Argent FINANCIAL GROUP, INC

2017?

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Summary

- A calendar-year forecast for 2017 is even more difficult than usual because of the uncertainties accompanying the new regime in Washington
- Proposed tax reform, deregulation and fiscal stimulus could be good for the economy
- Despite Republican control of Congress and the White House, there is no guarantee that such reforms will occur
- Potential trade wars and the ballooning deficits from unfunded military and infrastructure spending are significant risks
- Interest rates and inflation will need to be monitored closely
- The strengthening of the dollar has beneficial and detrimental effects to the U.S.
- Despite the uncertainties, we are positive in our outlook and expect equities to outperform cash and bonds

Forecasts are exercises in futility undertaken by madmen. This is particularly true at the beginning of the calendar year when lunatics, not content with one month or three month auguries, throw their straitjackets to the wind and set their crystal balls for twelve months. This year, the future looks even murkier than usual. Even our trusty Eight Ball oracle repeats the phrase "reply hazy, try again", whenever we seek its wisdom. The chief source for this elevated level of uncertainty is the advent of a new government in Washington. As a reminder, this is not just a new government, but a revolutionary new government, headed by a president who has never held public office and who carried the day by promising to Make America Great Again", details to follow. Despite his celebrity, Donald Trump remains a mystery to much of the public. His pronouncements on plans and policy during the campaign were vague, often contradictory and sometimes unconstitutional. The promise of radically changing the status quo resonates with almost everyone. Few people are happy with the dysfunction that has long characterized the federal government. The uncertainty of what the new government will try to change and how successful it will be at accomplishing those changes make predictions about the future even more challenging than usual.

The stock market, for now, has embraced change. Since election day, the S&P 500 has added 8.6% in value; for the ten months of 2016 prior to the election, the market had only advanced 2.0%. The market is responding to what it perceives to be the new president's agenda on deregulation, tax reform and fiscal stimulus. From what we think we understand about the new president's plans for these items, they could provide a significant stimulus to the economy as well as corporate earnings, if actually enacted. Real deregulation could add significantly to corporate earnings and, at least theoretically, would be easy to accomplish; since many of the regulations imposed over the last eight years were done by executive fiat, the new president could order his cabinet officers to reverse them. Unfortunately, it will take more than theory to "drain the swamp". A recalcitrant congress or stalling bureaucrats could well delay or eliminate many of the economic benefits of deregulation. Tax reform, if it includes a sharp reduction in the corporate tax rate, could certainly spur growth: not only could it increase profit margins and make the U.S. more competitive for new businesses, but it could also encourage the repatriation of billions of dollars of foreign earnings to be reinvested at home. Fiscal stimulus -- using public monies for military and infrastructure improvements -- could also add to growth, but the case here is less compelling than it is for tax and regulation reform. The market's post-election response to these possibilities is encouraging, but the reality of politics will likely trim this enthusiasm. Although the president's party will still have majorities in both the House and Senate, the majorities will be thin and the president's own party is not likely to be unified in its support for all of his agenda. Accordingly, we expect more volatility -- positive and negative -- in the days ahead as speculation becomes reality.

There are also many reasons for the markets to be pessimistic about the future economy under a Trump presidency. Politicians have a well-deserved reputation for promising more than they can deliver. From an economic perspective, we hope that Trump was doing more than his share of prevarication during the campaign. The candidate Trump spoke of shutting down NAFTA, taking a hard line with China on its trade surpluses and generally avoiding all trade deals that were bad for the U.S. We hope that much of this was campaign bluster or pre-negotiation tactics and that a president Trump will take a more constructive view towards our trading partners. Pushing for better terms is desirable, but starting trade wars by raising tariffs and walking away from profitable trade arrangements is not. Candidate Trump promised large increases in infrastructure and defense spending as well as tax cuts for individuals and corporations. There are ways of managing some of this without ballooning the national debt -- public/private partnerships, cutting tax rates while eliminating deductions (tax reform) -- but without the details, the prospect of runaway deficits could terrify the most optimistic investor.

The soon to be new administration in Washington is not the only cloud that obscures our crystal ball. The Federal Reserve, after a one year hiatus, has renewed its commitment to raise short term interest rates to levels appropriate to its dual missions of full employment and price stability. Knowing where the economy is and where it's headed is obviously critical to setting the appropriate short term rate that balances these two missions. Given what we've said about madmen and predictions, it's far from certain that the Fed will make the right call. So far, however, the Fed appears to be moving cautiously. In December, they increased overnight rates from a range of .25% - .50% (set in December of 2015) to a range of .50% - .75%. Unlike what happened in December of 2015, there was no market tantrum: Wall Street generally agreed it was time. The Fed further indicated that they anticipated three more moves over the next twelve months. Assuming that their assumptions about the economy in 2017 -- moderate growth, full employment, inflation at around 2% -- prove true, then in December of 2017, overnight rates will be in a range between 1.25% and 1.50%. The primary uncertainty that Chairman Yellen mentioned in the forecast for the 2017 economy was the change in Washington: "the outlook for the economy, due to fiscal stimulus under the incoming administration, has perhaps changed substantially." Too much stimulus from the government could quicken inflation above the targeted 2% rate, upend the Fed's incrementalist approach and push rates significantly higher across all maturities.

