Economic Commentary

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"Ch-Ch-Ch-Ch-Changes Turn and Face the Strange " *- David Bowie - "Changes"*

It is common for writers of end-of-year investment letters to recap the previous year. The past year could be summed up with the Grateful Dead verse: "What a long, strange trip it's been."

The past year has been one of the more confounding periods for market forecasters. When pundits felt stocks were poised for a rally, they fell. When stocks were viewed as likely to have little near-term potential, they rallied sharply. Consensus forecasts on interest rates, currencies and commodity prices were generally wrong. It was by and large a challenging year for investment managers of all types. Of course, most prognosticators also failed to spot the populist wave that drove key election outcomes, including the "Brexit" vote, the U.S. Presidential elections and the Italian constitutional vote.

From a financial markets standpoint, 2016 was a year of significant change. The year began with investor attention focused on the direction of interest rate policy; the single most important item for markets over the past five years. Monetary policy had been the mainstay of the Post-Crisis recovery. Base interest rates had been held at zero percent for so long, the Fed's "zero interest rate policy" (ZIRP) almost seemed normal. When the Fed raised rates in December of 2015 (for the first time in almost ten years) and strongly indicated more hikes would soon be coming, markets panicked. Last January was one of the worst months for stocks since 2008.

As if to accentuate the priority of interest rates over growth, both stocks and bonds rallied off the early lows in the first half, despite weak domestic and global growth rates. The Fed was viewed to be on hold until December, even as early signs of growing domestic strength, especially in US nonfarm payrolls, were beginning to accelerate. These early indicators were dismissed by most investors, who believed the broader global economy was too fragile for the Fed to risk another U.S. rate hike. Of course, the "Brexit" vote helped solidify this view.

On June 23rd, 2016, Great Britain voted to leave the European Union. The E.U. had long been enshrined as a pillar of political progress and a major force in global trade. That one of its major member nations would choose to leave came as a shock to many. The vote precipitated a massive global equity selloff, with some markets falling in excess of 12%. This shock prompted multiple central banks to announce open-ended support for the financial system. This support kept bond yields low while leading to a sharp rally in global equity prices, commodities and the U.S. dollar. The currencies of exporting countries also rebounded from the initial selling on renewed optimism about future sales. Even the Federal Reserve became more cautious, awaiting firmer signs of economic growth.

The election of Donald Trump changed all of this. The election has to rank as one of the strangest campaigns in the history of American politics. A Trump win was widely discounted as a long-shot and few were prepared for the outcome. Following his victory, Trump's talk about growth, fair trade (not free trade) and repealing regulations has resonated with a market starved for a catalyst. Whether these positions can become law, or will even be effective, remains to be seen. However, the results sparked a strong stock market rally and sent bond prices reeling as investors, either gleefully or grudgingly, acknowledged the likely efficacy of the pro-growth policies he has outlined.

Looking ahead to 2017, we start the New Year firmly in expansion mode. The President-elect will be handed a solid economy and his announced policies—whether one finds them agreeable or not—should accelerate growth over the next year or two; a point acknowledged by the Federal Reserve at its last meeting. We expect to see a steady economy in the upcoming year, barring an exogenous event. If there is a systematic risk, it lies in the fact the proposed policies will need time to be fleshed out and implemented. The market is already pricing in the apparent benefits of these changes as if they were already law. Stock prices may be over-extended for certain segments, at least in the short term.

Monetary policy will still remain a major focus in the months ahead, even if it may no longer be the dominant force in the market. Rising commodity prices and continued wage pressures have pushed inflation levels ever closer to the Fed's 2% target range. This target has been a major hurdle for the start of policy normalization, even as other indicators have shown that we are well out of the "emergency" range that prompted ZIRP in the first place. The Fed will have to take explicit action if inflation is sustained at this level for a quarter or two. Many, including several FOMC members, now see three interest rate hikes coming in 2017.

