# MARKET PERSPECTIVE

JANUARY, 2017

*"The margin of safety is the difference between the percentage rate of the earnings on the stock at the price you pay for it and the rate of earnings on bonds, and that margin of safety is the difference which would absorb unsatisfactory developments"*

**Benjamin Graham: "Thoughts on Security Analysis" March 1972.**

## IN FOCUS:

### *Brief Overview of the Trump Administrative Agenda:*

**In discussing the margin of safety in owning stocks in aggregate terms, we should first understand the context in which market risk is viewed from a geo-political vantage point.** At present, despite only a few weeks into the new administration, a few generalizations can be made concerning the executive branch that promised to dismantle many of the initiatives that the Obama administration spearheaded over the past eight years. His stream of Executive Orders since inauguration demonstrates that we can expect the President, through a micro-management style, to move forward with many of his campaign promises without typically testing the waters of Congressional support. His business initiatives have overtones of a protectionist anti-trade agenda that has been criticized as exhibiting potential inflationary tendencies. This potential headwind for international trade has already negatively impacted the U.S. dollar index that appears to be in a flattening trend perhaps based on some of the uncertainties raised by a Trump presidency. It remains to be seen whether this apolitical approach will prove as effective an economic policy as his winning the U.S. elections.

**Trump's agenda addresses lowering tax rates, reducing regulation from government agencies, upgrading the country's infrastructure, and improving the nation's defense capabilities.** He has also broached that the improvements will be done more efficiently and at lower costs, an attribute of a successful business strategy. With regard to taxation, he advocates a 15% corporate tax rate versus the current 35%, lower tax brackets for individuals with the highest bracket at 33.0% compared to the current 39.6% rate. In addition, the 3.8% tax on investment income to pay for Obamacare will be removed. Capital gains taxes will also be lowered while the Alternative Minimum Tax will be eliminated. Finally, he has proposed that the $2.6 trillion held abroad by companies should be taxed at 10% in order to spur economic growth here in the U.S.

**President Trump has also stated that most deductions should be eliminated with the possible exception of mortgage interest and charitable contributions.** Similar to President Reagan, he believes that the Office of Management and Budget (OMB) should use dynamic scoring in estimating the effects of tax changes on the fiscal Federal budget. The idea of dynamic scoring is that estimates of the fiscal effects of tax cuts should make allowance for the higher economic growth rates that will result from the tax cuts because of higher incentives to spend and invest. His belief is that private spending will have more accelerating effects on economic growth than government spending.

**He has also stressed that lower corporate taxes and eliminating many regulations will result in financial incentives for business** - not dissimilar to the Reagan administration's supply-side argument without the incipient inflation that Paul Volker, then Federal Reserve Chairman, was intent on breaking.

**The above very optimistic outlook does have some caveats, however.** It assumes that the Republican Congress will pass the above measures, while many Republicans favor less government spending to reduce the government debt and are in favor of trying to balance the budget. They also might not believe in the concept of dynamic scoring but prefer the current OMB methodical approach. Many economists believe that a large percentage of tax cuts could be saved, rather than spent or invested. Companies might opt to buy back stock or increase dividends rather than make capital investments or increase research and development spending.

**In addition, the Republican Senate majority is only 52 to 48, and there could be difficulty in getting some important positions filled by the cabinet President Trump has chosen to enact his proposals.** Since 60 votes are needed to approve certain positions, Democratic Senators will be needed to reach the necessary threshold. At present, it appears that financial markets are ignoring all of the details of the necessary actions needed to move President Trump's proposals forward.

## CLOSE-UP: The Economic Landscape

**As we await further clarity on fiscal policy, we would expect the flurry of Executive Orders to slow in the weeks ahead, as President Trump and his administration conclude there are limits on their ability to govern by dictate.** It is clear that if Trump wants to achieve anything of substance, it will require Congressional approval. The question now is whether the administration can successfully modify their approach and work with the legislature. It already appears that health care reform will be delayed for some considerable time because of the difficulties in developing a viable alternative. We believe that the possibility of a meaningful reduction in income tax rates by mid-year is still possible, however, and Trump is set to unveil more details on fiscal policy in his speech to Congress on 28th February.

