Solving For 2017 - Shifting Regimes

A Review of 2016

The page on the calendar has turned; we now have a new year, a new president, and new economic policies forthcoming. Distinguishing the signals from the noise is challenging and there was plenty of noise in 2016 - just like every year. Before the Standard & Poor 500 (S&P 500) index registered a 9.5 percent return in 2016, fears of a China slowdown blanketed headlines last January (the S&P 500 declined 15 percent from its highs and small company stocks dropped a staggering 26 percent), and the Brexit (British exit) referendum caused a brief 48 hour hiccup in June. Oil was also in the news as prices hit a low of $26 a barrel early in the year, before more than doubling by year-end to $54 per barrel (yet well below exceeding $100 in 2014). On the interest rate front, 10-Year Treasury rates hit an all time low at 1.36 percent in July, while trillions of dollars in global bonds were incomprehensibly paying negative interest rates. Fears of inflation scared bond investors and yields finished the year near 2.50 percent. Finally, the Federal Reserve reversed course on its near zero interest rate policy as evidenced by their second rate increase in December.

Despite the abbreviated volatility caused by the aforementioned factors, it was the US elections and surprise victory of President Donald Trump that dominated the media airwaves for most of 2016, and is likely to continue throughout 2017. In hindsight, the amazing Twitter-led, Trump triumph was confirmation of the sweeping global populism trend that has also replaced establishment leaders in the United Kingdom, France, and Italy. There are many explanations for the pervasive rise in populism, but meager global economic growth, globalization, and automation via technology are all likely contributing factors.

The Federal Reserve

As mentioned earlier, the Federal Open Market Committee (FOMC) increased the federal funds rate. The Committee also released its latest summary of economic projections (SEPs), which highlights the expected path for the federal funds rate, which is consistent with their forecasts for Gross Domestic Product (GDP), unemployment, and inflation.

The FOMC made five principal observations in their statement. First, the labor market had strengthened further, with solid job gains and a decline in the unemployment rate. Second, the economy expanded at a moderate rate since midyear. Third, household spending increased moderately; but, fourth, investment spending was soft. Finally, while inflation increased from earlier this year, it remained below the Committee's 2 percent target.

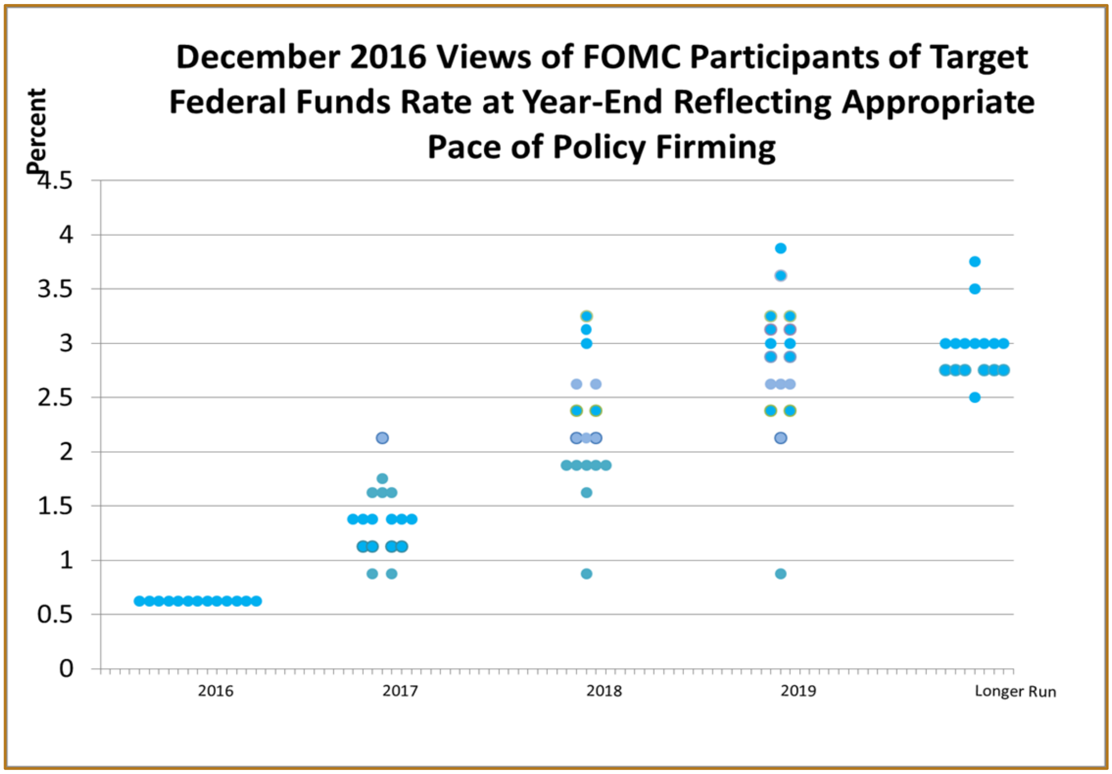
Of great concern to the Federal Reserve is the level of slack in the labor force. While the headline unemployment rate has declined, the U-6, which measures the percentage of people working part-time but who want a full-time job, has remained above historical norms, leading some policymakers to argue that interest rates can remain low until additional improvement materializes. On the other hand, the number of job vacancies has climbed to over 5 million, which leads us to conclude that labor markets are essentially at full employment and that skill mismatches help to explain the difficulties that employers are experiencing finding workers.

