Quarterly Investment Outlook

"A little more growth, a little more inflation, a little more Fed."

January 2017

Boyd Watterson

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A TRUMPED-UP ECONOMY

Donald Trump's election to the U.S. presidency defied expectations and political conventions and sent equity prices to new heights and bond prices to old lows. The markets rapidly priced in a higher-growth, higher-inflation scenario. The uncertainty that characterized the election now surrounds the new administration as investors debate the degree and the speed of policy implementation. The far-reaching changes proposed make it difficult to estimate future policy impact, though it is widely believed that the Republican-controlled House and Senate will remove the previous constraints of divided government. While it is fair to assume that many items on President-elect Trump's wish list will be addressed, it is also fair to assume that a certain amount of compromise will be involved.

Growth: Recession Worries Receding

Prior to the election, a recession appeared unlikely despite much recession talk and worry. Classic recession signals such as an inverted yield curve, declining leading indicators, weak consumer confidence, and falling equity prices were absent. When we consider the first four of the six facets of policy that will be the new administration's focus, a recession in 2017 appears even more remote:

(1) Tax reform, including individuals and corporate tax cuts and repatriation
(2) Solid increases in defense spending
(3) Significant infrastructure spending
(4) Substantial regulatory reform
(5) Trade protectionism
(6) Immigration policy reform

The first four measures are constructive for the economy. Although Republicans are generally against significant government spending, they may agree to large-scale fiscal spending if the expenditures target growth-producing endeavors rather than entitlements. The latter two measures, trade protectionism and immigration policy reform, are growth retardants. Protectionism would increase prices for imported goods and reduce global trade. Reducing labor supply via immigration reform when at full employment would push wages higher. Overall, we believe sustained consumer spending, increased capital investment, and pro-growth fiscal policies will support moderately higher economic activity. We expect 2017 domestic growth to exceed the Fed's forecasted GDP of 2.1%.

	Performance for periods ending 12/31/2016					
	QTD	YTD	1-Yr	2-Yr	3-Yr	5-Yr
2-Year Treasury	-0.55	0.66	0.66	0.56	0.60	0.48
10-Year Treasury	-6.81	-0.16	-0.16	0.37	3.71	1.38
Barclays Aggregate	-2.98	2.65	2.65	1.59	3.03	2.23
Corporate Investment Grade	-2.88	5.96	5.96	2.61	4.22	4.25
Corporate High Yield	1.85	17.34	17.34	5.83	4.69	7.30
Leveraged Loans	2.25	9.88	9.88	4.62	3.76	5.35
Mortgage Backed Securities	-1.98	1.67	1.67	1.56	3.04	2.05
S&P 500	3.82	11.96	11.96	6.54	8.87	14.66
MSCI EAFE	-0.71	1.00	1.00	0.09	-1.60	6.53

Source: Interactive Data, Credit Suisse, Bank of America/Merrill Lynch/Bloomberg

Inflation: Well-Behaved

After several lackluster years, inflation began to pick up during the second half of 2016. Trump's aggressive fiscal spending and borrowing plans have also increased inflation expectations, yet inflation should remain well-behaved. For the past several years, there has been an absence of meaningful price pressures: no demand-pull inflation, no supply shortages, low wages, and low input costs. Excess capacity, slow growth, a strong dollar, and restricted bank lending have also kept inflation in check. Although increased infrastructure and defense spending, along with protectionist trade measures, are inflationary, counterbalances to inflation include dollar strength, low energy prices, pension cutbacks, and social security decreases. Inflation could reach the Fed's 2.0% target (and perhaps a bit beyond) somewhat sooner than was anticipated prior to the election, but it is unlikely to rapidly increase or move significantly higher.

Monetary Policy: Twice in a Decade

In December, the Federal Reserve raised the benchmark interest rate for the second time in ten years, citing signs of economic strength, a stronger labor market, and progress toward its inflation target of 2%. Although the rate increase was unanimous, the Fed was decidedly more conservative in altering their growth and inflation forecasts than the markets have been in response to the anticipated economic policies. The Fed noted that inflation may increase in the short-term but expects long-run inflation to lag 2.0%. With further labor market improvements and persistent inflation, Yellen foresees three fed funds rate increases in 2017.

