SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2017/II

"It was the best of times, it was the worst of times." The opening line of Dickens' Tale of Two Cities is so familiar to us that we rarely consider the stark contradiction it lays out. Perhaps we should, because we find ourselves facing a similar paradox.

From Election Day to the end of March, the Dow Jones Industrial Average has risen +12.7%, its best post-election performance, up to that point, since Kennedy's election in 1960 kicked off a multi-year rally dubbed the "Go-Go Years". The MSCI Emerging Markets Index has surged +12.5% year-to-date, while the MSCI Eurozone Index is up +8.7%.

Yet the new president, Donald Trump, has seen his Gallup job approval rating drop to the lowest level (35%) of any president this early in his term, since polling began—putting both his agenda and the market excitement it generated in jeopardy. Britain officially pulled the trigger and started the clock ticking on leaving the European Union, while a leading candidate in France's upcoming presidential election threatens to do the same—a development that would almost certainly be the death knell for both the Euro and the E.U. The price of gold—often a reflection of market anxiety—is up +8.6% so far this year.

There are some facts that could make investors super-confident, others that could make them super-worried. Which to place stock in? The disparity between these two sets of facts—the best of times, the worst of times—is so stark that the temptation is to dismiss either one, or the other, as a temporary aberration. But both need to be taken seriously, and a closer look at both the good and the bad give us reason to believe this market will find a way to muddle through.

TRUMPED

Conventional wisdom in politics works like this: Whenever Democrats win an election, pundits put out a slew of articles about how the Republican Party faces insurmountable problems, is totally doomed, and may never win an election ever again. Then, two or four years later, when the Republicans win, pundits put out a slew of articles about how the Democratic Party faces insurmountable problems, is totally doomed, and may never win an election ever again.

When Donald Trump was elected president in November, the conventional wisdom was that, with friendly Republicans controlling both houses of Congress, his entire agenda—including repealing Obamacare, tax cuts and reform, deregulation, a big defense build-up, and an even bigger infrastructure spending package—would be enacted quickly and easily, a prospect that helped drive the post-election rally in U.S. share prices. (The prospect of other Trump policies less welcome to investors, on immigration or trade for example, was conveniently brushed aside). Now, after a series of stumbles and setbacks, that conventional wisdom has been flipped on its head: the president's entire agenda could be dead on arrival, prompting fears of a sharp market downturn.

Neither of these expectations was ever reasonable. That's why we pushed back, in our last quarterly letter, against the notion that President Trump's agenda would simply sail through, or that even its more constructive aspects would affect all investors, or all investments, in a uniformly positive way. Turning promises into policy, or legislation, would require patient planning, tough compromises, and the skillful deployment of political capital. There would inevitably be false starts, wrong turns, or even outright fumbles that would force the president's team to rethink and recalibrate what they could accomplish and how.

Nearly every new president makes mistakes, and the failure of Trump's push to repeal and replace Obamacare was just such an experience. To begin with, the president set a high bar for success, promising "something wonderful" that would cost both the government and consumers less, provide better care, and cover everyone. The vagueness of his proposal—"you'll love it, you'll see"—invited people with very different priorities to project their own vision onto its blank canvas, setting the stage for conflict and disappointment later. The initial bill introduced by Speaker Ryan, and somewhat incautiously embraced by the president, fell well short of such promises, and the president's brusque "take it or leave it" negotiating stance backfired with members of his own party who were facing anxious and angry voters back home. Nor did the president spend any time cultivating key industry groups—hospitals, doctors, drug-makers, insurers—whose sign-off was instrumental in passing Obama's Affordable Care Act. Whatever their dissatisfactions with Obamacare, they weren't sold on the alternative that was offered.

The notion that Republicans will find relief in switching gears from "complicated" health care to "much easier" tax cuts is rather fanciful. Even if Republicans agree on reducing tax rates, there is no consensus on how to accommodate that. They could offset lower rates by eliminating major deductions, exclusions, or credits, many of which have strong popular support with important constituencies. Adopting the "border adjustment tax" could bring in an estimated $1 trillion in revenue, but with untested and potentially painful impact on retailers and consumers, who may push back against it. Cutting spending sounds attractive, except President Trump has pledged big increases to defense and infrastructure spending, and to leave entitlements untouched, which leaves only discretionary programs—many of which are quite popular or important—to bear the entire burden. Republicans could simply add to the deficit, which won't go down well with "Tea Party" fiscal conservatives. These choices are all complicated by the failure to pass the leadership's health care bill, which was expected to save $337 billion over ten years. The tax and spending issues raised in the health care debate won't go away but will simply roll over into the budget debate.

