Global Economic Review

Eagle Eye

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Market & Economic Outlook

Eagle Strategies is pleased to present economic and market insights from the Portfolio Managers in the MainStay Investments Strategic Asset Allocation and Solutions Division.

The tectonic plates of politics are in motion—seismic activity to follow. 2016 was remarkable for the degree to which it saw radical change in sentiment toward government institutions and their leaders, trade, and immigration. The vote by Britons to exit the European Union (EU), followed shortly thereafter by Donald Trump's victory, sent shockwaves through Western democracies. The status quo has effectively been rejected. An unexpected majority of the electorate is demanding dramatic change and will soon have that wish granted, for better or worse. Equally surprising to many observers was the market response to both events. The uncertainty that accompanies radical shifts in political and cultural standards typically injects turmoil to capital markets. We have seen the opposite here as both Brexit and Trump's election success have been met with a surge in risk assets.

The question we must necessarily ask ourselves now is what should we expect from here? The environment seems ripe for continued political disruption, particularly in Europe, but financial market implications are less clear.

Investors in the U.S. recognize that economic output is already growing at a reasonable rate and may be accelerating a little even before policy change is introduced. They have further embraced the possibility that growth may see an additional boost from a simplified tax code with lower statutory rates, a streamlined regulatory environment, and increased government spending. And, the negative effects of trade barriers and immigration restrictions are getting less attention.

"I think people in this country have had enough of experts." — Michael Gove, British Member of Parliament in support of the Leave *Campaign*

That being so, the range of potential outcomes for equity investors in the year ahead strikes us as being wider than typical. The incoming government may be successful in amplifying economic growth and spurring corporate profit gains, most especially through tax reform.

On the radar screen

1. As President-elect Trump's inauguration and the installment of the 115th Congress approaches, we are carefully monitoring developments in Washington to see what elements of the campaign are likely to be prioritized and in what form they are most likely to take.

2. While GDP growth remained tepid in the fourth quarter, survey data suggests that business activity was picking up as the year came to a close. We look for signs of further improvement in domestic consumption and investment through the winter.

3. All signs point to higher inflation, but the pace at which it rises is highly uncertain. Wage growth is likely to be the most useful indicator.

4. Italian politics are in disarray and the ground is a bit shaky in other EU countries as well. A continuing shift toward euro-skeptic parties might have significant implications for capital markets in the quarters ahead. Italy, Greece, and France all rank high on our list of concerns.

5. Anxiety around Chinese growth contributed to stock market swoons in '15 and early '16 before fears of a "hard landing" abated. It may have been a temporary reprieve. A softening property market, too rapid credit growth, and capital outflows may render China a source of global instability again in 2017.

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"I have a feeling that people are going to find out the meaning of duration." – Jared Dillian.

On top of stronger earnings, shareholder enthusiasm, and enlarged share buyback programs resulting from a tax holiday on repatriated earnings may result in higher valuation multiples. Conversely, it's altogether possible that the new government fails to implement the policy framework markets now expect. With stock prices having already run a considerable distance, the resulting shareholder disappointment could spawn a steep correction.

In this environment of enlarged tails in the distribution of potential returns, we have a keen interest in convertible bonds and have begun building a position. Doing so enables us to participate to a considerable degree should the market rally go significantly higher.

The U.S. continues to enjoy what has become a very prolonged expansion, and over these past seven plus years the labor market has healed to a point at which most economists consider it to be relatively well balanced. With the supply of available labor gradually becoming scarcer, wages are rising at an increasing rate as employers compete for qualified candidates. Faster economic growth that puts a still greater demand on labor is very likely to further fan these inflationary pressures. At the same time, food and energy prices are poised to start rising on a year-over-year basis, pushing headline inflation readings that much higher.

Fixed-income investors tend to be very sensitive to changes in inflation. When inflation rises, the stream of future coupon payments and return of principal they are to receive is devalued in real purchasing power terms, so the value of the bond declines. The benchmark ten year U.S. Treasury bond is currently trading to yield near 2.5%, as of 12/31/16, which is very low both in historical terms and relative to nominal Gross Domestic Product (GDP). We anticipate that as inflation becomes more evident, we'll see the yield continue to rise as it has been doing now for several months already (a bond's yield moves inversely to its price). The longer the duration of the bond, the more adversely it will be impacted by the change in market yields. To help offset any potential negative effects in changing market yields, we emphasize fixed-income instruments with shorter durations (short maturities and lower quality issues with high coupon rates) within our portfolios. We've been adding to positions in floating rate bonds in particular.

Predicting market behavior is an imperfect art indeed. We freely acknowledge that more than a few of our calls have been well wide of the mark over the years (fortunately, we've proven prescient often enough to add value within our portfolios despite our intermittent missteps). Understanding that all investment forecasts are inherently flawed, regardless of their source, is an important element to successful portfolio management. However, diversification still remains essential!

"The man who makes no mistakes does not usually make anything." – Edward John Phelps.

Eagle Strategies
51 Madison Avenue New York, NY 10010 www.eaglestrategies.com
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