January 2017 Market Commentary – Make America Inflate Again

Key Benchmarks: Performance and Characteristics as of 1/31/2017

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range
S&P 500	1.9%	1.9%	1.9%	18.9x (11.4x – 18.9x)
MSCI EAFE	2.9%	2.9%	2.9%	16.4x (9.2x – 17.8x)
MSCI Emerging	5.5%	5.5%	5.5%	13.6x (7.8x – 17.2x)

Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Barclays Aggregate	0.2%	0.2%	0.2%	US REITs	0.1%	0.1%	0.1%
Barclays US High Yield	1.5%	1.5%	1.5%	GSCI Commodities	-1.4%	-1.4%	-1.4%
Morningstar Global ex US	1.5%	1.5%	1.5%	GSCI Prec Metals	5.5%	5.5%	5.5%

Data Source: Bloomberg

Highlights:

- January turned out to be a reversal on what worked in the 4th quarter of 2016. Large cap growth and momentum styles dominated U.S. equity performance while ex-U.S. markets outperformed the U.S. on the back of a weakening U.S. dollar.
- Fixed income was flat as Treasury yields fell from intramonth highs on more muted expectations of policies coming out of the new administration.
- Precious metals also reversed their 2016 poor performance reflecting the heightened macro uncertainty surrounding the executive orders pushed through by the new administration.
- Make America Inflate Again? The tectonic forces of cyclical reflation and secular disinflation are running up against one another and the fulcrum appears to be the long-term break-even rates between nominal Treasury yields versus TIPs currently at 2%.

- The upshot of positioning in this new regime: get more of your cyclical risk in equities and less of it in fixed income.

Make America Inflate Again

Source: istockphoto

The January Reversal – What Worked in the 4th Quarter Lagged This Month

Whether it was profit-taking or the markets questioning the Trump reflationary trade, the cyclical risk assets that drove strong year-end performance took a breather while asset classes and styles that lagged in the prior quarter, such as precious metals and momentum, performed well (Exhibits 1 and 2).

Exhibit 1: Precious Metals Makes a Comeback in January…

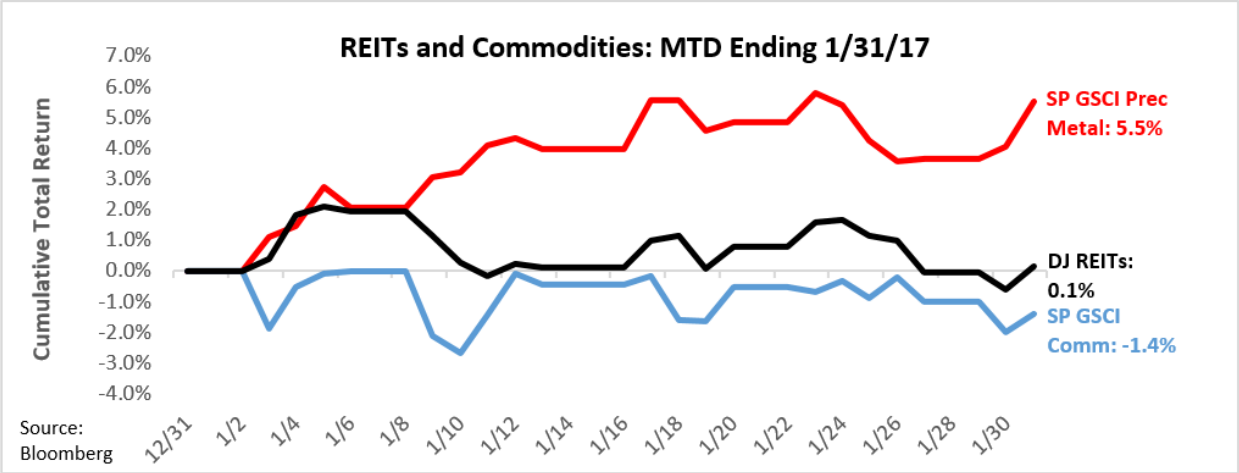
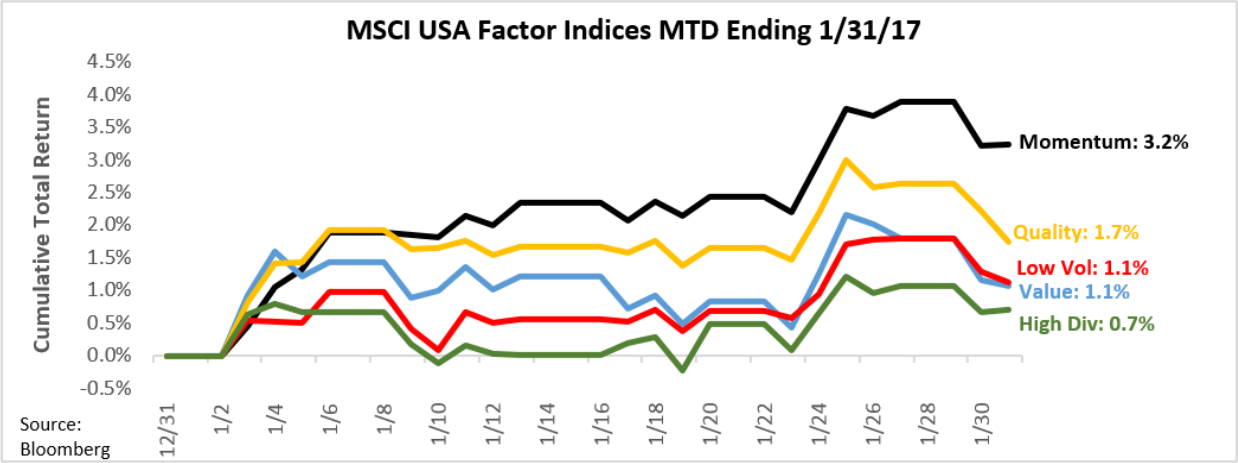


