

ECONOMIC OUTLOOK

Summary

Sugar and Spice, makes everything nice... This brief phrase may be an apt way to characterize the tone and mood of the financial markets since November 9, 2016. This rush of hope and optimism is rooted in the prospect for lower personal and corporate taxes, reduced regulation and generally, a more business friendly environment. However, there are many rough edges and potential sticking points with the new president's policies and demeanor that make forecasting growth in the economy difficult to quantify.

President-elect Trump may be on a collision course with wide swaths of American industry when one examines some of his proposed trade and tax policies. Individual companies have drawn the ire of Mr. Trump from importing goods produced in lower cost countries to building factories outside the United States, but this is just a mere warm up to the potential disruption from his Border Adjustment Tax. This major change in tax policy was already included within the house republican blueprint, as put forward by Speaker Ryan. The idea is to convert the corporate income tax into a destination-based cash flow taxation system that would "border adjust" by not taxing revenues from exports and disallowing deductions for the cost of imports.

Reducing overall corporate tax rates requires a revenue offset and major changes in how imports and exports are taxed may be one vehicle to generate new revenue. The problem is that companies have set up their supply chains around the world based on the current system. This new tax platform would be

highly disruptive to existing business models and could initiate retaliatory tariffs on our exports to other countries. China and Mexico seem to be two of the countries most in the crosshairs for the new administration and a major trade spat could result in a significant drag on global growth. None of this is good news for the economy in the short run and may never come to fruition, but it widens the distribution of economic outcomes for 2017.

Positives

Unemployment rate at 4.7% continues to reflect a strong labor market

ISM manufacturing and service surveys spike higher on Trump optimism

CPI year over year holds at 1.7%, keeping inflation in a welcome comfort zone

Negatives

Current account and trade balance data deteriorate, with exports leading the way lower

Building permits continue lower with a spike in mortgage rates

U.S. continuing claims for unemployment insurance rise from cycle low in Q3 2016

EQUITY OUTLOOK

Summary

As we usher in the new year, we find consumer confidence clearly upbeat, auto sales at record highs, production improving, employment levels improving, one party rule in Washington and U.S. equity markets sitting at record levels.

Lest we forget, the journey through 2016 was fraught with volatility. Right out of the starting block, the S&P 500 fell 12% in six weeks. On February 11, the market found its footing, reversed course and closed the year with an 11.9% gain. Most of that move came after the election.

Market rotation was fierce as well, as individual sector performance changed leadership throughout the year. Declining interest rates drove the dividend paying sectors of utility and telecom stocks early in the year. That trend gave way to the energy sector bottoming coincidentally on February 11 (see above) when WT crude touched \$26 a barrel. The sector subsequently roared back, eventually closing up 27.4% for the year.

Finally, post-election leadership shifted to the perceived beneficiaries of the newly elected administration, particularly the financial sector, up 21% in the third quarter, which would benefit from reduced regulatory oversight. Small companies, which normally pay higher corporate tax rates, fared as well.

As we have noted in past commentaries, there was nothing so out of kilter with our economic underpinnings that would raise cautionary flags for equity markets, but renewed corporate earnings growth would go a long way to justifying valuations.

Today markets are higher still, all in anticipation of sweeping changes in corporate and personal income tax policies, reduced regulatory burdens, overseas earnings repatriation, etc., etc. All the good news seems to have been factored into current stock prices.

There appears to be near unanimity among market strategists that the U.S. economy is on the threshold of a cyclical resurgence. This outlook has contributed to the significant outperformance of deep cyclical, or value stocks, to the detriment of growth stocks. (Think Caterpillar versus Amazon)

That may be so, but we are none-the-less wary of such consensus conviction. The adage that “price leads earnings” may prove true in the short run. Yet non-cyclical growth stocks have been thrashed so thoroughly in the past year that their valuations once again appear quite attractive.

A well balanced portfolio would have exposure to both sides of the value/growth debate, and after such a one sided year as 2016, it's time to rebalance the equity portion.

Positives

Economic backdrop positive for continued U.S. expansion

Fiscal policy tilts pro-business

Negatives

We haven't reached Inauguration Day yet

Brexit overhangs on Europe

Unknown

Actual policy endeavors on trade, immigration, taxes, etc.

FIXED INCOME OUTLOOK

Summary

After the sharp increase in rates following the surprise Presidential victory by Donald Trump, interest rates peaked in Mid-December and then moved slightly lower for the last two weeks of the month. Still, the entire yield curve ended December higher than it began. The 2-year increased almost 8 basis points (bps) to end the year at 1.19%. This was only 14 bps higher than the level at the beginning of 2016 but more than twice the lowest yield of 0.55% on July 5. Likewise, the 10-year ended the year at 2.44%, up only 6 bps for the month and 17 bps for the year but up 1.08% from the lowest closing yield of 1.36% on July 8.

Corporate credit remained strong with credit spreads continuing to narrow by an average of about 15 bps in December. This narrowing allowed intermediate-maturity corporate bonds to deliver a positive return of 24 bps versus a return of -0.03% for intermediate Treasury bonds. For the entire year, credit spreads narrowed by about 40 bps for intermediate corporate bonds. The sector delivered a return that was almost 3% better than that of intermediate Treasury notes (4.04% versus 1.06%).

The market's move to higher yields makes sense to us given the likelihood that the new Trump administration will make a push for significant fiscal stimulus through an infrastructure spending program and tax cuts for (middle-class) individuals and corporations. Both of these measures would cause the federal budget deficit to increase at a higher trajectory than it was already expected to rise.

At the same time, increasing rhetoric about labeling China as a currency manipulator and slapping trade tariffs on imported goods is not likely to win favoritism from one of the largest investors in the U.S. government debt market. Tariffs in any form will cause inflation to be higher than it would be otherwise.

We have shortened our duration policy and become more defensive in anticipation of a gradual move higher in rates. The move will not be straight-lined, but another 25 to 50 bps seems

reasonable given the policy uncertainty. Investors should not fear a move back to the type of levels seen a decade ago. At 3% on the 10-year, we believe that bonds would become a significant competitor to other investment classes and that money would flow into the asset class, thus capping the increase. We still favor corporate credit, but are less optimistic than before.

Positives

Demographic headwinds in most developed countries have not changed with Trump

U.S. Treasury and corporate bonds offer significantly higher yields than in other developed nations

Higher yields and lower prices should cause rebalancing in favor of bonds

Negatives

Fed has been signaling that three rate hikes are possible for 2017

Increasing budget deficits require greater debt issuance

Anti-trade and currency manipulation rhetoric and tariffs could scare debt buyers away

Inflationary expectations have risen (with good reason)

Unknowns

Terrorism and potential impacts on travel and global economic growth

Bad debt and capital inadequacies in Europe (it's not going away)