Interest rates have already increased since the election. For example, the ten year U.S. Treasury climbed from an early November yield of just below 1.8% to a high of 2.6% before settling down to 2.45% at year end. Even before the election, bond yields had been climbing from their lows, with the aforementioned ten year U.S. Treasury yield climbing from 1.39% in early July of 2016. The pre-election rise in rates was a recognition by markets, both foreign and domestic, that U.S. growth and growth prospects were less mediocre than those of the rest of the world. We suspect that the jump in rates following the election was due to excess enthusiasm over the growth possibilities of the country under the new president. The more recent decline in yields -- from 2.6% to 2.45% -- is probably the first of many vacillations between optimism and pessimism that will possess the markets as the details of the new government's agenda emerge from the darkness. The overall trend should be for higher yields based on quickening economic activity, but at a gradual rate, much like the rise in rates from July through November of 2016. This gradual increase in rates, however, does present another source of uncertainty for 2017: the strength of the U.S. dollar.

With interest rates and growth hovering near zero in other parts of the world, yield hungry and risk averse investors have developed a true affection for U.S. government and corporate bonds, thereby driving up the value of the dollar vis-a-vis the euro, the yen, the yuan, the peso, etc. This, of course, means that from a domestic perspective, imports are cheap and exports are expensive. Since the U.S. is a net importer, one would expect this to be a good thing. However, in this ever more global economy, things are not necessarily that simple. A very strong dollar creates difficulties for other countries, and for corporations in those countries, who have borrowed heavily in U.S. dollar denominated instruments in order to increase their opportunities for growth. Having to pay back loans with more expensive dollars pushes them closer to default. And for savers and investors in these countries, weakening currencies engenders a strong impulse to invest overseas, creating a flight of capital that is sorely needed for improvements at home. Many of these countries -- for example, China, Mexico, India -- are some of our most important trading partners. Defaults in these markets could be catastrophic for the world economy as well as for U.S. corporate earnings. Remember, something like 60% of S&P 500 earnings comes from international sources. A too strong dollar could have a very deleterious effect on the U.S. economy. We don't believe the dollar will keep appreciating against the rest of the world -- as the world's largest economy, our economic growth should promote expansion and stronger currencies among our trading partners -- but it is another uncertainty.

The future is always uncertain. It is perhaps more uncertain today because of the unexpected agenda change in Washington, but this is more a difference in degree than an absolute change in character. Despite the added uncertainty, we maintain that the U.S. economy will continue to expand and that the economies of our trading partners will eventually gain positive traction. There could well be a deceleration in growth in the first quarter of 2017, much like the decelerations in the first quarters of 2015 and 2016, but this should be transitory. We base our belief on a combination of positive trends and conditions. First, fiscal and monetary policy will remain expansionary, particularly outside of the U.S., but also at home, where interest rates will only increase at a modest and sustainable pace. Second, oil prices, despite the recent accord of OPEC to reduce supply, will likely remain low and stimulative due to the overhanging threat from non-OPEC production. Third, capital expenditures (CapEx) by U.S. corporations will finally make an appearance as the number of qualified workers reaches a critical level. Lastly, animal spirits, released by the prospect of change in Washington, will encourage individual and corporate investments.

Given the above scenario, we believe that stocks will provide superior returns to bonds and cash in 2017. We acknowledge that equity indices currently carry above average P/Es and that, historically, an environment of rising interest rates has had a negative impact on multiples of earnings; accelerating earnings, however, should overcome the negatives of moderately higher rates and will likely be reflected in higher prices. In addition, the continuing experience of bond losses due to increases in interest rates will extend the migration of investor funds from bonds into stocks. In the equity space, we maintain our emphasis in U.S. markets over foreign markets. However, we have marginally increased our allocation to foreign emerging market stocks because overblown fears of default have substantially improved their relative valuations. On the fixed income side, the last few years' experience of low rates and an apparent new environment of rising rates lead us to keep maturities short for core fixed income allocations. We have made investments in Emerging Market debt and are evaluating bank loans for additional and new allocations as we look for exposure and credits that might benefit from an improving economy. We employed this strategy to good purpose in 2016 when we invested in domestic high yield bonds; we anticipate similar gains for emerging market debt as the global economy expands.

We anticipate that 2017 will be another interesting year for the markets, full of both negative and positive surprises. We believe that equity returns will outpace those of bonds as overall interest rates gradually rise. A too rapid acceleration in rates, due to unexpectedly high inflation, could derail market optimism. A trade war, or indeed any kind of war, could also wreak havoc with our outlook. This, of course, is why we promote diversification. But, in spite of the risk and uncertainty inherent in the future and in spite of the questions surrounding regime change in Washington, we believe there is at least some room for cautious optimism in 2017.

For more information about the commentary found in this newsletter, please contact a member of the investment committee.

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