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.

A fully expected journey. In stark contrast to this time last year, signs of economic acceleration abound, particularly in the U.S. A short list: the ranks of the employed continue to expand; regional activity indices and purchasing manager surveys are elevated; capital goods orders, a proxy for business investment, are up sharply; new home construction is climbing; and, growth rates in corporate revenues and earnings are rising. Potentially adding fuel to the fire is the abrupt jump seen in measures of household and business confidence post election. Swelling confidence can become something of a self-fulfilling prophecy to the extent that it fosters more aggressive risk taking. Individuals, for example, may be more willing to change jobs or commit to a home purchase while businesses are more likely to expand operations by adding headcount and investing in plant and equipment.

So, it appears that our new President was dealt a good hand, and that he has played it well to date. With the support of a Republican controlled Congress, it's possible that he could run the table with a battery of growth-friendly policy initiatives. Industry deregulation and the permitting of stalled energy projects fall into that category, and the administration is off and running on that front.Tax reform, especially in the corporate arena, could likewise prove quite stimulative if well executed. Progress there is harder to discern, but it's known to be a Republican priority and we would be surprised not to see something enacted.

"It's a dangerous business, Frodo, going out your door." — J.R.R. Tolkien

All this being so, there is ample cause to be enthusiastic about the outlook for U.S. equities. Our base case scenario for the year ahead calls for returns in the mid to high single digits, but with the potential for still higher returns should additional fiscal support be provided, investor enthusiasm maintained, and a rotation away from bonds and into stocks occur. There's also the potential for prices to move in the other direction, of course. Confidence can be brittle. Failure to deliver on key elements of the campaign platform could see investor enthusiasm swing to disappointment quite swiftly with market levels moving in parallel. And then there are the trade and immigration issues.

On the radar screen

1. Inflation is one of the fears of bond investors, and a variety of inflation indicators have pushed higher over the past six months. We anticipate that trend to persist into 2017, but at a more moderate pace.
2. Confidence among both households and businesses has shot up post election, fueling an equity rally and bolstering economic activity. But confidence can be fleeting.
3. In the early days of his administration, President Trump has taken a very hard stance on trade negotiation. Continuing too far down this path could be very damaging for all parties involved.
4. There has been much speculation as to the structure and timing of tax reform and industry deregulation, but relatively few details have yet emerged.
5. The U.S. dollar has come off its recent highs, but faster growth, monetary policy divergence, and tax law changes all suggest that dollar strength may be in the cards.

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"Never cut what you can untie." – Joseph Joubert

Peak globalization may now lie behind us. Brexit was arguably the first shot fired in the war on globalization, but the Trump administration is readying for blitzkrieg. One week into office and he has withdrawn the U.S. from consideration of the Trans Pacific Partnership and leveled threats of unilateral 20% tariffs on Mexican imports. There is room for renegotiation of trade agreements, but such aggressive tactics could well lead to trade wars highly destructive to both sides. The implications for equity investors should be self-evident.

Immigration policy, too, has the potential to drag on economic performance. Undocumented workers make critical contributions to the functioning of our society. Threats of deportation will drive them into the shadowy end of the informal economy, lessening their participation and leading to worker shortages in some sectors. Likewise, curbs on the H1-B visa program that governs the admittance of highly skilled workers to the U.S. will leave firms in technology, healthcare, and other industries without access to the human capital needed to compete on the world stage.

It is our hope that the administration is more bluster than bite where it comes to some of the more extreme policy options that have been put on the table, but we invest more cautiously than we otherwise would, allowing for the possibility of negative policy action.

All in, we have a moderately positive outlook for U.S. stocks while allowing for the possibility of a large move in either direction. We're rather less confident when it comes to overseas investing, with Europe being an area of particular concern. True, market valuations are generally more attractive abroad than at home, growth has been relatively stable, unemployment has been declining, and geopolitical tensions are abating a bit at the moment. Nevertheless, the next shoe to drop in the gradual unraveling of the Eurozone may be near at hand.

"Europe exemplifies a situation unfavorable to a common currency. It is composed of separate nations, speaking different languages, with different customs, and having citizens feeling far greater loyalty and attachment to their own country than to a common market or to the idea of Europe.."
– Edward John Phelps.

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Greece remains deadlocked with creditors over disbursement of much needed bailout funds; lurching toward early elections, Italy's political dysfunction persists leaving it poorly equipped to contend with a still unfolding banking crisis; agreement with Turkey to restrain the flow of refugees could collapse at any time; the Netherlands, France, and Germany all face contentious elections with populist parties threatening to unseat more mainstream incumbents; and the challenges of negotiating Brexit are still in their early days. There are simply too many things that can go wrong for us to be excited about investing there. Instead, we have adopted a home country bias, tilting our portfolios to favor the U.S., particularly shares in small- and mid-cap companies that are comparatively well shielded from turbulence abroad and the effects of a rising dollar. We're likely to maintain that bias for some time yet to come.

About Risk: All investments are subject to market risk, including possible loss of principal. **Brexit** is an abbreviation for "British exit," which refers to the June 23, 2016, referendum whereby British citizens voted to exit the European Union. **The Trans-Pacific Partnership (TPP)** is a trade agreement between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States (until January 23, 2017), and Vietnam. **The H-1B** is a non-immigrant visa in the United States under the Immigration and Nationality Act, section 101(a)(15)(H). It allows U.S. employers to temporarily employ foreign workers in specialty occupations. **Stocks and bonds** can decline due to adverse issuer, market, regulatory, or economic developments. **Foreign securities** can be subject to greater risks than U.S. investments, including currency fluctuations, less liquid trading markets, greater price volatility, political and economic instability, less publicly available information, and changes in tax or currency laws or monetary policy. These risks are likely to be greater for emerging markets than in developed markets. **A bond's prices** are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise. **Bonds** are subject to credit risk and interest rate risk. **Diversification** cannot assure a profit or protect against loss in a declining market.