# *2017 INVESTMENT OUTLOOK*

In many ways financial markets ended last year the opposite the way they began. Stock markets commenced 2016 amidst a correction that saw the S&P 500 fall more than 13% over a three-month period through mid-February over concerns about tighter money following the Federal Reserve's first rate hike this cycle. Crude oil prices were collapsing, reaching a low of $26 in the U.S. in the first quarter. Global interest rates reached historic lows with benchmark bond yields trading into negative territory in some countries while the 10-year U.S. Treasury touched 1.36% by early July on the heels of less than stellar GDP growth and benign inflation. Bank stocks declined to three-year lows at the time as energy credit risk and the prolonged impact of low interest rates were on the minds of investors.

By spring the monthly economic data dispelled any near term prospects of recession and global central banks became more vocal about the inherent risks of maintaining zero/negative interest rate policies for prolonged periods, dramatically impacting the business models of important financial intermediaries such as banks and insurance companies. While stocks, bond yields, and commodities rose in tandem through the summer in response to stable growth prospects it wasn't until after the U.S. election that some of the biggest moves occurred. Since the election of Donald Trump on November 8th, the S&P 500 has advanced 6%, the 10-year Treasury has risen 60 bps to 2.45%, and oil prices have risen 20% to $54 per bbl. The U.S. dollar strengthened 7.1% in the fourth quarter alone, the largest appreciation in a quarter since 2008.

The unexpected election results have led to a dramatic shift in policy expectations by financial markets towards the implementation of pro-growth fiscal measures including lower taxes, deregulation, and infrastructure spending, which have the potential to drive higher growth and higher inflation. In essence markets are attracted to the economic "message" despite the flaws of the "messenger," hence the occurrence of a Trump rally in the U.S. equity markets to end 2016.

***Equity Markets – 12/31/16***

| | Index Price Level | 2016 Total Return |
|---|---|---|
| S&P 500 | 2,239 | +12.0% |
| NASDAQ Composite | 5,383 | +8.9% |
| MSCI All Country World Index ex-USA | 725 | +5.0% |

## *Outlook*

As 2017 commences perhaps a key question to consider is whether the "animal spirits" that prevailed in financial markets as 2016 ended will be unleashed in the real economy. With a businessman set to inhabit the Oval Office the U.S. could become more business-friendly in the coming years, leading to greater confidence among the decision-makers that drive the nation's economic engine. Following the election, the National Federation of Independent Business (NFIB) Small Business Optimism Index spiked to its second highest level of the recovery, and this measure of business confidence could still improve further based on survey results that prevailed during previous economic cycles. A pro-business backdrop has the

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potential to attract capital and lead to a drawdown in savings which could drive better productivity growth for the country.

Under Trump, the country is unlikely to experience the 4.5% average GDP growth that prevailed during the Reagan expansion due to the demographic slowdown in growth of the labor force. However, policies that promote higher levels of productivity growth than the 0.7% rate of the past five years can help raise overall GDP growth. Productivity growth has averaged a much higher 2.0% over the past 35 years. Two building blocks to raise productivity are tax reform and regulatory reform. The Federal Reserve's intention to accelerate interest rate hikes could also motivate businesses to increase investment. The challenge will be generating productivity across an economy that is much more service-oriented and much less manufacturing-driven than it was 30-35 years ago under Reagan.

The U.S. has the highest corporate tax rate amongst its developed market peers at 35%, putting it at a competitive disadvantage relative to other economies whose rates are in the 20%-30% range. President-elect Trump proposes to lower the corporate tax rate to 15% while eliminating most business deductions (Congressional Republicans have offered a 20% rate). He has also proposed that businesses be permitted to immediately expense 100% of capital investment (instead of depreciating it over time) and for multinational corporations to be able to repatriate foreign profits at a 10% rate. Mr. Trump is also offering to tax so-called "pass-through" income—the bulk of small business profits—at 15% (the House plan proposes 25%) compared to 39.6% for those individual business owners in the highest marginal bracket. On the individual front various proposals aim to reduce the number of tax brackets from seven to three as well as to eliminate the estate tax.

