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Andrew Kohl
Chief Investment Officer

Economic Update

December 2016

By Andrew Kohl

Commentary

As 2016 draws to a close, it will be likely be best known as the year that populism took hold in several parts of the developed world. There is no better evidence of this than the surprise election of Donald Trump in the U.S. and the U.K.'s vote to leave the European Union (a.k.a. "Brexit"). Prior to their occurrence, conventional wisdom was that these events would lead to market turmoil. Instead, a sense of optimism regarding economic growth in the U.S. has taken hold and the stock market has surged forward to an all-time high. In 2017, the question is whether this sense of optimism will be fulfilled.

Optimism is being fueled by expected changes to the fiscal landscape in the U.S. The market is expecting the incoming Trump administration to deliver on its promises to cut taxes and to increase infrastructure spending. Given that the Republicans control Congress, it is very likely that some progress will be made on both fronts. Although, we are doubtful that the timing and the magnitude will meet current expectations.

On the tax side, it is important to analyze the last two episodes of major tax cuts (1981 and 2001) to see if they offer any clues. The first thing that stands out is that those cuts took place when the Congressional Budget Office ("CBO") was projecting budget surpluses. Currently, the CBO is projecting budget deficits over the next several years. Secondly, the level of debt to GDP is much higher today than where it was when the previous cuts were enacted (77% currently vs. 31% in 2001 and 25% in 1981). Given these factors, we think that the level of tax cuts will be watered down (or offset by other changes) by a relatively significant amount from Trump's latest proposals.

As for the timing of when any tax reform will occur, it would likely take until the latter half of the year before any changes would be enacted into law. After that, it has been more common for tax reform to be phased-in over a certain period rather than have the full impact hit in year one. This was the case for the last two major tax cuts. For political reasons, Republicans may prefer that the largest benefit to consumers' wallets coincide with the election cycle (2018 & 2020). Therefore, we see little economic impact to tax cuts in 2017.

We see much of the same story on the infrastructure spending side. The markets seem to be underestimating how long it takes to move through the legislative process. Even if a plan were to move through Congress quicker than expected, it takes time for allocated funds to actually get "spent".

Fortunately, the economy in 2017 should be able to manage along just fine without these expansionary policies taking effect until 2018 or beyond. Economic data was already turning up prior to Trump's election. We think that another year of 2% of real GDP growth is in the cards for 2017. The main risks to this forecast are trade protectionism and populism. Protectionism can hurt economic productivity and further gains for populism in the developed could lead to a dismantling of the Euro.

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Fixed Income Outlook

The Treasury curve rose marginally since the end of November. As expected, the Fed hiked rates on December 14. The Fed's updated economic projections and Janet Yellen's press conference was slightly more hawkish than the market projected. Importantly, Yellen seemed to dismiss the notion of running a "high pressure" economy to get further improvement in the labor market. In addition, the median projection for the number of hikes in 2017 moved from two to three. Bond prices seem fairly cheap at these levels as the market is assuming high odds that Trump's plans get enacted quickly.

