Economic Discussion

A Review of the Economy and Financial Markets

December 2016

Financial Markets and Interest Rates

Immediately following the election domestic stock prices rose and interest rates increased. Four weeks later, as this is being written, the movements have not reversed. Chart I, which follows, shows the movements of stock markets since November 1st.

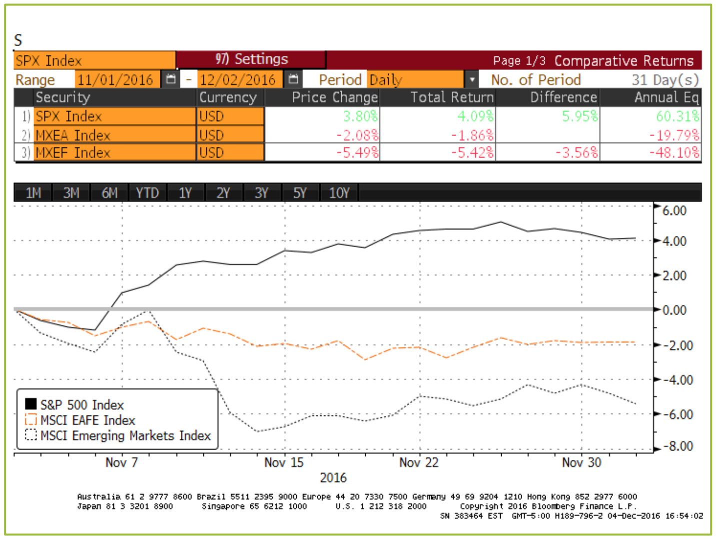

Chart I

The black line represents the S&P 500 index of domestic stocks. Foreign developed stocks are shown by the red line and emerging market equities are denoted by the gray line. It is clear that U.S. stocks have been the best performers since the election.

Interest rates have also moved up. The ten-year Treasury yielded 1.86% on November 8th. It currently yields 2.40%. Remember that bond prices fall when yields rise. Chart II shows the U.S. Treasury yield curve on November 7th (red) and December 6th (black).

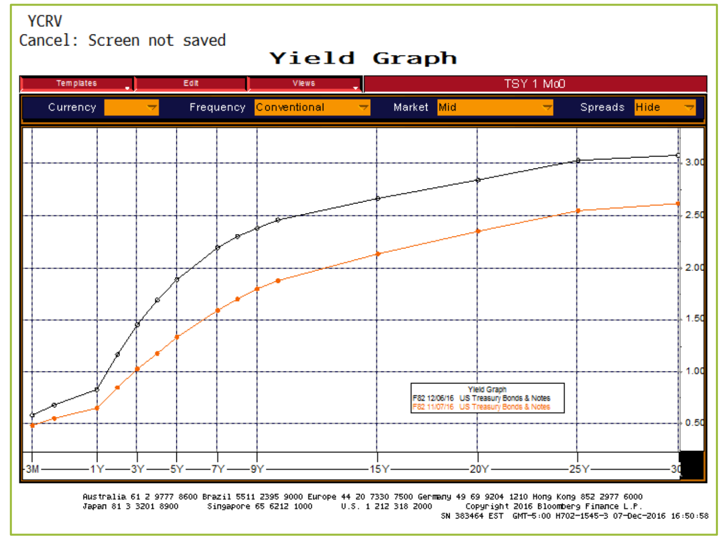

Chart II

The change in yields has been dramatic. The market value of a ten-year bond held on November 7th would have declined about 5% over the course of a month.

While all of this has been happening, the underlying economic fundamentals have shown modest improvement. U.S. real GDP is estimated to have increased 3.2% (annual rate) in the third quarter of this year (Q3'16). That followed gains of 0.80% and 1.40% in the prior two quarters. Growth is expected to drop back to around 2.35% in

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4Q'16. If so, the U.S. economy will have grown 1.91% in 2016. In 2017 the economy is expected to advance 2% to 2.25%.

According to the Labor Department 178,000 jobs were created in November. Chart III shows the monthly change in jobs for the past eight years. Data from 2009 and 2010 are included to show the emergence from recession. In the past five years average monthly jobs growth has been 205,000.

