MARKET
PERSPECTIVES

STC Investment Committee

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While some of the momentum of the post-election reflation trade (betting on a return of inflation) subsided in January, its directionality remained intact, with U.S. equities gaining 2.7% to reach new highs while global bonds continued lower. Perhaps the bigger news was a reversal in the dollar, which was significantly weaker after administration officials suggested it was too strong.

Fourth quarter growth in U.S. gross domestic product came in a bit light at 1.9%, although a significant decline from the prior quarter's 3.5% rate was expected. Consumer confidence fell off modestly, but remained near a 15-year high. Service sector growth was strong, while manufacturing grew at a faster pace in January as the Institute of Supply Management Manufacturing index climbed for its fifth straight month. Elsewhere, higher interest rates may have impacted new home sales, which fell to a 10-month low.

The dollar fell nearly 3% after President Trump jawboned the currency down. While the Japanese Yen was the most visible beneficiary, gaining 3.7%, the dollar was weak across the board, particularly in Asia, as currencies in Australia, New Zealand, Taiwan and Korea gained 4-5%. The British pound sterling was volatile, falling below $1.20 on fears of a "hard" Brexit before rebounding to close over $1.26 after the Supreme Court required a vote of Parliament on any Brexit deal. Despite rising trade tensions, the Chinese yuan gained nearly 1% and the Mexican peso retreated only modestly. European currencies were generally 3% stronger; the Turkish lira was an outlier, falling nearly 7% and extending last year's 24% decline, as investors interpreted the central bank's lack of a rate increase as a sign of political interference.

While Treasury yields were little changed, international developed-market sovereign bonds were weaker in local terms. European bonds were particularly weak, with yields rising 35 basis points, as inflation hit a three-year high and economic confidence surged to a six-year high. Greek yields spiked another 74 basis points to 7.7% on budget deficit-related bailout concerns. Japanese yields drifted up to a one-year high despite negative year-over-year inflation as the Bank of Japan skipped a planned monthly bond purchase. Nonetheless, the international aggregate bond index gained 1.9% as currency gains easily offset local market losses. In credit markets, one would have expected the amazing high-yield bond rally to continue and it did, with speculative (CCC) bonds tacking on an additional 2.5%.

U.S. equities lagged, but still returned 1.9% on good economic reports and hopes that the future would be even better. There was somewhat of a reversal of market leadership as growth style beat value. Large-cap growth bested small-cap value by more than 400 basis points. Large-cap technology and materials sectors gained nearly 5%, while energy trailed and lost 3.3%.

Developed markets outperformed the global benchmark by returning 3.0%, despite European markets gaining only 2.1%. While Germany was strong, Italy lost 2.6% and the U.K. gained only 1.2%. In Japan, equities did well and gained 3.7% on stronger export numbers. Overall, growth outperformed value, but not to the same extent as in the US.

Emerging markets were the natural beneficiary of a weaker dollar and stronger non-energy commodity prices. Whether it was equities, bonds, or currencies, emerging markets were the standout performers for the month. Equities rebounded from their post-election weakness with a 5.5% gain. Latin America gained 7.6% on higher metals prices and Brazil's 6.8% jump after a bigger than expected interest rate cut. China-centric emerging market positions were most affected, with Asia up 5.9%. While economic news was mixed, China gained 6.2% as investors took comfort in the weaker dollar, which reduced immediate capital outflow concerns. India

Continued on next page.

bounced back from self-induced problems as exports grew while inflation fell more than expected. Russian equities paused on lower energy prices. Emerging market debt gained around 2% as yields on both hard and local currency bonds bucked the upward rate move in the rest of the world by falling 10-15 basis points. Finally, emerging market currencies gained 1% against the dollar despite increasingly confrontational rhetoric, highlighted by President Trump's cancelation of the Trans-Pacific Partnership trade deal following Chinese President Xi Jinping's defense of free trade.

Commodity prices were mixed despite the weaker dollar as energy was weak, but metals were strong as gold and oil reversed recent trends. Crude oil was down over 3% on concerns over a growing rig count, while natural gas plunged 16%. Copper gained 5% on China stability and supply concerns, while growing political risk in the U.S. and Europe boosted precious metals, with silver up double digits and gold rallying back above $1200/oz.

Outlook

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 2.1% growth in the U.S., core personal consumption inflation of 1.9% and global growth rising only 15 basis points from 2016 levels. None of the confidence shown in recent business surveys in terms of upside risk is reflected in these consensus forecasts.

