Insights: April 2017

Market Overview and Performance

And so the pause sets in. While equity and bond returns were unremarkable on an absolute basis, March undoubtedly signaled a shift in the narrative. Without sugar coating the current state of affairs, it's simply been a rough period for Donald Trump. Shockingly so. The effort to repeal and replace the Affordable Care Act crumbling at the hands of his own party, coupled with a luke warm reception to his first pass at budget changes, a chilly meeting with the leader of Germany and of course unanswered questions regarding his relationship with Russia, culminated in a collective "wait a second.." moment for the market. As Eric Peters, Chief Investment Officer at One River Asset Management paraphrased in his most recent weekly commentary, Mr. Market sat back in his chair and begun to question, "How's he going to cut taxes and make it revenue neutral? How's he going to do massive infrastructure when we are so deep in debt? And why is the yield curve flattening? Why is loan demand declining? Why is consumer confidence at historic highs while retailer stocks are getting demolished? What happens if he can't cut corporate taxes? What happens if we have calibrated earnings to a future that was just an illusion?" To be fair, many of these issues would still have been in place no matter who won the election, and political inexperience can account for some implementation missteps, but as we have discussed in the past, the market has priced in a future that is simply not justified by the current fundamentals. As a result, we'll have to wait and see how long this pause lasts. As always, thank you for reading our latest Insights.

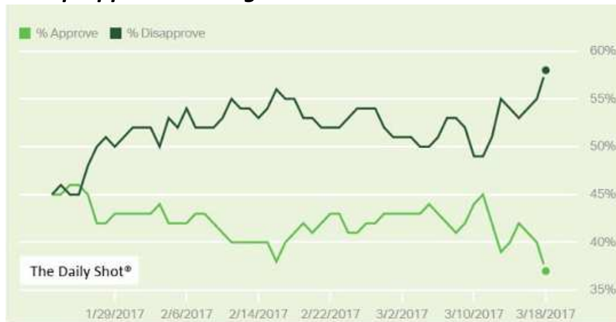
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	0.12	6.07
Russell 2000 Index	0.13	2.47
MSCI EAFE Index	2.75	7.25
MSCI Emerging Markets Index	2.52	**11.44**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.05	0.82
Barclay's U.S. Credit Index	-0.15	1.30
Barclay's Corporate High Yield Index	-0.22	2.70
Barclay's Municipal Bond Index	0.22	1.58
Macro Measures		
Gold	-0.22	**8.64**
Crude Oil	-6.74	-5.81
CBOE Volatility Index	-4.45	-11.89
USD Dollar Index	-0.80	**-1.61**

Current Theme – Market Shifts Attention from "When will the Trump Agenda get implemented?" to "Will any of the reforms actually ever get passed? The Market Rotates as a Result.

Markets Have Not Given up on Trump Priorities but the Playbook has Changed

Regardless of your politics, the below chart is not an encouraging sign for the leader of a country that generates 25 percent of the world's GDP.

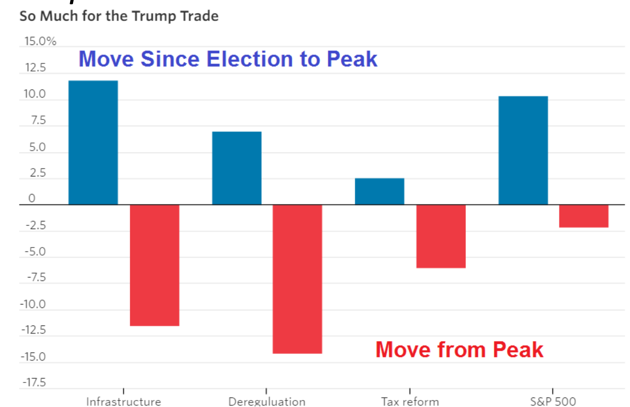
Trump Approval Rating Has Cratered to Historic Lows



