

TRUMPXIT – AND NOW?

14 November 2016

Watch Out For The Unintended Consequences

- Last week's gains in US equities coupled with higher interest rates (30-year yields soared by 30bps, the biggest rally since 2009) indicate that the arrival of Mr. Trump to the White House is seen as reflationary by the financial markets
 - ✓ as his “expansionary” economic program is believed to put the US economy on a higher growth gear
- This is a fair assessment when taken alone but when fully analyzed with Mr. Trump's economic and geopolitical agenda, the end results might not be the ones which are currently played by the markets, and as such we would caution investors against drawing hasty conclusions
- The best example is energy → Mr. Trump plans to rip up energy regulations, lift moratoriums on production in federal lands, save the coal industry and calls for a big increase of nuclear power
- In our view this program would lead the US (and the world) to cope with a huge oversupply of fossil fuels in an already oversupplied market → With operating costs to come down for energy producers, the likely impact is a massive increase in production, which would send energy prices possibly much lower from current levels
- The consequences on inflation and geopolitics overall are still not taken into account by the financial markets, and we try to address those (and many others) throughout this research report
- Finally, on a few fronts, Mr. Trump and the Democrats' views do not differ...the main unknown is whether his own party will stand behind him or not
- If we were to sum it up in a single word, we would say: Volatility

The Current Political System Has Reached Its Limits?

- Over the summer we commented on Brexit and how the old and poor decided the fate of the young by voting for Brexit, as the well-being of a big chunk of UK citizens is under massive pressure after almost ten years since the financial crisis began
- Furthermore, the Brexit vote brought some interesting and instructive data points that at the time we interpreted as follows:
 - ✓ ***the structure of the economic and political system we're currently living in (and not only in the western world) is ripe for a major change***
- With the nomination of Mr. Trump as the next President of the United States, the above statement is reinforced, and likely to serve (together with Brexit) as a catalyst for more changes to come in the very near future, notably on immigration issues
- Mr. Trump cannot be defined as a true Republican but more as someone against a political and economic system seen by many as responsible of their misfortune
- The trick with such populist fellows is that they are for the most part unpredictable, possibly leading to a very volatile new world, where the word democracy would at best be absent from the dictionary
- More troubling, the thin line not to cross (respect the principles of democracy) might have already been crossed in some parts of the world (the Philippines notably), at least from an ideological point of view
 - ✓ and those who massively voted for such a change might be the ones standing to lose the most going forward

The Limits Of Democracy

- Our primary job is not to be partisan but to have our investors and clients benefiting from the changing political and economic landscape by bringing up the most accurate economic and financial analysis
- In order to achieve this, we perform (something we regularly do in our selection of themes and stocks within themes) a worst and best-case scenario analysis and try to pick what meshes with the data we have in hand
- On democracy, we believe that the limits might have been reached, as the foundations of democracy look like to apply not anymore in today's environment
- An article written by [Mr. Jason Brennan](#) summed up very well the problems of democracy, and the system in which the larger part of us live, by saying:
 - ✓ *“Democracy is supposed to enact the will of the people. But what if the people have no clue what they're doing?”*
- He goes further by stating that:
 - ✓ *“Imagine a college professor told her class of 210 million students, “Three months from now, we'll have a final exam. You won't get your own personal grade. Instead, I'll average all of your grades together, and everyone will receive the same grade. ” No one would bother to study, and the average grade would be an F.”*
- The main problem with today's democracies is that for most voters, having to choose between one or the other politician won't make any difference, as none of the voters is really incentivized. This situation opens up the door to masses attracted by those saying they will change the entire system → Mr. Trump perfectly understood this concept

