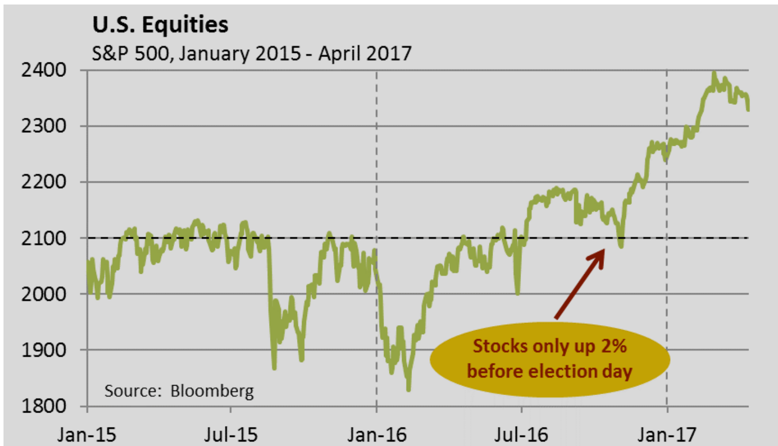
Strong Start & Rising Risks

April 2017

Summary

In an election year like 2016, the stock market tends to rally in advance of election day when a clear winner emerges. Although economic data was strong last summer, the election uncertainty kept a lid on market returns as stocks fell for two months before election day. After the election, markets rallied on a combination of the known election outcome and high expectations for economic expansion.



The Federal Reserve has started to normalize monetary policy for the first time in almost 10 years. The economy seems to be on solid footing, but Fed stimulus of this size has not been removed before. Many indicators showing strength 6-9 months ago have weakened, but expectations are still high.

