January, 2017

Year End Outlook

ANIMAL SPIRITS - - A KEY TO 2017

Animal spirits, which is how John Maynard Keynes described human psychology that drives consumer confidence, has pivoted from worries about deflation and stagnation a year ago to hopes of reflation and improving growth. A year ago markets were in freefall amidst economic problems in China, declining U.S. corporate profits, plunging oil prices and disinflation. Now, oil prices are double their February 2016 low of $26/barrel while bond yields and inflation expectations have been rising. As a result, equities posted new highs at the start of 2017 in sharp contrast to an 8% plunge in the S&P 500 in the first 12 days of 2016.

We believe the equity bull market during the past 5 years was fueled roughly 75% by unprecedented monetary policy accommodation and historically low interest rates. Historically low bond yields lowered the discount rate applied to future earnings resulting in an expansion of P/E multiples from 12 times forward earnings in 2012 to 17.7 times forward earnings in 2017. With bond yields rising, this multiple expansion phase should be ending and higher earnings and dividends will likely be the primary driver. Aided by improving top line growth, a rebound in energy earnings and tax cuts, corporate profits should expand nicely over the next couple of years, which should then offset moderately higher bond yields and narrowing P/E ratios.

The new Administration's pro-growth policies have stirred capitalism's "animal spirits" driving a surge in consumer confidence to near a 13-year high.

Deregulation, tax reform and infrastructure spending programs are being discounted in the equity market with expectations that they will be approved with Republican control of the executive branch and both legislative chambers. A positive economic transformation may be developing with stronger growth (already underway prior to the election), after subpar real U.S. GDP growth averaged only 2.2% over the past 5 years. A risk is that the surge in animal spirits and the equities market has gotten ahead of itself and high expectations are beginning to outpace the benefits of the new Administration's policies.

ACTIVE EQUITY MANAGEMENT - 2016 was one of the most challenging years for active equity management with 68% of fundamental and quantitative funds underperforming their benchmarks according to J.P. Morgan. During the past couple of years through mid-2016 there was a high correlation and low return dispersion with stocks. This tended to reward indexation as stocks largely moved more in tandem, driven mainly by monetary policy-induced P/E multiple expansion. Massive "risk on, risk off" trades, unrelated to fundamentals of individual stocks, made it very challenging for most active managers to outperform. As bond yields started rising since July 2016, there was a sector rotation out of leadership from momentum stocks and low volatility "bond proxies" (i.e., consumer staples and utilities) with record high valuations. After July 2016 there was a significant rotation into Value and correlations dropped significantly; this helped Fundamental stock pickers like us, as our stocks finally broke out and away from the broad market trend. Increasing differentiation at the company-specific level, with rising importance of fundamentals of rising earnings, dividends and cash flows, rather than macro dominated markets, provides an environment that should again reward value-oriented stock picking.

Following are additional thoughts impacting our strategy and outlook:

TAX REFORM - Tax legislation, a top priority for the Trump Administration, is likely to get moving in 1Q17 and a bill could be signed as early as August 2017 (possibly retroactive to Jan. 1, 2017). Tax policies will be geared to making U.S. companies more competitive globally since our corporate rate is now the highest among developed nations. The tax plan of House Speaker Paul Ryan and House Way and Means Chairman Kevin Brady would lower the marginal corporate tax rate from 35% (39% with state taxes) to an estimated 21%, which appears more likely than President-elect Trump's plan to lower it to 15%. The S&P 500 average tax rate is currently 26% (largely because profits earned abroad are not taxed). There is also likely to be a repatriation "tax holiday" at perhaps a one-time 10% tax rate which could result in some $200Bn of the S&P 500 companies' $1 trillion of overseas cash being repatriated.