**We don't expect Fed Chair Janet Yellen to shed much clarity on the outlook for interest rates during her semi-annual Congressional testimony.** The Fed is firmly in wait-and-see mode until it gets a better idea on the size, timing and composition of the proposed fiscal stimulus. We don't expect the Fed to raise rates in March, but do expect a June rate hike and, assuming the fiscal stimulus is concluded successfully, see as many as three more 25bp hikes in the second half of this year. Otherwise, higher gasoline prices will probably push CPI inflation up closer to a five-year high. We expect January's retail sales to be constrained by a drop back in motor vehicle sales from the near-record highs experienced at the end of last year, while industrial production should be constrained by the unseasonably warm weather, which hit utilities output last month.

**Although U.S. equities have surged and U.S. government bonds have rallied since Donald Trump entered the White House, we expect this pattern to continue.** The relationship between U.S. equities and Treasuries has changed markedly since Trump was elected president on 8th November, and can be split into three distinct stages. The *first stage*, which lasted until the Fed hiked rates in mid-December, was when higher equity prices were accompanied by higher bond yields. During the *second phase*, which lasted until Trump's inauguration on January 20th, there was very little change in either equity prices or bond yields. This period was followed by the *third phase* of higher equity prices accompanied by lower bond yields. The first phase is relatively easy to explain. Equity investors welcomed the prospect of a big fiscal stimulus, while bond investors assumed that it would boost inflation as much as growth at this late stage of the business cycle, prompting the Fed to tighten policy more aggressively than they had previously envisaged. The second phase after the election was the "classic pause" - a period during which not much happened. The third phase or last phase in our view, was followed by a recovery in the bond market supported by some signs that fiscal stimulus may be delayed and that it may be less expansionary than many had previously hoped, in which case Fed policy might not need to be as tight as would otherwise be the case.

**How do we explain the most recent surge in the stock market?** One plausible explanation for the surge in equity prices is that the rally in the dollar has run out of steam, which is good news for the multinationals that dominate the S&P 500. However, the dollar came off the highs in early 2017 phase and has since begun to appreciate again. Some offer an alternative explanation for the dollar rebound as a relief rally following Trump's behavior since taking office. One might conclude that the performance of the dollar over the last few months underscores how the relationship between equities and government bonds is not a stable one. This is not surprising because equity prices represent the consensus view on future earnings, the value of which is only partly influenced by the return available on "risk-free" assets. The value of equities is also affected by the rate at which earnings are expected to grow, and by the equity risk premium (the extra yield that investors require for buying equities as opposed to "risk-free" assets).

**For the time being, we think that bond yields and equity prices may be range bound.** Admittedly, any delay in the fiscal stimulus may push back the timing of further increases in the federal funds rate. But we still think that Fed policy longer term will be tighter by a bit more than investors are anticipating, to the detriment of bonds. Meanwhile, we think that some of the heat is likely to come out of equities, whose valuations are now looking a bit stretched on an aggregate basis. Even if there is an eventual boost to earnings from lower taxes, we suspect that it will be muted by a drag from higher wages and further strength in the dollar.

**Our year-end forecast for 2017 is that the 10-year Treasury yield will climb to 3.0% (from 2.3% now), and that the S&P 500 will have some difficulty rising materially higher as P.E. ratios reflect headwinds until greater clarity on the macro landscape emerges.** Any decline in the University of Michigan measures of consumer confidence may represent a fall back, after the initial surge seen in the aftermath of Donald Trump's election victory in November and a recent rebound in gasoline prices. In any case, the index remains at a high level by historic standards and still suggests that consumer spending growth is set to accelerate bolstered by employment growth since the start of the year.

**Does the U.S. need a strong or weak dollar?** A few years ago, when unemployment was high and inflation uncomfortably low, we would have said a weaker dollar was needed to boost aggregate demand via stronger exports. With the economy now close to full employment, however, an equally valid case could be made that a stronger dollar, which would improve real living standards, is more desirable. More than anything else, a relatively stable currency would probably be most helpful over the next couple of years.

**On balance, we still don't think the Fed will raise interest rates at the March FOMC meeting despite a surge in consumer prices of 1.9% in January.** Admittedly, almost half of the increase in headline prices was due to an almost 8% jump in gasoline prices. Even excluding food and energy, core prices increased by 2.3%, from 2.2%. The upshot is that the improvement in consumer confidence since President Donald Trump's election victory now appears to be feeding through into stronger gains in actual spending. Keep in mind that the recent fall in industrial production is only temporary, due to a weather-related slump in utilities output. The drag from the dollar's surge in 2014 and 2015 has mostly faded at this point and global demand appears to be picking up as factory orders should show continued strength as the year progresses.

