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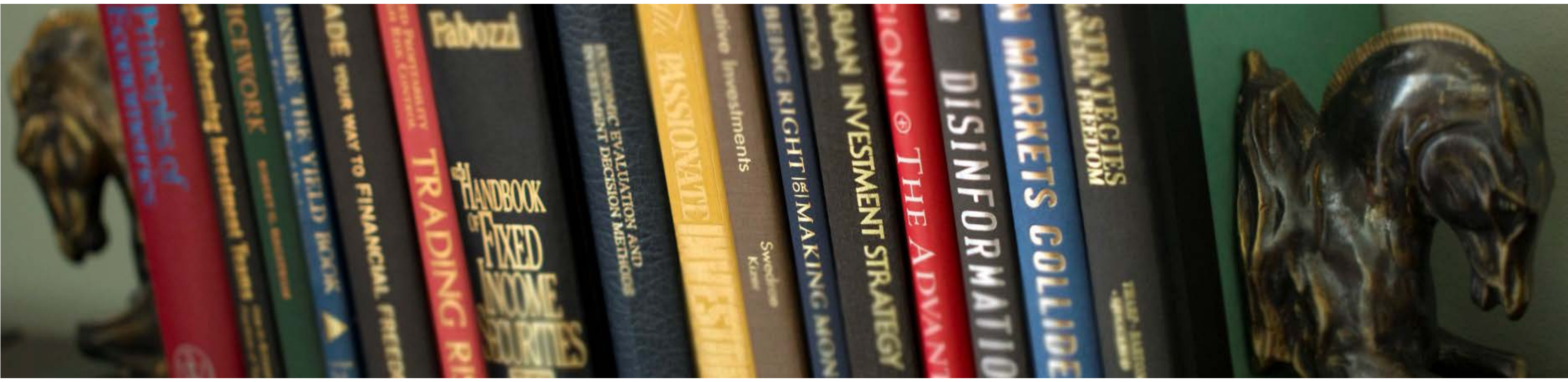
AVALON PERSPECTIVES

Quarterly Note

Fourth Quarter 2016



Looking forward is always an interesting exercise, and 2017 does not disappoint on this front. From President-elect Trump's administration and its promise of less regulation, lower taxes, and more jobs to the implementation of the OPEC deal to cut oil supplies, the possibilities for interesting economic outcomes abound. Markets, both equity and bond, have already reacted to portions of the above possibilities. As 2017 unfolds, there will be surprises for both the economy and markets—as usual.

Understanding the Trump Rally

Following the election, equity markets surged. Unquestionably, the reason for the advance in stocks has been the prospect of lower corporate tax rates coupled with a less onerous regulatory environment that would increase earnings and reduce valuation multiples. This caused a sharp reversal of sentiment in certain parts of the market. Inflation prospects, spurred by potential tax breaks and infrastructure spending, began to pick-up. This led to a fall in bond prices and the concurrent rise in yields. The combination of these primary factors leads to the natural question of whether a structural change has occurred and shifted the prudent allocation of portfolios. In some ways, the post-election market is an indication of the reason a well-designed portfolio with well-defined goals is critical to long-term financial success.

Digging into the drivers beneath the equity market rally is crucial to understanding how markets have evolved since the election. From Election Day through the end of November, the financial, industrial, energy, and material sectors rose the most within the S&P 500. These sectors have tailwinds ranging from potentially less burdensome regulation (financials and energy) to fiscal spending (industrials and materials). In other words, the rally was concentrated in sectors expected to benefit directly from a new direction in economic policy. What is critical to understand is that these policy changes have not yet been enacted; any disappointment in the agenda of the incoming administration could deflate at least pockets of the post-election rally.