Trump has also proposed cutting the top personal tax rate to 33% from 39.6%, trimming the capital gains tax, eliminating the estate tax and capping the top rate for pass-through entities (i.e., LLCs, etc.) at 25%. According to the Tax Policy Center, the after-tax income of the top 1% would increase about 14% whereas the after-tax income of middle and lower income taxpayers would grow less than 2%. Income tax cuts on high income earners and corporate tax cuts tend to have a low multiplier effect (well below 1) while direct infrastructure spending by governments tend to have a much higher multiplier (above 1).

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Changes to interest deductibility and depreciation of capital investment are being discussed, but numerous questions remain, e.g., whether interest payments on current debt would be grandfathered. There would be a first-year 100% expensing of all new capital investment in the United States.

We believe S&P corporate profits will rise about 10% to $128 per share in 2018 aided by somewhat better top line growth and a positive contribution from much higher energy earnings. Lower taxes and benefits from share repurchases from tax repatriation proceeds could add roughly $10 per share to S&P 500 eps in 2018. Somewhat offsetting these positives could be a decline in P/E ratios as bond yields rise, which would increase the discount rate that should be applied to expected future earnings to determine Net Present Value for equities.

SECTOR ROTATION - The rally has been characterized by a dramatic sector rotation with a notable shift into previously lagging and undervalued Financials, Industrials, Consumer Discretionary and Materials, and away from previously leading bond proxies, notably Utilities and Consumer Staples.

Since the election Financials have had the strongest rally, as they should be a major beneficiary of tax cuts and rising rates, and the repeal of some financial-services regulation and improved economic growth benefits loan growth. A 20% federal corporate tax rate would increase earnings for Financials by 18% on average while +100bps increase in short term interest rates and +100 bps of a steeper yield curve would add 7% to earnings, according to Evercore.

Healthcare has been pressured again this year with headline risk stemming from Trump commentary keeping investors from investing in the sector. Specialty Pharma and Biotechnology stocks were the worst performers in 2016, after 5 years of strong outperformance, due to concerns about drug pricing. Healthcare valuations are now close to the lowest levels relative to the overall market since 1990.

HIGHER INTEREST RATES - Over the last 50 years there was 15 years of secularly rising bond yields followed by 35 years of secular decline, which likely has ended in July 2016. Bond yields bottomed on July 6, 2016, with the 10 year U.S. Treasury yield at 1.37%, very close to the prior bottom of 1.37% in July 2012 and 10 year yields have increased about 100bps to 2.3%. Although we are probably at the beginning of a long cycle of rising bond yields it doesn't mean that stocks will be negatively impacted at this juncture. When 10 year yields are below the nominal rate of GDP growth (roughly 4-5%) like they are now, modest interest rate increases have historically helped equities. Economic growth can withstand rising bond yields because they are associated with improving fundamental earnings and dividend growth. Further, Treasury bond yields are still low and the gap between bond valuation and stock valuation still remains high and favors equities over bonds.

POLICY RISKS - Protectionism, tariffs, trade wars and immigration constraints may present serious headwinds. Increased tariffs on foreign goods risk more expensive imports, a profit margin squeeze for companies with high import content and can reduce growth. A deportation of 2 mm illegal immigrants would send wage costs higher. The scale and timing of fiscal

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stimulus is uncertain, but if aggressive stimulus increases demand more than supply it will create inflationary pressures with the economy near full employment and wage growth increasing. Greater inflationary pressures may compel the Fed to offset more fiscal stimulus with tightening at a faster pace of rate hikes than investors are discounting. With increasing deficits and rising government debt-to-GDP, bond vigilantes could push bond yields sharply higher, thereby putting monetary and fiscal policy into conflict over time. Hopefully, President-elect Trump will likely take a far more practical approach to U.S. trade policy than his rhetoric would suggest.

FIXED INCOME OUTLOOK

Short term and Long Term Considerations

Investing involves both short term and longer term considerations. Over time, the longer term ones matter most and sufficient emphasis therefore should be put on them, however, proper evaluation and weighting of shorter term considerations can also add value and we will discuss them later in this Outlook.

