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What to Expect in the Years Ahead: Examining Economic and Financial Market Trends

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The economic recovery that started in 2009 as we pulled out of the 2008-2009 recession propelled earnings and global equity prices. Concurrently, global central banks were aggressive in the administration of easy monetary policies, and they remain so today.

The Federal Reserve Bank has followed an accommodative monetary policy since August 2007, first by lowering short-term interest rates repeatedly and then by conducting three specific episodes of "quantitative easing" measures (government purchases of bonds and securities).

Many other central banks around the world have implemented similar monetary policy measures, in some instances even instituting negative interest rate policies (NIRPs).

As a result, central bank balance sheets have expanded, and for the time being, monetary policy seems to have placed a ceiling on longer-term interest rates.

The issues we will examine in this paper include:

- The pace of current economic expansion in the United States and the rest of the world, and how it compares historically.
- How the extraordinary liquidity injections noted above were deployed, and what that may portend for growth in the years ahead.
- Considerations for assessing the return on capital assets in making important cash flow and spending decisions in both the private and public sectors.

A Look at Growth

United States

The graph below highlights the growth of Real Gross Domestic Product (GDP) in the United States over the last 35 years. The vertical gray lines are recessionary periods.

The decade of the 1980s was marked by rapidly falling interest rates, which helped to set up good productivity growth. In theory, lower rates enabled businesses to borrow more at a lower cost, allowing them to make the necessary investments to improve efficiency and spur future growth.

The 1990s witnessed the "boom" in technology and was a period of significant productivity growth.

The next decade, the 2000s, was a consumptive period by the consumer, with strong demand for housing and financing. It was also a period of poor productivity and debt assumption by both the consumer and the corporate sector, particularly financial service companies.

After this consumptive period and the severe financial and debt dislocations it created, culminating in the recession of 2008-2009, consumers engaged in repairing their balance sheets.

A key element here is that Real GDP growth has been at successively lower rates during each of the four expansionary periods since 1983, as illustrated in the chart below.

United States: Real GDP
(Percentage Change Year/Year; SAAR, Bil.Chn.2009)
1980 – 2016

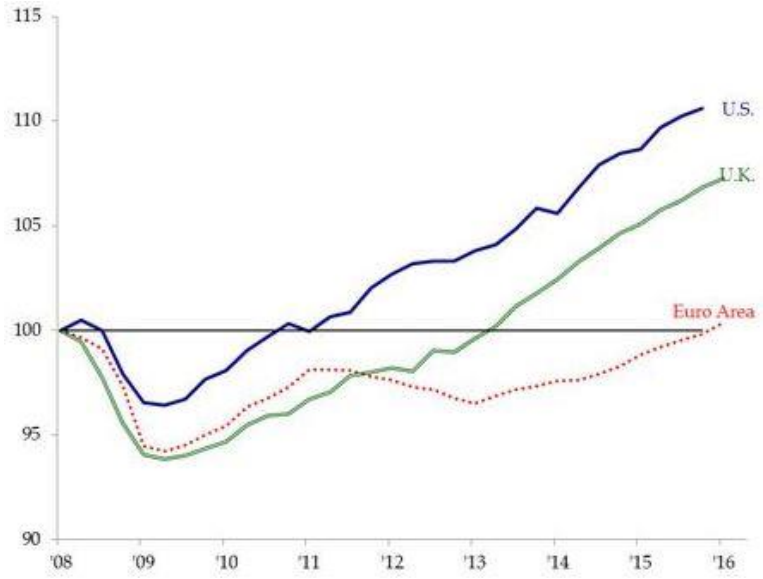
Source: Bureau of Economic Analysis/Haver Analytics

UK and Europe

The slower rate of expansion is not a phenomenon unique to the United States, as the graph below indicates. This graph picks up growth since 2008-2009 and is "benched" at 100 for comparative purposes.

The Euro Area is struggling to register anything positive. The full effects of the Brexit vote of June 23, 2016, are yet to be fully understood, but they will likely translate into slower growth for Europe, as well as the UK, going forward.

