MID-CONTINENT CAPITAL

CONSILIUM*

Volume 29~January 2017

*advice; judgment; resolution; wisdom

"Just When You Thought You Had It Figured Out"

Everyone has seen a film that turned out to be something completely different than they expected. Stock and bond investors could be forgiven if they felt that 2016 was akin to a three-act production that started out as horror, morphed into comedy, and finally ended up being an optimistic "feel good" story.

The year began with rapidly worsening financial conditions and a slowdown in economic activity that briefly threatened to tip the US economy into recession. The S&P 500 index fell by more than 12% from its December highs to its February lows, gold prices soared by 20% over the same period, and bond yields tumbled, all signaling to the Federal Reserve that its initial, first-time-in-a-decade interest rate hike at the end of 2015 had been terribly premature.

Less than three months later, Fed officials were backtracking, and for a time it appeared that the popular investment narrative of the last two years – disappointing economic growth, "lower for longer" interest rates, and a bidding war for assets capable of producing income – was back.

Then, within just a few weeks of each other over the summer, the UK voted to leave the European Union, and the Republican Party made Donald Trump its presidential nominee. The astonishing outcome of the General Election may have left about half the country feeling dismayed, but it did not last long, as the equity market quickly discerned that something might well have changed for the better – and by year-end, the expectations component of the Conference Board's Consumer Confidence Index had reached its most optimistic level in 13 years.

There is significant uncertainty around policy specifics, but we believe there is good reason for increased optimism about the economy, corporate profits, and stock prices in 2017. Mr. Trump's fiscal agenda is dominated by ideas and proposals that, all else being equal, should be helpful to growth over the next few years:

- corporate tax reform featuring incentives to repatriate overseas cash
- large (but undefined) infrastructure spending plans
- lower individual tax rates, including lower capital gains rates
- reducing regulatory burdens on business
- reforming the Affordable Care Act
- encouraging even more aggressive development of domestic energy resources

Even acceleration in growth of as little as one percentage point from the moribund levels of the last few years could propel a solid earnings recovery, particularly among domestically-focused companies. This could be sufficient, at last, to spur an increase in business investment spending – a key missing element of the economic backdrop since 2013. A positive feedback loop driven by income and spending gains – by both businesses and individuals – could make the current expansion one of the longest on record.

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As always, even under the best of circumstances, there are reasons for caution, and we see two main obstacles. The first of these is the already-elevated level of stock valuations. On its latest 12 months' results, the S&P 500 index trades at a price/earnings multiple of over 19 – the highest since 2002. "Starting points matter", we frequently remind our clients, and high valuations are usually followed by below-average *long term* returns. (Valuation is typically of little help in forecasting near term results, however.) This appears to be an example of investors pulling returns forward and discounting a very strong earnings expansion. The latter may happen, as suggested above – but it hasn't happened yet.

The second concern is the path of Fed policy in response to stronger growth and potentially higher inflation. One school of thought suggests that the Fed may indeed be set for a long series of short term interest rate hikes, but it will be in no hurry to choke off economic growth – they may opt to let the economy "run hot" for a time, as it did for much of the late 1990s. But other Fed-watchers believe there is an institutional urge to "normalize" our very low short term interest rates as quickly as possible, now that the opportunity exists. We believe Fed rate hikes would not prevent higher stock prices, as long as they were justified by economic growth. Unfortunately, the Fed's track record in this regard is poor, usually continuing to boost short term rates beyond the point that such action can be justified. Caution around Fed policy is never a bad idea.

One year ago in our *Consilium* we said that "it is harder than normal, as we enter 2016, to defend a strong opinion about the year-ahead outlook." It is difficult to recall a year when so many predictions on important matters turned out to be wildly incorrect, and we are glad to have skipped the opportunity to be wrong! But 2017 is a new year, and the incoming Trump administration offers reason to be openly optimistic about the economy and the stock market. Still, Mr. Trump's surprise election is itself a reminder to investors to avoid overconfidence – a wide range of outcomes is possible. Therefore, while hoping for the best, we will continue to look for opportunities to invest in high quality companies that are built to grow and prosper in any political climate.

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On behalf of everyone at Mid-Continent Capital, we would like to thank our clients and readers of *Consilium* for their support, and we offer our best wishes to everyone for a healthy and prosperous 2017.

Sources: FactSet, Baseline

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