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2016
4th QUARTER

Sarah Potter,
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The Equity Market

Happy New Year!

By Sarah Potter
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As is probably always the case in election years, it's difficult to look back at the entire year without the picture being painted in large part by the election. And unsurprisingly, it also sets the scene heading into the New Year. Whereas investors approached 2016 with apprehension, 2017's entrance has been one of unexpected hope. We aren't as unabashedly convinced as the market might suggest, but we're staying tuned.

Renewed Optimism?

In the aftermath of the election, some sectors of the equity markets have responded in a manner that former Federal Reserve Chairman Alan Greenspan once characterized as "irrational exuberance." We can at least characterize some of the recent market performance as speculative. The stock market did hit all-time highs in November; however, the S&P 500 was down preceding the election and finished the month up only 3.7%, while the perception was that it finished the month having performed much better than that. H&R stocks were up in the month of November, but bond prices were down nearly as much, negating the outperformance in many cases, especially for balanced clients.

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The Bond Market

4th Quarter Overview

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It has been a busy quarter for the markets with a considerable amount of repositioning due to changing expectations in terms of stronger growth, higher inflation and a lighter regulatory environment. This has led to a poor quarter for fixed income performance, with the 10-year Treasury yield rising the most we've seen since the taper tantrum in 2013.

The best performing sectors of the Barclays U.S. Aggregate index (broadest of the Barclays indices) were the GNMA 3/1 (Adjustable Rate MBS) with the least negative return of -0.10%, followed by the Auto ABS which returned -0.26%. Both sectors performed well on a relative basis due to their short duration compared to other sectors. The worst performing sectors were U.S. Treasury: 20+ Year with a return of -12.16%, followed by U.S. Treasury: Long with -11.67%. Within the investment grade sector, the lower end of investment grade outperformed as market expectations shifted towards improving growth and higher inflation. Baa rated bonds returned -2.75%, compared to Aaa rated bonds returning -2.98%. Our benchmark index, the Intermediate U.S. Government/Credit, returned -2.07%. High yield bonds once again outperformed relative to investment grade bonds and had a positive return during the past quarter. The Barclays U.S. Corporate High Yield index returned 1.75% in the fourth quarter, returning 17.13% for the year. This past quarter saw a fairly sizable reversal from the flattening of the yield curve we had seen throughout most of the year with the curve steepening, driven by yields on the long end of the curve rising significantly after the U.S. election.

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There seemed to be a renewed sense of optimism from investors in the last couple months of 2016, but it remains to be seen whether some or all of the pro-growth policy statements alluded to during the presidential campaign will actually materialize. Further, it remains to be seen whether or not these policies will have the same positive economic impact that they may have had in previous historical presidential cycles. There is little doubt that reducing marginal tax rates at both the individual and corporate levels is economically stimulating, but there are caveats. While the market has been euphoric about potential prospects for growth, and some people are drawing parallels to the potential that was realized during the 80s, we think it is premature to extrapolate a path for economic growth based on campaign promises until there is more evidence of what is real. There are too many different factors at play (debt to GDP, for example, which is more than three times higher now than what it was in the early 80s under President Reagan, as well as differences in the role of the Federal Reserve) to draw dramatic conclusions about the economy today based on history. There is also potential danger in heading into a new year with such high expectations and optimism because that means, naturally, more room for downside surprise. History does, of course, offer interesting perspective and food for thought, given that patterns do sometimes emerge, but we must stay disciplined in our approach and rational about the current real prospects for economic growth.

Given that Donald Trump did not win the popular vote, and his presidential victory was a surprise to many, one might expect to see consumer confidence down, as well as other indicators. However, the aforementioned ideas and stock market rally (and an impressive unemployment rate at 4.6%) are probably part of the reason for the recent uptick in the reading. However, we're holding our breath as 2017 settles in and the market begins digesting actual events rather than potential ones.

Let Us Not Forget

We, of course, remember that despite recent market rallying, much of 2016 was witness to volatility in the markets due to China's stock market sell-off in the beginning of the first quarter, Brexit concerns, unimpressive oil prices for most of the year, and finally, the political trail leading up to the election. Early on in 2016, the S&P 500 was down over 10% (a technical correction), but the year ended with the market up over 9.5%. Therefore, the exuberance felt of late by many seems to be based off spirit more than true fundamental evidence. We know that the market responds to news and perception with nearly the same intensity as it does to fundamental data, but the underlying economy holds the most clout and is still the most important thing at the end of the day.

