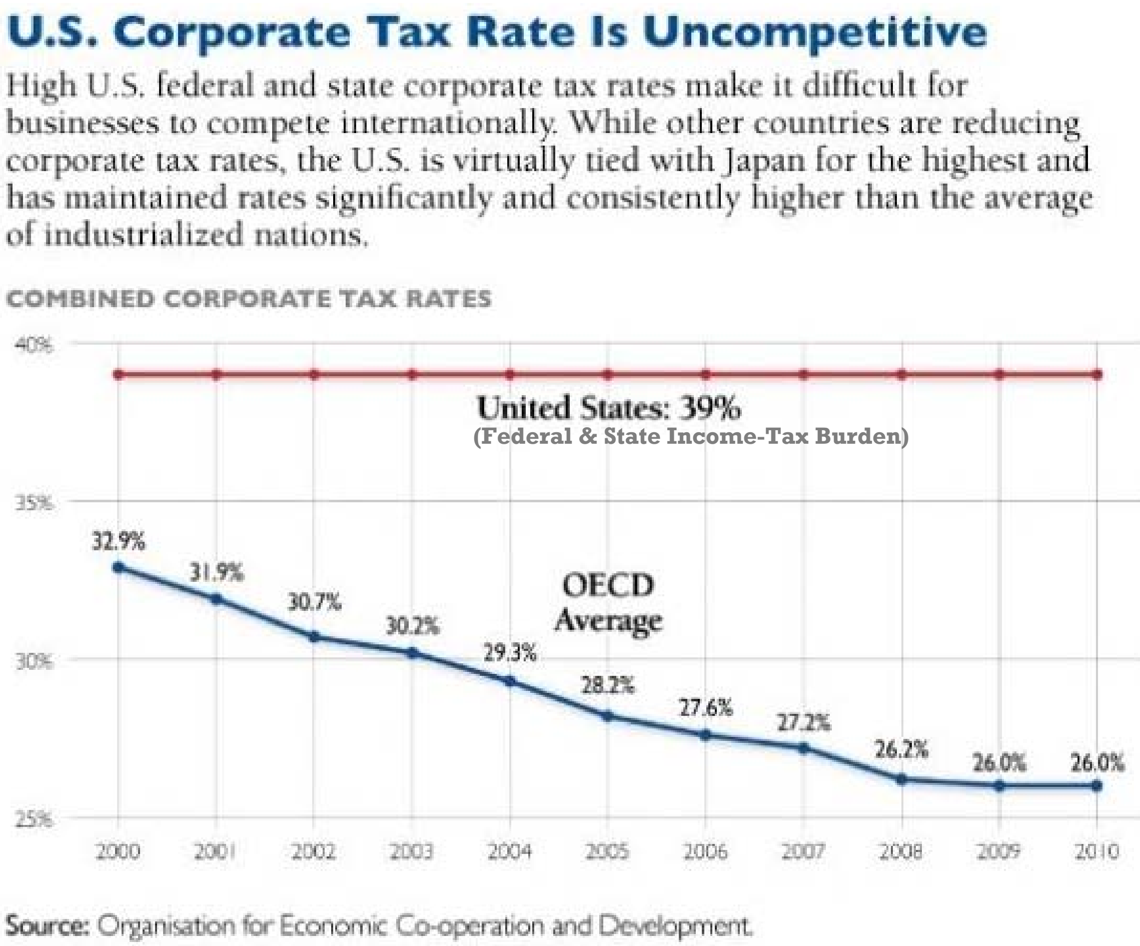
THE TRUMP EFFECT & THE INVESTMENT CLIMATE FOR 2017

TAX REFORM

The outcome of the U.S. elections has triggered an investment tailwind that suggests broadening economic growth accompanied by higher inflation and interest rates. The fuel for this tailwind appears to be premised on the expectation of increased spending on infrastructure and defense coupled with "big league" tax cuts. Because investors are a forward-looking lot, the resulting lift these forthcoming cuts are likely to provide to corporate earnings are already being reflected in equity values.

More specifically, President-elect Trump may push for a simplified, three-tax-bracket system for individuals while reducing the corporate federal income-tax rate from 35% to 15%. The idea is to stimulate economic growth to a hoped-for level of around 4% per year. The U.S. hasn't seen that level of growth for years, but his desire to reduce corporate rates some has merit when viewed in a global context:



Many question the government's ability to make such a drastic cut, but corporate revenues amount to only about 11% of federal revenues versus 47% from individual income taxes. Still, a lower rate will allow U.S. companies to be more competitive.

