

SIGNATUREFD

WINTER 2017

## MARKET SENSE: A Base-Case Scenario for 2017



The majority of global equity markets ended 2016 with historically normal returns of between 5 and 10%; however, the path that they took to get to those results was anything but normal. In fact, it was just a year ago when investor angst was rising and stories about the “worst start ever for stocks” were used to forecast a miserable year for growth investors. With hindsight, we know that this was a decent buying opportunity as long as one could also suffer through the Brexit panic and then the lead-up to the U.S. election.

We think the biggest lesson from 2016 is for those who are perpetually inclined to try to time major market events. Both the Brexit episode and the U.S. election taught that to be successful in market timing, one has to not only anticipate the outcome of an event but also forecast the reaction by investors to that outcome. In both of these cases, something on the order of 75% of investors expected the opposite outcome to occur, and of those who were contrarian in predicting a Brexit “yes” or a Trump win, they largely assumed that the market would be negatively hit by the outcome. Thus, in both of these cases, the vast majority of traders were caught off-guard—while long-term investors were able to ride through the volatility. In the end, fundamental trends drive markets, and they are where investors should allocate time and resources.

In our newsletter a year ago, we stated that the two key fundamental risks as perceived by the markets—an overly aggressive Federal Reserve and a Chinese currency collapse—were overstated and that the base case for 2016 was constructive. Specifically, we said that “if investors have been preparing for a worst-case outcome—Chinese-induced global recession—and this does not come about, then a return to positive market returns is likely to develop, potentially abruptly.” Though the start of the year gave us some trepidation, the base-case thesis for 2016 was proven largely correct.

Before shifting gears and looking at the current state of affairs, it is worth reviewing the results of several key markets over the past quarter and year in the following table.



AT THE START OF 2017, WE FIND OURSELVES IN THE SOMEWHAT UNFAMILIAR POSITION OF BEING LARGELY OF THE SAME MIND AS CONVENTIONAL WISDOM.

	4th Quarter	52 Weeks
S&P 500	3.82	11.96
Dow Jones Industrial Average	8.66	16.50
MSCI EAFE (International)	-0.71	1.00
MSCI EM (Emerging Markets)	-4.16	11.19
Bloomberg Commodity Index	2.66	11.77
Barclays Global Aggregate Bond Index (Global Bonds)	-7.07	2.09
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	-2.98	2.65
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	-2.63	-0.39
HFRI Fund of Funds Composite Index	0.83	0.47

## 2016: A CHANGE IN DIRECTION

At the start of 2017, we find ourselves in the somewhat unfamiliar position of being largely of the same mind as conventional wisdom. For the year ahead, this means remaining optimistic on the trajectory of economies and the markets. We say the position is unfamiliar because it often feels safer to be of a minority view, but we have learned that being contrarian just for the sake of being out of consensus is not a winning strategy. Again, fundamentals matter, and right now the fundamental backdrop largely supports growth. Of course, risks always exist, and we will touch on those shortly.

In our opinion, a key observation that many are missing is that a “Trump rally” is really a misnomer. In reality, the economic data began strengthening in the summer, and this led to a market rotation toward reflationary ideas that started in July, well ahead of the U.S. election results. Of course, the Trump victory added new strength to the tailwinds in the market, but the ship had already sailed by November 8.

Take the 10-year Treasury as a bellwether: The yield bottomed post-Brexit on July 6 at approximately 1.34%. By election day in the U.S., it had already pushed higher to 1.86%. Since then, the pace of change has nearly doubled to land at the current level of around 2.50%.

A second piece of evidence is the bellwether bank stock JPMorgan. From the Brexit low through election day, the stock materially outperformed the broad market—rising 23.4% versus 7.8% for the S&P 500. Since election day it has gone on to see a further 23.7% positive move, compared with the S&P 500 rising by 6.2%.

