

Economic and Market Outlook

First Quarter 2017

The November presidential election was the seminal event of the fourth quarter and may prove to be the most important single event since the financial crisis. The end of the campaign may have been a relief for the market. But relief does not explain the price swings between different asset classes or even between different stock market sectors. As December progressed, the S&P 500 closed most days near a record high and the Dow Jones Industrial Average marched inexorably towards the psychologically important 20,000 mark. Bond prices fell, leaving the ten year yield near 2.60%, a high for the year. The dollar, riding a wave of optimism and higher rates has risen to levels not seen in decades.

There were vast return differences within the stock market as well. Small company stocks, considered both a tax reform beneficiary and sheltered from a rising dollar have soared since the election. Bank stocks, weighed down by regulations and low interest rates for the past decade, sprung to life at the expense of utilities and other “bond proxy” stocks. The promise of robust government funded infrastructure projects helped support industrial and material stocks.

In the months leading up to the election and since, the election took on a life of its own. Lost in the election headlines were the more mundane measures of economic output that tell an interesting economic story.

The economy has grown at about a 2% pace since the recession ended in 2009, marking the slowest average rate of any expansion since at least 1949. Measures of economic activity, however improved notably as the year progressed. Gross domestic product (GDP), the broadest measure of our economy ended the 3rd quarter at 3.5% growth, the strongest level in two years and substantially better than the lackluster readings from earlier in the year. Another broad measure, the unemployment rate was similarly positive measuring 4.6% in December. There are jobs to be had and we have more employed than ever before.

In spite of the recent run up in interest rates, we remain in a historically low interest rate environment. Low rates combined with new job creation have had a sustained positive impact on the housing and auto markets. Millennials, for whom jobs were scarce five years ago, are finding work and creating new households providing a solid foundation for home sales and prices. Consumers are more positive than they have been in years, the December confidence expectations index jumped to the highest level since December 2003.

The negative effects of a deflationary energy market are largely behind us. With oil hovering around \$55 per barrel, business investment is likely to increase. Business investment has not recovered from its unprecedented collapse during the financial crisis and has been a drag on economic growth. OPEC’s recent production agreement, their first in 10 years combined with non-OPEC producers’ similar agreement should provide a conducive floor for investment spending.

In our opinion, economic prospects are strengthening, notwithstanding the proposals proffered by President-elect Trump to jump start the economy. Trump’s proposals, if made policy, could bolster growth but probably not as fast or to the degree many envision. The proposals are far reaching impacting fiscal, tax, and trade policies. For that reason, forecasting the impacts on our economy or the markets is inexact at best.

One thing is almost certain, there will be less regulation emanating from Washington. In the wake of the financial crisis, the regulatory burden on business increased considerably effecting small businesses disproportionately. Less regulation would allow small businesses to hire more freely, positively impacting job growth, increasing competitiveness and fostering innovation. Financial firms, and banks in particular, would also benefit from an easing regulatory environment.

Trump’s fiscal spending plans are less clear. The last big infrastructure plan was initiated in the early stages of the Obama administration and included “shovel ready” projects. Trump’s fiscal spending plan appears similar to the Obama plan and promises improved roadways, airports, and rail services. These type of initiatives usually take longer to implement and take root. Furthermore, repairing existing infrastructure has a more muted economic benefit than new greenfield projects. In this regard, new plans agreed to in 2017 would benefit 2018 and beyond.

A proactive fiscal spending plan may reduce dependency on the Federal Reserve Bank’s (Fed) monetary programs, a welcome outcome in our view. After eight years of monetary expansion and quantitative easing, the Fed’s ability to kick start growth has waned. A more aggressive fiscal policy may help limit any negative effect of Fed’s latest increase in the federal funds rate.

Trump’s tax proposals are ambitious and encompass broad corporate tax reform and lower tax rates for individuals. Broad tax reform is often discussed but has eluded the previous

four administrations. With party support in both houses of Congress, we should experience, at a minimum, lower personal and corporate tax rates. Lower rates would bolster spending and provide some growth at the possible expense of lower federal tax revenues.

As we enter 2017, the driving factors behind our economic picture are largely established. Job growth and low interest rates are supporting enhanced growth. Wages are trending up, supporting an already optimistic consumer. Interest rates are likely to gradually increase reflecting a stronger economy. The new administration's policies, if enacted as proposed, would likely benefit the latter half of 2017 and 2018.

Stocks remain the preferred asset class. Policy uncertainty has increased and will present opportunities as the year progresses but valuations are reasonable and the prospects for earnings growth are sound. Bonds may be more challenged but are an integral part of a more conservative portfolio.

Best wishes for a happy and healthy 2017.

**Investment Policy Committee
Daniel A. Lagan, CFA, President**

January 3, 2017



Two Seaport Lane - Boston MA 02210 - 800.234.4516 - www.congressasset.com