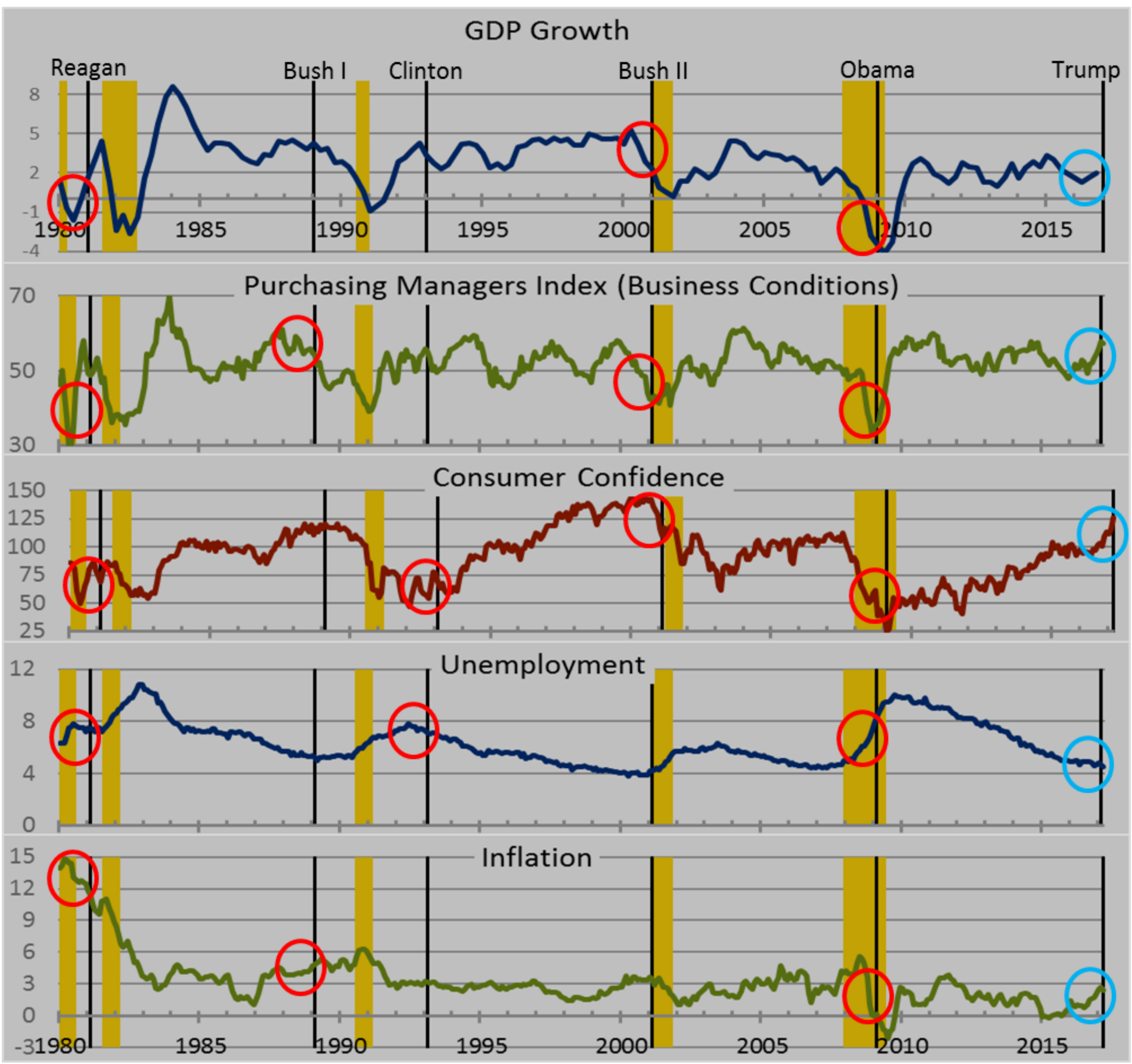
- **Current economic conditions are the strongest for a new president in decades.** Most past presidents were greeted with a recession or poor economic conditions in their first months of office.
- **The business cycle is back.** While an important piece of returning to a more normal economic environment, the business cycle may also bring back less stability and larger swings in stock returns.
- **Stocks realized a solid start for the year.** While U.S. stock returns were good (+6%), international and emerging market stocks posted stronger gains (+7% and +11%, respectively) in the first quarter.
- **It has been roughly 8 months since the start of a 5% stock market correction.** Five percent corrections occur on average every 2 months, and there has only been one longer rally since 2000.
- **The post-election year tends to start hot and then fade.** In year one of the presidential election cycle, there is typically strength in the first half followed by weakness in the second half.
- **There are many signs of elevated optimism, which can be a contrary indicator.** Consumer confidence reached the highest level since 2000, and home prices have returned to their pre-recessionary peaks.

After 18 months of lackluster stock returns, the post-election rally was a welcomed advance. However, the presidential election cycle has shown that high optimism is often met with disappointment in the second half of a post-election year. Risks are increasing from rising interest rates, high expectations of economic growth resulting from tax and regulation reform in the U.S., and political elections in Europe. Client portfolios were allocated at their maximum equity allocation since shortly after the election and benefited from the strong stock market advance. This week, in expectation that the market may pull back at some point after the recent rally, client portfolios were moved to their neutral equity level. The market could continue to rally, but it seems prudent to preserve some of the recent gains.

The Best Economic Conditions for a New President in Decades

The U.S. economy is reasonably healthy. In fact, the conditions Donald Trump inherited are likely the best for any new president in decades. Three of the last five presidents started their term in a recession or fell into one within six months. And all five faced some combination of slowing economic conditions, low or declining consumer confidence, high or increasing unemployment, or inflationary extremes. Both Reagan (in the midst of a double-dip recession) and Obama (during the worst recession since the Great Depression) had to act quickly to pass economic expansion bills.

With low unemployment, mild inflation, surging consumer confidence, strong expectations for business conditions, and modest GDP growth, the beginning of the Trump presidency is much healthier than his predecessors. Instead of being saddled with a difficult economy, Trump has focused his early efforts on the following: 1) reducing personal taxes; 2) reducing corporate taxes; 3) increased fiscal spending on infrastructure; and 4) reducing regulation. The "business friendly" economic environment has generated high expectations and allowed optimism to soar.

