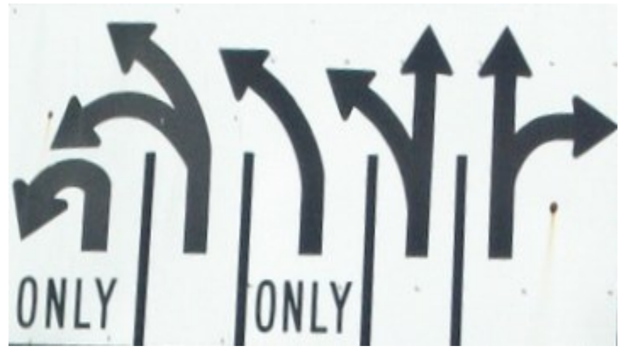
A New Direction

Volume I, 2017

President-elect Trump campaigned heavily on reducing corporate taxes, government regulation and unfair trading practices, in addition to repealing Obamacare, strengthening defense spending and implementing a national infrastructure spending plan. The "unexpected" election of Donald Trump has sparked a sharp rise in both business and consumer confidence based on the potential for significant business-friendly changes ahead.

The difference between these heightened expectations and the reality of practical politics will determine the actual levels of consumer spending and business investment, and the reaction of financial markets over the coming year. Our expectation is that the Federal Reserve will potentially play a much larger role than expected in determining the slope and direction of the economy in 2017.



In this issue we discuss the expected market impact of each of the major factors that drove Trump's victory, explore the administration's likelihood of delivering on his campaign rhetoric and how that will impact financial markets over the 2017 investment horizon, given other key influences, both domestic and international.

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Election Recap

Our October newsletter examined the upcoming Presidential election and the underlying factors we felt would tilt the scales towards Donald Trump. We highlighted such issues as widespread polling fallacies, turnout failures of key Democrat constituencies, the emergence of "margin of shame" Trump voters, and other sundry factors, writing:

"It is highly unlikely that Hillary will pull a D+6 result in 2016. In fact, tracking results show African American, Hispanic and youth absentee ballot requests and early voting ballots are down 10-30% from a similar period in 2012 in key markets, while cross-over Democrat voters are boosting Trump's numbers in others."

The oft-spoken mantra of Trump having *"No path to 270"* was at its heart a 'narrative' across much of the mainstream press, left, right and center, to discourage Trump voters from showing up. In fact, they did show up, with Trump outperforming expectations for each of the groups listed above, in addition to an expansion in Midwestern working class whites and evangelicals of all stripes.

The election result was a shock to many who gave too much credence to the consensus thinking, and not enough to a critical examination of the underlying data; a pattern we find often repeats itself in the analysis of modern financial markets.

While President-elect Trump's cabinet appointments have largely pleased Conservatives, and in some cases horrified Progressives, the emerging pattern is one where traditional politicians, lobbyists and consultants will likely find no meaningful place in a Trump administration. This means market strategists and analysts would be wise to embrace an extra measure of caution and humility in forming their prognostications for 2017.

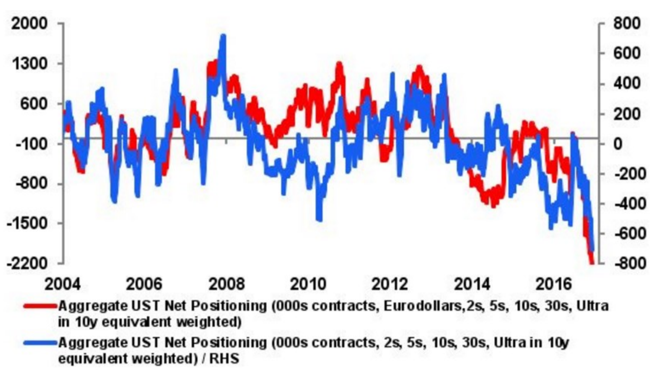
We concluded our October newsletter with the following summary: "*Governing is much harder than campaigning and neither of the candidates will get a free ride to implement their visions. Other than short term reactions in certain sectors, we don't anticipate much in the way of a long term market reaction from a new President. We maintain the Fed will be the key factor in 2017.*" Below we take a look at what we believe will be the key factors to influence U.S. financial markets in 2017.