President Trump, and his partners in Congress, will either learn from their failures, or they won't. If they do, they stand a decent chance of eventually overcoming such obstacles, and achieving their most important goals. If not, it will be Groundhog Day over and over again. One thing is clear: achieving meaningful progress takes time, and concerted effort. The last major tax reform act, in 1986, took nearly two years to take shape and pass. President Obama's Affordable Care Act took the same—and he, unlike today's Republicans, started with a filibuster-proof Senate. Since time and political capital are not unlimited, the Trump White House will have to prioritize, and we will be watching carefully as those priorities emerge—either consciously, or by default.

The net effect on the economy, and on markets, will depend a great deal on which priorities they pursue. Democrats and Republicans may disagree about their longer-term impact on the country's economic health, but there is little question that deregulation (in which the president is already actively engaged) could boost the earnings of companies in sectors like energy and banking, and corporate tax cuts (which may eventually come to pass) could have an even broader impact on share values. Other initiatives, like tighter border and immigration controls, could hurt sectors like travel and tourism, food and agriculture, and high-tech. Even some of President Trump's early fans on Wall Street worry he may be getting distracted from the proposals that helped trigger the "Trump rally." That distraction could grow if his Administration gets bogged down in scandal over alleged Russia ties or family business deals.

This isn't a partisan critique. We've said nothing here that the president's own advisors aren't saying, in private. Being a bull in a China shop has gotten President Trump this far, and it may still be useful in achieving certain political objectives, but as far as turning promises made into promises kept, it has its limits. Most people can clearly see that. The future of his agenda—and its impact on markets—depends on whether he can see it too.

BREXITED

Across the Atlantic, other uncertainties are brewing. On March 29, Prime Minister Theresa May officially informed Brussels of Britain's intention to leave the European Union. This notice triggered a two-year negotiation process that automatically ends—deal or no deal—with the U.K. out of the E.U.

The real question is what kind of relationship Britain will have with the E.U. after it departs. For a while after the Brexit vote, many hoped for a "soft Brexit" that would give the U.K. continued access to the Common Market and the Customs Union, in a sort of special arrangement like those enjoyed by non-EU members Norway, Iceland, and Switzerland. However, May's insistence on maintaining full control over immigration, and refusal to put the U.K. back under the European Court of Justice, have made a "hard Brexit" all but certain. How hard is hard? One major obstacle to an agreement, of any kind, is that Brussels insists the U.K. owes it £60 billion, to cover spending commitments made while Britain was a member. Most British voters don't think they owe the E.U. a dime, and won't look kindly on a government that forks over too much of their money.

The absence of any major negative economic consequences, following the Brexit vote, along with hints from the Trump Administration about a possible bilateral U.S.-U.K. trade deal, have made Britons, and the politicians who represent them, a great deal more confident—some would say cocky—about weathering the risks of a hard Brexit. Behind the scenes, banks and businesses are a lot more concerned what the future holds, but have largely held their tongue. Many hope for a post-Brexit Free Trade Agreement (FTA) with the E.U., but Britain is primarily a service economy, and an FTA might do little to ensure the continued access of its banks, insurers, and other leading service firms to European markets, without having them relocate.

The last several months have also seen a change in the E.U.'s perspective, in the opposite direction. At first, the rhetoric from Brussels and other European capitals was all about the need to make an example of Britain, lest other members be tempted to follow in its footsteps. The election of President Trump has made them think again. A recent Pew poll asked transatlantic "thought leaders" whether, if a European nation became involved in a conflict with Russia, the U.S. would honor its NATO commitment: 49% said yes, 48% no, an amazingly tepid response. Worried what Trump's "America First" position could mean, Europe is increasingly focused on keeping as positive a relationship as possible with the U.K.—on both trade and security—after Brexit. That may translate into a more pragmatic, flexible approach to negotiations.

The challenges Brexit presents to Britain, however, are not wholly external. Scotland and Northern Ireland both voted last June to "remain" in the E.U., and May's decision to start the clock ticking prompted the Scottish Parliament to vote in favor of another referendum on independence. Last year's drop in oil prices makes Scottish independence a trickier proposition, as does Spain's likely opposition to letting Scotland stay in the E.U.—for fear of encouraging Catalonia to break away. But frustrated with the U.K.'s hold over Gibraltar, Spain just said it might not object after all. Meanwhile, the Irish—in both north and south—are upset that Brexit could mean the imposition of a hard customs border that could undermine the peace accord. You get the picture: there are a lot of moving parts here.

