Investing in a Trump Economy

In a year full of stunning macro surprises, which included Britain's vote to leave the European Union and the election of Donald J. Trump, markets were remarkably buoyant after an ugly start. Heading into 2017, optimism is high as the global economy appears to be finding its footing and forthcoming policies from the Trump administration are expected to be pro-growth. In particular, we believe economic growth may be boosted by tax cuts and relaxed regulation. Cuts to both corporate and individual tax rates are likely to encourage firms to repatriate cash, and the unwinding of many regulations recently enacted by the Obama administration on the beleaguered financial, energy, and healthcare sectors are likely to renew their growth. A large infrastructure spending program is also anticipated, but is likely to meet some resistance in Congress. Vocal opponents within the Congressional Republican caucus, who are concerned that entitlement spending programs and increasing interest expense are already pushing the federal deficit to troubling levels, may be reluctant to support any plans for additional expenditure. What is reasonable, in our view, is to expect improving trends and likely tax policy changes in the U.S. to generate better economic growth in 2017 than during the past twelve months. The consensus now largely reflects this view.

We are mindful of several risks to our viewpoint. While these aforementioned growth initiatives are likely to drive optimism, trade policy remains a wild card which could hamper global growth if protectionist policies such as tariffs are enacted on a widespread basis. Economic growth failing to meet rising expectations and sentiment turning somewhat more cautious could also challenge markets. More concerning is the possibility that growth-boosting policies may spark inflationary pressures, accelerate increases in interest rates, and bring forward expectations for future Fed rate hikes to create headwinds to growth. A more hawkish Fed might also push the US dollar higher, which could tighten global financial conditions in a manner similar to 2015. Lastly, we are concerned that financial markets may have become too optimistic too fast. The 12-month forward PE ratio for the S&P 500 has surpassed long term averages, and, factoring in an aging economic expansion, the third longest domestic equity bull market on record and a rising interest rate environment, any disappointment may quickly reverse this euphoria. For now, we view these scenarios as tail risks that could disrupt our base case expectations of another solid year for global equities.

In short, a very exciting macro backdrop is likely to result in a somewhat boring market outcome in the first half of the year. Overall, our outlook remains one of tempered optimism, with the bull market likely to remain intact but facing headwinds from stretched valuations, diminishing central bank support, and frothy investor sentiment. This environment is likely to limit upside for global equities to single-digit gains. Leadership from cyclical groups, and particularly financials, remains intact, and we will be watching for renewed strength from defensive sectors such as utilities, telecom, and consumer staples for evidence that rising interest rates are increasing the odds of a significant equity market correction.

On the fixed income side, even in the wake of moderately higher rates, we still believe bonds serve a valuable role in a portfolio. With a strong economic backdrop, we recommend shorter-than-benchmark duration and still favor credit-sensitive bonds.

Lastly, to mitigate unforeseen volatility, we believe it is prudent to retain an allocation to alternative investments that have low correlations to traditional investments, and we prefer managers with flexible investment styles with the discretion and ability to move nimbly within their mandates in the face of the changing economic environment that we foresee.

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