Investing in the Age of Trump

by John S. Traynor, EVP, CIO

In a few weeks, the 45th President of the United States will take the oath of office and begin what is sure to be one of the most unorthodox administrations in the country’s history. Donald Trump ran an unconventional campaign against what turned out to be very conventional candidates from both parties. Whether the next four years will be as unconventional as the campaign is assured if the post-election period of tweets continues. We believe any forecast for the Trump administration and its potential success or failure in pursuing the challenges ahead should be divided into three sections.

1. Policy

Many of the initial tax and regulatory changes proposed by the incoming Trump administration should have a positive impact on the economy and enjoy bipartisan support. Debates around education and energy policy will tackle topics that we hope will enliven thoughtful discussion and help to overcome some of the more vexing hurdles faced by the Obama administration.

2. Politics

The fact that Hillary Clinton won the popular vote has emboldened many Democrats to oppose the Trump administration as fiercely as many Republicans opposed the Obama administration. We therefore see no end to the partisan positioning in Washington and will endeavor to try to separate fact from fiction as the battles unfurl.

3. Personality

It is an understatement to say that Donald Trump has a unique personality. During the election, many of his Republican detractors were more upset with his personality and temperament than they were with his individual policies. At the age of 70, it is unlikely that Trump will change now. One encouraging sign for the productivity of his administration is that he has appointed a group of advisors and Secretaries who should be able to temper the inevitable bluster.

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This three-point filter should help us navigate what looks to be an interesting year ahead for investors. A new administration, the Fed at a turning point on interest rate policy and a world full of boiling challenges will lead to continued volatility and investment opportunities. We believe equities will generate positive returns for investors and outpace the returns earned by bonds this year.

Looking back to see the future

One way we have navigated the tumultuous markets of the last two years is to focus on the underlying strength of the U.S. economy. As Chart 1 shows, there were three very disconcerting declines in the equity market over the last two years that caused investors to question whether the economy would fall into recession. The Chinese yuan crisis in 2015, the oil price decline in early 2016 and the Brexit vote in June 2016 each served to shock many investors into building recessionary portfolios composed of defensive utility stocks and long term bonds. In hindsight, as we know now, the U.S. economy remained steady and grew over the entire period.

Investors today have become confident in the continued growth of the U.S. economy. Combined with the economic proposals emanating from the Trump team, it appears that growth may accelerate in 2017. The rally in the U.S. equity markets after last year’s election was driven by this higher confidence and can be seen in the sector returns illustrated in Chart 2. The recession portfolio performed best in the first six months of 2016 but once the short Brexit decline ended and second quarter GDP was reported, investors turned quickly to the growth portfolio which became the supercharged “Trump” portfolio in November.

We believe the “Trump” portfolio will perform well in 2017. Investors should maintain exposure to economically sensitive sectors such as Energy, Financials, and Technology and underweight the Utility and Telecom sectors. Likewise, we will maintain our underweight to bonds in balanced portfolios as interest rates continue moving higher.
A Rising TIDE may temper the Trump rally

The tone of this note has communicated our positive economic outlook for 2017, and while we remain optimistic around equity market returns, investors must understand the countervailing forces already active in the market which will act to slow the economy. We refer to the four forces as a rising “TIDE” threatening the Trump economic acceleration.

1) Trade tensions rising

Trade is an area where the Trump “bluster” has had the highest profile and where we believe some of the discussed renegotiations, restrictions and reneging will have a negative impact on the economy. While we certainly believe in fair and open trade accords, it is critical to remember the post WW II increase in global trade has led to increased global growth and individual productivity. Make no mistake about it, the US economy will be negatively impacted by trade restrictions.

2) Interest rates rising

The eclipsing of the era of “free money” as reflected in the incredibly low interest rates seen over the last eight years will impact industries benefitting the most from low rates, such as home building. Sustained low rates allowed borrowers to refinance and capture billions in additional cash flow that was in turn moved back into the real economy. That tailwind will be lower this year and as rates rise will become a headwind. We will be watching for the effect of rising rates on the economy very closely.

3) Dollar rising

A rising dollar makes US exports more expensive and imports more attractive. In our interconnected world, a higher dollar will impact trade flows and serve to slow the economy.