Two more moving parts: France and Germany are holding national elections later this year. France's presidential election will likely prove the more dramatic, with far-right nationalist Marine Le Pen almost certain to qualify in the initial round on April 23 for the two-person run-off on May 7. Betting markets currently give Le Pen, a committed advocate of France quitting the Euro and the E.U., a 25% chance of winning, but both of her potential opponents lug around a great deal of political and personal baggage—not unlike Hillary Clinton. However unlikely, a Le Pen victory has to be taken seriously, because it would probably spell the end of the European Union. Angela Merkel's opponent in the German elections, in September, is a more conventional center-left politician, whose victory would not signify any sharp break in policy. Nevertheless, Merkel has been such a central and steadfast figure through so many a European crisis that her absence would be felt, on Brexit and everything else, should she depart the scene.

So far, markets haven't been inclined to overreact to these risks, and neither are we. If the past year has taught us anything, it's that while we should not underestimate the chance of big political shocks, we must be wary of overestimating their market impact. This is a "show me" market, one that wants to actually *see* the negative consequences of political upheaval before pricing them in. In the meantime, what it *does* see is the economy still chugging along.

AGING BULL

Headlines came and go, and some of them may even come to pass. But our view of the market has never depended primarily on political guess-making. It's been based on the fundamentals we've watched develop over time. Despite what President Trump may say, one of the best things he has going for him is that he did *not* inherent a "mess", at least when it comes to the U.S. economy. What he inherited is an eight-year old recovery that, while lurching and uneven, still gives every sign of continuing to stumble along in a positive direction.

The Atlanta Fed currently projects +0.6% GDP growth for Q1, while the New York Fed projects +2.8%. The wide disparity doesn't offer us much comfort, but much of the data looks noticeably better than it did last year. Manufacturing has rebounded from the slump it experienced last year: output rose +0.5% in February, up +1.5% from a year before. February orders for core capital goods—a key indicator of business investment—were up +2.7% from a year ago. The inventory-to-sales ratio, while still elevated at 1.35, is lower than it's been for two years, reducing the risk of oversupply. The ISM Manufacturing Index for March continued cooking along in solid expansion territory at 57.2, with new orders at a still blistering 64.5. ISM's gauge of the large Non-Manufacturing sector slipped to a still-healthy 55.2, with several of those surveyed expressing concern about how the president's moves on trade and health care could affect business, but new orders remained strong at 58.9, suggesting growth will continue.

In March, the two most looked-to gauges show consumer sentiment—which got a big boost following the election—either still near cycle highs (University of Michigan) or super ebullient (Conference Board), surging nearly 10 points to its highest level since December 2000. That confidence is bolstered by continued job growth (an average of 178,000 per month for the past three months). Personal income in February was up a solid +4.6% since a year ago, while consumer spending is up +4.8%. Retail sales in February were up an impressive +5.7% from last year; some of that was due to rising fuel prices which failed, however, to bite into other sales which—stripping away auto and gasoline sales—were up +4.4%

from last year. The housing market is also seeing a rebound, with existing home sales up +5.4%, new home sales up +12.8%, and new housing starts up +6.2% in February, compared to a year before. The NAHB Housing Market Index surged 6 points in March to 71, its best reading of the cycle. Whatever else might be happening, U.S. consumers see no reason to hold back, and that is supporting business confidence.

The U.S. WTI price of crude oil spent much of March below the $50 mark, and ended the month down −6.0% year-to-date. Despite OPEC's effort to boost prices by cutting production, U.S. shale production—honed by greater efficiencies and lower costs—has rushed in to fill the gap, causing inventories to rise rather than fall, and keeping oil prices down. That may have revived drilling in the U.S., but weaker oil prices put downward pressure on energy sector profits as a whole, and investment in new oilfield equipment remains low.

Lower oil prices also help keep inflation in check, although despite this, prices have slowly but steadily been rising. In February, the CPI inflation gauge hit +2.8%, its highest level in almost five years, while the Fed's preferred PCE index rose to +2.1%, surpassing 2% for the first time in nearly as long. While core inflation rates (excluding energy and fuel) are somewhat lower—2.2% and 1.8% respectively—the steady uptick in prices surely lent confidence to the Fed's decision to raise interest rates by another 25 bps in March.

One factor that gave the Fed room to hike rates is a weaker U.S. dollar. The dollar has declined by −3.0% so far this year, on a broad trade-weighted basis, losing about half its post-election bump, as expectations of a strong tax and spending stimulus from President Trump have been tempered. In recent years, the dollar exchange rate has acted as a kind of regulator of the U.S. economy, keeping it from blowing too hot or too cold relative to rest of the world economy. The tighter grip that a stronger dollar began to impose on the U.S. economy immediately after Trump's election, widening the trade deficit and shaving −1.8 points off GDP growth in Q4, is loosening again, keeping the moderate pace of growth from moving too far off track in either direction.