REGULATORY RELIEF

The Dodd-Frank Act was passed in response to what now seems to be called The Great Recession. Broadly speaking, this Act was intended to monitor and control systemic financial risk, increase the transparency of capital markets, strengthen consumer protections, and to improve the Federal Reserve's ability to respond to unusual circumstances.

While some argue Dodd-Frank does not have enough teeth, Mr. Trump and his team believe it represents a regulatory overreach that has stifled economic progress. As such, they have vowed to dismantle it. The American Action Forum estimates that the cost of complying with the Dodd-Frank Act has cost $36 billion and 73 million hours of paperwork since it was enacted in mid-2010. Without knowing what bad things Dodd-Frank might already have prevented or could prevent, no framework exists to know whether those figures support retaining it or dismantling it. But there can be no doubt that financial firms will have a less costly time operating without this law or, at the very least, operating under a skinnier version of it. Accordingly, investors have reacted in advance and the shares of financial firms have surged.

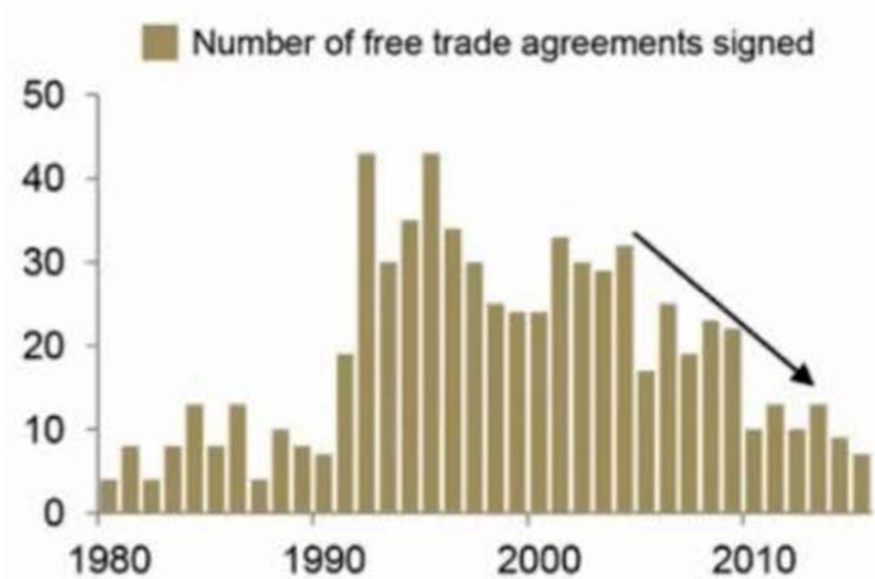
HEALTHCARE REFORM & INFRASTRUCTURE SPENDING

One major Trump promise is to repeal and replace the Affordable Care Act (ACA). Now that Republicans control Congress, it seems certain the ACA will at least be modified, if not replaced in its entirety with something else. Healthcare stocks reacted as soon as the election results were in. Insurers and pharmaceutical firms surged higher while hospitals nosedived. In lieu of some major change in the political winds, I would expect any firm whose revenues are materially dependent upon the existence of the ACA to continue to face healthcare-reform headwinds.

With respect to the vitalization of our nation's infrastructure, our president-elect has proposed investing $1 trillion dollars on a variety of infrastructure projects over the next decade. From what I can gather, somewhat over half of this $1 trillion would be funded by investors with the remainder coming in the form of tax credit subsidies to those investors. According to Goldman Sachs, however, this spending is not slated to begin until the third quarter of 2017, so whatever lift this effort might provide, it is not likely to provide very much of it this year.

