Redstone Advisors

Economic and Market Review

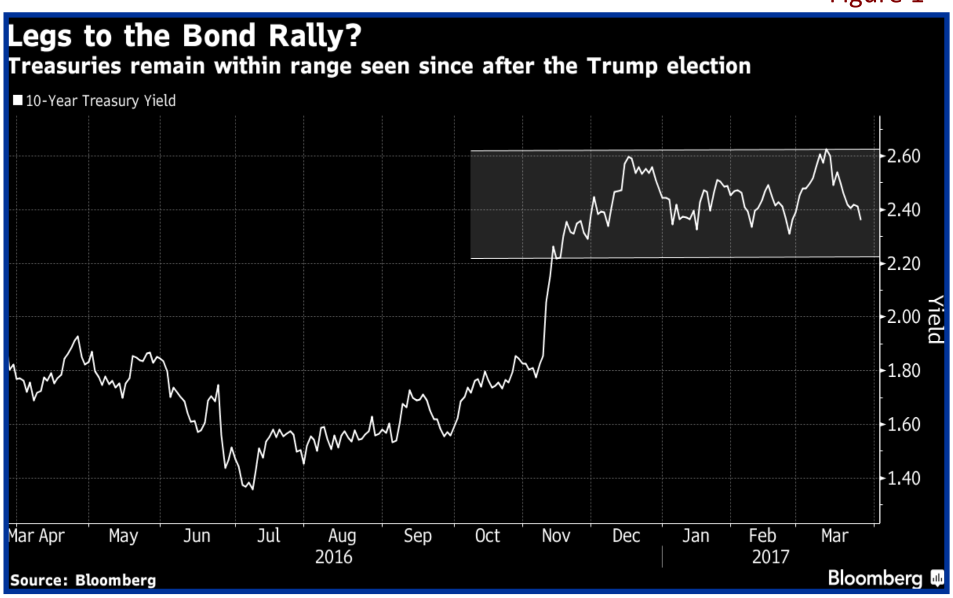
First Quarter 2017

After the "Trump Tantrum" market reaction that defined the fourth quarter of 2016, the first quarter of 2017 largely saw a reassessment and increasing doubts regarding the initial consensus forecast of higher growth, higher interest rates and higher inflation. Our opinion remains that **fundamentally nothing has changed regarding the long-term trajectory of the economy**. The forces of secular stagnation—through past excesses of perpetual intervention and inflation—are still conspiring with the **headwinds of a massive overhang of debt, deteriorating demographics, and the financialization and the globalization of the economy to restrain economic growth**. These deeper, long-lasting and secular (non-cyclical) forces are helping to hold down long-term interest rates. *"The whole Trump trade, the reflation trade—odds are, that's over. What we're seeing is there's no breakout trade of massive, upcoming fiscal stimulus,"* noted Robert Tipp, chief investment strategist at Prudential.

Markets have a well-established tendency to "rush to judgment" during periods of major policy shifts. The election of President Trump in November along with a GOP-controlled House and Senate certainly had the market jumping to conclusions about the fiscal policy one-party rule in Washington would be able to achieve. However, given that the economic environment post-election remains virtually unchanged, it remains our judgment that the secular declining trend in long-term interest rates remains equally unchanged. Furthermore, new regulations aimed at making the financial system safer require that banks, life insurers and pension funds hold sovereign bonds to meet liquidity requirements and match liabilities. This means that continued demand from investors and banks due to regulatory changes could hold long-term bond yields at relatively low levels, even as recovering economies push some central banks to tighten monetary policy. *"Demand for longer-dated higher-yielding cash flows is very, very present"* said Scott Thiel of BlackRock.