More importantly, the Fed also holds $3.8 billion of government bonds (Treasuries, agencies and agency-MBS) on its balance sheet; a legacy of the Quantitative Easing activities earlier in the decade. It will eventually have to allow these securities to mature (and not be reinvested) or be liquidated through outright sales. They will move slowly on this unwinding, but there is no easy way to add this large supply of bonds back to the market without some disruption. We expect the yield curve to steepen as these holdings are rolled off. The Fed has signaled it would not begin the unwinding process until after the third rate hike. The next move will be the third hike off the ZIRP (zero interest rate policy) bottom. We expect this risk to gain more attention by mid-year.

On a final note, geo-political risks remain a big unknown. As with Brexit, the Trump election reflects voter disdain for the status quo and illustrates a growing wave of populism in the world. This was again the theme in December, when Italy voted not to amend its 1948 constitution, forcing Prime Minister Renzi to resign and prompting new elections. It is likely to continue to be a significant force in the year ahead, in both elections and in political decisions. The risk of an unexpected "event" is certainly increasing, as a result.

Strategy and Market Outlook

Stocks have carried the post-election rally into the New Year. The fundamentals support current prices and there are few indications the broader market is overvalued. We expect "risk assets" to continue to perform well, in anticipation of the pro-growth policies and regulatory reforms set to be in place under the new administration. However, many segments of the market have already seen significant gains, while others will be hurt by the pending changes in government policies. The incoming "growth tide" will not lift all boats evenly.

While risks remain, and may even be elevated, equities are generally under-owned. This year should see a rebalancing back toward traditional asset allocation levels. We are already seeing money flows out of fixed income funds and into equities. Large institutional investors were particularly underweight equities at mid-year and could feel the most pressure to add to their stock holdings, if they have not done so already. Such money flows could support continued buying and add fuel to rally.

While value stocks outperformed growth stocks in 2016, value has still not made up the ground lost in 2014 and 2015. We continue to favor value-oriented stocks with strong cash flows and strong balance sheets in this environment. We believe the risk to these shares - especially for bank and energy stocks - is that many of the potential positives are already priced in as certainties, but may not materialize or may not be as effective as expected when they do come to pass.

On the negative side, expectations of stronger fiscal stimulus plans have caused the value of the dollar to surge. This could hurt the earnings of multinational corporations, export-oriented companies and foreign firms with strong U.S. sales. It also makes imported goods far more attractive to domestic buyers, which might force U.S. companies to slash prices.

A surging dollar is not necessarily a bad event. This has occurred in the past without negative implications for stocks. The late 1990's, for example, saw a strong stock market rally despite an 80% increase in dollar index. Granted, this only happened because earnings multiples expanded rapidly, more than offsetting the impact on corporate earnings; a development that eventually led to a nasty market bubble. Investors will be rewarded for paying attention to valuation metrics in the years ahead.

At the margin, interest rates will be the wild card. The Fed has little cover left to keep rates low. Higher rates are coming, but it is the speed of the rate increases that will matter. Sharp moves will hurt both stocks and bonds, especially longer duration bonds. Steady increases may be more manageable and lead to an old-fashioned "Goldilocks" scenario.

The bond market is not as risky as this may imply. Credit analysis and security selection may trump (no pun intended) central bank actions. Furthermore, the flow of capital to the U.S. from overseas economies, attracted by our higher interest rates and stable currency, should keep US rates lower than Fed commentary suggests. The downside to such flows is the risk a "debt bubble" builds if the deficit is not addressed.

Despite the many vagaries facing the fixed income market, we still see value in maintaining fixed income exposure. And some risks. Virtually all spread sectors of the bond market are at or near their tightest level of the last five years. It is hard for us to imagine the high yield sector being able to come close to the stellar returns posted in 2016, although we expect the sector to be positive on the year. Lower-quality, investment grade corporate bond spreads (BBB) are pushing on 5-year narrows relative to high-quality AAAs; we do expect this relationship to widen only modestly in 2017. We expect total returns for this sector to be attractive on the year. Spreads on mortgages and high-grade corporate bonds, in general, are also tight, but should hold steady in the face of modest rate increases. Municipal bonds may be the best of the worst, since much of the bad news was priced in during the second half of 2016. We continue to like municipals, but they have their issues with credit deterioration, strained budgets, and an unknown tax policy. We intend to keep client portfolio durations on the shorter side of benchmarks and focus on security selection and sector selection to enhance returns.

As always, please contact us should you have questions.

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