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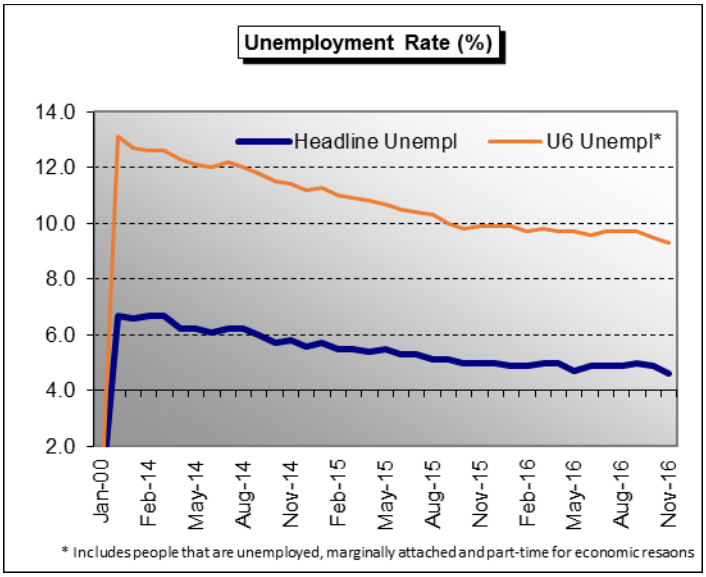
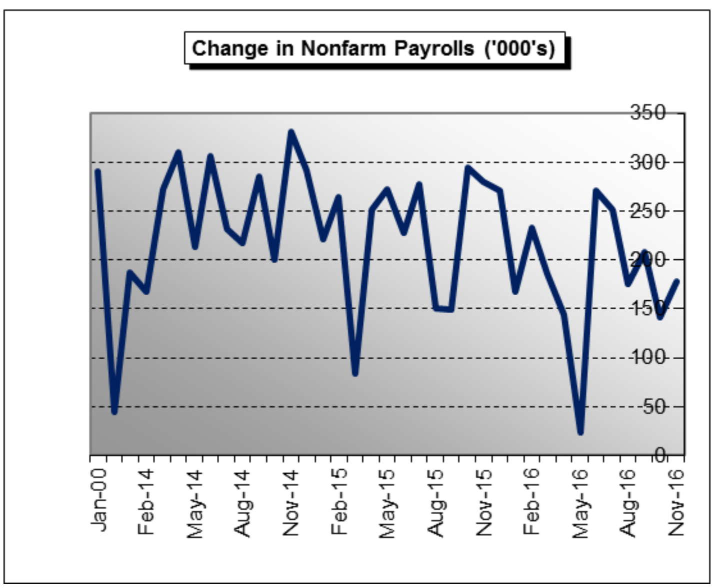
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Declines to 4.6%

The unemployment rate in November dropped to a post-recession low and now stands at 4.6%. The number of involuntary part-time workers dropped to an eight-year low, which caused the "underemployment rate" to fall to its lowest level since April 2008. Average hourly earnings came in below expectations, but it was largely due a one-off event (Hurricane Andrew). The three-month moving average of hourly earnings remains near a post-recession high.



Job Gains Meet Estimates

Payroll growth in November was in line with estimates. Payrolls increased by 178,000 jobs versus an expected gain of 180,000 jobs. The three-month moving average of job growth is 175,000. If this pace continues, the job market will continue to tighten and wage gains should see further upside.

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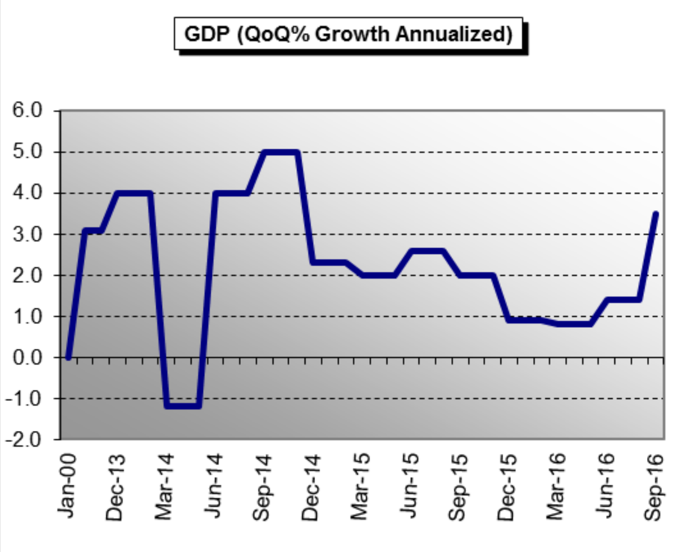
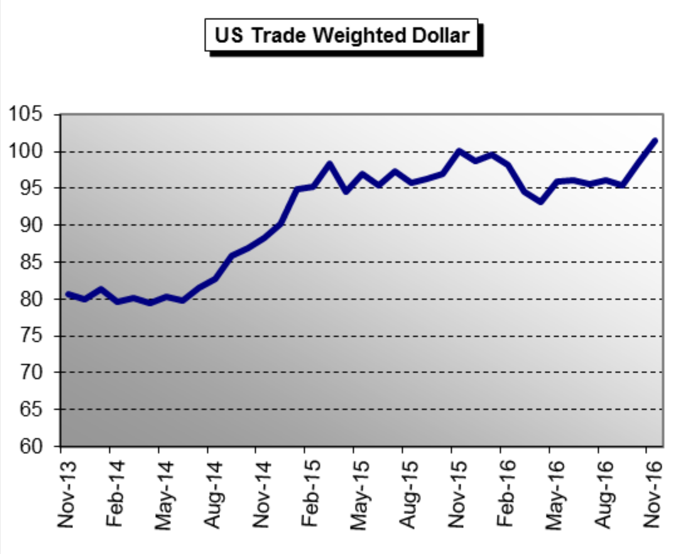
Economic Growth Readings
(Data source: Bloomberg)



