Title: Advocacy Investing® Portfolio Strategies, Issue 87
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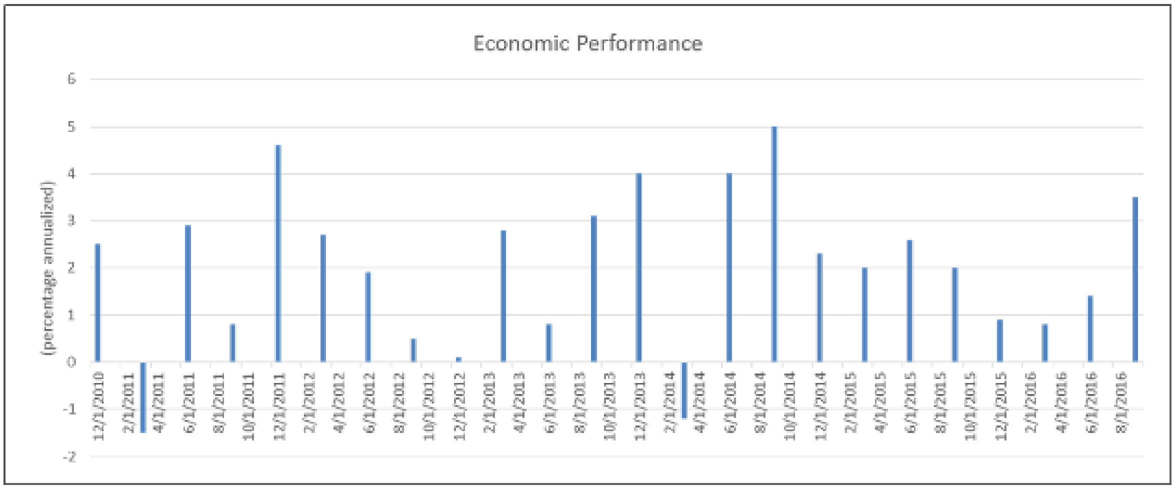
Advocacy Investing®

CLOUD OF UNCERTAINTY

- **Third quarter 2016 GDP grew at a healthy clip of 3.5% annualized**
- **Labor markets deliver a 75th month of jobs increases**
- **Oil prices stabilize above $50/barrel**
- **The Fed increased interest rates by 25%, and has indicated the potential for a faster pace of monetary normalization**
- **With the new administration coming to power, we can expect major shifts of economic policies**
- **Significant repricing in financial markets, but the Trump rally seemed to run out of steam in mid-December**

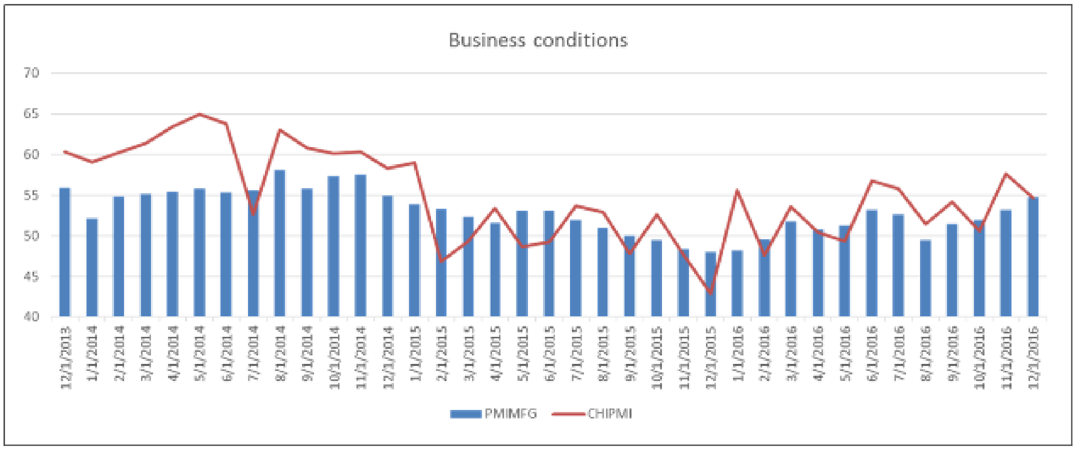
With the Republican Party now in full control of the Presidency and Congress, the country can expect major shifts in economic policy. This shift in control comes after a seven year period of steady, albeit modest, growth, robust labor markets and a sharp fall in the unemployment numbers to pre-Great Recession levels. The third estimate of economic performance in 3Q16 was released by the government, showing that the economy had been growing at a faster pace than earlier estimated. Real output growth was revised upwards from 3.3% to 3.5% (annualized). Growth was broad-based, with personal consumption expenditures (PCE), inventories, non-residential fixed investment, net exports and government all contributing to the economic expansion, while the contraction of residential investment being the only drag on the economy.

