Insights: January 2017

Market Overview and Performance

By and large, the last month of 2016 proved to be a fairly tepid one. That's easy to understand given a backdrop with a tremendous amount of unknowns surrounding the reality of a future under a Trump administration. Essentially, much of what we discussed In November held true for December as well. Rather than waiting around for action or proof, the Market "monetized hope." In fact, the Market has a well established track record of this kind of behavior historically, but it can often lead to a "buy the rumor, sell the news" reversal in the days following. For now, markets seem content to believe that an environment with lower taxes and decreased regulation will yield future growth. History is always an important guide in uncertain times and as we stand at the precipice of a transition of power in the White House, it's remarkable to read the words of the first outgoing President, George Washington. 220 years ago in his farewell address he voiced his concerns that are still relevant today writing, "Party factions become potent engines, by which cunning, ambitious, and unprincipled men will be enabled to subvert the power of the people and to usurp for themselves the power of government." Adding, "It agitates the community…kindles the animosity…and opens the door to foreign influence and corruption." He also warned about rising federal debt and unequal foreign trade policies. This is all virtually right out of today's headlines. We remain hopeful that Trump policies will result in constructive outcomes, however, it's a bit unnerving that no one is pricing in the possibility of a negative scenario. We shall see. As always, thank you for reading our latest Insights.

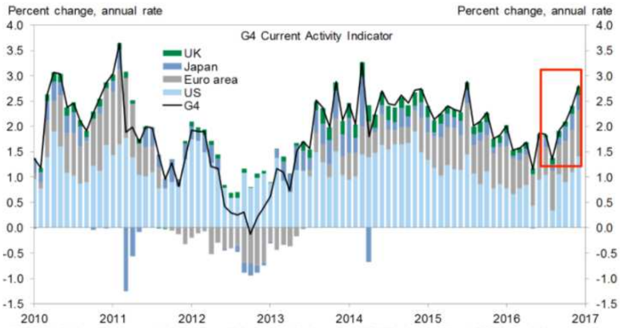
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.98	11.96
Russell 2000 Index	2.80	**21.31**
MSCI EAFE Index	**3.42**	**1.00**
MSCI Emerging Markets Index	0.22	11.19
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.14	2.65
Barclay's U.S. Credit Index	0.61	5.63
Barclay's Corporate High Yield Index	1.85	**17.13**
Barclay's Municipal Bond Index	1.17	0.25
Macro Measures		
Gold	-1.89	8.57
Crude Oil	8.66	**45.03**
CBOE Volatility Index	5.33	**-22.90**
USD Dollar Index	0.67	3.50

Current Theme – Hope for Trump to Deliver Part II

Markets Look to the First 100 Days for Policy Action

On the positive side, 2016 ended on solid footing economically. There are many data points that have altered course since the Trump election victory, however, at a base level, global economic activity moved forward at an increasingly brisk pace as the year came to a close. As seen below, the major G4 economies of the United States, the United Kingdom, Japan and the Eurozone all witnessed growth trending higher.

Global Economic Activity Increased as 2016 Concluded

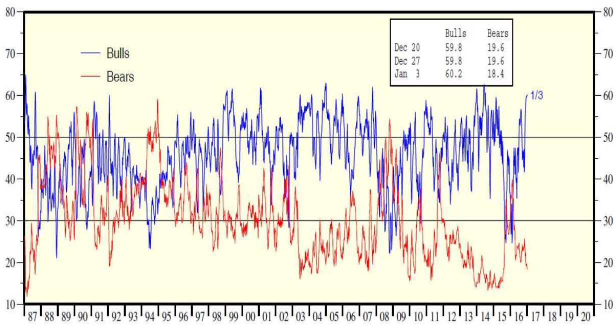


Note: Contributions have been calculated by combining the individual economies' CAI levels according to IMF PPP weights.

Source: Federal Reserve Board; Bloomberg; Goldman Sachs Global Investment Research

It also comes as no surprise that the hope surrounding the potential benefits of the tax cuts and de-regulation being discussing has translated into much higher sentiment readings. In fact, bullish investors now outnumber their bearish counterparts by more than three to one.

