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2017 Mid-Year Outlook

Whither the Trump Reflation?

July 25, 2017

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Executive Summary

- **Economy resilient; growth continues, maintain equity positions**
- **Expect increased volatility, valuations elevated**
- **Low interest rates due to dampened inflation expectations, not signaling imminent downturn**

After President Trump's unexpected November 2016 election victory, both stocks and bond yields ripped higher. The new market narrative of broad fiscal and healthcare reforms, infrastructure spending, and deregulation all served to reinvigorate prospects for growth in the US economy. However, since the calendar flipped to 2017, we've seen unusual market trends evolve. Equities continued to rise while longer term bond yields reversed course and steadily declined. This is surprising in the face of three Fed rate hikes during the last six months

What should we make of all this? In this Mid-Year Review, we discuss these developments, including market drivers which we believe may prove volatile but resilient during the second half of the year.

A Strange Divergence

Following last year's election, a more optimistic market narrative quickly took hold and sparked major stock and bond market moves under the assumption that a Republican Congress and Presidency would quickly pass market-friendly policies, including:

- Tax cuts and tax reform
- New stimulus and infrastructure spending
- A reduced regulatory burden, and
- Repeal and replacement of Obamacare

This resulted in a sharp stock rally and a significant uptick in rates (decline in bond prices), which persisted through the end of 2016. This was a "normal" market reaction during times of increased economic confidence, as higher equity prices signal greater near-term business optimism while rising rates indicate better odds of rising inflation and Fed hikes.

Since early 2017, however, this Washington-driven optimism has eroded as DC gridlock set in and very little of the expected pro-growth agenda has materialized. During this period, the stock and bond markets have noticeably diverged:

- The S&P 500 kept rising and is up over 8% on the year
- The Treasury yield curve flattened (a shift with higher short-term rates but lower intermediate and long-term rates), with the 10 Year Treasury declining from 2.44% to 2.30% as of June 30th

S&P 500, 2016 Election – June 30th

Source: Bloomberg

Situations where the prices of both bonds and stocks are rising simultaneously (bond prices move inversely to yields) are unusual and often not sustainable. This is because higher stock prices typically signal economic optimism while lower bond yields (and a flattening curve) often signal an upcoming economic slowdown. Given the lack of progress in DC, why haven't stocks followed bond yields and reversed direction?

Shifting Market Narrative

We believe this stock-bond relationship makes sense given the current economic reality, and is likely to persist. There are reasons to believe the domestic economy is strong and generating the organic earnings growth necessary to sustain this lengthy economic expansion. Given that this strength is also now being augmented by long-awaited recoveries in other major international economies, this appears to be the real engine behind the S&P 500's strong YTD performance despite fading prospects for Trump policy reforms and stimulus.

We can point to several pieces of evidence showing resilient organic expansion:

- Corporate revenue and earnings per share (as shown by S&P 500 EPS) are finally growing following several years of no perceptible growth. Revenues in the first quarter were up 9% and profits rose 15% year over year. Moreover, the detailed breakdowns indicate Corporate America appears to have moved on from relying on cost-cutting to raise margins.

S&P 500 Earnings

Source: Bloomberg

- Despite three Fed rate hikes since 2015's "Liftoff", the absolute level of rates is still accommodative with the 10 year treasury at 2.30%. Consumers and corporate borrowers continue to benefit from low mortgage and financing rates.
- Inflation remains extraordinarily tame despite very strong employment numbers. In previous cycles, higher employment levels typically led to inflationary wage pressures, spurring more aggressive Fed rate hikes that tightened financial conditions and cooled the expansion. For now, we are enjoying the best of both worlds. But rising wage pressure leading to an aggressive Fed is a potential risk in 2018.
- Both oil and commodity prices remain low and pose no immediate inflationary threats. This provides cheap raw materials to bolster global growth, which supports lower inflation expectations (leading to lower bond yields) as well as higher equity prices via improved earnings.

