Observations and Outlook

April 9, 2017

Selected Index Returns 1st Quarter 2017

Dow Jones Industrials 5.19%   S&P 500 6.07%   MSCI Europe 7.44%   Gold 8.3%

Small Cap (Russell 2000) 2.47%   Emerging Mkts 11.4%   High Yld Bonds 2.32%

US Aggregate Bond .82%   US Treasury 20+Yr 1.41%   DJ/UBS Commodity -2.33%

Equity prices peaked on March 1 and have been sideways to down since. Interest rates (10-yr treasury) peaked on December 16 and were nearly matched on March 10, but since then have declined, going slightly below the range we have seen since November 22. Gold bottomed in mid-December (along with bond prices), climbed to a high in late February and as of today, is pushing through that high mark. On balance, risk assets have ebbed lower while bonds and gold have increased in price since the end of February. Bond and gold prices have climbed back to their mid and early November (post-election) levels. This price action speaks directly to the “Trump/Reflation Trade” we hear about in the news.

Trump Trade Withers

Source: heisenbergreport.com
The “Trump Trade” is seen to manifest itself in a rising US Dollar (green), higher stock prices (purple) and higher interest rates (blue).
The Trade has gone nowhere since mid-December, and was decidedly weaker as ACA reform failed to pass in Congress.

The past five months’ gains in the stock markets have been widely attributed to the policies the new administration hopes to implement. At the same time, U.S. corporate earnings ended an Earnings Recession, that had pulled down earnings to 2012 levels. In the fourth quarter of 2016 the earnings recession ended and had been forecast to do so since early in 2016. Most of the gain in earnings was due to the base-effect seen in the energy sector. Energy sector earnings plummeted in 2015 and provided a low bar for earnings to cease its ‘negative growth’. The two concurrent topics that coincided with the latest rapid climb in stock prices were the cessation of declining earnings, and anticipated policy changes along with their presumed financial impacts.

For the remainder of the year, the focus will remain on these two areas: **earnings and implementation of Trump's promised policy changes.** The repeal and replacement of the ACA (Obamacare) did not occur and its unknown when it may. Recently this was seen as the gateway to then reforming the tax code followed by a fiscal spending plan focused around a decrease in social programs, a large increase in defense spending and a $1T to $2T 'infrastructure' plan. With the defeat of the first attempt to repeal and replace ACA, the collective Trump Trade was dealt a blow and the remaining policies passage and implementation are less certain.

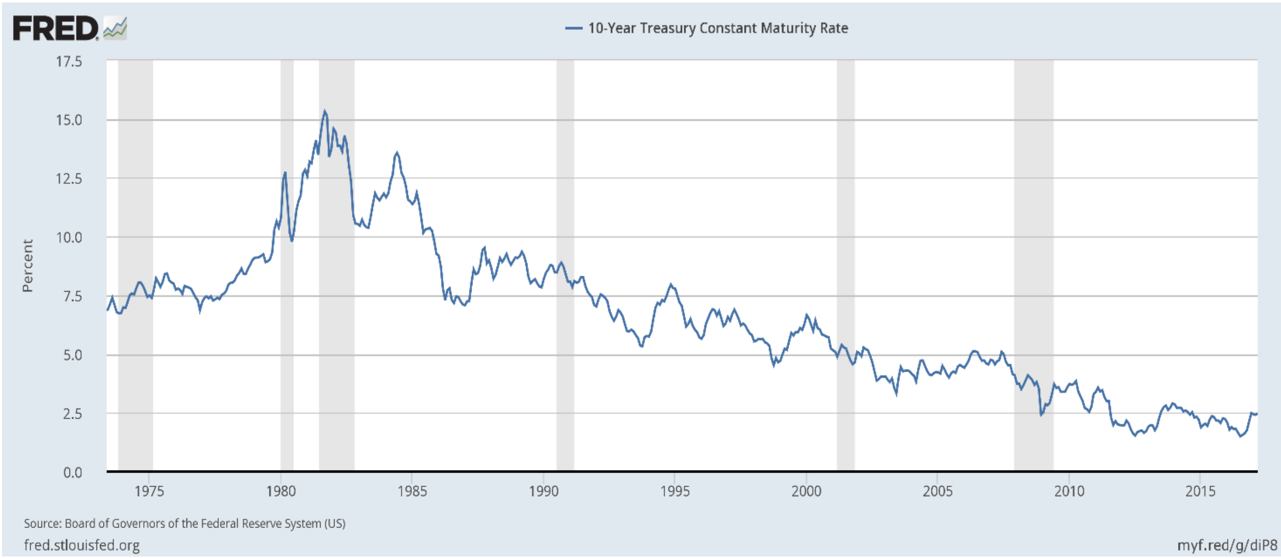
Tax policy and regulatory reform are next up and as the conversation around these begins, it's likely that hope of tax law change will increase. The expectation that these changes will have a meaningful impact on earnings and disposable income will buoy stock prices in the short term. Passage, implementation, and resulting impacts of policy changes are literally a multi-quarter process. During that time, as I indicated in January, ***markets are likely to swing up and down several percentage points*** as hope of passage and fear of failure compete for investors' attention.