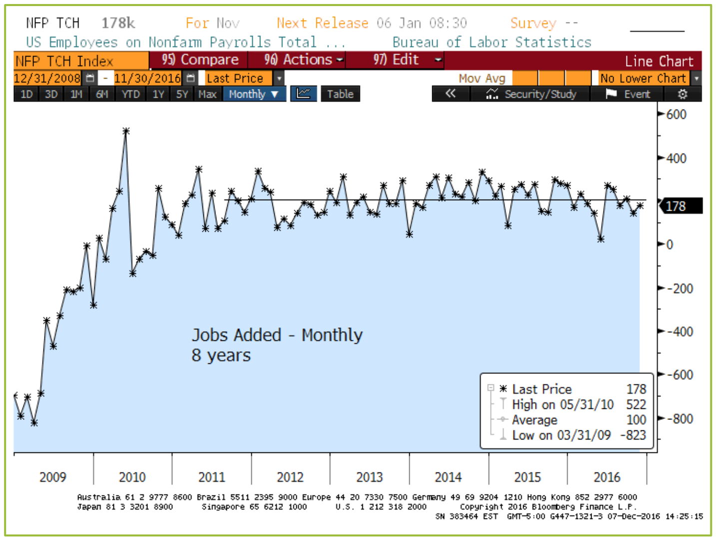

Chart III

In November the unemployment rate declined to 4.6% from 4.9%. The labor force participation rate was 62.7%. It is above the low point reached about a year ago, but still at a very low level. The average workweek was unchanged and average hourly earnings declined slightly.[1]

The foregoing data points to an economy that is making slow progress. Unfortunately, a 2% growth rate does not generate sufficient new jobs or income growth to satisfy the American populace. Trump's triumph has been attributed by some commentators to that economic angst.

As sluggish as the U.S. seems, it is growing faster than most of the developed world. The Eurozone countries are expected to grow at about 1.5% annually over the next couple of years. Japan is likely to grow at a third of that rate. The United Kingdom (UK) will probably grow 2% this year but is forecast to slow to about 1% in the next couple of years. Emerging economies will grow at about 5% in the aggregate with wide variations among the constituents.[2]

Inflation remains low. In the most recent quarter the Personal Consumption Core Price index (the Federal Open Market Committee's [FOMC] favored inflation gauge) increased at a 1.7% annual rate. The following chart tracks this measure over fifteen years.

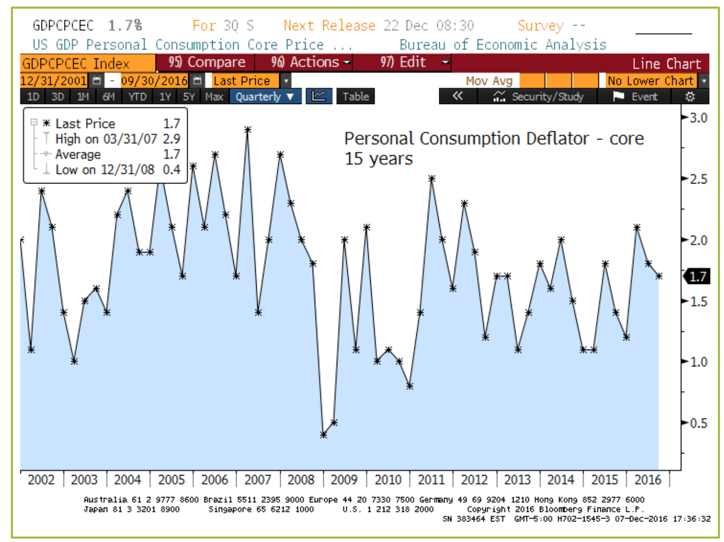

Chart IV

No accelerating trend is visible in this chart. Spreads between Treasury

Inflation Protected Securities (TIPS) and conventional Treasury securities of comparable maturities have increased in the last month. The widest spread is at thirty years and it is the only one exceeding 2%.[3]

Investors and economists have been wondering and speculating on when the FOMC will raise short-term rates. The committee has indicated that they will raise short-term rates when the labor market firms up and when inflation approaches two percent. A rate increase is widely expected at the committee's meeting in mid-December. The labor market has become firmer, but the inflation data is not compelling.

Pundits say that stock prices have increased due to a perception that regulatory pressures will be lessened under a Trump presidency. His picks for key administration posts support that view. Also, his statements about infrastructure programs have stimulated interest in companies that would benefit from big building projects.

The reasons for the sudden increase in bond yields are not so clear. The one most frequently heard is that inflation is likely to re-ignite. Mr. Trump's earlier critical comments of the Federal Reserve may also have contributed.

It will take time to know which of President-elect Trump's campaign pronouncements will turn into policy initiatives. Some may have been simply campaign rhetoric and some may indicate specific objectives. Even those ideas which he pursues may face obstacles to implementation. Although Republicans control both houses of Congress, Democrats can still influence legislative initiatives. Moreover, Congressional Republicans are not in lock-step with all of his ideas.