Unfortunately, while the economic backdrop is supportive, especially near-term, markets are priced for perfection and vulnerable to any form of bad news. At the same time, euphoric sentiment indicators and a seeming disconnect between extremely high levels of economic uncertainty and unusually low levels of expected volatility (fear) reinforce that concern. That reality colors our investment positioning. We will be patient in rebuilding our domestic equity exposure, tolerating tactical exposure levels even slightly below at minimum tactical levels. This does not require a broad-based market pullback - for example, we recently added to our telecom exposure on weakness. We strongly prefer international equities, particularly in Europe as the economy is in a sweet spot and markets should rally through the significant political headline risk. We are booking gains in high quality municipal bonds as recent gains have eroded relative value and tax reform risks loom large. Credit exposure is further reduced following the continued corporate rally and the meaningful rebound in higher yielding municipal bonds.

Twelve months ago, everyone thought the world was ending in a deflationary ice-age. We had a strong contrarian view early last year that growth and inflation were far from dead. Subsequent data releases have caused investors to do an about face and uniformly embrace a reflationary outlook. As we have discussed previously, reflation is not just in the U.S. and not just related to Trump, as the rebound in the global economy started long before the election. His policies served to turbo-charge trends that were already well established.

For example, the eurozone grew at a 2.0% annualized rate in the third quarter, with the strongest growth outside of Germany. For the past three years, the growth in Europe and Japan has outperformed the U.S. on a per capita basis. Above-trend growth will continue in international advanced economies as every post-election measure of global growth is in an acceleration mode, whether it be the ZEW Financial Market Survey Indicator of Economic Sentiment, the global leading economic indicators index, the global manufacturing index or the increase in global earnings estimates.

In the U.S., the small business survey share saying this is a good time to invest was three times the average of the Obama years, while the percentage saying they expect better near-term business conditions has quadrupled since the election. More than 70% of the increase in small business confidence was due to stronger views of sales and the economy. It is possible that the survey simply reflects this population's satisfaction with the election results and that confidence will not lead to corporate spending. But the change cannot be ignored as this potential revival in corporate animal spirits is not yet reflected in consensus economic growth estimates.

This rising U.S. business confidence suggests that growth rates and investment rates are biased to the upside. U.S. personal income and spending are well supported by rising wages, a tight labor market, an increased propensity to borrow as deleveraging (at the household level) is complete, and the wealth effect from higher housing and stock market prices. I guesstimate up to 0.5% of upside to developed-market growth versus consensus in 2017.

European Elections

While the European economic backdrop seems quite supportive, the risks are on the political side as several important elections are likely to reflect the continuing strength of an anti-European Union (EU) populist movement. Bonds recently sold off in France and Italy, reflective of those concerns. While not to diminish the risks, I think the actual risk to asset prices is overstated, particularly as the eurozone recovery seems so well entrenched.

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The Netherlands holds parliamentary election with proportional voting in mid-March. The anti-immigrant and anti-EU Freedom Party is currently leading in the polls; however, even if it wins, the country would most likely form a minority coalition to dilute its potential power. Prime Minister May will Trigger Article 50 by the end of March, starting the two-year clock on the U.K.'s formal exit from the EU. While little is expected to be decided this year, evidence that negotiations are not proceeding could give rise to the risk of a "hard Brexit," with the UK leaving without having any new agreements in place on issues such as immigration and trade. In Germany, while Merkel's coalition will no doubt prevail in the German general elections of late September, the anti-immigrant party (AfD) will likely gain more than 10% of the vote and will become the first far-right party represented in parliament since WWII.

The Italian referendum lost by even greater margin than expected, nearly 60/40 against. As expected, Prime Minister Renzi resigned shortly thereafter, as he had staked his legitimacy on the outcome, much as David Cameron did in the U.K. While previously there had been fears that a no-vote would trigger new elections, there was an orderly transition to a caretaker government. There are still catalysts that could lead to a new general election, with the risk that the anti-EU Five Star movement would do well in the voting, the referendum's defeat had a silver lining in terms of making it more difficult for that extremist party to gain effective power.

All eyes seem focused on the French Presidential elections, where Marine LePen has made a referendum on whether to remain in the EU the cornerstone of her campaign. The election is structured as a two-round process starting in early May. It may initially come down to a race between Francois Fillon (Republican) and two independents, Emmanuel Macron (ex-Socialist Finance Minister) and Marine Le Pen (far-right, anti-EU National Front). While Le Pen will quite likely scare markets by winning the first round, the hope is that voters ultimately will unify behind a more moderate candidate in the second round.

Emerging Markets and China

Emerging market finally had a positive year, gaining nearly 12% after 3 years of negative returns as China fears proved overstated and commodities recovered, helped by a weaker dollar in the first half of the year.

