ECONOMIC OUTLOOK

bounty management

unique investment insight

Bounty Management Corporation
The Rice Building
10 High Street, 5th Floor
Boston, Massachusetts 02110
t 617.357.8285 *f* 617.451.9064

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The Rise of Populism
The Rollback of Globalization

Calendar year 2016 was a year that defied predictions. The U.K. vote to leave the European Union and the U.S. presidential election were just two signals of a desire for change among voters that moved markets over the past year. The U.S. and the world have been stuck in a low growth, low interest rate rut since the last recession and voters flocked to populists who decry the harm inflicted by globalization and immigration. The post-recession coordination of global policy has likely ended, with a greater divergence between global monetary and fiscal policies and between equity and fixed income returns. As two of three major central banks (European Central Bank and Bank of Japan) continue on paths of easy monetary policy, the U.S. Federal Reserve raised rates in December and promised more rate hikes for 2017. The positive U.S. stock market reaction to the Trump victory and Republican control of Congress is a first bet on sectors that benefit from fiscal stimulus (e.g., infrastructure spending), de-regulation, and tax cuts, all of which would contribute to increases in economic activity, earnings, inflation, and interest rates. Interest rate sensitive assets went in the opposite direction with ten year U.S. Treasuries dropping in value as yields rose to 2.45% at year-end.

Freed by a lack of details, investors could indulge in optimism after the election, a bet on action and more stimulus. Initial "Trump trade" moves in November have at best consolidated, and in some cases lost ground since early December. The global reaction has been muted, with European stocks neutral and emerging economies and currencies very clearly struggling. The reality of an unconventional President who has so far provided few policy details poses some risk and uncertainty. Unilateral ability to dismantle existing trade pacts or impose tariffs requires little oversight from Congress. If history is a guide, measures to repatriate foreign corporate earnings are likely to boost dividends and buy-backs, not investment. More worrying is that a roll-back of globalization might initially look like a clear win for the U.S. as wages rise, but with tariffs and possible trade wars to follow. Choose your term - nationalism, protectionism, or populism - these cats are all out of the bag, and 2017 brings key elections in France, Germany, and the Netherlands. Chinese authorities are unlikely to sit quietly as the country has its own political transition in the fall.

More fundamentally, this is not the 1980s, when tax reform came amid far higher tax rates, double-digit interest rates, and a developed world filled with a substantial and rising share of workers entering their prime earning and working years. Even if fiscal stimulus and tax reform come without the downsides, those coupled with restrictive immigration policies at a time of low unemployment will tend to be inflationary, requiring a different policy response from the Federal Reserve. Tighter financial conditions and a stronger dollar will temper growth, and the consequences of any serious foreign policy missteps cannot be overstated.

U.S. Economy

In the first six months of 2016, growth averaged 1%. The second half began with Q3 at 3.5% although nearly one percentage point was from a quirky surge in soybean exports. Expectations for Q4 are for roughly 3% growth. With the lowest jobless rate since 2007, 4.7% in December, wage growth and consumer spending are rising. A tight labor market, coupled with lessening of immigration flows, or a quicker pace of deportations, should raise American workers' wages if textbook relationships hold, but prices would need to rise too. The Federal Reserve raised interest rates in December to 0.75%, and officials are closely monitoring risks to the outlook. Dollar strength, trade shocks, or financial instability in the new era are key downside risks, but fiscal stimulus risks juicing inflation above target. The Federal Reserve's growth projections at 2.1% for 2017 were raised slightly, but the long-term projection of 1.8% for economic growth has not changed. Our 2017 U.S. growth forecast is in the range of 2.0% to 2.4%.

