The Type 2 Investor

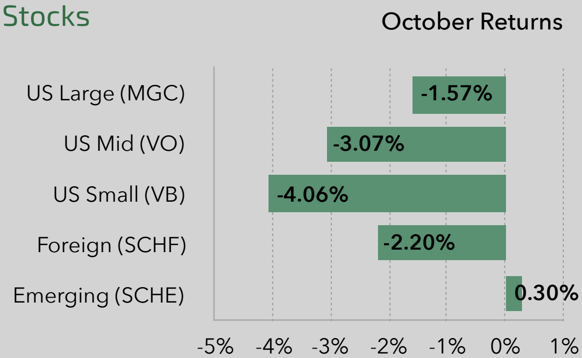
November 7, 2016

October 2016

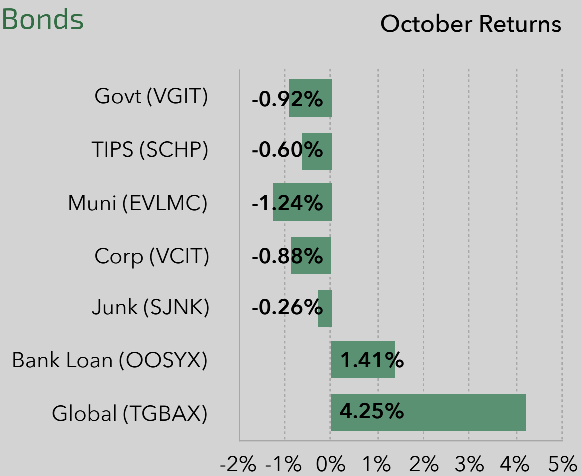
Economic Data

- GDP was up 2.9% in the 3rd quarter, but 0.6% of that came from inventory build and another 1.2% came from exports, most of which was soybeans due to weak crops in Argentina and Brazil
- Year-over-year inflation (CPI) is accelerating quickly, up to 1.5% in September from 1.1% the previous month; the core edged down to 2.2%
- Retail sales bounced back, up 0.6% in September after falling 0.3% the previous month
- 161,000 jobs were added in October, below expectations; unemployment rate edged back down to 4.9% as the labor participation rate fell to 62.8%

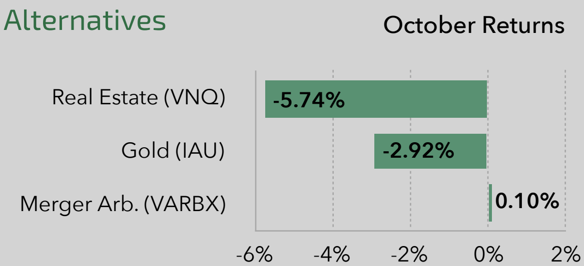
Stocks



Bonds



Alternatives



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

Buckle Up, Buckaroos!

The market has a history of being a fairly reliable indicator when it comes to the presidential election. Since 1928, if the S&P 500 is up in the three months prior to the election, the incumbent party has won 12 out of 14 times. If the S&P 500 is down, the incumbent party has lost seven out of eight. That's an 86.4% success rate for calling elections.

As of Friday's close, the S&P 500 is down 3.65% over the trailing three months with the bulk of that coming since FBI Director James Comey's letter to Congress informing them that the bureau was investigating new emails that seemed relevant to the Hillary Clinton case. In fact, since the letter was released the S&P 500 lost value for nine consecutive days, a streak not matched since December of 1980. The emails were retrieved off of Anthony Weiner's laptop in connection with his sexting case. Has a man ever been so aptly named? Weiner, Weiner Weiner! Comey did release a second letter Sunday afternoon saying "Based on our review, we have not changed our conclusions that we expressed in July with respect to Secretary Clinton." The damage to the Clinton campaign is already done, though, and it has put Trump back in the running.

I keep thinking back to the Brexit vote in June. Polls, pundits, markets, and bookies all had it wrong. According to Lord Ashcroft, voting was pretty clear across various demographics. The young were 'in' (73% in the 18-24 bracket), the old were 'out' (only 40% in 65+). 57% of what they call 'ABs' (upper/middle class - professional/ managers etc) voted remain, while only 36% of the 'C2DEs' (working class) did. Furthermore, the Wall Street Journal reported some 70% of college graduates voted in favor of remaining in the EU, whilst 68% of those who didn't finish high school voted to get out. The City of London wanted to remain, while the shire folk wanted to leave. It was a socioeconomic battle between the haves and the have-nots, and a political battle between the urbanites and the ruralites. Voters were clearly disenfranchised and lashed out against the establishment. It was part of a larger trend rising in the Western World – a battle between the losers of globalization and its winners. The pro-Brexit demographics looks very similar to that of the Trump crowd. Don't be surprised if Donald Trump is the president-elect at the end of tomorrow night. Buckle up, buckaroos!

Tomorrow we will head to the polls with the hopes of putting an end to what has arguably been the most embarrassing election in our nation's history. Regardless of the outcome, however, it won't really be over tomorrow. The loser will challenge the outcome, whether it be by voter fraud or FBI tampering, and the winner will be viewed as illegitimate by a large portion of the population.

Portfolio Positioning

If the coin flips Trump, expect some civil unrest in urban areas across the nation. A sharp selloff across most asset classes globally would also be likely. Treasury bonds will probably not provide much of a safe haven, but gold and cash should. As a result, the Fed may decide to hold off on raising rates in December, but Chairwoman Janet Yellen's remaining time at the Fed will be short. Trump has accused her of creating a "false economy" by keeping interest rates low and has said the U.S. economy is in a "big, fat, ugly bubble". So expect a new, more hawkish chairperson when Yellen's term ends in 2018. In the long-run this might be a good thing as Fed manipulation of markets should abate.

If the coin flips Clinton, expect a short-term but very limited rally in global assets as this will indicate more of the same and Hillary will want to keep the asset bubble inflated as long a possible. Ultimately, this will just mean a market correction further down the road. In this scenario, Janet Yellen's job is likely her's again if she wants it when her term is up. Clinton would assume the presidency under a cloud of scrutiny over allegations of corruption, leaving the potential for an impeachment trial down the road that could hurt markets.

I believe we have been appropriately positioned leading up to this election, with an underweight to both equities and bonds, and an overweight to gold and market-neutral strategies. Within bonds we are underweight riskier high yield bonds and overweight safer Treasury Inflation-Protected Securities (TIPS).

Markets are pricing in a Hillary victory today, so that's not our concern. If Trump were to win, however, I believe international and emerging markets stocks would be hit hardest. To reduce risk further we have trimmed these along with REITs amid this morning's rally. REIT valuations are stretched, and their growing influence within equity indexes with their newly enacted separate sector designation makes me question the ongoing need to view this as a separate asset class. The proceeds will temporarily remain in cash while we look to capitalize on better opportunities as they present themselves.

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Cash				●	
Fixed Income		●			
Core Domestic		●			
TIPS					●
US High Yield	●				
Bank Loans				●	
Foreign Bonds			●		
Equities		●			
Large Cap		●			
Mid Cap		●			
Small Cap		●			
Developed Intl.		●			
Emerging		●			
Alternatives				●	
Real Estate		●			
Commodities					●
Hedging					●

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About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies, as well as fiduciary investment management for select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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