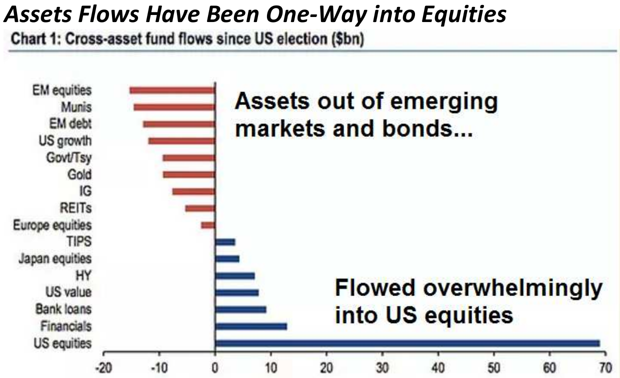
Bullish Sentiment Approaching Prior Peak Levels



Source: Yardeni.com

Those kind of extreme sentiment readings typically suggest that current trends are closer to their end than their beginning. We would not argue otherwise, but between the election and the close of the calendar year, it would have been challenging to fight the one way trend of asset flows charted below.

Assets Flows Have Been One-Way into Equities



Source: BofAML Global Investment Research; EPFR Global

The consequence of this has been that the once "kind-of-pricey" U.S. equity market has become outright expensive. As we have said in the past, expensive markets don't necessarily exclude further gains going forward, however it helps to get some context on just what current valuation levels look like relative to the past. As Goldman Sachs highlights below, the aggregate market in highly valued by almost any measure and the median stock is now in the 98th percentile of its historical range, meaning it has only traded at a higher valuation during 2 percent of it entire history.

S&P 500 and Median Stock are Rarely More Expensive

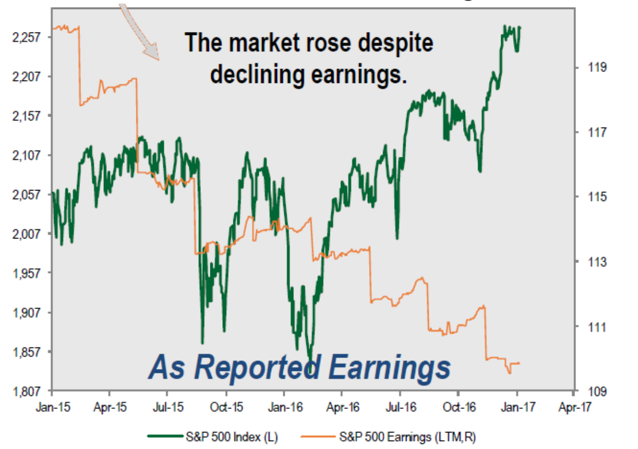
Exhibit 31: Historical valuation of index and median stock since 1976 for all metrics except PEG ratio (1982) and free cash flow yield (1990)

	Aggregate index		Median stock	
S&P 500 valuation metric	Current	Historical %ile	Current	Historical %ile
P/E to growth (PEG)	1.5 x	97 %	1.9 x	100 %
EV / sales	2.1 x	94	2.7 x	100
EV / EBITDA	11.3 x	88	11.4 x	99
Forward P/E	17.4 x	88	17.7 x	95
Cyclically adjusted P/E (CAPE)	23.7 x	85	NA	NA
Price / book	2.9 x	76	3.3 x	98
Free cash flow yield	4.4 %	43	4.8 %	30
Median metric		88 %		98 %

Source: Goldman Sachs Global Investment Research

Now again, high valuations in and of themselves do not prevent stock prices from going higher. However, what we now need to see to support these high ratios and allow for future gains is an advance in earnings. For all of 2016, we witnessed a sharp decline in earnings while stocks continued to move higher as shown in the chart below.

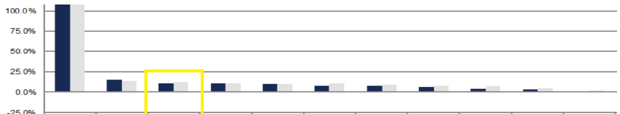
P/E's Growth Drove 2016 Gains, Not Earnings



Source: Cornerstone Macro

Earnings growth drives stock prices over the longer-term so it is vital that earnings catch up to what has been priced into the market. Given all of the hope around a more business friendly environment under Trump, one would think that those earnings estimates would be climbing notably higher for 2017. But that is not the case.