So what caused this shift during the summer? In our view, it was the realization that the Brexit results would force a change in direction by policymakers. The leadership strategy of continuing to do more of the same was being rejected by the people, and a shift toward wholesale change took hold. For investors, this meant that fiscal spending would begin taking over for central bank stimulus and that the era of ever-declining interest rates was potentially ending.

As we demonstrated with the performance of 10-year yields and JPMorgan stock price, it was Brexit that triggered the realization that things had changed. Thus the Trump victory is just another example of the ground-level change that has occurred. In his New Year piece, “2017: It’s Bigger than the Donald,” market strategist Donald Luskin writes: “We think [Trump] is only an effect, not a cause. He will do specific things that matter ... but the real agent of change is the underlying force that put him in the position he now occupies.” Late in the year, further evidence of the change in the populace’s attitude came from the referendum rejection in Italy and the unexpected selection of Francois Fillon, a free-market conservative, in France as the most likely candidate to run against Marine Le Pen in this spring’s presidential election.

Given that more than half of those who voted in the U.S. did not think Donald Trump was the best candidate, we can only assume that a portion who read this edition of Market Sense did not support Trump. We reiterate that we are not making political judgments; we are merely taking note of the reaction by investors that something notable occurred in late 2016. Of course, with this change comes opportunity and risk. We will take stock of these below as we anticipate a base case for 2017:

## WHAT WE KNOW

Global economic data has been improving since the summer, and this momentum looks like it will continue into early 2017. U.S. gross domestic product (GDP) was revised up to 3.5% in the third quarter of 2016. Though the data for the fourth quarter is running closer to 3%, it largely supports above-3% growth early in 2017. Our research partners at Strategas compiled a comprehensive list of global confidence and sentiment surveys for the fourth quarter and concluded that 57 of the 75 reports (76%) are moving higher, signaling rosier economic views by the majority of global consumers, business owners and investors. The Leading Economic Indicator index as compiled by Ned Davis Research has been in positive mode since June 3 and continues to strengthen. Finally, a full set of manufacturing indicators shows the strongest and most synchronized global growth in manufacturing since 2011.

**Bottom line:** Although a recession was not the base-case scenario for 2017 previously, the odds have lessened even more based on recent data and the prospects for fiscal reform and tax cuts in 2017.

With the solid fundamental story and the recent surge in investor sentiment, the so-called *animal spirits* of investors have returned. This can be seen in the data on investor flows. For example, according to financial services firm INTL FCStone, U.S. investors added more than \$100 billion to equity funds in the final seven weeks of the year, which was more than double the \$48 billion in the year leading up to the election. Thus one should ask: How much of the news has already been accounted for in asset prices? On almost all valuation methodologies, U.S. equities look expensive when compared with historical levels. They generally look attractive only when compared with the alternatives of cash and high-quality fixed income, which are even further from historical levels. Outside the U.S., most markets look attractively priced compared with history, and a few even look cheap. However, these lower valuations come with higher perceived risks, and this has tempered investor enthusiasm for the past few years. Though the U.S. economy has been leading the world, others now seem to be catching up, and this should allow equity markets to rise together.



ON MANY MEASURES, MARKETS APPEAR MORE EXPENSIVE IN THE U.S. THAN IN ANY TIME OTHER THAN THE BUBBLES (1929, 2000 AND 2007).

**Bottom line:** On many measures, markets appear more expensive in the U.S. than in any time other than the bubbles (1929, 2000 and 2007). Even though this means that risks are elevated, this, in and of itself, is not usually a limiting factor for near-term gains. As Ned Davis Research often says: “The bull receives benefit of the doubt until proven otherwise.” Moreover, with non-U.S. stocks showing better valuation and economic data broadening, we are looking for these markets to begin participating.

