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2017 Economic Outlook

A Long-Range Economic Look at the Year 2017

Economic Outlook

Economy

POSITIVES

- Rising spending on big ticket items
- Potential for lower taxes and regulations
- Upsurge in consumer expectations
- Recession tripwires are benign

NEGATIVES

- More active Federal Reserve
- Stronger dollar
- Uncertain tax and spending policies

Gross Domestic Product (GDP) growth over the last ten years has been among the lowest in our nation's history. However, recent upsurges in consumer and business expectations could prove beneficial.

While hope is rising, concerns remain on *when* and *what* will get done in Washington. Campaign promises have included lowering corporate tax rates and eliminating two federal regulations for every new one passed. Proposed infrastructure spending is for $1 trillion over the next ten years. Too often campaign promises are delayed, watered down or abandoned.

Among the challenges for the economy are the ending of the lax monetary policy era. Further, rising inflation could eventually prove problematic. While unlikely, a trade war would put pressure on U.S. and worldwide GDP growth. Overall, we believe economic activity should improve over 2016.

Stocks

POSITIVES

- Excessive institutional bearishness
- Smaller cap stocks rebounding
- Market moving out of doldrums
- Improving economy

NEGATIVES

- Post-election year
- High valuations
- Excessive indexing
- Federal rate hikes

After a case of the doldrums, the election appears to have triggered a "hope" rally in stocks. These often continue for a period of months. Institutional investors have built up high liquidity reserves due to their bearishness, a solid positive.

Valuation methods like Schiller's CAPE*, Tobin's Q* and Market-to-GDP* are all extended and large stocks usually underperform over the next five years. Retail investors have aggressively moved into index funds leaving the market vulnerable to shifting sentiment. The Federal Reserve will likely hike short-term rates, historically a dampener for stocks.

Compared to large stocks, we believe smaller ones offer better bargains. Smaller stocks have lagged for years and are finally showing signs of strength, which could prove long-lived.

Bargain stocks suffered in much of 2016. This condition has historically been temporary and we expect a return to normal in the months ahead. This would favor stocks with relative value, solid earnings and excellent price strength.

Overall risk levels are moderate. We will see some added volatility as the market continues its transition but active management should add value.

Bonds

POSITIVES

- Repatriation could reduce borrowing needs
- Potential overreaction to Trump proposals
- Municipal bonds attractive

NEGATIVES

- 35-year era of lower rates may be ending
- Wage inflation picking up
- Foreign Treasury selling suggests low demand
- Low yields mean greater volatility

Interest rates have been steadily falling for the past 35 years. The potential for higher rates is afoot. Wages, one of the main contributors to inflation, is rising. Inflation expectations are near multi-year highs and suggest overall inflation could be above the Fed's target rate of 2%. Lower demand for U.S. Treasuries across the globe could also affect rates.

Even with a long-term outlook of higher interest rates, we have found some potentially sound approaches to bond investing. These include less volatile shorter-term instruments. Certain investments such as Treasury Inflation Protected Securities (TIPS) and Floating Rate notes should provide price stability when rates move higher. High-quality municipals may be attractive. The recent sell off after the election could provide a short-term buying opportunity.

International

POSITIVES

- The global economy is growing faster
- Growing number of new pro-business countries
- Europe moving away from austerity
- Many commodity producers are cheap

NEGATIVES

- Migration issues stress European economies
- Federal Reserve Bank (Fed) raising rates could scare emerging markets
- China slowdown a drag on global growth

The world breathlessly waits for the Trump administration to show its hand. But we believe the global economy will likely grow at a faster rate in 2017 than in 2016. Central bankers are calling for more stimulative fiscal policy, while holding rates close to historic lows. Inflation is being ushered back into the global economy.

Opportunities are rising in emerging economies producing basic commodities, especially metals. Some of these markets are very reasonably priced and may do well even if the U.S. dollar continues to strengthen. New pro-business governments in Peru, Argentina and other nations should be good for their stock markets. An end to austerity and lower taxes should mean stronger economies in many countries, even in Western Europe.

We believe trade negotiations will be fruitful for the United States and a trade war is unlikely. If evidence of this becomes clearer, emerging markets such as Russia and Indonesia could experience a strong Relief Rally.

Conclusions for 2017

For Business Executives

- **Prepare for potentially lower taxes**
- **Plan on stronger dollar**
  - Import prices should fall
  - Export growth to slow
- **Potential for overall growth to improve**
  - Borrow while rates are low
  - Emphasize U.S. facilities
  - Overall growth likely to improve

For Investors

- **The Year of Transition**
- **Key: being nimble**
- **Domestic Stocks**
  - Expensive valuations problematic for indexing
  - Smaller stocks better bargains
  - Bargain/active investing likely to improve
  - Overweight: financial, telecoms, discretionary sectors
  - Underweight: electric utilities and certain basic material stocks
  - Precious metals not as compelling
  - Market vulnerable to negative surprises
- **Bonds**
  - Fed rate hikes likely
  - Inflation to pick up slightly
  - Expect more bond volatility
  - Utilize ladder approach: diversify across maturities
  - Select municipal bonds attractive
  - TIPS and floating rates may offer opportunities
- **Foreign Investments**
  - Favor pro-growth countries, especially commodity producers like Australia, Argentina and Peru
  - Lower taxes could benefit certain Western European countries
  - Wildcards: successful trade negotiations would benefit Russian and Indonesian stocks

**__Shiller's CAPE__ – (cyclically adjusted PE) is a valuation measure, generally applied to broad equity indices, that uses real per-share earnings over a 10-year period. *__Tobin's Q Ratio__ – the Q ratio is calculated as the market value of a company divided by the replacement value of the firm's assets. *__Market-to-GDP__ – the stock market capitalization to GDP ratio is a ratio used to determine whether an overall market is undervalued or overvalued.*

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