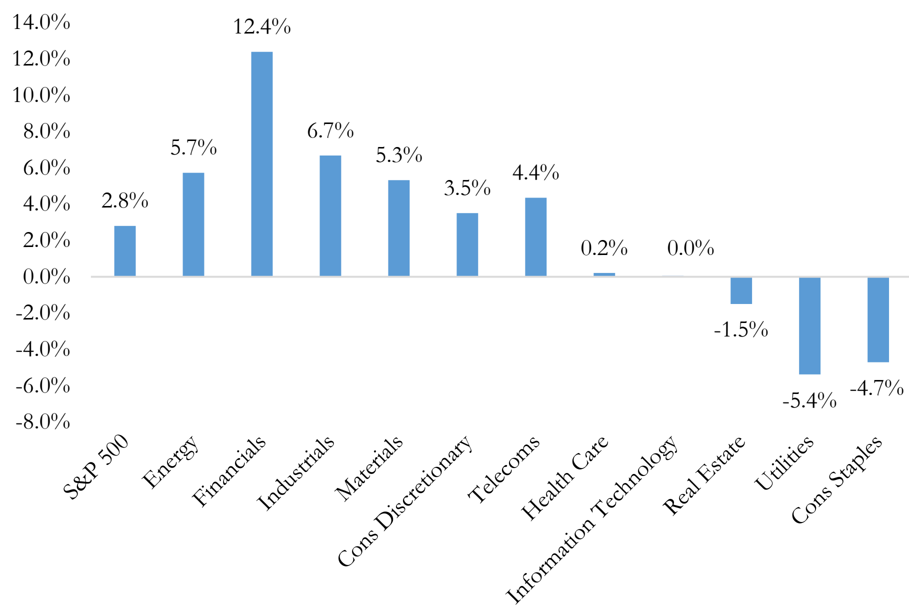
The energy, financials, and industrials sectors saw their prices move higher, predominately through their multiples, meaning that the price increased without the fundamentals moving concurrently. The price-to-earnings multiple measures how many "times" the price of a stock or index is relative to its earnings. For example, the once struggling energy sector saw its multiple expand the most by more than seven times. Financials expanded by 1.7 times and industrials 1.2 times. An expansion of 1.7 times may sound insignificant, but multiples are powerful. Taking the example of financials, the price-to-earnings multiple was about 14 times before the election, and it is now 15.7 times. That is a 12% expansion, and represents most, if not all, of the return. For some perspective, the S&P 500 rallied roughly 3% after the election through the end of November. Financials contributed 60% of the run as industrials and energy added 24% and 17% respectively. Essentially, the top three sectors drove all of the return with a wide dispersion elsewhere.

These four sectors constitute roughly 35% of the S&P 500, which is not insignificant. Of note, though, are the sectors that did not participate in the rally—health care, info tech and staples did not move. Simply, the surprise of President-elect Trump's victory does not fundamentally change the outlook for all sectors equally.

Putting it all together, equities rallied on the hope of regulatory leniency, tax breaks, and infrastructure spending. If the policies currently under consideration are implemented with precision and prudence, the post-election rally could fundamentally make sense.

However, the longevity of the rally may depend on the depth and nature of the shifts in economic and tax policies. Disappointments or delays in the size or timing of policy changes could have a negative impact on sentiment and multiples of the affected sectors. However, in general, corporate and personal tax breaks and less regulation should have a positive effect.

Price-to-Earnings Expansion in %
(Election Day to End of November Source: Bloomberg)



