Economic & Market Commentary

The year 2016 was full of surprises. For U.S. equity investors, the final quarter and the whole year ended in surprisingly pleasant fashion, with the markets providing a mirror image to the way the year began. A year ago, January started as the worst beginning of a year in history. Events in China and North Korea, the price of oil collapsing, and weak economic data raised the fear of a U.S. and global recession, resulting in an equity market decline of close to 10%, which bottomed early in February. The pundits were looking at the "January barometer" ("as goes January so goes the year") and concluded that 2016 would not be a good year for investors. Markets recovered the January – February decline quickly and stumbled through the rest of the first half. In June, we had the surprising British vote to leave the European Union, which caused another dive in the markets of close to 5%. In a week's time, the decline had been recovered and the markets treaded water until the U.S. Presidential election. This event provided the final and biggest surprise. Like the wobbly pencils of Brexit, no one got this right. The initial reaction to the Trump victory was fear of a global downturn, based on his campaign rhetoric, and equity futures plunged the limit on election night. Then after an acceptance statement that dampened prior vitriol, and appeared more conciliatory, and some early morning discussion of his potential economic policies by a couple of Trump spokesmen, the equity markets closed up the next trading day. In that 16 hour period, U.S. equities had a swing of close to $1.5 trillion (U.S. GDP is about $18 trillion). Truly amazing. And since then it's been off to the races, as equities (as measured by the S&P 500) closed the quarter +3.8% and the year +11.9%. So much for the "January barometer." U.S. stocks were the place to be as, with a strong dollar, most other global equities underperformed (Brazil and Russia were exceptions). As has been the case for most of the year, small capitalization stocks did better than large and value did better than growth, for both the quarter and the full year. With interest rates firmly in an uptrend, bonds struggled, producing a modest positive return, with negative returns since the election. Ten year Treasuries, for example, were yielding about 1.8% around midyear, but closed the year about 2.6%.

The election of the populist candidate, Donald Trump, has altered the investment landscape dramatically. Since the election $70 billion has flowed into U.S. equities (according to Merrill Lynch) and stocks are up 5-6%. Bonds, on the other hand, have suffered from outflows of funds and declining prices, as interest rates rose. After the election night market spasm, a somewhat conciliatory speech by the newly elected candidate and morning statements about economic plans by Messrs. Navarro and Ross, stocks began their upward march. The immediate assumption was that the statements about the economy made by the new administration would be positive for U.S. economic growth. Will this happen? That is the big question. It puts one in the position of being a two handed economist – "on the one hand and on the other hand". Our base case for the economic backdrop is the same as it has been for a long period. We are in a below trend growth environment, with U.S. real growth in the 2% area and global growth about 3%. U.S. job growth continues at a decent pace, consumer balance sheets have been repaired and wages are beginning to grow. Interest rates are low and even if the Fed raises the Fed Funds target a few times in the coming year, they will remain so for some time. Energy prices are manageable and are expected to remain so for a while. Inflation is contained and shows little sign of acceleration (yet), so there is no evidence of recession around the corner. The current expansion is now 90 months old, which is long, but there have been three of longer duration, so our working assumption for economic activity continues to be more of the same: slow growth, low inflation and upwardly biased interest rates. To these base ingredients has been added the yeast of post-election talk of policy plans that could be interesting. With monetary policy having shot its bullets, pro-growth fiscal policies including the talk of a large infrastructure program could be a welcomed answer. In addition, the following could provide additional yeast for a rising loaf:

- Further fiscal stimulus through increased defense spending.
- A redo of our tax system – both personal and business.
- A reduction in regulation which has been a choke for business, (the Heritage Foundation has estimated that new regulations from the Obama administration have added more than $100 billion annually to costs for business since 2009).

So, on the one hand, these prospects could ignite Lord Keynes "animal spirits," and be a strong plus for the U.S. economy. This appears to be in process as reflected by investors' initial reactions, and the fact that consumer confidence and small business confidence are at their highest levels in over a decade. As an aside, the Financial Times points out that the Trump team has spent a collective 85 years in business, while the Obama administration had just 5 years. If all goes well the country could be led by an administration that has a growth agenda for the first time in many years.

