—New Albany—
Investment Management

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Market Insight:
Markets Signal a Positive Change is Afoot

In my thirty five years of participating in the financial markets, there have been a handful of extraordinary memorable periods. The last past three weeks has been added to the list!

Though almost half the US voters were disenchanted with the election outcome the financial markets have reacted very positively and in fact are now signaling that a significant change in the economy is afoot. At the same time, Wall Street's talking heads have done a one-eighty. Their view of the economy, earnings, and inflation has dramatically shifted. What has changed?

In sharp contrast to the past eight years when fiscal policy was dormant and monetary policy ruled the economic/financial landscape, the new Trump Administration is proposing radical changes to fiscal policy that are reminiscent of the Reagan era of pro-growth, supply-side economics. With global short term interest rates at or below zero, monetary policy has become impotent and economic growth has stalled. But with new fiscal stimulus, the prospects for improvement have been revived. Sweeping changes in corporate taxes, infrastructure spending, and foreign trade policies are viewed as a new engine to boost productivity and kick economic growth out of its slow growth rut. The potential changes are significant and the global markets have taken notice.

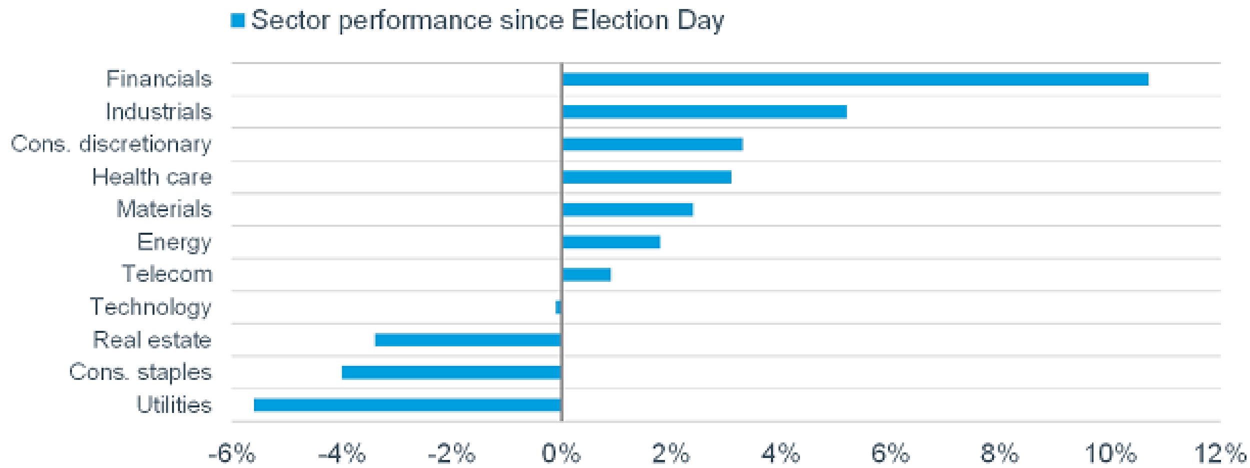
Here is a snapshot of the Street's new outlook for the economy, stocks, and bonds.

Fundamental Rethink: Mark Cabana, head of U.S. short rate strategy at Bank of America Merrill Lynch, thinks "there's a fundamental rethink in the near-term outlook, as it relates to expectations for growth and also (Federal Reserve) policy. All of this has to do with increased optimism that there will be some fiscal stimulus in the near term and some type of deregulation, both of which will underpin growth."

Regarding Stocks: JP Morgan's Dubravko Lakos-Bujas gives insight …"We interpret the US election outcome with a Republican sweep as pro-growth for equities. Expectations of decreased regulation, favorable tax reform, increased fiscal spending, and less congressional gridlock should drive stronger revenue growth and higher net income margins. Further, the removal of election uncertainty and some form of cash repatriation should result in increased investment activity." According to Barclays' Jonathan Glenna, "We predict adjusted earnings per share for the S&P 500 will grow 7% in 2017 to $127 (and) would be the strongest EPS growth since 2014."

Regarding Bonds: The sell-off comes on the expectation that Trump's promised infrastructure spending and tax cuts will result in higher growth — but also higher inflation and higher amounts of U.S. government debt. George Goncalves, head of rate strategy at Nomura offers this perspective: "U.S. interest rates have been held down by Fed policy and sluggish U.S. growth, but they have also been distorted by super-low and negative yields, courtesy of central banks in Europe and Japan. Now, the U.S. Treasury market, like a once sleeping giant, is dragging world rates higher (prices lower) with it."

Unprecedented Sector Rotation in Stocks: The surprise election outcome caused one of the largest stock sector rotations in the modern market era- where defensive sectors were dumped and previously lagging growth sectors were aggressively purchased. The chart below illustrates this dramatic shift in investor sentiment over the last three weeks. Utilities (defensive sector) have fallen -5.8%, while Financials (lagging growth) have risen +11.5%. The huge spread of over +17% in sector performance is unprecedented and signals a major shift in expectations of rising rates and stronger economic growth in the years ahead.