TRADE PROTECTIONISM, NATO & INTERNATIONAL TENSIONS

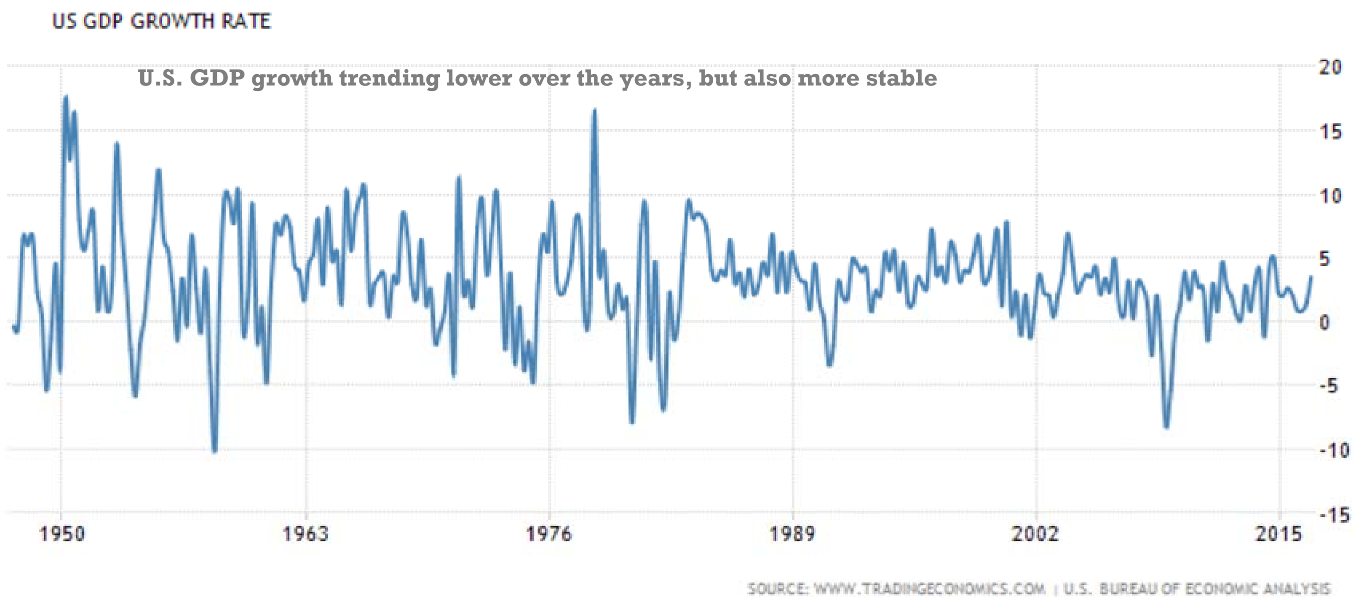
Although economists generally view free trade as an economic positive, the world at large has tended to become less likely to share this view over the past decade.



Mr. Trump is expected to attempt to renegotiate the North American Free Trade Agreement and he is also apparently willing to at least allude to an increase in the use of tariffs in an effort to strengthen U.S. leverage. He also seems inclined to label China as a currency manipulator. As usual, I have no idea how various trade do-overs might jangle investors' nerves, but the risk of trade-induced instability seems like it could only increase. Mr. Trump's criticisms of the North American Treaty Organization (NATO) and its famous Article 5, where an attack on one NATO member is regarded as an attack on *all* NATO members, suggests international tensions could increase as a result of countries scrambling to fill whatever security voids might occur as a result of a weakened NATO. All else being equal, increased trade and security tensions would tend to cause various risk premia to increase and equity valuation to fall.