Real GDP by Country: United States, UK, and Euro Area
(Indexed to 100 as of 1Q 2008)
2008 – 2016



Source: Strategas Research Partners

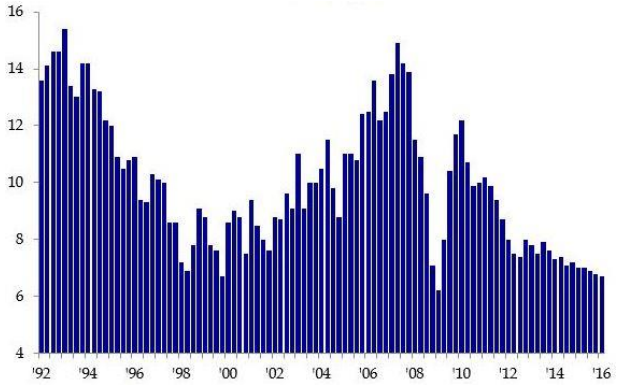
China

The narrative regarding China is not new. China is the world's second-largest economy, and it is undergoing a transition from one that is industrially driven to one that is at least equally balanced to a service-oriented economy.

Reform measures in China have been unevenly applied, at best, as they relate to its stock market and "structural reforms" to improve growth. While China's growth has been slowing, its economy is still growing at a faster pace than that of the rest of the world.

This slowing growth clearly has an impact on China's Asian-Pacific trading partners, such as Hong Kong, Taiwan, and South Korea, as well as the European Union.

China: Real GDP
(Percentage Change Year/Year)
1992 – 2016



Source: Strategas Research Partners

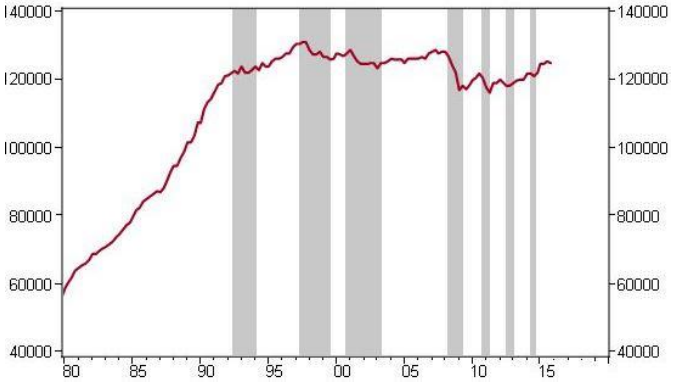
Japan

There are certainly many differences between the United States and Japan, including differences in demographics (Japan has a declining workforce), attitudes towards savings and debt, and mere geography (the capacity for natural resources).

The graph below, however, is sobering, as it highlights 25 years of stagnant growth in Japan.

According to the Federal Reserve Bank of San Francisco, in the 30-year period from 1960 to 1990, Japan contributed 16% to global GDP growth. In the 25 years since 1990, Japan's contribution to global GDP growth has dropped to 3%. In that same 25-year period, the Nikkei 225 Index has been essentially flat.

Japan: Real GDP
(SA, Bil.Yen)
1980 – 2016



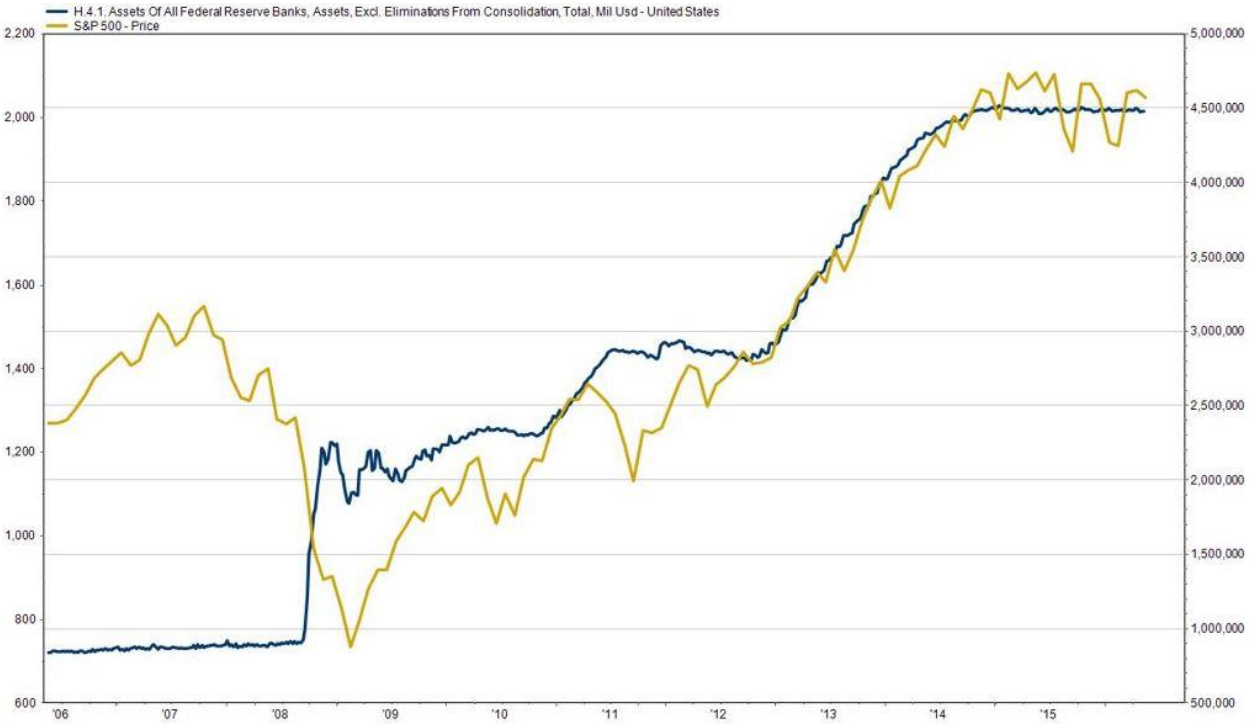
Source: Cabinet Office of Japan/Haver Analytics

