HIGHLAND

CAPITAL MARKETS QUARTERLY
THIRD QUARTER 2016

BOILING POINT

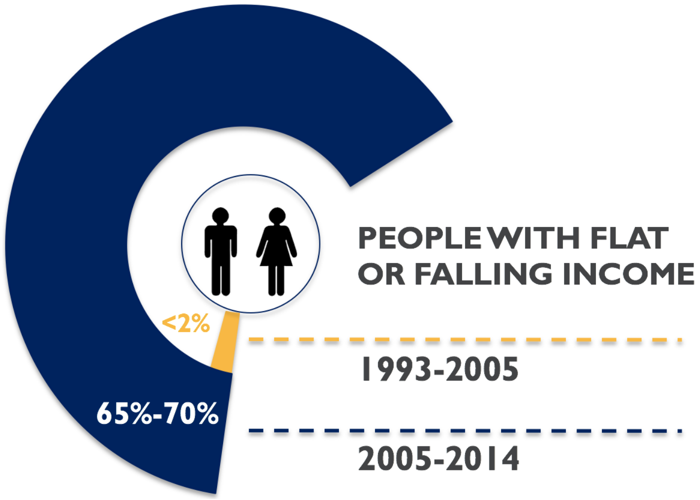
HIGHLIGHTS

- **As citizens in developed countries have questioned who truly benefits from free trade and open borders, populist candidates have become a draw for the disenfranchised.**
- **The scales are shifting from capitalism to populism. This is important, as capitalism is inherently deflationary while populism is innately inflationary.**
- **The main pursuit of populism is to shift the burden onto others through either redistribution or protection. This movement ultimately leads to lower growth due to the negative impact on business investment and corporate earnings.**

As we fall into the 4th quarter of 2016, one event that is front and center on everyone's minds is the presidential election. This year's cycle seems to have received even more attention due to the polarizing nature of each of the major party candidates. The focus of this paper is to understand possible policies and what the implications are for future growth with respect to the populist movement.

According to Gallup polls, the two U.S. candidates are the most disliked presidential candidates in history. One of the candidates is running as the antiestablishment candidate and vying to be the voice of the disenfranchised. Tempers are boiling from citizens who believe they are worse off due to current trade and immigration policies. This is not just a U.S. issue but one that is reverberating globally. A recent study from McKinsey reviewed incomes of households in 25 developed countries. It concluded that between 2005 and 2014, real incomes were either flat or had fallen for 65%-70% of the population (see **Figure 1**). This is a much different experience than these citizens had from 1993-2005, when incomes rose for most.

FIGURE 1



SOURCES: INSEE; BANK OF ITALY; CBS; STATISTICS SWEDEN; ONS; CBO; MCKINSEY GLOBAL INSTITUTE; HIGHLAND ASSOCIATES

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There is a growing chorus from voters who believe that globalization is the problem. Some populist candidates characterize the opposing forces as “globalists” versus “patriots.” Reva Goujon, Geopolitical Strategist for Stratfor, noted the following sentiments from upset citizens about globalization: “When people feel that they have fallen behind economically...leaving domestic decisions to foreign leaders with completely different priorities, customs, and interests is unfair. ...the will of the ordinary should prevail over that of a privileged elite.”

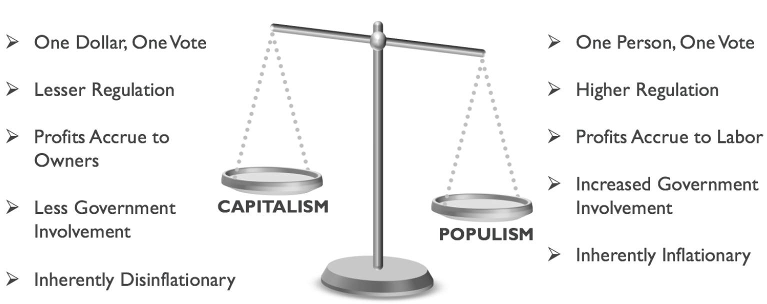
It is these feelings that are driving more to the question of who has benefited from free trade and open borders. The biggest triumph to date for the disenfranchised was the United Kingdom’s vote to leave the European Union. In the U.S., this movement is rumbling through candidates on both the right (immigration controls, trade protection) and the left (income redistribution, trade protection).