Mr. Trump Economic Program

- While the political and economic program of Mr. Trump is still somewhat unclear and half-finished, the key of his thesis is that the economy overall needs to be less regulated (if not completely repealed), and that fiscal spending needs to take place in order to restore faster growth
- While fiscal policies might be good and maybe the only way to exit from the deflationary world we're living in, we are more worried that a completely unregulated economy might not serve the interests of those that voted for Trump, but would yield precisely opposite results
 - ✓ further increasing the divide (increasing even more income inequality) between the rich and all the others, leading to a certain form of [libertarianism](#)
- While some see in Mr. Trump's economic program a remake of what was performed by Mr. Reagan and Thatcher during the 80's and that led to the financialization of the world and a world leaving on borrowing
 - ✓ we believe that a model based on harsh privatizations, whereby only a few would benefit at the expense of everybody else, would for sure be the guarantee of greater problems to come
 - ✓ additionally, what has been achieved during the 80's, is unlikely to work in today's world as we are in a low interest-rates environment and already full of debt
- In our [18 May 2016 Weekly Barometer](#) we showed how fiscal stimulus works and recommended our readers to have a look at the [blog from former FED chairman, Mr. Bernanke](#) to see how the Government and the FED would need to work hand-in-hand in order to make this possible
- Among the most important points of Trump's program, as outlined in [his contract with the American voter](#) (something we already saw with Mr. Berlusconi in Italy) there are:

Energy

- Mr. Trump wants to rip up energy regulations, lift moratoriums on production in federal lands, save the coal industry and increase nuclear power
- Mr. Trump would like to see the Keystone XL oil pipeline from Canada to the US back on track (but the new Canadian government is not interested anymore) and the go ahead to the very controversial Dakota access pipeline in which Trump holds an equity interest
- Donald Hoffman, President of the American Nuclear Society and CEO of EXCEL Services, which provides specialized professional services to nuclear utilities in licensing and regulatory support and technical specifications, could become the next Secretary of Energy
- Mr. Peter Thiel (Facebook board member and PayPal co-founder) has been already nominated to the inner circle of Mr. Trump → Mr. Thiel is also a strong supporter of nuclear energy and an investor in a few advanced nuclear energy development start-ups, among other tech start-ups
- We believe these are among the easiest tasks for Mr. Trump to execute as Republicans are clearly pro-energy → While investments in nuclear-related companies could benefit from such a political will, we believe Mr. Trump's program would lead to sharply lower energy prices
- ***The likely winner in the energy theme is going to be nuclear in our view.*** It is a wild card in Trump's hands to show to those 41% of adult Americans, thinking that the issues on global warming are serious, that he also cares about them despite saying the opposite
- While nuclear energy is a long and costly process (and directly competes with natural gas), we believe the Trump program could accelerate the advent of next-generation nuclear reactors, which are safer, cheaper, and more efficient, but largely need prototyping
- Furthermore, Mr. Trump might want such startups (more than 50 startups are working in the US and Canada on next-gen reactors) not to go to China to do business...

Energy (cont'd)

- Renewables are likely to do fine despite last week's market sell-off in the sector, as the US Congress already extended the renewable energy Production Tax Credit to 2021, while most of environmental and energy regulations are in the hands to the single states
- We believe that crude oil and natural gas prices are likely to go lower from current levels, due to the expected increase in oil and gas production coming from the US
- Even if Mr. Trump is not to honor the Iran nuclear deal and U.S. sanctions that have been lifted or suspended are going to be re-imposed, it won't prevent the others signatories (China, Russia, UK, France and Germany) from keeping doing business with Iran, and in our view, it won't affect exports of Iranian's oil and gas
 - ✓ we see this as a positive for China, Europe and especially Russia, which is to reconquer its strategic importance in the country and the Middle-East if the US were to abandon the Iran nuclear deal
- Regarding coal, we don't see any chances for coal to resuscitate, as it competes with low natural gas prices → It might only get a small positive from the export market, and if overall energy prices were to fall further as we expect, the US coal industry would definitively die
- We also believe that the Energy agenda of Mr. Trump would weaken the position of Russia, Saudi Arabia and all the oil-producing countries
 - ✓ as with lower oil and natural gas prices (the bulk of revenues for the most part of them)
 - ✓ the coffers are likely to get emptied further and higher budget deficits to persist going forward with Russian and Saudi Arabia's oil representing respectively 50% and 80% of their budgets

