Market Pulse Report

December

SUMMARY

The knee-jerk reactions to the surprising election outcome are out of the way, leaving longer-term implications to consider. While the investment implications of new policies will need to be continually evaluated as many unanswered questions remain, rash portfolio decisions should be avoided. For now, we suggest investors:

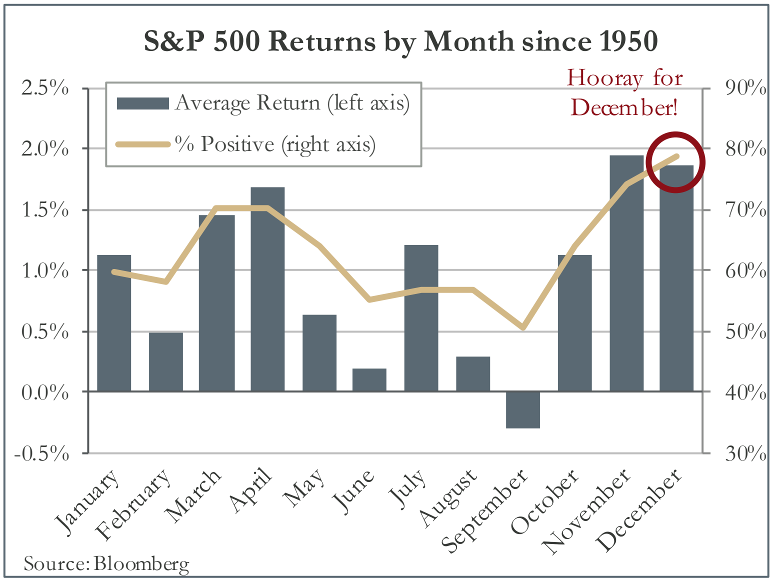
Embrace the earnings revival. Trump policies might or might not provide a jolt to economic growth. Regardless, corporate earnings were already on the right track to provide a tailwind for stock markets.

Don't stress over a moderate rise in inflation. An increase in inflation to a pace that is more consistent with a steadily growing economy would be welcome after years of tepid growth, and could be of benefit to risk assets. Given lingering slacks in the economy, we do not see extreme levels of price gains on the horizon.

The spike in yields may or may not have run its course. While there is a case to be made for higher yields from here, there are also still plenty of forces putting downward pressure on rates (such as demographics and central bank policies). Even if yields continue to rise, it should not be of a magnitude that would be disruptive to the economy or capital markets. Longer duration core bonds, however, remain a relatively unattractive asset class.

A Turning of the Tide: New Trends in Earnings, Inflation, and Interest Rates

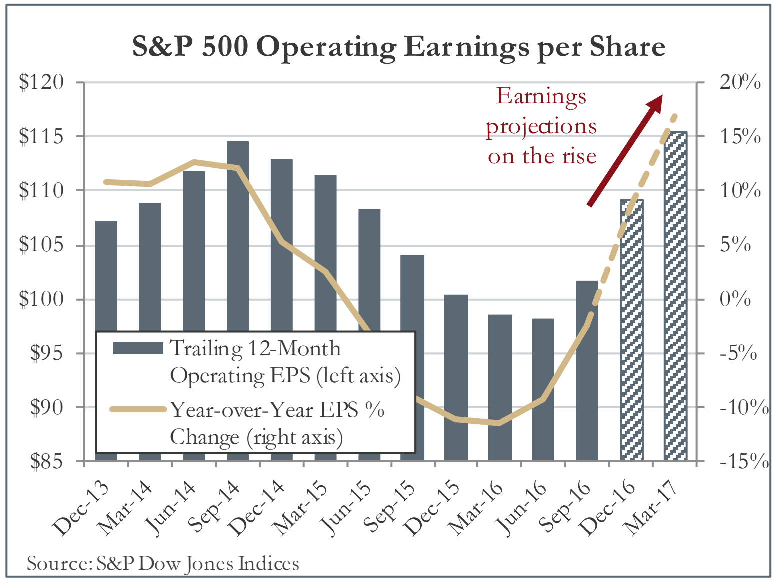
The elections have come and gone, and investors can now look past politics and turn their attention to what matters—the holidays! The winter season is often, after all, a merry time for markets. The S&P 500 has generated a positive return in December nearly 80% the time over the past 65 years, far and away the best winning percentage of any month. And December's historical performance is nothing to scoff at either, with an average monthly return of 1.9% since 1950 (the second-best performance of any month, just lagging behind November). That's a