**Since the time of the Clinton administration, the U.S. has officially had a strong dollar policy.** Even as recently as 2008, Treasury Secretary Hank Paulson was happy to argue that "the strong dollar is in the nation's interest". Nevertheless, what that policy meant in practical terms has been gradually watered down. When recent Treasury Secretaries referred to a "strong" dollar they meant a currency backed by strong economic fundamentals, which international investors could have faith in as a reserve currency when buying U.S. assets.

**The Trump administration appears to have taken a different position moving away from the strong dollar policy**, and some of the comments from Trump, his adviser Peter Navarro, and the incoming Treasury Secretary Steve Mnuchin, even suggest a coordinated effort to talk the dollar down. By reducing the local currency price of U.S. exports, a weaker dollar should boost export volumes. At the same time, imports become more expensive in U.S. dollar terms, resulting in a substitution to cheaper domestically produced goods. The upshot is a boost to aggregate demand.

**There is also the negative income effect, however, because for some goods that have few domestic alternatives (i.e. petroleum), the result is U.S. consumers paying more for domestic products, leaving less to spend on other goods.** In other words, the deterioration in the terms of trade leads to a decline in real living standards. A weaker dollar also leads to gains for U.S. investors on their overseas assets and boosts the overseas earnings of U.S. multinationals when converted back into dollars. With multinationals now accounting for a significant share of the S&P 500, shifts in the dollar could have a notable effect on equity prices and stock market valuations. Our portfolio has 40% of revenues coming from outside North America.

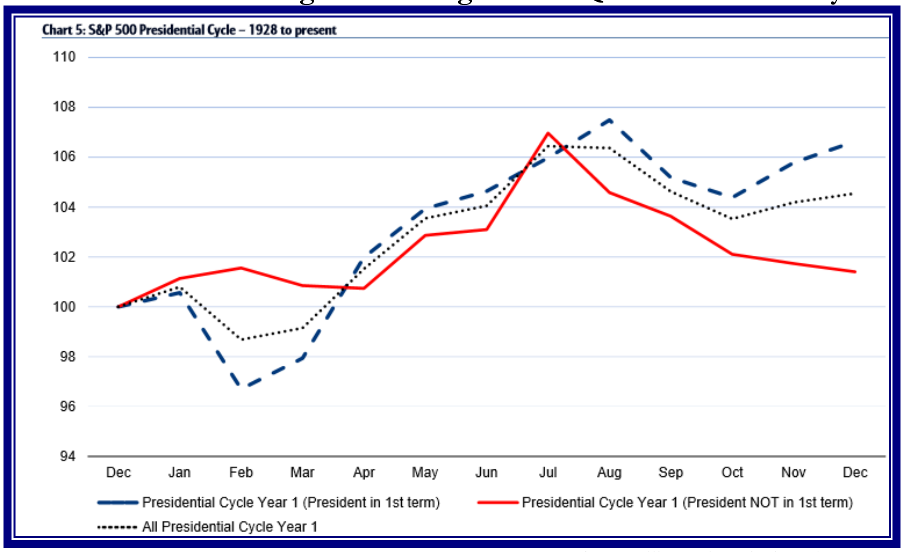
**In addition, the desirability of a currency shift depends crucially on why that shift occurred.** Circumstances matter. We would naturally expect the dollar to appreciate when domestic demand growth was strong and the Fed was hiking interest rates. Currency is a core transmission channel of monetary policy. As far as the impact on inflation and real economic growth are concerned, the speed of the currency adjustment is almost as important as the overall magnitude. The impact of the dollar's recent 20% appreciation in trade weighted terms has a greater impact on economic growth because it occurred in only a year and a half, between mid-2014 and end of 2015.

**Finally, we need to distinguish between nominal and real exchange rates.** The dollar should be appreciating in nominal terms against developing market currencies because the latter will, on average, have higher domestic inflation rates. In nominal terms, the trade-weighted dollar is close to a record high. In real terms, however, which is far more important, the dollar is almost 10% below its peak in 2002 and 20% below its peak in 1985. A weaker currency is preferable when an economy is operating well below capacity because of the resulting boost from net external demand. With the U.S. economy close to full employment, however, it is not clear whether a stronger or weaker currency would be beneficial. A weaker dollar might do little to boost real exports and end up pushing domestic inflation higher. Given its current level and the state of the economic cycle, the U.S. dollar probably doesn't need to rise or fall much at all. In conclusion and most important, a stable currency is probably the most desirable, since it minimizes uncertainty.

