



Second Quarter 2017 Outlook and Commentary

For the better part of the last five months global stock markets have been on a roll. From last November's presidential election through the end of the first quarter the S&P 500 Index climbed over 10%. Developed markets outside the U.S. rose even faster, gaining more than 12%. Conventional wisdom attributes the market gains to optimistic views of President Trump's economic agenda. Accumulating evidence suggests, however, that markets may be reacting to something else.

The premise of the "Trump trade" is that Congressional action on the president's priorities—especially tax reform, deregulation and infrastructure spending—will boost economic growth and corporate profits. We cautioned in January that passing this legislative agenda was much easier said than done. In the wake of the failed attempt to repeal and replace Obamacare, our skepticism appears justified. Having been thwarted by the conservative House Freedom Caucus, the administration is now suggesting it may reach out to Democrats on a range of issues. Much as we like the idea of pragmatists from both parties joining forces, we're dubious that the White House has laid the groundwork for a bipartisan legislative coalition.

Despite the stalled presidential agenda, the post-election surge in consumer and business confidence continues, based perhaps on the conviction that a pro-business president and cabinet will, through executive action (or lax enforcement), clear away a jungle of red tape and inspire a wave of business investment and innovation. That may yet happen, but it's not showing up in any economic data. Notably, bank lending has slowed over the last several months. Either businesses have yet to translate newfound confidence into concrete plans, or banks are, for whatever reason, not cooperating. Meanwhile, first quarter auto sales were mediocre, there are no signs of job growth picking up, and quarterly and annual estimates of GDP growth look suspiciously similar to the two percent that has become the norm in the wake of the financial crisis.

But maybe it's not all about us. And by us, we mean the U.S. It's beginning to appear that the stock market surge of the last five months has as much to do—if not more—with economic strength in Europe and China as anything happening here¹. (Bear in mind that companies in the S&P 500 Index get thirty percent of their revenues outside the U.S.) As the chart below illustrates, manufacturing data has been accelerating in

¹ The evidence that factors beyond President Trump's economic agenda have driven stock market performance is compelling. Following the election, stocks that would benefit from lower corporate tax rates and infrastructure spending surged. According to the Wall Street Journal these categories have now retreated to pre-election levels.

tandem in the world's three largest economies. If current forecasts hold, 2017 will be the first year since 2010 to see growth in every one of the G-20 countries².



In fact, one could argue that the global economy is healthier than at any time since the Great Recession. Beginning with the U.S. Federal Reserve's first round of "quantitative easing" (QE) in November 2008, central banks around the world have (with a brief pause in 2010) been buying up bonds to artificially lower interest rates and stimulate economic growth. Total central bank assets—less than 20% of world GDP before the Great Recession—will reach 35% by the end of 2017. From there, with the global economy increasingly able to stand on its own, central bank assets are expected to begin a gradual decline. If that happens, perhaps it will mark the end of the aftermath of the global financial crisis, nearly a decade after the crisis began.

It's appealing to think that healing from the financial crisis is nearly complete, but we hasten to add several notes of caution. First, as Federal Reserve Chair Janet Yellen knows, transitioning away from monetary stimulus is a tricky proposition. At the end of 2015, when the Fed increased the fed funds rate for the first time in nine years, it signaled that it would raise rates four times in 2016. Those plans were abandoned as a weakening U.S. economy early last year pushed the Fed to the sidelines. Instead of four rate increases, the Fed hiked once. Only in the last few months has the Fed reached a point that it could engage in a sustained round of interest rate increases without spooking capital markets.

As challenging as it has been for the Fed to wean the U.S. economy off monetary stimulus, the comparable task in Europe will be much more difficult. Somehow the European Central Bank (ECB) will have to balance (a) inflation-phobic Germany, which wants to end European QE as quickly as possible, (b) countries like Greece, Italy and Portugal, that are dependent on QE to prop up their fragile economies and sustain their massive government debt, and (c) right-wing political parties eager to instigate a breakup of the European Union.

² The G-20, or Group of 20, an international forum for promoting global financial stability, comprises twenty of the world's largest economies.

Speaking of anti-EU parties, there was a bit of good news when Geert Wilders' radical anti-Muslim Party for Freedom fell short in the recent Dutch election. While somewhat reassuring, there is still the possibility of trouble in upcoming elections in France (first round later this month followed by a runoff in May) and Germany (late September). While it's less likely to generate a real surprise, the Chinese Communist Party Congress in October may also be significant. We continue to believe that there is a debt bubble in China. It's impossible to know what might cause it to burst, and the fact that China is a command and control economy could allow it to go on longer than it otherwise would. But it can't go on forever.

Perhaps as significant as the possibility that a political or geopolitical crisis (have we mentioned Syria or North Korea?) will knock the stock market for a loop are the demographic forces that almost guarantee modest global economic growth over at least the next ten years. As discussed in these pages six months ago, growth in the working-age population is slowing sharply across the developed world and in much of the developing world as well. While the global economy appears likely to grow faster this year than last year, very slow growth in the global labor force almost guarantees that we are not entering a lengthy period of robust growth.

The good news is that the stock market doesn't generally require super-charged economic growth to deliver decent returns. Slow and steady growth, combined with low interest rates, provides the ideal environment for stocks. And, by and large, that's what we've had for the last seven years. The bad news is that the U.S. stock market appears to have gotten ahead of itself. From its early February 2016 low to the end of March 2017, the S&P 500 Index rose over thirty percent. That low came as oil prices were in a free fall and investors feared a global recession was around the corner. The global economy is on much sounder footing now and corporate earnings are growing more rapidly than they have in several years. But the price-to-earnings ratio of the S&P 500 is north of 24³, a level that historically has not been sustainable. There are three ways to get this number back into its normal range: (a) a dramatic rise in corporate earnings, (b) an extended period in which stock prices are flat or modestly down, or (c) a stock market correction, which is defined as a decline of ten percent or greater and occurs, on average, once every 26 months. We're hoping for the first scenario, but it would be wise to be prepared for the second or third.

While US stock returns are projected to be lower than normal, low interest rates still make US stocks attractive relative to bonds. Luckily for investors with a diversified portfolio, better valuations are found in foreign stock markets and especially emerging markets. Within emerging markets, value stocks appear especially cheap right now after a long period of underperformance, and we have been adding these strategies to portfolios.

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³ Based on the previous twelve months reported earnings. Bullish analysts typically use estimates of next year's operating earnings. These so-called forward earnings are more subjective, as they depend on estimates (often overly optimistic) of what may happen next year and exclude certain one-time charges that management deems to be non-recurring.

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