The Fed is the Key

As we forecast in May of *2015*, the Fed formally began the tightening phase of their monetary policy at their last meeting, raising the Fed Funds rate by 25 basis points, with expectations of three more increases next year. We had held, against consensus opinion for the last 17 months, that U.S economic growth was too tepid, the global political and economic situation too unsettled, and inflation pressures too subdued for the Fed to be taken seriously in their statements signaling an imminent rise in rates over the last year. Our stated forecast was that the Fed would not embark on the next tightening cycle until September 2016 at the earliest, and most likely not until December.

As the tightening cycle now begins, potential changes in the Board of Governors loom, and economic growth outlooks and yield dynamics abroad continue to shift, we feel we can't emphasize enough the importance of Fed policy in the coming year. Indeed, several global central banks have already followed suit in raising rates, in an effort to maintain a static yield spread with the U.S and to stabilize their currencies.

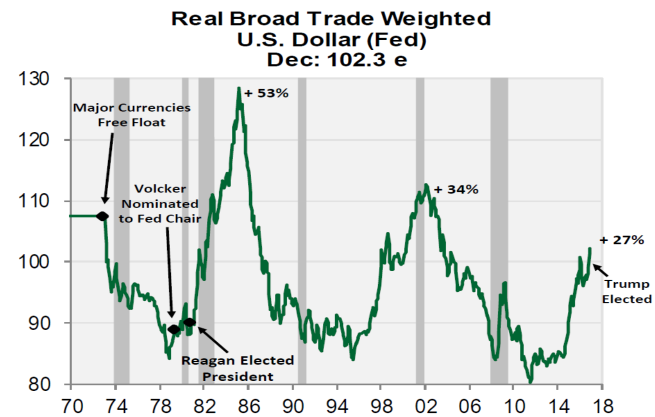
Much has been written about the sharp backup in U.S Treasury yields since the election; does it foreshadow increasing inflation expectations, or a likely higher demand for borrowed funds as the economy ignites under Trump's expected fiscal policies? We expect neither to be much of a factor, and that the rise is largely a function of Chinese sales of Treasuries to support the value of the Yuan, and a <u>massive</u> short position among speculators, nearly five standard deviations above normal according to this recent analysis by Citigroup.



Rising interest rates present a strong headwind to continuing improvements in economic growth; impacting trade, the housing industry, consumer finance companies, and auto dealers (where delinquency rates are climbing sharply). It wouldn't take much of a policy misstep to overcome the newfound expansion of business and consumer confidence and send spending and investment back into a renewed slump.

Dollars and Sense

As expected, the U.S. dollar (USD) rallied strongly after the election on expectations for a stronger outlook for the U.S. economy and continued stability in U.S. rates, hitting 14-year highs, while the Euro/USD exchange rate has hit 13-year lows. As a result, U.S. manufacturers may see their export prices rise, decreasing their price competitiveness abroad at the same time that their repatriated earnings from abroad contribute less to the bottom line, negatively impacting valuations.



Source: Cornerstone Macro Research / (Grey bars represent recessions)

The biggest impact will likely be on the larger exporters relative to small businesses, who depend more on local markets for sales even in the face of a more globalized economy. The latter, while benefiting from relatively cheaper imported foreign components and raw inputs do not face the same magnitude of exchange rate pressures on their mostly domestic sales.

At the same time, higher oil prices (priced in U.S dollars) will likely lead to trade challenges for China and the emerging market countries as their input costs rise faster than their relatively cheaper exports in a slowing global economy. Whether the dollar continues to advance will depend largely upon whether investors believe the actual implementation of PE Trump's business-friendly policies will occur within a reasonable time-frame, as advertised, or in a weakened form.