2017 Earnings Estimates Continue to Move Downward

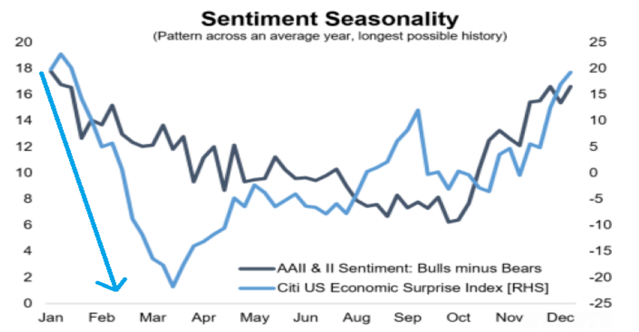


	Energy	Materials	S&P 500	Financials	Info. Technology	Consumer Disc.	Health Care	Consumer Staples	Industrials	Telecom Services	Utilities
Today	343.6%	15.9%	11.5%	11.3%	11.1%	9.0%	8.5%	6.8%	4.1%	3.7%	0.2%
30-Sep	317.7%	14.8%	13.0%	11.9%	11.2%	11.5%	10.3%	9.0%	7.7%	4.7%	2.1%

Source: Factset

As the table above from Factset highlights, despite an eye-popping +300% anticipated growth out of the energy sector this year, estimates for the overall market have ratcheted downward since September 30th. This seems out of synch with the Trump hope trade, but it actually makes sense if you view it through the lens of a CEO or CFO of a public company. Essentially, no one really has a clue as to what the shape and size of any simulative policies will come to look like should they become reality. Even if the Trump pro-business wish list was mostly approved, any effects would not be seen until late 2017 at the earliest. As a result, corporate managements and analysts have been reluctant to raise any projections and in fact have done the opposite. Industrial giant Caterpillar for example, whose stock shot 14 percent higher following the election, took the opportunity in December to lower guidance after expectations for a Trump induced bonanza for their business segment had gotten out of hand in their opinion. As 4Q 2016 earnings season kicks off, we are likely to see more of this lowering trend. Companies essentially have a free pass to lower the bar for 2017, blaming it on an uncertain regulatory and fiscal environment, with an added incentive that Trump policies might actually end up helping their bottom line by the end of the year. Before we even mention Trump trade policies, there are some other headwinds to consider as well.

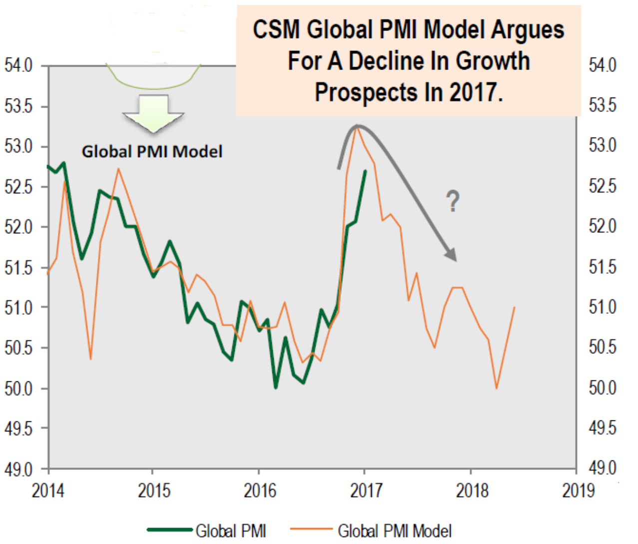
Economic Data Tends to Weaken in the First Few Months



Source: TopDown Charts; Thomson Reuters

As you can see from the chart above, economic surprises which surged right on cue during the last quarter of 2016, historically trend sharply lower during the first three months of the year. This also has the follow-on effect of knocking down that investor sentiment we mentioned earlier – the one that just happens to be close to all-time highs right now. "So what?" you might ask, seasonal patterns are not causation. That is true. To get a more concrete view of what lies ahead, Cornerstone Macro has actually created a model comprised of a number of inputs including credit conditions, monetary policy and inflation which has proved prescient. As you can see from the chart on the following page, their model is anticipating a fairly steep decline in global activity throughout all of 2017.

Global Economic Activity Poised to Slow in 2017?



Source: Cornerstone Macro

Cornerstone Macro is in the ***only*** bearish strategist we have come across this year. While their estimate of a 15-20 percent decline for the S&P 500 in 2017 is not very appealing, the consensus Wall Street strategist estimate points to a target of 2356 which is a mere 4 percent higher than current trading levels. That kind of cautious tone again seems to fly in the face of the Trump hope thesis. What's driving this contradiction?

As we said, we have basically only seen a monetization of hope at this point. The realities present some challenges, most obviously, a stronger dollar and higher interest rates, and more frightening, the potential for a trade war. Legendary bond investor Bill Gross, who somewhat shockingly compared Trump's strong-arm tactics regarding corporate behavior to that of Mussolini in the 1920's, wrote in early January of his skepticism about Trump's ability to push GDP growth from 2 percent to 3 percent. As he put it, "Demographic negatives of an aging population, high debt/GDP now more at risk due to rising interest rates, technological displacement of human labor, and finally the deceleration/retreat of globalization pose negative ongoing threats to productivity and therefore GDP growth." The key metric he is watching will be the moves in the yield of the 10-year Treasury, and he makes it clear that the current trend is very concerning in his view.