Market Rotation

The market's acceptance of this narrative shift is apparent in the relative performance of different sectors. From the November 2016 election through year end, the "Trump Reflation" trade drove certain industries higher that would likely benefit from a pro-infrastructure, regulation-cutting policy agenda (such as Financials, Telecoms, and Industrials).

S&P 500 Performance by Sector, 11/9/16-12/31/16

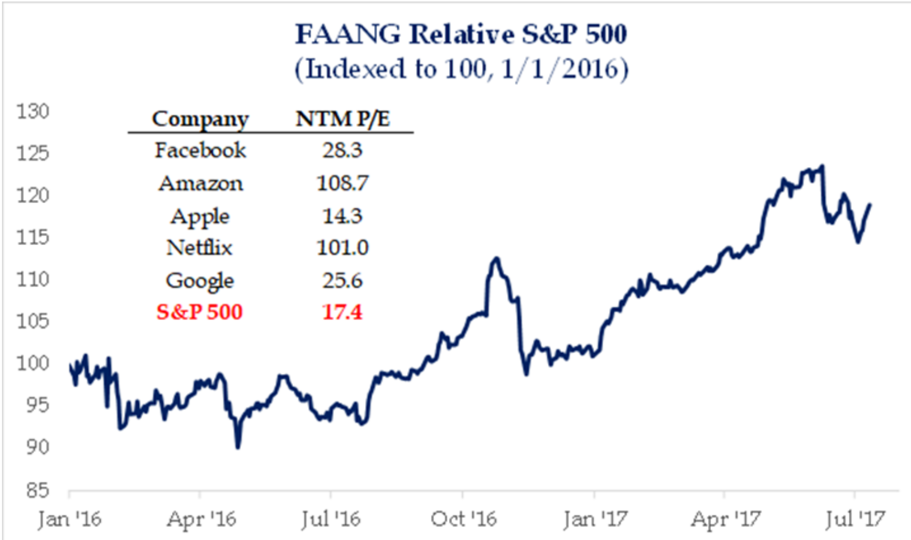
Source: Bloomberg

In 2017, however, we've seen these sectors turn into laggards as hopes for rapid growth from policy changes ebbed. Instead, rotation has occurred and other sectors less dependent on Trumponomics have moved higher.

S&P 500 Performance by Sector, 1/1/2017-6/30/17

Source: Bloomberg

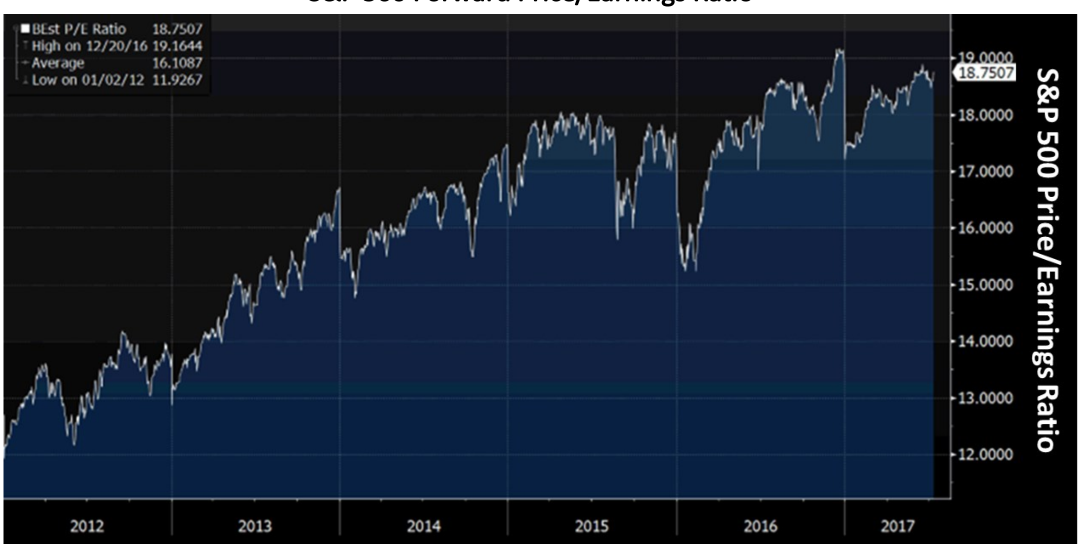
Remarkably, shades of 2015 have reappeared through renewed outperformance of the so-called "FAANG" stocks of Facebook, Apple, Amazon, Netflix, and Google (now Alphabet). Investors have decisively shifted their growth expectations from the policy-driven sectors to large tech companies – again.



