LAKESTONE
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OUTLOOKS

December 2016

ECONOMIC OUTLOOK

Summary

What a difference a month makes when viewed through a political lens. Thunderstruck, unbelievable, it'll never happen, but well...it did. Here are some of the economic consequences related to the new administration and how different the outlook is for the economy going forward. Mr. Trump appears to be a "supply sider" who would like to cut taxes and regulations while re-negotiating better trade agreements. He is also very vocal at targeting companies that he believes are engaging in bad, "America First" behavior, like United Technologies/Carrier and Ford Motor Co.

The big picture is that fiscal policy, after years of taking a backseat to Federal Reserve monetary policies, will be taking the lead role in economic stimulus. This is a significant change from the last eight years and what many investors thought would occur over the following four years. Enter Mr. Trump and we have the prospect for a series of policies and initiatives that are a 180 degree U-turn away from those of Mrs. Clinton. In the blink of an eye, small cap domestically oriented firms soared in value, while large, multinational trade oriented companies lagged the rally.

Long-term Treasuries that thrived over the last eight years were sold off quickly, causing their yields to spike about 0.7% over three weeks. Here is where the rubber meets the road, interest-rate sensitive sectors of the economy will be impacted well before any of these new Trump policies ever see the light of day. We are eight years into the slowest business expansion since WW II, with an economy that has little pent up demand. Therefore, the Administration and the Fed will have to operate delicately when implementing this very different regime change, so as not to spook the bond market, creating the potential for a recession and not an expansion.

Positives

ISM Manufacturing and Service Index bounces higher last month

Housing Starts jump 25% last month

Durable Goods orders spike 4.8% last month

Negatives

MBA mortgage applications tumble 9.2% month to month

Industrial production was down last month and lower year over year

Trade balance for October was - $62 billion from -$56 billion last month

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EQUITY OUTLOOK

Summary

The election is over! The people have spoken, and the broader equity markets are breaking to new highs. There are some tangible, economic-based catalysts for the markets' moves, but first to review November.

The surprise trifecta sweep of the Oval Office, the House and the Senate unleashed a sizeable bull rally in anticipation of business friendly legislation coming within the first months of the new administration (read profits).

Overall, the S&P 500 jumped 3.7% for the month, bringing year to date gains to 9.8%. However, not all sectors participated equally.

The possibility of a roll-back of Dodd Frank financial regulations drove the financial sector up 13.7% for the month. Late cycle sectors of industrials (+8.5%) and energy (+7.9%) surged as well on expectations of low corporate tax rates and renewed energy exploration.

Not surprisingly, the focus by traders on these sectors skewed overall performance to deep value strategies, to the detriment of traditional growth areas of the economy. Especially health care, which has taken a drubbing as traders anticipated an unwinding of the Affordable Care Act. Year to date, the sector is off nearly 5%.

The market has focused laser-like on campaign promises, pledges and inferences, including a lower statutory corporate tax rate, large infrastructure builds, increased defense spending and an expansionary energy policy.

We have noted, for some time, that a resumption of corporate earnings growth was necessary for this bull market to continue. Certainly a lower tax rate would go a long way toward driving earnings across a broad swath of corporate America. In fact, all else remaining equal, our global competitive standing would most likely improve.

At the moment, we are enjoying a honeymoon rally of sorts led by the heretofore most neglected sectors of the market. However, we find little of consequence to influence any change in our asset allocation stance, which tilts toward U.S. based companies, with an emphasis on the small to mid portion of capitalization.

Positives

Job and wage growth continues

Consumer confidence still positive

Negatives

Election fatigue

Unknown

Less than decisive election outcome

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FIXED INCOME OUTLOOK

Summary

Interest rates soared in reaction to the election of Donald Trump. Not only were the vast majority of political experts wrong in their expected outcome for the election, but the vast majority of investment professionals were wrong in their assessment of how the markets would react if Trump did win. Thought by most to be an overwhelming negative for equity prices and the economy, the surprise win sent the stocks and the U.S. dollar higher by more than 3% on optimism that the economy will perform better under Trump's leadership. The real estate mogul's prescribed mix of infrastructure spending, corporate and personal tax cuts, and renegotiated trade agreements should give the economy a boost in the short run, but the timing and the ultimate cost in the long run are still up for debate.

The majority of the yield curve moved higher and steeper with the 2-year Treasury note yield increasing by 27 basis points (bps) and the 5-year and 10-year gaining 54 and 56 bps, respectively. The 30-year bond moved 45 bps higher flattening the spread over the 10-year to 65 bps from 76 bps. Bonds delivered their worst monthly return in over a decade for most of the major bond indices. Investment-grade corporate bonds performed about the same as comparable maturity Treasury notes. On the surface, the market's move to higher yields makes sense given the likelihood that the new Trump administration will make a push for significant fiscal stimulus through an infrastructure spending program and tax cut for (middle-class) individuals and corporations. Both of those measures would cause the federal budget deficit to increase at a higher trajectory than it was already expected to rise. At the same time, increasing rhetoric about labeling China as a currency manipulator and slapping trade tariffs on their imports is not likely to win favoritism from one of the largest investors in the U.S. government debt market. Given what has been discussed at this point, we believe that the market has fairly priced in this increasingly worrisome supply and demand balance. Rates are more likely to grind a bit higher as Trump and his administration make good on some of his campaign promises, but the majority of the move is behind us at the current yield levels.

Positives

- Demographic headwinds in most developed countries
- The U.S. yields are significantly higher than other developed nations
- Year-end fund rebalancing should favor bonds

Negatives

- Likely December rate hike and at least two more in 2017
- Fiscal stimulus and increasing budget deficits
- Anti-trade rhetoric and tariffs could lead to higher inflation
- Reductions in foreign buying of U.S. government debt

Unknowns

- Nationalist, populist movements around the world
- Bad debt and capital inadequacies in European banks