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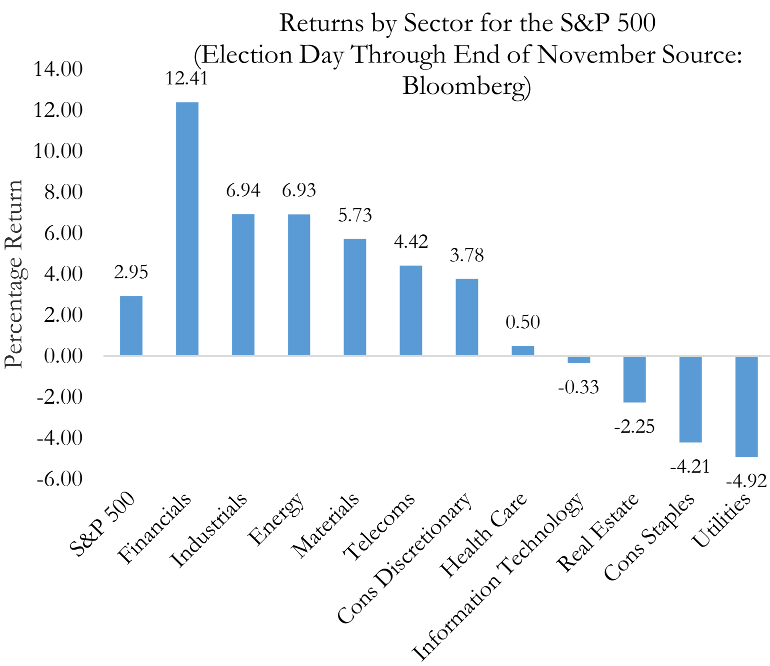
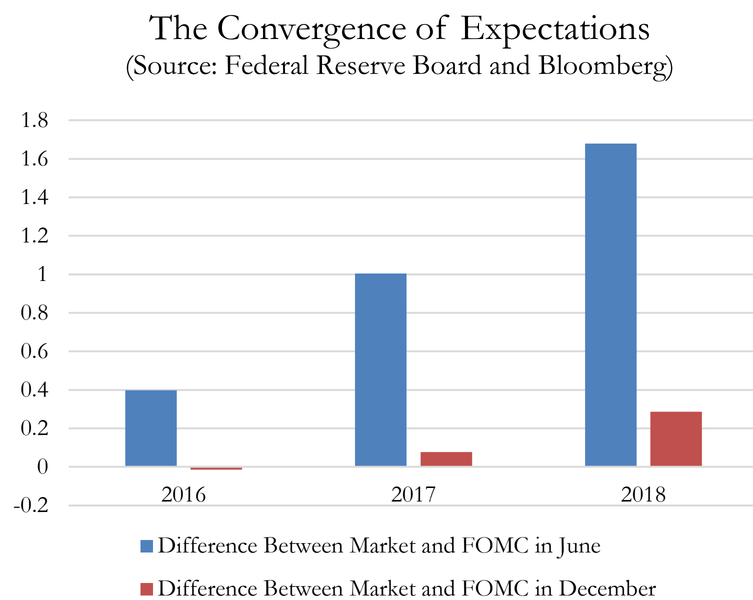
The Bond Market Catches Up with the Fed

For the first time in a very long-time, the market and the Federal Reserve's Federal Open Market Committee (FOMC) agree concerning future rate hikes. Both believe there will be three in 2017 and about the same in 2018. For the past several years, they have not been on the same page with the market anticipating fewer hikes than the Fed. For most of 2016, this dynamic was unchanged. Unsurprisingly, the market has been correct in expecting fewer hikes. However, following the election, the market's and the Fed's expectations converged. This dynamic of an alignment of opinion creates an interesting setup for 2017.





Over the past couple of years, the market was not surprised by slower Fed hikes. However, it would be now. This gives the Fed more "ammo" to fight a downturn than simply lowering the Fed funds rate—it can back away from hikes that are already priced-in. This is a luxury the Fed has not had in recent years.

Granted, the Fed anticipated it would get four hikes to play with entering 2016. But the market never bought into it. The convergence of expectations expands the ability of the Fed to react to the negative economic outcomes, certainly. But it also allows the Fed to move interest rates higher without much disruption. After all, the market has priced in three hikes, and three hikes should not cause outsized moves in longer-term interest rates (higher short-term rates may even limit the movement of longer rates by lowering growth and inflation). The Fed may be in a sort of sweet spot: It now has sufficient leeway to surprise markets "dovishly" in 2017.