Real Estate

The volatile housing market of the past 15 years is showing a widening divide between the coastal areas and more affordable inland regions. Average home prices rose 5.6% in the 12 months through October. Much of the increase since 2008 has been concentrated on the high end: homes worth between $500,000 and $1 million are now worth 103% more than 16 years ago vs. a rise of 24% for homes with values less than $150,000. Even though unemployment is low and home prices have surged, the number of single family homes under construction remains at recessionary levels. Adjusting for population growth, construction is barely back to the prior troughs of recessions in 1981 and 1991. Reasons range from student loan debt, poor job prospects, stagnant wages, and tight mortgage lending standards. Rising interest rates will obviously not help here. A 1% increase in mortgage rates can shave nearly 10% off a loan amount for a given monthly payment.

Employment and Wages

Average hourly earnings rose to +2.9% y/y in December, while average weekly earnings remained pinned at around 2% y/y. Key trends of automation and robotics are in their early stages in industries like retail (see Amazon's physical store with no checkout counters), transportation (driverless vehicles, package delivery), and food services, but acceleration in coming years might put in jeopardy the very service sector jobs that have formed the bulk of recent years' job gains. McDonald's plans to introduce automated kiosks at all U.S. locations in November - the firm employs two million people worldwide. A wave of state minimum wage increases have helped drive faster wage growth in leisure and hospitality (4.4% y/y), retail trade (2.5% y/y), but also high-demand sectors like information services (4.4% y/y).

Consumer and Manufacturing

A surge in consumer sentiment followed the Trump election with the key Michigan survey up from 93.8 to 98.2 in December (a 12-year high!), just off a two-year low of 87.2 in October. Results through October were declining and matched a deceleration in real income growth as price inflation recovered. Economists use the term "animal spirits" to refer to the importance of confidence in the future in generating action today and we will test that premise in 2017. Before we get ahead of ourselves, that same sentiment survey above showed consumers' assessment of home buying conditions ended the year around 4-5 year lows, and perceptions of the vehicle market softened as well. Incentives boosted light vehicle sales to a post-recession high at 18.3 million in December. Brick and mortar retailers were increasingly under pressure - department store sales fell 6.4% y/y in November compared to a rise of +11.9% y/y for on-line shopping.

World Economy

Europe

There is a growing sense that the logic in how or why further bond purchases should boost inflation has broken down. With firmer current inflation and a 5-year high in the Eurozone manufacturing PMI as a backdrop, the European Central Bank (ECB) scaled back its bond purchase program to a pace of €60B a month (from €80B), while extending it for nine months through December 2017. The adjustment keeps the program intact in the event more or less stimulus is required ahead of what will be a risky year with several key elections. Italy rejected allowing constitutional changes and voted "no" in its key referendum in December. The previously popular Prime Minister Renzi was shown the door, and an anti-establishment theme may mark elections in France, Germany, and the Netherlands.

Japan

GDP growth rose 1.3% annualized in the third quarter, after 1.8% in the second quarter. Along with the ECB, the Bank of Japan (BOJ) remains a key source of liquidity injections, having committed to continue buying assets in an attempt to get inflation sustainably toward 2%. Even 0% has been tough to maintain (0.1% ex-food-and-energy in November), but a 15% drop in the yen in Q4 should provide a temporary boost via import prices. Increasingly negative demographic pressures are restraining real consumer spending and puts the onus on fiscal policy and exports. Protectionism creates risks for the latter. Improvement in the trade balance in recent years has been driven by a faster drop in imports (-23% since year-end 2014, in large part on oil) than exports (-8%), not an export surge.

China and Developing World

Chinese Manufacturing PMIs have turned higher. 2016 ended with the highest readings in several years as a massive expansion of credit filters through the economy. Official estimates of economic growth showed a steady 6.7% y/y rate of expansion in Q3. Stable top-line growth masks significant debt growth under the surface and authorities are watching surging home prices in key cities. The 70-city average of home prices accelerated to 10.5% y/y in November (Beijing 26%, Shanghai 29%). Tamping down on unsustainable growth requires hawkish policy, but that is complicated by the autumn 2017 National Congress of the Communist Party (latest since 2012). Domestic stability is a key concern and a shifting international landscape raises risks on the foreign policy front. The U.S. President-elect will find that regional players may band together to create "great deals" of their own, and trade wars will be a high-profile risk to monitor. The IMF recently raised its forecast to 2.3% growth in 2017 in the US and world growth of 3.4%. Our world GDP forecast is 3% due to the effect of the stronger dollar, lower emerging market growth, and a risk of currency devaluations.