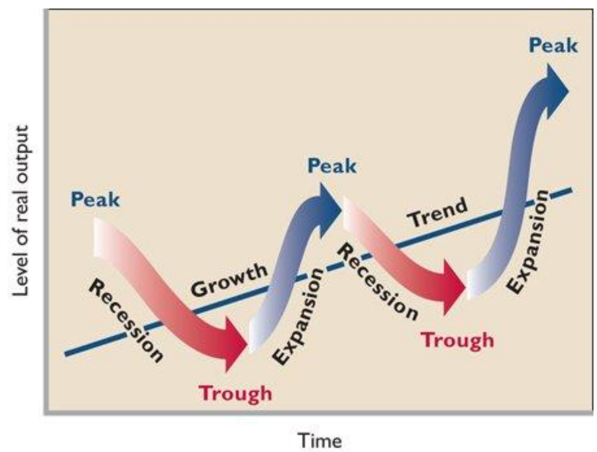


Yellow shaded areas represent NBER recessions; source: Bloomberg

The Return of the Business Cycle

In 1939, Joseph Schumpeter published a work titled, “Business Cycles”, which is the foundation of the modern definition of the term. Schumpeter’s analyses were groundbreaking, but his works were overshadowed by those of John Maynard Keynes, one of the most impactful economists in history. Despite the lackluster response to his work in 1939, Schumpeter’s analysis of business cycles and his later work on “creative destruction” demonstrated how struggles in one period lead to innovation in the next.

The current definition of a business cycle can be described by four phases: expansion, peak/crisis, recession, and trough/recovery. First is a period of expansion, which includes high economic growth and rising prices for goods and services. At some point, the market overheats and a crisis ensues, creating distress or bankruptcy for many companies and significant drops in stock markets. The crisis leads to a recession which is associated with less production and lower prices for goods and services. After production and prices fall too far, the opportunity initiates the start of new businesses, and stock prices begin to rally. Over time, the cycle repeats.

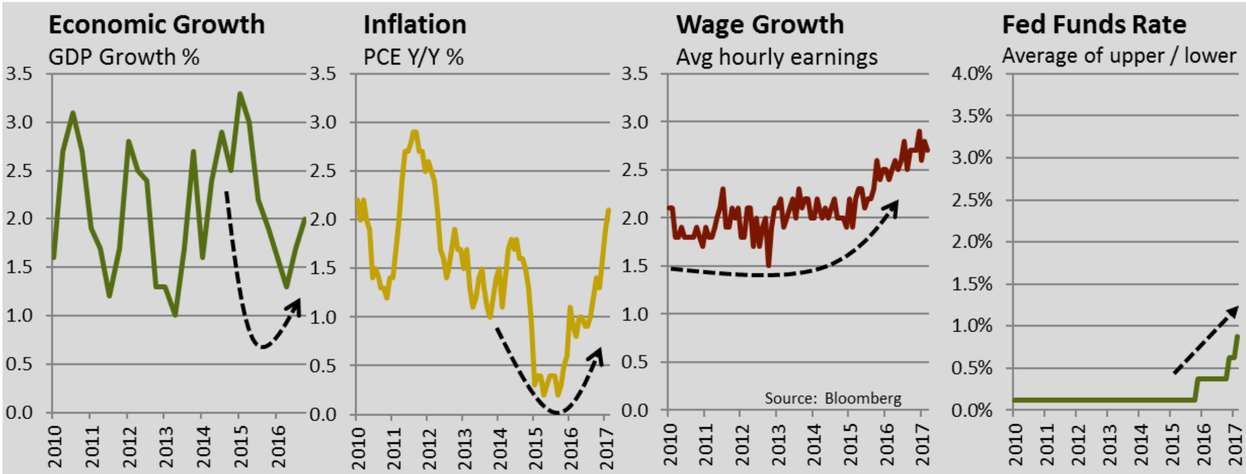


Schumpeter posits that while the ups and downs of the business cycle are frustrating, they are crucial to the overall health of the economy.

