SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2017/I

HOPE AND FEAR

At an investment conference I recently attended, one participant gave a very impressive talk. Instead of presenting his research on the economy or the market, he discussed a research project he did *on himself*. He had examined every investment *mistake* he made over his career as a trader, to see if he could identify a pattern. In his case, he found that he could handle one market setback a day, and still make good decisions; but two or more setbacks in a single day affected his equilibrium, and he started making bad decisions. Armed with this new self-awareness, he can devise ways to prevent himself from making the same errors in the future.

It was a brutally honest and thought-provoking exercise, one that highlights a lesson worth taking to heart: *often the greatest risks to our investment security and success come not only from external events, but the way we respond to those events, buffeted by the natural human responses of hope and fear*. It comes as a timely reminder, in the wake of a deeply divisive election.

For many people, right now, their economic and market outlook is essentially a referendum on how they feel about Donald Trump. If they like him, then good times are just around the corner. If they don't, things are headed downhill. In the week immediately after the election, the gap between Republicans who told Gallup the economy was getting better, versus getting worse, rose from −65% to +5%, while the gap between Democrats plunged from +26% to −1%.

We understand the temptation to see everything through the divided lens of the election, but we are self-aware enough to realize that this can mislead us, or at least blind us to signposts that have guided us well. There was an economy before the election. We wrote about what it looked like, and what it meant for investors. The election introduced new factors into that equation, but it didn't wipe the chalkboard clean. Presidents can do things that influence the business cycle, but they do not command it, and they often find themselves constrained by it.

In the two months since Election Day, the U.S. stock market has focused on the potential upside of a Trump Administration—and rallied accordingly. Analysts have discussed how a proposed cut in the corporate income tax rate, from 35% to 20% or even 15%, could deliver an immediate boost to earnings per share (EPS), justifying higher share prices. A more accommodating regulatory stance towards banks, fossil fuels and small business is expected to give those sectors a further boost. Trump's pitch for a $1 trillion plan to upgrade the nation's roads, bridges, tunnels, and airports, along with $250 billion to build up U.S. military forces, have bolstered investor enthusiasm for domestic makers of construction equipment and building supplies, as well as defense contractors. The combination of big tax cuts and big spending, many hope, could juice U.S. GDP growth in 2017. They are counting on another plan, to encourage American companies to bring home nearly $2.5 trillion in overseas profits by charging a special tax rate of just 10%, to pay for at least some of it. Even if that returning money doesn't kick off a boom in new business investment, as proponents envision—and given all the excess cash so many U.S. companies are already holding, there's reason to doubt that it will—it could still end up being channeled into acquisitions, additional share buybacks, and dividend payouts, which would support higher share prices.

As a result, the Dow Jones Industrial Average (DJIA) has surged +8.2%, its largest gain from pre-Election Day close to year-end since Herbert Hoover was elected in 1928. The Hoover parallel is *not* predictive—the next runner-up was Eisenhower in 1952—but it does illustrate how things are never quite as simple as they seem.

IT'S NOT SO SIMPLE

Take taxes, for instance. Investors need to understand that the plans being proposed involve not just tax *cuts*, but changes to the *structure* of the tax code, changes that could affect different people and different companies in very different ways. To help pay for reducing and simplifying personal income tax rates, Congress is looking at eliminating the deduction for state and local taxes, which could undo much of the benefit for people living in high-tax states like California or New York. It may offset cuts to corporate tax rates by eliminating the deductibility of interest payments on future loans, which could make debt financing a lot more expensive. The most dramatic move being considered is the so-called "border adjustment tax": exempting exports from the corporate income tax, while imposing it on the value of all imports. Exporters would obviously see a big tax cut, while companies that need to buy inputs or merchandise from abroad could end up paying more taxes, even at a lower rate. Even if exchange rates eventually shifted to cancel out the impact, as many anticipate, the price adjustments could be highly disruptive, with some better able to cope than others, both at home and abroad.