Figure 1: Economic Growth Acceleration



Data releases were mixed, with the balance of risks on the upside. Industrial production and manufacturing fell by respectively 0.4% and 0.1% month-on-month (m/m) in November, and durable goods shrank by 4.6% m/m (+0.5% excluding transportation). Factory orders fell by 2.4% m/m. In contrast, both early-month and late-month surveys of business activity were positive. In early December, the Empire State measure rose from 1.5 to 9.0, while the Philadelphia Fed index increased from 7.5 to 21.5 over the same period. Late-month December surveys also pointed to continued expansion, with the ISM-Manufacturing rising to 54.7 from 53.2 the previous month, and the broad-based Chicago PMI falling from 57.6 to 54.6 over the same period. On the household side, we witnessed a note of caution, with personal income flat in November and PCE growth slowing to 0.2% (m/m). However, indices of consumer confidence were sharply up. The Conference Board index jumped to a 14-year high of 113.7 at the end of December from 107.1 the previous month, while the University of Michigan-Reuters measure rose from 98.0 to 98.2 over the same period.

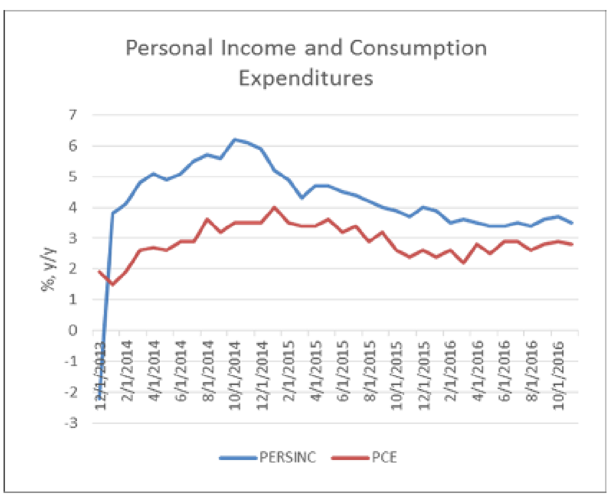
Figure 2: Manufacturing Rebound



The services sector remained robust, with the end-December ISM Non-Manufacturing index remaining at 57.2 and the Markit PMI-Services slightly down to 53.9 from 54.6 the previous month. The trade deficit rose to a nine-month high in November as imports rose and exports fell.

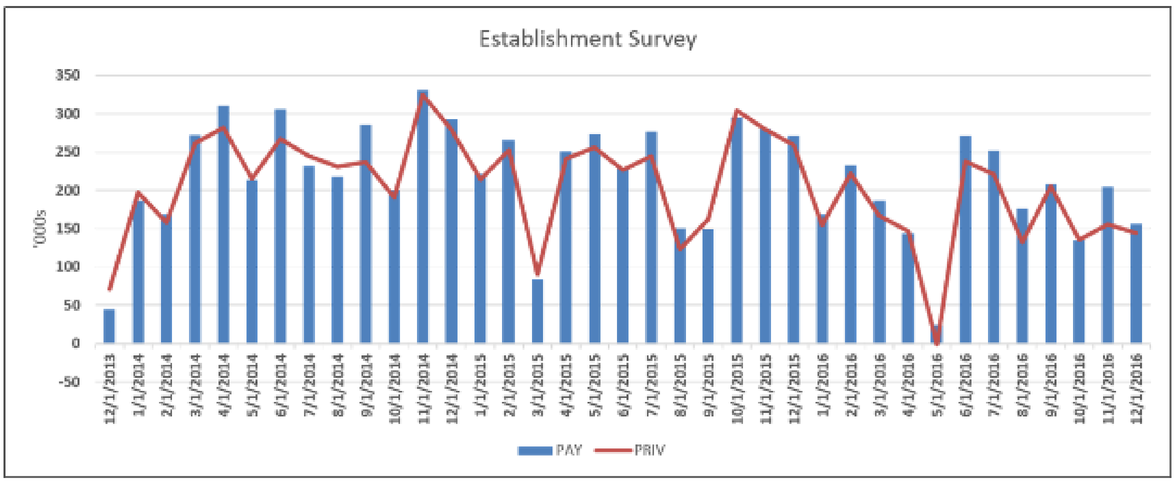
The housing market remained steady. Housing starts and new home sales fell slightly in November, while existing home sales rose somewhat. Home prices, as reflected in the Case-Shiller 20-City index, increased by a healthy 0.6% in October (5.1% y/y), and November construction spending jumped by 0.9% m/m.

