Advisory Service

Trends

December 2016 Research Report

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Trends

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In brief

In brief, 1) The U.S. economy is expected to grow near the 1.6% pace in 2016 and 2.5% in 2017, 2) Consumer spending, which is approximately 68% of GDP, is expected to grow faster than the overall growth rate, 3) Capital spending increases next year, 4) Intellectual property spending may expand in the 3% range in 2017 and 5) Residential construction, which is 3.4% of GDP, may expand near 2% next year while 6) Net exports work to subtract slightly from GDP growth next year.

Global Growth

Global growth in 2017 may improve slightly. But the Trump economic agenda of lower marginal tax rates, lower corporate tax rates and a major reduction in the regulatory burden is unlikely to be followed in Western Europe or Japan. France, Germany, Italy and Japan may support more government spending but not a reduction in their regulatory burdens or in their marginal tax rates.

Federal Reserve

The expected Trump economic agenda means the Fed will be increasing short-term interest rates in December and in 2017 to catch up to the market interest rates and the expected increase in nominal GDP in 2017 and 2018.

Equities

Factors *constructive for higher equity prices* include: 1) Growing dividends which are increasing at 5% y/y before inflation, 2) Low inflation using the Fed's preferred personal consumption deflator measure, 3) Low interest rates, 4) Favorable earnings yield, 5) Favorable balance sheets and 6) A yield curve that has taken a more positive shape since Mr. Trump became President-elect.

Negatives include: 1) Third quarter estimated S&P 500 earnings of $28.89 that remain below third quarter 2014 earnings of $29.60 and 2) Equity prices have had double digit gains since 2014 while earnings are lower. But fourth quarter 2016 earnings are expected to be above prior peak earnings in 2014:Q4, which is a plus. Pricing power has improved in 2016 which means earnings growth can resume so earnings can catch up to price gains.

Special Topic	**Special Topic – Trumpnomics and Capital Markets** (summary page)
Less regulation	• The Trumpnomics agenda includes: 1) Less regulation meaning a much weaker Dodd-Frank and an ObamaCare repeal,
Lower tax rates	• 2) Federal marginal personal income tax rate reductions and a reduction of the corporate income tax rate,
Infrastructure	• 3) Infrastructure spending spread out over multiple years,
Trade	• 4) A move toward fair trade and legal immigration.
Ahead of earnings	• Equity markets have responded well but the price gains have run well ahead of any earnings gain.
Higher	• The Federal Reserve has more room to increase rates and could allow the balance sheet to start its runoff. If so, that could amount to perhaps $200 billion of incremental Treasuries that need to find a home/year.
Runoff	• That potential Fed balance sheet runoff combined with tax rate cuts and additional Federal spending could mean about $1 trillion of Treasuries per year that need to find a home.
Higher yields	• In an economy that is close to full employment it may require higher bond yields to find a home for that amount of Treasuries. If so, it could mean crowding out business and residential investment unless foreigners significantly step up purchases of Treasuries.
Inflation premium	• In a weak economy, such as the U.S. economy from 2009 to 2012 there was no issue in finding a home for large amounts of Treasuries. In a full employment economy, it may be a different story.
Term premium	• Both the inflation premium and term premium suggest the 10-year Treasury could be at 3% or above by the end of 2017. The crowding out effect, if it occurs, would be unlikely until 2018. It may be the second half of 2017 before Trump's tax policies take effect.

	2013	2014	2015	2016f	2017f
Real GDP (%)	1.7	2.4	2.6	1.6	2.5
Treasury bond(%)	2.4	2.5	2.1	1.8	2.8
Vehicle sales(mm)	15.6	16.5	17.4	17.4	17.1
Housing starts(mm)	0.93	1.00	1.11	1.18	1.29
CPI (%) (y/y)	1.5	1.6	0.1	1.3	2.5
S&P 500 earnings($/s)	107.30	113.01	100.45	109.14	130.94
S&P 500 dividends($/s)	34.99	39.44	43.38	45.50	47.75

Special Topic **Special Topic – Trumpnomics and Capital Markets**

Trumpnomics **Trumpnomics**

Three dimensions to Trumpnomics are well-defined in terms of concepts:

Less regulation

1) Less regulation meaning a much weaker Dodd-Frank and an ObamaCare repeal,

Lower tax rates

2) Tax rate reductions for Federal marginal personal income tax rates and a reduction of the corporate income tax rate,

Multiple years

3) Infrastructure spending spread out over multiple years,

Trade

4) The fourth dimension of trade and immigration is less well defined and may take more of a piecemeal approach to implementation.

