Market & Economic Outlook

December 2016
Market/Economic Review and Outlook

The dramatic market shifts in November were not for the fainthearted. Risk assets ended the month mixed with domestic assets posting strong positive returns and international assets generally negative. November began with risk assets in a steady downtrend but abruptly reversed in the aftermath of the Trump victory. Markets surged with the anticipation of Trump policy initiatives such as increased infrastructure spending, tax reform and less regulation. Expectations of increased economic growth coupled with rising commodity prices heightened fears of higher inflation and continue to fuel speculation of a Fed rate hike during the fourth quarter. As political and central bank policy continue to unfold, we expect heightened market volatility to continue.

The S&P 500 Index was up 3.7% for the month with cyclical sectors outperforming defensive sectors. Most notable was the financials sector (+13.9%); performance soared as expectations for a more benign regulatory environment under the Trump administration created a tailwind for the sector. Within defensive sectors both consumer staples (-4.3%) and utilities (-5.4%) exhibited negative performance. Anticipated reduced production barriers to entry served as a positive catalyst for the energy sector (+8.4%). Value outperformed growth and continues to lead year to date. Small cap rallied, outperforming large cap and mid cap by a large margin for the month.

International equity markets were a negative for November, spurred by the election of Trump. A strengthening dollar coupled with uncertainty surrounding trade policies under the Trump administration created significant headwinds to international markets. Central bank policy of ECB and BOJ as well as the protracted process of Brexit created additional uncertainty. Emerging markets fared worse than developed markets, a reversal from recent strong performance of the region. Latin America plummeted in light of the Trump fueled anti-Mexico sentiment remarks and continued talks of "building a wall". India was also a strong negative as recent demonetization policies created turmoil in their economy.

Fixed income sold off sharply as the Trump administration policies point to higher inflation in the future. The Bloomberg Barclays US Aggregate was down -2.4% for the month will all sectors posting negative returns. After steadily declining in the first week, 10-year Treasury yields spiked 61 basis points to end the month at 2.4%. High yield was down -0.5%; credit spreads slightly widened mid-month as investors processed the victory of Trump but finished the month slightly lower than where they started at 455 basis points. Municipal bonds underperformed their taxable counterparts and were down -3.7% for the month.

We remain positive on risk assets over the intermediate-term, although we acknowledge we are in the later innings of the bull market and the second half of the business cycle. While our macro outlook is biased in favor of the positives and recession is not our base case, especially considering the potential of reflationary policies from the new administration, the risks must not be ignored.

Reflationary fiscal policies: With the new administration and an all-Republican government, we expect fiscal policy expansion in 2017, including tax cuts, repatriation of foreign sourced profits, and infrastructure spending, as well as a more benign regulatory environment.

Global monetary policy remains accommodative: The Fed's approach to tightening monetary policy has been patient. The Bank of Japan and the ECB remain supportive, and the Bank of England may need to join in response to the Brexit vote.

Stable U.S. growth and tame inflation: U.S. economic growth has been modest but steady, and the reflationary policies discussed above should boost economic activity. Wage growth, a big driver of inflation, has remained in check.

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Constructive backdrop for U.S. consumer: The U.S. consumer should continue to benefit from lower oil prices and a stronger labor market.

However, risks facing the economy and markets remain, including:

Risk of policy mistake: In the U.S. the subsequent path of rates is uncertain and may not be in line with market expectations, which could lead to increased volatility. Should inflation expectations move significantly higher, there is also the risk that the Fed falls behind the curve. The ECB and the Bank of Japan could also disappoint market participants, bringing the credibility of central banks into question.

Slower global growth: Economic growth outside the U.S. is weaker.

Risk of more protectionist trade policies: The new administration may impose tariffs and/or renegotiate trade agreements.

The technical backdrop of the market has improved, as have credit conditions, helped by the favorable macroeconomic environment. We have also seen some reacceleration in earnings growth. So far Trump's policies are being seen as pro-growth, and investor confidence has improved. We expect higher volatility to continue as we digest the actions of central banks and the onset of the Trump administration; but our view on risk assets remains positive over the intermediate term. Higher volatility can lead to attractive pockets of opportunity we can take advantage of as active managers.

Brinker Capital