The real puzzle for policymakers, however, is the failure of inflation to pick up, given the extreme policy accommodation in place and the large amount of excess reserves now on its balance sheet from its asset purchase programs. There are at least three plausible explanations for the failure of inflation to pick up.

- A lack of demand. The most recent survey of small business owners suggests that access to credit is not a significant problem;
- Many companies, especially large companies, have excess cash reserves and don't need to borrow; and;
- A large portion of these reserves (almost 40 percent), are on the balance sheets of foreign banks that aren't major suppliers of credit to US businesses.

As part of the report at their December meeting, the Committee released its projections on targets for Gross Domestic Product growth, unemployment, and inflation. Upon review, we think it is important to note three key observations from the data. First, the Committee has continually overshot economic growth and inflation, yet has typically underestimated unemployment. Second, growth throughout the forecast horizon is viewed as being substantially below historical trends, hovering around 2 percent and within a narrow range. This evidence suggests that low productivity and slow growth in the labor force will combine to put the economy on only a modest growth trajectory for the foreseeable future. Lastly, despite what is seen to be a relatively tight labor market, with projections for the unemployment rate below 5 percent through 2019, inflation is seen as being below target. This suggests there is little need for the FOMC to quickly raise rates.

Below is the Committee's so-called dot chart that details each participant's assumed federal funds rate at the end of each year.



Much has been made of the fact that the median funds rate suggests the committee sees three rate hikes in 2017 and that the projected path going forward was revised up from September. However, investors must remember that all the participants behind the dots are not equal. What matters is not the median or the range but who the voters are and what their views are.

Our conclusion is that the probabilities favor only two rate hikes in 2017 rather than the three increases widely discussed. Moreover, a cautious approach also seems more likely because of the uncertainty about the Trump administration's policy initiatives. Chair Janet Yellen made it clear at her post meeting press conference that unlike markets, which have started to price in an economic stimulus, the summary of economic projections forecasts largely did not. As the year and administration policies evolve, these conclusions may change.

The Economy

There is tremendous uncertainty in terms of what policies the Trump administration and Congress will implement, the timing of those policies, the magnitude of the economic impact, and finally, how the financial markets will react to and discount those potential impacts. In her press conference following the FOMC meeting on December 20, Janet Yellen summed it all up as 'a cloud of uncertainty.'

In any case, the consensus at the moment seems to be the Trump administration and Republican controlled Congress will implement fiscal stimulus via both increased infrastructure spending and reduced corporate and individual tax rates. Potential deregulation across many industries is further stoking market optimism that dormant 'animal spirits' (and corporate profits) will soon be revived.