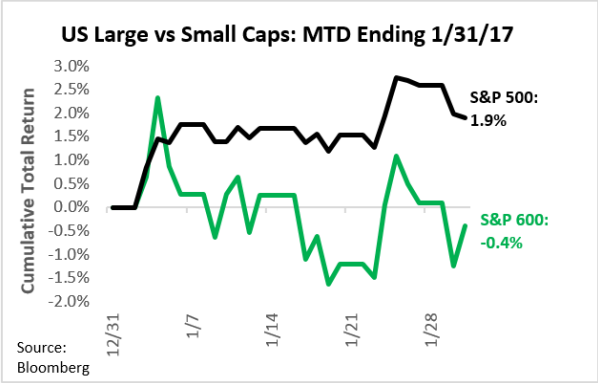
Exhibit 2: …As Does Momentum

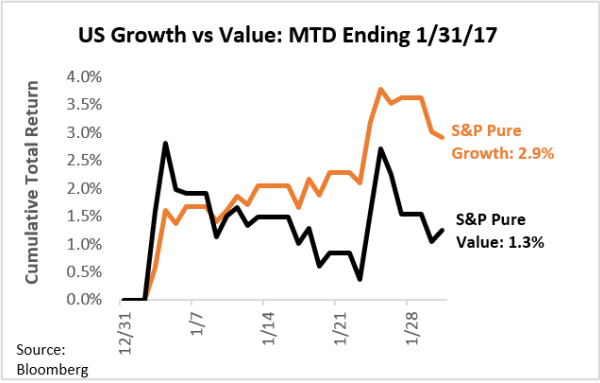


Fixed income turned in a flat month although investors continue to thirst for below investment grade high yield credit. In addition, after having lagged U.S. markets following the election, non-U.S. developed and emerging markets outperformed the U.S. market on the back of a weakening dollar (DXY) which dropped 3.6% during the month partly in response to concerns over President Trump's blitzkrieg of executive orders covering immigration and his negative statements over relations with key trading partners.

Large cap growth (Exhibits 3a and 3b) outperformed in January as technology companies reported strong 4Q earnings, which helped support the market advance.

Exhibits 3a and 3b: US Large Cap Growth Outperforms





January's market performance largely amounted to investors coming to grips (and reality) with a dramatic shift in policy and tone coming out of the new administration. In addition, the market remained on edge concerning how aggressive the Fed will rate hikes this year as well as whether company earnings will meet heightened expectations for the next year or so.