There's a case to be made for many of these changes: plenty of economists have argued that the federal tax code shouldn't be subsidizing higher corporate debt or state taxes, or that the U.S. should move to a more consumption-based tax. The fact remains, however, that if enacted, these changes would produce losers as well as winners—with important implications for investors. In the meantime, some of the prospective losers are likely to push back, which means we could see months of political horse-trading before we get a final picture of what any new tax legislation will look like. If unpopular clawbacks are dropped, it could limit the amount of tax cuts that are possible, or deepen the budget deficit resulting from any stimulus.

Talk of a fiscal stimulus comes, in any event, at an unusually mature point in the business cycle, with the Federal Reserve already looking to raise interest rates. Fed Chair Janet Yellen, after their December meeting, drew an important distinction between potential Trump Administration policies aimed at unlocking productivity gains, which she welcomed, and measures that simply juice demand—which, as the U.S. economy nears full employment, could prompt the Fed to raise rates, to head off inflation. Expectations of Fed pushback against short-term stimulus have already boosted the U.S. dollar to a 14-year high, following the election. The dollar's rise makes U.S. exports more expensive, reduces the value of U.S. corporate earnings abroad, and undercuts the pricing power of U.S. companies at home. These headwinds to growth and earnings, from a stronger dollar, could blunt much of the positive impact from a Trump stimulus, even before it materializes.

Another potential complication is health care. For the past six years, Republicans have made repealing the Affordable Care Act (ACA, otherwise known as Obamacare) their defining cause. Now that they've captured the White House, they see delivering on this promise as a political imperative. That could prove tricky, because while they can use the budget process, which is immune from a Senate filibuster, to disable the financial provisions that make ACA work, they don't have enough votes to replace it with a functional alternative over solid Democratic opposition. We hear their most likely strategy will be to strip out those key provisions, but on a time delay (2-5 years), then ask Democrats to let them replace it with something before time runs out—or else. Democrats could refuse, calculating that voters would hold Republicans responsible for whatever train wreck ensued. In any case, we may be in for an extended period of uncertainty, and political brinksmanship, over the rules governing a sector that accounts for 1/7 of the U.S. economy.

And then there's trade. Like us, Donald Trump sees the chronic U.S. trade deficit as a problem that puts limits on growth. Unlike us, he sees "bad trade deals", rather than deep-seated structural imbalances, as the culprit. By banging our fists on the table a lot harder, Trump believes, we can get better deals and turn things around. And banging away is just what he's been doing: pulling the plug on the 12-nation Trans Pacific Partnership (TPP) signed last year and on similar talks with Europe, insisting he will renegotiate NAFTA or pull out, talking tough on China, and threatening to slap big tariffs on U.S. companies that relocate jobs abroad.

We don't take every "tweet" from Trump as established policy, but it's clear that some kind of showdown is in the cards. Trump's aides brush aside worries he might trigger a trade war with China, arguing we're already *in* a trade war—one that China started, and we're losing. It makes a great quip for TV, but takes little account of the more than $650 billion in trade the U.S. does with China each year, which would find itself in the crosshairs. True, more of that are imports than exports, but Americans are consumers as well as producers. Whatever the shortcomings of the current relationship, American exporters selling soybeans or airplanes to China, companies managing complex global supply chains, and consumers buying the clothing and iPhones they make could all be severely affected if it took a turn for the worse. Trump's suggestion that the U.S. could disavow its "One China" policy towards Taiwan, unless Beijing makes a deal on trade, shows how easily trade tensions can spill over into something larger and more dangerous. Many of the more radical actions Trump has threatened could run afoul of World Trade Organization (WTO) rules, a prospect that has prompted some—including Trump himself—to suggest that perhaps the U.S. should quit the WTO, an act that would have historic and far-reaching consequences that would be difficult to calculate.