Interest Rates: Upward Bound

Interest rates rapidly priced in higher growth and inflation in response to the proposed policies. After soaring to 2.60% from 1.88% on November 8th, 10-year Treasury yields have retraced about 30% of the 72 bps spike, pulling back to a 2.38% yield in early January. Initially oversold, the bond market is searching for a new equilibrium, striving to price in expectations not only for an uptick in growth and inflation but also a larger deficit and an increase in Treasury debt issuance. Heightened policy uncertainty and volatility given Trump's sometimes unpredictable nature add an additional risk premium to rates. Post-election, we increased our long-standing broad range on the 10-year Treasury yield from 1.50%-2.50% to 2.00%-3.00%, with a near-term trading range of 2.25%-2.75%.

Caveats and Conclusion

The likelihood of a 2017 recession has declined in anticipation of new growth prospects. Under the proposed economic policies, higher growth will come from regulatory and tax relief in the short term and from infrastructure spending in the long term. Still, the U.S. economy is in the later stages of an 8-year expansion, and substantial improvements in growth and inflation are unlikely at this point in time. Globally, many economies still struggle with poor growth and subpar inflation; improvement in U.S. growth is unlikely to benefit these economies. Other factors that may hinder growth include sustained dollar strength, which would reduce exports and earnings for U.S.-domiciled multinationals; repercussions arising from tensions with geopolitical and Democratic relationships; more room for monetary policy error; and the potential for falling energy prices.

Despite the altered investment landscape, equity and fixed income fundamentals—corporate credit profiles, balance sheets, inflation, and GDP growth—have changed little since early November. The markets may have over- or underpriced the new policy measures. The economic impact of a Trump presidency remains to be seen, but our view is that there will be a little more growth, a little more inflation, and a little more Fed.

Source: Bloomberg and FRBSF

Macro Expectations		
Domestic Growth	2.20%	Upward Bias
Inflation (PCE-core)	1.90%	Upward Bias
10-year TSY	2.00% - 3.00%	Balanced

Source: Boyd Watterson Asset Management

2017 Expected Returns	
Broad Investment Grade	0.00% - 1.00%
Real Estate	6.00% - 8.00%
Domestic Equities	6.00% - 7.00%

Source: Boyd Watterson Asset Management

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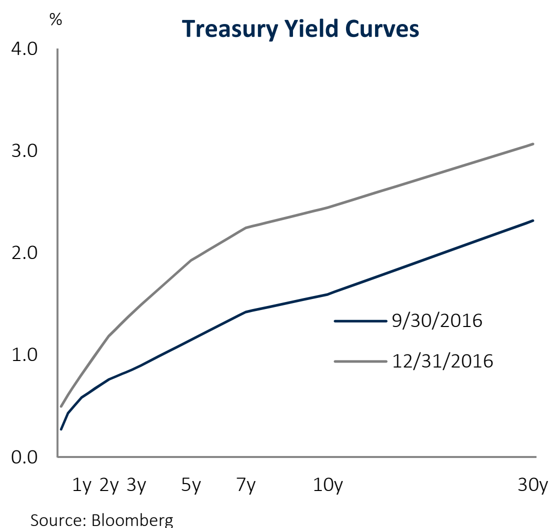
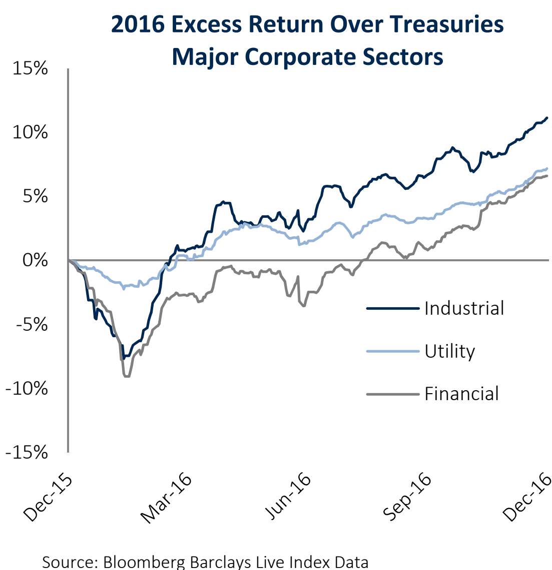


