Economic & Market Quarterly

Winter 2017

This summary is provided by BMT Wealth Management.

Economics and Politics

The Nov. 8 elections resulted in Republican control of both the executive and legislative branches of government and changed the outlook on the sustainability of the current, and aging, economic expansion. This has been manifest in the recent behavior of the financial markets.

President Donald Trump and his cabinet, as well as members of Congress, are in the process of structuring economic policies that include infrastructure spending, tax reform, and deregulation. If these plans are enacted, they could alter the direction of economic growth over the next several years. The timing and specifics of legislation are critical and will be monitored closely by market participants.

The Current Expansion

The first release of fourth quarter 2016 Real GDP came out on Jan. 27. It indicated a quarter-over-quarter increase of 1.9%, which was below the 2.2% consensus forecast and a deceleration from the robust 3.5% pace of the third quarter. For calendar year 2016, Real GDP grew at a pace of 1.6%, down from the 2015 growth rate of 2.6%.

Consumer confidence is reaching levels not seen in more than 10 years. The Conference Board's Consumer Confidence Index jumped to 113.7 in December, compared to 109.4 the prior month.

The strong consumer spending and confidence data have been largely supported by decent job growth and an improving wage growth picture.

In December, non-farm payroll employment rose by 156,000 new jobs, in line with the release from ADP that reported 153,000 new jobs, although these numbers were lower than forecast. The civilian unemployment rate was little changed at 4.7%. The three-month average gain of 165,000 jobs/month is a healthy rate of improvement, particularly given the length (90 months) of this economic expansion.

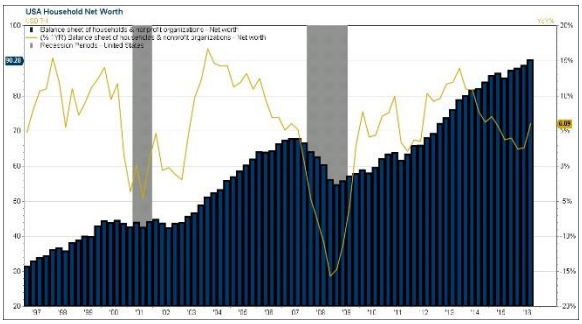
Wage growth is finally showing up in this expansion. In December, average hourly earnings grew at a strong 0.4%. The year-over-year increase stands at 2.9%, which is a high-water mark for this cycle.

Pent-up Demand?

During this expansion, and coming out of the financial chaos that precipitated the Great Recession of 2008-09, consumers have de-leveraged significantly. The repair of consumer balance sheets during this time has been cited as one of several reasons that the pace of growth in this expansion has been more subdued than that of previous recoveries.

The blue bars in the graph below highlight the improvement in U.S. household net worth over the past 20 years (sum of assets less liabilities), along with the year-over-year change (gold line). The shaded areas are economic recessions.

U.S. Household Net Worth
Last 20 Years



Source: FactSet, Inc.

In sum, improving labor market conditions, higher wages, lower personal income tax rates, and pent-up spending and borrowing may serve to extend this recovery longer than previously forecast.

Equities: A Tale of Two "Halves"

The performance of the S&P 500 during the final quarter of 2016 can be easily divided into two segments: pre-election and post-election. From the start of the quarter until Election Day on Nov. 8, the S&P 500 registered a negative return of -1.10%. After the election, the results were radically different, with the Index moving higher by 4.98%, bringing the return for the quarter up to 3.82%.

For the calendar year, the S&P 500 was up 11.96%.

"Make America Great Again" was President Trump's campaign slogan. Some people took exception to it, arguing that America was already great. In politics, there is almost always disagreement, and that was certainly the case in this election. In the investment arena, however, there can be no denying that America's recent stock market performance has been great relative to the rest of the world.

In broad terms, equity investments can be geographically divided between domestic stocks, international stocks (MSCI EAFE Index), and emerging markets equities (MSCI EM Index). As the table below displays, over the past 10 years, U.S. stocks have outperformed their peers, in many cases by a substantial margin.

	2016	3 Years	5 Years	10 Years	15 Years
S&P 500	11.96%	8.87%	14.66%	6.95%	6.69%
MSCI EAFE Index	1.00%	-1.60%	6.53%	0.75%	5.28%
MSCI EM Index	11.19%	-2.55%	1.28%	1.84%	9.50%

It is worth noting, however, that the 15-year returns for these three indices show substantial outperformance by emerging markets equities over their U.S. counterparts.