Infrastructure

- This is one of the pillars of Mr. Trump economic revival programs and a top campaign promise
- It's one of the most closely watched themes by investors as an infrastructure boom would for sure lead to higher employment, higher consumption and higher inflation down the road
- While the markets welcomed Mr. Trump's election by sending shares of many companies in this sector higher, we believe this task might be one of the most difficult to execute and maybe among the worst for his voters if executed as initially sold to his electorate
 - ✓ as strong resistance from his own party is to be expected (most Republicans do not believe that infrastructure spending represents an economic stimulus and that higher deficits are a positive)
 - ✓ and on the other side it would have the blessing of the Democrats if financed with federal money, which is not likely to happen as the idea behind Mr. Trump is a full privatization, something Democrats are not likely to vote for
- The problem with the one trillion dollar 10-year infrastructure program is that the money needed won't be the federal money, instead it will rely on tax credits to incentivize private investments (de-facto a global privatization program)
- Financing with a reduced (10% vs. 35%) repatriation-fee on the \$2.5 trillion held abroad by US corporations looks like a good idea, as it could bring up to \$250B into federal coffers
- The key question that needs to be answered here is if US corporations are going to follow
 - ✓ knowing that they won't be able to access the foreign markets as Mr. Trump suggests higher tariffs for goods entering the US markets? Nothing is so sure in our view

Infrastructure (cont'd)

- Corporations are likely to ask for guarantees before doing such a deal → Additionally, we don't subscribe to the thesis that US corporations would repatriate everything held abroad but probably only a small part, which would be a blow for Mr. Trump
- The problem with private money is that it would only flow to the highest ROI projects
 - ✓ as such only to the bigger and most wanted projects such as the largest airports and the most congested roads, as investors would see strong financial returns as a guarantee
- What about for dams, levees, seaports, waterways, electrical grid, water pipes etc.? If you need an additional proof of this, have a look at what did happen to the US Telecom industry in the past
- If it was not for some FCC regulation, we would not have had net neutrality (and in essence no tech industry in the US, as the cost to accessing the internet for many companies, and for users living in remote locations would have been just prohibitive)
- Furthermore, only the bigger US cities would have had access to the internet and to simple telephony → If the Trump program had been enacted in the Telecom industry in the past, private money would have flown only into positive cash-flow projects and most Americans would not have internet access
 - ✓ thereby creating a society of those who can pay and all the others, with the "others" representing the core of his electorate
- If privately-enacted, the Trump infrastructure project would leave most Americans out of the infrastructure dream and worse, we think it has the potential to further divide the society (between those who can afford and those who cannot)