pretty good combination, and usually worth celebrating. But before we break out the eggnog, let's check in on some things that *matter* for capital markets—namely corporate earnings, inflation, and interest rates. In the post-election environment, each of these elements is in a state of flux, with some major trend reversals underway.

Earnings are Recovering.

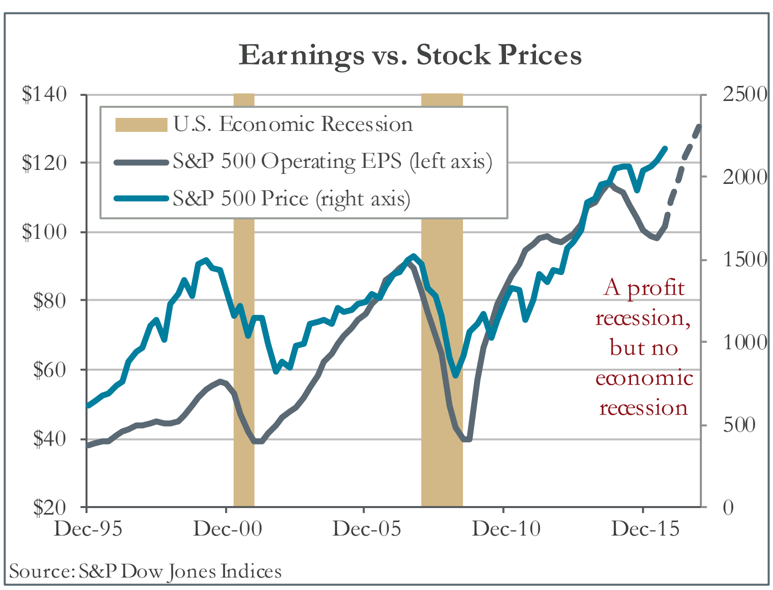
President-elect Donald Trump will inherit quite a few challenges, but it appears that a "profit recession" (consecutive quarters of declining earnings growth) may not be among them. The recent earnings season has shown the tide is turning, with profits and revenues making headway in rising out of their recent lull. Optimistically, markets are also hoping some of Trump's perceived policies (tax cuts, increased fiscal spending, and relaxed regulation) might provide a boost to stagnant economic growth, which in turn would provide a further lift for corporate earnings. As earnings are one of the primary fundamental drivers of stock returns, this could bode well for equity markets.



Source: S&P Dow Jones Indices

Of course, the earnings situation is far from rosy. Judging by recent earnings performance calculated by S&P, year-over-year earnings growth is still underwater and recovering from a rough patch (which stemmed largely from the energy sector collapse). By most definitions, we have been in profit recession for more than a year. Whether the new administration's growth-enhancing policies actually come to fruition remains to be seen, and the benefits to domestic profits could be offset by rising interest rates, a stronger dollar, higher inflation, and restrictive trade policies. In any event, with equity valuations considered to be at full levels, earnings likely need to show meaningful improvement over the next several quarters to drive positive stock returns.

The good news is that the tide has been rising— a trough was forming even pre-election. Major headwinds from 2015-2016 (the energy price collapse and U.S. dollar spike) have subsided. Furthermore, the ongoing recovery should be sustainable regardless of the Trump administration's impact. Consumer confidence remains high, wages are starting to show gains, and if a long-awaited increase in consumer spending materializes, it could lead to better corporate profits going forward. Barring an external shock (such as another oil price collapse, a dramatic dollar surge, inflation, a spike in wages, or a debilitating trade war), the U.S. earnings situation going forward should continue to look better than it did a year ago, even if the economy continues to only muddle along.