Source: Gallup; The Daily Shot

While not a perfect correlation, the markets have mirrored this trend in the approval rating as well. As we all know, the idea was that once Trump got into office, he would cut taxes, ease regulation and launch an infrastructure spending program. This in turn would spur a period of reflation and growth in the U.S. economy. Just buy financials and small caps and a few industrials. The U.S. Dollar and interest rates will go up, so avoid non-U.S stocks, bonds and gold. Simple, right? Well, that worked until it didn't. As we said in our opening comments, the events of March certainly altered investor thinking about the future, but if we look closely, it becomes clear that the "Trump Trade" outlined above actually peaked in December. If you had asked most portfolio managers and strategists how they believed stocks would react to the lack of progress by the Trump administration and particularly to the failure to replace the Affordable Care Act, most would generally give you an answer of down 5 to 10 percent perhaps. But that is not what has transpired. Instead of selling risk assets, investors have subtlety but unquestionably rotated away from the Trump Trade. As JP Morgan, highlights in the chart below, the Trump thematic trades have reversed.

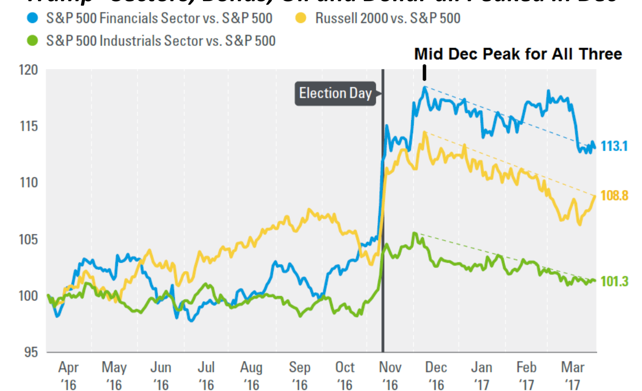
Trump Trade Themes Have Reversed Course



Source: JP Morgan Chase & Co.

And as we mentioned, in hindsight, the Trump Trade actually peaked in mid-December. Since that time, "Trump" sectors, bonds, oil and the U.S. Dollar have all declined.

"Trump" Sectors, Bonds, Oil and Dollar all Peaked in Dec

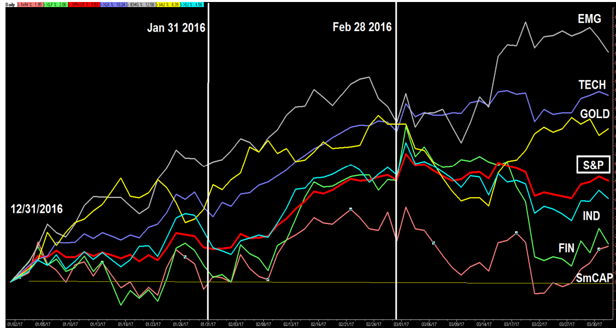


Source: LPL Financial Research

This trend isn't particularly intuitive since markets have been incredibly resilient. Even the seemingly endless stream of news about Russian conspiracies, policy failures and Trump's erratic Twitter feed have not been able to pull stocks lower. So if the Trump trade is getting tired and investors have not buckled to the countless uncertainties floating about, where has the money been going? Rather than park in the safety and assurance of cash, they have quietly moved into what

would have been viewed as the "anti-Trump" trades heading into this year.

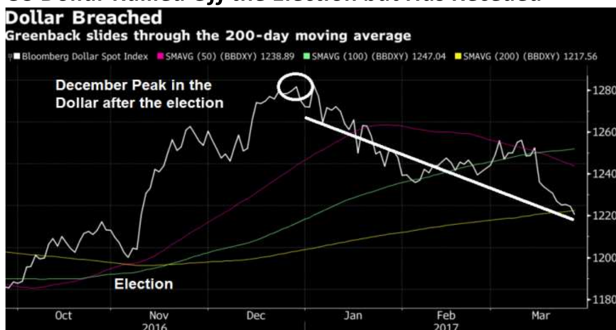
"Anti-Trump" Trades Have Led Thus Far in 2017



Source: Thomson Reuters

Investors have clearly favored Emerging markets, Technology and Gold in 2017. This would suggest that the initial sharp "Trump Hope" trade narrative that took hold immediately after the election has run out of steam. In fact, other market internals outside of equities are confirming that this trade is on the wane as well. Below we can see that the Dollar and the yield curve have come down off the post election rally, peaking in mid December along with the other Trump Trades.