Reflating America (and the World)

This month, readers of 3D's monthly market commentary get a twofer. In addition to highlighting what drove market performance this past month, we provide an update on the global cyclical versus secular disinflation theme that we've been writing about for the last several months. Normally, we would dedicate a separate article to this topic, but it has become apparent that the interaction of these two tectonic forces will drive pricing of short- and long-term investable securities; hence, a play-by-play update of this ongoing battle warrants inclusion in this month's market commentary.

In our 2016 Year-End Market Commentary, we wrote:

"…something fundamental seems to have changed – a tectonic shift of sorts – following the June Brexit vote and U.S. November electoral outcomes. The market is now forecasting that a tangible cyclical recovery will take root, at least in the U.S.; a cyclical recovery strong enough to overtake the longer-term secular disinflationary pressures that have defined the "New Normal" forces of excess global capacity, aging demographics, and high debt levels."

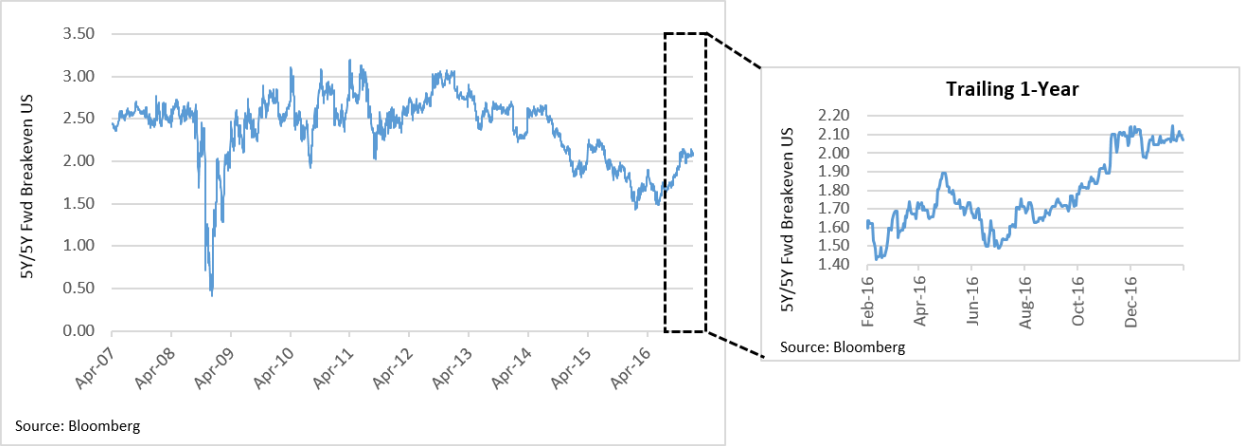
As we've observed since last September, global markets have been experiencing a global reflation trade which began shortly after the June 2016 Brexit vote referendum. The reflation trade accelerated with the November election and expectations for policies to be enacted under the new administration. U.S. small cap value and commodity prices recovered at such a strong pace since the election as to suggest that the world just exited a recession (just like they did following the 2008 recession), which in some ways, felt like a recession given the magnitude of the sell-offs in cyclical risk assets from late 2014 through early 2016.

We've also seen the 'Trumpflation' trade back off a little in January as the markets grapple with a flurry of executive orders covering immigration and trade stances and whether the subsequent uproar will burn too much of this administration's political capital, which will be needed in pursuit of regulatory and tax reforms. Incidentally, there is a debate concerning the uproar over this administration's latest executive actions on immigration as to whether these executive actions are merely a noisy sideshow designed to distract and exhaust political opposition from blocking more substantive initiatives.

Nevertheless, the near-term should continue to favor the cyclical reflation trade benefiting global industrial sectors, commodity producers, and levered borrowers. A more hawkish Fed could preempt further run-ups, but the Fed also needs to navigate a narrow corridor between 1) dampening animal spirits that could lead to credit bubbles and spiraling inflation versus 2) sending the country into recession due to overaggressive tightening. Per Fed Funds futures, the markets are pricing in a low probability of a March rate hike and only two rate hikes through the rest of the year versus the three implied by the latest Fed statements.

How all this is being priced into the markets can be viewed through the break-even rates implied by the spreads between nominal U.S. Treasury yields versus U.S. Inflation-Protected Securities (TIPS) yields. Exhibit 4 displays the 5-year/5-year forward break-even rates which remain comfortably above 2% despite the January reversal of the Trumpflation trade.