4) Energy prices rising

Whether the production cutbacks planned by OPEC and non-OPEC countries will hold is less than certain, but they are undoubtedly a step in the direction of higher prices. Every penny increase in the price of a gallon of gasoline has the effect of acting like a tax increase of one billion dollars over an entire year for US consumers. Higher prices will also lead to increased drilling in the oil patch which may offset some of the drag higher prices will have on consumers.

As we said at the outset of this note, 2017 should prove to be an unconventional year. While we believe the overall trajectory of the economy and equity prices will be upward, it could be a bumpy ride along the way.
Asset Class Strategy

By Albert J. Brenner, CFA
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How do current and prospective conditions affect our asset class strategy? The following is our strategy and tactics for each asset class.

- The strategy spells out the why.
- The tactics spells out the how.

Of course, each investor is unique. Investors should review the strategies and tactics discussed here with their portfolio manager to see if they are appropriate to their portfolios.

Equity

Strategy

- The economic expansion will continue through 2017 with some boost from Trump policies. Economic growth will support moderate corporate revenue and earnings growth. The risk of a recession is low.

- U.S. equities are not cheap when measured on a stand-alone basis. Large-cap stocks are trading at 17 times estimated earnings – in the 82nd percentile of their long-term trading range.\(^1\)

- We believe assets should not be valued on a stand-alone basis but with reference to other asset classes. On this basis U.S. equities are still attractively valued compared to bonds, but investors should be prepared for below-average returns.

  - The recovery in oil prices, and the prospects for higher interest rates will lead to higher earnings for the energy and financial sectors and higher earnings for equities overall.

  - The high probability of corporate tax reform is strongly supportive of equity returns.

- We are entering the late stages of the current business cycle, which has been different from other post WWII expansions. The typical rotation of equity sector performance has not occurred during this cycle and is not likely to occur through the remainder of the cycle.

Tactics

- We are maintaining an overweight to equities with the expectation that stocks will outperform bonds in 2017. Equity returns will be driven by increasing earnings rather than increases in valuations. Longer-term, we expect equity returns to fall short of historical averages. Investors should adjust their financial plans in the face of lower-than-average long-term returns.

- In view of the extraordinary nature of this business cycle and the prospects for higher near-term growth as a result of the new administration’s policies, investors should pay close attention to sector allocations. We are maintaining exposure to economically sensitive sectors such as energy, materials, and technology while underweighting utilities and telecom.

- Sector performance will be critical to the relative performance between growth and value and among large-cap, mid-cap and small-cap stocks. The higher concentration of financial stocks within mid- and small-cap stocks has boosted their recent performance relative to large-cap. We are maintaining a neutral allocation across large-, mid- and small-cap as we do not expect relative returns for 2017 to warrant an overweight or underweight allocation to any size sector. We are also maintaining a balanced allocation between growth and value in view of the prospects for traditional value sectors such as financials and utilities and growth sectors such as health care and technology.

\(^1\) From 1990 to date. The 82nd percentile means that the current valuation level is higher than 81% of all valuation levels since 1990.
International Equity

Strategy

- International equity markets are currently priced at favorable valuation levels relative to historic averages and at levels below the S&P 500. Developed market equities are trading at 15 times estimated earnings for the next 12 months, and emerging market equities are trading at 12 times compared to 17 times for the S&P 500. We do not believe these valuation differences warrant an overweight to international equities. We continue with an overweight to the U.S.

- The major developed market economies, the euro zone, Japan, and the United Kingdom face economic and political challenges which will constrain economic growth. The rise of populism in the eurozone threatens the cohesion of the European Union. We are maintaining a neutral weighting to developed market equities.

- Emerging market economies – and China, in particular – are the major engine of world economic growth. China is in the middle of a challenging transition from an export and investment based economy to a consumption based economy. Total debt has increased to a level that is not sustainable in the long run. We are underweight emerging market equities despite the favorable valuation level.

Tactics

- Investors realized higher returns from U.S. equities in the second half of 2016 than from international equities, developed or emerging. Although international equity returns in 2017 are likely to continue to lag U.S. returns, we expect longer-term international returns will exceed U.S. returns. Investors should maintain exposures to international equities. We continue to hedge the currency risk of a portion of the developed market allocation.