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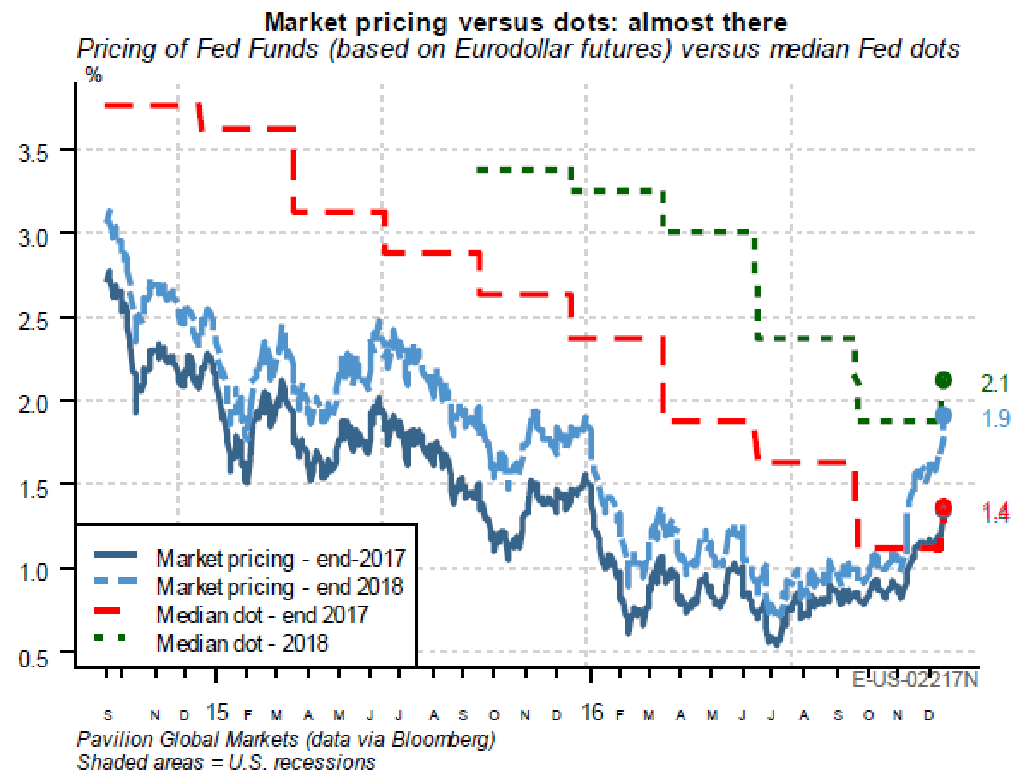

Some of the increase in rates was due to markets pricing in more inflation and a faster growth rate for the economy following the election of President-elect Trump. Similar to the analysis around timing or size of policy changes, disappointments in the content of Trumponomics could cause this inflation and growth to stall of even reverse. The Fed signaled more hikes in 2017 as a whole, but the voting members next year are more dovish than the FOMC in general. This sets up an interesting situation for the Fed—and the markets—in 2017. With the ability but not the urgency to raise three times, the Fed may truly be data dependent again. This does not mean the Fed will move rates aggressively and persistently—or that longer-term rates will follow shorter-term rates.

What Does All This Mean?

The unknowns in 2017 are primarily related to how the new administration will prioritize its economic policies. With a broad range of goals—from tax to regulation—the facts are not immediately clear, and even the timeframes are not easily discernible. However, the economic and political goals in general have been consistently stated, and markets have reacted accordingly. But there is still little known about the timing of Trumponomics, how it will be implemented, and the room for it to disappoint markets. Maintaining investment discipline and having a sound asset allocation is valuable in these periods of significant uncertainty.

2017 Global Outlook

Following the November U.S. presidential election, a lot has been said and written about where we are headed in terms of economics, politics, foreign relations. The subject is rich in conjectures since, at least at first glance, the new U.S. administration will be radically different from its predecessors. Some political pundits have drawn a parallel with the incoming Reagan administration in 1981 which was also a clear departure from the immediate past.

When it comes to equity management, we focus our attention on the key elements that will drive, at least initially, our investment strategy in 2017.

Probably, the central variable of 2017 will be the U.S. Dollar. Its role is fundamental because, while the U.S. represents about 25% of world GDP, the dollar represents 60% of world financial flows. From the beginning of 2015 until November 2016, the trade weighted dollar remained in a well defined range. But, since the elections the dollar is on an uptrend. The main reason is that, in line with the new administration pro-business statements, markets expect an acceleration of the U.S. GDP growth rate. This acceleration of the economy would be achieved through fiscal stimulus, tax cuts, infrastructure spending and deregulation.

One of the immediate consequence has been a rapid correction of the U.S. bond market. The 10 Year Treasury moved from 1.7% to 2.5% in less than six weeks, a very attractive yield for European and Japanese investors. Also the market implied expected inflation has increased from 1.5% to 2%. Last but not least the U.S. stock market, already expensive after an eight year bull market, moved up 5.7%(Russell 1000). But, here an important difference must be mentioned: growth stocks (Russell 1000 growth) went up 3.4% while value stocks (Russell 1000 value) went up 8.2%. This is the acceleration of a trend that can be traced back to the second half of 2015. Value stocks do better than growth stocks in an increasing interest rate environment, for many reasons including a lower sensitivity to interest rates and a lower exposure to global trade.