Exhibit 4: 5-Year/5-Year Forward Inflation Expectations Imply Cyclical Reflation Remains Intact



Make no mistake – global inflation is on the rise (Exhibit 5). This is largely due to the run-up in commodity prices, namely energy; however, with the exception of Japan, core inflation figures (which exclude energy and food prices) are also on the rise (Exhibit 6).

Exhibit 5 – Global Inflation on the Rise

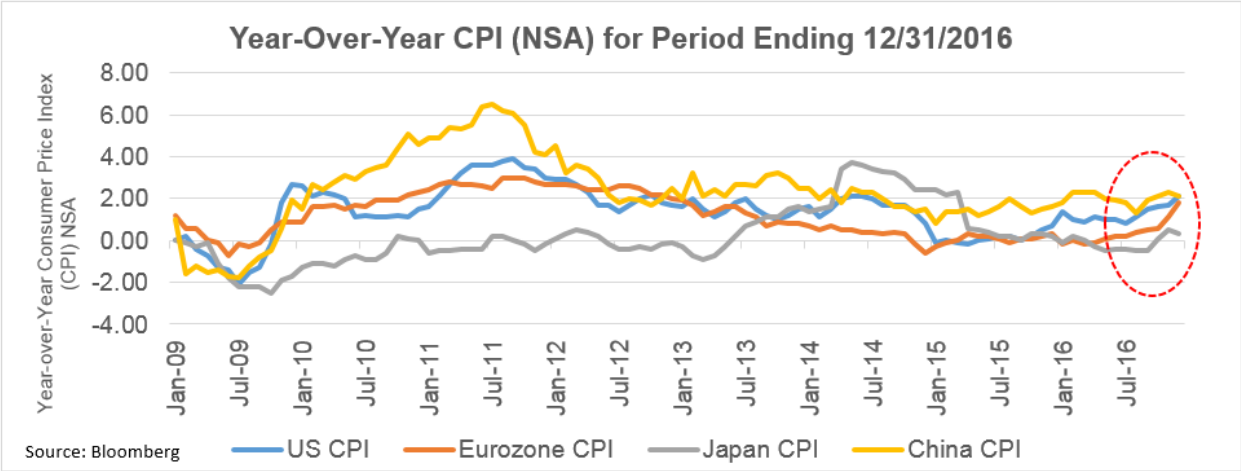
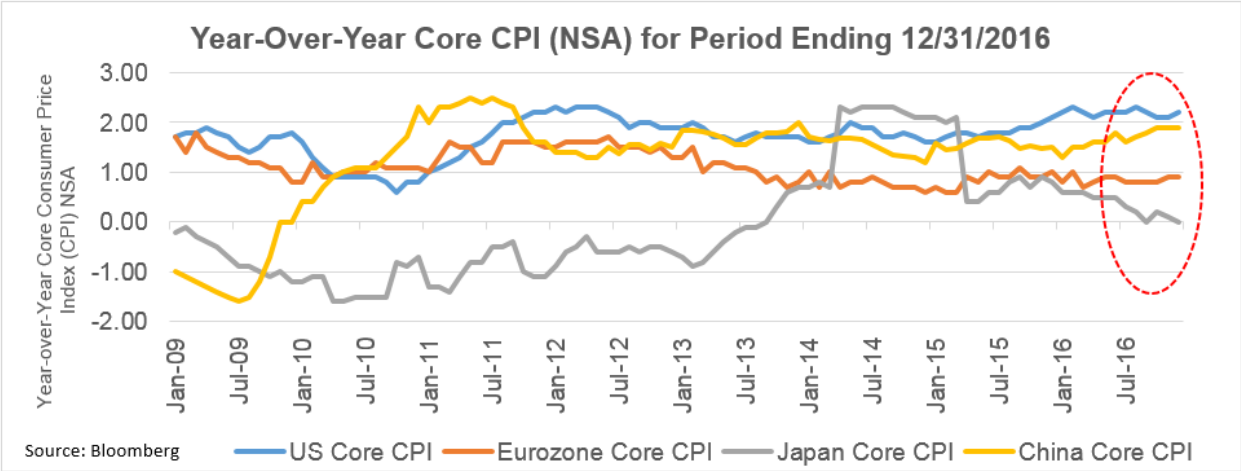


Exhibit 6 – Global Core Inflation Also on the Rise



Private wage growth (Exhibit 7) has been slowly recovering and could see further upward pressure given the tight labor markets.