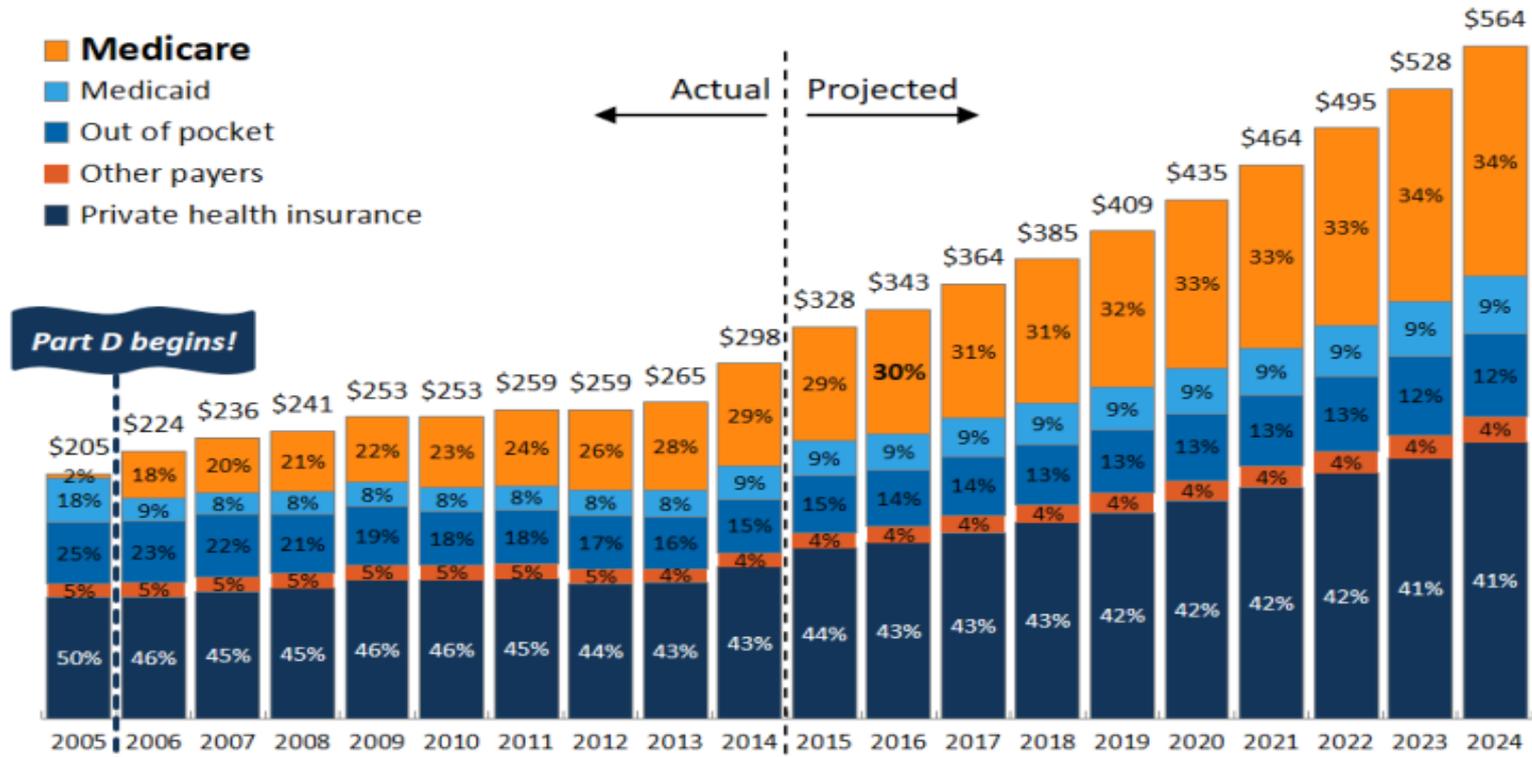
Pharma & Biotechnology

- Those are two sectors where we are quite happy not to have Mrs. Clinton as US President but here again, a more detailed analysis is needed before drawing hasty conclusions
- Mr. Trump's Presidency is quite positive for the sector overall, but as outlined in the previous pages of this research report
 - ✓ the sector would need to cope with Mr. Trump's volatility and unpredictability
- Mr. Trump has said in the past that runaway drug price inflation must be addressed but it is highly unlikely that a new legislation controlling the pricing of drugs and healthcare services would ever take place → ***But will he let Medicare negotiate drug prices directly with pharmaceutical companies?***
 - ✓ Democrats (unlike Republicans which always blocked) would vote for this overnight, as they have been trying to give Medicare that power at least since 2003, when the Medicare drug benefit law was passed (chart on the next page)
- Mr. Trump is also likely change the FDA → On Mr. Trump's [website, under the Healthcare](#) section, we can see: *"Reform the Food and Drug Administration, to put greater focus on the need of patients for new and innovative medical products"*
- This is the perfect example of why it is so difficult to understand Mr. Trump, as on one side he wants less regulation and on the other side he wants his own regulation...
- Over the past four years the FDA has changed, notably it speeded up its processes and got drugs on the market faster than ever before → Adding fuel to the fire would lead to a likely booming Biotechnology sector in our view, but only if Medicare is not allowed to negotiate drug prices

Pharma & Biotechnology (cont'd)

- Prescription drugs accounted for \$97B (16% of the total) in 2014 Medicare spending

Total U.S. prescription drug spending, in \$ billions:



NOTE: Medicaid prescription drug spending accounts for rebates.
 SOURCE: Kaiser Family Foundation analysis of CMS National Health Expenditure Data for Historical (CY2005-2014) and Projected (CY2015-2024) Retail Prescription Drug Expenditures, 2013-2024.

Pharma & Biotechnology (cont'd)

- In the case of the FDA, we could see a law similar to the [21st Century Cures Act](#) (gathering patient data and leaning more on the burden of disease), which is intended to speed up approvals and scientific discoveries
 - ✓ with the idea that all of the above would increase competition and choice, concepts that are well anchored on Republican's' ideology
- Mr. Trump's promise to repeal the ACA (Affordable Care Act) sent hospital and healthcare insurers sharply down in the past week, as they benefited from the increase in the number of insured people (+20 million) under Obama
- But only three days after his win, Mr. Trump is already backpedalling on some of its plans and notably will leave unchanged some of the ACA provisions:
 - ✓ the prohibition for insurers to deny coverage because of patients' existing conditions
 - ✓ and a provision that allows parents to provide years of additional coverage for children on their insurance policies.”
- We believe that Mr. Trump won't have the time to come up with a completely new healthcare system replacing the Obamacare which covers everyone, costs less and offers more choices
- While some changes are to be expected (notably new regulations for the FDA), we believe that a complete overhaul of the ACA looks unfeasible at present time