While the dollar appears a bit overbought at the moment, we see it maintaining its relative strength over the coming year even if much of the Trump administration's pro-business agenda doesn't take effect until late 2017 or early 2018. In fact, the dollar could even see relative strength in the event of a global recession (similar to the recessions of the early 1980's). It is really driven by the *relative* strength of the U.S economy, and the likely *easing* of global interest rates as our trading partners face renewed economic weakness both at home and abroad.

Trumponomics

As we write the S&P 500 is up nearly 9% from election day as investors embrace the possibility of a more business-friendly administration that appears to be long on action and quick on implementation. There will likely be numerous areas of opportunity, conflict and a few possible surprises ahead in the coming months. As we wrote in our October newsletter:

"A Trump Presidency would likely see him in an ongoing battle between the Democrats on his left and Establishment Republicans on his right. The odds are long for Trump building "The Wall", cutting corporate taxes to 15%, repealing Obamacare, nuking U.S. trade agreements, raising defense spending, shutting down the EPA, IRS or DHS, etc., or passing term limits without a protracted and bloody fight from both sides."

However, a "lighter" version of the more economic related issues above are likely to get some traction, and collectively would produce a much more positive economic environment for the U.S. at home, and possibly weaken our economic competitors abroad. The questions are likelihood, timing and implementation.

The recent surge in consumer and business confidence has been a key to short term market performance and is perhaps equally important for an economic resurgence if it translates into actual spending and investment. Business confidence increased due to the outlook for lower regulatory burdens and lower tax rates, but is offset by the potential for trade and tariff wars, especially with China. As we discussed above, small, domestic businesses are better positioned to benefit the most if our projections hold. But timing will be the sticky part, with reality likely a 2018 phenomenon.

Any meaningful impact from a national infrastructure spending program, whose passage is anything but assured, is likely to be a late-2017/2018 phenomenon. Current weakness in Industrial Production and Capacity Utilization rates indicate the economy may muddle along until businesses are confidant that tax relief will occur. Tax cuts, when approved, will likely be effective in 2018, which may paradoxically lead to capital spending sluggishness in 2017 as spending is delayed.

As a result we still expect economic growth to be around 2% or so at least until 2018, which implies that while some improvement may be seen in hiring and employment, the majority of the impact may be delayed. The question then becomes will the enthusiasm, increased confidence and market highs be maintained until investors can glimpse the actual turn?

We see the more political of Trump's campaign promises being more difficult to obtain, and likely to require a good deal more political capital. We suspect, given his personality, that Trump will be inclined to fight multiple battles on multiple fronts, counting on his cabinet heads to spearhead the efforts. While we expect most of his cabinet picks to encounter limited resistance, we foresee that his Supreme Court nominee will likely face a bruising confirmation if they are indeed "in the mold of former Justice Anthony Scalia".

We suspect that given the broad perceived mandate that Trump will claim, both he and his opposition will have to choose their battles wisely in order to be effective. We expect a mixture of both practical and symbolic issues to be addressed in the first 100 days. We also see Trump making significant use of both alternative media and social media to get his message out, not counting on the traditional media to fairly present his positions to the public. We are quite certain that his non-traditional campaign approach will translate directly into a non-traditional Presidency.

Trade Policies

As we mentioned in the Dollar discussion, China has continued to struggle with internal growth targets, currency outflows and a challenging export outlook, even before the recent dollar rally. We expect more strident language, especially around any proposed tariffs on imported goods, if such policies exacerbate the situation. It is highly likely that China would retaliate directly against the U.S., and that other impacted nations will as well. We expect any trade battle will cause far more economic harm to China, and others, than to the U.S.