Source: S&P Dow Jones Indices

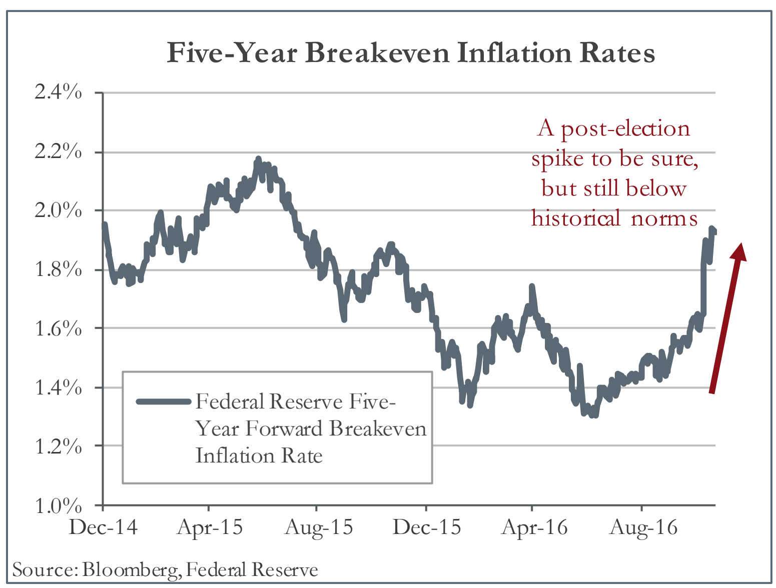
Why does this matter? As a chart overlaying earnings against stock prices illustrates, the two tend to go hand in hand. As long as we expect the economy and corporate earnings to experience positive long-term growth terms, so too should the stock market. A rebound in earnings and profits in 2017 should only provide a tailwind for stocks.

A Hint of Inflation. While prospective Trump policies have brought hopes of a growth revival, there has also been a resurgence in U.S. inflation expectations following the election. The same recipe of tax cuts and expansionary fiscal policy that may be a boon for growth is also a formula for inflation, especially if a tight labor market (which could be constricted further by new immigration policies) and restrictive trade policies are thrown into the mix.

Now, a little inflation is not necessarily a bad thing, and a return to moderate levels is something that has been sought after by central banks in recent years. Over time, steady and relatively mild inflation provides an environment conducive to real wage increases, which in turn may propel broader economic gains. Inflation can also be beneficial to stock holders and owners of physical assets such as property, increasing confidence as prices rise and leading to a boost in spending. Too little inflation (or even deflation), and consumers tend to delay purchases while the real value of debt increases and wages decline (a bad combination).

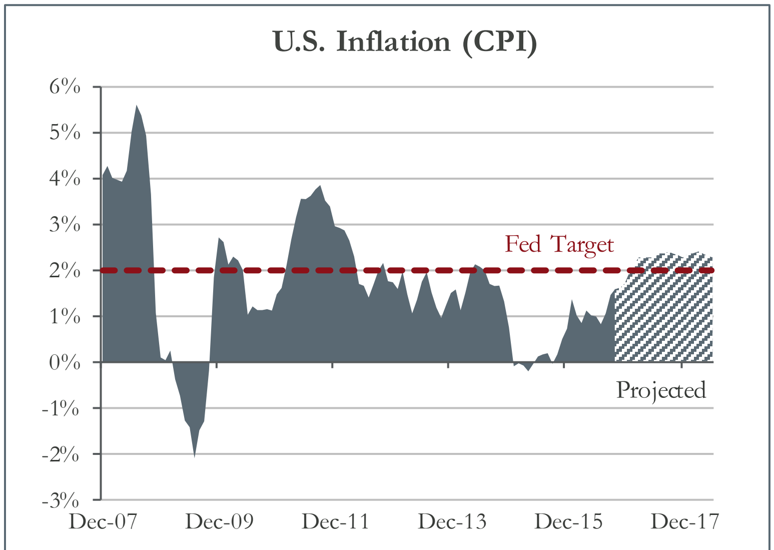
Too much inflation, on the other hand, is not good either. Inflation erodes the purchasing power of one's currency and can particularly hurt those whose incomes are more or less fixed (such as retirees). When inflation is accelerating, corporate profit margins are encumbered due to rising costs, discouraging investment and growth. Hyperinflation can even lead to a shortage of goods.

