DECEMBER 2016

RUSH TO JUDGMENT

Before the presidential election, market participants envisioned a broad array of outcomes for US markets and the economy, many of them pessimistic. Now, following the election, Wall Street appears to see no middle ground for outcomes and has rushed to judgment that the hopeful path for our markets and economy will indeed be realized. This has been demonstrated by the reactions of the stock, bond and currency markets. Optimistic assumptions concerning employment, fiscal spending and taxes to mention a few, are embedding themselves in asset prices. Looking first at the US stock market, **Chart #1** offers the pre and post-election reaction of the S&P 500 Index, a 5% gain from November 4th. This price move in the index is not especially important in terms of magnitude, but it is in directional terms as the market had been moving irregularly lower since early September, and threatened to test the previous February, lows as the Federal Reserve is poised to hike rates and third quarter earnings came with muted outlooks. Now there is the notion of an oven-ready fiscal spending impulse to be released in 2017 that will be a general panacea for all that monetary policy has failed to deliver.

While increased fiscal spending is a positive ambition, we believe markets have moved too quickly to price in a new growth impetus strong enough to support an effectual increase in US GDP, which may, if it occurs at all, not arrive until 2018. Globally, we are still in the deleveraging process. US growth will not be large enough to off-set the weakness in China and emerging markets. Corporate tax cuts may allow capital to be repatriated to the US, however, given already low utilization rates and over capacity, corporations are still unlikely to increase CAPEX. More likely they will use their cash to boost reported earnings with mergers, acquisitions and stock buy-backs. By extension, it is my judgement that the rotation taking place in our stock market is too one-sided. Stable, dividend-paying bond proxies are now, in a U-turn, being replaced in popularity by cyclical and financial stocks. I think it is too soon to abandon defensive sectors as if the corner has been turned that we will see a cyclical recovery and steadily rising interest rates. **Chart #2** demonstrates the astonishing change in direction for government 10 year bond yields, partly from Fed policy expectations, but more from rising growth expectations. Both stock market bulls and bond market bears seem to believe higher rates are compatible with a strengthening economy.

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Chart #1

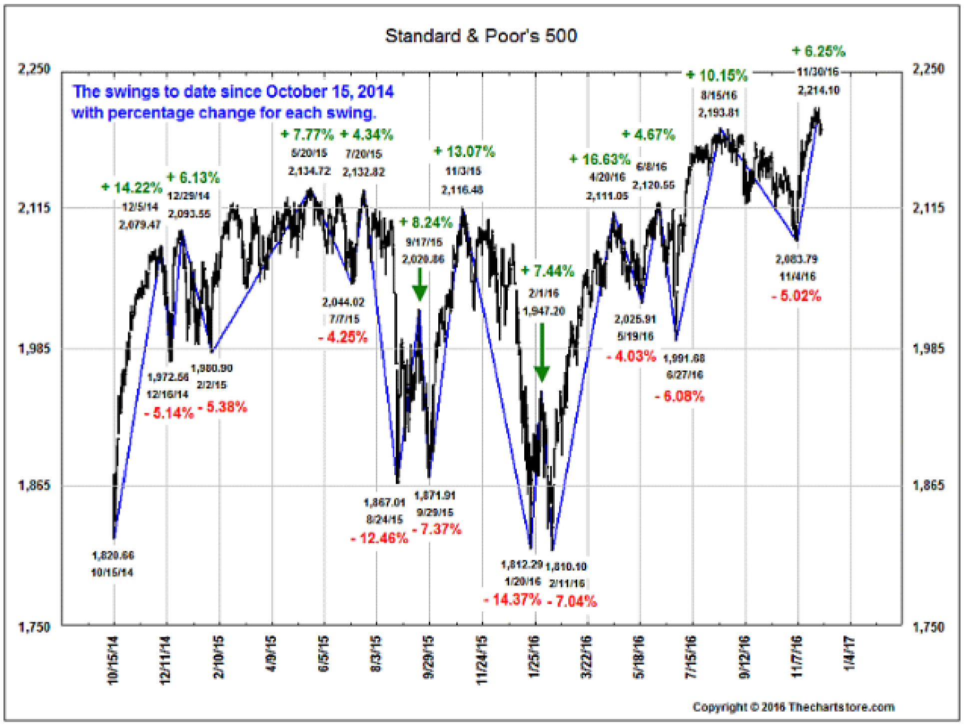
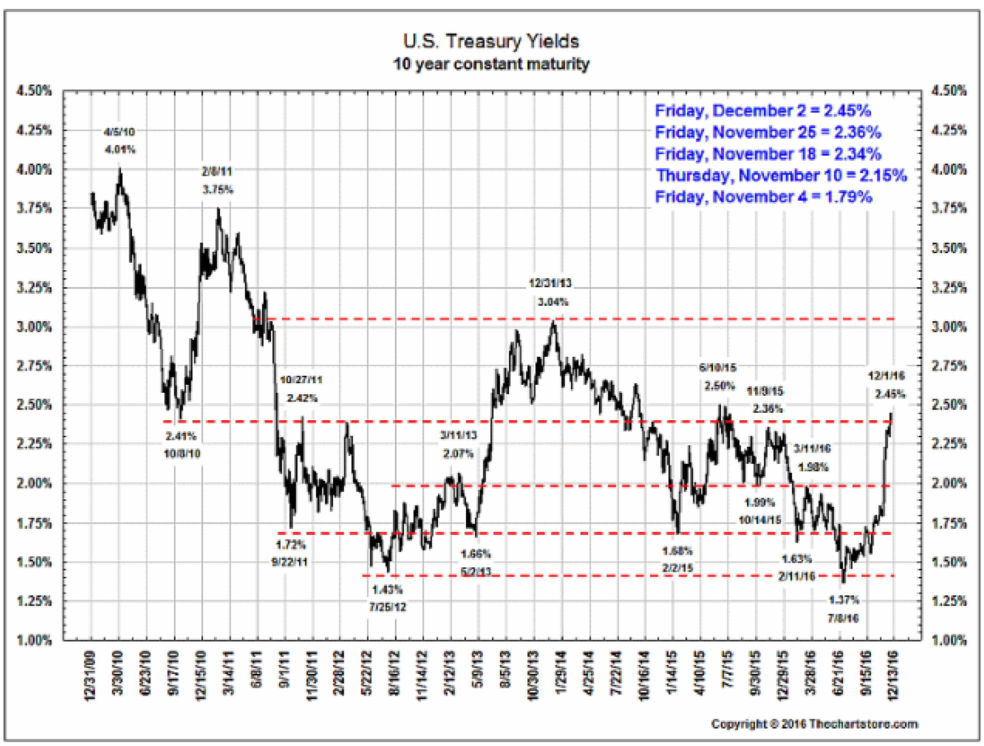