US Dollar Rallied Off the Election but Has Receded



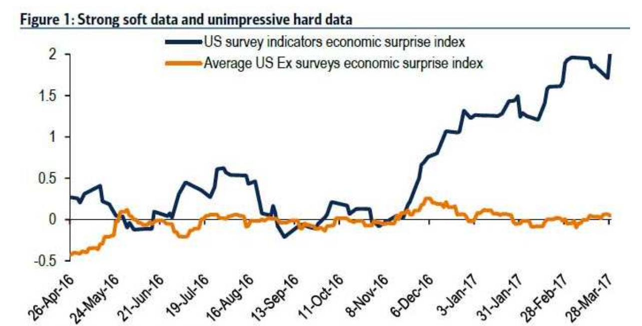
Source: Bloomberg

Yield Curve Has Flattened Since Mid December

Source: Federal Reserve Bank of St Louis

Most troubling is the flattening of the yield curve as measured by the 10 Year Treasury yield minus the 2 year. A flattening suggests that the bond market is anticipating both *lower* growth and inflation going forward. This is certainly not in the Trump playbook. Neither is the chart below which shows that there remains an enormous gap between "hard" economic data and "soft" sentiment data.

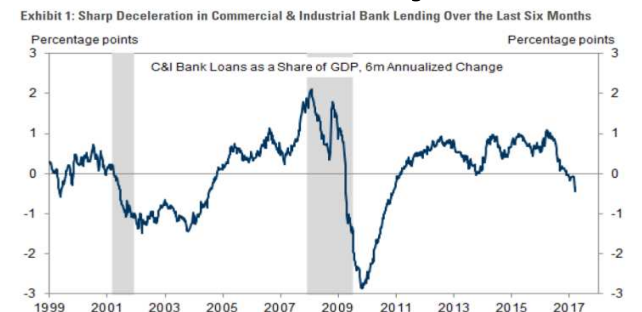
Gap Between Hard and Soft Data Remains Unresolved



Source: BofA ML Investment Research

This disparity between these two measures will eventually resolve itself, but as of now, investors are still patiently waiting (and hoping) for the hard data to catch up to the soft data trajectory. It just hasn't happened yet. On the positive side, the labor market remains very stable and earnings are estimated to grow by 9 percent in the first quarter which would help to alleviate what are still very high stock valuations. However, we continue to see softness in other areas. For example, despite several surveys suggesting that consumer confidence is near all time highs, consumer spending has been very tepid in 2017 and is now at six month lows. More troubling, the chart below illustrates commercial and industrial lending growth. Not only has it declined, it has now turned sharply negative.

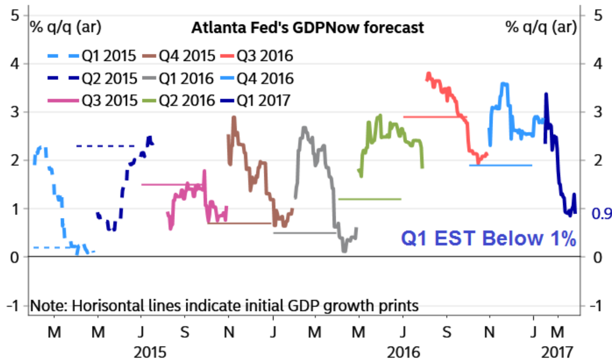
Commercial & Industrial Bank Lending Has Declined



Source: Goldman Sachs Global Investment Research

Lending and borrowing activity is generally viewed as a proxy for overall economic health. This is a very important measure to watch going forward, but if we look more broadly, the cumulative results are not suggesting much economic growth either. The Federal Reserve Bank of Atlanta estimates quarterly GDP based on the 13 subcomponents that comprise the GDP figure. As you can see below, in 2017, their estimate for Q1 has fallen dramatically from over 3 percent to less than one percent. Based on current labor market productivity, the Congressional Budget Office has estimated that annual GDP will only average 1.9 percent for *the next 30 years*. Now we are not saying that the economy is in bad shape, its fine if uninspiring, but the point is that stimulating real growth is going to take a lot more than promises and hope.