Major longer term considerations:

1. Aging populations in the developed economies with underfunded health care and retirement benefits will put increasing stress on consumer and government budgets. All Western developed economies and Japan have very large and increasing proportions of their populations entering the post 60 years of age cohort. Many of them are dependent on government transfer payments and insurance schemes to fund their living and health care expenses, but in almost all cases governments have not adequately funded these retirement and healthcare benefits. Politicians either hoped or assumed that rising prosperity and population increases would generate future tax payments that would be sufficient to fund them. Over the next several decades, several factors will put enormous financial, social and political pressures on these governments with important implications for the capital markets and investments. Most peoples' incomes have stagnated due to increased competition from developing countries with far lower wage and benefit costs. Additionally, except for the United States, population growth has not only not grown but birth rates have declined, leading to declines in future populations whose growing incomes were expected to be taxed to pay for the older populations "entitlements". Wonders of medical science are now compounding the problem in that post retirement populations are likely to live far beyond prior expectations and cost far more than was projected when these programs were first put in place. Small tweaks, such as modest increases in the age to collect maximum social security benefits, are both difficult to implement and ineffective in the long run. Limitations on, or rationing of health care, are similarly politically toxic.

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2. Further complicating the funding dilemma are the huge and rising budget deficits, combined with rising public debt burdens at the central government and local levels in the developed countries, including the United States. At some point, interest rates will rise to reflect the credit stresses imposed by these increasing deficits and then this will be exacerbated as lower yielding securities mature and have to be funded with higher yielding ones, placing more stress on budgets due to increased government interest expenses. On the flip side, this increased interest will be additional income to the owners of these issues and will help the U.S. economy to the extent that the issues are owned domestically. Foreign buyers however own an increasing share of the U.S. debt so not all this increased interest will be domestically recycled.

3. After the impact of the recent increases in minimum wages and the upward adjustment for those earning above it, the loss of jobs due to digitalization, robotics, artificial intelligence and outsourcing to lower wage economies are likely to continue to dampen lower and middle class wages and the tax revenues that can be collected from them. Accordingly, income taxes on the upper income earners, consumption taxes, user fees and the like are likely to increase over time, regardless of any near term tax cuts introduced by the Trump administration. Historically, inflation has been a government device to push people into higher nominal incomes and higher tax brackets without their real incomes actually rising proportionately. There is a reason that U.S. government policy now no longer aims for stable prices as is mandated to the Fed but has been adjusted upwards to 2%. At only 2%, an individual earning $50,000 (after all tax deductions) today would need $110,410 in 40 years. If tax brackets were not adjusted, that person's tax would be $22,585 up from $8,293. While the individual's nominal income grew by 1.21X, his tax increased 1.72X and his living standard would have declined. With rising inflation, the government can tinker with the cost of living adjustment for benefits and gradually and invisibly reduce actual benefits without reducing nominal benefits. The higher the inflation, the easier and faster benefit reductions become.

4. Climate change, caused by global pollution, is another cost imposed on future generations by earlier generations that got a benefit from burning fossil fuels, but not funding greater efficiency, cleaner technology and alternative energy sources. "Cap and trade" and carbon taxes were initiated to provide economic incentives to switch to cleaner technologies. With the internet of things (think smart thermostats, network controlled street and traffic lights, etc.) and electric vehicles, we are on our way to reducing carbon emissions. However, the impact of climate change on droughts and food production, rising sea water levels and the like have substantial but unquantified costs. It is estimated that seemingly small increases in temperatures at the polar ice caps (which are already shrinking) can flood cities

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like New York and Miami during storms that are not “hundred year events”, creating economic and personal losses like hurricane Katrina that devastated New Orleans. Infrastructure measures to protect vulnerable but very valuable areas are not even in the advanced planning stage but are tremendously costly to implement and pose great risks if ignored.