Source: Strategas (NTM P/E = Next Twelve Months Price/Earnings ratio)

Overall, however, equity valuations are elevated, having seen a steady multi-year increase in Price/Earnings ratios. At their current forward P/E ratio of over 18x estimated earnings, stock prices are already quite high by historical standards (although nowhere near the ratios witnessed during the 1990s tech bubble). One item to monitor going forward is the relative narrowness of 2017's market performance – the top 10 S&P 500 stocks are responsible for 30% of its YTD price performance.

S&P 500 Forward Price/Earnings Ratio



Source: Bloomberg, as of dates shown

Inflation in Modern Times

The inflation/employment relationship discussed above touches on an important force in today's fixed income markets, and explains why the downturn in rates isn't necessarily signaling an impending economic slowdown.

Since the Great Financial Crisis, inflation (both at home and abroad) has remained persistently low despite a major economic recovery, large increases in employment, and unprecedented monetary stimulus. Measures of future market inflation expectations anticipate this to continue long-term. What's behind this widespread complacency?

We believe structural and technological changes to our economy contribute to the seemingly puzzling decline in bond yields and inflation. As a result, the lower, flatter yield curve is not necessarily signaling economic pessimism in conflict with the narrative in the stock market. The past 30 years have obviously seen significant advances in technology. However, many of these "disruptive" technological advancements have only become widespread throughout numerous businesses and industries within the past 10 or so years. For example, hydraulic fracking has driven global energy prices to surprisingly low levels. E-commerce continues to pressure retail margins and encourage ever more efficient supply chains. Some of the most promising developments on the horizon, such as automated cars, seem like they will only contribute to this trend. Simply put, across all industries we are creating value faster, more efficiently, and with fewer inputs than ever before.

These structural changes to the economy are a real and pervasive force that may help keep inflation sustainably low for the foreseeable future. And if inflation remains "lower for longer", nominal interest rates will remain subdued (compared to historical averages). Thus, the new economic reality may indeed be compatible with current rates at levels which had previously only been maintained during times of severe economic crisis.

Treasury Partners Outlook

With the backdrop of continued synchronized growth, low interest rates, modest inflation, flat commodity prices, powerful technological change, and the possibility of new pro-growth government policies, we believe equities will trend higher. This self-reinforcing trend should be supported by further improvements in corporate profits (the key metric to sustained growth).

We've always believed the market's post-election expectation for rapidly-enacted federal policy changes was overly optimistic. Given the realities of the political process, we expected a 'Trump Gap' where we won't see meaningful policy initiatives until late 2017 or early 2018 at best. While all of these initiatives are still achievable, we still prefer to consider them as "pleasant surprises" that may or may not come to pass, and base our thesis on the current stable economic expansion remaining the most likely driver of returns.

Of course, there are always risks that must be carefully monitored, including:

- A shift to a more aggressive Fed policy, as Chair Yellen's term ends in February 2018
- Severe geopolitical tensions, such as increased North Korean aggression
- An unexpected rise in inflation expectations, which would impact equity and fixed income valuations

Accordingly, we are generally maintaining client Asset Allocations but continue to monitor for any changes that would warrant opportunistic rebalancing.

As always, please reach out if you wish to discuss these topics and how they affect your portfolio.