180 degrees from Obamanomics

This Trump approach is essentially 180 degrees from the past eight years which have been characterized by new productivity-killing regulations, higher taxes, open borders and useless infrastructure spending on so-called shovel-ready projects.

Implications **Implications for Capital Markets**

Faster trend growth

1) Faster trend economic growth lifting growth from the 2% per year pace to the 2.5% per year pace by 2018 for a 25% increase,

Productivity

2) Faster productivity growth, which does the heavy work of generating faster economic growth,

Higher yields and inflation

3) Higher bond yields to at least 3% on the 10-year Treasury by one-year from now,

4) Higher trend CPI inflation by at least 50 bps one-year from now compared to the current 2% pace,

Larger deficits

5) Larger Federal deficits by perhaps $150 to $200 billion per year from about $600 billion in 2016 to $800 billion in 2018,

Normalize

6) A Federal Reserve that can more readily normalize interest rates resulting in a federal funds rate of 1.25% by year-end 2017,

A stronger dollar

7) A stronger dollar. Higher bond yields imply a stronger dollar as foreigners sell their currencies to purchase U.S. assets,

An extended cycle

8) An extended economic cycle. The Clinton-Obama economic prescription would have likely had the economy in recession by early or mid-2018. Now, that is pushed out for another year to 2019 or later,

Timing

Timing

It would have

The Trump economic agenda, had it been enacted in 2009, would have generated 3% to 4% economic growth per year for several years. It's a growth agenda and a growth agenda implemented in an economy coming out of a major recession generates very rapid economic growth.

But not at or near full employment

But it isn't 2009. It is 2017 and this economic cycle is already near full-employment or at full-employment in some sectors like construction, technology and health. Trend economic growth increasing from 2% per year to 2.5% per year is perhaps about it for the Trump agenda at this stage of the economic cycle. The economy was already developing late-cycle indicators for a Clinton recession in 2018.

Timing not good

The timing for the next recession is not great for President-elect Trump in that the next recession is likely to occur closer to the end of his first term than the beginning.

Federal Reserve

Federal Reserve

Clinton's policies were sailing into recession

Had Mrs. Clinton won, the next recession was due in 2018 due to excessive regulation and excessive taxes. In comparison President-elect Trump's talking points are to junk as many regulations as he can and reduce Federal marginal personal income taxes and the corporate tax rate.

Trump's economy will likely only go into recession from the Fed

In turn the Trump economic agenda suggests the next recession may be induced by Federal Reserve policy. For example, CPI inflation one-year from now is expected to be trending at 2.5%. *But if the CPI is at 3% instead, the Fed could have four rate hikes in 2017 instead of two which would put the federal funds rate at 1.75%.*

Balance Sheet

Fed Balance Sheet Runoff?

Allow for a runoff to start?

Not likely

Federal Reserve officials could decide to allow the runoff of maturing Treasuries to start in 2017 instead of reinvesting the proceeds. *Once that decision is made, the runoff amounts to perhaps $200 billion per year*. The market may handle that okay but the Federal deficit may be $150 to $200 billion larger than expected. But Federal Reserve members may think a large balance sheet is a plus. No runoff in 2017 is likely.

Combined: $1 trillion deficits	Combined, *one could be thinking about finding a home for a total $1 trillion of Treasuries per year* – a $750 to $800 billion Federal deficit plus $200 billion of Treasury runoff from the Fed balance sheet.
Issue at full employment	*There was no issue when the U.S. economy was in its recovery from recession in 2009-2012. The market could absorb that large of an incremental Treasury supply. But this economy is near full employment* and increasing Treasury bond yields could have the effect of crowding out some business and residential borrowing at the margin. *If so, it would have the effect of slowing economic growth at the margin.*

Discounting — **Discounting**

Equity and bond markets have already discounted most if not all of President-elect Trump's first year's positive impact on the economy. There could well be some giveback on the gains.

Bond Yields — **Bond Yields**

The components of bond yields include the inflation premium, tax premium and the term premium.

Inflation — **Inflation premium**

A rise in inflation expectation due to the Trump economic agenda is likely being built into the rise in bond yields since the election. If inflation expectations eventually shift higher by 50 bps, it would mean bond yields higher by 50 bps.

