THE NORTH PIER*spective*

Market & Economic Commentary

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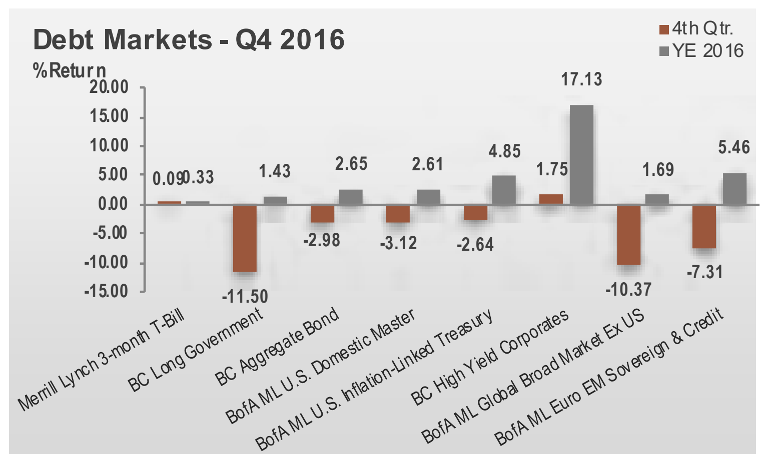
Ready Set Grow!

TRUMPeting in a New Era! (or Huge Error?)

Our last commentary was released hours after, as we put it, “the most shocking election in modern U.S. history.” What was even more of a shock is what unfolded in the days and weeks thereafter. Leading up to the election, markets were indicating that if Donald Trump were to upset Hillary Clinton, global equity markets would crash; and in the wee-hours of election eve, that’s exactly what appeared to be unfolding. Somehow, within one short day of the anointment of Mr. Trump as President-Elect, stock markets across the globe recovered and U.S. exchanges rallied. After our commentary was published, U.S. indices continued on to challenged all-time highs, shooting up nearly 10% in the five weeks that followed the pre-election lows. Yields on U.S. Treasuries, which are always a harbor of safety in uncertain times, reversed course and skyrocketed, as investors sold ‘security’ and embraced a new hunger for risk and appreciation. In my position, I am fortunate to regularly have conversations with peers who are some of the brightest portfolio managers, advisors and fiduciaries of pools of institutional capital in the world. There wasn’t one of them that wasn’t initially baffled by the rally.

Nonetheless, the financial ‘celebration’ has happened, regardless of its cause. What’s left is to sort out what a Trump Administration means for domestic and international capital markets and economies going forward… if it even means anything at all. As we sort through the massive amounts of data, policy and conjecture, I harken back to the most important thing I remember from the fog of the financial crisis: don’t speculate on the ‘what-ifs’… just continue to dig deep to find what it is that you are certain you know, and proceed accordingly. We attempt to do so in the following PIER*spective.*

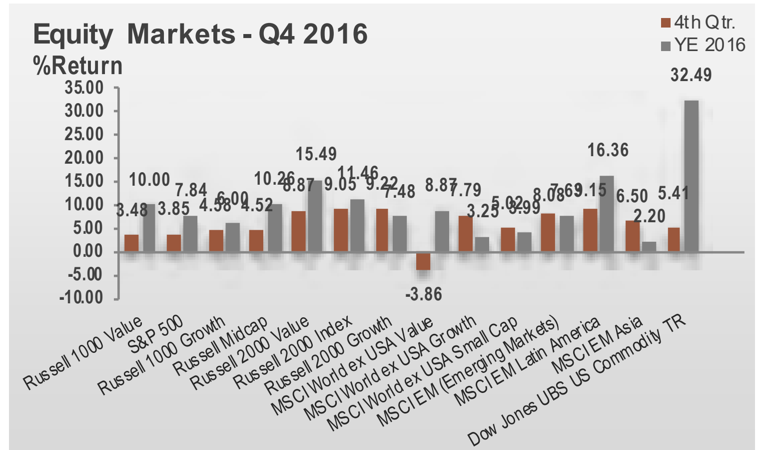
HOW THE MARKETS FARED



There were a lot of sparks in the bond markets after the surprising Trump win. Interest rates, which had plummeted on election night as election results came in, reversed course and skyrocketed over the next several weeks, spiking one full percentage point from where they started the quarter. The bellwether 10-year Treasury rose to 2.45% at year’s close after starting Q4 at 1.60%. The massive sell off in high-quality fixed income led to 3% net losses in most intermediate-duration indices. When the dust settled, interest rates finished the year almost exactly where they started, leaving net returns of just their poultry two-and-change percent coupons. Long-term government bonds saw double digit declines in Q4,