The challenge for central banks everywhere is striking the right balance. Inflation is kind of like porridge—best when it is not too hot nor too cold. And whereas recent years have been marked by a dearth of inflation, the election outcome has warning bells ringing for a resurgence. A chart of the five-year breakeven inflation rate (what market participants expect inflation to average over the next five years, as implied by TIPS prices) shows just how dramatically U.S. inflation expectations have spiked in recent weeks. Adding fuel to the fire, many believe the Federal Reserve may be willing to tolerate any possible overshooting of inflation rather than raise rates too fast and risk choking off growth.



But let's not put the cart before the horse. While traders have embraced the reflation theme, whether many of the new administration's potentially inflationary policies actually see the light of day is uncertain. Moreover, policies that might lead to further dollar strength could even dampen inflation. For now, actual U.S. inflation remains relatively benign, and it is too early to tell whether inflation is truly making a comeback.

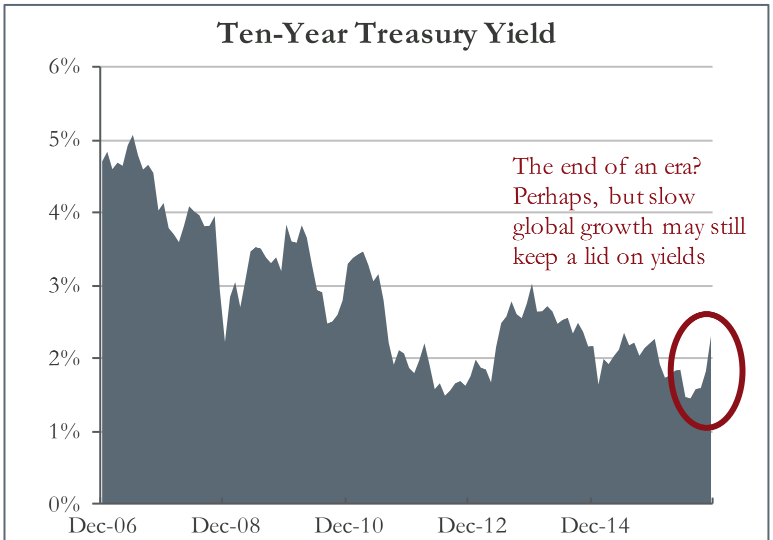
Headline consumer prices did, however, accelerate in October to their highest rate in two years (due largely to rising shelter and energy costs), but the 1.6% year-over-year pace remains subdued from a historical context. And while projections for the next couple of years are slightly above the Fed's target of 2% (which they believe represents a healthy balance of promoting growth without overheating), expectations remain well below the damaging levels seen in the 1970s.



Source: Bloomberg

We do not think any moderate uptick in inflation is something to get overly excited about, especially if it comes in conjunction with faster rates of growth and not as a result of protectionism and higher import prices. Certainly, a faster pace of inflation could speed up the pace of Fed rate hikes and hinder the bond market. In such a case, asset classes that tend to perform well in inflationary environments, such as TIPS, commodities, natural resource equities, and MLPs, may warrant new consideration. But there is no rush to add inflation protection, and we would temper any desires to drastically modify portfolios.