Tax — **Tax premium**

A proxy for the tax premium is the difference between 10-year municipals and 10-year Treasuries of the same credit rating. That difference, depending on the day and credit rating, may be 25 to 45 bps. A Trump cut in marginal tax rates would mean a smaller tax wedge which helps offset the increase in the inflation premium.

Term premium — **Term premium**

This is the excess yield that investors demand for holding a long-term bond as opposed to a series of shorter-term bonds. The main aspect which determines the term premium is investor expectations about the future direction of short-term interest rates over the life of the long-term bond. The Trump economic agenda implies higher short-term rates so the term premium increases.

Equity **Equity Implications**

Constructive

Factors *constructive for higher equity prices* include: 1) Growing dividends which are increasing at 5% y/y, 2) Low inflation using the Fed's preferred personal consumption deflator measure, 3) Low interest rates, 4) Favorable earnings yield, 5) Favorable balance sheets and 6) A much more positive yield curve since Mr. Trump became President-elect.

Negative

Negatives include: 1) Third quarter estimated S&P 500 earnings of $28.89 that remain below third quarter 2014 earnings of $29.60 and 2) Equity prices have had double-digit gains since 2014 while earnings are lower. But fourth quarter 2016 earnings are expected to be well above prior peak earnings in 2014:Q4. Pricing power has improved in 2016 which means earnings growth can resume over the short term.

Both the equity market and economy were likely in their late-cycle stage before the November election. The expected Trump economic agenda has modified that by extending this expansion.

101 months old

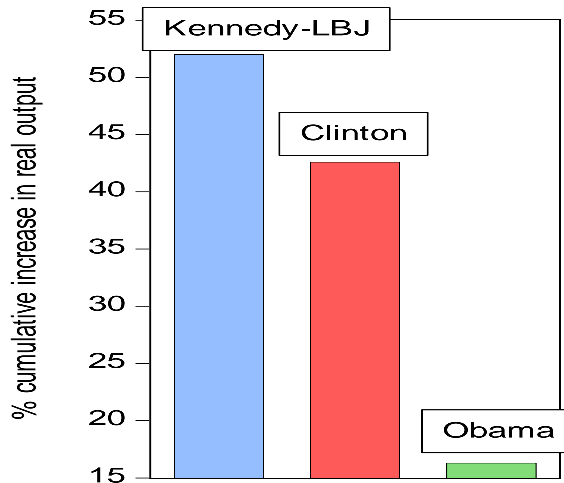
Only 2 longer

This expansion is already 90 months old. Only three prior expansions have run on a lot longer – the 1960s and 1990s expansions. The length of this expansion will likely surpass the one in the 1960s which ran 106 months. In a few more months it will only be the 1990s expansion that is longer. *The expected Trump economic plan suggests that this expansion may surpass the 1990s expansion which ran for 120 months from trough to peak.* As indicated, this one is already at 90 months.

Expansions

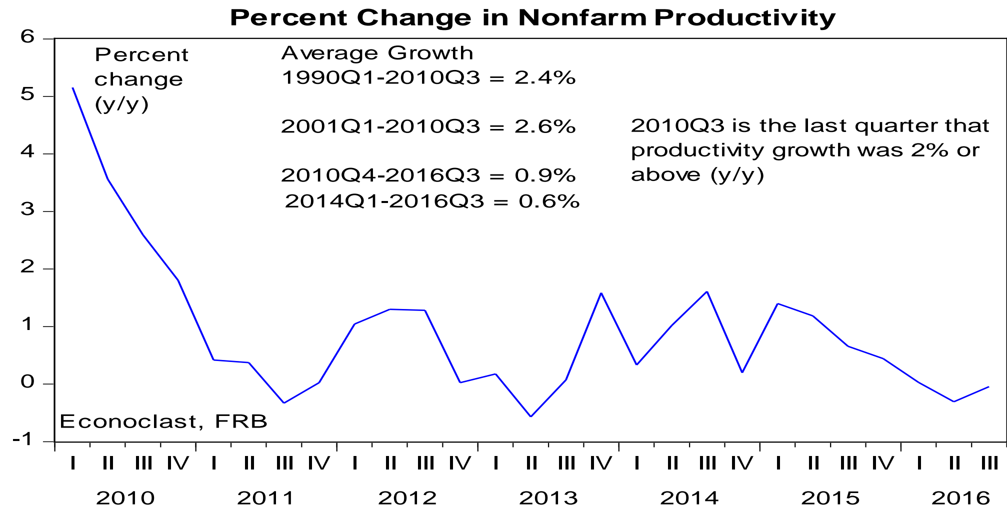
Economic Expansions -- The Kennedy-LBJ expansion increased real output by a cumulative 52%; Clinton by 42.6% and Obama to date of 16.3%. The President Obama economic expansion has been weak. The Bush expansion, which only ran 73 months, was also weak at an 18% cumulative increase.