Exhibit 7 – Rise in Private Wage Growth Will Put Further Pressure on Inflation

Longer-term, the tectonic battle between cyclical reflation and secular disinflation could result in the worst of outcomes, namely stagflation. A move towards de-globalization through the imposition of cross-border taxes and import tariffs would pose longer-term ramifications on productivity and standards of living. The research staff at Renaissance Macro Research highlighted several Federal Reserve and IMF studies stressing the importance of maintaining innovation in the face of secular disinflation brought on by aging demographics, high debt levels, and global excess capacity.

"Import Penetration and Domestic Innovation: A View into Dynamic Gains from Trade" published by Maria D. Tito, demonstrates the link between import penetration and innovation activity as manifested through patent applications. The paper maintains that the threat of cost-competitive imports (particularly out of China) drives domestic companies to focus capital on research and development to counteract competitive threats. Neil Dutta from Renaissance Macro believes that the increased focus on trade protectionism could reduce the incentives for U.S. companies to innovate resulting in a loss of global competitiveness. This would negatively impact

productivity which is already anemic due to a lack of fixed capital spending, although the loss in productivity could be alleviated by a more benign regulatory environment to incentivize greater domestic business activity.

Another paper speaks to the longer-term drag of aging demographics on total factor productivity as can be observed in Japan. In "The Impact of Demographics on Productivity and Inflation in Japan," published by Niklas J. Westelius and Yihan Liu from the IMF, Japan's aging demographic and declining population are "hampering growth and reflation efforts" and have "had a significant negative impact on total factor productivity."

So, rising trade protectionism mixed with the secular disinflationary forces of aging demographics, which most industrialized nations are now facing (including China), will weigh on productivity growth – a recipe for stagnation where, outside of a cyclical boost in growth, would lead to a Bad New Normal of low growth but with higher prices.

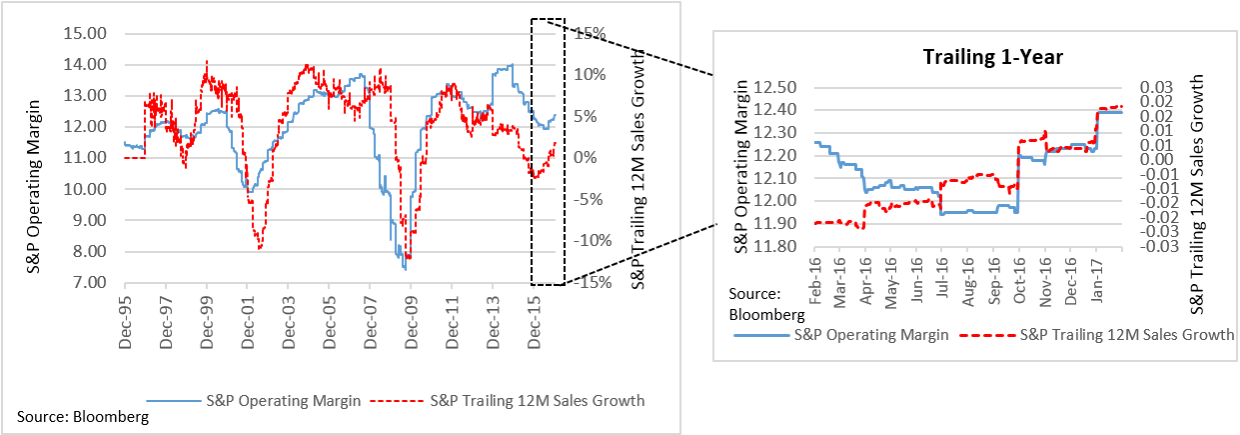
Offsetting this scenario will be technological innovation in which one insulated-and-protected industry after another succumbs to technological disruptions resulting in unanticipated shifting patterns of consumption at lower prices. This Vanity Fair article ("Why Hollywood as We Know It Is Already Over") outlines the disruption faced by film production that has already hit music, publishing, and other industries. Here is a quote worth highlighting:

"Hollywood, these days, seems remarkably poised for a similar disruption. Its audiences increasingly prefer on-demand content, its labor is costly, and margins are shrinking. Yet when I ask people in Hollywood if they fear such a fate, their response is generally one of defiance. Film executives are smart and nimble, but many also assert that what they do is so specialized that it can't be compared to the sea changes in other disrupted media. 'We're different," one producer recently told me. "No one can do what we do." That response, it's worth recalling, is what many editors and record producers once said."