The U.S. immigration system has been malfunctioning for decades. Politicians have been unable to address it. President George W. Bush tried to institute a guest worker program but was thwarted by the far left and the far right. President Obama tried to address the question by executive order. Court action has stymied that effort. As a candidate, Mr. Trump said he "would build a wall." It will be interesting to see how that statement fleshes out when he takes office.

Immigration is a real and multi-faceted problem. It does not lend itself to simplistic remedies. Many workers without legal documentation are said to comprise a significant part of the work force in many U.S. regions. The situation has resulted from inconsistent enforcement. In more recent years, migrants and refugees from the Middle East and Africa have posed a different problem. Only those with the hardest of hearts are unmoved by the plight of people caught in the crossfire between the factions in Syria. Yet there is a genuine security issue in that terrorists use the migrant routes as cover. Perhaps President-elect Trump can navigate the thicket that has stumped his predecessors.

During the campaign Mr. Trump railed against companies that moved production from U.S. sites to foreign ones. His calls for "America First" smack of a modern day mercantilism. Fears of U.S. instigated trade wars have rattled enterprises and nations around the globe.

Since being elected, he has "jaw-boned" Carrier Corp. into keeping production in Indiana that had been scheduled to move to Mexico. Earlier Ford Motor modified its plans to move some production south of the border. An important factor is omitted in the rhetoric and the news coverage of these events. The consumer drives the need for companies to seek lower cost venues for production. And consumesr (that's us) demand an optimal combination of high quality and low cost.

Another campaign announcement was to replace the Affordable Care Act (Obamacare in common parlance) with something better. Not many details have been spelled out. Obamacare is not universally popular. There are people who have been able to get coverage for the first time. Others have found their coverage to be too expensive. It would be difficult to reverse course back to 2007. It appears that the public would welcome an improved version.

Mr. Trump's promise to reduce unnecessary regulation could partially address the question of jobs being "exported" as he calls it. Reducing instances of redundant regulation could make American business more competitive with foreign competitors. Few would want to live in an unregulated society, giving the "animal spirits" free rein. There is redundant regulation in many areas of our economy. For example, the Consumer Finance Protection Bureau (CFPB) created by Dodd-Frank has authority over areas which were already regulated. The Environmental Protection Agency has been aggressive in expanding its area of authority. Mr. Trump's selection of Oklahoma Attorney General Scott Pruitt indicates a desire to rein in the Agency. It is being met with much criticism from environmental activists. Harold Hamm, CEO of energy company Continental Resources, said Mr. Pruitt would work "through the proper use of regulations and adhering to the rule of law."

Mr. Trump has spoken of tax reform. The term means many things to many people. He's been specific about reducing the corporate tax rate. That would be good because the U.S. has the highest rate among developed nations. His other plans are not so clearly articulated. If he is able to simplify the corporate and individual rules, it could generate growth by encouraging financial decisions to be made on economic bases and not on specific tax provisions.

As noted above, it will take time to see which of these ideas are implemented and in what form. Investors need to decide if the recent market movements are transitory or if they foretell new directions.

Strategic/Tactical Considerations

Mr. Trump's policy pronouncements above are a mixed bag. Simplified tax structures, a simpler health care scheme and more efficient regulation would be beneficial. Tariffs and trade wars would stifle growth both at home and abroad. Trade is not a zero-sum game.

Stock prices may have jumped a bit ahead of themselves, but the overall valuations are still reasonable. Last month we recommended that stock allocations be at the mid-points of normal ranges. That still is the advisable stance. If, however, market movements have changed the allocation levels significantly, re-balancing the positions would be in order.

Bond prices have fallen because of the increased yields. It is likely that over the next year bond yields will continue to increase. Bonds already in portfolios should be held. Generally we have advised short-to-intermediate term bonds. Price declines are mitigated by shorter duration.

If bond allocations have fallen below a portfolio's normal mid-point it would be appropriate to re-balance. Moreover, if cash balances have accumulated awaiting higher yields, it would be wise to invest a portion of the reserve in intermediate term bonds at these levels.

We are living out the ancient Chinese curse: May you live in interesting times. Many things are changing and the complete outcome is unclear.

Don't fret. Enjoy a happy holiday season and have a Happy New Year!

December 14, 2016
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[1] "The Employment Situation – November 2016", Bureau of Labor Statistics, U.S. Department of Labor, December 2, 2016.

[2] Foreign economic forecasts are sourced from Bloomberg Finance, L.P.

[3] The spread between TIPS and conventional Treasuries is considered a proxy for inflation expectations.