Obama -- very weak



Productivity	**Productivity**
Weak	Productivity has been weak during the current expansion. As outlined before the likely reason is the productivity restraints signed into law in 2010 known as Dodd-Frank and ObamaCare. In addition, many other regulations were implemented by various Federal government agencies such as the EPA and Labor departments plus executive orders signed by President Obama.
Can improve under Trump	The result is that the last quarter that productivity growth exceeded 2% (y/y) was 2010 quarter three, when ObamaCare and Dodd-Frank were signed into law. President-elect Trump's economic agenda includes repeal of ObamaCare and reduction of the regulations in Dodd-Frank plus reversing many of the executive orders. If that occurs and productivity gains start to pick up, then we will know why productivity growth has been so dismal.

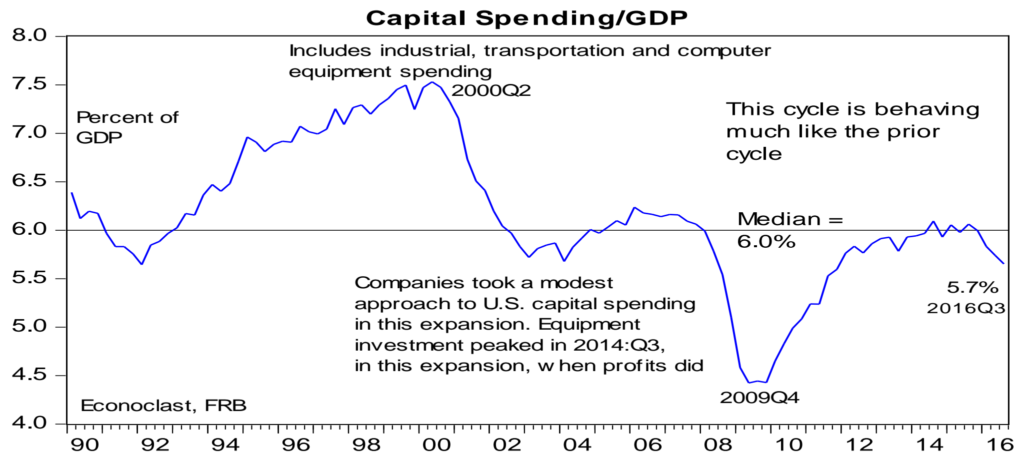
Over regulated



Investment

Business Investment - Removing regulations can help productivity growth short term but capital investment is needed for long-term productivity improvements. Businesses may still be cautious about new investments.

Should do better in 2017

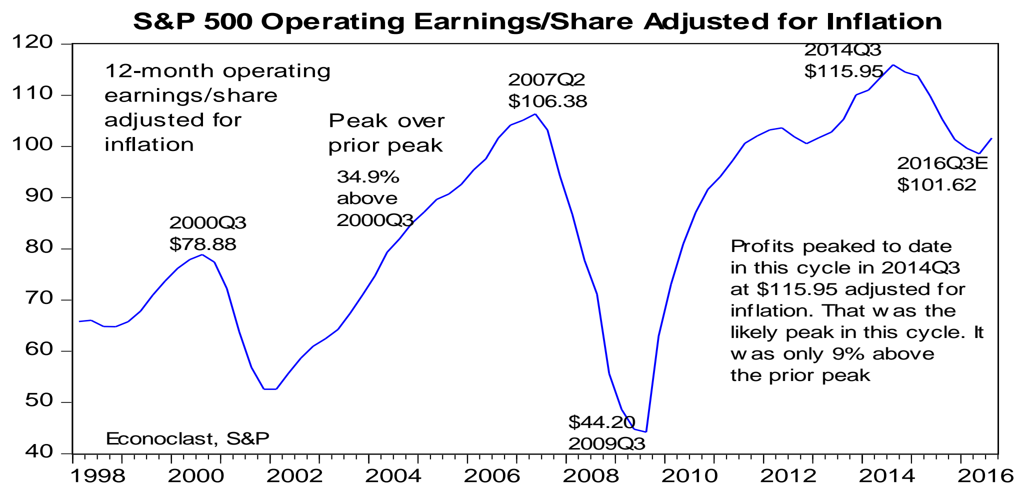


Capital investment may not improve much until the next economic cycle.