- Developed market equities are more exposed to China and emerging markets than U.S. equities and can provide a means of accessing the large consumer markets in developing countries.
Fixed Income

Strategy

- The U.S. economy is finally strong enough to be removed from the life-support of the Fed. GDP growth, unemployment, and inflation are all at levels that warrant a return to normal monetary policy. December’s rate hike is likely to be followed by several hikes in 2017.

- Bond returns will face the headwinds of rising interest rates in 2017. Investors will still realize positive returns, but returns will be lower than normal. Bonds will continue to be necessary for portfolio risk management. In view of the prospective rate environment, we are maintaining an underweight to bonds.

- The Republican sweep of the November election marks a paradigm shift in the bond market. Bonds have moved from pricing in deflation to inflation. Inflation expectations have risen in anticipation of the shift from monetary policy support (low rates) to fiscal policy stimulus (tax cuts, infrastructure spending).

- Historically, Treasury prices have adjusted rapidly to significant changes in growth and inflation expectations.
  - The worst of the selloff in longer-term Treasuries is over for now.

- Corporate balance sheets remain strong despite an increase in the level of debt. We expect defaults to remain low as the economic expansion continues.

- The global savings glut will continue to impact U.S. interest rates as foreign investors look to the U.S. for higher-yielding safe-haven assets, namely U.S. Treasuries and high quality corporate bonds.

Tactics

- We expect the biggest moves in interest rates will be in short-term rates as the market anticipates further Fed hikes. We expect long-term rates to remain relatively anchored, especially after the post-election spike in long-term rates. Future rate moves will flatten the yield curve as two-year yields are likely to move well above 2% by 2018.

- Managing duration in a rising rate environment will be a trade-off between harvesting coupon returns and managing price depreciation induced by higher rates. This will be especially challenging in an environment with short-term rates rising more rapidly than long-term rates. We are maintaining a neutral duration strategy focusing on intermediate-term bonds in the 3 to 7 year maturity range.

- Interest rate premiums for investing in high-yield bonds are at or below historical averages. We expect high-yield bond defaults to be modest. In accounts where high-yield holdings are appropriate, we are maintaining our current underweight allocation.

- Interest rate premiums for investment-grade corporate bonds are also at or near to their historical average level. We are maintaining an overweight allocation to corporate bonds for the interest rate protection provided by the higher coupons (than Treasuries) and to maintain stable portfolio duration (compared to mortgage-backed bonds).
Real and Alternative Assets

Strategy

- Real estate. Investor demand for yield pushed real estate investment trust (REIT) valuations well above historic norms. After returning nearly 14% in the first half of the year, REITs declined over 9% from July through November 2016 as investor confidence in the economy and in equities returned.

- Gold became a safe-haven currency in early 2016 as interest rates and the opportunity cost of holding an asset that pays no rent, interest, or dividends approached zero, or went negative in some cases. As with real estate, gold produced strong returns in the first half of 2016 (24.5%) and suffered a sharp decline in the second half of the year.

- Commodities. Commodity returns in 2016 followed a similar return pattern to real estate and gold – strong first half returns (13.3%) followed by second half losses (-3.0% through the end of November). The rising price of oil and China’s return to infrastructure spending to bolster its economy contributed to the early 2016 returns.

- Hedge fund returns for the first eleven months of 2016 were less than half the return on the S&P 500.

Tactics

- On top of stretched fundamental valuations, REITs will be less attractive as interest rates increase. We are maintaining an underweight allocation to REITs.

- Gold can be a currency, a hedge against inflation, and a safe-haven asset in times of economic or political uncertainty. With a stronger dollar, rising interest rates and inflation remaining modest, we continue to maintain a zero allocation to the precious metal.

- Most commodities remain in an oversupply condition. We expect supply and demand conditions for crude oil to come closer to balance in 2017. Oil prices will rise above $50 per barrel, but increased shale oil production will prevent prices from increasing above $70. We continue to maintain a zero allocation to commodities.

- We believe select hedge fund strategies implemented through liquid, tradeable mutual funds can be useful for risk management in select situations.
We recommend that investors review the investment topics discussed in this strategy note in light of their own unique circumstances. The People’s United Balanced Portfolio illustrated above should serve as a starting point for a conversation with your advisory team about building a portfolio customized to meet your goals and aspirations.

Source: People’s United Wealth Management

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