Figure 3: Households



The oil markets continued to consolidate as traders gained confidence in the sustainability of OPEC production cuts, pushing oil prices (West Texas Intermediate, WTI) to an 80-month high of $53.99/barrel in early January—more than double the level in early 2016. In particular, the Saudi commitment to keep production low to bring down the record levels of global crude inventories in the mid-term helped boost the markets. However, the prices seem to have overshot and the rally stalled in the face of an acceleration of U.S. drilling activity and continued high U.S. oil stockpiles—prices have settled in the low $50s.

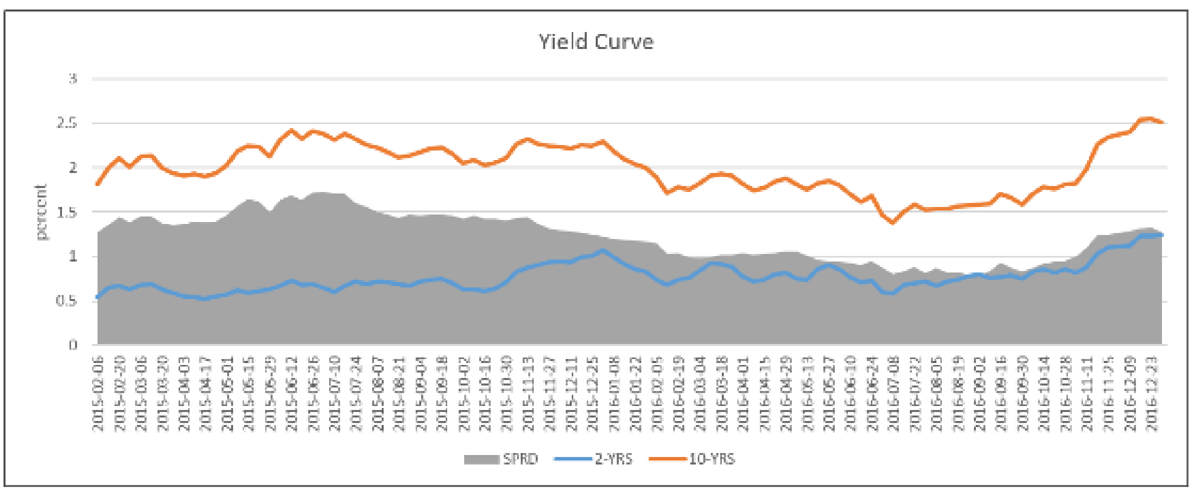
Figure 4: Steady Payrolls



One Final Good One: The last payrolls report of the Obama administration underscored continued tightening and consolidation of the labor markets. Total payrolls increased by 156,000 in December (+144,000 for the private sector), the 75th month of consecutive jobs increase—the longest on record. In addition, the previous two months were revised upward by 21,000. This brought the total for 2016 to 2.2 million new jobs. The three-month moving average fell to 165,000 for 4Q16, down from 212,000 the previous quarter. The goods sector generated 12,000 jobs, with manufacturing returning to a positive, with 17,000 new positions. Private services jobs and government increased by respectively 132,000 and 12,000. While average weekly hours worked fell by 0.1, to 34.3 hours, average hourly earnings increased by 0.4%, bringing the total for 2016 to 2.9%. In combination with the increase in hours worked, this translated in a solid 4.2% (annualized) rise of the labor earning proxy. The separate households' survey showed a slight increase in the unemployment rate (U3) to 4.7% (but still down from 4.9% in October) and a rise in the labor force participation by 0.1% to 62.8%. Another sign of improvement has been the sharp drop in the unemployment and underemployment rate (U6) from 9.7% at the end of 3Q16 to 9.2% at year-end as more part-time workers moved to full-time jobs. The high-frequency data was equally positive, with initial weekly unemployment claims falling to a 43-year low of 233,000 in the last week of the year.