Passing legislation is a much different task than simply making proposals. Both parties indicated a desire for tax reform and simplification of the tax code during the campaign season. However, the challenge now will be crafting policy that becomes permanent, which requires a filibuster-proof 60 votes in the Senate and hence a minimum of 8 Democrats crossing the aisle in bipartisan manner. Even if they fail on this front, the Republican–led Congress will still be able to pass tax legislation through budget reconciliation measures that ensure enactment for a ten-year period. Such policies will be fiscally more expansive than current law. Mr. Trump is sure to have run-ins with his own Republican Congress, too, who want tax cuts to be financed with across-the-board spending cuts elsewhere in the federal budget. It's unlikely that the GOP accepts the tenet that "deficits don't matter" and improbable it will allow large shortfalls in the budget over the near term in exchange for the higher growth that Trump's economic team is promising over the medium term.

While tax cuts have generally been good for the economy the devil is in the details. The ultimate impact on job creation and capital investment is uncertain, especially eight years into an economic expansion. Some measures floated by the GOP such as a border adjustment on imported goods could offset a portion of the incremental benefits of lower rates. Nonetheless, businesses could see an increase in their after-tax profits and the investor class is likely to benefit as more funds become available for dividends, share repurchases, and M&A. As an example, a purely domestic enterprise whose effective federal rate is at the 35% level would see a 15% boost in after-tax profits (and a similar boost to its stock price assuming its current P/E ratio prevails) even if the corporate rate fell to a less dramatic 25% under a compromise scenario. Multinational corporations with global profit streams would experience less of an overall benefit but still see their U.S. tax liability fall. This is one reason stocks have reacted positively following the election results.

Public investment as a share of GDP has fallen to its lowest level since the end of WWII at just 3.3% and much of the nation's infrastructure is approaching the end its intended lifespan. Trump's pledge to spend $1 trillion over 10 years on infrastructure could run head-on into Republican intransigence on deficit spending, coupled with an unaccommodating Federal Reserve. The Congressional Budget Office projects rising deficits throughout his first term due to entitlement benefits even assuming a recession is avoided. Republicans have been very skeptical of stimulus programs in general following the experience of 2009 with so-called "shovel-

ready" jobs. Such projects take time to get off the ground and passing legislation will take intricate planning, considerable coaxing of GOP members, and creative financing. Thus, it is a bit of a surprise to see many industrial stocks immediately snap higher following the election and trade at 13-year high P/E ratios while management teams remain cautious and profit benefits so uncertain.

A recent Barron's cover piece promotes the return of Build America Bonds in which the federal government subsidizes a portion of the interest expense for municipalities to finance such projects. This seems like a reasonable idea as it pushes decision-making and most of the financial burden to the local level and avoids a massive spike in the federal deficit. Mr. Trump would be wise to move on an infrastructure plan early in his term as such policy generally garners bipartisan support. Economists on both sides of the aisle believe it has a higher multiplier effect on GDP than general government spending and is positive for job creation.

The prospects of more accommodating fiscal policy could assist the Federal Reserve in raising interest rates to more normalized levels. Following just two rate hikes over a 10 ½ year period, the median expectation of FOMC members is currently for three increases in 2017, which would put the fed funds rate between 1.25%-1.50% by year-end. Longer term interest rates moved higher after the election due to the magnitude of fiscal measures being discussed and the potential for such stimulus to spur higher inflation in the U.S. given the current unemployment rate of 4.6% is approaching the trough of prior cycles. Chairwoman Yellen reasons that fiscal stimulus this late in the economic cycle has the potential to be inflationary as the supply of available labor dwindles. We suspect that the labor force still has some slack considering a portion of the decline in the unemployment rate over the past year or so is due to folks leaving the labor force. Wage growth also continues to be uneven. Nonetheless, measures of inflation across various global economies have picked up recently as oil and various industrial commodity prices have risen. This bears watching as the year unfolds.

The strength of the U.S. dollar could temper the growth and inflation outlook, however, and limit the number of rate hikes during the year. A stronger dollar leads to lower prices on imported goods into the U.S. and makes U.S. exports less competitive with the rest of the world. The dollar could be considered the de facto fed funds rate for the rest of the world. When the Federal Reserve raises interest rates at home and the dollar strengthens it tightens financial conditions across the globe, especially in emerging markets that need to service dollar-denominated debt. In essence, all of the dollars that flowed out of the U.S. and into other financial and goods markets during the easy money policies of the past are now beginning to be called back home. This could crimp global fundamentals. Stocks, in particular, are priced for an economic pickup based on successful execution of a pro-growth agenda by the new administration. If the anticipated legislation gets delayed or watered down and the expected growth does not materialize, then higher rates and a stronger dollar would be detrimental to fundamentals.