### WHAT WE THINK WE KNOW

Many of the observations that fit into this category revolve around the policy shifts that have occurred due to political change. This includes the outlook for tax cuts and reform, lower regulations and the prospect of fiscal stimulus via infrastructure spending. Investors broadly assume that some or all of these proposals will be enacted in the U.S. and, to varying degrees, outside the U.S. But, as they say, the devil is in the details. For example, tax cuts are not tax reform. Tax cuts would require a 60-vote majority in the Senate due to their impact on the budget deficit. Thus, to secure passage, the Republican majority may rather seek to implement tax reform—e.g., lowering tax rates but countering that with reductions in offsets such as deductions and credits. However, because deductions and credits are beneficial to specific individuals and businesses, their advocates are likely to resist such a change.

Taking the Reagan years as a model, his administration was first able to push through a tax cut, but it wasn't until his second term that he was able to finalize true tax reform. The challenges with regulatory reform and infrastructure spending are similar. Our point here is that the market has so far looked past the logistical challenges of enacting current proposals, but as we move into 2017, the reality of those challenges could become more evident.

As stated above, the market was shifting before the election, and thus the near-term improvement does not necessarily depend on immediate action by the new administration. We do think the confidence boost can add a few percent to GDP over the next few quarters. But going out a year or two, will there be a change in the growth trajectory of the U.S. and globally? Will the changes in government policy create a lasting effect? It is very possible that potential growth rates have shifted lower due to demographics and reduced productivity. A major debate among economists the past few years has centered on the theory of secular stagnation: Have we shifted into a period where slower population growth and lower productivity are persistent and thus the burst of growth from fiscal and regulatory stimulus can fade rather quickly?

Though it is not possible to know the long-term impacts yet, it appears that we are entering the late cycle of the current recovery. Credit has started tightening in several sectors of the economy (albeit from very accommodative levels). Usually, the shift in markets toward more cyclically oriented companies

like energy and industrials happens toward the end of a cycle. Finally, the pressure of rising wages on inflation often leads to a more aggressive central bank, which over time pushes the economy to a point of reversal. The Federal Reserve was able to hike rates in December and set the stage for three hikes in 2017 without causing panic in the markets. In the current environment, the combination of U.S. fiscal stimulus and tightening monetary policy, coupled with ultra-easy central banks in Europe, Japan and China, could lead to even more strength in the dollar. In 2016 the dollar advanced 3.7%, but this all came since the election and builds on a sharp move in 2015. The vast majority of strategists, including us, believe the bias to the dollar is upward. What remains uncertain is how high it can go and the ramifications of its continued strength on the global economy.

**Bottom line:** Investors have taken a largely optimistic view about tax and regulatory changes as well as the potential for fiscal spending. This is directionally correct, but risk remains around the timing and significance of the final results. Moreover, economic cycles often end when central banks hike rates and tighten policy enough to cause credit to reverse course. The tightening comes in the form of higher interest rates and stronger currency. It is assumed that the late stage of this cycle can continue for some time, but no one knows at what point the tightness starts to bite.

## WHAT WE DON'T KNOW

Loosely quoting Donald Rumsfeld, it is the risks *we don't know we don't know* that cause the biggest problems—and likely the biggest opportunities. By definition, it is impossible to be aware of everything that fits into this category. However, it remains important for investors to be aware of the areas that are at the forefront of today's shifting landscape. On the positive side, we can't think of any major economist or market strategist who is forecasting the potential for a major shift higher in worker productivity, standard of living and economic growth. If a golden era of innovation and productivity does arrive, it will surprise almost all.

On the risk side, many of the concerns continue to revolve around China. The country has produced a staggering amount of debt (now above 250% the size of the economy, after doubling over 10 years), and in recent years it has expanded much faster than underlying growth. This by definition can't last forever. Moreover, China and other emerging countries have \$9.7 trillion in debt outstanding that is denominated in U.S. dollars. This becomes more difficult to pay off with a strong dollar, but there is no magic line at which this goes from being a mild negative to precipitating a crisis.