Inflation had been gradually moving higher in 2016 prior to the election. President Trump's policy agenda suggests further inflationary pressure is likely. From the perspective offered by a simple Economics 101 supply/demand framework, fiscal stimulus should shift the demand curve outward - leading to higher economic growth and rising price pressures. To the extent Trump also carries through on his protectionist trade rhetoric, which would shift the supply curve inward, at least in the near term. This would also be inflationary but negative for growth.

More important, economics in the real world is never as clean and simple as it is in the textbooks. There are numerous other variables that impact growth and inflation. The direction of interest rates and the US dollar are two important ones. In theory, these policies, if implemented, should drive both US interest rates and the dollar higher. We've already witnessed the bond and currency markets respond in that way. The dollar hit a 14-year high in December and the 10-Year Treasury yield hit a two-year high. It is not obvious how much further they will move from here - or even in which direction they'll move.

Further complicating things, financial markets are global markets. Policy decisions and outcomes in other countries impact the United States, and vice versa. Treasury yields can only rise so far if other government bond yields with similar risk aren't also rising. The consensus does not expect the European Central Bank or the Bank of Japan to tighten monetary policy any time soon, and with those countries' rates at rock-bottom levels, that should constrain US rates. On the economic growth side, despite the expected fiscal stimulus, long-term, structural drivers of lower expected growth remain, such as an aging population, high overall debt levels, depressed investment spending, and low productivity growth.

While the initial rise in interest rates and the dollar would reflect optimism about stronger US economic growth, higher rates and Treasury yields mean higher variable and fixed mortgage rates, which would hurt the housing market and ancillary industries. Higher rates for consumer and business loans depress demand and spending. Higher rates and expanding government budget deficits from fiscal stimulus also pose risks given the already high levels of government debt. A stronger dollar hurts exports and the competitiveness and profits of US companies that do business overseas, ultimately having an impact on corporate earnings as in 2015.

Monetary stimulus has been the primary support for the global economy over the past six years as gridlock in Washington and debt burdens internationally precluded other stimulus efforts. In 2017, we believe that monetary policy will shift to both structural and fiscal stimulus policies from the new administration.

Fixed Income

As we entered 2016, Wall Street expected Chair Yellen to raise rates and see yields rise (the 10-Year Treasury yield started the year at 2.27 percent). After the Brexit vote in July, the yield declined to an all time low at 1.36 percent before moving sharply higher by more than 1 percent before year-end.

This was the sharpest sell-off in fixed income assets since the 2013 'Taper Tantrum.' The recent volatility has investors fleeing the asset class, as evidenced by the outflows from fixed income mutual funds and exchange-traded funds (ETFs). Estimates following the election indicated $9.06 billion flowed out of bond funds (the most in 3.5 years) and $25.38 billion flowed into equity funds (the most in 2 years). This is the largest disparity between fixed income and equity fund flows on record.

Fixed income remains an important portion of a properly diversified strategic portfolio - even in a rising interest rate environment. The inevitability of fiscal stimulus, and more specifically, the reaction to it from the Federal Reserve Open Market Committee, are much less known quantities right now than has been commonly discussed by pundits.

A Fixed Income - Municipal Bonds

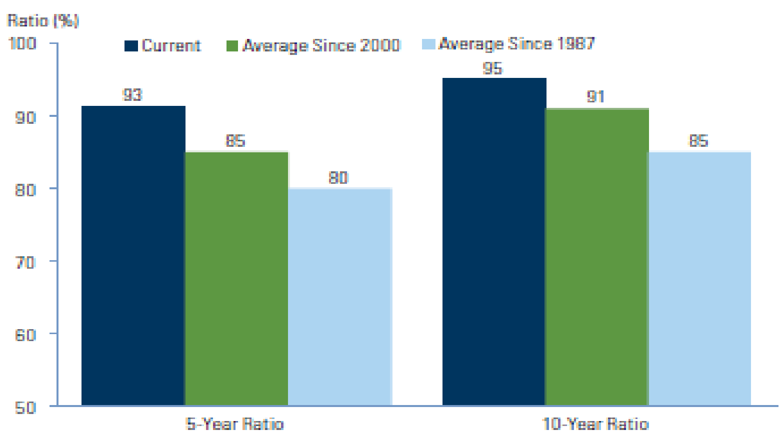
Municipal bond holders were not immune from last year's swift change in US Treasury yields. In October, municipal bonds were enjoying solid returns, only to be affected by losses arising from rising interest rates and budding concerns about tax changes in the wake of the United States presidential election. The abrupt redemptions of municipal bond mutual funds only exacerbated these losses, with the pace of outflows second only to the mid-2013 taper tantrum. All told, municipal bonds suffered one of their worst years in recent history, with intermediate municipal bonds actually experiencing a loss.

