MARKET
PERSPECTIVES

STC Investment Committee

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December Recap

Risk assets across developed markets continued their rally on the back of firm economic news and expectations that the new administration's policies would boost growth. Markets took a constructive view of potentially hawkish central bank actions here and in Europe, seemingly signing off on efforts to facilitate a long-overdue normalization of interest rates. The dollar continued its rally against advanced economies, gaining 2.5% versus the Euro after the European Central Bank (ECB) announcement extending its quantitative easing program, but gave back some recent gains against emerging market currencies. Despite dollar strength, commodities gained 4.7% as natural gas and oil spiked 9-10%. Precious metals were weak with gold falling 2%, close to a one-year low.

World equity markets gained 2.2%, with international advanced economy equity markets returning 3.3% versus 1.95% for U.S. stocks, as Eurozone stocks spiked 7.4%. China-centric markets fell, with Hong Kong down 3.4% and China down 4.1% on concerns over protectionism and renewed capital outflow risks.

The economic expansion continued in the U.S. as the manufacturing sector expanded for the fourth straight month in December, with the Institute for Supply Management (ISM) manufacturing index hitting a two-year high. Services were also strong, with ISM-services maintaining the highest level since October 2015. The strong economy appeared to be laying the foundation for higher inflation as wages grew at 0.4%, the largest monthly increase since the early stages of the recovery in 2009. Home prices gained 5% on the year-over-year basis, the most since 2014. Perhaps most importantly, consumer confidence rose to a 15-year high.

European stocks were the top performers, as economic news was supportive, the ECB managed to start the tapering process in a benign manner and investors took the Italian referendum defeat as an all-clear signal to buy. In December, Eurozone inflation rose to 0.6%, the highest in more than three years. The ECB tip-toed into interest-rate normalization by reducing the size of its monthly purchases, but extending the program an additional nine months. German stocks rose 7% on the ECB's dovish taper and strong economic numbers, as both Eurozone manufacturing and the German IFO Business Climate index hit two-year highs. With investors conditioned by Brexit to buy dips following bad news, Italian stocks surged 13% after Prime Minister Renzi stepped down after losing the referendum (60/40) and the country was forced to step in and rescue the world's oldest bank after private sector efforts failed.

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While emerging market (EM) equities lagged, returning only 0.2%, the near-term technical picture stabilized, with greatly diminished liquidations from overseas investors, particularly on the equity side. Russia gained 12.5% with the oil price move while EM-Asia was weak: China fell 4% on indications that it will prioritize exchange-rate stability after reserves fell in November and India declined 1.4% as the economic slowdown continued following the elimination of high-denomination bank notes.

While the Federal Reserve Board's 25 basis point rate hike came as no surprise, the Fed now forecasts an additional rate increase in 2017 (three increases, not two). Equally important, all Fed members appeared to be on the same page, at least for 2017, with a tight range of two to four hikes, taking note that market-based measures of forecast inflation had moved up considerably. Interestingly, the Fed chose not to specifically comment on the potential implications of President Trump's economic policies.

Bond investors interpreted the Fed's language as a policy shift from one of supporting economic growth to that of ensuring price stability, defined as 2% inflation. Treasury yields rose modestly to their highest since mid-2015. Despite rising Treasury rates, credit markets were strong as spreads tightened on economic optimism. Corporate bonds gained 0.7%, while their more economically sensitive, high-yield bonds gained 1.9% for the month, with CCC-rated bonds gaining 3.7%. Emerging market bonds rebounded from recent weakness: despite weaker Treasuries, dollar-denominated EM bonds gained 1.3% and local-market bonds gained nearly 2% on the currency rebound.

Outlook and Positioning

Our positioning has changed little from last month, aside from taking profits in the municipal space, as markets have performed in line with expectations and our macro-views are little changed. International equity markets have outperformed U.S. equities this month, 2.5% to 1.0%, with emerging-market equities up 3.5%. Since our letter of December 9th, international equities have outperformed by more than 200 basis points. The relative value opportunity in municipal bonds (high-quality municipals over Treasuries and low-quality municipals over high-yield bonds) has also played out: intermediate municipal bonds have gained 35 basis points more than similar Treasuries and high-yield municipals have returned more than 3%, almost 200 basis points more than high-yield corporates.

As we have stated previously, there is a regime change afoot, one that is both political and economic. Unlike the case of the past eight years, the risks to both economic growth and inflation are to the upside. This is because the 2017 consensus economic expectations remain so modest, with estimates of 2.0% growth in the U.S., core personal consumption expenditures (PCE) inflation of 1.9%, and global growth rising only 15 basis points. None of the confidence shown in the small business survey appears reflected, as the percentage of respondents saying that this is a good time to invest is three times the average of the Obama years. The percentage saying they expect better near-term business conditions has quadrupled since the election. It is quite possible that the survey reflects this population's political satisfaction with the election results and that the newfound confidence will not lead to a surge in corporate spending; but the change cannot be ignored.

Unfortunately, while the economic backdrop is supportive, especially near-term, markets are priced for perfection and vulnerable to any form of bad news. That reality colors our investment positioning.

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