Source: Bloomberg



Source: Bloomberg Barclays Live Index Data

FIXED INCOME: Repricing for Higher Growth and Inflation

The ten-year Treasury yield closed the year a mere 17 bps over 2015's year-end yield. The seemingly benign point-to-point move belied a tumultuous year marked by a new historic low in long-term yields, a spate of negative interest rates around the globe, a credit-spread blowout and sharp rebound in the energy complex and, in the fourth quarter, an abrupt spike in interest rates. Not since the 2013 taper tantrum have bond yields increased so rapidly. The catalyst was, of course, the surprise election result on November 9th. Trump's victory promised tax reform and regulatory relief to both the stock and bond markets, and heralded an era of long-awaited fiscal stimulus. Whereas higher rates are a welcome event for savers and those seeking fixed income, such a quick pathway to higher yields temporarily reduces total returns. For perspective, consider that on November 8th the Long Treasury Index (comprising Treasuries with maturities of 10 or more years) had a year-to-date total return of 9.36%. By year end, the Index's return had plunged more than 800 basis points, to 1.33%. The broad market Bloomberg Barclays Aggregate Index fared much better, ending the year with a return of 2.65%.

Risk Sectors Embrace the New Era

Risk sectors cheered the prospects of higher economic growth and less regulation; in a move that mirrored strong gains in the stock market, corporate bond spreads tightened post-election. Longer-dated maturities and lower-quality issues were the best performing cohorts in 2016. Securitized sectors, with the exception of mortgage-backed securities, also posted positive total and excess returns for the year. Mortgage-backed security durations extended significantly as negative convexity kicked in after the selloff in rates reduced the likelihood of prepayment on many mortgages. The sector still managed to post positive total returns despite lagging the broad market index.

Politics, Policies, and 2017

Trump's surprise win brought with it several catalysts for higher interest rates. Aggressive fiscal stimulus and increased Treasury issuance will nudge inflation higher. Lower corporate and individual taxes and a lighter regulatory burden should buoy growth and ensure additional federal funds rate increases. Still, Trump's policies will take time to pass through Congress, with compromises likely along the way.

Our outlook is for higher interest rates in 2017, yet the markets may have temporarily outpaced themselves. We forecast an expected near-term range of 2.25%–2.75% for the 10-Year Treasury note and a broad trading range of 2.00%–3.00%. This range, higher than our previous broad range of 1.50%–2.50%, reflects the anticipated increases in inflation and growth, along with further increases in the federal funds rate. As the markets digest and price new information over the coming weeks, tactical duration movements and conservative yield curve positioning should help hedge the many uncertainties surrounding the Trump administration's new policies and the speed of enactment during the first 100 days. The additional yield from credit securities should benefit performance as balance sheets are poised to benefit from an increase in profits amid projected improved growth prospects.

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REAL ESTATE: Real Estate Markets Meet Interest Rate Hikes

As interest rates hovered near historic lows during the past few years, supply and demand factors became the primary determinants of real estate asset pricing. Limited supply, strong demand from overseas investors, and attractive expected returns relative to other asset classes have led to increasingly higher valuations. With three expected fed funds rate hikes on the horizon in 2017, however, the impact of interest rates on real estate prices is poised to rise.

Higher interest rates are likely to affect the real estate market in two ways. Financing costs will rise along with interest rates, and capitalization rates will increase as investors seek relative value equivalent to investment returns that could be had elsewhere. The result is likely to be lower fundamental real estate valuations, although prices could lag fundamentals for some time. Sellers, mindful of how real estate values continued to climb in the recent past when interest rate hikes were expected, initially may not accept lower values.

The rise in capitalization rates may take as long as one to two years to materialize, and presents an additional element of risk in the real estate market. In the meantime, a surplus of international capital is still seeking U.S. real estate, and strong demand plus the specter of higher financing costs may tempt investors to overpay for assets in the near term. But a solid economy is a strong plus, and some investors view higher cap rates as a secondary consideration.

EQUITIES: Braced for a Pro-Business Agenda

Despite Brexit, the unforeseen Trump victory, and a resounding "no" vote on the Italian referendum, equities proved to be resilient in 2016. The S&P 500 Index closed the year with a 12.0% return at 17x future earnings, slightly above its historical mean P/E ratio of 16x. Consumer confidence is strong, Trump's pro-business agenda is hailed as a positive for stocks, and capital investment—a laggard during this recovery—is projected to increase amid new forecasts of greater economic growth and fiscal spending.