Rising 10 Year Treasury Yield Testing 30 Year Resistance

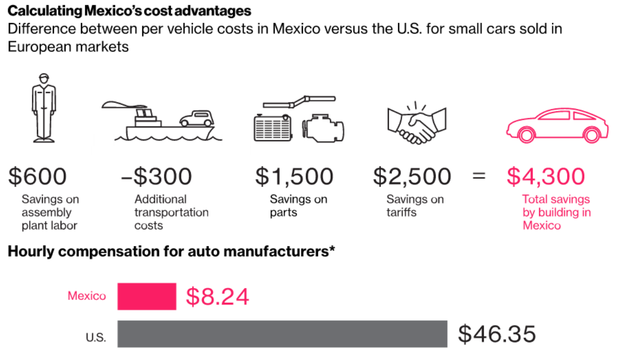
Source: Janus Capital; Bloomberg

"If 2.60% is broken on the upside – a secular bear bond market has begun. Watch the 2.6% level. Much more important than Dow 20,000. Much more important than $60-a-barrel oil. Much more important than Dollar/Euro parity at 1.00. It is the key to interest rate levels and perhaps stock price levels in 2017."

Investors as whole certainly aren't quite as worried about the future as Mr. Gross. We will not argue with them, however, we do find it astounding that the market is pricing in effectively zero probability of a negative outcome. At a minimum, even if tax cuts and fiscal spending plans are approved, they are likely to be whittled down by those in Congress concerned about deficits. In our view though, the biggest economic danger by far is the potential for tariffs and protectionist policies to drastically reduce global growth.

In last month's Insights letter, we discussed some of the implications of Trump's stated desire to place a 45 percent tariff on goods imported from China and a 35 percent tariff on goods from Mexico. Over the course of the last 30 days, Trump has stepped up the rhetoric of these policy threats almost exclusively through his use of Twitter. This has universally caused consternation among economists and strategists who unequivocally believe that protectionist policies serve as the biggest impediment to Trump efforts to stimulate U.S. domestic growth. Consider the details surrounding automobile manufacturing in Mexico, something Trump has very publically lambasted as hurting Americans. It is no secret why manufactures would prefer to assemble goods outside of the U.S.

Cost Advantages to Manufacturing in Mexico are Large



Source: Bloomberg

As the chart above clearly highlights, there are tremendous cost advantages to manufacturing a car in Mexico rather than the U.S. In the example above regarding a $25,000 mid sized sedan, a manufacturer would save almost 20 percent by building the car in Mexico. While labor is certainly cheaper, the bulk of the benefit comes from tariff savings. Mexico has trade agreements with 44 countries giving automakers access to half of the global market tariff free according to Bloomberg. The U.S. by contrast has agreements with only 20 nations which account for just 9 percent of the market. The most recent data from 2014 suggests that automakers avoided $770 million in tariffs that they would have paid if their exports had come from the U.S. instead of elsewhere. Ironically, if Trump could simply match the trade deals, with the EU in particular, he could eliminate that $2500 per vehicle tariff and level the playing field. So negotiating more global trade deals rather than placing punitive roadblocks to trade would help spur grow more effectively. Otherwise, the cost will simply be passed on to the end consumer which certainly won't benefit the average American. As Brian Krzanich, CEO of Intel which manufacturers almost entirely within the U.S. and exports 75 percent of their product stated, "The real answer is not a trade war. It not restrictions. It's really about making the U.S. more competitive."

Obviously, China is a huge part of global trade. As we discussed last month, China has many options to retaliate if they believe it is warranted. In December, the Communist Party there stated, "There are flowers around the gate of China's Ministry of Commerce, but there are also big sticks hidden inside of the door – they both await Americans." Any U.S. tariffs would likely be met with similar Chinese tariffs, taxes and anti-trust probes on U.S. businesses, a sharp reduction of imported U.S. goods like soybeans and maize, a curbing of orders of goods like cars and planes, and maintenance of a weaker Yuan relative to the Dollar. This "tit-for-tat" response would hit U.S. consumers the most as the prices of things like clothing and appliances rise while farming and manufacturing jobs are placed in jeopardy.