Defense

- This is in our view the best risk-reward Trump investment bet
- Mr. Trump's program on defense is quite ambitious as he wants to eliminate defense sequester, eliminating the hard cap on defense government spending, which is a huge catalyst for the whole sector
- He also wants to modernize the nuclear triad, likely triggering increased spending on the nuclear arsenal and services attached to it
- Mr. Trump's foreign affairs policy is seen by many as very dangerous for world peace (the US were the guarantors of peace over the last 70 years)
 - ✓ and increased spending on defense is likely to be expected not only in the US but across the world, whether Trump challenges the NATO or not
- During his campaign, Trump repetitively slammed NATO, calling the alliance "obsolete" → He also suggested that under his administration, the US may refuse to come to the aid of NATO allies, unless they "pay their bills" and "fulfill their obligations to us."
- This is a big deal for the world and for Europe notably, as any withdrawal of the US from NATO would put the whole European continent at risk and into panic mode → We believe Europe has no choice but to get on a large spending spree on military and defense
- We don't know if Mr. Trump's rhetoric is a way to put pressure on Europeans to accept his future commercial requests, but this is definitively not a great sign

Defense (cont'd)

- NATO Secretary General Jens Stoltenberg recently said that Russia has tripled defense spending and has invested heavily in a modern military equipment, despite falling oil revenues
- Russia (fourth largest defense spender in the world) spent \$54B in FY2015 (up 21% Y/Y) in defense-related spending → FY2016 spending is set to remain essentially flat Y/Y amid continued pressure in the oil market
- Back in February 2016 we launched an [Index on Global Defense](#) with an investment certificate attached to it that is set to benefit from increased defense spending, as defense is not a Macro play but rather a geopolitics play
- With the arrival of Mr. Trump at the White House, we believe that the geopolitical situation around the world is likely to get more volatile and maybe more instable

Technology

- Technology shares have been under huge pressure since Mr. Trump has been chosen as the next US President, and for good reasons (no wonder California massively voted against him)
- Trump's political program is likely to impact the technology sector the most as:
 - ✓ He is likely to kill net neutrality
 - ✓ His opposition to immigration will have a ripple effect through the tech industry
 - ✓ His attacks on trade policies could dent tech companies as most of them outsource production overseas
- Due to Mr. Trump's aversion for any guidelines regulating the economy, the FCC (Federal Communications Commission) regulations for Internet providers could simply be destroyed with the appointment of a new chairman to lead the agency
- He plans to scale back the H-1B visa program, vital for many high-tech companies to find the needed talent people overseas
- We often commented in our past reports what net neutrality is but as a refresher:
 - ✓ Net neutrality, also known as "open internet" is a concept that asserts all the data on the internet should be impartially delivered to consumers regardless of their content, destination, source or cost of service
 - ✓ The net neutrality principle holds that wired and wireless internet service is a utility like gas, water, electricity and landline phone service that should be available to everyone and subject to government regulation

Technology

- In essence the net neutrality rules are aimed at making sure the Internet stays an open platform and that cable and telecom companies can't use their position in the marketplace to unfairly benefit and shut down competition
- If Trump and the Republicans were to turn down net neutrality, the Telecom and Cable companies would likely raise prices for many services (or slow down download speeds)
 - ✓ and would make many business models, such as Netflix, too costly to operate or too costly for consumers
- But how can Mr. Trump say that he's going to make American infrastructure among the best in the world and at the same time conceivably kill the internet infrastructure?
 - ✓ and put at risk 6.5 million jobs, representing 5.7% of the entire private workforce in the US and 7.1% of the country GDP?
- We believe that since the nomination of Peter Thiel (the only one in Silicon Valley that backed Trump) within the inner circle of Mr. Trump, fears should abate somewhat and eventually might represent the lifeline for the entire industry
- While the next several weeks and months are very important for the overall US technology sector, we believe that the rest of the world could potentially benefit from Trump's lack of knowledge on how technology works and how much technology is important to the US
- Our view is that whatever happens, the technology advancements cannot be stopped and that the Trump's rhetoric would have only a small short-term effect

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