

POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2017

- *Political developments will be dominant and uncertain*
- *Global economic activity will remain positive but muted*
- *Uncertain political developments in a benign economic environment will lead to increased risks and instability in the markets*

Political Considerations

The major political event in 2016 was the election of Donald Trump to be the next President of the United States. This development was widely unexpected, particularly within the United States, and defied our own expectations. It has resulted in a flurry of new analyses and speculations about policies of the new administration.

We note, however, that the election is in line with a trend of rising populist political movements that have been emerging around the world over the past several years. The “Brexit” vote earlier this year, in which voters in the United Kingdom unexpectedly chose to leave the European Union, is one prominent example, followed by the recent populist outcome of a referendum in Italy. Various causes for these populist trends have been put forward: the global financial crisis of 2008-2009, ongoing growth in government bureaucracy, immigration, widening economic inequality. Whatever the cause, these trends at present appear to be firmly in place and for the time being are likely to persist.



On the campaign trail, Mr. Trump espoused a number of populist policies: adopting anti-immigrant policies with regard to Mexico and Islamic countries; taking a more aggressive protectionist stance with regard to trade with China; pursuing domestic policies directed towards lower taxes, promoting business, and investing in infrastructure. Many of his proposals may be

difficult to implement. At times Trump appeared to contradict himself. Without question, however, he is outside the existing political establishment and is committed to pursuing policies that are radically different from those of the Obama Administration. Trump did not win the popular vote, but his election in the Electoral College was decisive and he will come into office with Republican majorities in control of both houses in Congress. This indicates that, at least initially, he will have political support to implement his agenda.

In the plethora of expectations about what the future holds under Trump's leadership we see a wide range of opinions, ranging from panic to euphoria. "Uncertainty" is frequently used to characterize the outlook. He has demonstrated a style that appears impulsive and he readily challenges the political establishment. His selections for cabinet members and other leadership positions are generally conservative and also outside the existing order. As to the actual course of events, we suspect it will not be as bad as some fear but not as good as some hope. We may see less gridlock in U.S. Congress – but we are less sanguine about what comes out of it. We trust that the checks and balances within the U.S. political system will inhibit poorly conceived or destructive policies being undertaken.

As investment advisors, our focus is on the markets. We cannot, however, ignore political considerations. In the current environment, we believe they will remain dominant. Since Donald Trump is a businessman, we believe he is unlikely to pursue policies that are aimed towards undermining business or investments. However, that does not preclude policies that inadvertently do so. We also note Trump's quixotic, anti-establishment style that may easily lead to instability in the markets, as well as dramatic changes to the existing order that will also be destabilizing.

Here in the United States, we are heavily focused on Trump and his incoming administration. Reports from others around the world express concerns about this change in U.S. political leadership. What does it mean for U.S. policy with regard to China – trade as well as support for their "one China" policy? What is the outlook for U.S. support of NATO? How might U.S. policies towards Russia, Iran and Israel evolve? Since the fall of the Soviet bloc, the United States has been the leader on the global stage. Political leadership in the U.S. is therefore critical. At the same time, we note political developments outside the United States that are significant. We see rising tides of populism in Europe and other countries around the world and the ascent of oppressive governments in Venezuela, Egypt, Turkey and Syria.

The second major political consideration we highlight going into 2017 is terrorism. We highlighted terrorism in our Review & Outlook for 2016. During the past year we witnessed a stream of ongoing attacks around the world. In the United States many were perpetrated by "home-grown" extremists who have been radicalized over the internet, including incidents at a gay nightclub in Florida in June and bombings in New York City in September. Outside the U.S., bombings took place in Brussels in March. In France a truck plowed through crowds celebrating Bastille Day in July. In December, a similar attack using a truck took place at a Christmas fair in Germany. The number of murders committed in these attacks may be relatively

small, but they attest to an ongoing breakdown in civil society. They increase anxiety and contribute to anti-immigrant sentiments, which underlie much of the strength of populist political movements. Fundamental Islamic movements in the Middle East sustain instability and violence in the Middle East. Regardless of who is President in the United States, we believe that these problems will continue and that they will contribute to instability in the investment markets.