One is hard-pressed to identify an industry that has not faced technological disruption – financial services being a prime example with the advent of exchange-traded funds (ETFs) and robo-advisory platforms. Hence, one can understand the outcry coming from U.S. tech companies over the H1B visa restrictions being proposed by the Trump administration. Rising protectionism could just mean delaying the inevitable for many domestic industries protected by higher trade barriers, but those industries would still end up falling behind due to an unwillingness to maintain high levels of innovation.

The long-term implications may be difficult to map out, but the recent rally in the 30-Year Treasury Yield versus the 10-Year can be interpreted as investors expecting the longer-term secular forces overwhelming the near-term cyclical reflationary bounce. Rising input costs can also show up in a profit margin squeeze, keeping a lid on final prices, but at the expense of corporate profitability which, more recently, has enjoyed historically high profit margins offsetting anemic revenue growth (Exhibit 8). Over the longer run, there exists a strong relationship between S&P profitability and revenue growth due to the high operating leverage enjoyed by large cap companies, particularly in financial services and technology. S&P companies have enjoyed 20 years of globalization which may now be reversed under the new regime; we could now see a breakdown of this positive relationship between revenue growth and profitability.

Exhibit 8 – S&P Profitability and Revenue Growth Tied at the Hip (Until Now?)



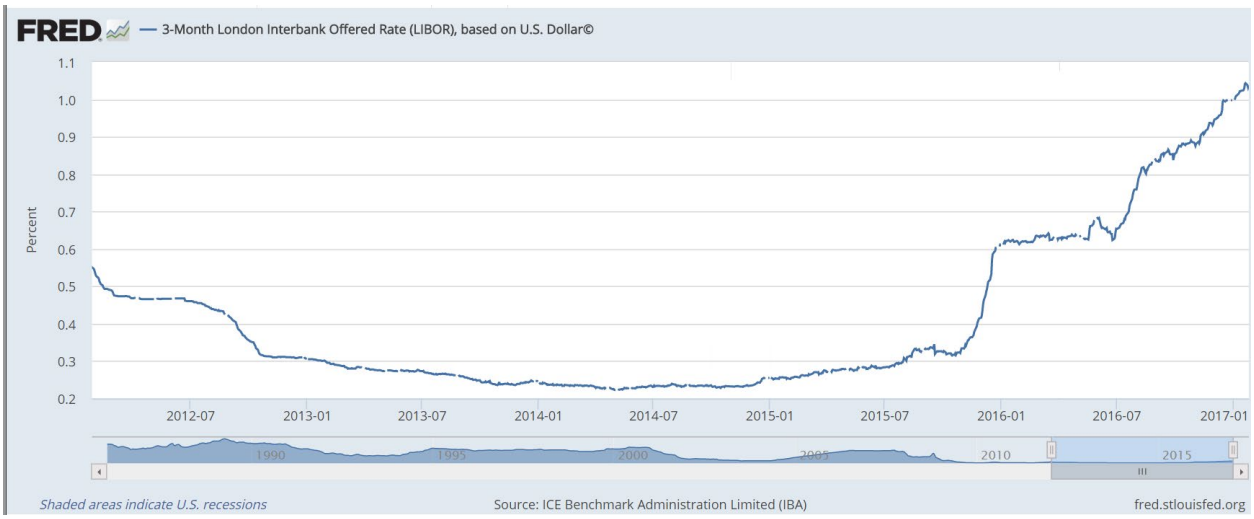
All this may not matter for this year nor the next as sell-side analysts have ratcheted up their fiscal year 2017 operating earnings estimates for the S&P 500 to $131.11 from $108.52 (a 21% increase) based on 57% of companies reporting 4Q results so far. In the wake of Trumpflation and policy uncertainty, the forward valuation multiple may come down from its 10-year high, but the markets should continue to advance alongside earnings growth. Cyclical reflation is here to stay although eventually the move towards de-globalization will need to be arrested for this current reflationary cycle to sustain itself.