Unfortunately, the short-term outlook remains challenging. Mutual fund flows tend to be sticky in this asset class, with persistent periods of both buying and selling depending on the trajectory of interest rates. Based on historical episodes, there is scope for the current string of outflows to extend further. Moreover, clarity on tax policy will remain elusive for months, during which time headline risk will be significant. Even worse, a sizable reduction in the top individual tax rate for municipal bonds - if ultimately passed - could significantly shift the economics of owning them, leading to further sales. These fresh worries on tax policies only add to existing concerns about pension funding levels.

A silver lining to last year's selloff is that we begin 2017 with a valuation buffer to help absorb them. As seen below, the ratio of municipal yields to Treasury yields is above average for both 5 and 10 year maturities. In turn, investors can currently earn an extra 70 basis points of after-tax yield by owning five year municipal bonds instead of the same maturity Treasuries. Moreover, this incremental after-tax yield would still be around 50 basis points if the top individual tax on investment income were reduced by 10 percentage points - from 43.4 percent with the Affordable Care Act (ACA) tax to 33 percent under new policy recommendations.

Exhibit 83: Ratio of Municipal Bond Yields to Treasury Yields

Current municipal bond yields offer a larger valuation buffer to absorb risks than in the past.



Data as of December 31, 2016.
Source: Investment Strategy Group, Bloomberg, Thomson MMD.

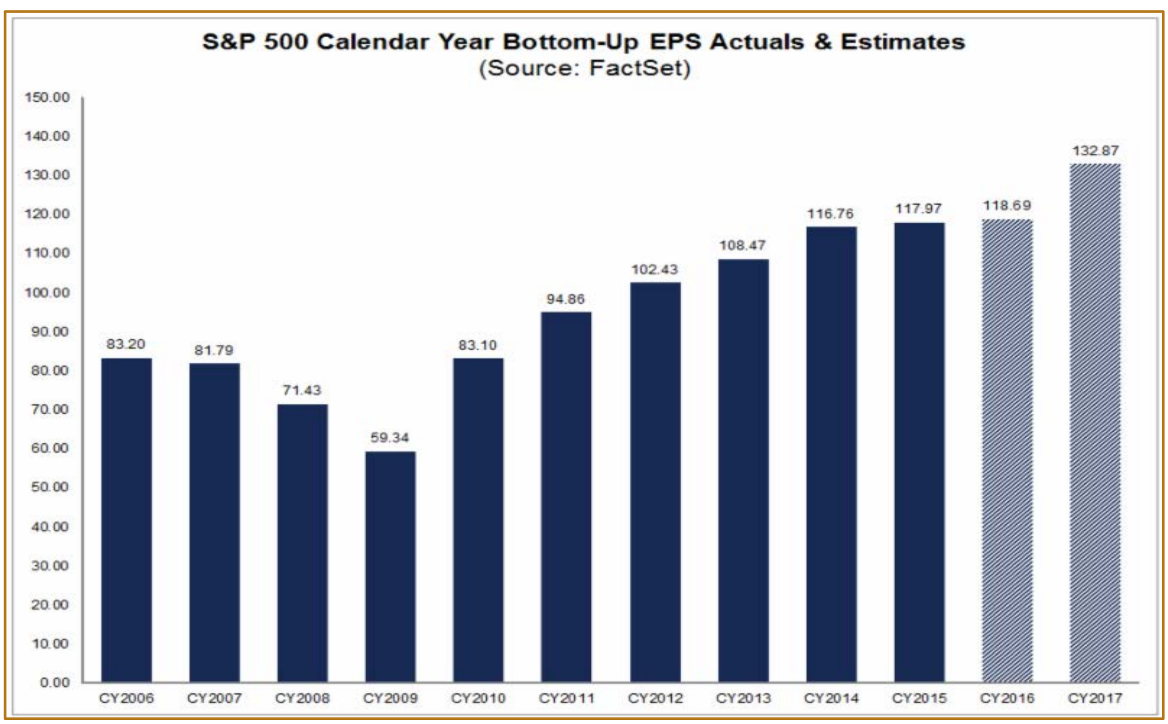
Also keep in mind that municipal fundamentals remain stable. Major state and local tax revenues have continued to increase at a moderate 3 percent pace, which should be supported by US economic growth and rising home prices. Meanwhile, governments have exercised restraint on capital spending which has kept net supply low and has also helped municipal finances. Ratings trends have improved as a result of both stable revenue and spending discipline, with upgrades in the Moody's universe seeing a notable uptick in last year's third quarter.

