SMITH AFFILIATED CAPITAL

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Irrationality Won't Out Trump Reality

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As the curtain rises on 2017, expectations in the financial markets are running high, as investors are pricing in faster growth – and higher inflation – than was the case a few month ago. However, this is not the first time that the winter has ushered in a blast of optimism, reflecting firmer data over the second half of the year. In most cases, however, the reality failed to live up to the hype. In five of the past six years, the economy's performance over the first six months of the new year turned out to be weaker than the second half of the previous year. Will the opening act of 2017 suffer a similar disappointing fate? Or, should we cling hopefully to the notable caveat that past performance does not guarantee future results?

Time will tell. Clearly, much of the optimism is based on hope – as well as hype. Yes, the economy picked up some momentum over the second half of last year. But a 2.5 growth rate – the likely second-half pace – hardly represents the escape velocity that would propel it out of the lackluster 2 percent growth orbit. Indeed, the economy lost momentum towards the end of 2016; following the promising 3.5 percent increase over the July-September period, incoming data for October and November indicate that growth in GDP slowed to under a 2.0 pace in the fourth quarter. At this juncture, the economy is poised to grow modestly faster in 2017 than in 2016, assuming it can avoid the first-half bust that damaged growth this year; from our lens, however, the markets are overreacting to the trumped-up growth prospects of the president-elect.

No doubt, the markets have thrived on the prospect of a more expansionary fiscal policy, expecting that the economy will receive a positive jolt from lower taxes, increased infrastructure spending and reduced regulation, all major themes the president-elect espoused during the campaign. In a certain world, that scenario would have a reasonably good chance of playing out. Traditionally, elections have reduced political and policy uncertainties. But in this case, an unusually elevated degree of uncertainty remains. How much of Trump's proposed tax and spending plan – which is estimated to balloon the public debt by more than $5 trillion over the next decade – will be accepted by Congress? While Republicans control the House and Senate as well as the White House, they are still the party of fiscal orthodoxy. Hence, the process of cobbling together a fiscal policy will involve some serious horse-trading on Capitol Hill early next year. If it turns into a headline-grabbing acrimonious debate, it could undercut household and business confidence and erase the goodwill now prevailing in the financial markets. The theatrics seen during the campaign may be the opening chapter of what's to come.

Where's the Beef?

With a nod to that old Wendy's commercial, we can't help but wonder, "Where's the beef?" For sure, the economy displayed more muscle over the second half of the year than in the first, when it grew by a skimpy 1.1 percent pace. But the soybean-fueled spike in growth during the third quarter has already faded even as investors still believe the economy is off to the races. If the data since the election is any indication, market participants may soon have to reconsider their ebullient outlook. True, the economy has not relapsed to the near stall-speed of the first half of the year. But the main growth driver—consumers – is looking fatigued, as spending has slowed considerably from the summer months. Some hint of that was provided in the Commerce Department's report that retail sales increased by a tepid 0.1 percent in November. The agency later confirmed that the consumer lethargy was broadly based; in its more comprehensive report on personal income and spending, it revealed that real personal consumption expenditures for all goods and services – which account for roughly 70 percent of GDP – also increased by a skimpy 0.1 percent in November, the same as in October.

Significantly, that was the slimmest back-to-back increase in nearly three years and puts real PCE on track to increase at an annual rate of 2.0 percent in the fourth quarter. That would be a marked slowdown from the upwardly revised 3.0 percent in the third quarter and the more robust 4.3 percent in the second. With other recent data on industrial production, inventories and trade also coming in on the weakside, the broader economy is tracking a growth rate closer to 2.0 percent than the 3.5 percent of the third quarter – belying the nascent momentum that the financial markets assumed was underway. Simply put, the economy ended 2016 like a lamb, not a lion, hardly justifying the ebullient behavior of the financial markets since the election.

What's more, the consumer price data have yet to validate the recent uptick in market-based inflation expectations that has driven long-term interest rates up by more than a half-percent since the election. Both the personal consumption deflator and the core deflator, which excludes volatile food and energy prices, were unchanged in November and the year-on-year increase in the core deflator slipped to 1.4 percent from 1.6 percent in October. This widening shortfall from the 2 percent target has to be disappointing to Fed officials, particularly since it is occurring despite the firming of energy prices over the past year. If, as we suspect, the economy's growth engine remains in second gear at least through the first half of 2017, little progress will be made towards closing the disinflationary output gap any time soon. In November, the industrial operating rate stood at 75 percent, a full 5 percentage points below its long-term average.