## *The Outlook for Financial Markets:*

**The verdict is still out if the above-mentioned uncertainties are removed within the first 100 days of the Trump presidency.** However, history shows us that markets on average do quite well between March and August following the first year of a new presidential term.

**All Else Held Constant…**
**Markets Exhibit Strength Following Weaker Q1 in Presidential Cycles**




Source: BofA Merrill Lynch and Bloomberg

**But we know that in reality nothing is held constant and history is not a guarantee of future returns.** Macro economic analysis is utilized to construct our forecasts and postion our portfolios. Currently, the economy, as measured by GDP, is growing close to a 2.0% rate in terms of our fourth quarter reports and in line with the past seven years' growth rate since the Great Recession. It looks like GDP in 2016 will grow at a rate of 1.6%, as compared to 2.4% and 2.6% in 2014 and 2015 respectively. Trending below historical levels of 2.8% growth is not indicative of inflationary pressures. The anticipated tax cuts, if implemented would provide an immediate boost to the economy, but could potentially weaken the U.S. dollar (USD). The USD spot index, which measures the dollar performance against a basket of the 10 leading global currencies, is off only 3% from its all-time high, so there is room for a pull back before inflationary concerns become prominent.

**The rise in interest rates and in the stock market suggest that future economic growth rates will increase along with corporate profits.** In keeping rates unchanged in February following an increase in December, the Fed reiterated its current accommodative stance. However, in citing confidence in improving labor market and the level of inflation, Fed Chairman Janet Yellen does not see as great a need for continued expansive monetary support going forward. The main concern among investors is that while economic growth might improve, it will be accompanied by higher inflation. The Fed anticipates that gradual adjustments of 2-3 rate hikes this year will allow the U.S. economy to continue to grow at a moderate pace. Historically, the Federal Reserve's interest rate policy has lagged inflation such that it starts to damage the economy and then higher rates are applied that cause a recession.

**Oil prices plummeted in recent years as a result of slowing global demand in conjunction with higher production levels.** The drop in prices was swift and hit earnings of U.S. companies, and stock multiples took a break from the post recessionary rally. Market valuations on a trailing basis are above their 18x historical average. U.S. WTI Oil is now trading around $52 a barrel and looks to have some support at this level. There is room for oil to climb and settle around $60-70 on higher demand and this would bode well for company bottom lines. However, if oil prices rise too quickly and reach loftier levels, this would be inflationary and thus pressure stock multiples. The Energy sector is 7.5% of the market but has a much broader impact indirectly on earnings within other industries, such as banking and transportation. The speed at which oil prices return to normal levels is important to monitor in order to gauge the risk of inflation.

## *Stock Valuations:*

**Market valuations have continued to climb throughout 2016.** At 19x forward earnings, the S&P 500 is now the highest of the current bull market. But what's different this time around is that in prior peak valuation periods the U.S. 10yr, Treasury yield was loftier, above 5%. Whereas the yield is currently only 2.46%, indicating the stock market may have more room to grow. Inflation and Fed target rates also remain historically low and support higher price levels. We will need to monitor GDP as it strengthens to determine whether or not productivity improves coincidently. Over the current market cycle that began in late 2007, productivity has been weak, particularly in the area of output, and remains a concern of the Fed with regard to its timing of interest rate hikes.

**If the S&P 500 remains unchanged at current levels through the end of the year, a 10% increase in earnings this year would actually lower the market price earnings multiple to 15.8%**, while a 20% would lower the earnings to 14.4%. So yes, we would conclude that the multiples are elevated as investors appear to have gotten ahead of earnings. But earnings could do some significant catching up if the Trump programs boost earnings as much as investors now anticipate.

## IN SUMMARY:

**Overall, the economy is growing steadily with no imbalances, and credit conditions remain generally favorable**. Consumption continues to strengthen, housing remains strong, and there is evidence that manufacturing and industrial production continue to improve. At present, both income and employment are healthy year-over-year, and we continue to forecast real GDP growth in excess of 2.5% with CPI inflation of 2.1% and corporate profits exceeding single digit growth record of 2016. The consensus estimate for S&P 500 earnings for 2017 among Wall Street strategists is $130 per share, a gain of 11.1%. While current valuation multiples are elevated, they aren't excessive given record low bond yields and the expectation of accelerating corporate profits in 2017. As we enter the first quarter of 2017, we remain generally optimistic about the economy, although we recognize the expectation that earnings will accelerate is dependent on the successful implementation of a bold economic agenda. The greatest risks ahead lie in trade and foreign policy. Only time will tell what the future will bring.



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