The Trump Rally and The Markets

Following the election of Donald Trump U.S. equity markets have rallied on expectations of a pickup in economic growth and corporate profits. President elect Trump's bold plan to boost growth has centered around tax cuts for corporations and individuals, repatriation of cash held overseas, increased infrastructure spending and less government regulation.

Despite the fact that this economic expansion has been the weakest in the post-World War II period (as measured by real GDP), the S & P 500 has staged its largest 35 day post-election rally since 1928 (Source: Investech). This is mostly based on the prospect that Trump's policies could unleash a period of stronger, more dynamic growth in the quarters ahead.

For now the market is advancing largely based on expectations for a pickup in economic growth as opposed to an actual pickup in growth. In addition, little attention is being paid to the potential of trade wars and tariffs (a low but not zero probability) that may also result from Trump's new economic policies.

On the economic front, recent data has largely been positive and that has also helped provide a tailwind for equity markets over the past several weeks. For example, consumer confidence data (Source: The Conference Board) recently increased to the highest level since July, 2007, the latest Small Business Index (Source: NFIB Small Business Sentiment Index) rose 3.5 points last month, the most recent Home Builders Sentiment Index (Source: Wells Fargo / National Association of Home Builders) rose to a new cycle high of 70 and weekly jobless claims (Source: Bureau of Labor Statistics) remain near multi-decade lows.

The recent surprise announcement by OPEC to curtail production by 1.2 million barrels per day has helped support oil prices and should create a more positive supply / demand picture in coming quarters. The sharp decline in oil prices from mid-2014 into 2015 helped drive down inflation and also led to a drop in global capital equipment spending. Some of that should now start to turn around.

Compared with their prior peaks, nominal disposable income, nominal GDP and corporate profits all stand 25-30% above peak levels established during the last recovery. In addition aggregate household net worth (i.e. total assets minus total liabilities measured quarterly by the Federal Reserve Bank) has recovered following the last recession and now stands at $90 trillion dollars (35% above its prior all-time peak).

One area that has continued to lag the recovery in the rest of the economy (and one that President-elect Trump is focused on) is manufacturing. Here evidence is somewhat mixed in terms of recent data. On the positive side the widely watched Institute for Supply Management (ISM) manufacturing index currently stands at 53.2 and has now been above the key 50 level for three straight months (note: a reading above 50 indicates expansion while a reading below 50 indicates contraction). The Philadelphia Fed's 3-6 month outlook on capital expenditures (which is forward looking) was just released and rose to its highest level since January, 2015. On the other hand, new orders

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for durable goods on a national level (which also come out each month) have been more mixed over the past year.

In terms of the markets, investors have certainly turned more bullish in recent weeks. Fund flows have started to pick up, the American Association of Individual Investors weekly survey now shows that there are more than three times as many bullish investors as bearish investors and the number of investors buying puts versus calls (reflecting a rising complacency) has fallen considerably.

Looking ahead, we remain moderately constructive and believe that as a result of new policy initiatives, there is a good chance the economy experiences a pickup in growth next year. For reference, The Organization for Economic Cooperation and Development ($OECD_1$) currently forecasts a pickup in growth of 0.4% in 2017 and 0.8% in 2018. Trump's fiscal plans are still somewhat vague and making dramatic speeches to get elected and actually implementing those plans are two different things.

We are also mindful that equity markets have already enjoyed a pretty significant advance in recent weeks. Valuation levels (measure by the P/E ratio) which were on the higher side before Trump got elected have moved even higher. The "P" i.e. price in the P/E ratio has advanced while the "E" i.e. earnings has not kept up with the P in recent weeks. Thus the forward looking price to earnings ratio for the S & P 500 is now around 17.5x versus a 20 year average of 15.5x (source: Factset). Valuation levels could continue to advance near term but will ultimately need to be supported by stronger economic fundamentals and a sustained rise in corporate profits.