Ultimately, how markets react to 'Making America Inflate Again' comes down to whether the inflation is cost-push (i.e. the 1970s) or late cycle catch-up. How much of the intermediate cost pressures will show up in final prices (i.e. core inflation) remains to be seen. In addition, what will be the productivity impact from policies that either incentivize or inhibit innovation? These issues will play out as we move beyond the 2016 commodity price recoveries to get a sense for the true run rate of inflationary trends.

Positioning in a Trumpflationary Landscape

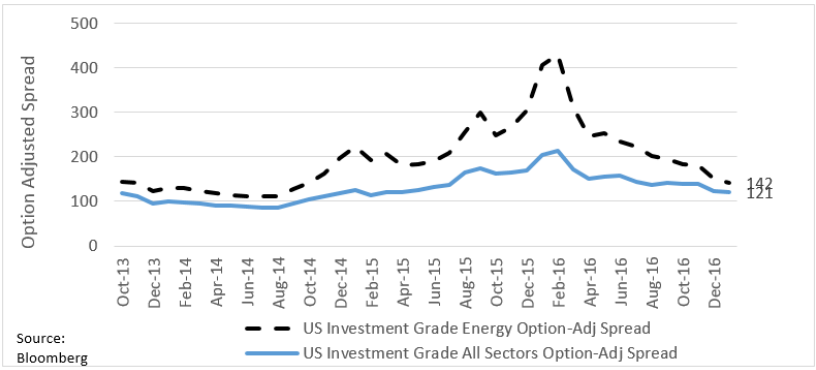
Readers interested in hearing more about positioning for a Trumpflationary environment should register for our upcoming webcast, "Trump vs Bonds – What's next?" which will include fixed income ETF specialists from Powershares and First Trust. TIPs have largely priced in 2% inflation for the foreseeable future, so investing in TIPs or inflation swaps amounts to a bet that inflation will come in higher than what is currently priced in. On the other hand, the 3-Month London Interbank Offered Rate or LIBOR, which serves as a reset point for many floating-rate loans issued with LIBOR floors, has risen above 1% (Exhibit 9). LIBOR is expected to rise with the Fed Funds rates, so shortening the duration (or interest rate sensitivity) of your fixed income portfolio may make sense if one believes the Fed will hike more aggressively than what is priced into the bond market. The intermediate part of the curve (3-7 year range) may be more at risk versus the short- and long-ends of the curve as a more aggressive Fed would reduce the profitability of so-called roll-down trades (investing in the steepest part of the curves to take advantage of rates rolling down from year to year).

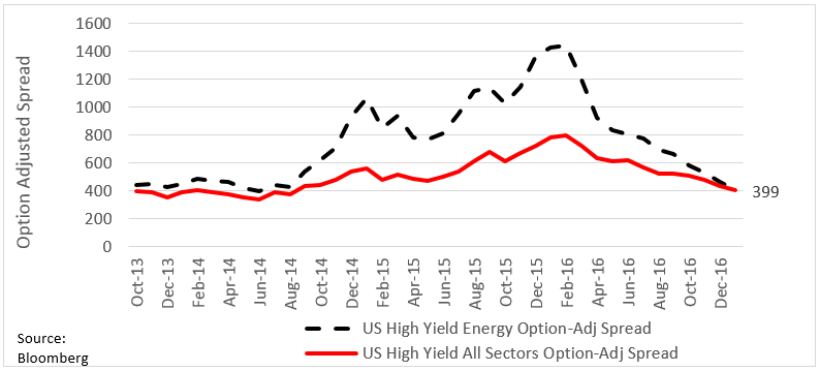
Exhibit 9: 3-Month LIBOR Crosses 1%



One may argue that both equities and fixed income have fully priced in a second wind for global growth, yet equities participate more in cyclical upside surprises than fixed income. For fully invested balanced portfolios, why take on more cyclical risk in fixed income via traditional high yield and emerging market debt? At this point, given how narrow credit spreads have gotten (Exhibit 10), take your 'equity risks' in equities while keeping fixed income positioned for downside surprises.

Exhibit 10: Energy Sector Credit Now Trades in Line with the Broader Credit Markets





Disclosure:

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