Equity Investment Outlook
January 2017

Since the election of Donald Trump as our next President and the Republicans' win of both the House and Senate, much has changed in regards to our economic and investment outlooks. Clearly the slow pace of the economic recovery, coupled with the uneven distribution of its benefits, left many voters frustrated and angry with the Obama leadership and were factors in Trump's surprising victory. As contrast, Trump's populist message resonated with a sizeable portion of the electorate that believed a more pro-business, pro-growth president would better serve their needs. Whether Trump actually delivers remains to be seen, but one thing is for certain: namely, there's a new sheriff in town.

Trump has stated very clearly that he wants to lower the corporate tax rate, enable companies to more easily repatriate foreign earnings, reduce the regulatory burdens that had built up under Obama and finally stimulate the economy through aggressive infrastructure spending. Taken together, these four policy aims are massively pro-business and pro-growth. But a key question that remains is whether this combination of fiscal spending and tax cuts is sustainable. Long-term, there could be serious issues if the spending is not funded with greater tax receipts.

The stock market responded appropriately and has risen sharply following the election. The bond market, sensing inflationary pressures, responded as well, and the U.S. Treasury 10-year yield jumped from about 1.85% pre-election to about 2.50% today. And the Federal Reserve (the Fed) has begun to move off of its extremely low interest rate targets and hiked the target fed funds rate by 0.25% in December.

As we wait to see what the future holds with Trump as President, we think it's also appropriate to set the stage by reflecting on the past eight years since the 2008 Financial Crisis. The following is an abridged version of the course of recovery as described in our last Outlook.

"For starters, the Great Financial Crisis of 2008 was a balance sheet crisis, not a typical business cycle downswing. The housing bubble that led to the 2008 crisis was a debt-fueled mania and, as such, involved pretty much the entire financial system. Over the preceding two or three decades, banks and other financial institutions significantly increased their leverage and then during the housing bubble, aggressively piled on loans of the most dubious credit worthiness (i.e., sub-prime). When these loans started to sour – as sub-prime typically does – the very existence of many financial institutions was threatened. If a lender is levered 20:1 and 5% of its loans default, its equity is wiped out and the lender goes bankrupt. Numerous companies either failed or had to be married off in government-sponsored shotgun weddings. The potential for a complete meltdown of the financial system was palpable.

Fortunately, the authorities did step in to rescue key players and pump needed liquidity into the system. The system survived. But in the aftermath of the crisis, a number of things changed. First, banks and other financial institutions were forced to de-lever. This caused banks to restrict credit, thus reducing the velocity of money and neutralizing much of the monetary stimulus the Federal Reserve (the Fed) was using to pump up the economy. Second, the consumer also needed to de-lever. So did businesses. This great de-levering was a major factor in assuring that the post-2008 recovery remained anemic and sluggish by historic standards…

Over the past seven years, businesses have grown profits quite significantly despite the anemic growth in the economy. Early in the recovery, profit margins expanded dramatically as corporations enjoyed the benefits of productivity gains following major post-financial crisis cost-cutting layoffs. They also benefitted from the ability to refinance high-cost debt at ever lower interest rates as monetary stimulus drove rates to historic lows. Today, both the productivity gains and the effect of cheaper financing have run their course, so the big question is whether corporations can sustain their current high profit margins or whether they will see them erode.

For the consumer, conditions are relatively favorable. Employment has grown steadily over the past seven years and the economy is approaching full employment. Fuel costs have dropped, thereby freeing up funds for other purposes. Moreover, wages appear to be rising in more and more industries, so the consumer should be able to sustain and perhaps, even increase spending levels. We say this knowing full well that labor participation rates are lower than in the past, that many manufacturing jobs are lost forever and that there is a widening gulf between higher paying jobs requiring advanced skills and lower paying jobs requiring little skill. The point is that on a sequential basis, the consumer's financial health is improving and this should be good for the economy over time."

Looking ahead, we see no reason to doubt that economic growth will accelerate in 2017 as Trump policies take hold. But the sustainability or durability of the gains is not assured and, to a large extent, the stock market has already priced in stronger growth. First of all, the faster growth in the U.S. will likely entail greater inflationary pressures and cause the Fed to continue raising interest rates throughout the year. This may push the dollar higher and have an adverse effect on U.S. exports and a depressing effect on the translation of foreign earnings back into dollars. Second, Trump has also made much of "bad" trade deals and he could well launch into a protectionist trade mode that could spiral into a series of trade wars that would ultimately suppress U.S. growth. Third, he could take a more provocative and adversarial approach to foreign policy that might lead to unsettling foreign confrontations.

Of these negative scenarios, we think a stronger dollar is the most likely, but least damaging threat. The possibility of trade wars is real and could be quite damaging. We have no way of gauging foreign policy impacts.

From an investment perspective, it seems pretty likely that U.S. economic growth will accelerate in 2017 and probably push into 2018. Inflation is also likely to accelerate and, therefore, the great Treasury bond bull market that began over 30 years ago may now be over.

Despite trading at above-average valuations, we think stocks should do reasonably well over the next twelve months as earnings gains offset valuation pressure caused by rising interest rates. There is likely to be volatility as the market vacillates between over enthusiasm about growth prospects and frustration at the pace of policy implementation. Longer-dated investment grade bonds are likely to suffer from rising rates, but more credit-sensitive bonds should do well, buoyed by rising corporate earnings. Moreover, short-duration bond portfolios should benefit from rising rates as lower yielding bonds mature and the proceeds are re-invested into higher yielding ones.

Within the stock market, some companies, such as financials, should benefit from rising interest rates while others, such as utilities, could be hurt. We also think that cash-rich companies will benefit from rising rates as their cash may finally be able to earn a return. We continue to believe that structural changes in the economy increasingly favor dominant players and we have thus focused our attention on finding market leading companies where we have a differentiated view and can confirm the presence of a favorable asymmetric risk/reward profile.

OSTERWEIS
CAPITAL MANAGEMENT

We thank all of our clients for the trust you have placed with us and for your loyalty over the years. We wish you much health, happiness and prosperity for the New Year.

Sincerely,

John

John Osterweis & Team

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