The Fed Braces for Mr. Trump: As expected, the Federal Open Market Committee (FOMC) increased the Fed funds rate by 25 bp at its December 13th-14th meeting to a range of 50-75 bp, the second rate increase in the past 12 months. The minutes of the FOMC meeting shows that the participants focused on the impact of the fiscal stimulus package expected from the incoming Trump administration. On one hand, all FOMC participants agreed that the risks to growth were on the upside in the near term. At the same time, the FOMC participants emphasized increased uncertainty about the impact of the new economic policies on inflation. With inflation inching up to the 2% level, fading fears of a global slowdown and the tightening of labor markets, the Fed should be shifting away from concerns for downside risks to a more conventional monetary policy. As such, the Fed might be behind the curve, but has hinted at a potentially faster pace of interest rate increases if required by unexpectedly higher inflation. Furthermore, there are some medium-term uncertainties regarding the Fed leadership. Janet Yellen's term expires in 2018, and President Trump will have the opportunity to replace her, as well as to fill vacancies at the Fed Board of Governors. Such changes could have profound effects on Fed policies, as well as its hard-won independence.

Figure 5: <u>Yield Curve Steepening</u>



From Fear to Hope: Earlier concerns about a sharp global slowdown have not materialized, as the global economy regained momentum in the last months of 2016. In fact, we have seen a recovery in the Chinese economy, with both the PMI-Manufacturing and Composite above 50 and rising, and manufacturing prices up for the fourth consecutive month. The eurozone economy enters 2017 with the strongest momentum since 2011, with the economic recovery entering its second year. The Markit PMI-composite rose to 54.4, its highest level in 67 months, German industrial production is on the rebound, unemployment is down below 10% (the lowest since 2009), and German inflation surprisingly jumped to 1.7% (y/y) at the end of the year. The British economy continues to defy post-Brexit prognostications by expanding at a steady clip. The IMF recently revised economic forecasts upwards, projecting an acceleration of global growth in 2017 and 2018, citing improved prospects for the U.S, the Eurozone and China as major growth drivers.

Overall, while there are some problematic emerging market countries (Mexico, Brazil and Turkey), the fading of the drags from lower oil prices and deflationary pressures presages a continued improvement in 2017. Furthermore, the IMF cited U.S. policy uncertainty and the threat of trade tensions as main downside risks.

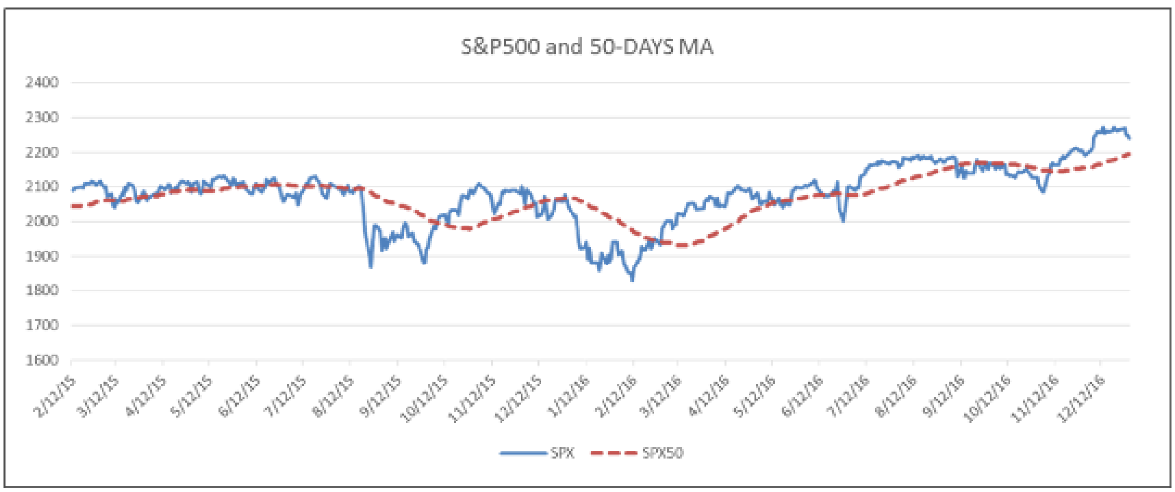
Table 1: <u>IMF Economic Outlook</u>

Region (GDP, %)	2016	2017	2018
World	3.1	3.4	3.6
U.S.	1.6	2.3	2.5
Eurozone	1.7	1.6	1.6
Japan	0.9	0.8	0.5
Emerging Mkts	4.1	4.5	4.8