The low bar for the energy sector remains low, and analysts' expectations for earnings to grow remains intact, supported by the lower-than-usual reduction in earnings forecast. Often a full year's earnings forecast can drop by 1/4 through the course of the year, and when we see earnings estimates decline less rapidly the end of year reduction is often more like only a 1/8 reduction from beginning of year estimates to end of year final numbers. Current 2017 earnings estimates are $119.80, which is about 5% lower than forecast a year ago and 1% lower than forecast at the end of 2016. Continuing this pace of reduction, an estimate for 2017 earnings is $112.50. IF that number is accurate it puts the forward Price to Earnings ratio at 20.9, which is higher than 90% of all other time periods since 1900. ***Longer term forward returns from this level are often in the low single digits.***

Over short periods of time (less than 3 years) investors often bid up prices well above longer term averages, which we have seen since 2014 and the start of the earnings recession. Stock prices have risen far faster than earnings have over the past 4 years and its likely with growth resuming we could see even more extended valuations.

Other Considerations

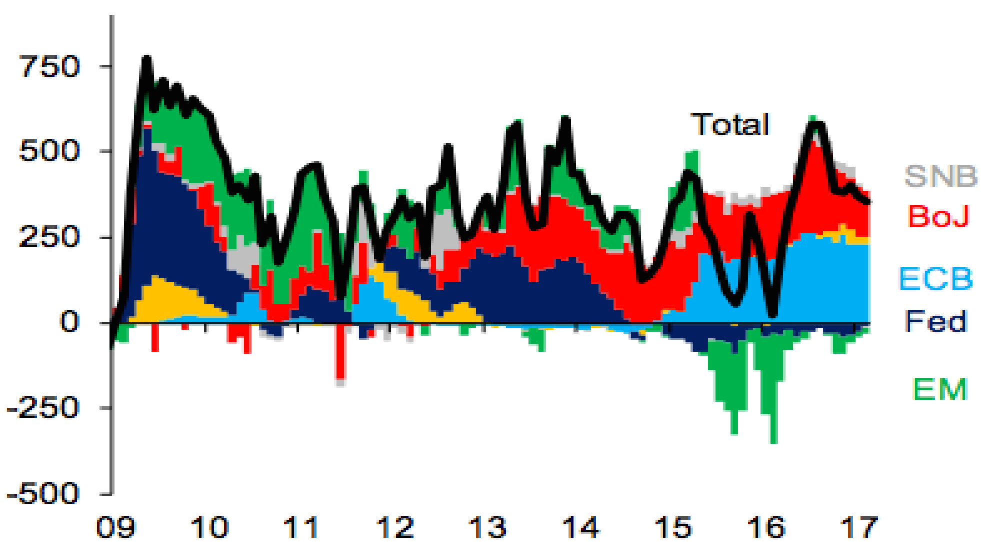
The 30-year bond bull market is not dead. Over the past few years, the idea that low interest rates were the 'reason' one should be accepting of high stock valuations (high p/e ratio, low earnings and dividend yields). More recently we are hearing that increasing rates are also good for stock prices. For rising rates and rising stock prices to occur together, there is a fine line to be tread. Not too much inflation, not too much of an increase in rates while companies grow sales and earnings. Essentially, we need the rate of change in the growth rate to be bigger than the change in interest rates. Given the Atlanta Fed's GDP Now Forecast shows **only .6% rate of growth estimated for the first quarter.** This rate is lower than the past few quarters while the yield on the 10-yr Treasury has gone from 1.33% to 2.37%. It's more likely that along with stock prices, bond prices will vacillate within a range as policy expectations evolve and we await economic growth.