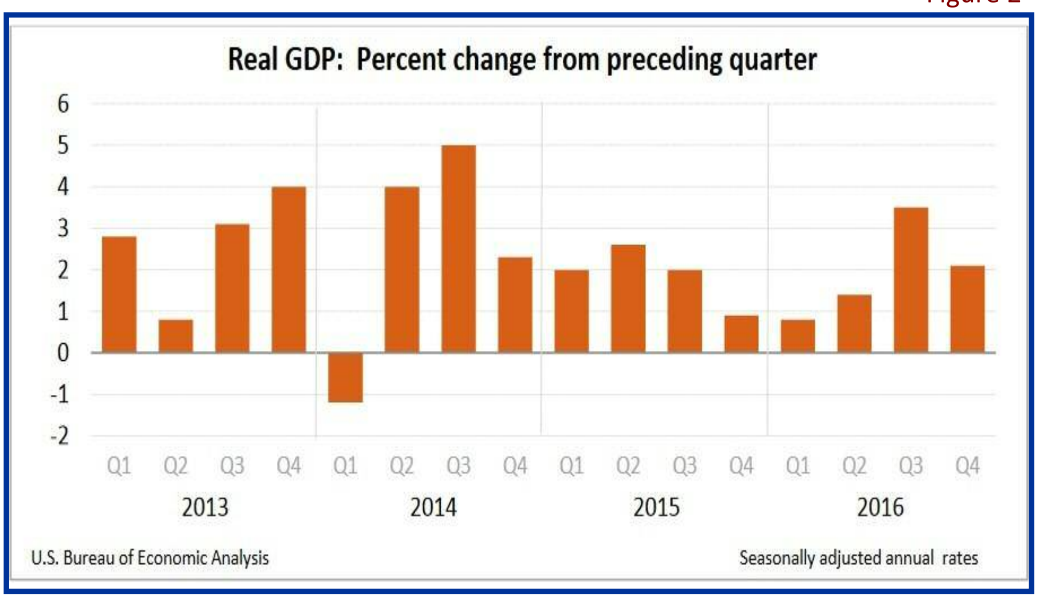
This past quarter saw the Treasury yield curve slightly flatten, with 1 and 2 year rates on the short end rising and rates at the long end very modestly declining. The spread between the 2-year and 10-year Treasury narrowed from 130 basis points at the beginning of the year to 114 basis points at quarter end. A **flattening yield curve suggests that the bond market is skeptical of the reflation trade, seeing little risk of accelerating growth and inflation**. *"It seems that the bond market just hasn't really bought into the idea that inflation is coming back, or that economic growth is going to be surprisingly strong,"* proclaimed Yardeni Research president Ed Yardeni. Treasuries have stabilized this quarter, following their biggest quarterly loss since the 1980s. While short-term rates are influenced by the Federal Reserve's monetary policy, longer-term bond yields are driven partly by inflation expectations and are more sensitive to fiscal policy and overall economic growth. Yields on long-dated debt are still near their historic lows, even after the "Trump Tantrum". Yields on 30-year Treasuries are about 3% now compared with 2.3% in October. The benchmark 10-year Treasury note has fluctuated sideways in a narrow 2.31 percent to 2.63 percent trading range since the end of November. It appears the bond market is seeking greater clarity on proposed tax reform and fiscal policy from the Trump administration before making its next significant move. The recent consolidation of the 10-year Treasury yield can be seen in **Figure 1**.

Figure 1



Inflation-protected Treasury prices have been reflecting roughly 2 percent inflation (the Fed's target) for quite some time now, and despite a low unemployment rate and relatively good payroll numbers, the bond market largely agrees with the Fed that there is slim chance of an inflationary outbreak anytime soon. The end of the first quarter saw the "Trumpflation" trade, driven by hopes of aggressive pro-growth policies including tax cuts and infrastructure spending, begin to unravel. The dollar dropped from a 14-year high in January to a four-month low in late March. Safe-haven gold had its best quarter in a year and oil prices slid, giving crude its worst quarter since the end of 2015. Moreover, U.S. stocks are the most overvalued in 17 years, according to a Bank of America fund manager survey. The **dark realities of political gridlock and intraparty divisions, even with single-party control of both the White House and Congress, squashed any dream of quick action that would theoretically boost growth and inflation higher**. Speaking of growth, the Commerce Department reported their final estimate for 4th quarter 2016 gross domestic product (GDP) was 2.1 percent. GDP grew at a subpar rate of 1.6 percent for all of 2016, the weakest pace in five years. Since the Great Recession officially ended in 2009, the U.S. economy has averaged annual GDP growth of just 2.1 percent, the slowest recovery since the end of World War II. Quarterly GDP growth going back to 2013 can be seen in **Figure 2**.