Cloud of Uncertainty: On the eve of the assumption of the presidency by Trump, the only certainty we can honestly have is the lack thereof. President Trump is a disrupter, with little apparent regard for the Republican economic orthodoxy on spending, deficits, trade and free markets. While the Republican establishment sees him as a vessel for their long-deferred plans of massive tax cuts and shrinking government, Trump's economic policies might fly in the face of the GOP wish list. Moreover, in contrast with recent presidents at the beginning of their terms (Reagan, Clinton and George W Bush), Trump inherits an economy close to full employment.

A Republican-dominated Congress is likely to focus on tax cuts and be less amenable to the large increases in infrastructure spending promised by the new administration. This in itself should limit the economic impact of the expected Keynesian stimulus package. In any case, the macroeconomic impact of any stimulus package is unlikely to be felt before second half of 2017, if not later. Furthermore, while the Trump and the Republicans have promised to deregulate the economy, there is little historical evidence that such a move could increase productivity in the short to medium term. As a result, the economy is not expected to grow at a faster pace than its current potential of 2.0-2.5% over the next few quarters, with higher inflation and a potential tightening of monetary policy acting as headwinds. Trump remains an inexperienced policy-maker and politician, and his positions on trade and his interventions in the auto industry could also prove to be disruptive, run afoul of Republican mainstream thinking and have adverse economic implications.

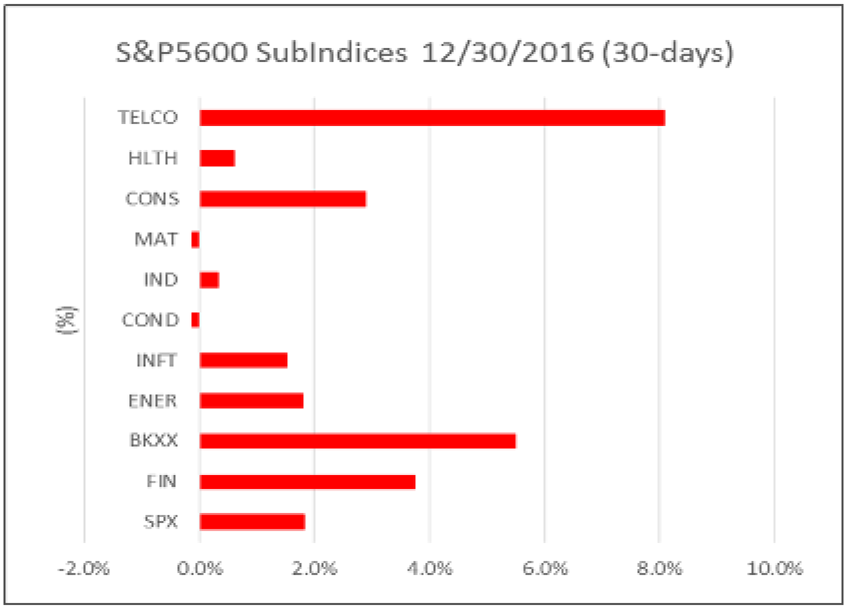
Figure 6: <u>Trump Rally Runs out of Steam</u>



Running out of Steam: We saw a significant repricing in financial markets after the Trump victory: equity markets soared, long-term interest rates rose sharply and inflation expectations jumped. However, the Trump stock market rally seemed to run out of steam in mid-December. The S&P500 flattened after rising by 8.2% between its November low on November 4th to its 2016 high of 2,256 on December 12th. The index has remained in the 2,259-2,295 range since and is struggling to break through the 2,300 level. The markets are cautious as the earlier euphoria over the pro-growth policies of the incoming administration has faded somewhat. President Trump's first press conference did little to provide policy clarity either.

The market recovery has been led by the banking, finance and energy sectors, with a special emphasis on the top names in each sector. However, some market sectors were rattled by pressure from President Trump—autos and pharmaceuticals—a pattern likely to repeat itself in the next four years.