> *“Cycles are not, like tonsils, separable things that might be treated by themselves, but are, like the beat of a heart, of the essence of the organism that displays them.”*
>
> - Joseph Schumpeter, 1939

This is important since the U.S. economy has been devoid of any business cycles for several years. It has been eight years since the last recession. For most of that period, economic growth has been dull, inflation has been non-existent, and wages have been flat. Financial markets recovered from the depths, but the economy has seen neither boom nor bust. After the Great Recession in 2008-2009, stability was the key goal of the Federal Reserve, and for the most part, that mission has been accomplished.

More recently, signs of a more normal business cycle have begun to appear. In 2016, many economic indicators started to turn more positive. Although economic growth continues to hover near 2%, wage growth is clearly trending higher, and inflation hit its highest level since 2012 (see chart, page 4). After a deflationary scare in 2015, inflation is back near 2%, which is a desirable level. In March 2017, the unemployment rate (not shown) fell to 4.5%, the lowest level since 2006.



The actions of the Federal Reserve are one of the biggest indicators of a return to normalcy. In December 2015, the Fed raised interest rates for the first time in 11 years. In December 2016, the Fed raised rates again and announced the intention for three rate hikes in 2017, the first of which occurred in March. Although Fed monetary policy and low interest rates are still very friendly to markets, the path to higher rates is becoming more clear and likely. How long will it be until higher interest rates begin to drag on the economy? There is no magic number, but one bellwether to monitor is the 10-year treasury yield (currently 2.3%), which has a strong tie to many borrowing rates, such as mortgages. Either way, the Fed Funds rate pegged at zero is clearly not a normal environment. Ongoing rate hikes are an important piece to the return of a more normal business cycle.

The return of a more normal business cycle is likely positive for the economy, financial markets and investors despite how turbulent the ride may be along the way.

Stock Returns – A Strong Start to the Year

Equity markets started the year with a strong quarter. U.S. stocks were up 6.1% over the first three months, while international stocks were even stronger. Developed international markets were up 7.3% over the first three months (already beating their entire 2016 return handily). Emerging markets stocks were strong as well, posting double-digit returns in just three months. Bonds were steady as interest rates were mostly flat during the quarter.

Investment Returns

As of March 31, 2017

	2017 ytd	2016	2015
All Country World Stocks	6.9%	7.9%	-2.4%
S&P 500	6.1%	12.0%	1.4%
Dow Jones Industrial Average	5.2%	16.5%	0.2%
Small Caps	2.5%	21.3%	-4.4%
International	7.3%	1.0%	-0.8%
Emerging Markets	11.4%	11.2%	-14.9%
Bonds (Barclays Aggregate)	0.8%	2.7%	0.6%
U.S. Treasury Bonds	0.7%	1.0%	0.8%
Commodities	-2.3%	11.8%	-24.7%

Source: Bloomberg

Evaluating the Recent Rally

It has been over a year since recessionary risks flared up in January and February 2016. At that time, the S&P 500 fell by 13%. The market recovered in the spring and then rallied to new highs after the election in late 2016. The long-awaited rally is a welcome one, but it has lasted an unusually long time without even a minor setback.

Average Number of Days Without a Correction

S&P 500, 1928-2017

	Since 5% correction	Since 10% correction	Since 20% correction
Mean # days	50	167	635
Current rally # days	171	265	2010

Source: Ned Davis Research

It has been 171 days (roughly 8 months) since the start of a 5% correction. Since 1928, the average number of days before a 5% correction is 50, or roughly 2 to 2.5 months. Although March and April were somewhat weak, there was not much of a pullback; only one or two days neared a 3% drawdown from record highs. Since 1980, there have been 4 other instances of longer periods without a 5% correction, and 3 of 4 occurred during the technology boom in the 1990s. Since 2000, there has been only one rally that lasted longer than the current one without a 5% correction.

In addition to the length of the recent rally, the stock market has also been abnormally stable. For instance, the month of January was one of the lowest volatility starts to the year ever. Even after posting double-digit gains, the market seems to be internalizing only good news and discounting the bad. Although the market could continue to rally without a pullback, it seems prudent to preserve some of the recent gains and wait for some of the growing risks to come to a resolution.

