MD SASS

FIRST QUARTER 2017

IMPLICATIONS OF FADING ANIMAL SPIRITS

As the U.S. embarks on its 9th year of economic expansion and equity bull market, animal spirits are beginning to fade. Following the sharp post-election U.S. confidence boost, there have been increased worries about legislative gridlock, delays and reductions in implementing meaningful fiscal stimulus until 2018. While the legislative agenda remains in limbo the market may be somewhat pressured or locked in a trading range. Most importantly, we do not expect this to mark an end to the U.S. equity bull market, since the expansion remains intact and there is a relative lack of excesses that trigger recessions and bear markets. Inflation remains at the low end of the historical range since 1960 and interest rates are expected to increase only gradually.

Economic cycles and bull markets do not die of old age; they usually end when the Fed tightens materially to fight inflation, which is unlikely this year while secular inflation remains subdued. In its March 2017 meeting, the Fed hiked the federal funds rate by 0.25% to the 0.75%-1% in a move to normalize monetary policy and bring the target rate to a "neutral rate" aimed at keeping the economy on track. The equity market historically performs well during early phases of interest rate increases like now, because they generally mark periods of improving economic growth. The Fed is entering a new phase of its cycle. The Fed is moving from stimulative monetary policy to a normalization of monetary policy, rather than meaningful tightening that would end this economic and market upturn. The Fed will shrink its bloated balance sheet later this year which should be supportive for the U.S. dollar.

For the remainder of 2017, the global economy is likely to gain momentum. The labor market continues improving (while wages and salaries grow at a below average pace) and corporate earnings and dividends continue rising. The earnings yield/bond yield spread is at the wide end of its historic range (since 1957) making equities attractive relative to fixed income. Also the S&P 500 P/E at 18X consensus earnings estimates for 2017 is well below the peaks of past major bull markets and is fairly priced to deliver modest returns. The fundamentals continue to indicate a self-sustaining synchronized global economic expansion which continues to favor stocks over bonds over the coming year.

Outlook for Fiscal Stimulus

The failure to repeal and replace the Affordable Care Act (ACA) and current struggle to revive it is delaying the Administration's tax reform program, the centerpiece of its pro-growth reflationary agenda. The Administration will not meet its August target for tax cuts and reform. Final tax reform implementation will likely be delayed until the first half of 2018 and infrastructure spending is likely to be pushed later into next year and be less than proposed. Recent questions about the impact and timing of fiscal stimulus, a defensive move to safe-havens due to heightened geopolitical concerns in Syria, North Korea, Afghanistan, weaker than expected core CPI and an unwinding of short positions in bonds have caused an abrupt reversal of the rapid rise in yields following the U.S. Presidential elections. Ten-year Treasury yields declined from 2.6% a month ago to 2.2% at this writing, reaching a 2017 low.

A hindrance to tax reform is the risk of disputes over the FY 2018 budget, a necessary precursor of tax reform. The federal budget deficit is likely to balloon and the non-financial debt level is at a record high, both are headwinds to meaningfully cutting taxes. The size of the corporate tax rate cut will almost certainly be reduced to at best an effective rate of 23% instead of the 15% proposed by President Trump or 20% proposed by Speaker Ryan to be effective at the beginning of 2018. A special tax rate on foreign repatriated earnings of around 10% is likely to pass in 2018.

Support from Rising Corporate Dividends and Earnings

Once there is more clarity on the timing and magnitude of the Administration's fiscal stimulus, corporate earnings and dividend growth should again be the main driver of equities. A strong recovery in corporate share earnings has been underway since their 1Q16 low, driven by a rebound in energy prices as well as cost cuts and share buybacks. First quarter 2017 earnings growth for the S&P 500 is likely to beat consensus and post the fastest gain in 11 quarters since 3Q11. Forward earnings guidance will be important since profit margin compression is a risk beyond that with higher wages, inflation and interest rate headwinds.

FIXED INCOME OUTLOOK

Premature Exuberance

While Europe and Asia are showing signs of renewed upward momentum, including increased inflation and interest rates, their growth and the continued U.S. growth is far below that required to offset the negative impacts of aging demographics, high sovereign debt combined with unfunded social benefit programs, low personal savings and job displacement from globalization, digitalization, artificial intelligence and robotics. The U.S. markets responded very positively to the expectation that the Trump presidency, combined with a Republican House and Senate, would enable rapid implementation of a very stimulative growth strategy combining, corporate tax reductions, repatriation of offshore corporate profits at lower tax rates and individual tax reductions and a huge infrastructure spending program, partially funded through a repeal of the Affordable Care Act and a much cheaper replacement of it.

The capital markets are now adjusting to the new reality that savings from replacing the Affordable Care Act will not materialize any time soon, if at all. The agenda now shifts to tax reform and infrastructure spending. Without the savings from reduced health care spending, repatriation of foreign earnings at a lower tax rate remains likely. In the short run, it will

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provide a substantial increase in tax revenues and buoy the capital markets by reducing the supply of corporate borrowings, providing funds to increase dividends and share repurchases and providing funds for acquisitions. Corporate tax rates are also likely to be lowered, but far less than the 15% proposed by Candidate Trump. The Border Adjustment Tax is unlikely to be enacted as consumers (another word for voters) realize that the higher prices of imports will mean that they will be paying higher prices as these increased costs are passed along by importers and retailers.

While we are in favor of simplifying the overly complex tax laws on individual taxes, this is likely to be delayed as Congress grapples with health care, corporate taxes and infrastructure spending. Republicans want lower tax rates and increased infrastructure spending, but not increased budget deficits. Progress will be made but at a much slower pace than the past exuberance implied. Interest rates have already adjusted upwards, reflecting the prospects for continued economic growth and further central bank interest rates will now focus on actual progress and no longer on campaign promises.

While we expect further interest rate increases, the pace will be more erratic and slower until there is greater certainty on the magnitude and timing of tax reform and infrastructure programs.

A Growing Debt Bubble

The U.S., which of course is our focus for our bond strategies, has record high deficits at the end of 8 years of economic growth. The annual budget deficit is projected to be almost $560 billion and heading toward $1 trillion by the end of the decade without the increased infrastructure spending and tax reductions discussed above. Even without additional increases from infrastructure spending and deficit funding increases from an eventual, inevitable cyclical slowdown, these increases will exert upward pressure on interest rates. Credit problems are already beginning to surface. The more than $1 trillion in student loans and their high and increasing defaults is slowing family formations and first time home buyers. Credit card balances are now at post-recession highs and sub-prime auto loans are impeding auto sales. Credit spreads are very narrow and investors are not being compensated for the increasing default risks. Federal Reserve Chair Yellen recently commented that the Fed, at some point, will start to unwind the $4.5 trillion it holds in mortgage and government bonds acquired through its Quantitative Easing program. The Fed's balance sheet reduction is likely to be gradual, by not reinvesting the interest earned and principal cash flows from maturing bonds. This is likely to exert gradual upward pressure on intermediate and longer term issues. At this point in the cycle, the safety of short term U.S. Government Agency backed mortgage issues is exceptionally appealing.

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CONCLUSION

With the fading of animal spirits stirred by high expectations for the Republican pro-growth agenda, equity markets are likely to be trapped in a trading range over the near term. Once policy initiatives become less uncertain, we believe the fundamentals of U.S. corporate earnings growth to be the primary driver of U.S. equity prices. As the synchronized global economic recovery continues, we expect a resumption of the erratic upward move in interest rates to continue, which will be a headwind for bonds.

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