Third Quarter GDP Revised Upwards
The final estimate for third quarter GDP showed stronger growth than the initial projections. The growth rate was revised upwards from 3.3% to 3.5%, mainly due to stronger R&D expenditures and consumer spending. Despite the weak start to the year, it appears that 2016 will produce the 2% year-over-year growth rate that we've been experiencing over the last several years.



Dollar Soars with Trump Election
The U.S. dollar has risen by over 5% since the election. The dollar's strength is due to higher expectations for U.S. growth and interest rates given the Trump victory. A stronger dollar is a negative for the U.S. manufacturing sector, as imported goods are relatively cheaper and exports more expensive.

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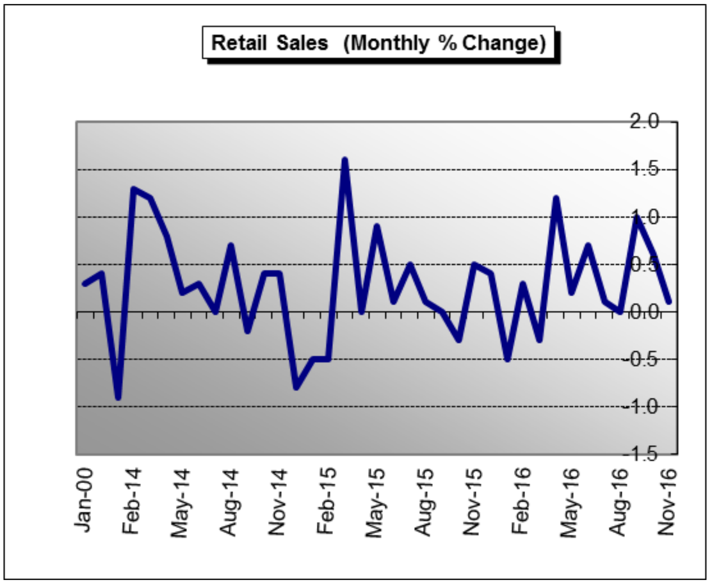
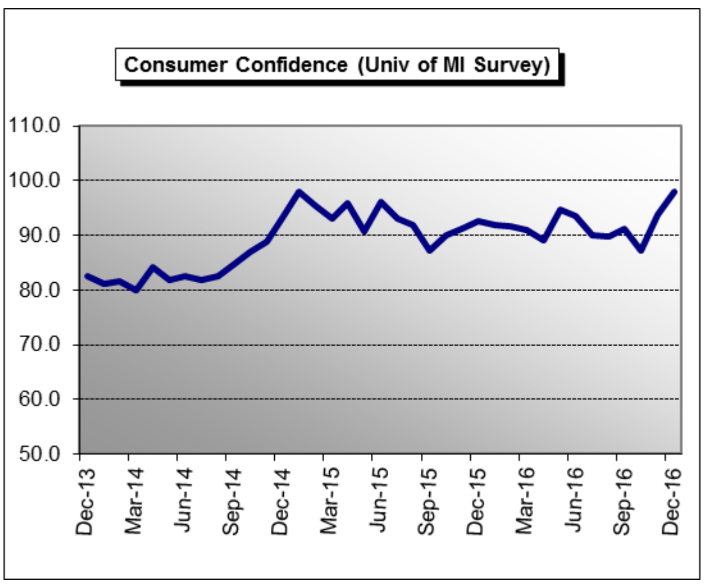
Consumer Readings
(Data source: Bloomberg)



Retail Sales Disappoint
Retail sales in November came in below expectations. Sales advanced by .1% on a month-over-month basis versus a forecast for .3% growth. In addition, October's sales were revised downwards. Despite the downside miss, the consumer remains in good shape given the improving labor market and asset prices.



Consumer Confidence Surges
Consumer confidence jumped more than forecasted and stands near the highest level in two years. The increase over the last two months combined is the largest for a two-month period since 2012. The current conditions component of the index reached the highest level since 2005. The optimism is being driven the Trump election and hope that he will implement positive changes in taxes and economic growth.