We remain strongly overweight U.S. stocks, as we have been over the past several years. According to data from the research provider Factset, profits and sales for companies in the S&P 500 are currently forecast to rise 11.5% and 5.9% respectively in 2017 (versus estimates of very modest growth in 2016). Ten out of eleven S&P 500 sectors are currently forecast to generate positive growth next year led by double-digit growth in financials, materials, technology and energy stocks (bouncing back from losses in 2015 and 2016).

Out of favor foreign stocks provide lower valuation levels but greater uncertainty. We believe that there will be a time to add to overseas holdings but we are not confident that the time is right just yet.

On December 14th, The Federal Reserve Bank raised the short term Federal Funds Rate for the second time this cycle to a level of .75% or 75 basis points. This was widely expected by the markets and well telegraphed by the central bank. Despite the fact the market was expecting a quarter point increase in rates, equity markets sold off following the Federal Reserve Bank meeting due to the fact that the statement issued by Janet Yellen and company following the Fed meeting forecast three rate hikes in 2017 versus the original 2 that investors had been looking for.

We think it's important to keep two points in mind. First the starting point for the current rate cycle of close to zero is much lower than the level where the central bank has started raising rates in the past cycles (including 1994, 1999 and 2004). Second, it's important to recognize that The Federal Reserve Bank is raising rates because the economy is no longer on life support and somewhat higher rates reflect a healthier economic outlook.

Looking at market technicals, the Dow Jones Industrial Average posted a new all-time high back in July but the Dow Transports and Russell 2000 Small Cap Index failed to post new highs due to the fact they fell more sharply back in 2015. However, over the past few weeks all

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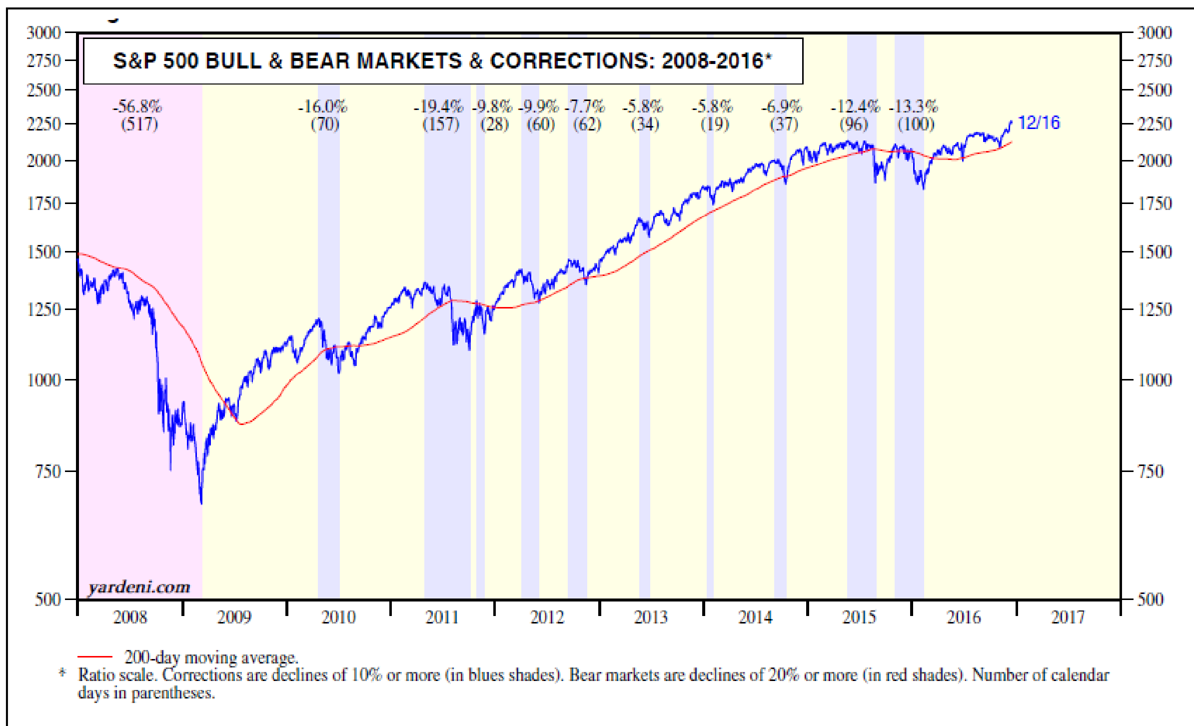
three indices recently posted all-time highs and the advance / decline line for the S & P 500 posted a new all-time as well. Due to the fact that the advance / decline line for the market has historically peaked several months ahead of the overall market, we think this is a positive sign that the bull market is likely not over just yet.