The big question here is: will all go well? Which brings us to the "other hand". The details of the administration's policies are sketchy at this stage and we won't have a clear picture of them for several weeks at best. The administration itself is mercurial, and at times contradictory, which adds to the lack of clarity, so there is much we don't know. What we do know is that most of these polices will have to pass through both houses of Congress, which will be no easy ride. It is probably a good bet to assume legislation could be altered, and for sure take more time than currently assumed. Whether there are enough "shovel ready projects" on the infrastructure front, what a tax bill will look like, what will replace the Affordable Care Act, and what other regulations will be reduced, are all huge unknowns. In addition, Trump has his own special problems, as we are seeing almost daily. There is enough dirt under the rug that keeps rising to the surface to be a massive distraction to allow a smooth running legislative process to proceed. It is safe to say, in any event, that most of these positives, should they be enacted, will have little impact on 2017. They are more likely 2018 events. Then, of course, there could negative fallout from some of the initiatives taken. Counterproductive trade or immigration barriers, relations with Russia and China, and other geopolitical risks all could come into play. The process of U.K. exit from the European Union (Brexit) has not yet started. When it does it will take 2 years, and could be messy. Other members may want to follow, which would be a negative for the EU.

Elections in France, the Netherlands, Germany and Italy could raise populist fervor across Europe. All of these could detract from what initially looks like a positive economic framework.

So, there are the two hands we're facing, and given the policy statements to date, we come down on the positive side of the ledger. Our base case going forward is ratcheted up, and we lean towards the hope that the growth agenda prevails, Congress works in nonpartisan fashion to pass significant legislation, and the outcome justifies the strength of the initial reaction. We say this with the realization that stocks have vaulted to a level that is not cheap. The S&P 500 is trading at more than 18 times 2017 earnings, after the post-election rally. Stocks are in their tenth decile of valuation – more expensive than they have been 90 percent of the time. From this level of valuation, stocks have historically produced below average returns over the succeeding 5 and 10 year periods. In addition, there aren't many sectors that can be considered cheap. Barron's recently published a survey of 10 prominent Wall Street strategists about the coming year. Their median conclusion was that stocks (as measured by the S&P 500) would end the year about 7% higher than the 2016 close. While this is not an unreasonable expectation, we expect the path throughout the year will be bumpy. Equity volatility during the last half of 2016 diminished significantly. Given the uncertainties we have discussed earlier, we fully expect this to reverse. There are too many unknowns in the picture not to have bumps in the road, which could cause down drafts much like we saw last year. As is always the case when we write, earnings reporting season is upon us. Investors will be closely watching what managements say about guidance for the rest of 2017. Attitudes and plans for the rest of the year will be closely monitored, with disappointment most likely punished and optimism rewarded, adding to the increased volatility we expect. As individual stock prices have approached our estimate of fair value, we have reduced the size of those holdings and used the proceeds to invest in other fundamentally sound companies that we believe are undervalued.

Fixed Income Market Review

Like stocks, bonds provided surprises in the final quarter. But unlike stocks, the surprises were negative, as interest rates rose significantly across the entire yield curve. The unexpected result of the Presidential election preempted the Fed and led to a stunning move in bond yields. During the 4th quarter the yield on the 10-year Treasury Note rose 85 basis points (0.85%), while the yield on the 30-Year Treasury rose 75 basis points (0.75%). The heaviest impact was felt in longer maturing bonds, but even shorter maturity issues were hurt by the sudden spike in yields. It was the most significant movement in rates since the "Taper Tantrum" in 2013. The sudden rise in yields was reflected in the Bloomberg Barclays US Aggregate Bond Index, which returned -2.98% for the quarter to bring the 2016 return to 2.65%. In 2016, corporate bonds were by far the strongest performing sector of the benchmark index returning 6.00% compared to 1.67% for mortgage pass-through securities, 1.46% for agency bonds, and 1.04% for Treasurys.

The Federal Reserve did finally raise its Federal Funds rate target by 25 basis points for the first and only time in 2016 at its December meeting. However, the action by the Fed was completely overshadowed by the momentous movement in bond yields during the prior month. The most significant news coming out of the Fed meeting was that it is now targeting three rate hikes during 2017, up from a previous expectation of only two.