What's In Store

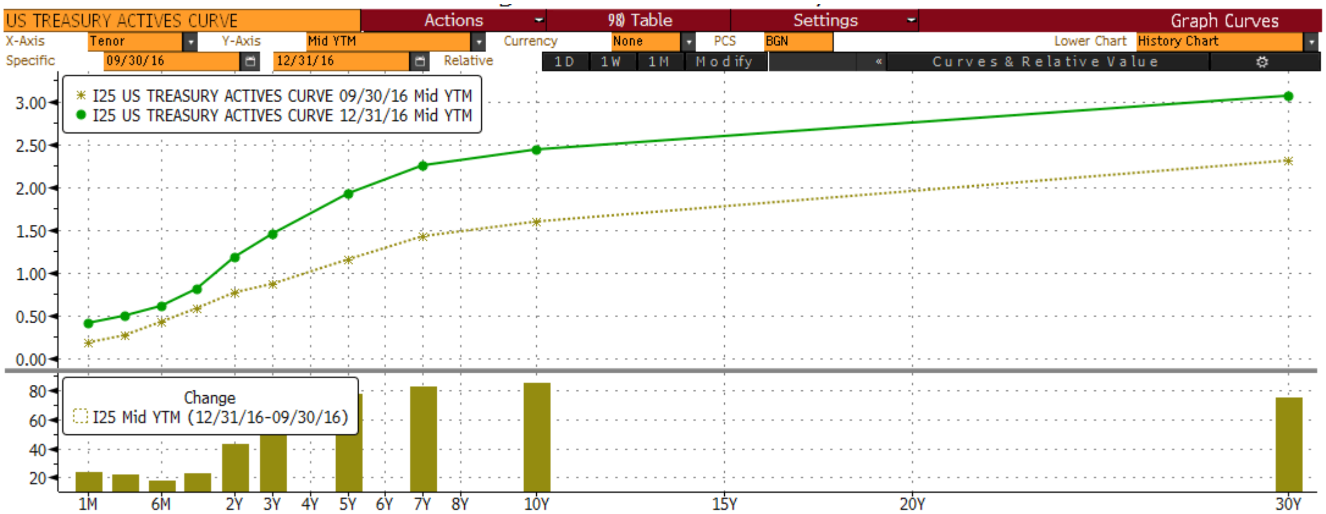
We're anticipating a 2017 whereby value is still favored over growth. This has been reflected in our investment approach for a while now, and we're still confident moving in that direction. At the individual stock level in this market of names, we're doing more to analyze growth potential and stock price momentum of each stock itself and are being sure to capture wide sector exposure at this late stage of the market cycle. Although there are fairly valued stocks posing opportunities for investors, many stocks are expensive with less appealing valuations (something you may hear often in market rhetoric as of late). Therefore, we expect earnings to continue to play a very important role in stock performance and, hopefully, stock market growth. While we remain cautious about oil given that demand hasn't changed much, the global supply of oil has begun to balance out, and it's being positively reflected in the energy sector as well as for commodities. We expect volatility to continue, though.

Consensus is that we are on track for relatively flat real GDP growth here at home, after 2016's growth of around 1.6%. Are you sick of "slow and steady" as a mantra yet? Let's hope not, because it's still very much alive as a characterization of yet another year for the US economy. According to Evercore ISI company surveys, growth isn't likely to take off anytime soon, although inflation is anticipated to pick up (something we are closely monitoring). President Trump's expansionary policies (deregulation, tax cuts, infrastructure expenditures), if enacted, would prove positive and significant for our economy; but again, *if enacted* is the key phrase.

However, global growth is positive and may even be accelerating, as evidenced by manufacturing PMI increases in Japan and composite PMI increases in the U.K, Eurozone, and China. And it is no surprise that the European Central Bank, Bank of England, and Bank of Japan are continuing to increase their countries' balance sheets and stimulate their economies, as well, adding to growth on a global scale.

Geopolitically, as we mentioned last quarter, next year will see national elections in the Netherlands, France, and Germany. The general election takes place in the Netherlands in March, France's presidential election begins in April of 2017, and Germany's parliamentary election will be in late summer or early fall of 2017. These types of events are generally surrounded by uncertainty, as was the case with our own presidential election. And although it's been a relatively silent issue of late, we're likely to hear more about Brexit next year as the logistical details of what has so far been a theoretical concept are hashed out. Things are still fragile for Europe, to say the least, so we are remaining cautious but hopeful about the region.