which likely hit LDI fixed income portfolios in pension funds especially hard. The US dollar index, which had spent most of the year in negative territory rocketed up 6% following the election, leading to substantive losses in both developed and emerging international debt markets. These losses erased most of the recovery gains that were made during the year. The news was much better in the more credit sensitive areas of the bond markets, with high-yield posting modest gains for the quarter, capping a year that rivaled the returns of most equities. As confidence in the economy grew, so did appetites for risk.

Investors piled into equities here in the United States immediately following the surprise results of the election. With an expectation that a Trump administration agenda would lead to a near term acceleration in the economy, value stocks vastly outpaced growth names during the quarter. This was a continuation of a trend that we saw as we emerge from the depths of the sell-off during the beginning of 2016. Both situations resulted in building economic confidence, that typically bolsters more cyclically, value-oriented companies more than steady growers. Though the S&P 500 gained 12% for the year, value stocks outpaced growth stocks by 10 full percentage points. With the flood of new capital into equities, the effects of money-flow were much more magnified in the small cap space where gains nearly doubled that a large caps both for the quarter and the year. Here we saw even more lopsided performance from the value side of the spectrum, with value leading growth by 10 and 20 percentage points for the quarter and full-year-2016, respectively.



This dominance also played a factor in international developed markets, with value leading growth by 10 percentage points for the quarter and the year. Returns in the international markets were muted somewhat when measured in U.S. dollars, but realized gains similar to U.S. equities in their home currencies. Emerging market equities continued to be a tale of two cities (or rather continents) with Latin American stocks faring much better than those EM names in Asia. Latin America recovered handsomely from its 2015 commodity-based slide, adding nearly a third to stock values during the year. Asian EM equities gave back half of their gains in Q4, still managing respectable returns for 2016. This dynamic was logical due to the broad rebound in natural resources that occurred, which would play more strongly in Latin America than the manufacturing-based Asian economies.

LET'S GET REAL

The National Association of Realtors (NAR) reported that median existing home prices were up 4% for 2016. This was consistent with the October data from the Case Shiller reports which showed a 5.6% price increase year-over-year for the 20 city Index and a 4.3% gain for the 10 largest markets. First time buyers continued to be active, representing approximately one-third of purchases. Distressed sales from foreclosures and short sales maintained a modest 7% share, indicating that there is presently not much stress in the residential sector. New home prices increased at a stronger rate, rising nearly 8% year-over-year. However, December saw over a 10% pullback in the rate of activity in this sector, which caters typically to newer and lower-income buyers. Clearly the effects of the higher interest rates that followed the election caused a pause in buying for those who weren't yet under contract. North pier believes that the market will likely digest these new mortgage levels and resume the prior pace (providing that interest rates don't rise meaningfully from here in the near-term). The housing market is likely to stay firm in 2017 due to drastically low inventories. Supply is presently at the lowest level (3.6 months) since the NAR began to track data in 1999. This

remarkably consistent up-trend continues to add confidence to homeowners. However, higher prices and mortgage costs are likely causing first time buyers that are attempting to get into the market to take pause, which could affect low-end properties.

Hip hop hooray -oh, LAYBOR-ay-oh!

The Unemployment rate held steady at 4.7% for December. Initial Claims for unemployment (those newly out of work) are now hovering at their lowest levels since 1973! Continuing claims are now challenge the lows set in 2000. This tightness in the labor market continues to allow workers to demand higher wages. Hourly earnings in December increased by a whopping 0.4% netting gains of nearly 3% for 2016 as a whole. The argument made by both sides of the isle in the last few elections, that real wages have declined, is no longer true as gains are substantively outpacing inflation. Even the number of people that are underemployed or have left the workforce out of discouragement has dropped of late. Jobs are a-plenty in the United States, and they are starting to pay better and better wages.