Fed Balance Sheet and Assets

It is worth reiterating that the recent growth in the Federal Reserve's balance sheet has been the result of extraordinary easing measures, including the purchase of U.S. Treasury notes and bonds, along with federal agency mortgage-backed securities.

The increase in the balance sheet (blue line in the graph below) has paralleled the rise in value of the S&P 500 (gold line).

Fed Balance Sheet and Assets
2006 – 2016



Source: FactSet, Inc.

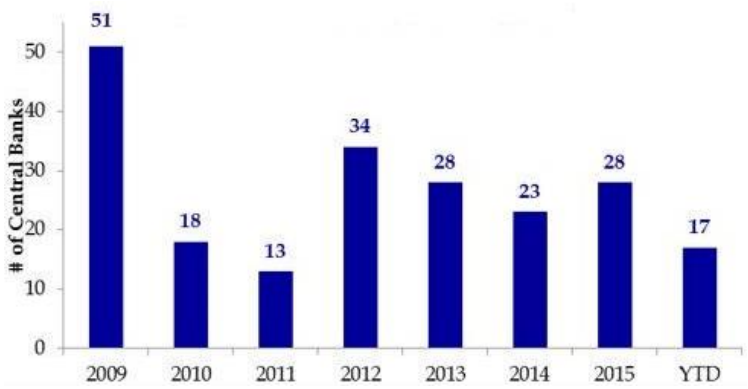
Central Banks and Monetary Policy

As noted in the next graph, central banks began to ease as we emerged from the recession of 2008-2009, but then re-accelerated their activity as a result of a secondary growth scare in the fall of 2011.

While the number of central banks that have lowered interest rates has varied on a yearly basis since 2008, many have engaged in more extreme measures, such as quantitative easing and the implementation of NIRPs by Japan and several European countries.

We believe that central bank easing cannot be relied upon as a future catalyst to drive returns, given that corporate profits have recently stagnated and economic growth for many parts of the world continues to be lackluster by historical standards. Clearly, another catalyst is necessary.

Global Central Banks Lowering Key Benchmark Rate
(EOP Year/Year Change)
2009 – 2016



Source: Strategas Research Partners

A Look at U.S. Corporate Revenues and Earnings

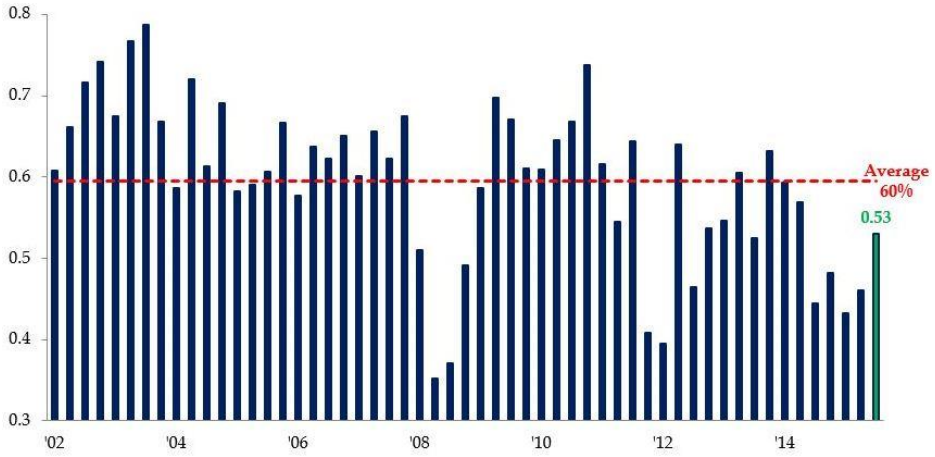
In light of the pace of economic expansion in the United States and the extraordinary liquidity that has been injected into the domestic economy, where are we in terms of corporate earnings at this stage of the economic and market cycles?