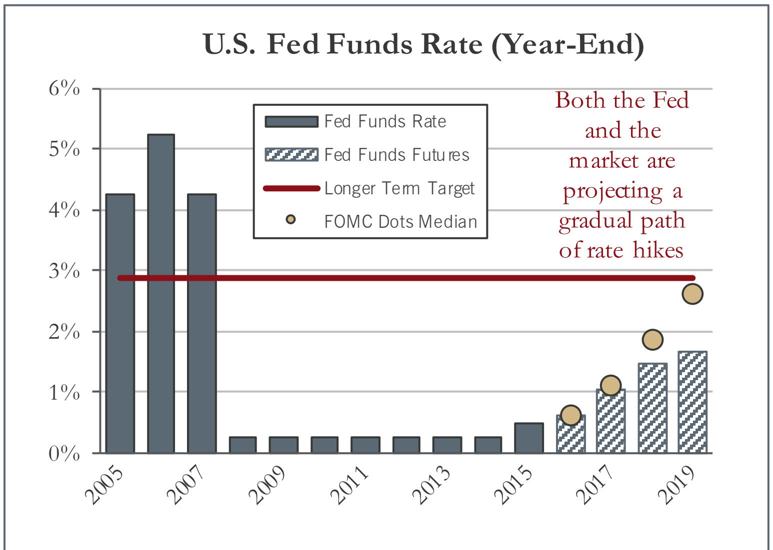
A Spooked Bond Market. Worries of higher inflation and increased deficit spending have sent bond markets into a tizzy. That should not come as much of a surprise, as fixed income instruments such as Treasury bonds see their income eroded with rising inflation. What might be surprising is just how quickly the tide of public opinion regarding bonds turned negative in the post-election period, especially given that new spending policies will take time to be enacted (if at all). The yield on the U.S. ten-year Treasury note jumped from below 1.8% prior to the election to above 2.3% in the weeks following (a pretty big move in such a short amount of time for the normally placid bond market). Investor flows out of bond mutual funds and ETFs since the election, are also shaping up to be significant.



Source: Bloomberg

It is easy to overlook the trend reversal towards higher yields was already in place prior to voting—the ten-year note is 100 basis points higher now than its summer low (1.36% on July 8th). As bond prices move in the opposite direction of yields, the iShares 7-10 Year Treasury Bond ETF (ticker: IEF) has since lost nearly 7% of its value (reinforcing the fact that bonds are not risk-free in the near-term, especially those with longer duration). Clearly, bond investors are resetting expectations, and many are suggesting the 35-year bull market in bonds is finally over.

It is not just Donald Trump that has bond investors worried—Fed Chair Janet Yellen has also been contributing to bond market anxiety. Markets have increasingly priced in a 25 basis point rate hike at the upcoming December 14th FOMC meeting (astoundingly, now a 100% probability based on Fed funds futures). There is also some concern that if Trump's policies end up causing faster growth and rising inflation, it could force the Fed to raise rates faster than previously planned. Thus far, Chair Yellen disagrees, reiterating that the central bank expects to raise rates only gradually over the next few years (as the Fed's so-called dot plot, which tracks the assessment for appropriate rates by each member of the Federal Open Market Committee, suggests) and that the near-term risk of "falling behind the curve" is limited. Markets, as based on Fed funds futures, tend to agree with her assessment and are perhaps even more sanguine.



Source: Board of Governors of the Federal Reserve System

So, if inflation is not a huge threat and the Fed is not off to the races, is the bond market overreacting? Perhaps—we anticipate a more gradual shift higher in yields from this point—but it does not change the dismal outlook for core bonds. Until rates reset at much higher levels, the odds heavily favor subpar returns from core bonds over intermediate timeframes. They will either generate scant income due to low yields (though one-time price gains are possible if yields fall) or will be hurt by rising rates (and falling prices).

Conclusion. The surprising election outcome leaves longer-term implications to consider. If you can believe the hype, there will be massive fiscal stimulus, tax cuts, reduced regulation, a bump in economic growth (assuming trade restrictions and a strong dollar do not provide too much of a hindrance), and a significant increase in the national debt. The implications of these new policies include hopes for renewed earnings growth, the threat of faster inflation, and the burden of rising yields. These implications contrast with trends the markets have been experiencing over the past few years, and a change in tides can be quite scary for investors. While the investment implications of new policies will need to be continually evaluated as many unanswered questions remain, rash portfolio decisions should be avoided.