Growth Constraints Will Impede Trumped-Up Forecast

During the campaign, Trump promised to lift growth to the 3.5-4.0 percent range, breaking through the 2.0 percent orbit that has become the new normal for the economy over the past decade. While the financial markets appear to be buying into this bold assertion, the odds of such a sustained dramatic ramping up of the economy's growth engine are very low. The economy has not reached a 3.0 percent growth rate for a full year since 2005. The best since then was the 2.6 percent recorded in 2015; last year, growth slipped back to 1.6 percent. If all goes smoothly, the pace should pick up to slightly over 2.0 percent in 2017 and accelerate to about 2.5 percent in 2018, which would be the earliest that a more expansionary fiscal policy – if enacted quickly – would have a meaningful impact on growth.

Keep in mind though that Trump the candidate strongly espoused some growth-dampening proposals during the campaign. While some of them would require congressional approval, others could be implemented quite soon. For example, president Trump would have the executive power to pull out of trade agreements and impose tariffs on our trading partners. Such protectionist measures would no doubt lead nations to retaliate in kind, resulting in lower exports – and business investment – and growth. What's more, if Trump 'sticks to his guns' on immigration and strives for mass deportations, the labor force would come under further downward pressure, thus reinforcing the reduced participation rate that is already slowing labor force growth.

Even assuming that Trump backtracks on his harsh protectionist and immigration proposals, it will be very difficult to elevate the nation's potential growth rate much above 2 percent on a sustained basis. The economy's speed limit is determined by growth in the labor force and in productivity. Both have slowed considerably from their long-term trends over the past decade. Since 2007, productivity has increased at less than half the 2.2 percent annual rate seen during the 1990's and significantly slower than the 1.7 percent postwar average. Few experts believe that productivity will return to the trend growth rates seen in earlier years. In its latest forecast, the Congressional Budget Office estimates that productivity growth will average 1.3 percent a year over the next five years. That, together with the projected slowdown in the labor force, to an annual rate of 0.4 percent from a postwar average of 1.5 percent, is why the agency believes the economy's potential growth rate is much weaker than in the past. The CBO is projecting a 1.7 percent annual growth rate in potential GDP from 2016 to 2021, a significant haircut from the postwar average of 3.2 percent.

To be sure, brief growth spurts –perhaps even to 4 percent – can be generated if more workers are lured off the sidelines, lifting the participation rate, or existing workers are coaxed into putting in longer hours. But the long slide in the labor force participation rate to a 38-year low is more than just a cyclical phenomenon related to weak demand. With the aging baby boom generation entering retirement at a rate of 10, 000 a day, it would take more than just stronger growth to lure them back to the work force. Nor could the declining participation rate among the prime 25-54 age cohort be easily reversed; according to recent respected studies, most of that decline is due to health-related reasons, not to the lack of job opportunities.

Perhaps the most direct way to boost the labor force would be to open the gates for foreign workers to enter the country, but that would be in direct conflict with Trump's immigration stance as well as the perception by labor that globalization has been stealing American jobs. What's more, the major source of worker displacement since the beginning of the century has come from automation, which ironically is the best hope of boosting productivity growth. But as noted, productivity has been slowing along with the labor force, and near-term prospects for a turnaround are grim.

One reason is that the long slog in capital spending – which would give workers more productive tools to generate output – is showing no signs of ending. For one, corporate America is operating with ample spare capacity, as evidenced by the low utilization rate noted earlier. For another, the prospective return on new investment in a weak global environment does not justify the expenditure, mirroring the low interest rates that prevail around the world. While cash flow is plentiful and financing is accessible, corporations are using their excess funds to reward shareholders, repurchasing stock and boosting dividends. We suspect that if president Trump gives tax relief to companies to repatriate funds from overseas, most of the estimated $2 trillion would be employed for the same purposes, not pumped into plant, equipment or updated software.

Near-Term Headwinds Will Arrest Yield Climb

From our perspective, irrationality has taken hold in the financial markets since the election, driving stock prices and bond yields well beyond the point justified by economic and inflation fundamentals – both actual and prospective. Growth slowed considerably towards the end of the year, inflation remains under control and headwinds are gathering force. That said, the irrational movement in asset prices is having real results. The spike in mortgage rates over the past month is poised to dampen activity in housing; refinancing activity has already fallen off a cliff – dropping by more than 30 percent since October – and the NAR's Pending Home Sale index, a leading indicator of existing home sales, fell 2.5 percent in November to the lowest level in nearly a year.

