NEWPERSPECTIVES

Commentary from New Century Advisors

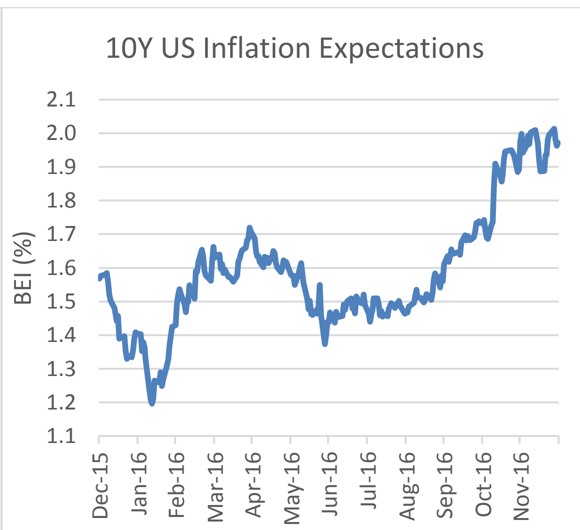
January 2017

Overdone?

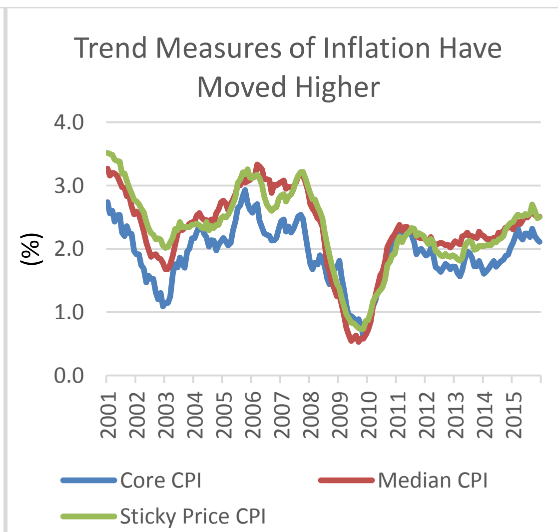
The tectonic plates of the financial markets shifted quickly following Donald Trump's election. Treasury rates sold-off and inflation expectations jumped dramatically along with equity prices. While these moves anticipated the benefits of growth oriented policies, the truth is inflation expectations were already rising and investors had priced in a Fed hike. Let's curb at least some enthusiasm, as the anticipated shifts in policies just do not happen overnight. And after January 20th, investors might be disappointed when they realize that Trump is unlikely to be able to fulfil all of his campaign promises immediately. Here are a few observations about financial markets going into 2017.

Inflation

- **Inflation expectations were already rising headed into the election**. The resulting near-certainty of fiscal stimulus has solidified these expectations. Energy price declines have masked inflation pressures that have been quietly building since 2014.

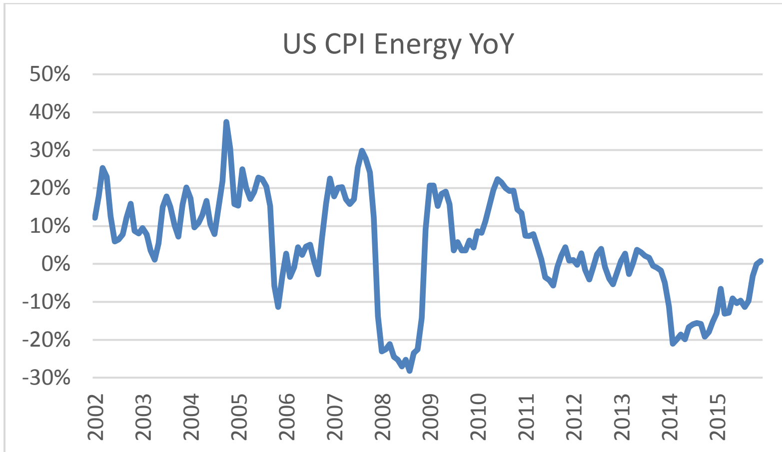


Source: Bloomberg



Source: Bloomberg, BLS, Cleveland Fed, Atlanta Fed, NCA

- **At the same time, energy disinflation has abated**, further supporting these expectations.