Our short-term strategy is to remain measured in our approach to investing, with a focus on preservation of capital. We will allocate capital in client portfolios conservatively while looking for opportunities as the markets presents them.

The US Markets

If you ever needed a year to demonstrate just how challenging it is to devote time to predicting the future with any degree of certainty, you received one in 2016. Investors (ourselves included) failed to predict Brexit, the path of interest rates, the US election, and the financial market response to that election. Thankfully our investment strategies were not based solely on the outcome of these events.

Going forward, we believe global economic growth and its impact on corporate earnings will be one of the factors in the continuation of the post-election equity rally. As of December, the most recent estimate of third quarter Gross Domestic Product growth was 3.2 percent and estimates for the fourth quarter GDP of 2.4 percent. These are solid numbers in the context of recent trends, but still a far cry from a truly robust expansion. The hope is that the new administration's plans for meaningful fiscal stimulus, including both corporate and personal tax cuts and an increase in infrastructure spending, can provide the tailwind needed to boost growth above these levels. Improved growth will likely fuel acceleration in corporate earnings and serve as a strong foundation for further improvement in stock prices which was previously driven lower by bond yields. As you can see, corporate profits are at record levels and forecast to accelerate in 2017.



Of course, this scenario is not without its risks. Anti-trade sentiment in the United States and other developed market economies could have a very negative effect on global growth. Policies such as renegotiating the North American Free Trade Agreement, fighting the Trans-Pacific Partnership or increasing auto tariffs could set off a domino effect across the globe, exacerbating the slowdown in trade we've seen in recent years. The stronger dollar is already beginning to make things difficult for large, export-intensive companies, and these problems could persist. Since the election, the dollar has risen 4 percent against a basket of global currencies and even more against the currencies of key trading partners like Mexico and Japan. Yet just as the dollar's post-election rise coincided with a selloff in emerging-market assets, we'd expect the reverse to be true as well.

International Markets

The US share of global stock market capitalization has risen from roughly 35 percent to just over 40 percent of the total in the past four years. Domestic stock returns have dwarfed the international markets throughout this cycle. We've had a lot of questions from clients asking us why they should ever own foreign stocks. It's a legitimate concern.

It's easy to say that you'll be happy only investing in US stocks because it feels much better when you're invested in the best performer as opposed to one of the worst performers. It may not be all that easy when the cycle inevitably turns. And it will turn at some point. The US does not have a monopoly on stock market returns, profit growth, dividend payments, innovation or good ideas.

The underperformance of international stocks tries our own patience, at times, as well. As wealth managers, we are continually digesting data, information, and news relevant to our asset class analysis. While there were certainly plenty of headlines over the past year, our fundamental tactical views on developed foreign stocks and emerging market stocks have not materially changed. Our research implies that from current price levels, both markets are likely to generate higher returns over the next three to five years.

