S&P 500 up post election through January

Positive (*read cautious*) reaction as Dow hits 20,000

President Trump exercises agressive agenda - increased optimism and angst

By Daniel Wildermuth

President Trump is wasting no time in clearly differentiating himself from past administrations. Investors have reacted mostly positively. The S&P 500 was up over 7.3 percent from election day through January 29 and the Dow Jones Industrial Average closed above the symbolic 20,000 mark for the first time. Yet, shortly after reaching new highs, the market suffered its worst day since the election following President Trump's restriction on immigration from seven majority-Muslim countries.

Trump's first days in office have been very busy, and anyone craving an aggressive president could hardly be disappointed. The unexpected seems to be the new normal, which is great as long as sentiment remains positive. If it changes, markets nearly always become jittery and head south. In the past, I have highlighted reasons for optimism such as expectations for lower taxes, less regulation, more fiscal stimulus, and generally a much more favorable business climate. Yet, the concerns around trade, protectionism, instability, and future effectiveness seem likely to move more into the forefront as Trump implements policies that inevitably upset some people, particularly the press which is already at war with Trump. Investors also could become grumpy very quickly if Trump's protectionist rhetoric transforms into more destructive policy.

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Obviously, recent U.S. market gains are based on growth hopes and expectations, and not actual changes or actions. Achieving policy expectations could be difficult for a president still establishing a working relationship with his own party, much less all the members of Congress. Furthermore, Trump continues to take on the establishment, which may be the only path forward for him to implement his agenda, but likely makes success more challenging.

Moving beyond political sentiment and into economics, GDP growth rose at a disappointing 1.9 percent annualized rate during the fourth quarter resulting in average growth for the year of the same percentage. There had been hopes that Trump would inherit a strong economy following third quarter's unusually impressive growth rate of 3.5 percent. But the quarter proved an anomaly, and GDP expansion reverted back to its plodding average of about two percent per year.

As Trump was inaugurated, the International Monetary Fund (IMF) reacted to Trump's tax and spending plans by increasing its economic growth forecasts. The IMF raised their output estimates nearly a half percentage, which would peg U.S. economic expansion at 2.3 percent this year and 2.5 percent next year. American small business optimism also rose by the most since 1980 and to its highest level since 2004 on expectations of economic growth and regulatory relief according to the National Federation of Independent Business' (NFIB). The percentage of business owners claiming that now is a good time to expand is three times the average of the current

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Market environment: Stocks likely to outperfom bonds

expansion, according to the NFIB's data. More companies also said they plan to increase investment and keep hiring.

Voicing similar enthusiasm, the U.S. Federal Reserve Bank repeated its earlier projections for more than one rate increase in 2017. In past years, rate increase threats have caused market panics due to fears of a resulting slowdown. Now, most economists feel the economy is plenty strong enough to weather the increase, and investors shrugged off the announcements. Historically, when the 10-year Treasury Yield rate is below five percent, increases are associated with stock market gains because the economy is believed to have more room to expand. At a current rate of 2.49 percent, the 10-year rate remains well below five percent and its historical average.

In this environment, it seems likely that stocks again will outperform bonds because bond prices normally decline with greater growth. Yields at 2.49 percent for the 10-year Treasury remain low, but have risen significantly from 1.37 percent on July 8, and they appear poised to keep rising. As a reminder, rising rates result from bond prices decreasing. It is very feasible that bonds will lose money on the year net of their yield, and if stocks outperform them, they would beat bonds for the sixth year in a row for the first time in 20 years. In this climate, it's highly possible that cash could prove more rewarding for investors than bonds.

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International markets may finally be turning a corner. In spite of concerns over Trump's impact outside of the U.S., the IMF left its global growth projections unchanged at 3.4 percent for 2017 and 3.6 percent for 2018. The projections signal faster growth than in 2016 which saw GDP increase by only 3.1 percent for the year, the weakest growth since the 2007 - 2009 financial crisis.

Improving international growth projections and recovering economies should drive international markets higher after less than stellar recent performance. Many equity markets, particularly in emerging economies, possess very attractive valuations because investors have been very slow to venture back into these regions post recession. In addition, deeply depressed currencies make purchasing assets more attractive and also present the possibility of future tailwinds assuming currencies recover to at least some extent.

Asia will likely remain a dominant global growth engine. Growth in per capital income and consumption combined with continuing urbanization should provide sustained growth to the region. China's growth is also expected to pick up further driving the region's growth expectations.

Back in the U.S., it seems highly likely that various pro-growth initiatives will pass, but their implementation and impact will take time and probably also increase uncertainty. Growth should increase earnings and bring valuations back closer to historical norms, but delays and inevitable changes to policy intentions could easily cause investor angst if progress fails to materialize as expected. Still, relative to bonds, equities look more attractive even if volatility for both should probably be expected to rise in 2017. As always, owning stocks is a long-term undertaking that requires not only patience but a willingness to live with uncertainty and occasionally some pain. This year seems likely to deliver a bit of everything to investors.

[1]While the Dow Jones Industrial Average is mentioned here, the S&P500 is normally used to represent the broad U.S. equity markets. The S&P500 represents $2.1 trillion of equities versus the Dow at under $36 billion according to Howard Silverblatt at S&P Dow Jones Indices. Furthermore, the Dow's calculation methodology results in some companies such as Goldman Sachs impacting the index's movements nearly eight times as much as other companies such as General Electric or Pfizer, resulting in less precise and often misrepresentative market measure.

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