Meanwhile, the dollar's post-election surge puts another obstacle in the way of a manufacturing revival, increasing the price of factory goods relative to overseas competitors. Even as higher interest rates underpin the dollar's strength, it is also luring foreign capital to the U.S., which may already be capping the yield increase. Foreign demand accounted for more than 70 percent of the Treasury's $34 billion 5-year auction held in the last week of the year, a record share. With more than $10 trillion of long-term bonds carrying negative interest rates globally, this pull from overseas investors is poised to continue. Not coincidentally, the Treasury auctions coincided with a modest decline in bond yields at the end of the year.

To some extent, the increase in bond yields over the past month reflects expectations that the Fed will follow through on its plan to hike short-term rates three times in 2017, as set forth in the dot plots at the mid-December policy meeting. But an even more aggressive forward guidance was given at the December 2015 meeting, which fell by the wayside: instead of the planned four rate hikes, the quarter-point increase last month turned out to be the only move taken in 2016. We suspect that the planned 3 hikes for 2017 will also be watered down as we see the economy tolerating at most two increases. What's more, both will be back-ended towards the end of the year assuming a more expansionary fiscal policy is put into effect.

Our sense is that the first installment of the fiscal stimulus will consist of tax reductions, which deliver a smaller bang for the buck in terms of economic growth than increased government spending. Trump will not have an easy time getting an austerity-minded Republican Congress to agree to large spending initiatives. If some infrastructure outlays are agreed upon, they will most likely not go into effect until later in the year and would not have a meaningful impact on the economy until early 2018.

While the budget deficit is destined to grow in 2017, it should not contribute to upward interest rate pressures. Not only is there a huge foreign appetite for Treasury issues, as indicated by the latest auction bidding, but pension funds and other institutional investors need to rebalance portfolios that have become top-heavy with stocks owing to the run-up in equity prices following the election. The growing event risk from geopolitical disruptions will reinforce the demand for safe and liquid assets. Trump will have his hands full balancing his relationship with Putin against Russia's unpredictable meddling in the political affairs of former Soviet satellite states, not to mention his desire to undercut NATO and other Western alliances. Then there is the risk that Trump will ramp up tensions with China, which he continues to label a currency manipulator, something that could, if nothing else, heighten volatility in the financial markets. Also, let's not forget Brexit and the rise of populist sentiment, which could facilitate the disintegration of the EU as we know it. In this uncertain economic, political, and global environment, we suspect that the ebullient market behavior in recent months will fade as investors adopt a more defensive posture.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.48	0.43	0.61	0.12	0.67
2-Yr. Note	1.05	0.76	1.19	-0.56	0.64
5-Yr. Note	1.76	1.15	1.93	-3.34	0.48
10-Yr. Note	2.27	1.59	2.44	-6.81	-0.16
30-Yr. Note	3.02	2.32	3.07	-13.75	0.88

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	2.85	2.35	3.36	-4.52	1.11
ML G.O. 22+ Index	2.66	2.33	3.32	-5.99	-0.04

Equities	Levels			US $ Terms (%)	
	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
S&P 500	2,043.94	2,168.27	2,238.83	3.81	11.93
DJIA	1,742.50	18,308.15	19,762.60	8.65	16.46
NIKKEI (Tokyo)	1,903.40	16,449.84	19,114.37	1.17	5.85

Commodities	US $			Percent Change (%)	
	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,060.20	1,315.75	1,147.50	-12.79	8.23
CRB Future Com. Pr. Index*	176.14	186.32	192.51	3.33	9.29
West Texas Intermediate Crude ($ per bbl)	37.04	48.24	53.72	11.36	45.03

Currencies	Levels			Percent Change (%)	
	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
Yen	120.22	101.35	116.96	-15.40	2.71
Sterling	1.47	1.30	1.23	-4.87	-16.26
Euro	1.09	1.12	1.05	-6.39	-3.18

Foreign Bond Markets	Levels			US $ Total Return (%)	
	12/31/2015	9/30/2016	12/31/2016	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	-0.09	-0.35	-0.35	N/A	N/A
ML German 10-Yr.+ Bond Index	1.20	0.18	0.63	-6.52	9.65
3-Mo. LIBOR Yen Fixing (3)	0.08	-0.02	-0.05	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.78	0.22	0.40	-3.17	8.12

Source: Bloomberg Financial Data
Notes: 1) 9/30/2015 thru 12/31/2016 2) 12/31/2015 thru 12/31/2016

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index