AN EARNINGS CAVEAT

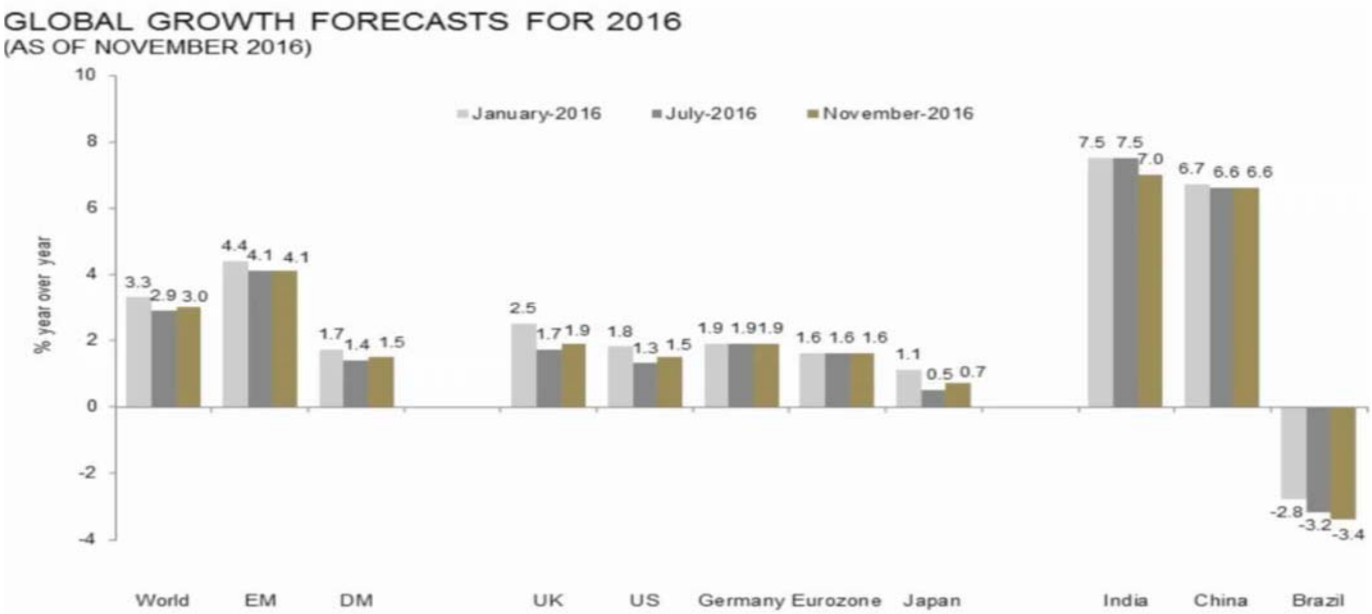
Mr. Trump believes the combination of his tax plan, regulatory relief and trade reform could spur the U.S. economy to grow at a rate of 4% per year. That's a pretty stout target for a huge economy with an aging population. As shown below, GDP growth and the volatility of that growth has clearly tended to moderate within the U.S. over the past two-thirds of a century, but it is worth noting that the annual run-rate for U.S. GDP growth within the U.S. did jump to 3.5% during the 3rd quarter of last year (most recent data), so maybe a 4% figure actually is within reach.



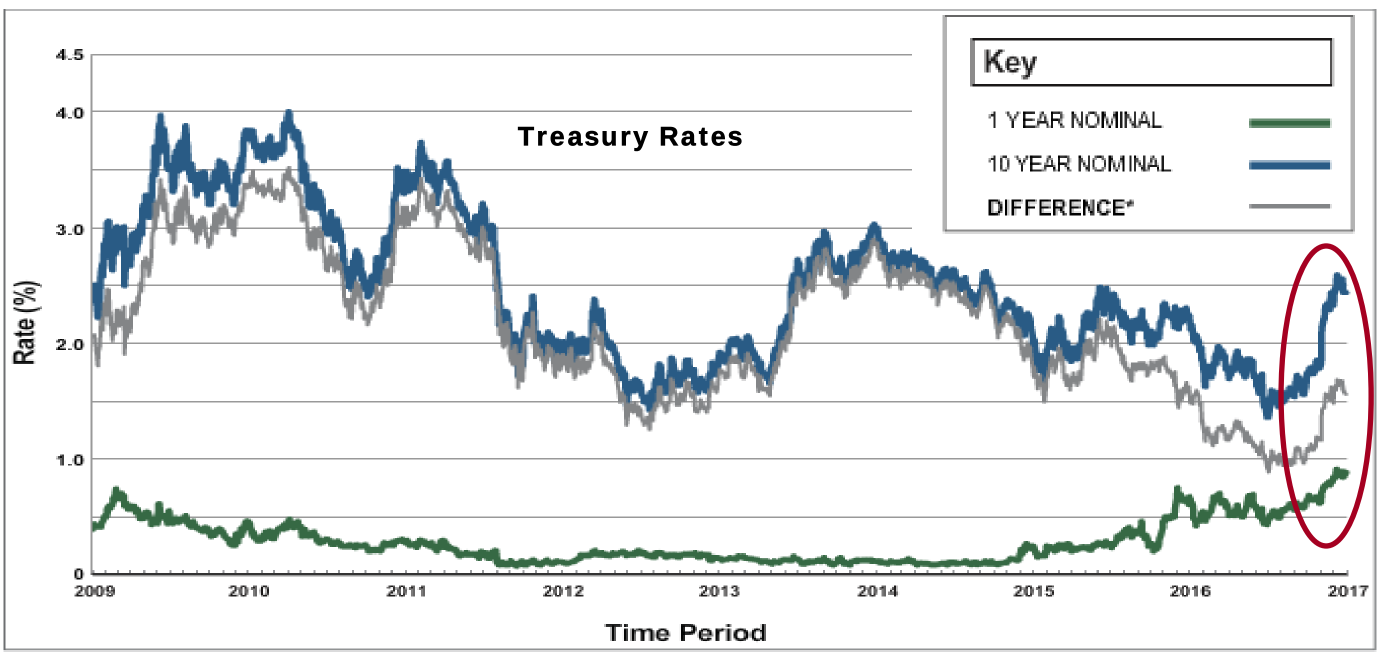
Although equities advanced nicely last year, the 3rd quarter of 2016 was the first time corporate earnings have grown on a year-over-year basis since early 2015. So, the gains we've experienced recently seem to mostly be the result of an increase in expected earnings, not actual ones. To the extent earnings disappoint, I would expect equity valuations to follow suit.