From 1980–2008, the world experienced a global expansion that produced an era of innovation that has not been witnessed since the industrial revolution. Globalization was king, and capitalism reigned supreme. When economic growth was high and incomes were rising, many of the effects of capitalism and globalization, such as moving jobs overseas and an increasing share of profits for business owners, were overlooked. However, since 2008, many workers have been displaced, jobs have been lost, and incomes have fallen. The policies set forth after the Great Recession initially advantaged the wealthy and the business owners. The profits of this most recent expansion have largely accrued to owners, while the laborers have struggled to stay afloat. Business profits and the equity markets in the U.S. surpassed all-time highs, making the affluent wealthier.

The subsequent increase in income inequality sowed the seeds for the changes we are witnessing today. The scales are beginning to shift from capitalism to populism and will reverberate through to the capital markets and impact asset prices (**see Figure 2**).

FIGURE 2

CAPITALISM VS. POPULISM



SOURCES: PIMCO; HIGHLAND ASSOCIATES

Populism is the concept of the majority rule, while capitalism is the idea that the most profitable win. Capitalism is inherently deflationary while populism is innately inflationary. In populism, labor costs increase due to governmental regulations, such as changing overtime exemption rules or raising the minimum wage. Labor costs decline in capitalism because the labor is typically outsourced to the cheapest producers. Within capitalism, a greater share of the profits accrue to the owners, while within populism more profits accrue to the labor. The rise of capitalism is one of the larger reasons that free trade and movement of capital and people was so prevalent from 1980–2008. These attributes have been key deflationary forces over the last 30 years.

In moving from one regime to another, investors must follow a different playbook because there are diverse economic philosophies at work (see **Figure 3**).

FIGURE 3

Regime:	Redistribution	Protection	Fiscal + Monetary Intervention	Monetary Intervention	Laissez-Faire
Economist:	Karl Marx	Friedrich List	John Maynard Keynes	Milton Friedman	Friedrich Hayek
Description:	Focus to reduce income and wealth inequality through taxes and gov’t regulations	Focus on isolationism through exiting free-trade agreements, adding tariffs, etc.	Focus on stimulating the economy by fiscal and monetary means (i.e., spending, tax policy, QE, etc.)	Focus on monetary policy to help during crisis, but has no long-term impact on growth	Focus on markets to resolve prices on their own and gov’t has no impact
Parties Impacting Regime:	Executive Branch + Congress	Executive Branch + Congress	Executive Branch + Congress + Federal Reserve	Executive Branch + Congress + Federal Reserve	Executive Branch + Congress

SOURCE: HIGHLAND ASSOCIATES

POPULISM

The main pursuit of populism is to shift the burden onto others through either redistribution or protection. The main idea of redistribution is to have a nation with small gaps in income inequality. It is usually pursued through progressive tax policies and higher government regulations (i.e., higher minimum wages and supplemental benefits). However, redistribution pursued through direct income and required higher wages without focusing on training and other measures to boost productivity will drive up prices and stagnate real growth. Redistribution also involves more government regulation. This is effectively a redeployment of corporate profits from owners to consumers through higher costs.

Protection is a philosophy of nationalism and is generally applied through government intervention to support domestic business. Protecting and subsidizing domestic industries reduces competition, thus slowing down productivity and driving up prices. Historically when countries have attempted to use tariffs and other methods to hurt imports, this has backfired with a retaliation from other countries to not buy that country's goods. In addition, if many of the jobs that have been moved out of the U.S. were forced to be brought back on-shore, then it's more likely these would be handled by automation. The jobs that this would create would be higher-skill jobs such as IT, engineering, and logistics.

Some of the pervading anger from citizens who favor nationalism is due to the dichotomy within unemployment in the U.S. Although the headline unemployment rate is 5%, the U-6 unemployment rate, which includes discouraged workers who have given up finding a job and people who want to work full-time but have to settle for a part-time job, is closer to 10%. Furthermore, according to J.P. Morgan, the unemployment rate for those with a college degree or better is 2.7%, while those with less than a high school degree is 7.2%. As the U.S. economy has evolved, there are more opportunities for the educated. For the less educated, there is a mismatch between the jobs available and the skills needed for those jobs.