In the economic plan they put out during the campaign, Trump's top advisors put great emphasis on closing the U.S. trade gap as a way to boost growth. But trade imbalances aren't the result of hapless deal making, to be fixed with some tough-minded arm-twisting. They reflect patterns of consumption, savings, and investment embedded in the broader economy, at home and abroad. Ironically, Trump's other policies—debt-funded fiscal stimulus, for one, and encouraging U.S. companies to bring home overseas profits, for another—affects these factors in ways that are actually likely to *widen* the trade deficit. We may even be seeing the effects already, as goods exports fell (−1.0%) and imports rose (+1.2%) in November, in part due to the soaring U.S. dollar. A widening trade deficit is likely to detract from GDP growth in Q4.

KEEP CALM AND CARRY ON

So, given these concerns, do we think the U.S. stock market is overvalued, and due for downturn? Not necessarily—and here's where the economic and market trends that preceded the election come into play.

The U.S. economy continues to show resilient, if uneven, growth momentum, with the Atlanta Fed projecting Q4 GDP growth of +2.9%, and the New York Fed a more cautious +1.9%. Manufacturing output slipped −0.1% in November, but the sector generally seems to be on the mend from last year's slump, which was induced in large part by a rising dollar. The ISM Manufacturing Index jumped to 54.7 in December, its highest reading in two years, bolstered by the strongest new orders in 2½ years. Consumer confidence has also surged to its highest levels this cycle, following the election, with raised expectations among older consumers leading the way. Actual spending and sales have been slower to perk up, but consumer spending is still up a healthy +4.2% from a year ago, with retail sales up +3.8%. One good sign: companies have been able to steadily rein in their inventories, back from worrisome levels, without pulling the economy into recession.

Stock prices have indeed rallied, but it's been accompanied by a solid rebound in corporate earnings from last year's energy and materials-led slump. In Q3, S&P 500 quarterly operating earnings per share bounced back to its highest level in two years, and if Q4 earnings meet our projections, the 12-month trailing P/E ratio will actually recede slightly to 20.8x, from a peak of 22.1x three months ago. The post-election surge in U.S. Treasury yields (to 2.45% for the 10-year), coming alongside the stock market rally, has compressed the equity risk premium from 6.3%, at the beginning of November, to 5.7% at the end of December. That's still well above the long-term average of 4.1%, and highlights a case we've made before: that a generous equity risk premium can act as a cushion for share prices as interest rates rise on rising growth expectations. That's precisely what it's doing right now.

The thrust of our concern isn't that the economy is suddenly going to fall into a ditch, pulling the market along with it, but that kicking growth into higher gear will prove harder than a lot of people seem to think. After seven years of recovery, the issues placing limits on U.S. growth are mainly structural, and structural challenges can't be solved with counter-cyclical policies.

Take jobs. The Fed often elicits guffaws when it points to an official unemployment rate of 4.7% as evidence the U.S. may be nearing full employment, considering that nearly 15% of men age 25-54 aren't working, compared to just 5% in 1953. Yet new jobless claims are close to their lowest point in 43 years, and the nation's 5.5 million job openings have outpaced hiring for the past two years, indicating that employers are having a hard time finding the people they need. We've talked to software developers desperate to find young people who can code, trucking companies struggling to find drivers who can pass a drug test, construction firms that are losing out on contracts for lack of plumbers, carpenters, and electricians. Simply creating more jobs, by ramping up demand, without improving people's capacity to fill those jobs, accomplishes little.

As he enters office, Donald Trump faces a difficult set of choices. The market, and voters, will cheer policies that promise a quick and easy bump to growth. But the key to growth—not just in America, but in China, Europe, Japan, and elsewhere—lies in tackling challenges, and laying foundations, that often come at a short-term cost, in exchange for a longer-term payoff.

It's tempting to ride the current wave of confidence—only to turn tail at the first sign of disappointment. Our advice to investors is the same as it was before the election: have realistic expectations, keep your eyes on the long term, and avoid falling prey to the changing tides of sentiment. Last year, Silvercrest's projection of +5% earnings growth proved far more realistic than the consensus projection of a +30% rise. This year, our optimism—which is rooted in evidence of continuing growth momentum, a recovery in earnings, and the absence of any immediate threat from inflation—is once again tempered by a sober appraisal of risks.