These two political trends stand out for us as we evaluate the investment markets in the year to come. Nevertheless, we also identify some positive political trends which may favorably impact the markets. Foremost among these are some anti-populist and reform movements currently underway, particularly in several Latin American countries. Within the United States we see good opportunity for beneficial tax and regulatory reforms, which may lead towards stronger economic growth and returns on investment. Overall, we are not fearful of the markets in 2017 or the outlook for favorable investment returns. But we anticipate that will be in the context of uncertain political developments, which will lead to increased risks and instability.

Economic Review and Outlook

In a continued theme of the last few years, global growth ended the year lower than consensus estimates. The World Bank originally anticipated global GDP growth of 2.9% for 2016, but subsequently reduced its estimate to 2.4% due to a combination of lower than expected growth in developed countries, as well as continued struggles of several export related emerging market countries, such as Brazil and Russia. Consensus economic growth conditions have proven to be too optimistic for every year but one of the last seven years, according to annual polls of economists conducted by Bloomberg. Looking ahead, we have pared down our expectations and project a 2.6% global growth rate.

In the U.S., it is unlikely that GDP will rise much beyond 2.3% in 2017. While pro-growth policies of infrastructure spending and tax cuts of the Trump Administration can boost the economy, they have limitations. Increased infrastructure spending may be inflationary. Importantly, the spending will be supportive to those in the labor force who have not benefited from the economic growth of the past 8 years. These same low to middle income households that will benefit from the related construction jobs will provide an added boost to the economy, as these households have a much higher propensity to spend rather than save. However, the amount of spending and hiring associated with infrastructure spending in 2017 will likely be modest, as much of the year will be occupied in approving legislation and planning projects. We foresee the economic effects of infrastructure spending to be larger in 2018 and beyond.

Tax cuts, if passed, look to make a larger impact on the economy in 2017 than infrastructure spending. Deficit spending is stimulative to an economy, and decreasing revenues via tax cuts translate into increased deficit spending. The effects on the economy will depend on the size of the tax cuts, and who gets them. In a similar fashion as the above infrastructure employment, tax

cuts for the low and middle class will provide a larger economic boost than tax cuts for the wealthy – a fact not missed by Speaker of the House Paul Ryan, who has long advocated for an increase to the earned income tax credit. Lowering tax rates for upper income earners and large corporations will translate into higher price levels for financial assets.

A downside to increased deficit spending is the strain it poses on the government's balance sheet. Deficit spending at a rate higher than that of GDP growth is primarily a transfer of economic activity from the future into the present. Along with increased debt the government will need to finance the deficit, borrowers will demand higher interest rates on U.S. Treasury bonds. Higher rates will apply to all types of credit, such as mortgages, auto loans, and corporate loans for factory expansions. Increased interest rates could dampen economic activity, and put at risk the intended economic benefits from deficit spending. However, we foresee only a modest risk to U.S. growth in 2017 from rising interest rates, due primarily to still pervasive low global interest rate regimes held by foreign monetary authorities. Likewise, we expect interest rates to rise only modestly during the year in the U.S., resulting in weak, but positive returns for bonds.

In developed nations outside the U.S., economic growth will be muted. Much of Europe continues to be restrained by difficult labor policies, resulting in a less dynamic workforce and high unemployment for unskilled young workers. Furthermore, the uncertainty surrounding the how and when of Brexit will limit economic growth, as business decisions will be postponed. Despite these negatives, the economy in Europe is likely to grow 1.7%. In Japan, the declining population and large debt burden will keep the country in yet another year of stagnation with essentially flat economic growth. We continue to have concerns over Japan's fiscal stability which, as its debt grows, increases the possibility of a crisis. In general, we think that weak economic growth is currently factored into foreign stock prices.