Revenue Growth

As evidenced by the graph below, revenue growth and "beats" have been lowered and are running below the average rate of increase of the past 14 years.

We also note that revenue growth in the current expansion has been below trend and below expectations.

Percentage of S&P 500 Companies
Beating Revenue Estimates by Quarter
2002 – 2016



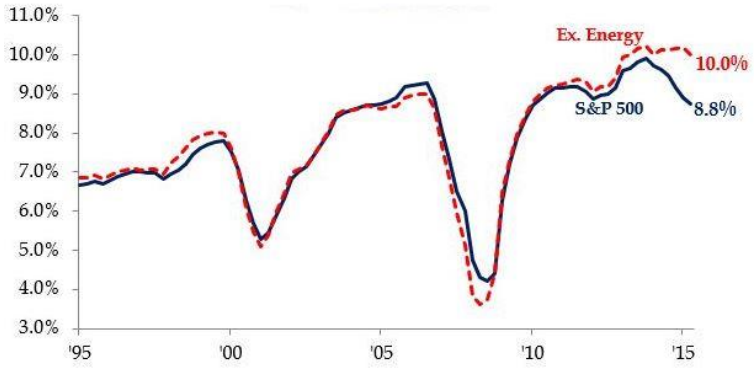
Source: Strategas Research Partners

Operating Margins

The graph below shifts the discussion to corporate operating margins. We note that the strong growth in this important measure has driven equity prices higher in this expansion. Importantly, companies have done a very good job of managing expenses.

However, we observed in the third quarter of 2014 that margins began to contract. We continue to monitor this data and trend very closely.

S&P 500 Operating Margin vs.
S&P 500 Operating Margin Excluding Energy
(Trailing 12 Months)
1995 – 2016



Source: Strategas Research Partners

What Happened to All of That Cash?

The table below outlines the uses of cash before and after the financial crisis of 2008-2009.

Corporate share buybacks experienced the highest percentage of growth since the post-crisis low, and they are now back to where they were on a pre-crisis basis.

The percentage increases in merger and acquisition expenditures, along with bond issuance and dividends, also registered solid growth from post-crisis lows.

Considering the strong rebound in non-financial corporate profits (+87%), it would have been very healthy, in our opinion, to have seen greater growth in capital expenditures in plant and equipment.

An inference to draw from this data is that companies did not keep pace in making investments in the future growth of their businesses. Some suggest that this issue was an unintended by-product of lower rates, a challenging regulatory environment, and generally lackluster demand.

Uses of Cash:
Pre-Crisis High and Post-Crisis Low vs. Now

Use of Cash	Last Updated	Pre-Crisis High	Post-Crisis Low	Current*	% Chg High To Current	% Chg Low To Current
Buybacks (TTM, $BN)	3/31/2016	$589	$138	$589	0.1%	328.2%
M&A (TTM, $BN)	7/31/2016	$1,061	$328	$1,096	3.4%	234.0%
Bond Issuance (TTM, $BN)	6/30/2016	$2,747	$765	$1,462	-46.8%	91.0%
Dividends (TTM, $BN)	6/30/2016	$252	$195	$388	54.2%	99.7%
Capex (SAAR, $BN)	6/30/2016	$1,982	$1,584	$2,286	15.3%	44.3%
Non-Financial Corporate Profits w/ IVA & CC Adj (SAAR, $BN)	3/31/2016	$1,078	$655	$1,227	13.8%	87.2%
Non-Financial Corporate Cash (TTM, NSA, $BN)	3/31/2016	$5,043	$4,894	$6,408	27.1%	30.9%