Perhaps for no other economy is the direction of the dollar more critical than it is for China, which continues to see capital flee the mainland amidst a property bubble and a banking system that is effectively insolvent. The yuan declined 6.5% in 2016, suffering its worst year of losses vs. the dollar since 1994. Nearly $800 billion left the country last year through November and its foreign exchange reserves hit a five-year low of $3 trillion. As a recent Bloomberg article simply states, China is caught between trying to prop up a currency facing long term decline and letting capital leave at will, risking a banking crisis. This comes alongside protectionist trade rhetoric from Mr. Trump, who seems to be fighting yesterday's battle regarding the Chinese currency.

While one could argue that the Chinese currency was kept artificially weak during the previous economic cycle due to its strict peg to the dollar at that time, the yuan is probably set to depreciate further due to the country's real estate bubble, high corporate debt levels, capital flight, and slowing growth. Such decline could exacerbate trade tensions even further. Mr. Trump will need to soften his stance on China or he risks dampening the growth prospects of the global economy, which is already experiencing stagnant trade flows

due to weak demand and the slowdown in China. We're hopeful that his rhetoric is just an opening gambit to more thoughtful negotiations but this risk bears watching as Mr. Trump tapped uber-China critic Peter Navarro to lead his new White House trade council.

The Eurozone presents some additional uncertainties as 2017 begins. National elections will be held in Germany, France, and the Netherlands and there is the potential for snap elections to be called in Italy following the resignation of its prime minister in December. A populist, anti-Euro backlash is gaining momentum due to the ongoing migrant crisis and Brexit vote in June as well as a decline in living standards in many peripheral countries. The Eurozone has also failed to clean up its banking system, which poses substantial risk to medium term growth. According to KPMG, the European banking sector has about $1.2 trillion in nonperforming loans, nearly three times as much compared to the U.S. Italian banks pose the greatest risk near term with 18% of their loans gone sour. Resolution has been complicated by Eurozone rules that impose losses on creditors including mom-and-pop investors who bought bank bonds without understanding the risks. Bloomberg estimates that Italian banks need at least $54 billion to resurrect their balance sheets, much more than proposed government rescue packages.

There are other parts of the economy we are also watching closely to see how events unfold throughout the year. Various healthcare stocks have come under pressure following the election due to the uncertainty surrounding the Affordable Care Act (ACA) and Mr. Trump's rhetoric around drug pricing. While the ACA was essentially Medicaid entitlement expansion disguised as healthcare reform, repealing the law without immediately replacing it could lead to additional spikes in premiums for individuals that want to remain covered but cannot afford it; political backlash could ensue. The 30-year mortgage rate has spiked to over 4.5%, a level last seen in early 2014, and this could impact refinancing activity and the marginal demand for housing. Commercial real estate prices are back to historical peak levels, a concern of some Federal Reserve Governors of keeping money too easy for too long. Oil prices have climbed back into the mid-$50's on the back of OPEC production curtailment promises while domestic production growth in the U.S. has resumed since mid-October following a 16-month decline. Prices are approaching levels which could induce resumption in U.S. shale investment and temper further price gains.

## *Investment Conclusion*

The economy appears to have some momentum as the calendar turns with the Atlanta GDPNow forecast of fourth quarter GDP growth at 2.9% and monthly manufacturing activity across many geographies climbing to multi-year highs during the month of December. The presidency of Donald Trump is going to be anything but conventional, so investors should be prepared for volatility. The pro-growth agenda could give the economy better fundamental underpinnings and allow the Federal Reserve to begin to normalize interest rates, but the timing of policy implementation and the magnitude of economic response is uncertain. Stocks are priced at a historically high premium at a time when the central bank is contemplating multiple rate hikes. The stock market's trailing P/E ratio has climbed 12% over the past year to 19.3x earnings, a valuation not seen since early 2004 when profits were growing at a 20% rate. Our best estimate for the year ahead is for earnings growth of 5-8% but that range is prone to revision as the year progresses. Thus, we remain in capital protection mode but on the lookout for individual opportunities as they evolve based on our company-specific research and individual stock valuations. Higher interest rates would present an opportunity to extend the maturity of our bond ladders but could also pose a hindrance to higher stock prices.

January 5, 2017