

June 2017

Despite the Negative Covfefe

We have highlighted the strength of corporate earnings growth this year. Healthy profit trends remain in place due to the underlying fundamentals of the economy. The current political situation, while seemingly dire, does not immediately impact the economy.

Some clients have asked if the political crisis unfolding in Washington will derail the bull market. We note that Fed watching has been replaced by “Twitter watching” (there were 135,000 retweets of the “covfefe” tweet on May 31st), as monetary policy gives way to fiscal policy. Will the fiscal initiatives that the President trumpeted last fall be thwarted by political foes? Proposed fiscal stimulus, tax reform and sweeping deregulation now seem to be at risk.

U.S GDP growth has averaged only +2% in real terms since the Great Recession, with both US workforce growth and worker productivity averaging just over +1% annually. While the private sector has grown at a healthy +3% in real terms, government spending has barely kept pace with inflation. (For the mathematically inclined, 60% private growth at +3% real plus 40% government at 0% real results in +2% total real GDP growth). If the private sector is doing its job by growing at +3%, the onus is on public sector spending to increase the overall economy's growth rate.

Assuming the Trump administration budget proposal is indeed “dead on arrival,” does this mean that tax reform, infrastructure spending, and deregulation are off the table? We don't think so. A more realistic scenario is a diluted version of the budget, weighed down by Washington gridlock.

So far in 2017, the stock market seems to anticipate increased fiscal spending, while the bond market indicates slow and steady growth over the long term. We expect another testing of investors' nerves this year. Any significant signs of weak economic growth may be enough to spook equity markets. So, we expect a correction in equity markets over the next several months, but believe that underlying economic trends – both in the US and abroad – are strong enough on their own without all of the Trump administration's promises being fulfilled.

TRANSLATION:

We expect US markets to deliver a correction at some point this year, with a rebound over the next 12 months. Underlying economic trends are strong enough on their own and won't be derailed by a political crisis alone.

A Look at the Numbers	Current / Last 12 months	5 year Average
US GDP Growth (Real)	+1.2%	+2.0%
US Unemployment	4.4%	6.1%
US Profit Growth (Real)	+12.0%	+2.0%
S&P 500 Total Return	+17.5%	+15.4%
US Govt 10-Year Note Yield	2.21%	2.07%

Sources: Fact Set Indexes, St. Louis Federal Reserve. Data as of May 31, 2017.

Balancing the Portfolio

We expect an increased probability of a correction in equity markets. We would use market weakness as an opportunity to rebalance into client equity allocations (“buy the dip”) and adjust fixed income allocations based on current yields, duration and credit quality at that time. As noted previously, we have been increasing allocations to international equities, which have outpaced US equities in 2017.

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notwithstanding China’s ability to navigate a soft landing of its economic slowdown. At this time, US stock markets trade at higher valuations than European and Asian markets. This situation should allow those foreign markets more potential upside as their earnings growth improves. Inflation expectations globally seem well contained, with major commodity and energy prices still in a down trend this year.

In fixed income portfolios, we have been reducing duration over the past few months, in anticipation of two more +0.25% rate increases by the Federal Reserve this year. We have also trimmed high yield exposure, as credit spreads have tightened. We have used proceeds from high yield bonds to fund the growing allocation to international equities.

Summing it up – What does it mean for investors?

STAY THE COURSE ON STOCKS

- Our current allocation to US stocks is neutral relative to long-term positioning. We would consider adding to core US equity positions on weakness.

EXPLORE INTERNATIONAL OPPORTUNITY

- International markets, namely Europe and Asia ex-China, present potential opportunity. We are currently neutral in client allocations to emerging markets equities.

REDUCE INTEREST RATE RISK

- On Fixed Income, we continue to reduce exposure to long-term interest rates by shortening the maturity profile of allocations. We also are reducing allocations to high yield bonds as the current level of additional yield relative to government bonds has narrowed considerably in 2017.

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