End



Source: Bloomberg

While 2016 began with growing fears of a potential global recession and strong disinflationary pressures, we have come full circle as 2016 closed out the year with improving economic data, as well as hope for stronger growth and expectations of higher inflation. The primary driver for this change in market expectations has been the surprise victory of Donald Trump and the potential impacts that his policies might have on the US and global economy. Based on Trump's campaign rhetoric, the market has begun to price in fiscal stimulus via tax cuts and increased spending on infrastructure, leading to a rally in stocks and a sharp sell-off in bonds, particularly on the longer end of the curve (due to long-term bonds' sensitivity to the rate of inflation). Coupled with the Fed raising rates in December, it has been a tough quarter for bonds. But the size and speed of these moves leaves one wondering if the market has gotten a bit ahead of itself on pricing in some of these policies and the impact these policies would have on growth and inflation. Many market participants seem to be drawing from Reagan's presidency to extrapolate what a Trump presidency might look like from an economic standpoint. While we don't have enough information currently to do much more than speculate, it is important to draw some distinctions between the two periods. The point that I'm trying to make here is that there was much more room for Reagan to propose and promote stimulative fiscal policies than there is for President-elect Trump. Monetary policy was a tailwind to the economy rather than a headwind, even though interest rates are still historically low. Federal debt was less of a concern in 1981 and required less "political capital" to increase deficit spending. With U.S. federal debt-to-GDP currently at an all-time high of 104.8% and a fiscally conservative Republican-controlled Congress, is it realistic to expect stimulus in the form of lower revenues (cutting taxes) and increased expenses (infrastructure spending) with federal debt at all-time highs? It is also less likely that the multiplier effect of fiscal stimulus would be as great given that we are currently approaching what many consider full employment. In regards to increased deficit spending, there was (arguably) more justification to adopt fiscal stimulus given labor market conditions at that time rather than now. Considering the higher headline unemployment rate, there was a lower risk of a rapidly higher rate of inflation from fiscal stimulus in 1981. The one area in which there seems to be a lever to pull is tax rates. Although current tax rates are lower than they were in 1981, relatively speaking, we still have one of the highest corporate tax rates in the world. Using data gathered by KPMG, the average global statutory corporate tax rate is 23.62%, and the average OECD tax rate is 24.81%. There is definitely some room for corporate tax rates in the U.S. to move lower, allowing the U.S. to become a more competitive place for companies to invest and for capital to grow.

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	Now	January, 1981
Monetary Policy	Tightening	Easing
U.S. Federal Debt-to-GDP	104%	31%
Headline Unemployment Rate	4.70%	7.50%
Statutory Corporate Tax Rate	39%	50%
Highest Individual Marginal Tax Rate	39.6% at $415,050+	70% at $108,300+ or $300,446+ in 2016 dollars

Sources: Bloomberg & taxfoundation.org

There is no doubt that the market is sensing the potential for higher inflation, either because of increased fiscal stimulus, protective trade policies, or some combination of these two policies. But, given the competitive nature of the global markets and barring protectionist trade barriers (which we do not believe are in the best interest of the United States), it is still too soon to reverse course on inflation expectations increasing dramatically. Remember, up until 50 days ago, the central banks of most developed economies were more worried about disinflation. Have we forgotten how many banks were setting negative interest rate policies as a means to deter savings and stimulate consumption and capital investment? However, here in the U.S., we have seen inflation expectations increase modestly since Election Day. These expectations, as measured by the difference between nominal U.S. Treasuries and inflation protected U.S. Treasuries (TIPS), have increased by approximately 25 to 30 basis points (0.25% - 0.3%).

Let's take a closer look at deficit spending as a policy tool to understand why the market has reacted with higher inflation expectations. Deficit spending as a stimulus policy is usually done in response to a recession or economic downturn to boost aggregate demand with increased government spending as the private sector pulls back. This increase in demand is intended to incentivize businesses to invest and retain or hire labor to continue producing to match this demand. As employment grows and wages rise, disposable income also increases to support consumption from individuals. This further increases aggregate demand, to which companies respond with more investment and/or employment. In theory this positive feedback loop (also known as the multiplier effect) pulls the economy out of a downturn or recession. Looking at deficit spending through this framework with the unemployment rate currently near or at what many would consider full employment, it is unlikely that deficit spending would have the same multiplier effect as it would in a period of high unemployment.

Deficit spending also comes with risks and trade-offs. There is the risk of higher inflation from a tighter labor market and higher wages as previously discussed, potentially forcing the Fed to hike interest rates faster than expected to contain inflation. This would offset some of the stimulus from increased deficit spending. Another risk is increased demand for credit from the government to finance the deficit. This could cause interest rates to rise, making it harder for consumers to pay their bills as well as making it more difficult for businesses to invest in new opportunities because of higher financing costs.

With a smaller multiplier effect and the risk of higher inflation from a tight labor market, it would be even more important to find projects that are expected to increase productivity in order to have a sustainable impact on the potential growth rate while also keeping inflation in check. What President-elect Trump has outlined so far for increased spending seems to be centered on repairing or improving existing infrastructure. While this type of spending is necessary to extend the useful lives of these assets, will this spending really improve productivity significantly? The productivity gains from highways, bridges, airports, etc. have likely been realized, and any gains in productivity from repairing or improving these assets would be marginal. In our opinion, increased spending on research and development in areas such as machine learning and by extension artificial intelligence, or perhaps on virtual infrastructure that improve the security, speed and connectivity of information technologies (in an attempt to spur more innovation) would likely yield greater results.

Overall, we believe lowering individual tax rates would be the most effective form of fiscal stimulus, as putting money back in the hands of individuals to allocate these funds at their own discretion is considered by many to be more effective than government-directed spending.

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