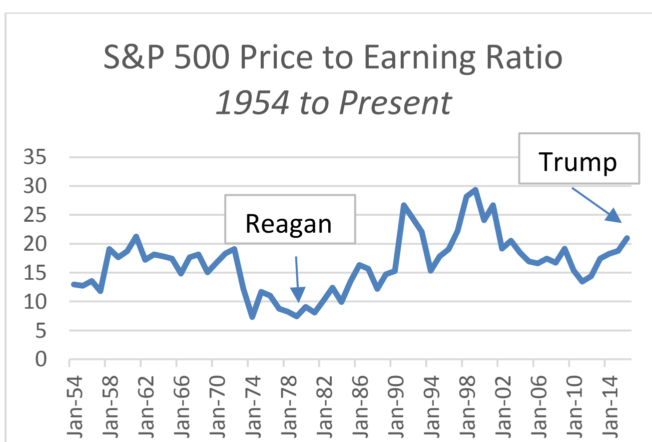


Source: Bloomberg, BLS, NCA

- **While TIPS BEIs have recovered dramatically from the Feb 2016 lows, we do not think the move is overdone.** The asset class will of course remain susceptible to a rollover in energy prices and reversal in general risk sentiment. However, we think the tailwinds of higher headline inflation prints over the next year should provide a floor for BEIs, leaving investors the potential for upside should the economic and policy backdrop evolve as hoped.

Growth & Equities

- **The stock market rallied over 6% since the US presidential election.** Investors quickly priced in higher rates and their impact on bank earnings, the prospect for lower corporate taxes, and general relaxation of federal regulation. It is very easy to compare the next few years to the early 1980s and beginning of the Regan presidency. There is one slight difference. The P/E on the S&P 500 was in the single digits in the 1980s, now the P/E on the S&P 500 is close to 20x.



Source: Bloomberg

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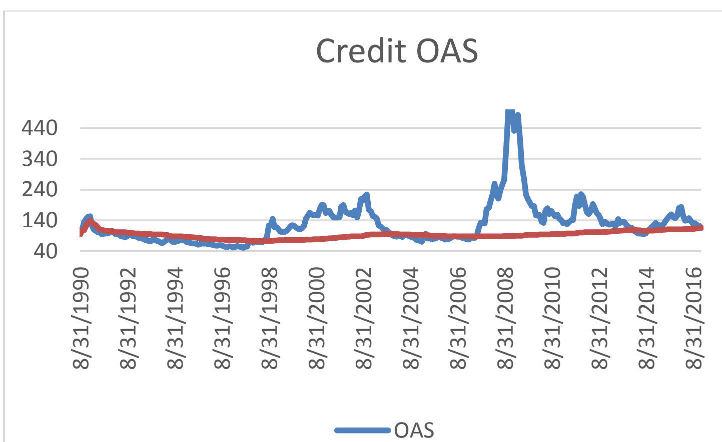
- **Trump's proposed corporate tax cut from a top level of 35% to 15% has investors optimistic for earnings growth**. Yes, that is a dramatic cut. But, when you dig deeper, one sees that the effective tax rate for the S&P 500 is close to 27%. Furthermore, the US House tax reform plan outlines a corporate tax cut that is closer to 20%. Thus, the savings may not be as meaningful as investors are hoping.

Median Effective Tax Rate by S&P 500 Sector	
Consumer Discretionary	32.3%
Consumer Staples	31.9%
Energy	26.0%
Financials	27.4%
Health Care	25.0%
Industrials	31.4%
Information Technology	23.1%
Materials	27.8%
Telecommunications	33.6%
Utilities	34.0%

Source: Thomson Reuters I/B/E/S

Credit

- **Despite having an exceptional year in 2016 with credit posting a positive excess return of 4.42% and the index now at a 25 year median OAS of +115, consensus expectations for 2017 are still bullish for further spread tightening.** Looking at where spread tightening would likely come suggests a further flattening in long dated credit curves and as well as continued spread compression between BBB and Single A rated credits.
- **Sector selection will also be key to further index tightening in 2017** with an expectation for historically wide sectors such as Energy to continue to tighten. Not surprisingly, the biggest risk cited for bullish outlooks stems from uncertainty around the new administration's policies and whether perhaps all the good news of tax cuts and fiscal spending is already priced into risk markets.