Chart #2



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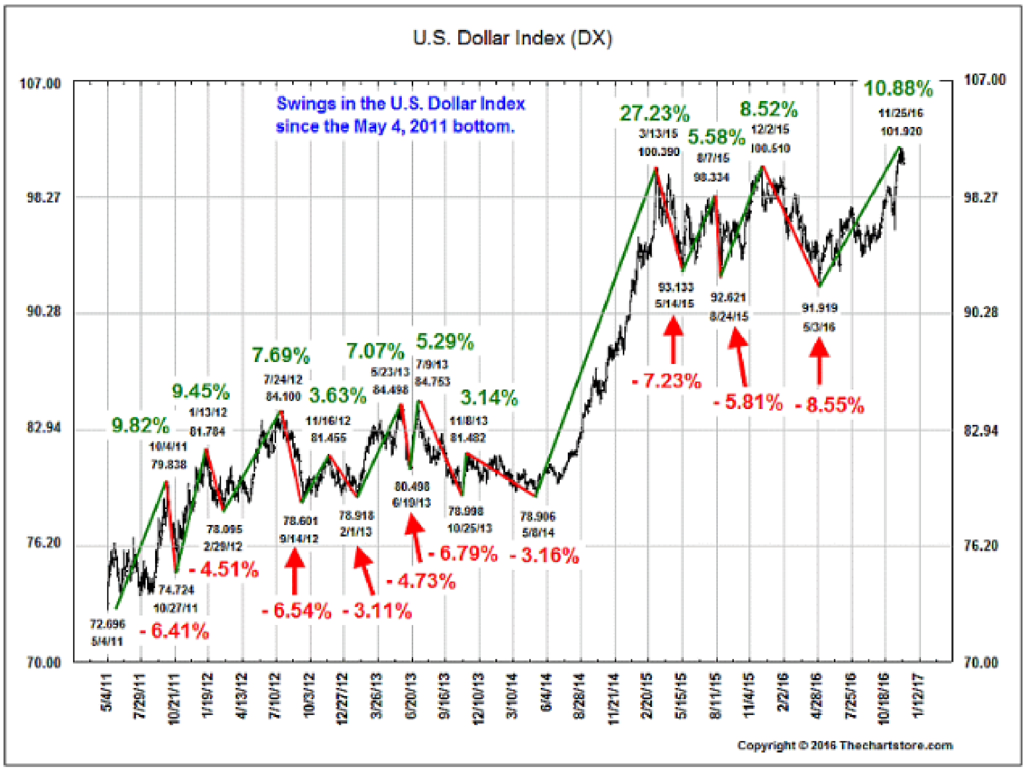
Higher US yields have boosted the Dollar, which has a tightening effect on global credit. The surging U.S. dollar is a growth impediment for many developing countries with large foreign debt liabilities and/or commodity based economies. For this reason, emerging markets won't be able to raise global growth any time soon.

Chart #3



Are we striking at an economic piñata from which will fall all the missing elements of economic recovery? We believe not. Protectionism that moves away from globalization runs the risk of increasing the input costs to US manufactures, endangering profit margins. There are many growth retarding forces; protectionism is one of them. The real impact of tariffs is their effect on household income and domestic production both of which would likely decline. It is far from certain that expansionary fiscal policies (tax cuts and increased Infrastructure expenditures) will lead to an improving economy in early 2017 as markets seem to believe.

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Investment implications:

We should not be too quick to abandon assets with strong cash flows in exchange for cyclical growth aspirations. Defensive sectors and dividend stocks are still warranted in stock portfolios. Interest rates will not be able to move up for long without shutting down growth. Meanwhile, growth is still held back by high debt levels that must be serviced. Middle income Americans are already much more leveraged than high income households who have benefited the most from expansionary monetary policy driving up asset prices. Housing and autos will rapidly hit a wall if rates move too far. Accordingly, take advantage of over-sold interest sensitive sectors and be wary of a strong Dollar stunting exports in now over-priced cyclical shares.

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