In Europe, earnings revisions have been positive for only the second time since 2010. Earnings are now projected to grow between 6%-7% in 2017 and 2018 based on stronger domestic demand and less stringent lending conditions. European equities are trading at a 17% discount to their U.S. counterparts.

The Japanese economy is improving with GDP growth now at 1.0%. Bank of Japan and Japanese corporations have been capitalizing on equity opportunities created by recession-wary international investors unloading stocks. Japan's equity market is at a price-to-book discount to the global markets of 33%. Bank of Japan will continue to support the market with easy money policies.

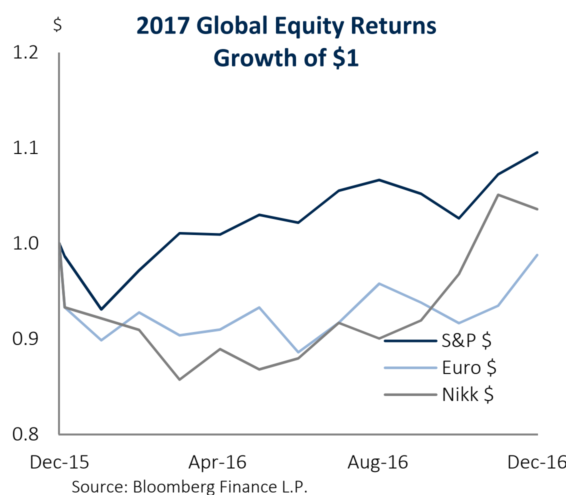
Entering 2017, Trump's pro-business policies are expected to spur a 7%–8% improvement in U.S. equity earnings and an approximate 6%–7% total return on the S&P 500 Index. That said, U.S. stocks face potential headwinds from Trump's proposed trade restrictions and continued dollar strength that will weigh on the earnings of multinationals.

Capitalization Rates – U.S. Core Properties over $2.5 Million

Year	All Properties	Office	Industrial	Retail	Apartment	Hotel
2001	8.75	8.88	9.08	8.77	8.77	NA
2002	8.51	8.76	8.81	8.57	8.57	NA
2003	8.07	8.50	8.57	8.15	8.15	NA
2004	7.49	7.95	7.99	7.54	7.54	NA
2005	6.88	7.30	7.60	6.96	6.96	9.01
2006	6.64	6.86	7.07	6.71	6.71	8.92
2007	6.51	6.57	6.85	6.53	6.53	8.85
2008	6.81	7.12	7.47	6.86	6.86	9.02
2009	7.32	8.05	8.24	7.61	7.61	9.55
2010	7.27	7.78	8.31	7.81	7.81	8.21
2011	6.88	7.43	7.76	7.49	7.49	7.94
2012	6.76	7.19	7.48	7.22	7.22	8.15
2013	6.71	6.98	7.49	7.04	7.04	8.18
2014	6.49	6.85	7.12	6.77	6.77	8.15
2015	6.31	6.77	6.82	6.55	6.55	8.39

2016	All Properties	Office	Industrial	Retail	Apartment	Hotel
Jan	6.41	6.75	6.77	6.54	5.82	8.42
Feb	6.37	6.76	6.82	6.55	5.81	8.44
Mar	6.30	6.55	7.19	6.59	5.69	8.46
Q1	6.14	6.59	7.22	6.60	5.71	8.53
Apr	6.28	6.56	6.87	6.50	5.70	8.50
May	6.30	6.62	6.87	6.51	5.63	8.49
June	6.38	6.65	6.76	6.44	5.69	8.47
Q2	6.14	6.63	6.78	6.41	5.79	8.43
Jul	6.10	6.55	6.83	6.38	5.75	8.31
Aug	6.07	6.44	6.82	6.40	5.72	8.32
Sep	6.05	6.44	6.59	6.43	5.61	8.40
Q3	6.05	6.44	6.59	6.43	5.61	8.40
Oct	6.06	6.48	6.71	6.38	5.63	8.38
Nov	6.04	6.38	6.61	6.49	5.52	8.58

Source: Real Capital Analytics



Source: Bloomberg Finance L.P.

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