Additionally, we have seen this, and higher increases in nominal rates without the bond bull dying out. Some may say that as our national debt and aging demographics continue, our interest rate outlook may be similar to Japan's experience over the past 20+ years.

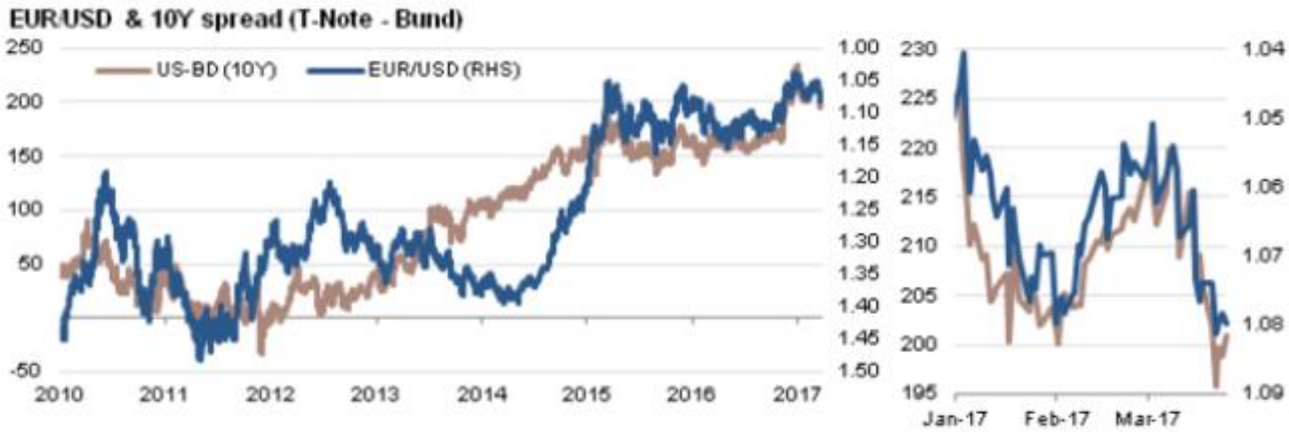
While the US Fed has ended, its bond buying ("QE") the eurozone and Japan continue to add liquidity by buying government and corporate debt of approximately $300 billion per quarter.

Figure 5. Global CB securities purchases, rolling 3m, $bn



Source: Citi Research. EMFX reserve changes are adjusted for valuation effects.

This is referred to as "Policy Divergence". While the ECB and Japan 'liquidate' their bond markets, the US has ceased and expectations are that the Fed will tighten/raise rates while Japan holds their 10yr at 0%. This expected interest rate differential leads to changes in exchange rates. The changes we have seen since mid-2014 is a much stronger US dollar. There is nothing on the horizon that indicates this Policy Divergence will end, which should indicate a continued strengthening of the US Dollar.



Source: SocGen

This chart shows how the relationship between interest rates corresponds (currently very tightly) with the exchange rate, EUR/USD. The future path of the US dollar will be determined by US economic and Federal Reserve policy vs. ECB and eurozone policy and rate of growth. Since the US has the early lead, ceasing QE and beginning to tighten, along with a new pro-growth President, it's hard to see how the US Dollar will weaken without dramatic shifts in US and ECB policies.

In Summary

The outlook for stocks and bonds remains: choppy with large swells. Since November, markets have priced in passage of, and perfectly positive impacts from, Trumps tax and reform policies. While at the same time, earnings have begun to grow anew, but are only at 2015 levels. This combination has made today's equity prices among the most expensive in history. The Hope and Expectations born from Trump's election are still with us, despite the recent healthcare setback. As such, stock prices may very likely become even more stretched (higher) as debate regarding taxes begins and evolves into the summer months.

Bonds were sold off very dramatically post-election and will likely continue to gain in price as uninspiring economic data comes in while we continue in our multi-year vision of "growth in the second half of the year".

While earnings may be increasing, the age-old question of how much are investors willing pay for $1 of earnings persists. Their 'willingness' is often derived from feelings and expectations of the future. If the future appears bright, prices can appreciate. Sometimes this appreciation begets its own feelings and can lead to further appreciation without commensurate changes in earnings. The risk there is that of an 'air-pocket' where future expectations are cut to match a duller present and prices move accordingly.

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