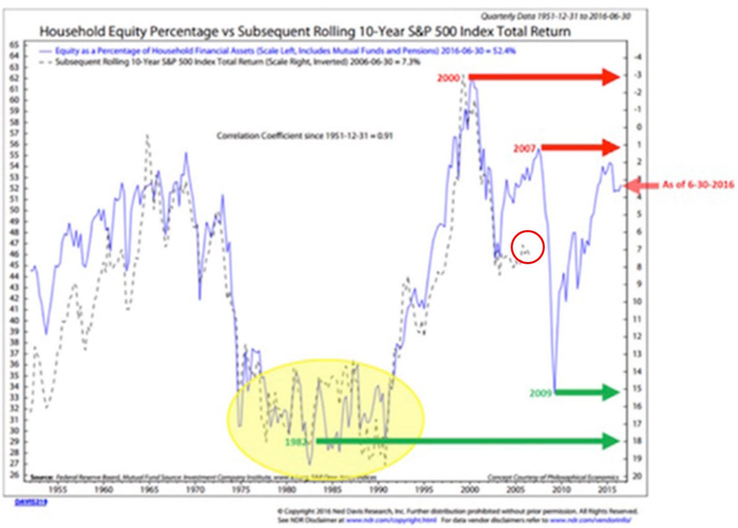
As we discussed above, China has been selling U.S Treasuries (for dollars) and converting the proceeds back into Yuan in an attempt to support their currency. A stronger dollar (weaker yuan) increases the costs of imports into China from the U.S. which negatively impacts their economy, and hinders their transition from a production economy to a consumer economy.

Overall, we expect that Trump's trade policies will be a net positive for the U.S. over time. The challenge is that the global economy is already operating well below capacity with many countries already in, or near recession. Any additional slippage due to tariffs and trade wars will likely result in more countries slipping into recession, as Canada recently did. We will watch this area very closely in the coming months.

Volatility and Returns

If there is anything we're sure of in the coming year it's that volatility, across most asset classes, will return. When, in aggregate, investors possess strongly held beliefs (and possibly starkly contradictory beliefs depending upon their individual ideologies) it can not help but inform their outlooks, and hence positioning and confidence levels in various asset classes and securities. The question, as always, is whether the new-found confidence and enthusiasm of the bulls can outweigh the potential despair and foreboding of the bears as the year unwinds and the data unspools.

Expected Future Returns



http://www.zerohedge.com/news/2016-12-23/6-charts-make-case-we-are-long-term-secular-bear

The chart to the left from *Ned Davis Research* depicts, in aggregate, equities as a percentage of household assets (blue line-left axis), compared to the 10-year trailing average returns for the S&P 500 index (dotted line-right axis/inverted). Two facts should jump out as relevant to the reader; there is a high correlation between the movements of the two data series, and lower aggregate beginning equity holdings correspond with generally higher 10-year trailing equity returns.

Two more observations should give the reader pause. The only way for the current value (red circle) of the dotted line (trailing 10-year returns) to revert to a tighter match to the blue line (2007 historical equity holdings) in 2017 is for a significant selloff to occur. The second observation is that as of June 2016 the household equity holdings for the S&P would correspond to a 3.5% target for annual returns over the next 10 years. We note that these series are reflective of historical data, and are not necessarily predictive in nature, but the strong correlation does give us pause.

Finally, John Mauldin recently noted that it has been 1955 days since we suffered a 20% correction. Since 1928, the average number of days before a 20% correction was 635, with the current case now more than three times that average (for the whole period from 1-3-1928 to 12-8-2016). While we can't guarantee a significant correction will occur in any given period our caution entering 2017 remains high.

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Now What?

We have remained mildly cautious on equities as the modest summer rally faded throughout the fall, and even through the post-election bounce. Our perception of market risks remains elevated and we maintain our underweight positions in small caps, international and emerging market equities. We also maintain our positions in high quality, medium duration bonds, **and would begin to lower weightings to high yield bonds and interest rate sensitive securities at this point.**

It could be several quarters before the true impact of Trump's policies are felt in the actual data, as opposed to current expectations and measures of confidence. In the meantime we feel the greater potential impact on portfolios will be driven by the actions of global central banks, including the Federal reserve.

If you would like more information please contact us at 954 809-6363.