Developing countries will see discrepant economic results. The modest uptick in commodity prices will be a source of strength for much of the developing world. Despite headlines showing instability across the world, the reality is that most of the developing world has become more stable, and has established sensible pro-growth and business friendly policies. We expect emerging market economies to grow by 4.4% in 2017.

We also acknowledge the chance of a disruptive trade war, as anti-globalization sentiment grows in the U.S. and abroad. We see the economic collateral damage of such policy as being too large for this to be a viable strategy for nation states to pursue. However, small token trade issues, such as industry specific anti-dumping rulings or tax breaks that violate World Trade Organization rules, have the potential to escalate.

2016 Investment Markets Review

In 2016 investors experienced wide swings in the investment markets. Early in the year, the U.S. equity markets plunged approximately 10% in value, only to rebound sharply by the end of the first quarter. At the end of the second quarter, the stock market dropped again in response to the unexpected “Brexit” vote in the United Kingdom, rebounding this time in a matter of days. Then at the beginning of the fourth quarter stocks again headed lower until the time of the U.S. presidential election in November. In reaction to the surprise election of Donald Trump, the futures markets indicated another selloff. In this instance, however, the decline never materialized and the equity markets moved strongly higher over the balance of the year. At year end the Standard & Poor’s 500 Index was up 12% for the year.

Specific market sectors posted wide swings over the course of the year, often in ways significantly out of line with the S&P 500 Index. Early in the year, while the stock market was struggling, utility stocks soared 20%. REITs, too, posted big gains in July, but then gave them back over the balance of the year. In the fourth quarter, energy and financial stocks were particularly strong.

Meanwhile, bonds posted solid gains throughout the first half of the year, then declined, falling sharply after the presidential election and decision by the Federal Reserve to hike short-term interest rates. For the full year, total return on the Bloomberg Barclays U.S. Aggregate Bond Index was 2.65%.

In foreign stock markets, the EAFE index was truly volatile – down and up in the first quarter, up and down in the second quarter, up again in Q3, finally ending the year little changed from where it started. On the other hand, emerging markets moved more favorably, posting solid gains most of the year, with a moderate setback following Donald Trump’s election. Much of that selloff was due to the year-end relative strength of the U.S. dollar. Returns on bonds in foreign markets varied widely, particularly for U.S. based investors, as a result of the volatility in the global currency markets. Balanced funds, which invest in diversified portfolios of U.S. and foreign stocks and bonds, were up 7% on average.

Investment Markets Outlook & Strategy

As we look out into 2017, we note that analyst predictions of high volatility in the investment markets remain pervasive. As outlined above, we see that U.S. economic conditions are muted, but relatively favorable. We anticipate that economic strength in the U.S., along with a strong dollar, will strengthen economic activity around the world. Relatively stable underlying economic conditions provide a base for favorable business conditions and investment returns.

This benign backdrop, however, is accompanied by prospective radical political developments which are highly unpredictable.

In this environment, we are reluctant to make any bold prognostications. Nevertheless, we make the following observations:

- Despite expected U.S. Dollar strength, valuations on stocks outside the U.S. continue to look appealing
- Municipal bond markets will be unusually volatile, as investors try to anticipate future top-marginal tax brackets
- U.S. interest rates will be limited as to how high they can climb relative to rates in Germany and Great Britain
- If a tax deal in the U.S. on repatriation of foreign profits is enacted, stocks of large multinationals will move higher via special dividends and stock buy-backs
- Animal spirits and optimism about the economy may inspire financial markets, but underlying demographic trends will continue to restrict economic growth

As for our investment strategy, we deem it prudent to maintain a defensive investment posture. For investors with shorter time horizons or near-term cash needs – as well as for strategic investment purposes – cash, or cash-like bond investments, should be kept on hand. For longer term investors, we firmly believe that a well-diversified portfolio is the lowest risk strategy. We think it is sensible to remain agile and take advantage of opportunities in volatile markets.

Roy A. Hamrick, CFA
Senior Portfolio Manager & Strategist

Todd M. Wathey, CFA, CFP®
Portfolio Manager & Director of Operations

6 January 2017

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