Review & Outlook

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"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."
-James Carville, former policy advisor to President Bill Clinton[1]

Review

After the election on November 8th, a falling market appeared to suddenly turn around, with many calling this rebound the "Trump rally". But it is important to remember that appearances are not always what they seem. In reality, the S&P 500 index started its rally four days before the election results were known, when most people were still predicting that Hillary Clinton would win. The market had been grinding steadily downwards during the fourth quarter, and that mid-quarter rally helped the market regain its losses. For the remainder of the quarter, the market remained strong, reaching all-time highs in December before slipping a bit to end at 3.65%. The gains in the fourth quarter market were not broad-based, and it is important that investors not lose sight of the losses in 2016 that preceded the year-end gains.

The "Trump rally" was driven largely by the promise of reduced regulation, stimulus spending, and tax cuts for businesses. But those are promises that cannot be fulfilled immediately. It will take time to put policies in place that will help company earnings catch up with stock prices. We anticipate that the inherently slow process of crafting new policies, combined with the ensuing debates surrounding those policies, will invite questions in early 2017, and challenge the optimism of the 4th quarter.

While recent gains in the stock market have been significant, the increase in interest rates (particularly long term rates) and the resultant drop in bond prices has been truly remarkable. The US 10-year Treasury started the quarter with a rate of 1.6%, and is now currently at 2.5%. This is one of the sharpest increases in interest rates in US history. As a result, bond funds holding long duration bonds experienced significant losses, and shorter term bonds fell in value, but by much less.

Outlook

The Federal Reserve increased the federal funds interest rate by a quarter point in December, its first increase in 12 months. Based on expectations of continued slow growth in the economy, falling unemployment, and slight increases in inflation, there is anticipation of three additional hikes in 2017. However, we should remember that in December 2015, four rate increases were anticipated in 2016.

Recent economic forecasts remain conservative, with GDP growing a little over 2% in 2017[2]. This prediction comes from a panel of 52 professional forecasters, and reflects a post-election survey. It is still far from clear what President-elect Trump's policies will be on issues such as trade, immigration, and infrastructure spending. However, given Republican control of the executive and legislative branches, it is likely there will be significant tax cuts for both corporations and individuals. Corporations with vast amounts of pre-tax profits stored "off-shore" are likely to be enticed to repatriate some of those profits under a new tax deal. Some of this cash should find its way into the markets, either directly (through dividends and share buy-backs), or indirectly (through mergers, acquisitions, and increased investment). It is likely that a significant amount of regulation will be rolled back, which should generate additional profits, at least in the short-term. While there is much talk of massive infrastructure spending, it is not clear what Congress will actually approve, or when the effects of that spending might be felt.

Headwinds for the financial markets include higher interest rates driven by increased deficits following from tax-cuts and new infrastructure and/or military spending. Upward pressure on interest rates should be good for banks, but not for other areas of the economy. In general, rising interest rates slow the rate of economic growth. Rising US interest rates will likely drive up the US dollar, as foreign capital flows to US assets. This will negatively impact US exporters and the revenues of foreign multinationals translated into US dollars.

There are some scenarios that would be highly disruptive to global economic activities. These include policies that negatively affect trade and supply chains. For example, if technology supply chains with Taiwan were unsettled by disputes with China, companies such as Apple and Intel would almost certainly experience significant losses. This scenario would likely be bad for US equity markets, and could also disrupt fixed income markets. In past global financial crises, capital has tended to flow into US Treasuries as a safe haven asset, driving bond prices up and interest rates lower. It is not clear how foreign investors would react to a significant disruption like the example outlined above.

Moreover, if policies do not provide the benefits markets are expecting, we could see downward adjustments in equity prices. The big questions are when/if those adjustments might occur, and how large they might be.

In Focus

In the last "In Focus", we reviewed the case for a new normal regarding low interest rates. Since then, we have experienced a rise in the US 10-year Treasury rate from 1.61% to 2.59% (a gain of almost 1% in 72 days). Annualized, this works out to an increase of about 5% per year, a historically high rate of increase for the US economy. We doubt this level of interest rate increases will persist for any extended period of time, but we must keep in mind the actual 10-year interest rate itself is still very low by historical standards. Are we at the forefront of a long-term trend of rising interest rates that is likely to be measured in years and decades, rather than months? If so, what factors have changed to start driving interest rates higher? One thought is that the "Great Recession" is truly over and interest rates can return to normal. Another factor is a change in "fiscal tightening." After all, the recent move higher started well before the election, when it became apparent that both candidates would likely support significant spending on domestic infrastructure. President-elect Trump has added to that view with statements about trillion-dollar infrastructure investments.

Significant fiscal spending and increased deficits could potentially drive up interest rates, as the US Treasury would have to pay lenders more to borrow. However, if developed, sovereign interest rates around the world remain significantly lower than US interest rates, the US Treasury could likely borrow vast amounts of money causing a measured rise in rates over time, as opposed to a crippling, rapid rise.

One thing to watch is the deficit. If US deficits become large enough, global capital could demand significantly more payment for loaning the US money, driving interest rates up more rapidly. We recognize that risk, but do not expect rates to rise rapidly (or to continue the rate we saw in the 4th quarter of 2016). We anticipate tax cuts, but only limited infrastructure spending. Layering hundreds of billions of dollars in unfunded infrastructure spending on top of tax cuts seems unlikely, as it would result in larger deficits than many Republican policy makers are likely to accept. As such, we expect more moderate increases.

We also note that our strategy of holding laddered, short duration bonds with an ability to hold until maturity helps us avoid capital losses if interest rates continue to move upwards, regardless of the rate of change.

1. McCormick, Liz Capo, and Daniel Kruger. "Bond Vigilantes Confront Obama as Housing Falters." Bloomberg.com. Bloomberg L.P., 29 May 2009. Web. 1 Dec. 2016.
2. "NABE Outlook Survey - December 2016." NABE. National Association for Business Economics, n.d. Web. 23 Dec. 2016.

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