Despite the December jobs report of 156,000 new jobs, falling short of the 175,000 forecast, the labor market continued to show signs of strength, with unemployment at 4.7% as of December and wage growth of 2.9% over the past 12 months. The current unemployment level is below the Fed's target of 5.0% and at a point where many Fed officials have voiced concerns that wage pressures may begin to occur. Another important data point will come at the end of January when we get a read on inflation as measured by the Personal Consumption Expenditures Index which is currently at 1.4% and still well below the Fed's target of 2.0%, but up considerably from last August when it stood at 1.0%. These data points provide valuable information about the economy, but the fact is that the new policies of the incoming President may dwarf these economic data points in terms of impact on the fixed income market. Although President-elect Trump announced $500 billion in infrastructure spending during the campaign, there can be a wide divergence between campaign rhetoric and what will ultimately be proposed by the President-elect and then eventually approved by Congress.

While the Fed may strive to act independently of politics, it must take into consideration the policies of the new administration, given the potential for significant changes to trading policies, corporate and personal tax rates as well as increased infrastructure spending, which can all have pivotal impacts on both the economy and inflation. In addition, the Fed must take into account the recent strength of the dollar, which rose almost 6% from the Nov. 8th election through yearend and could both hurt U.S. exports and dampen inflation if the dollar continues to strengthen. The point of all this is that the Fed now has a new set of variables they must consider in making decisions regarding when and by how much to raise interest rates.

As mentioned above, the Fed is now firmly projecting 3 rate hikes this year, although the market is somewhat more skeptical. The fixed income futures market has only priced in a 44% probability of one rate hike by June and only a 32% probability of two rate hikes in all of 2017. There is currently only a 10% probability given to a 3rd rate hike in 2017 occurring. The Fed's ability to implement its projected three increases to the Federal Funds rate will be more dependent on the fiscal policies and programs coming from the Trump administration and Congress than they have been in recent years, when monetary policy was the primary driver of interest rates.

While interest rates were generally anticipated to rise from the historically low levels reached mid-year, the speed at which yields rose in November was certainly unexpected. Although many market participants thought that rates would rise slowly and steadily driven by cautious Federal Reserve actions, the fact is these movements often do come in the short, accelerated timeframe we saw in November. This is precisely why we have kept fixed portfolios invested in short-to-intermediate term investments and structured portfolios in order to have cash becoming available at regular intervals from maturing securities. The shorter-maturity bonds have lower durations and are less impacted by rising interest rates than longer-maturity bonds and also provide us with the opportunity to invest cash from maturing securities at the prevailing higher interest rates when yields are rising.

We remain comfortable with our overweight position in corporate bonds given the improving economy, growing profits and cash flows generated by companies, and stronger corporate balance sheets. In addition, we see the potential boost to economic growth from proposed new policies of reduced industry regulation, lower corporate tax rates and increased infrastructure spending. This of course assumes that these tailwinds for economic growth are not impeded by enacting hefty tariffs on our trading partners.

Municipal bonds were stellar performers for most of the year, but were weaker than other bond sectors during the November bond sell-off as the Barclays Bloomberg Municipal Bond Index fell 3.62% during the quarter. Due to that weakness they became more attractive relative to taxable credits, with 10-Year municipal bond yields reaching 107% of 10-Year Treasury bond yields in December, compared to only 83% last May. We consistently evaluate the after-tax returns of comparable credits for taxable and non-taxable securities in order to earn the highest after-tax return.

Although interest rates moved up dramatically during the quarter, particularly for such a short period of time, it is important to remember that Treasury bond yields are still below recent historical levels. Over the past 10 years, the average yields for the 10-year and 30-year Treasury bonds were 2.80% and 3.65% respectively compared to yields of 2.41% and 3.01% as of January 13th. There are an array of factors that will influence how rapidly rates rise and the movement may come in a short, pronounced burst as was the recent case. We believe our client portfolios are well-positioned to lessen the impact of rising interest rates, while being structured so that they can take advantage of a rising interest rate environment.