Figure 2

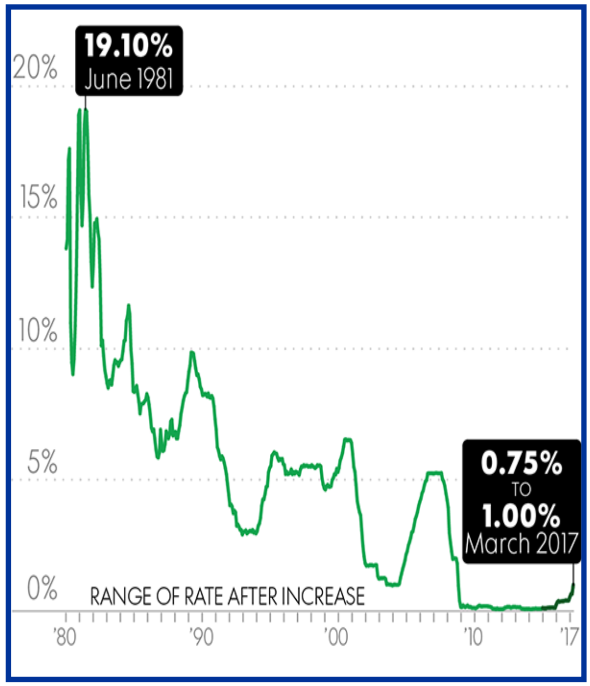


In late March, House Republicans withdrew their legislation to repeal and replace Obamacare after a revolt by conservative Freedom Caucus members and moderates within their own party. As a result, the **market was forced to revise expectations regarding the scope and timing of tax reform and other fiscal proposals on the Trump agenda**. In the aftermath, President Trump and House Speaker Paul Ryan both mentioned they wanted to prioritize tax reform. Tax reform is a complicated and thorny issue, where the devil is in the details. **Tax reform, which involves winners and losers, is quite different from tax cuts, which historically has been much easier to achieve and involves mainly just winners. Tax reform also happens to pit powerful and deep-pocketed interests against one another**. That is why we have seen several successful tax-cut bills signed into law over the years, while tax reform, despite having been attempted numerous times in Washington, has not been successful since President Reagan's effort in 1986. The tax code is filled with special-interest provisions and deductions enacted over decades. Popular tax breaks for individuals such as the mortgage interest deduction and charitable giving deduction account for huge amounts of revenue. Both have been discussed as being on the table to be reduced or eliminated to compensate for bringing down tax rates. The powerful real estate industry, charitable groups, and other special -interest constituencies are guaranteed to loudly revolt and make their voices heard at the first sign of any proposed changes to the tax code.

Complicating matters is that currently Congressional Republicans lack a unified vision on tax reform. For example, the centerpiece of the House GOP's plan is the **"border adjustment tax" or BAT**, a proposal which many GOP Senators have strongly opposed. The BAT, in its current form, would mean a 20 percent tax on imports into the United States. Speaker Ryan and other House GOP leaders argue this would raise as much as $1 trillion to offset reductions in individual and corporate tax rates. **The BAT idea has already created a sharp divide within the business community**. Retail heavyweights like Walmart are fiercely opposed to a BAT which they argue would increase the price of their products and end up raising costs for American consumers. Meanwhile, many industrial companies that are heavily dependent on exports support the BAT.

In mid-March, in a well-telegraphed move, the Federal Reserve increased their benchmark federal funds rate to a target range of 0.75 percent to 1.00 percent. As you know, the Fed kept rates at near zero from the end of 2008 through most of 2015 as part of its zero-interest rate policy (ZIRP), before lifting the benchmark rate a quarter point in December 2015 and once again in December of 2016. An increased number

Figure 3



of Fed officials are now expecting to raise rates at least twice more this year. That would put the target range at 1.25 percent to 1.50 percent by year end, still a very low level when put in historical context. The Fed's benchmark rate going back to 1980 can be seen in **Figure 3**. Fed officials continue to forecast a "Goldilocks" economy, not too hot or too cold, with the unemployment rate remaining around 4.5 percent and inflation around 2 percent for the next three years. This new phase of gradual rate increases has some Fed watchers questioning when the central bank might start shrinking its massive balance sheet. The Fed currently maintains their $4.5 trillion portfolio by reinvesting the proceeds of maturing Treasury bonds and mortgage-backed securities. The FOMC in their statement repeated a commitment to maintain their balance-sheet reinvestment policy until rate increases were well under way. Yellen said officials had discussed the process of reducing the balance sheet gradually, but that no decisions had been made and that the topic would continue to be debated.