Quarterly Newsletter

Fourth Quarter Review: Stranger than Fiction

Like every calendar quarter, the last quarter of 2016 contained three months. From the standpoint of asset market performance, though, we might as well just breeze right through the first month and eight days and start in the waning hours (East Coast time) of November 8. While our fellow citizens absorbed the realization that the maps on their television screens were starting to turn a decisive shade of red, stock futures indexes plummeted and set off the “circuit breakers” stock exchanges employ to contain price crashes. The selling abated, Clinton conceded and presumed winner Trump invoked the word “infrastructure” in his victory speech. A few hours later, markets opened and a new theme called the “reflation-infrastructure trade” was unleashed into the world. That theme would dominate the remaining weeks of 2016 and, with little more than an occasional hiccup, pick right back up as 2017 got under way.

The idea behind the reflation-infrastructure trade is that aggressive stimulus of the fiscal – rather than monetary – variety is back after a prolonged absence in which nothing got done in Washington. Infrastructure spending would be a big part of this, as would tax cuts on both wealthy individuals and corporations, and a major dose of deregulation to boot. The spending unleashed by both private wallets and the public purse would push up prices and thus rekindle long-dormant inflation, while public works projects would manage to add a point or more to real GDP growth.

By the end of the year, markets seemed to have priced in this outcome with a level of confidence bordering on certainty; while the S&P 500 set nine new record highs from Election Day to December 31, the CBOE VIX index, the market’s so-called “fear gauge” – was at multi-year lows. Financial institutions, energy stocks, a variety of resource commodities were the primary beneficiaries of the reflation-infrastructure trade. The US dollar also kicked back into rally mode, pushing down the yen and bringing the Euro closer to dollar parity. The idea that a strong dollar might be harmful to US corporate earnings barely registered. Meanwhile, prices on safe haven assets like gold and Treasury securities fell sharply. Bond yields soared, with the yield on 2-year Treasuries reaching highs last seen in 2009.

First Quarter Outlook: Reality (Maybe) Bites Back

The most curious thing about the reflation-infrastructure trade is how little empirical data exists to suggest that a new era of economic growth through fiscal stimulus is at hand. We’ve even had pointed commentary from Fed officials, including Chair Yellen herself, to the effect that the current pace of growth and in particular the strong trends in jobs payrolls and wages make fiscal stimulus unnecessary at best and potentially harmful at worst. Individual tax cuts tend to have a fairly weak economic multiplier effect, as evidenced by previous programs. Corporate tax reform is probably the one agenda item that could – if done right – produce meaningful economic benefits. However, there is little in the way of detail as to what a Trump plan may involve. To us, the market appears priced for perfection when there is a better than likely chance that some outcome other than perfection will result.

If we take stock of the economic landscape, what strikes us is how little things appear to have changed over the last year. Growth remains positive but below historical trends. Job growth continues, and inflation does appear to be heading towards the Fed’s two percent target rate. But global demand remains weak, the dollar’s strength continues to act as a headwind for US company sales, and the recent slow pace of business investment may continue to impede significant improvements in profit margins. The forecasts of Fed policymakers released after the December FOMC meeting (when the Committee went ahead with a 0.25 percent increase to the Fed funds target rate) showed little change either in economic outlook or interest rate assumptions over the next several years. The “cloud of uncertainty” (in Yellen’s formulation) contrasts with the market’s reverse-Murphy’s Law (if something can go right, it will!) pricing of risk assets.

Conditions, then, would seem ripe for a reset. That said, momentum trends like the reflation-infrastructure trade have the ability to defy attempts to time their demise. We could foresee a series of reality checks, perhaps during the closely-watched first hundred days of the new administration. That could catalyze the kind of pullback we haven’t seen since early last year, a drawdown of some five to ten percent or so. We don’t see much of a compelling case for a more sustained downturn, though, in the absence of any signs of a looming recession. Perhaps another bout of sideways trading, similar to much of 2015 and the first ten months of last year, is in store for 2017. But any base case has to acknowledge the potential for big surprises this year. Plan for the likely, but imagine the unimaginable.

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