At the same time, those with negative views on China have not been served well by trying to predict a crisis in that country. The fact that the financial system is broadly supported by the government and that the communist leadership wants to maintain a strong sense of control ahead of this fall's major political gathering (their five-year Party Plenum) means that the odds favor stability over the next few quarters.

Finally, the policies of a new U.S. administration remain a question mark. It is impossible to forecast not only the initial moves made by a Trump White House, but all future responses by all parties. To date, the market has been comforted by a sense that campaign rhetoric has calmed down into the reality of leading and thus a steadier pace of change. But we must acknowledge that global relationships and institutions that have been the foundation of the geopolitical and economic landscape since World War II run the risk of being scaled back or abandoned. This is true especially in Europe and North America, but also across Asia. An "America first" doctrine is an unpredictable way forward.



AS THE PAST FEW MONTHS SHOW, THE MARKETS CAN MOVE ABRUPTLY WHEN INVESTORS BEGIN LOOKING AT WHAT CAN GO RIGHT, RATHER THAN CONSTANTLY FOCUSING ON PROBLEMS.

**Bottom line:** As the past few months show, the markets can move abruptly when investors begin looking at what can go right, rather than constantly focusing on problems. It has been almost eight years since the beginning of the current recovery, and individual investors have yet to add one net dollar to U.S. equity investments. Some pent-up demand must exist. Of course, the reality of continued high global debt, and especially the rapid accumulation in China and emerging countries, could trigger the next downturn. But with the Chinese Communist Party Plenum coming in late 2017, stability and financial and social order will be desired at all costs. Trouble can always lurk around the corner, but for now we remain constructive and positioned for upside surprises.

## SUMMARY

We have been more optimistic on the economy and the markets than the majority of investors over the past 18 months, and this view is being rewarded. The near-term data was strengthening before the election and has accelerated since. Housing, jobs and consumer spending have been the foundation and held the U.S. economy above recession early last year. Since the election, most confidence-based surveys have pushed meaningfully higher, and this bodes well for a secondary source of growth coming from businesses. We suspect there are a few points of GDP worth of pent-up demand by consumers and businesses that will be unleashed by the current optimism. This, along with improving situations in Japan, Europe and China, is likely to usher in a period of globally synchronized growth.

Clearly the markets had not been prepared for this breakout of good news. Even though optimism has returned, expectations still seem modest. For example, in its “Outlook 2017” article, *Barron’s* noted that market strategists with 10 large Wall Street firms have forecasts for the U.S. market just barely 6% higher than the level on January 1.

Thus the first half of 2017 should see a continuation of recent trends. We don’t want to get ahead of ourselves, but by the second half, expectations and sentiment could become too optimistic, which would warrant a fresh look at the underlying fundamental improvements. Can a cyclical rebound over the next few quarters give way to longer-term strength? It is too early to make predictions, so we will let the data dictate future portfolio shifts.

We were active prior to last September and repositioned portfolios toward areas of perceived opportunity. Those changes have added value, and we concluded our last quarterly newsletter with a detailed review of portfolio positioning. Research since that time has not resulted in meaningful changes. To summarize: We believe growth assets represent the best current opportunity, and we are overweight global equities and underweight core fixed income. The move toward deflation is likely in its early innings, and we will continue to use any pullbacks to add to real assets, especially energy, as

well as sectors of the market that are positively impacted by this trend. Our fixed income allocations remain focused on shorter-term income investments. This positioning was helpful over the past six months as interest rates moved higher.

We don't expect to make material shifts to portfolio construction in the near term, but we recognize that investing decisions become more complex late in a cycle. By default, the next recession is getting closer as time goes by. Moreover, valuations of equity markets will become more extreme if our positive thesis plays out. We will look for signals that risks are rising or that economic fundamentals are deteriorating. We won't hesitate to shift the portfolio when our research guides us.

Thank you, as always, for your confidence in our team. Please reach out to us if you have any additional thoughts or questions on your specific situation.

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