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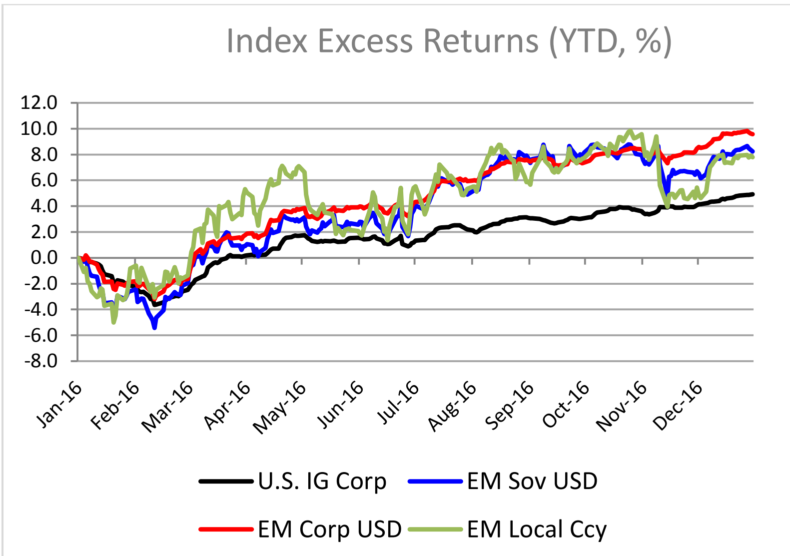
Source: Bloomberg Barclays Index, NCA

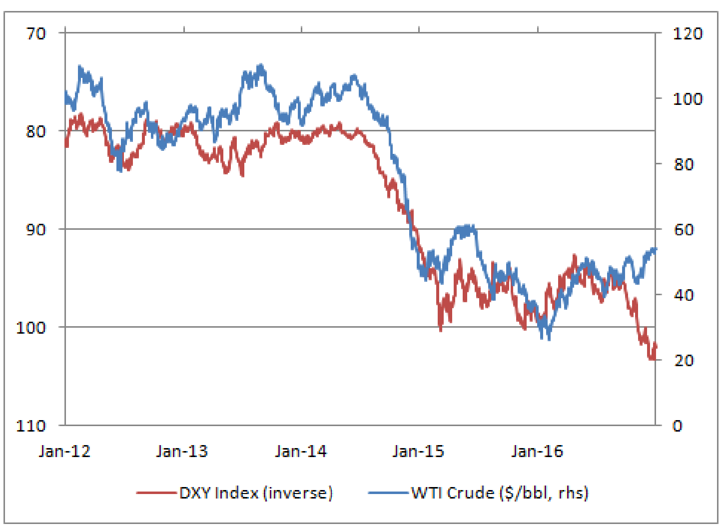
Global

- **Emerging market (EM) bonds had the best performance since 2012**, supported by the strong rally in commodities, growth recovery in developed countries and the lack of China-related headwinds. Both EM sovereigns and corporates ended the year with high single-digit positive excess returns. The outlook for EM bonds in 2017 is generally positive as global growth continues to accelerate. We prefer select hard currency credits, and EM rates and FX against the USD.



Source: Bloomberg, J.P. Morgan

- **One interesting macro trade to watch in 2017 is the crude-USD correlation** that broke down in the fourth quarter of 2016. Historically, the dollar's value generally declined when crude prices rose. However, in 4Q16 both crude prices and the dollar index rose, appreciating 11% and 7%, respectively. This correlation breakdown could create trading opportunities in the first half of the new year as the dollar and crude prices start to move in line with historic relationships.



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Source: Bloomberg

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