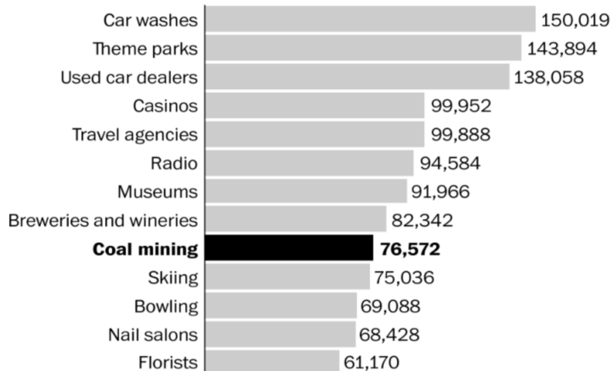
Q1 2017 GDP Growth is Estimated to be Less than 1%



Source: Nordea Markets and Macrobond

It's no secret that Trump has promised to "Make American Great Again" by returning to sectors that drove the U.S. economy some 40 years ago. This simply does not make economic sense. For example, consider the numbers in the chart below.

Coal Industry Represents a Very Small Number of US Jobs



Source: Washington Post; Census Business Patterns

Trump has focused on areas like coal production, but the free market has already decided that new alternatives will drive future consumption. At a base level, natural gas has already outstripped coal as the main source of electricity generation in the U.S. and the number of jobs (and investment) in renewables far outpaces that of coal. By comparison, the coal industry employs about 80,000 people while just solar and wind by themselves employ roughly 500,000 people according to the US Department of Energy. Referring back to the previous graph, Trump could make a much bigger impact by supporting breweries, nail salons, and car washes – they all have constant demand, are cheap to operate and reside within a growing business segment. Coal has none of this.

Trump has also focused on automobile production in the U.S. Unlike the warning signs from some of the data we discussed this is one area of the economy that is actually flashing some potential signs of danger. After a tremendous run of growth from 2009, auto sales appear to have peaked in 2016. Sales in 2017 are in decline, inventories are at historic highs and auto loans – this is the key - are getting worse.

Auto Trade Ins With Negative Equity are Rising – at Peak

Exhibit 7: Over 30% of all trade-ins toward the purchase of a new car through the first three quarters of 2016 were underwater - the highest rate on record

Source: Edmund's; Morgan Stanley Research

Moody's has termed the present situation the "trade in treadmill". Basically, a car buyer purchased a vehicle with a loan and three years later trades in the vehicle for new one without having fully paid off the first car. As Morgan Stanley estimates, demand for used cars is in decline with prices likely to fall by 20-50 percent. Therefore the trade-in car is worth less than the amount owed on the loan. Lenders are then being forced to take greater risk by rolling this

negative equity into a new loan with an even higher chance of default. These sub-prime auto loans are of course then bundled into a nice high-yielding product and sold to pension funds and the like. *This is very akin to how the MBS collapse began in 2007*. The parallel has come to the attention of several market observers and Wall Street firms and is a very important trend to watch. Bringing the discussion back a bit, given the current dynamics, the automotive sector hardly seems like a good candidate to be bringing on more supply at higher production costs.

As we talked about in the past, an obvious question would be, “Why does Trump even bother fooling around with all this old-industry and healthcare stuff? Why not just move directly to tax reform?” Without sounding trite, the answer is “Because it’s complicated”.

Essentially, healthcare had to be addressed to get to the good stuff that the market and the economy want. Tax reform requires tax cuts and within that process there will be both winners and losers. To simplify, Trump needed the $300 billion in savings generated from repealing the ACA and about another $100 million or so from a border adjustment tax to compensate the losers. But a border tax creates losers as well and the free trade advocates within the Republican Party are not going to have any of it. So to get any sort of tax reform legislation passed, Trump is forced to try to work with the Democrats who have absolutely no incentive to help him. Well then, maybe he can just boost the deficit for a while you might say? On this front, he is restricted in what he can do by the Byrd rule which limits deficit increases. So back to his own party then, right? Well, the free market figures amongst the Republicans are not likely to warm to the idea of higher deficits. Oh and by the way, this is the segment of the party that has the backing both ideologically and financially from the traditional Republican establishment. They hate Obamacare and they hate the notion of a border tax. So yes, its complicated. Both Trump and the market seem to be recognizing the enormity of the challenges to get tax reform enacted. Reagan was the last to successfully do it 30 years and it took him two years of negotiating to get it done.