CONSUME-MORE Confidence

Continually rising home values and a strong jobs situation are likely key reasons that Christmas proved to be a success for retailers (by most measures). The National Retail Federation reported that shoppers increased their spending for the holiday season by 4% compared to 2015. This beat estimates by better than 10%. However, this data conflicted with the December retail sales report, which showed practically no gain when autos and gasoline sales were taken out of the equation. Our viewpoint is that consumer spending was likely much more robust. One indicator supporting this notion is a substantive increase in the utilization of consumer credit during the month of December. Non-revolving credit, which is typically used for large purchase financing, has been steadily climbing at 6%-7% year-over-year since 2011. However, in November, revolving credit (such as credit cards) unexpectedly spiked by over 13.5%, likely due to robust holiday shopping. Taking out credit of any kind is a big vote of confidence about one's future.

Positive trends in the data regarding actual spending are supported by the consumer sentiment surveys. Consumer Confidence has jumped to a post financial crisis high. The University of Michigan Index for January came in at 98.1, dominated by a strong increase in the Present Situation Index. This was in-line with the December Consumer Confidence data from the Conference Board which soared to 113.7 in December -- the highest reading since 2001. The Conference Board data showed future expectations rising at a greater rate than the University of Michigan data. Despite the recent protests and media critiques of the newly-elected President, consumers as a whole seem to be enthusiastic.

PRETTY PRICEY

As North pier has consistently suggested, more evidence is surfacing showing that inflation continues to mount in the United States. Core producer costs (as measured by PPI) jumped 0.2% in December resulting in an increase of 1.6% for the year. December's rise is somewhat counterintuitive, given the fact that the dollar soared during that same time period. This should have resulted in raw material and import costs being lower in dollar-terms, which is especially

relevant for multinationals. The implication is that there may be even greater phantom-inflation that the headline numbers are not yet showing. We will know for sure once January and February's data is announced.

Prices are heating up even faster for consumers. The CPI was up 2.1% in 2016. Core CPI, which excludes volatile food and energy costs, was up even more at 2.2% year-over-year. We are also seeing the prices of imports rise, climbing nearly 2% in 2016. Again this is counterintuitive given the gains in the dollar. Though 2% is not an alarming rate, the trends suggests that we are heading higher. With a tight job market increasing labor costs and re-inflating commodity prices, there is a lot of oxygen fanning the flames of inflation going forward in the new year.

BUSINESS IS BOOMING, BUT WILL IT BE KABOOMING?

Our regular readers know that North Pier follows the Institute of Supply Management reports very closely, as we think those are the best indicators of future business-to-business conditions in the United States… as well as abroad. The latest U.S. Reports on Business (ROB) for January were encouraging both on the manufacturing and services side of the data. The ROB for manufacturing increased to 56, rising on the back of a two month trend showing a massive pick-up in new orders. The ISM projects that this suggest a 4% increase in GDP for the coming year. On the service-side of the survey, the non-manufacturing report declined slightly to 56.5, with high levels reported for new orders and present business activities. The services side of the ROB suggests a 2.9% increase in real GDP for 2017. Obviously any gains in GDP in the mid-3% range would be looked at as a substantive improvement over the last several years.

The only data that North Pier has witnessed in the business-to-business area of the economy is the widening of the trade gap. While exports have stayed steady, imports have continued to rise. With Donald Trump's threats of "border-taxes" and withdraws from free-trade agreements, there is a danger that the balance of trade will be upset even further. This is a wildcard that is quite difficult to forecast. A widening trade deficit presents a headwind to GDP growth. Though President Trump's hard-hitting negotiation tactics may prove to be successful down the road (or not), in the near-term, they could be quite disruptive to the trade-status quo. With manufacturing in the United States finally readying in for a comeback, any change in forward trajectory is of concern. When it comes to trade, a bull in the china shop could break more dishes than an Opa-dance at a Greek wedding, killing the momentum that we are finally starting to enjoy.

PIER*ing* Ahead

Ultimately, that's the crux of the conundrum. Clearly President Trump has policies that are likely to be near-term shots in the arm for the economy. A lowering of corporate tax-rates is likely in the first session of the new congress. That is always a near-term stimulus for growth. Repealing ACA mandates and creating more competition is likely to be additive as well. However, if President Trump starts a trade war, or incites a geo-political event (such as provoking a conflict near the Straits of Hormuz oil shipping lanes), all of the rosy present conditions that I have described above could evaporate very quickly. OR… perhaps Mr. Trump will bring savvy business efficiency to the bloat of government. It is impossible at this point to predict. What is most likely is that we will see grand examples of both. With a stock market that is trading at highly elevated valuations – valuations that are already pricing in uncertain future success, disappointments will surly lead to volatility. It's bound to be quite a ride. I hope you packed you Dramamine.

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