I expect that the good performance will continue. Emerging markets are growing at their fastest rate in two years. Valuations are attractive (depending on how one views the commodity price outlook), earnings growth estimates have been upgraded (with stronger global growth), and inflation seems well-behaved so interest rates may not move up much even as rates normalize in the developed world. (The emerging world never adopted quantitative easing and zero interest-rate policies.)

China's growth has surprised to the upside and the near-term outlook is quite positive as inventories across the economy are at low levels, suggesting economic support from the restocking effort. While government spending growth has fallen off, China's leading economic indicators are still strengthening, with an improving labor market subcomponent. With growth expectations somewhat muted, China growth rates should be sustained as exports benefit from higher global growth rates.

China does present the biggest risk. Trade tensions could lead to significant protectionist actions. The real estate recovery that has supported growth is about to fall off and needed state-owned enterprise (SOE) reforms have been put off. More generally, corporate debt levels have risen to elevated levels in the emerging world, particularly in China. While the earnings growth should help start the deleveraging process, excessive debt levels make markets vulnerable to a downside macro-economic shock. A particularly troubling scenario would have China responding to U.S. tariffs with a currency devaluation, resulting in an all-out trade war.

Federal Reserve Board and Interest Rates

While I think the Fed is behind the curve and absolutely should raise rates in March, up until this week I thought that the market was correct in anticipating that the Fed remain on hold, even after January's blow-out upside surprise ADP jobs number. Why did I agree with the market forecast? The Fed has not yet prepared markets for a March rate increase; the recent ECI (Employment Cost Index) came in at 2.3% wage growth, hardly a red-flag for incipient inflation pressures; consumer spending (after adjustments for volatile autos and energy) showed only mild growth; and finally, since inflation numbers for January and February 2016 were strong, one would not expect a big pick-up in year-over-year inflation until April.

Developments this week have caused me to now forecast that the Fed will raise rates in March. First, the two most important Fed leaders now sound much more hawkish, with Fed Chair Yellen testifying as to the dangers of waiting too long to raise rates and New York Fed President Dudley characterizing the economic risks to the upside. Subsequently, both inflation and retail sales numbers were much hotter than expected, particularly on the all-important

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core readings, with consumer price index excluding food and energy increasing to 2.3% year-over-year (the expectation had been a decrease to 2.1%) and retail sales excluding auto/gas jumping 0.7% month-over-month versus a 0.3% forecast. Finally, the Philadelphia Fed manufacturing number came in at twice the estimate, rising to the highest level since 1984. This figure confirmed both the euphoria in the business community as well as the likelihood that upside risks in the economy are unappreciated.

Commentators have noted a big tug of war in the bond markets recently, with institutional investors being aggressive buyers at year-end after the bond market plunge, while hedge fund investors followed the trend and added to their short positions. These technical forces could set us up for increased bond market volatility: should a macro-shock or tepid growth and inflation numbers buoy the bond market, hedge funds are likely to be forced to cover their losing trades, causing bonds to spike up. On the other hand, long-only fixed income investors, having been well rewarded by purchasing bonds on dips the past five years, will be shocked if that strategy doesn't work this time around, potentially triggering a round of panic selling.

Whether the Fed acts in March or not, interest rates are biased upwards for all the reasons we have discussed since calling the bottom of the bond market this summer. (I was finally right after some frustrating interest rate calls.) To briefly re-cap the sea change in views: the Fed is unified on the need for between two and four rate hikes this year; Yellen is likely to be replaced in early 2018 with a less dovish Fed leader (my prediction and hope is that it will be Kevin Warsch); there is currently an open seat on the Fed; even traditional Fed dove Eric Rosengren has talked about reducing the size of the Fed's balance sheet; wage inflation had been running at the highest since 2009; Institute for Supply Management prices-paid index closed at its highest level in five years; and the economy is at or past full employment at a time when the new administration is looking to further stimulate the economy (even if the actual stimulus occurs in 2018, consumers and corporations will look forward and spend this year). Perhaps most importantly, the heavy drag on U.S. interest rates from sub-zero rates overseas is being lifted, as foreign central bankers appeared to start their gradual retreat from quantitative easing and negative interest rates last June. For example, inflation in the eurozone hit 1.8% year-over-year; while mostly due to crude oil prices, core inflation has clearly bottomed and with another year of above trend growth, the eurozone will be at or near full employment by year-end, making it quite possible that European Central Bank head, Mario Draghi, will end his quantitative easing shortly thereafter. With the Fed increasing rates only gradually and short-rates anchored in eurozone and Japan, the result of higher growth and inflation could well be significantly higher interest rates on the long-end, as the curve "steepens."