Presidential Cycle

In terms of the presidential election cycle, the post-election year is one of the riskier ones in the cycle. On average, only 52% of the years generate positive stock market returns with an average of around 6%. However, most of those results are skewed by extremely low returns in year one for many presidents. As discussed earlier, three of the last five presidents have been greeted with a recession on day one or within six months of taking office. Not surprisingly, the post-presidential year is marked with a high degree of variation. Although most investors believe the market will return 5-10% per year on average, none of the post-election years since 1928 experienced the Dow Jones Industrial Average generate returns in that range. Returns were either double-digit positive or negative.

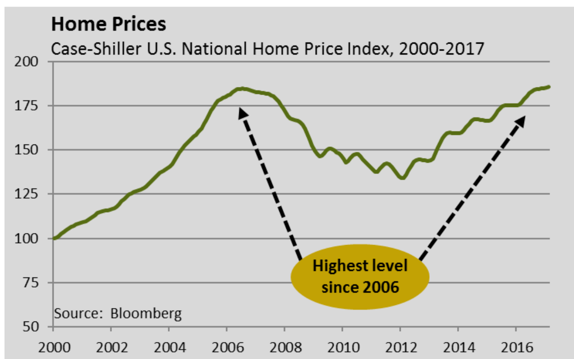
More important than the annual averages, there is typically strength in the first half of the post-election year which is followed by weakness in the second half. Since 1928, stocks in the post-election year begin with a rally of roughly 10% by midyear and then give at least half of the gain back before year end. Not surprisingly, optimism generated by a new term in the White House is embraced early in the year; when reality sets in during the second half, markets tend to falter. The fourth quarter is typically the strongest period for stocks in the year, but it has not followed that trend in most post-election years.

Home Prices are Elevated… Again

As discussed previously, there are many signs that the economy is healthy. These are mostly good signs; however, there are an increasing number of indicators that warn of excessive risk taking. The rising level of optimism is one indicator to monitor. Increasing optimism is good but at extremes can signal caution. Warren Buffet, one of the world's most successful investors, has preached such a perspective for many years.

> *"The most common cause of low prices is pessimism - sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."* - Warren Buffet (1990 shareholder letter)

One measure of optimism is consumer confidence, which reflects prevailing business conditions and likely future developments. The latest reading is very optimistic and has surged to its highest level in almost 20 years (see chart, page 2). Another indicator of investor sentiment is the Case-Shiller Home Price Index (see chart below). In the past few months, national home prices reached the same level as in 2006, prior to the financial crisis. The rate of price increases has been more moderate than the runup from 2003 to 2007; however, there is a fair amount of anecdotal evidence suggesting the home buying process is a seller's market with hefty premiums in many areas.



Key Risks

Since risk and reward are intimately tied together, there is always risk present in economies, markets, etc. However, there are a few notable risks in the current environment in addition to the excessive optimism discussed above. Political risk is high both in the U.S. and internationally, and the chance of market weakness from a policy disappointment is not trivial. President Trump signed 32 executive orders in his first 100 days. However, this is a common tactic for new presidents. President Obama, for instance, signed 19 executive orders in the same time span. Most importantly, none of the completed executive orders or bills are considered major changes, so most of the heavy lifting is still to come. Consumer optimism is at the highest level since 2000 due to high economic expectations from four key policy initiatives: 1) reduced personal taxes; 2) reduced corporate taxes; 3) increased infrastructure spending; and 4) decreased regulation. Expectations are high, but the attempted reform of the Affordable Care Act demonstrates how difficult it is to get the majority of the House, Senate and President on the same page.

Increasing political rhetoric is another area that could be a source of risk. Trade was an important area for Trump on the campaign trail, but international relations can be delicate (note recent trade issues with Mexico, Canada and China). A new approach to difficult issues like relations with North Korea or Russia may be disruptive. The same is true for international politics – elections in France and Italy could cause tensions to flare up again in the eurozone.

Summary

A strong rally followed positive economic data and increased certainty from the election. With consumer and market expectations perhaps too high and ripe for disappointment, client portfolios were moved to their Neutral equity positions this week. The market could continue to rally, but the risk of a pullback has increased and a slightly more cautious approach is warranted.

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