Profits **S&P Operating Profits**

Even with the Trump economic agenda we may have already had the peak in S&P operating profits in this cycle that was set in 2014:Q3. Pricing power is improving which is a plus for profits. *Nominal GDP is expected to improve which is a plus for profits. But the stronger dollar is a negative for external profits generated by U.S. companies. Plus, higher bond yields translate into a lower present value of earnings* for investors.

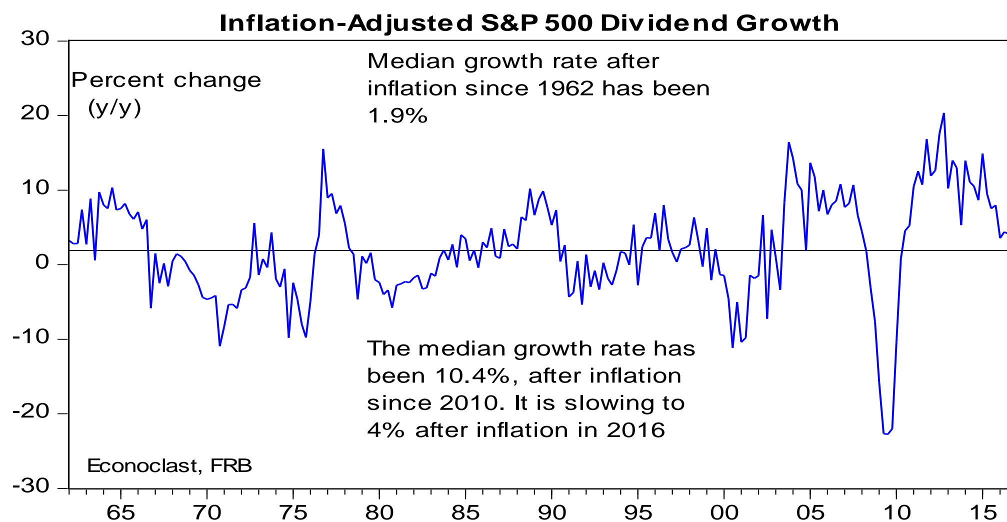
Profits are expected to improve



Dividends **S&P 500 Dividends**

Dividend growth continues to be a bright spot. Median growth after inflation has averaged 10.4% since 2010. In 2016 that slows to 4% after inflation. But the Trump agenda includes *repatriation of profits which could lead to more dividends and buybacks.*

Dividend growth continues

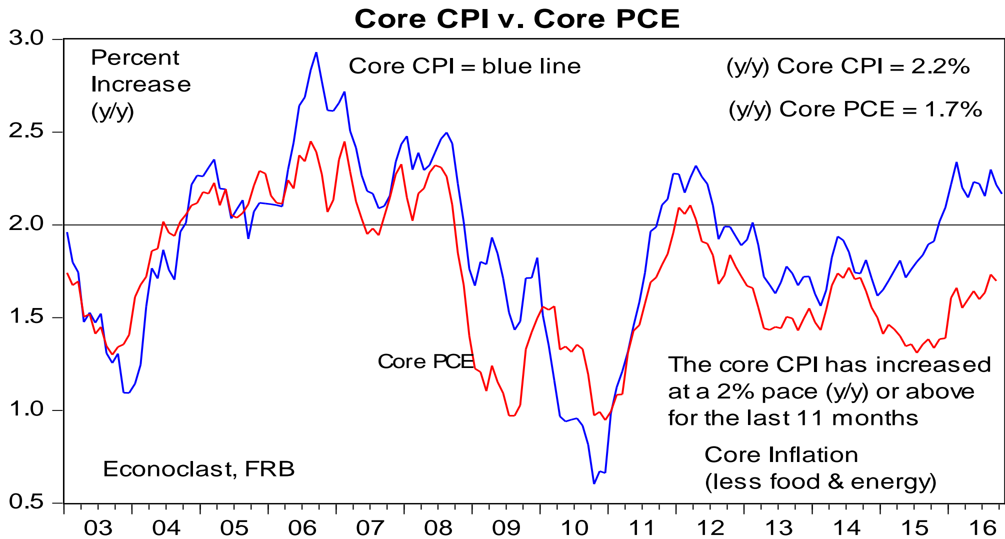


Core Inflation

Core Inflation

Core inflation remains contained but could be 50bps higher a year from now which would put the core PCE measure at 2.5%. Inflation at that level would put the Fed on a track of higher short-term rates. One can think about one increase in December and at least two in 2017. But core PCE inflation at 2.5% may imply more than two rate increases in 2017.