CAPITALISM

Letting businesses succeed and fail based on market forces is the laissez-faire (or hands-off) philosophy. This system is the purest form of capitalism and promotes entrepreneurship. While this system is great at allocating capital, it is extremely difficult during a crisis. At the heart of the philosophy is the idea that the market sets the clearing price, and this can generate very large gains and losses. The ultimate outcome is an economic cycle that fluctuates between booms and busts. In order to mitigate some of the pain from the extremes, economists have turned to monetary policy as the tool of choice.

The idea of a central bank employing tools to stimulate investors and businesses through interest rate policy and banking controls was central to the philosophy of Alan Greenspan during his time at the helm of the Federal Reserve. The concept of central banks aiding during predicaments led to market participants taking large amounts of risks regardless of the consequences, resulting in the notion of the "Greenspan Put." As we have written previously, the effectiveness of monetary policy is waning, and now there is a movement toward fiscal stimulus to play a greater role in stimulating growth and inflation. This allows business stimulus in the form of lower interest rates and economic stimulus through increased spending. If the government were to utilize the private sector to build infrastructure, then this could be the jolt needed to move business spending higher.

HIGHLAND'S VIEW:

While fluctuations between regimes is long-term in nature, it is important for us to understand which way the pendulum is swinging and which system we are moving toward. This framework helps in shaping portfolios to meet our client's needs and objectives over the long term. Given today's environment, it appears we are moving away from capitalism and toward populism. This will likely put us in a transition period that combines redistribution, protection, and fiscal and monetary intervention. If these types of policies are enacted, then the likely outcome of each regime will be the same: low real growth and higher inflation (see **Figure 4**).

FIGURE 4

	Redistribution + Keynesian	Protectionism + Keynesian / Friedman
LIKELY OUTCOME OF REGIME	**Low Real Growth / Higher Inflation**	**Low Real Growth / Higher Inflation**
CASH	short-term ⇧ long-term ⇧	short-term ⇧ long-term ⇧
FIXED INCOME	short-term ⇩ long-term ⇧	short-term ⇩ long-term ⇧
EQUITIES	short-term ⇧ long-term ⇩	short-term ⇧ long-term ⇩
HEDGED EQUITY	short-term ⇔ long-term ⇧	short-term ⇔ long-term ⇧
REAL ASSETS	short-term ⇧ long-term ⇧	short-term ⇧ long-term ⇧

SOURCE: HIGHLAND ASSOCIATES

With the one-two punch of fiscal and monetary policy, risk assets such as equities should benefit initially. Ultimately, however, the populist movements lead to lower growth. This is mainly due to the negative impact on corporate earnings and business investment. In redistribution, higher tax burdens and increased regulations decrease profits. They also stifle entrepreneurship due to the onerous regulations leading to lower productivity. Protectionism also lowers growth, but in a different way. Less international trade moves labor from overseas to domestic, but at a higher price, thereby lowering earnings. Combining these populist movements with fiscal or monetary intervention can lessen the pain, but both paths lead to the same end: low growth with rising inflation.

In light of the shifting landscape, Highland favors portfolios that lean toward inflation-sensitive assets and away from fixed income, due to the threat of rising inflation. Increased government spending is inflationary, and real asset prices move not on the level of inflation, but the change in the rate of inflation. The low growth component means that traditional long-only equities can struggle relative to their historical returns, but active management should be beneficial as opportunities can present themselves during changing environments. Alternative strategies should also benefit, as changing regulatory landscapes will often lead to businesses exiting markets and allowing managers to allocate capital.

We focus on building cycle-resilient portfolios that stand the test of time, which means that understanding the future path is vital. The era of global cooperation and free trade was extremely beneficial for all. It lowered the cost of goods for all consumers, advanced technology, and increased the standard of living for most. While positive, the advancement of most has been at a cost. That cost is that capital flows to the most efficient use, often choosing lower-priced labor. This benefited the emerging economies, which were able to increase their economic growth through manufacturing goods and services for U.S. companies. The costs were borne overseas and the profits exported back to the U.S., benefiting the owners. However, many of these manufacturing jobs have left, and now the populist voices are ringing the loudest. Throughout time, these capitalist and populist regimes have ebbed and flowed. It is very important to understand that the tides are shifting toward populism and how to position portfolios accordingly.

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