Another element that has helped bring the dollar's surge under control is stronger growth abroad, which makes aggressive easing by other central banks less likely, and reduces the pull exerted by Fed rate hikes on global capital flows. Markit's Purchasing Manager Index (PMI) for the Eurozone showed business expanding at its strongest level in six years, even as the ECB begins "tapering" its quantitative easing (QE) program. Brazil and Argentina both have new presidents committed to market reforms to reignite growth, while in India, Modi's pro-business reforms are making important, if highly uneven, progress. China is seeing renewed growth on the back of a new burst of fiscal and credit stimulus—though at the cost of adding to already dangerously high levels of debt. Meanwhile, fears that steps by President Trump to ramp up U.S. demand would lead to a global shortage in U.S. dollar liquidity, which hit emerging market shares hard in November, have receded, causing many of those markets to see a strong rebound.

The S&P 500 held steady in March, losing less than a point. So far it has gained +5.5% year-to-date. While operating earnings per share (EPS) in Q4 were up +21.0% from the same period a year before, helping to support valuation metrics, they actually fell −2.8% from Q3, and performance by sector was decidedly mixed. (Across the entire economy, unadjusted after-tax profits in Q4 were up +22.3% from a year before, and rose +3.7% from Q3). If quarterly earnings hold steady in Q1, as we expect them to, it would put the 12-month trailing P/E ratio at 21.4x. Historically, these are rich valuations, but even though the equity risk premium (ERP) between share prices and risk-free bonds has fallen from 6.3% just before the November election to 5.4% today, that is still well above the long-term average of 4.1%. While share prices are by no means cheap, the cost of seeking a safe harbor from whatever storm—real or imagined—that might worry investors is still quite expensive, in foregone returns while one waits for that storm to break.

We are often asked if this latest stock market rally is a bubble, or a new bull market. The answer is, it's neither: it's the old bull market, doing what it's been doing all along, climbing a wall of worry caused by shifting circumstances and uneven, if on the whole positive, data. Bull markets don't die of old age, they are killed by deteriorating fundamentals, or when inflation causes the Fed to lower the ax. Whatever concerns might be on the horizon—and there are plenty—we don't see imminent signs of either. That means we expect this aging bull to muddle on, through confusing times that are neither the best nor the worst.

April 11, 2017

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ECONOMIC FORECAST
(As of April 11, 2017)

	2014	2015	2016	Projected 2017
Real GDP (Y-O-Y)	2.4%	2.6%	1.6%	2.2%
Consumption Expenditures	2.9%	3.2%	2.7%	2.4%
Business Fixed Investment	6.0%	2.1%	-0.5%	2.0%
Inventory Investment (Billions)	$57.7	$84.0	$22.0	$20.0
Residential Investment	3.5%	11.7%	4.9%	2.0%
Government Spending * (Billions) (a)	$2,833.0	$2,883.7	$2,907.0	$2,951.0
Trade Balance-Goods & Services (Bil.)	-$490.2	-$500.4	-$500.6	-$515.0
Federal Budget*: Unified (Billions)	-$484.6	-$438.4	-$587.4	-$558.7
Gross Federal Debt* (Billions)	$17,794	$18,120	$19,537	$20,355
Consumption Price Deflator	1.5%	0.3%	1.1%	2.0%
Producer Price Index	0.9%	-7.3%	-2.6%	3.0%
Consumer Price Index	1.6%	0.1%	1.3%	2.5%
Industrial Production	3.1%	-0.7%	-1.2%	0.6%
Real Disposable Income	3.5%	3.5%	2.8%	3.0%
Average Hourly Earnings	2.1%	2.2%	2.6%	3.0%
Unit Labor Cost (Non-Farm)	2.0%	2.0%	2.6%	3.0%
Productivity Growth (Non-Farm)	0.8%	0.9%	0.2%	1.0%
Personal Savings Rate (% DPI)	5.6%	5.8%	5.8%	5.5%
Capacity Utilization – Total Industry	78.6%	76.8%	75.8%	76.0%
Trade Weighted $ Exchange Rate (b)	3.2%	16.1%	0.7%	2.5%
Vehicle Sales (Million Units)	16.9	17.8	17.9	17.5
Housing Starts (Million Units)	1.003	1.112	1.174	1.210
Civilian Employment (Millions)	146.3	148.8	151.4	154.0
Civilian Unemployment Rate	6.2%	5.3%	4.9%	4.8%
Corporate Profits – After Tax	2.5%	-8.5%	4.3%	4.0%
S&P-500 Earnings-Operating	$113.01	$100.45	$106.26	$117.00
S&P-500 Dividends	$39.44	$43.39	$45.70	$50.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.08	(0.02)-0.29	0.18-0.54	0.25-1.50
10-Year U.S. Treasuries-Yield (%)	2.07-3.01	1.68-2.50	1.37-2.60	1.50-4.00

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*

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