S&P 500	2163
10 year Treasury	2.08%

On November 8, 2016, Donald Trump won an historical and surprising election to become the 45th President of the United States, defeating Hillary Clinton.

Capital markets were expecting a Clinton victory; Trump's win, and the success of down-ticket GOP candidates, were material surprises. As a Trump win became more probable into the evening, global markets experienced roiling downside volatility. U.S. stock futures declined more than 5%, and Treasury yields dropped sharply as investors scrambled to reduce risk given the uncertainty inherent in the prospect of a Trump victory - a Clinton win would presumably have implied a continuation of many of the Obama Administration's policies, and markets tend to favor the known over the unknown.

Today, capital markets have reversed course significantly. The S&P 500 has rallied from an overnight low of 2020 to close at 2165, erasing the 5% overnight decline, and rallying an additional 1.3% on the day, placing the index up 6% on the year, and less than 2% below its all-time high level. Ten-year Treasuries traded at an overnight low of 1.72% but closed at 2.07%, the highest level since January 16.

Below, we summarize what we believe the key investment implications are surrounding the election:

1. Trump's win is clearly a surprise to the capital markets, and it will take time for investors to sort out what Trump's first term agenda priorities will be. Until Trump's initial policy directions are communicated in greater detail, we expect capital markets volatility to remain elevated relative to normal levels.
2. We continue to believe stocks are more attractive than bonds over the intermediate to long-term. A Trump win may signal the likelihood of the implementation of policy initiatives that are viewed by the capital markets as more "pro-growth", and more "free enterprise", policies which may lead to higher GDP and higher interest rates, which would affirm our long-held assessment of the relative attraction of stocks (reasonably attractive) versus bonds (very unattractive until nominal and real interest rates move higher).
3. Heightened market volatility, while disconcerting, creates more, and sometimes better, opportunities to commit capital to great companies at favorable valuation levels.
4. Our most effective investment tool in a choppy, uncertain, and volatile investment environment is our focus on companies with the following attributes: 1) high quality balance sheets, 2) strong business models, 3) strong

- prospects for long-term growth of revenues, earnings, dividends and free cash flow, and 4) attractive valuation metrics given the first three attributes. Time is an investor's best ally - we minimize risk in volatile markets by understanding that we are investing in strong companies that have demonstrated their ability to earn good returns for shareholders over the long run; sharp stock price declines create opportunities to enhance long-term returns by investing at discounted valuation levels.
5. The trajectory of corporate earnings remains the most important element for investors, followed closely by valuation. We believe U.S. corporate earnings will remain solid in the fourth quarter and into 2017. U.S. equities are currently close to our estimate of fair value for 2016, and about 10% below our estimate of fair value for year-end 2017 (18x estimated 2017 earnings of \$130-135 per share for the S&P 500 implies year-end 2017 fair value of 2350, versus 2165 today).
 6. Trump's key policy initiatives may include tax reform, decreased regulation, reform or repeal of Obamacare, increased infrastructure buildout, and some trade reform. Tax reform in particular may be very well received by the U.S. stock market, especially if marginal corporate and personal income tax levels are reduced, and rules regarding the repatriation of profits earned offshore are softened. Higher after-tax levels of corporate profitability could lead to higher valuation levels for stocks.
 7. Initially, sectors that could benefit from Trump's policies include health care, financial services, industrials/infrastructure, defense, energy, and companies that have large amounts of cash trapped overseas. Sectors that might be hurt by Trump's policies could include multi-nationals (if trade is restricted, and/or if the U.S. dollar strengthens in concert with rising interest rates and/or better GDP growth), beneficiaries of Obamacare (hospitals and certain health insurers), utilities, and consumer staples.
 8. Salient longer term trends beyond a Trump presidency include: disinflation, globalization, the ability to maintain competitive advantage, the accelerating pace of technological change, increased "winner take all" market dynamics, and widening income gaps. We continue to evaluate the impact of these large, long-term trends on our investment process.

Trump has a rare opportunity to effect significant change at the outset of his first term, given GOP control of both the Senate and the House. Both opportunity for constructive change, and execution risk, are high.

Capital markets are likely to remain more volatile than normal in coming months, and we will strive to balance flexibility to respond to new information within the discipline of our investment process.

Our approach will remain long-term in nature, and focused on identifying those companies that we believe have outstanding business franchises and attractive valuations such that we are able to earn solid returns on capital over the long run.

We welcome the opportunity to discuss our outlook and your portfolio at any time.

Ted Bridges, CFA