Figure 7: S&P500-Broad Gains



Large U.S corporations are entering the year in a stronger position. Over the medium-term, the earnings recession is over, some pricing power has been restored and the drags from low energy prices have faded. Furthermore, U.S. corporations are likely to benefit from two important factors: a corporate tax reform and deregulation. On the negative side, markets remain overpriced, economic fundamentals are unlikely to support a surge in earnings and the strong dollar remains a headwind.

Policy-wise, the broad shape of the Trump/GOP Congress economic program are clear: tax cuts, infrastructure spending and deregulation. But the policy mix is unclear, and the market expects to get clarity within a relatively short period of time. Furthermore, the ability of the Democrats in Congress to block change and/or force the GOP to negotiate remains another important consideration. Markets are experiencing a period of unexpectedly low volatility, but remain at risk of a Trump "disappointment" reversal. We can also expect markets to be rattled by Trump's off-the cuff tweets. Under these conditions, the S&P500 may struggle to break through and/or maintain the 2,300 level in the near-term.

December Data Releases

Economic Data Releases-December 2016	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP(2Q16 % Annualized, Second estimate	3.2%	3.3%	3.5%	3.2%	3.4%
PCE Deflator(m/m) Nov	0.3%	0.2%	0.0%	0.1%	0.3%
Core PCE (% m/m)	0.1%	0.1%	0.0%	0.1%	0.5%
Employment					
First Time Claims ('000) (Last week Dec)	263	260	235	255	262
Non-Farm Payrolls ('000), Dec	204	175	156	151	210
o/w Private Sector	198	165	144	136	200
Balance of Payments					
Trade Deficit $ billion) Nov	$42.40	$44.50	$45.20	$42.00	$46.00
Exports (% m/m)	-1.8%		-0.2%		
Imports (% m/m)	1.5%		1.1%		
Current Account Deficit ($ billion) (3Q16)	$118.30		$113.00		
Dollar Index-eom(Dec)	101.50		102.70		
Oil Prices-eom (WTI, $/bbl) Dec	$49.44		$53.72		
Industrial & Manufacturing					
Corporate Profits (y/y) 3Q16	5.2%		4.3%		
Business Inventories (Oct)	0.1%				
Empire State (Dec)	1.5	3.00	9.0	2.00	5.00
Philadelphia (Dec)	7.6	10.00	21.5	6.00	12.50
Chicago PMI dec	57.6	57.00	54.6	56.00	58.60
Markit PMI Mfg Dec	54.1		54.3		
ISM Mfg (Dec)	53.2	53.8	54.7	53.0	54.7
Industrial Production (% m/m, (Nov)	0.1%	-0.2%	-0.4%	-0.8%	-0.3%
Manufacturing (% m/m) (Oct)	0.2%	0.3%	-0.1%	-0.8%	0.3%
Durable Goods (m/m) Nov	4.8%	-4.0%	-4.6%	-6.3%	-2.4%
Durable Goods, ex transp (m/m)	0.9%	0.2%	0.5%	-0.1%	0.7%
Factory Orders (m/m) Nov	2.8%	-2.5%	-2.4%	-3.8%	-1.9%
Services					
PMI Services (Dec)	54.6		53.9		
ISM Non-MFG (Dec)	57.2	56.8	57.2	56.0	57.6
Consumer Spending					
Retail Sales (% m/m) Nov	0.6%	0.4%	0.1%	0.1%	0.6%
UMich Consumer Sentiment (end-Dec)	98	98.0	98.2	94.1	99
ConfBd Consumer Confidence (end-Dec)	107.1	108.5	113.7	106.3	111.0
Personal Income (m/m) Nov	0.5%	0.3%	0.0%	1.0%	0.4%
Personal Consumption Expenditures (m/m) Nov	0.4%	0.3%	0.2%	0.1%	0.5%
Housing Market					
Housing Starts ('000) Nov	1340	1230	1090	1125	1290
New Home Sale ('000) Nov	563	580	592	570	560
Existing Home Sales (MM) Nov	5.6	5.530	5	5.400	5.650
Construction Spending (m/m) Nov	0.6%	0.6%	0.9%	0.1%	0.8%
Case Shiller-20 (m/m) Sep	0.5%	0.5%	0.6%	0.5%	0.8%
Case Shiller-20(y/y)	5.0%	5.1%	5.1%	4.8%	5.3%

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.