Source: Strategas Research Partners, as of November 18, 2016.

Dramatic Rise in Interest Rates Rise; Yield Curve Steepens: Changes that normally would take months if not years, occurred in just two weeks. The US treasury market erased almost all the gains made over the past year. Medium and long term interest rates have risen and bond prices have fallen. The chart below shows the change in US Treasury yields from October to November over various maturities and the performance of each term. Notice how 3months T-bills only declined by -0.7% but 10yr T-notes declined by over -7% which means the yield curve has steepened quite dramatically and signals expectations of rising growth and inflation in the years ahead.

Maturity	October 3, 2016	November 25, 2016	Performance
3mo T-bill	0.34%	0.46%	-0.7%
5 yr. T-note	1.2%	1.8%	-2.7%
10 yr. T-note	1.5%	2.8%	-7.2%
Yield Curve Slope	86 bpts	234 bpts	+148 bpts (steeper)

The Meat of Change: What has gotten the market's attention? "The probability of significant legislative activity has increased as a result of single-party control for the first time since 2010, and Republican single-party control since 2006," said the Goldman Sachs report. "In addition, tax reform appears to be prominent on the policy agenda in 2017. <u>We expect to see initial tax reform proposals around March or April and possible enactment during the second-half of the year."</u>

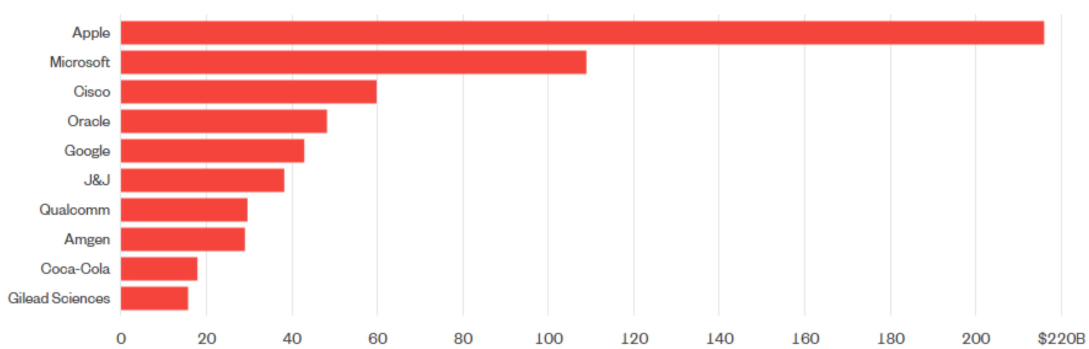
The Trump Administration Corporate Tax Plan. Why it's potentially a big deal.

- Tax cuts are subject to arbitrary congressional budget rules that say that every tax cut has to be offset by a tax increase of spending cut somewhere else. (This means no additional debt issued and good for the bond market)
- Trump's plan emphasizes growth. It could inject $4-6 trillion into the economy over 10 years, mostly by means of business tax cuts. (New engine for growth)
- Proposed reduction in the corporate tax rate to 15 percent from the current 35 percent. (The US currently has the highest corporate tax rate in the developed world.)
- Give US companies a one-time tax cut for the repatriation of corporate profits held overseas, from 35% to 10%. "This plan would indeed spur companies to bring back overseas cash", says Goldman Sachs.

According to Goldman Sachs lower taxes could prompt S&P 500 companies to repatriate close to $200 billion of their $1 trillion of total overseas cash in 2017, which will be directed primarily toward share repurchases." "In 2017, for only the second time in 20 years, stock repurchases will account for the largest share of cash used by S&P 500 companies. Share buybacks will rise by 30% to $780 billion in 2017, says the investment bank."

Pot of Gold

Here are some of the biggest holders of overseas cash among U.S. corporations



Source: Bloomberg

Is the Rally Sustainable? Has the market gone too far too fast? Perhaps in the short-term, but the <u>prospects of structural change of how businesses deploy their earnings and its potential impact on earnings and economic growth is like rain in an arid climate. It has prompted germination of new seeds of growth that have been dormant and is viewed as the strongest support for both the economy and stock market that we have seen in a long time.</u> Of course we will still see bouts of volatility as the stock and bond markets move from speculating about Trump's policies to actually facing their reality next year. And, the risks of overzealous investor' sentiment (a contrarian indicator), a strengthening U.S. dollar (which is causing a tightening of financial conditions), and international political events can be, at times, strong negative forces that will rock this market.

Investment Strategy: The momentum is likely to carry the market higher, however, volatility will also continue to rise. Thus a disciplined and diversified investment strategy is appropriate. Stock exposure has been increased slightly but continues to be broadly diversified across all sectors. Bond exposure has remained short term and has avoided much of the large decline in medium and long term bond prices.

As always, please contact me with any questions or concerns.

Kind Regards,
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