Strategic Investment Outlook
April 2017

During the first quarter of 2017, the stock market (as measured by the S&P 500 Index) enjoyed a 6.07% total return. The gains reflect (1) the steady, persistent, non-inflationary economic recovery that has characterized the post-2008 period and (2) investor enthusiasm for President Trump's pro-business, pro-growth policies. Moreover, when the Federal Reserve (the "Fed") finally raised rates another notch in March, Chairwoman Janet Yellen stated that she expects monetary policy to remain accommodative "for some time."

According to The Wall Street Journal (3/16/17), "Even with the Fed raising its benchmark federal-funds rate to a range of 0.75% to 1%, the real fed-funds rate – subtracting inflation – remains below zero, a sign of accommodative monetary policy." As we have said before, stocks can do quite well during the early phase of Fed tightening because in this phase the Fed is raising interest rates in response to early signs of inflationary pressure but is still accommodative. It is not until later, when inflation heats up to the point that the Fed feels compelled to squash it, that the Fed tightens monetary policy so forcefully as to trigger a recession. In that environment, stocks usually do poorly. In our opinion, we are probably two years away from the second, more aggressive, phase of Fed tightening. Again, quoting the Wall Street Journal (3/16/17), "Economists in a monthly survey by The Wall Street Journal last month placed a 15% chance of recession within the next year, down from 22% last July." In other words, a consensus exists that the economy should continue expanding, giving stocks further room to run.

In last quarter's Investment Outlook, we discussed Trump's pro-business and pro-growth policies, their likelihood of actually getting implemented and some of the potential consequences such as rising fiscal deficits if tax cuts are not offset with new revenue sources. We also discussed the risks associated with Trump's bluster over trade issues if the administration takes actions that could ignite retaliation and spiral into some sort of trade war. Investors also need to focus attention on the potential economic effects of one of Trump's non-economic policies, namely immigration reform. The concerns we raise are somewhat speculative at this point but are potentially disruptive enough to bear watching and monitoring.

Trump's efforts to make America safe by imposing travel bans on potential immigrants from six or seven predominately Muslim countries, coupled with his "build-a-wall" rhetoric, have multiple ramifications. Some observers see a drop in foreign tourism, although our contacts in the hotel industry see no such effect yet.

A second potential fallout from these policies could be much greater difficulty in attracting foreign-born engineers and scientists, long a source of talent and innovation in Silicon Valley and elsewhere. Should this talent pool dry up, decide to work elsewhere or otherwise not come to the U.S., it could have a long-term impact on our ability to innovate and maintain world-leading creativity in technology and service. We have seen some anecdotal evidence of

U.S. tech firms building research centers overseas. Whether Trump's policies are causing this trend to accelerate cannot be ascertained at this time.

Third, the "build-a-wall" and "deport-the-illegals" message is clear: If you are from Latin America, it is going to be more difficult for you to come to, and work in, the U.S. Since Latino immigrants comprise a large portion of our construction (roughly 27%) and farm labor (roughly 23%), there are already reports of both construction and farm labor shortages. The latter could ultimately affect farmers' abilities to harvest crops, thereby driving up the cost of such crops and adding to inflationary pressures both in the form of labor cost inflation and commodity price inflation. We have no idea how big a problem this could become or how significant the inflationary pressures might be, but it is clearly a trend that deserves monitoring. While we continue to believe that inflation will be subdued as the post-2008 economic expansion continues, changes such as a farm-worker shortage could alter the future trajectory of inflation, turning it upwards more sharply.

On another front, the inability of the President and House Speaker Paul Ryan to repeal and reform the Affordable Care Act ("ACA") is a marked setback for the Trump agenda. The impasse reflects a combination of poorly designed legislation and the deep ideological divide between classical conservatives who believe in responsible, but limited, government, and the Libertarians who espouse extremely limited government. This divide is not going to go away, making tax reform difficult to achieve. Some Washington insiders tell us they expect little will get done on tax reform until 2018 and then only a watered-down version. To the extent that the market has risen on hopes of lower taxes, it may be vulnerable to re-assessment (no pun intended). Ditto for hopes of massive infrastructure spending.

Politics aside, the economy does appear to be chugging along at a steady pace with inflation pretty well under control. The recovery in oil from $30/barrel to around $50/barrel had an inflationary impact, but as the price stabilizes around $50/barrel, that impact recedes.

Along with a rising stock market, we have seen sustained improvement in the high yield market. Companies have continued to feed the equity market with debt-financed buybacks and increased dividends. Investment bankers, never a shy lot, have pitched debt deal after deal this year as investors, flush with cash, have continued to accommodate heavy issuance. This type of frenzied refinancing can lead to protective covenants getting looser, maturities extending out and coupon rates declining as investors temporarily forget they need to be paid a fair rate of return for the risk they are taking. This is usually what precedes corrections. On the other hand, issuing companies are benefitting from very low rates, and this should help lower interest cost burdens in the next downturn, which could lead to lower default rates. While we don't see any industry bubbles currently, we do see some excesses brewing in the fixed income market. One interesting fact is that approximately 37% of bonds in the high yield market now have coupons below 6% with maturities longer than five years. As you would expect in this environment, we have become extremely selective about what terms we will accept. While many benchmark-oriented investors have been focused on staying fully invested, they seem to be okay with the rising duration in these lower yielding, longer maturity issues. If the next correction comes with higher interest rates, we believe that this recent crop of bonds could provide us with many investment opportunities as prices adjust lower.

Going forward, despite the potential negative fallout from the Trump presidency, we think that overall the economy should benefit from rising employment and higher wages, both of which put money in the hands of consumers who tend to spend it. Moreover, the growth in the 24- to 35- year-old- segment of the population should support higher demand for houses over the next few years. Housing demand has a powerful multiplier effect on economic growth, but as we have said for some time, it has not recovered in this cycle nearly as forcefully as normal, largely due to the unwinding of the sub-prime lending bubble leading up to the 2008 debacle and much stricter bank lending standards. Given the demographic pressures and the stronger financial picture of the banking system, we could easily see a modest acceleration in new homebuilding.

Among the other signs of economic pickup is a turnaround in durable goods orders and better conditions in both China and Europe. All in all, we are experiencing a "steady as she goes" economy and perhaps there could even be some acceleration. If true, this should be good for the stock market. Regardless, we are actively searching for companies whose prospects reflect industry- or company-specific factors independent of broader economic trends that can grow their dividends steadily. We think stock in such companies should make fruitful investments over time.

Sincerely,

John Osterweis   Carl Kaufman

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