This is not the time to be passive. Investors must actively distinguish between companies that stand to gain from proposed tax changes, and ones that could be harmed; companies that directly benefit from proposed stimulus spending, and those most vulnerable to headwinds from a stronger dollar; companies that might profit from get-tough trade tactics, and others that have the most to lose from a showdown or breakdown in trade relations.

Fixed income investors spooked by the abrupt rise in bond yields, after the election, should keep in mind that the 10-year U.S. Treasury rate ended 2016 just +18 basis points higher than it began. Yields fell to their lowest *ever* during the summer, so what the election triggered is less a collapse in the bond market than the end of a record-setting bond rally. Relative valuations still favor equities, but the gap is not as wide as it was before. Rising expectations for inflation and rate hikes are, so far, mainly limited to the U.S., which induces capital to flow to the U.S., keeping U.S. rates from rising as much as they otherwise might. It's also easy to imagine a range of political or economic shocks, at home or abroad, that could rekindle anxieties and send investors rushing back to "safe harbors". To the extent investors can't afford to ride out this kind of volatility, bonds continue to provide an important source of diversification and stability.

The incoming President-elect is unconventional and untested, with a flair for stirring controversy. We could be in for a bumpy ride. But whether we, as investors, "will be very happy", as Donald Trump promises, depends as much on what we do, to keep our heads and stick to a disciplined investment strategy, as on what he does.

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ECONOMIC FORECAST

(As of January 10, 2017)

	2014	2015	Estimated 2016	Projected 2017
Real GDP (Y-O-Y)	2.4%	2.6%	1.6%	2.2%
Consumption Expenditures	2.9%	3.2%	2.7%	2.4%
Business Fixed Investment	6.0%	2.1%	-0.5%	2.0%
Inventory Investment (Billions)	$57.7	$84.0	$7.0	$20.0
Residential Investment	3.5%	11.7%	4.3%	2.0%
Government Spending * (Billions) (a)	$2,833.0	$2,883.7	$2,910.0	$2,951.0
Trade Balance-Goods & Services (Bil.)	-$490.2	-$500.4	-$500.0	-$515.0
Federal Budget*: Unified (Billions)	-$484.6	-$438.4	-$590.0	-$593.9
Gross Federal Debt* (Billions)	$17,794	$18,120	$19,383	$20,162
Consumption Price Deflator	1.5%	0.3%	1.1%	1.7%
Producer Price Index	0.9%	-7.3%	-2.8%	-2.0%
Consumer Price Index	1.6%	0.1%	1.2%	1.8%
Industrial Production	2.9%	0.3%	-1.1%	0.6%
Real Disposable Income	3.5%	3.5%	2.7%	3.0%
Hourly Compensation	2.8%	2.9%	2.8%	3.0%
Unit Labor Cost (Non-Farm)	2.0%	2.0%	2.9%	3.0%
Productivity Growth (Non-Farm)	0.8%	0.9%	0.1%	1.0%
Personal Savings Rate (% DPI)	5.6%	5.8%	5.9%	5.5%
Capacity Utilization – Total Industry	78.2%	76.7%	75.3%	76.0%
Trade Weighted $ Exchange Rate (b)	3.2%	16.1%	0.7%	10.0%
Vehicle Sales (Million Units)	16.9	17.8	17.8	17.0
Housing Starts (Million Units)	1.003	1.112	1.160	1.210
Civilian Employment (Millions)	146.3	148.8	151.4	154.0
Civilian Unemployment Rate	6.2%	5.3%	4.9%	4.9%
Corporate Profits – After Tax	2.5%	-8.5%	4.1%	4.0%
S&P-500 Earnings-Operating	$113.01	$100.45	$107.50	$117.00
S&P-500 Dividends	$39.44	$43.39	$45.70	$50.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.08	(0.02)-0.29	0.18-0.54	0.25-1.50
10-Year U.S. Treasuries-Yield (%)	2.07-3.01	1.68-2.50	1.37-2.60	1.50-4.00

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*