Commodities

Crude oil prices ended the year above $50 per barrel, up 39% for the year. Although the annual average West Texas Intermediate (WTI) crude oil price in 2016 was $43—down $5 from 2015—the WTI price ended 2016 at $53, $16 higher than at the end of 2015. Despite robust demand for petroleum products, relatively high production and inventory levels provided downward pressure on crude oil prices throughout most of 2016. However, recent agreements to curb production over the next six months within the Organization of the Petroleum Exporting Countries (OPEC) and additional pledges by some key non-OPEC producers put upward pressure on prices at the end of 2016. Gold prices rose +9.4% in 2016. Gold remains a safe-haven asset and a hedge against macroeconomic uncertainty and fiat based paper currencies.

Investment Perspective

By the middle of this year, the current economic expansion will be the third longest since World War II. Unemployment is under 5%, the Fed is raising rates, and housing and stock prices are hovering around previous peaks. In normal times, these data points are indicative of the top in a business cycle. Fortunately, the market is still being held aloft by the prospect of more stimulus and relatively low interest rates. Even though the Fed has not committed to more quantitative easing, they are maintaining a $4.5 trillion balance sheet by reinvesting in bonds that are rolling off until the "normalization of the level of the federal funds rate is well under way." Proposals for more fiscal spending and lower tax rates are adding more stimulus after years of quantitative easing and zero percent interest rates. Most forecasts for 2017 are centered on a narrow range of expectations with 2% GDP, the 10 year Treasury rate of around 3%, and single digit returns for the U.S. stock market. Our experience shows that if all the experts agree then usually something else happens.

As the new administration tries to spark economic growth with tax cuts, spending, and regulatory rollbacks, they face two obstacles we have discussed in previous updates: an aging population and stagnant productivity. The potential growth rate for an economy is the sum of these two factors – population and productivity. In recent years, U.S. population and productivity growth have averaged about .75% or 1.5% in total, about half the rate of 40 or 50 years ago. Over the past 1,000 years no economy has broken free of the limits imposed by population growth. Before the 19th century, population growth was below ½% and growth was not above 1% over any sustained period. After WWII, the baby boom pushed population growth to 2% and economic growth to nearly 4%. Now as families around the world have fewer children, global population growth has fallen to about 1%. Even with additional stimulus, the long-run growth rate is still in the 2% range. A nation can partly compensate for lower population with more immigration, but this is unlikely. Fiscal and monetary policies that push growth beyond its potential level for too long carry the risk of provoking a volatile boom-bust cycle, overheating the economy, and generating high inflation.

Despite the length of the current U.S. economic cycle and stretched equity valuations, we still favor stocks and commodities over bonds. The U.S. economy may expand further in 2017 owing to supportive fiscal policies, growth and improved corporate earnings. Interest rates have been rising since last summer. A rising rate environment means that the returns in traditional fixed income will be muted, especially for longer-term bonds with the greatest exposure to rising rates. Even with the move up in rates, shorter-term, high quality bonds still have an important role for stability in balanced portfolios. In equities, we favor industrials, energy, technology, and telecom. Healthcare remains a core long-term trend, but may underperform depending on the shape of healthcare reform. We may make adjustments in the overall asset allocation mix over time, but finding value and maintaining a strict discipline are the keys to positive long-term investment results. Although there is considerable uncertainty with the transition to a Trump presidency, investors have so far shown optimism. We will as always remain vigilant.

December 31, 2016
DJIA: 19,762.60
S&P 500: 2,238.83

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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