Global trade has become essential for S&P500 companies, representing about 40% of their revenues. McDonald's, the quintessential U.S. company, opened its first restaurant outside the U.S. in 1976. Today, foreign sales represent two thirds of its revenues. At the beginning of the Reagan years, half of the world did not participate in the global market economy. Today, North Korea and Cuba are some of the last holdovers. The amount of U.S. dollar denominated debt issued by foreign borrowers is about $10 Trillion. Most commodities (oil, gas, iron, coal, copper, rice, wheat, corn) are priced in U.S. dollar. During Reagan's first term, the combination of a stimulative fiscal policy and a restrictive monetary policy triggered an 85% appreciation of the trade weighted dollar (DXY). Based on these few preceding points, such an appreciation would be impossible today. The dollar has already appreciated 4% since the elections and, for 2017, we assume that the dollar could appreciate another 1.5-3.5%. Beyond that we would get a global recession.

The Euro represents nearly 60% of the trade weighted dollar. It has been weakened by a poor economic environment and a profound political crisis. As we mentioned in our 2016 outlook, the populist movement is alive and well. Since the last recession, rebellion against the establishment has become an effective political platform. From the recent successes in the U.K., U.S. and Italy the inference is that 2017 elections in Europe will favor anti-establishment candidates and, consequently, bring a potential dislocation of the European Union. I do not agree with that point. Because of historical precedent, we do not believe a far-right anti-establishment candidate can succeed in Europe. Consequently we assume that a center-right coalition lead by Mark Rutte will win the Dutch March elections, François Fillon, the Republican's candidate, will be elected French president in May and Angela Merkel will remain the German Chancellor after the September elections. In Italy, we will get another coalition government with possibly some representation but no leadership of the Five Stars movement. Such political outcomes would be very positive for Europe. Also the ECB is starting to alter its quantitative easing program towards a less stimulative policy. Therefore we assume the Euro will remain above parity to the dollar, reaching a low for the year around March. As an aside, and despite the arduous process of going through Brexit, we estimate that the pound has already seen its lows against the Euro.

Since the elections, the Yen has lost about 14% of its value against the U.S. dollar. There is no sign at this point that the BOJ will change its monetary policy. So we assume that the Yen could depreciate another 2-4% against the dollar. This is obviously a very favorable outcome for all Japanese exporters. On the other hand, Japan, as the closest ally of the U.S. in Asia, could be affected both politically and economically, by the expectation of a more confrontational Sino-American relationship.

The appreciation of the U.S. dollar is an unexpected consolation price for China. It will make it more difficult for the incoming U.S. administration to argue that China is a currency manipulator: it is the dollar going up; not the Yuan going down. Investing in China will remain challenging in 2017. The Chinese leadership has shown significant reluctance to address resolutely the massive amount of debt accumulated in the system since 2009. Its efforts to restructure the steel and coal industries have been ineffective. Speculative construction is still encouraged at the local level, pollution is out of control, capital flight is constant. Xi Jing Ping mentioned for the first time that a 6.5% GDP growth rate was not etched in stone. A decrease in credit induced stimulus would be a good step towards addressing key imbalances in the economy.

A slowing Chinese economy would also be a negative for commodities demand. When it comes to commodities, I am still of the camp that the attempted re-cartelization of the oil market will eventually fail. So, even if we see a WTI at $60 during the year, we work under the assumption that such a level will not be sustainable and that we will revert to the $45-55 trading range that we have used since early 2015. After all, in Euro, Yen, Yuan or most emerging markets currencies, oil has already gone up significantly since the November elections.

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The second element that enter in our assumption for oil prices, is that we are not convinced that we will witness a rapid acceleration of the U.S. economy. At some point, probably in the first half of the year, expectations and reality will eventually collide. This should happen when it becomes evident that passing tax legislation, implementing a stimulus program and reforming healthcare will take quite a bit of time, effort and compromise. At that juncture some of the market assumptions should adjust back towards trend lines. Namely, based on demographics and productivity, we still assume a 2.5% real GDP growth rate. Also I expect inflation expectations to move back down to 1.5% and the bond market to rally at that point. It still remains to be seen if the Fed will be comfortable raising rates while the U.S. dollar is strengthening.

In conclusion and back to our first point, the U.S. dollar will be the central variable to watch in 2017.

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