Keep in mind that historically, equity markets have experienced a pullback of 5% or more approximately every 3 ½ months, a correction of 10% or more about once per year and downturn of 20% or more about once every 3 ½ years (Source: American Funds – based on market data from 1900 - 2015). Therefore despite the positive data highlighted above, that does not mean equity markets cannot experience periods of profit taking from time to time.

Markets are not designed to go up in a straight line as they basically have since the election. When this kind of straight line market advance occurs, there is typically some sort of pullback or consolidation. So like we have seen at least ten times since 2009, a pullback of some nature would not be a surprise to us and in fact may turn out to be an investment opportunity. For reference, the chart below (Source: Yardeni Research, Inc. - 12/16/2016) highlights market pullbacks and corrections that have occurred throughout the course of the current bull market.

Right now we don't see an economic downturn looking out over the next few quarters. Since we don't see a recession, our strategy has been to remain pretty much fully invested. As we have mentioned before, we don't try and time the markets. Since we continue to see growth ahead, even in the face of full valuations, astutely asset allocating is more prudent than trying to time temporary pullbacks or corrections in the market.

One thing we have done over the past few months is make modest allocation changes to upgrade and strengthen the overall quality of our portfolios. Given the positive returns that we have already experienced during the current expansion (which is now 90 months old), we



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believe that investors may have to be a little more patient and adjust their return expectations somewhat going forward.

On the bond side our fixed income strategy has been working as well as we could have hoped this year. While the majority of your fixed income holdings (for most clients) are in laddered individual bonds, our shorter-term diversified bond funds have at least so far done a good job navigating the most recent period of rising rates. Bond yields may head higher in early 2017 reflecting the prospect of somewhat higher growth and inflation. We would not be surprised to see a modest pickup in inflation during the first half of 2017 before inflation levels likely come back down over the next several quarters. Lastly, with the level of national debt to GDP at almost 80%, bond yields can only rise so much further but they would start to have a major negative impact on the U.S. economy.

In summary, equity markets in the U.S. have continued to move higher in recent weeks reflecting somewhat more positive economic data as well as a combination of hope and expectations regarding the future. Given the recent sharp rise in the dollar, the rapid increase in interest rates, above trend valuation levels and continued uncertainty surrounding implementation of President Elect Trump's economic plan, we feel the market may need to pause or pullback somewhat before investors reassess what comes next.

Some of the positives that have been driving stock prices higher are real such as rising consumer confidence, better retail sales data, a healthy jobs market, signs of a possible pickup in manufacturing and improvement in credit spreads. These trends appear likely to continue (and could get stronger). Overall, we remain generally constructive but also realistic as well. Importantly, from an investment perspective, the U.S. and global economies continue to grow. We remind everyone that just as we have witnessed throughout the current multi-year bull market, there will be occasional bumps and unforeseen events along the way.

Among some of the risks on our radar, the new Republican administration may fail to implement its ambitious economic plan, investors become wary of rising debt levels, the Federal Reserve could start raising rates more aggressively or a geopolitical event overseas could create a risk-off market environment.

Respectfully,

Ron Weiner
Managing Director/Partner

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Chief Investment Officer

1-The OECD stands for the Organization for Economic Cooperation and Development. It represents 34 democratic governments and more than 70 other non-member economics and its goal is to help promote economic growth, prosperity and sustainable development.

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