Many of the issues discussed above could be solved over the long run with 3.5% to 4.0% real GDP growth up from the sub 2.0% growth of the last decade. The critical question is how to create that growth on a sustainable basis. Currently, we see no credible proposal that would create a sustained 3.5% to 4.0% long term growth rate. Large tax cuts, combined with repatriation of foreign corporate cash and massive infrastructure spending, can accelerate growth for a shorter period of time and create the impression that it is sustainable. The existing government debt (including underfunded retirement and health care entitlements combined with continuing structural budget deficits, global competition, artificial intelligence and robotics suppressing job growth and wages), retiring baby boomers and increased inflation, will eventually increase interest rates to levels that will dampen growth regardless of Fed policies. Fixed income strategies must be mindful of the longer term risks even as they search for higher incomes.

The short run:

There is great optimism that the new Trump administration, aided by a Republican controlled House and Senate, reduced regulation and a likely more conservative judiciary over the next several years, will be able to stimulate higher economic growth through a combination of corporate, personal and overseas cash tax cuts and a $1 trillion infrastructure building program. While it is conceptually likely that these measures will have a positive GDP impact, their benefits take time to occur and the capital markets’ recent exuberance has already discounted some of these benefits. Over the next several months the capital markets will transition from a general euphoria to a focus on the specific programs and how they will be financed as the general wish list confronts the need for fiscal prudence. Not long ago, the same Republicans that many count on to support simultaneously both much higher spending and lower taxes, shut down the government over spending and forced the “Sequester” which mandated no increases in spending that could not be financed by other spending cuts or increased revenues. Possibly for some, this was a political tactic, but for others it was a bedrock philosophical belief. During the next legislative session, we will get a much more nuanced understanding of the probability and magnitude of tax and spending changes and the capital markets’ reaction as political rhetoric (remember talk is cheap but tax cuts and spending are expensive) confronts the harsh reality of trillions of dollars of reduced revenues and increased spending. Not all Republicans are of the same mind on these issues and there is likely to be a lot of transparent and covert wheeling and dealing to forge a consensus within the Republican Party, in addition to needing to win over some Democrats on some of these issues. This will all be occurring while the dismantling and complex replacement of the Affordable Care Act is also being debated in a highly politicized manner and one that affects tens of millions of voters.

Tens of millions is a big number, especially when you consider that thousands of voters can swing a congressional district. If we learned anything in the past election season, it is not to take political forecasts as reality and there will inevitably be periods of market volatility as doubts are cast on some ebullient expectations many have already built into their forecasts. As the debates ensue on these many and complex issues, we expect increased psychological and market volatility.

Implications for the bond market:

As indicated in the table below, interest rates have already risen from their lows creating substantial losses last quarter for holders of intermediate and longer term U. S. Treasury issues.

Treasury Maturity	Q4	2016
2 Year	-0.56%	0.64%
5 Year	-3.34%	0.48%
10 Year	-6.81%	-0.16%
30 Year	-13.75%	0.88%

If the tax reductions and infrastructure spending proposals come to pass, interest rates will rise further and intermediate and longer term bonds will sustain further price declines. If market expectations incorporate even modestly higher inflation, it will add further pressure to higher interest rates for intermediate and longer term issues. Our shorter term U.S. Government Agency Mortgage Backed strategies have held up well in this environment. Over the course of the next year, their relatively high yields and cash flows are likely to make them more stable than comparable quality and maturity issues while continuing to provide attractive relative yields. When, as and if interest rates rise, the monthly cash flows from these issues can be re-invested in higher yields.

The proposed heads of both the Treasury and HUD favor legislation to privatize Fannie Mae and Freddie Mac and eventually remove the government from the mortgage finance business. Existing issues would remain government agency backed and in that event we expect that their high credit status and growing scarcity value will add to their value.

2016 was a challenging year that started weak and ended strong. Throughout 2016, a constant has been our appreciation of the confidence shown by our loyal clients. All of us at MD Sass wish you and your loved ones a healthy, happy and prosperous New Year!

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