In the meantime, other events are influencing the future of global trade. We did not discuss it this month, but a huge historical event occurred in March when United Kingdom trigged their exit from the European Union. They now have two years to negotiate exit and trade terms, with Prime Minister Theresa May setting the stage by stating, “No deal is better than a bad deal.” This will be an incredibly difficult transition starting with a $60 billion dollar exit fee levied by the EU all the way down fishing rights in UK waters which were previously open to all 28 member countries, to Spain saying “as long as you are leaving, we will take Gibraltar back” and on, and on. The point here is that the unilateral global trade policies of the past are being ripped apart. And at the end of April, there is a chance that Marie Le Pen wins the French national election and takes her own country down the exit route as well.

The precedent of Brexit will shape how U.S. trade with Europe will look in the future, but with Xi Jinping, the leader of China coming to meet with Trump this week, Asia will certainly be in focus. Global trade is obviously at a pivot point and with the U.S. exiting the Trans Pacific Partnership, seeking to renegotiate NAFTA and backing out of the LATAM Development Fund, China has a lot to gain. If the U.S. formalizes its withdrawal from international trade partnerships and implements border taxes, China is likely to set up and fill the void. Already, they have moved forward with the Regional Comprehensive Economic Partnership, a rival trade pact to TPP, which includes 46 percent of the global population and 40 percent of global trade.

Trump and Xi Jinping will likely present a public appearance of great cooperation, condemning the actions of North Korea and the like, but as Trump himself Tweeted “The meeting next week with China will be a very difficult one in that we can no longer have massive trade deficits.” While Trump is juggling China relations and healthcare and tax reform, he also has to deal with the not so inconsequential issue that Congress has until April 28th to avoid a government shutdown. If you recall, this caused a credit downgrade in 2011. Ordinarily, a bipartisan deal would easily be struck, but given recent events all bets are off.

Going Forward

Trumps inability to implement any real pro-business policies coupled with his uncomfortable relationship with the rest of the globe has increased uncertainty. The honeymoon was short, but appears to be over. With valuations at historically high levels and tax and fiscal policy implementation not likely to appear anytime soon, we maintain our cautious posture. We are still in "show me" mode regarding Trump's actions until economic fundamentals indicate otherwise. As the failed healthcare reform process highlighted, the reality of getting things done is going to be very difficult. We choose to be nimble at present and feel that the present risk/reward proposition is tilted towards the downside.

Within equities we continue to favor the large cap segment of the U.S. market. We favor the technology, healthcare and consumer discretionary sectors which have rebounded since an initial post election sell-off and have now outperformed the broader market year to date. The financial and industrial sectors have benefited from an anticipated rising interest rate environment, increased fiscal spending on infrastructure and a lower corporate tax environment. Despite recent relative underperformance, we believe these sectors are still attractive going forward as well. 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. Since mid-December, the smaller segment of the market has trailed the larger cap components.

Equity markets outside of the U.S. underperformed significantly in 2016 and therefore are an area of focus for 2017. Despite attractive valuations and an accommodative backdrop, Europe has been a question mark. However, with U.S. equities at such extended valuation levels, we feel that there is a better risk reward trade off in global equities outside of the U.S. The heavy European election calendar will shape the trend going forward as will the debt situation in the periphery countries. Japan and Asia-ex Japan are attractive in our view as well, with many companies trading at reasonable valuations, paying solid dividends, and exhibiting above average growth rates. After an extended period of underperformance, emerging markets as a whole have taken a leadership role so far in 2017. Valuations levels have been cheap in emerging markets for some time, but now we are seeing some evidence of accelerating earnings growth and the once "sure thing" of U.S. Dollar strength, a headwind for the group, appears to be waning.

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.

Despite the OPEC production cut in late November, the price of oil has declined as supply data continue to show robust production. Energy companies themselves however, should benefit from an end to the challenging environment seen in 2015 and 2016. After a notable and surprising post-election sell-off, gold has rebounded nicely in 2017. 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 the commodity has been an additive exposure thus far in 2017. With the risk/reward profile of both equities and fixed income not compelling at the moment, gold is an area we would add to as global uncertainty increases. We have been adding gold to our portfolios this quarter.

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.

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