May be 50 bps higher next year

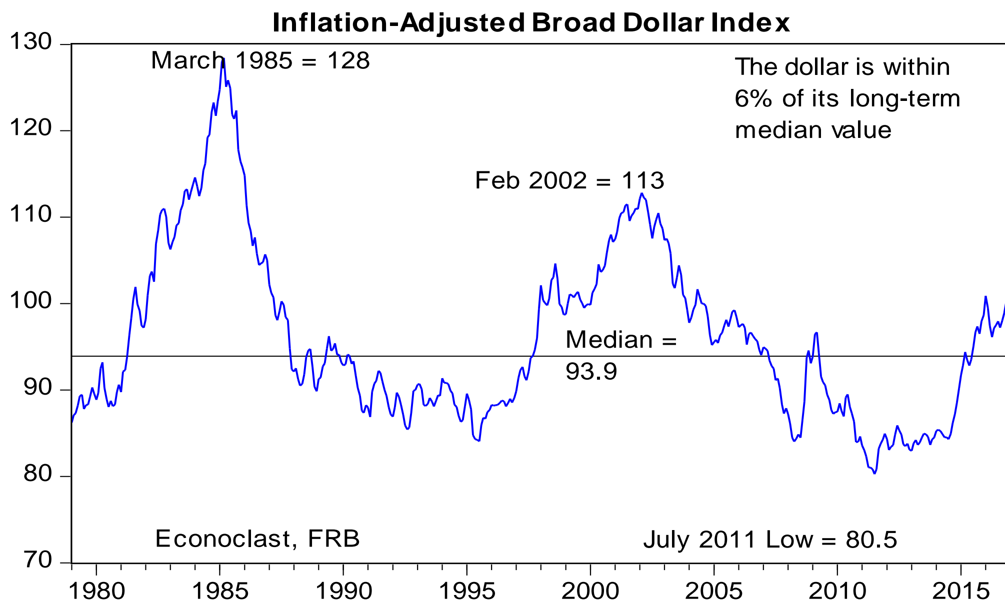


Dollar Value

Dollar Value

The dollar value is approximately where it was at the beginning of this year. It weakened during the year but with Trump's win the dollar value has moved higher as both short and long-term interest rates have moved up.