*Current is latest data point

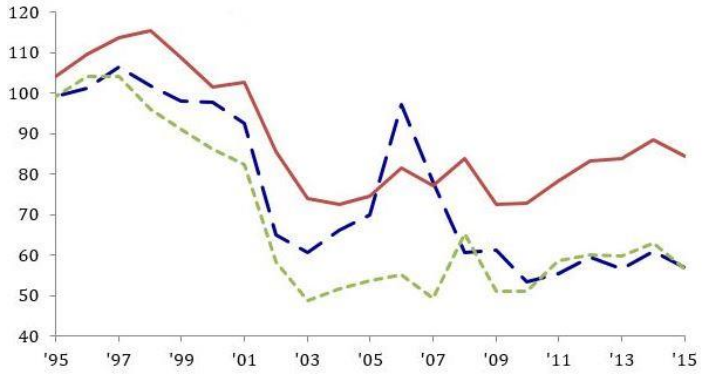
Source: Strategas Research Partners

Another view on this subject is illustrated in the graph below, which reinforces data from the previous table. This graph is also indexed to 100 for comparative purposes, and it commences in January 1995.

In the seven years since the end of the recent recession, productivity growth has been modest, and we have witnessed reduced capital expenditures on plant and equipment.

We note on the graph below that corporate capital spending on plant and equipment (capex), measured as a share of revenue, assets, and cash flow, has declined to its lowest levels in 20 years. The graph also reflects the high levels experienced during the tech boom of the late 1990s.

S&P 500 Capex Share of
Revenue (solid), **Assets** (dotted), **and Cash Flow** (dashed)
(Indexed to 100 on 1/1/1995)
1995 – 2015

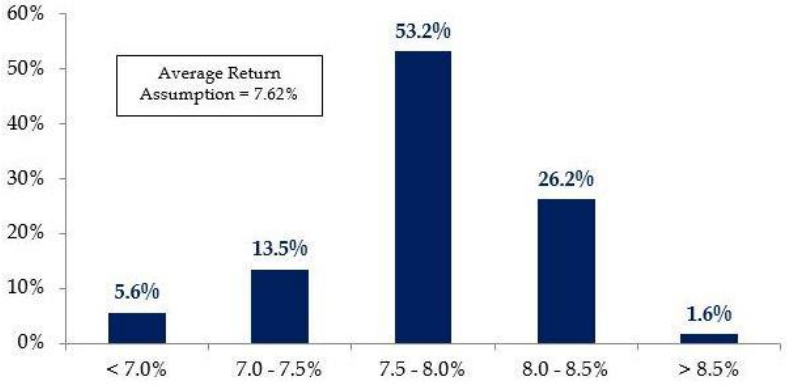


Source: Strategas Research Partners

Return Assumptions

In a recent study of public pension plans, the data indicates that an average assumed return of 7.62% is being used by more than half of those surveyed. In our view, this is aggressive, considering the environment looking ahead.

Public Pension Plans:
Percentage Distribution of Investment Return Assumptions



Source: Strategas Research Partners

Over the next seven to ten years, forecasts for fixed income returns are generally in the 2-4% range. Given the low level of interest rates (coupons), the likelihood of a change in bond prices will play a more important role in the calculation of returns.

Also over the next seven to ten years, domestic equity returns are forecasted to be in the area of 5-7% (3% premium to bonds), and we see more of the return coming in the form of dividends.

Returns in other regions of the globe, such as selected emerging markets, should be more robust, although also more volatile.

Returns for alternative strategies, which can be either risk-reducing or return-focused, should average around 4-5% in the liquid space and higher in the less-liquid/illiquid private space.

Using these general assumptions for returns, a long portfolio of traditional securities constructed with 60% Equities and 40% Fixed Income would produce an expected return in the range of 3.8% to 5.6% on a pre-inflation basis.

Observations

This paper touches on just some of the issues affecting the prospects of future returns and portfolio construction. Looking ahead, we observe that:

- Potential returns may be more compressed than historical returns would suggest.
- The lack of investment in productivity enhancements by the corporate sector since the late 1990s may continue to impact general profitability, and thus returns, of equity investments.
- Return assumptions may be too aggressive in both the public arena and the private sector. If true, we may see a negative impact on baby boomers, who are reaching retirement age in increasing numbers.

All of these issues have clear implications for asset allocation and security selection.

Conclusion

Despite lower forecasted returns for equities in general, we believe that the equities of high-quality (well-capitalized) companies with the capacity to maintain, initiate, and grow dividends will provide above-average market returns. We therefore see a greater percentage of a stock's return coming from this source. We also favor investment-grade and U.S. debt issues to provide a more secure return over the next several years.

In light of the prospects for lower returns from more traditional asset classes in the years ahead, investors should consider lowering cash flow and spending assumptions to accommodate an expected period of lower inflation, profitability, and returns. This applies equally to high-net-worth and institutional investors.

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