GLOBAL GROWTH

Except for Brazil and China, global growth forecasts have held fairly steady or have improved since the summer of 2016 (top of next page) due to an improving global economic backdrop. Growth within the U.S. and Europe have generally met or exceeded expectations and corporate earnings expectations have also improved.



INTEREST RATES RISE IN THE U.S.

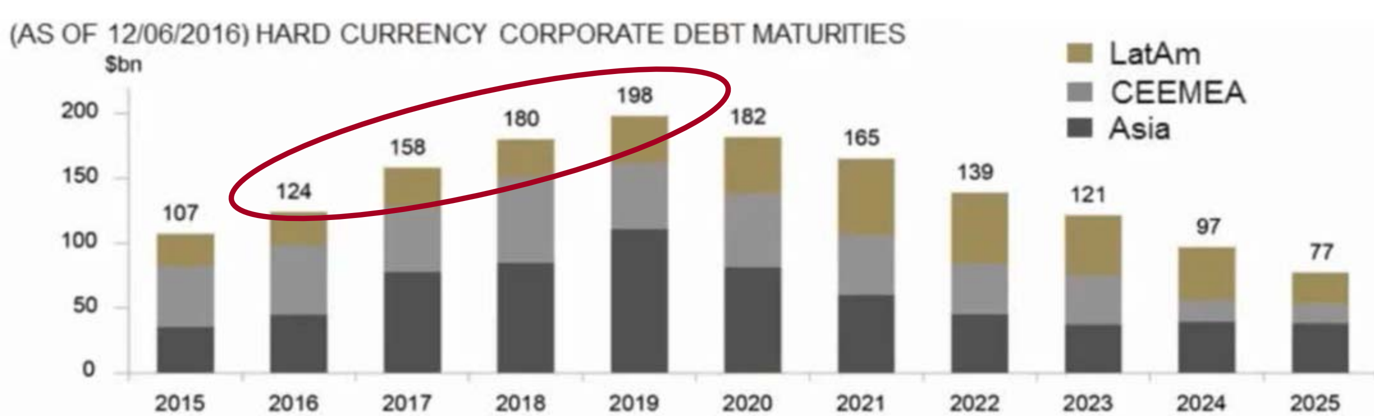


EMERGING MARKETS FEASTED ON LOW U.S. RATES ...

Low interest rates that resulted as a consequence of The Great Recession and the ease with which U.S. Dollars may be borrowed have induced many foreign entities to look to the U.S. for funding. According to the Bank for International Settlements, the amount of U.S. Dollar-denominated debt issued by non-financial companies in emerging economies increased from about 60% of their annual economic output in 2006 to about 110% of it by the end of 2015. Of the $10 trillion of U.S. Dollar-denominated debt that is now owed by foreign entities, emerging market economies are now responsible for paying back about a third of it. Here's how this debt explosion looks in a few important countries.

EMERGING MARKETS DEBT NOW COMING DUE IN LARGE CHUNKS

Of course, as interest rates (continue to?) rise within the U.S., floating-rate debt becomes more expensive to repay and to the extent a given issuer finds it necessary to refinance maturing fixed-rate debt, that becomes more costly, too. You can see in the image on the previous page that, in response to The Great Recession, longer-term interest rates declined precipitously during 2010, then declined somewhat further in 2011 and 2012. As shown immediately above, foreign borrowers took advantage of those low, long-term rates to refinance existing debt and to borrow anew. Increasingly large chunks of that debt is now beginning to mature and will continue to do so through at least 2019. Here's how things look for Latin America, Asia, and the CEEMEA countries (Central & Eastern Europe, Middle East and Africa).