Municipal Bonds

Let me start with some context in terms of how we think about municipal bonds. In arriving at our tactical exposure target for municipal bonds, perhaps the most important input is the relative value of municipal bonds versus comparable taxable bonds, often Treasuries or Agencies. For much of the past few years, we were fortunate to have maintained high levels of municipal bonds, despite being bearish on underlying Treasuries, as municipals looked attractive on a relative basis. We were also fortunate to have reduced municipal exposure over the summer in front of the collapse in the municipal market this fall. Our early December purchase recommendation was based upon relative value having returned to the market as municipals were once again yielding more than comparable Treasuries at that time.

The decision to take profits on our December purchase recommendation was primarily driven by tax reform risks (although we would have reduced exposure in any case following the outperformance versus Treasuries). While the potential reduction in top marginal tax rates from over 40% to 33% might be good for the economy, it is bad for the municipal market. Even more disruptive would be more radical proposals to cap the tax break, with no grandfather provisions for outstanding bonds. Perhaps less appreciated is the effect of corporate tax rate reduction on the municipal market, as insurance firms are large holders of municipal bonds. These tax rate changes would significantly disrupt the somewhat illiquid municipal bond market, particularly if they are accompanied by a spike in interest rates. Within the municipal market, bonds from high-tax states could outperform, given that they may retain more of their tax-advantaged status than those from states with zero state income tax.

Continued Equity and High-Yield Rallies

Both U.S. equities and high-yield bonds could continue to rally over the next three months despite being overvalued, particularly if the Fed does not raise rates in March and if inflation increases only gradually. As we have seen, while the global economic backdrop seems quite supportive near-term, valuations are unattractive and I prefer to invest where returns are more commensurate with risks, at this time in international equities.

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Sell-side strategists are deeply divided over the prospects for the high-yield bond market, with a double digit spread between the bulls (mid to high single-digit returns) and the bears (low single-digit losses). For the past six months, high-yield bonds have actually rallied despite higher Treasury rates. While it might seem strange that higher rates should be good for bonds, high-yield bond returns are driven more by changes in credit spreads than changes in the baseline level of interest rates. The lowest rated (C-rated) have been the biggest beneficiary, as expectations for a stronger economy (and higher commodity prices) have caused credit spreads to shrink, more than offsetting the drag from higher Treasury rates. While I agree that the macro environment is supportive, I remain underweight high-yield bonds as current spreads have priced in the expected good news, leaving little cushion for economic shocks or sharply higher Treasury yields. As an aside, if I am correct that the contemplated economic stimulus leads to more inflation, the high-yield market may experience a big distressed cycle in 2019, as the Fed may need to raise rates more than expected to fight inflation. Credit spreads would start to reflect this possibility well in advance of its actual occurrence.

Within the U.S. equity market, it is true that cyclic, economically sensitive stocks have had a big move. Unfortunately, by our numbers, defensive stocks remain overvalued, just less so in a relative sense versus cyclic stocks than previously. Industrial-sector stocks that are overvalued and economically sensitive stocks, such as financials, are at a much less attractive risk/reward levels than in mid-2016.

Market Anomalies

While it may or may not have direct investment implications, the post-election political-economic world has changed. First, the level of discord in the body politic appears quite elevated to judge from demonstrations and media confrontations, just as risk assets are setting new highs. Why the disconnect? While exacerbated by personalities, the underlying source of the discord is more fundamental and is a reaction to the real changes in substance and policy that are expected to take place. While President Trump's individual initiatives may be good, bad or ugly, the market has judged Trump's willingness to implement controversial policies as evidence that he will actually deliver on the rest of his promises - changes that in aggregate are thought to be highly pro-growth.

Second, readings of economic uncertainty are at heights not far from what we have seen post-Brexit election or during the Fed taper-tantrum. This represents a complete divergence from exceedingly high levels of business and consumer confidence, record high equity prices, tightening credit spreads and rising Treasury yields. I do not have an answer for this dichotomy: perhaps it reflects a confidence that economic prospects are bright, but considerable uncertainty as to just how bright and to the precise policy actions that will actually occur.

Third, we have a statistical anomaly where both expected and realized volatility (a measure of fear in the market) is unusually low at a time when markets have hit new highs. The Fed is on path to normalize interest rates and economic uncertainty is high. Again, I do not have the answer, but it could be explained with a view that near-term recession odds are non-existent at the same time as investors are rotating from bonds to stocks.

Finally, while more an uncertainty than an anomaly, we are trying to understand the ramifications of a potential border adjustment tax. While it would no doubt be phased in over time if enacted, there would be many firm-specific winners and losers unless the dollar rise precisely offsets the export subsidy. My guess is that it risks creating too many politically visible job losses to be enacted. However, there are enough deficit hawks in Congress that we are likely to see not only cuts in individual and corporate tax rates, but also some new forms of government tax revenue.

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