Stronger next year

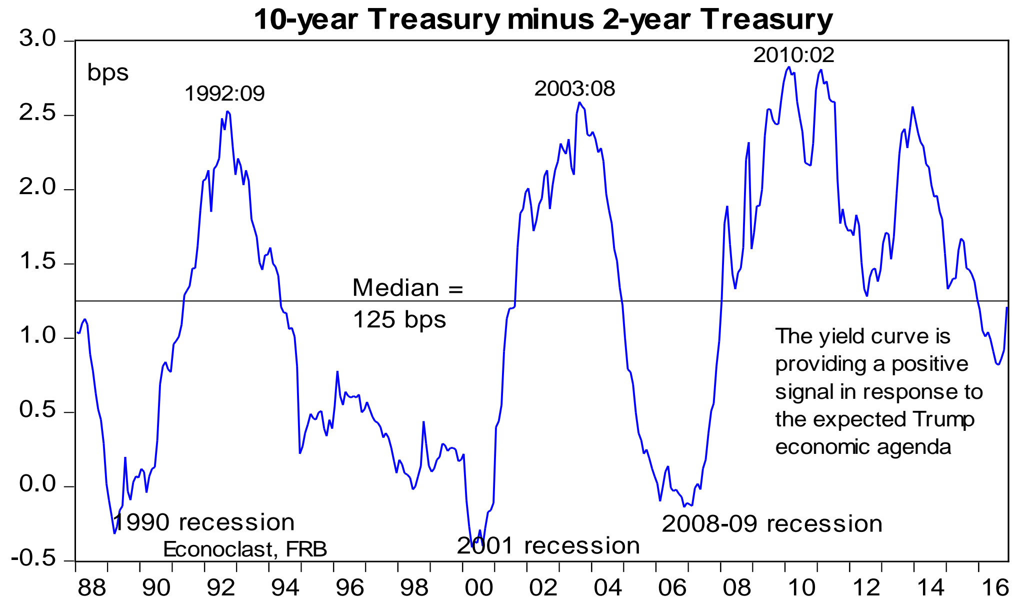


Fixed Income **Fixed Income**

Yield Curve

Yield Curve -- The potential economic agenda of President-elect Trump has helped the yield curve's shape. In turn it is easier for the Fed to increase short-term rates to catch up with the market.

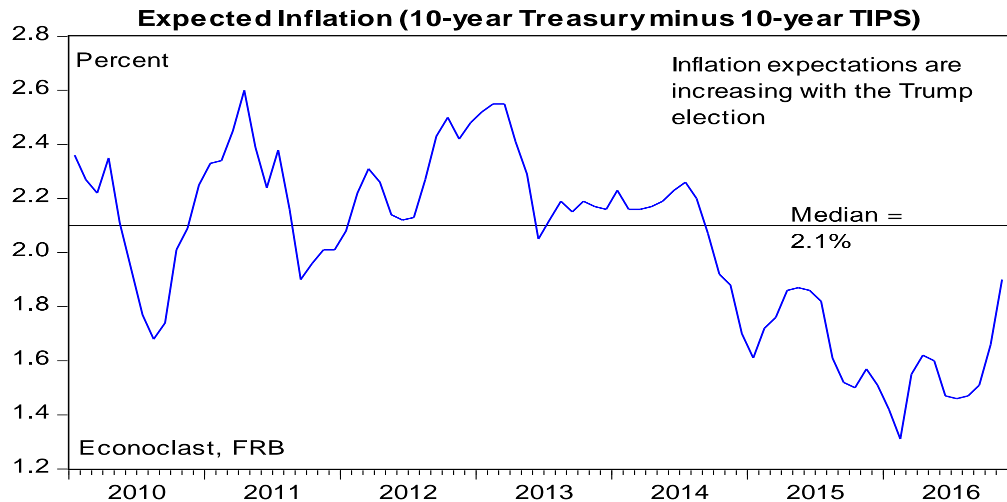
Looks better since Trump elected



Inflation

10-Year Breakeven Inflation Rate – The Trump election led to a sizeable increase in inflation expectations in a short time frame.

Inflation expectations jumped



Fair Value

Fair Value -- Fair value for the 10-year yield may be 3% or more by year-end 2017. The ECB and BOJ have an uphill battle in trying to use monetary policy to increase growth when lower tax rates and fewer regulations are what is needed. The U.K. exit told them that in spades. The U.S. election results sent the same message.

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Weighting of Market Sectors Reflects the "Sector & Segment" Report Fundamentals

December 2016

Market Sector	Weighting	Comment
Information Technology	Over	A modest capital spending upgrade is underway
Financials	Over	Short-term interest rate increases can help margins
Consumer Discretionary	Neutral	Lower energy prices are helping this sector
Industrials	Neutral	Pricing power needs to improve for this sector
Consumer Staples	Neutral	Companies are pushing through price increases
Health Care	Neutral	The political risk in this election holds back investors
Telecom	Neutral	Dividend yields are attractive but it is a competitive space
Materials	Neutral	This sector needs faster global growth
Energy	Neutral	Oil prices drift higher
Real Estate	Neutral	Low interest rates help create favorable valuations
Utilities	Under	Higher bond yields are a negative for this sector
Allocation to equities **Note: See the Sector & Segment Report for a ranking of 99 industry segments.**	Neutral	Equities can move higher with modest growth in the economy. Equities could achieve a total return, before inflation, of 5% to 8% per year over the next few years. The disposable income stream of U.S. taxpayers is impaired due to the higher taxes embedded in the Federal outstanding debt and underfunded entitlements
Bonds – 10-year Treasury	Under	Ten-year Treasury yields may increase if the Fed moves short-term rates higher this year. Overall CPI inflation may average near 1.3% in 2016 and 2.5% in 2017
Current Allocation		15% cash; 15% bonds; 55% U.S. equities; 15% foreign equities.
Normal Allocation		5% cash; 25% bonds; 55% U.S. equities; 15% foreign equities.

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