Again, a trade war is a worst case scenario, not our base case. We remain optimistic that a decrease in corporate and individual taxes and a fiscal spending initiative combined with a pro-business environment with fewer regulations will spur U.S. growth by late 2017 and beyond.

We did not touch this month on the developments in Europe, but it has been a busy time. Banco Monte dei Paschi required a $20 billion rescue package from the Italian government and UniCredit and Deutsche Bank are in the process of raising some $20 billion in total as well. It should be noted that between 2007 and 2014 the world's top 20 banks (17 of them European) have raised over $300 billion in capital to really no effect (via Financial Times). Additionally, UK Prime Minster Theresa May, confirmed that there will be a "hard Brexit" meaning there will be no single trade agreement with the EU. Essentially, her "red line they would not cross" is immigration control. This theme is prevalent throughout Europe right now and looks to have a prominent impact on the course of EU as 2017 progresses.

The European Political Calendar in 2017 is Busy

Date	Country/region	Event
15-Mar-17	Netherlands	General election
31-Mar-17	UK/EU	PM May's article 50 deadline
13-Apr-17	France	Presidential election, Round 1
02-May-17	France	Presidential election, Round 2
04-May-17	UK	Local elections
Sep-17	Norway	Parliamentary Election
Oct-17	Germany	Federal elections
May-18	Italy	General election, scheduled date

Source: Goldman Sachs Global Investment Research

Going Forward

As we stated last month, despite what short-term market behavior would suggest, there is very little in Trump's policies going forward that can be viewed with any certainty. That being said, as an investor, one has to look at the higher probability of events occurring and invest accordingly until facts change. Therefore, we are looking to opportunistically allocate a portion of the cash balance in our portfolios to areas that would benefit from a suggested "Trumpenomics" agenda. Namely, we are looking to add to value sectors which have underperformed for quite some time and stand to benefit from a fiscally simulative environment in the United States. With Trump slated to assume office in a matter of days, the first 100 days of his Presidency will be key. If he disappoints on the details of his domestic agenda or turns his immediate attention to creating more disruption internationally, the "Trump Rally" could easily reverse lower in short order. We choose to be nimble at present allowing us to take advantage of both positive and negative scenarios.

Within equities we continue to favor the large cap segment of the U.S. market specifically within the financial and energy sectors which would benefit from a raising interest rate environment, increased fiscal spending on infrastructure and a lower corporate tax environment. We also favor the technology and healthcare sectors which have rebounded since an initial post election sell-off since the election. If the Trump administration can succeed in getting tax holiday legislation passed, it would allow these companies to re-patriate billons in cash sitting overseas. This has the potential to unleash a tremendous wave of mergers and acquisitions since both sectors derive large amount of revenue from overseas. Although small and mid cap stocks are well positioned to benefit from Trumpenomics' domestic growth bent, that area of the stock market has become notably expensive. We would wait for a more attractive valuation levels before adding to exposure.

Equity markets outside of the U.S. have underperformed significantly in 2016 and therefore may present an area of focus for 2017. Despite unresolved debt issues in various countries and the ongoing precarious banking situation, economic data within the Euro Area has shown signs of resilience and with continued accommodative policies in place, Europe could present an opportunity as we look to next year. Particularly if we get an increase in inflation that policy makers have sought for so long. Again, this is highly dependent on what transpires with Trump policies. If protectionist tariffs lead to trade and currency wars, the environment overseas could quickly turn challenging from an investment perspective. This view holds true for our Japan exposure as well. After an extended period of underperformance, emerging markets are intriguing, however, the prospect of a strong US dollar and rising borrowing costs going forward are significant headwinds so we would prefer to monitor before adding to exposure.

As the post election down-draft clearly demonstrated, traditional fixed income is in fact vulnerable to periodic declines. As interest rates look almost certain to climb throughout 2017, we place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. With the recent sell-off after the election we feel that the opportunity in the muni markets is very attractive at present with reasonable valuations and compelling yields.

With the announcement of an OPEC production cut in late November, the price of oil has seemingly stabilized around $50 and could climb higher in 2017 as global growth has the potential to expand. However, the sector remains vulnerable to over-production, a strong U.S. dollar and Trump policy miscues, so we would suggest vigilance in the space. After a notable and surprising post-election sell-off, gold has rebounded somewhat in the early days of January. Given the macro outlook of a rising interest rate environment and a strong U.S. dollar, we are not buyers of gold for fundamental reasons. However, we have maintained a small position in certain portfolios as a hedge and have used to the recent pullback in the price of gold to add to positons when appropriate.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.