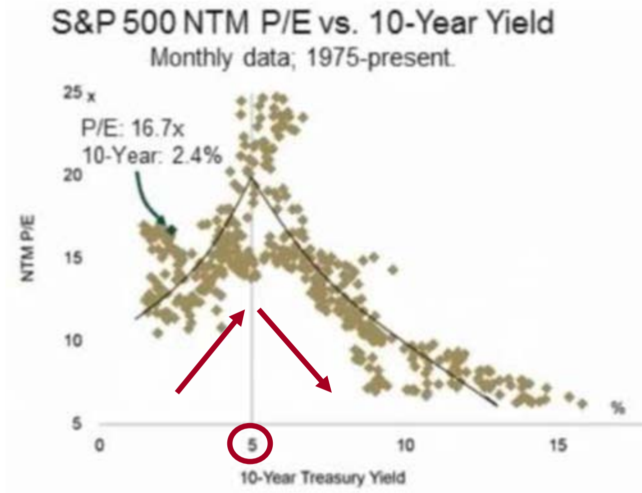


DOUBLE WHAMMY FOR EMERGING MARKET ECONOMIES ...

Since much of this debt will need to be refinanced and because it is likely to be refinanced at significantly higher rates, it will become more costly to service. In addition to that obvious economic pinch, this debt must also be repaid in U.S. Dollars. My first instinct was to liken this to a double-edged sword, but in this case both edges are on the *same* side of the knife. Here's why: Now that rates have risen within the U.S., those higher rates act as a magnet to foreign capital. In order for that capital to find a home in the U.S., it must first be converted into U.S. Dollars. That conversion process results in demand for U.S. Dollars and a lack of it for foreign currencies. Therefore, higher rates within the U.S. not only increase the basic cost of borrowing, they also tend to cause foreign currencies to depreciate versus the U.S. dollar, requiring more units of foreign currency to purchase that same unit (a dollar) of U.S. currency.

As an example, it now takes about 25% more Russian Rubles to purchase a U.S. Dollar than it did a year ago and Brazil's Real has depreciated similarly. Therefore, the cost of repaying U.S. Dollar-denominated debt for these countries has become about 25% more expensive versus a year ago, even *before* considering the aforementioned increase in interest rates. Consequently, a strengthening U.S. Dollar poses a significant economic threat to any emerging market economy tasked with refinancing or repaying a material amount of Dollar-denominated debt. Consequently, it's not too surprising that emerging market equities have cooled a bit as interest rates have risen within the U.S.

... BUT RISING RATES COULD ACTUALLY <u>BOOST</u> U.S. EQUITIES



Mathematically, rising rates pose an undeniable headwind to equity valuations, but when rates rise from below 5% as they now are and as shown to the right, equity valuations have tended to rise. Not until rates rise from significantly higher levels (from about 5%) do they then tend to have a deleterious effect on equity valuations.

This relationship probably exists because the Fed tends to raise rates *only* when it also senses economic growth, which is essentially what is happening now. Do you see that dot with the arrow pointing to it? That's the price-earnings multiple of the U.S. stock market as a whole recently. It's already a tad high in the context of the current level of interest rates, but if rates rise further, there could be more juice in the tank. Such relationships are exceedingly imprecise, but if corporate earnings do improve as expected, that improvement could provide a very complementary tailwind for U.S. equity valuations.

	All Days	Change in 1-Year Yield		Change in 10-Year Yield	
		Higher	Lower	Higher	Lower
S&P 500	**5.7**	**34.7**	**-21.5**	**48.3**	**-28.8**
Financials	11.3	84.8	-39.8	124.7	-50.5
Energy	9.3	38.0	-20.8	111.8	-48.4
Materials	9.2	41.4	-22.8	57.7	-30.8
Industrials	13.2	41.5	-20.0	53.0	-26.0
Technology	7.7	40.2	-23.1	49.7	-28.0
Discretionary	1.3	35.5	-25.2	40.9	-28.1
Health Care	-3.4	21.8	-20.7	33.5	-27.6
Staples	2.2	12.2	-8.9	12.2	-8.9
Telecom	10.9	6.8	3.8	14.0	-2.8
REITs	-2.1	0.7	-2.7	4.3	-6.1
Utilities	9.2	0.6	8.5	-12.6	25.0
% of Days	100	53	47	49	51

The image above shows how stock prices have reacted when interest rates, as measured by changes in the yield of 1-year and 10-year Treasury yields, have risen or fallen over a recent 100-day period. For instance, on days when the yield on 1– or 10-year Treasury securities *rose*, stock prices in most sectors tended to react very favorably (boxed areas). In contrast, returns have been lousy (except for utilities) when rates have fallen.

This is why I prefer U.S. equities over international ones at this point. — Glenn Wessel