For example, we took a look back at 5 year trailing returns on three different Vanguard equity index funds – United States, international and emerging markets - to show the cyclicality of returns:

	Trailing 5 Year Returns		
Period Ending	**United States**	**International**	**Emerging Markets**
December 2001	9.7%	0.1%	-5.0%
June 2006	3.8%	10.9%	20.4%
June 2010	2.6%	5.6%	14.8%
September 2016	16.2%	6.3%	3.3%

Funds: VTSMX, VGSTX, VEIEX

Notice the performance differential in December 2001 compared to what we see today. The returns had completely reversed by 2006 and stayed that way through 2010 until coming full circle…again.

Despite these cyclical differences if you looked at the 15 year returns of these funds since 2001 they weren't all that different:

- United States +7.8%
- International +6.3%
- Emerging Markets +7.3%

The hardest part about cycles is that there's no rhyme or reason to their length or magnitude. It's certainly possible that domestic stocks could continue their strong relative performance for years. Or it could end tomorrow. No one exactly knows.

Whether it is domestic or international, we strongly believe the re-emergence of corporate fundamentals will be a key driver of stock prices and thus an opportunity for active managers to generate excess returns. With more normalized monetary and interest rate policy likely for the United States, an increase in valuation dispersion among companies should support the efforts of active managers, generally speaking.

A Special Focus: Alternative Investments

Our lower-risk, non-correlated investment strategies should prove beneficial as the majority of their expected returns are driven by individual manager skill. As with active managers, we expect their investment opportunity sets to be fruitful in an environment where monetary policy no longer dominates financial asset pricing.

The macroeconomic environment over the next 12 months may be characterized by differentiation between fundamentally strong assets and those susceptible to deflationary pressures, increased volatility, periodic price dislocations, and occasional liquidity shocks. We continue to prefer alternative investment strategies that take a Balanced, Opportunistic, Low Net Exposure, and Tactical (BOLT) approach.

Here are our preferred alternative strategies:

Long / Short: This strategy remains our highest conviction strategy. We see a landscape characterized by lower correlations and high levels of dispersion, which, coupled with increased volatility and higher interest rates, should bode well for individual security selection, a vital component of this strategy.

Global Macro: We anticipate a key benefit of the strategy - its low correlation to global equity and fixed income markets - likely will be a valuable contributor to diversification for many investors.

Concluding Thoughts

We remain optimistic yet we understand there is no free lunch. While tax cuts, infrastructure spending, and regulatory relief should positively contribute to economic growth, these benefits will have to be weighed against the likely costs of higher inflation, debt, and deficits.

The nature of the financial markets and economy hasn't changed. The emotions of fear and greed rule the day just as much today as they did a century ago. What has changed today is the pace, quality, and sheer volume of news.

As always, we will adjust and communicate our views accordingly should the economic, financial or geopolitical backdrop change materially over the course of 2017.

Respectfully yours,

David

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Macro Summary

- We remain in uncertain time periods;
- It will be challenging to develop investment strategies solely on government policy;
- Volatility will persist due to political dynamics in the United States as well as in Europe;
- Economists' forecast GDP at 2.9 percent in 2017 with upside from prospective fiscal stimulus;
- The economy is near full employment as evidenced by more muted monthly payroll gains and increasing labor costs;
- Many measures of inflation are above the Federal Reserve's two percent target already - Services inflation is at 3 percent, the Employment Cost Index is at 2.3 percent, Average Hourly Earnings are at 2.9 percent and the Atlanta Fed Core Sticky CPI is at 2.5 percent;
- Global monetary policy remains accommodative on a historical basis;
- Every 1 percent increase in interest rates causes interest charges to soar $470 billion;
- The Consumer Confidence Index hit its highest level in the past nine years;
- Active management may stage a comeback. The removal of artificially low interest rates could result in individual stock performance being differentiated by company fundamentals, to the benefit of high-conviction, fundamental investors;
- 2016 marked the eighth consecutive year the S&P 500 had a positive return. The index has never had a nine year winning streak;
- Going back to 2008, this is one of the longest periods of US outperformance on record (compared against developed international markets);
- At 7.9 years of age, this bull market is now the second longest in S&P 500 history, and over twice as long as the historic norm; and
- History indicates presidents keep approximately 60 percent of their promises (source: FiveThirtyEight)

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