Clearly, the benefits of geographic diversification can be considerable over the long term, and we have little doubt that will continue to be the case. That said, as the figures above evidence, the winner of late has been U.S. equities.

Within the United States, the market began favoring cyclical stocks over their more defensive counterparts during the third quarter of 2016. This trend gained considerable momentum in the fourth quarter, after the Nov. 8 election results were tabulated. Economically sensitive sectors such as Financials and Industrials have rallied sharply.

Small cap domestic stocks appear to be the biggest beneficiaries of Trump's economic agenda. The Russell 2000, an index of small cap domestic companies, appreciated more than 14% between Nov. 9 (the day after the election) and the middle of January 2017.

Fixed Income

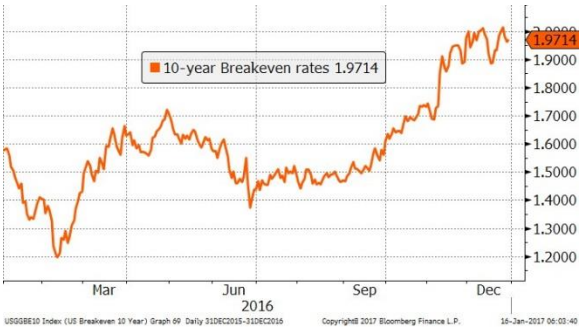
The U.S. bond market ended 2016 on a sour note, with rates rising rapidly across the yield curve in response to projected changes in monetary and fiscal policy.

The Federal Reserve (the Fed) raised the federal funds target rate 25 basis points (0.25%) in the fourth quarter, only the second time in the past 10 years that it raised rates. Although the change in monetary policy was expected, investors were surprised to note the hawkish change in the Fed's interest rate projections for 2017. Specifically, the Fed has suggested it will raise interest rates three times in 2017.

The modestly hawkish tone from the Fed, however, was overshadowed by fiscal policy and other changes expected under President Trump. As referenced above, anticipated infrastructure spending, along with corporate and personal tax cuts, may impact not only U.S. economic growth, but also inflation expectations and government deficits. Bond yields quickly readjusted higher after speculation of a Trump presidency became a reality on Nov. 8.

In the fourth quarter, bond yields increased across the yield curve, coinciding with a spike in inflation expectations, leading to a much steeper curve. The two-year and 10-year U.S. Treasury yield increased 43 basis points (0.43%) and 85 basis points (0.85%), respectively, and ended the quarter at 1.19% and 2.45%. The 10-year breakeven inflation rate (a measure of investors' annual inflation expectations over the next 10 years) increased 36 basis points (0.36%) and ended the quarter at 1.97%.

Annual Inflation Expectations Increased in Fourth Quarter of 2016



Source: Bloomberg Finance L.P.

The Barclays Capital U.S. Intermediate Government/Credit Bond Index returned -2.07% in the fourth quarter, its worst-performing quarter in 2016. Corporate bonds outperformed U.S. Treasury securities, but both sectors ended the quarter in negative territory, at -1.84% and -2.25%, respectively. For the year, the Barclays Index was up just 2.08%.

Municipal bonds also had a rough fourth quarter, due mostly to the same factors impacting taxable bonds. However, an additional concern for municipal bond investors was the potential for changes to corporate and personal tax rates. Municipal bonds are appealing to investors, because interest income is tax-exempt for federal income tax purposes. A drop in tax rates would reduce the benefit of owning tax-free municipal bonds over taxable bonds. The uncertainty around future tax cuts therefore put downward pressure on municipal bond prices relative to other taxable bond sectors.

Our View

There are numerous questions regarding how Trump's economic agenda will be implemented and whether some of his policies, especially those pertaining to global trade, could be detrimental over the long run. We acknowledge that there are plenty of geopolitical risks that could alter the economic landscape as we progress through 2017.

That said, a combination of lower taxes, less regulation, and infrastructure spending could stimulate growth. We therefore believe this economic expansion, which is already long by historic standards, could have more runway left.

We would obviously welcome an acceleration in corporate profits and above-trend economic growth, but we are not looking to make drastic changes in how we allocate capital within our equity strategies. We may tactically increase our

exposure to areas that are more leveraged to an accelerating economy, but will only do so with a strong valuation-sensitive mindset.

We continue to believe that bond yields will gradually trend higher in 2017, given the Fed's modestly hawkish tone and the new administration's focus on tax reform and government spending. Our fixed income effort will continue to target the short-to-intermediate part of the yield curve, including a diversified mix of high-grade corporate issuers.

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