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# Market Outlook & Strategy

First Quarter of 2017

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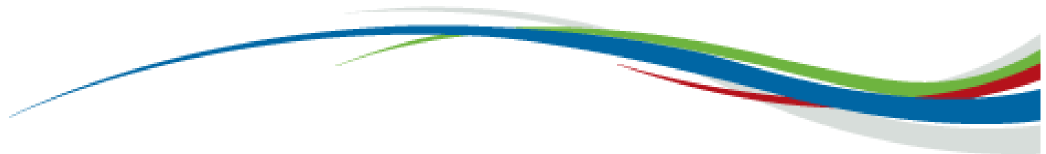

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***Executive Summary***


- Global equities delivered robust gains in the first quarter amid an upswing in global economic data. In the U.S., the overall equity market advanced by 5.8% with growth stocks and large company stocks outperforming value and smaller company stocks.

- Bolstered by a weaker dollar, non-U.S. equities led the Q1 global stock market rally. Developed markets increased by 7.4% overall, led by strong returns out of Europe. Emerging market equities significantly outperformed other asset classes, up 11.5% through the end of March.

- Fixed income returns were much more muted but positive in all segments, with the Barclays U.S. Aggregate Bond Index increasing by 0.8%. Against the backdrop of strengthening growth, rising inflation and marginally more hawkish central banks, lower-credit quality categories led the way.

- In this issue, we focus on two key threats to accelerating growth in the U.S.: restrictive immigration and President Trump's obsession with trade deficits. Continued immigration is vital for growth due to demographic trends in the U.S. Indeed, the U.S. Census Bureau estimates that fully 85% of the prospective growth of the labor force will come from immigrants over the next 10 years (assuming current immigration flows.) As for trade deficits, we explain why they are often caused by factors in the macroeconomy that are not even directly related to trade, and that the focus on trade deficits per se is tantamount to obsessing over the wrong thing.

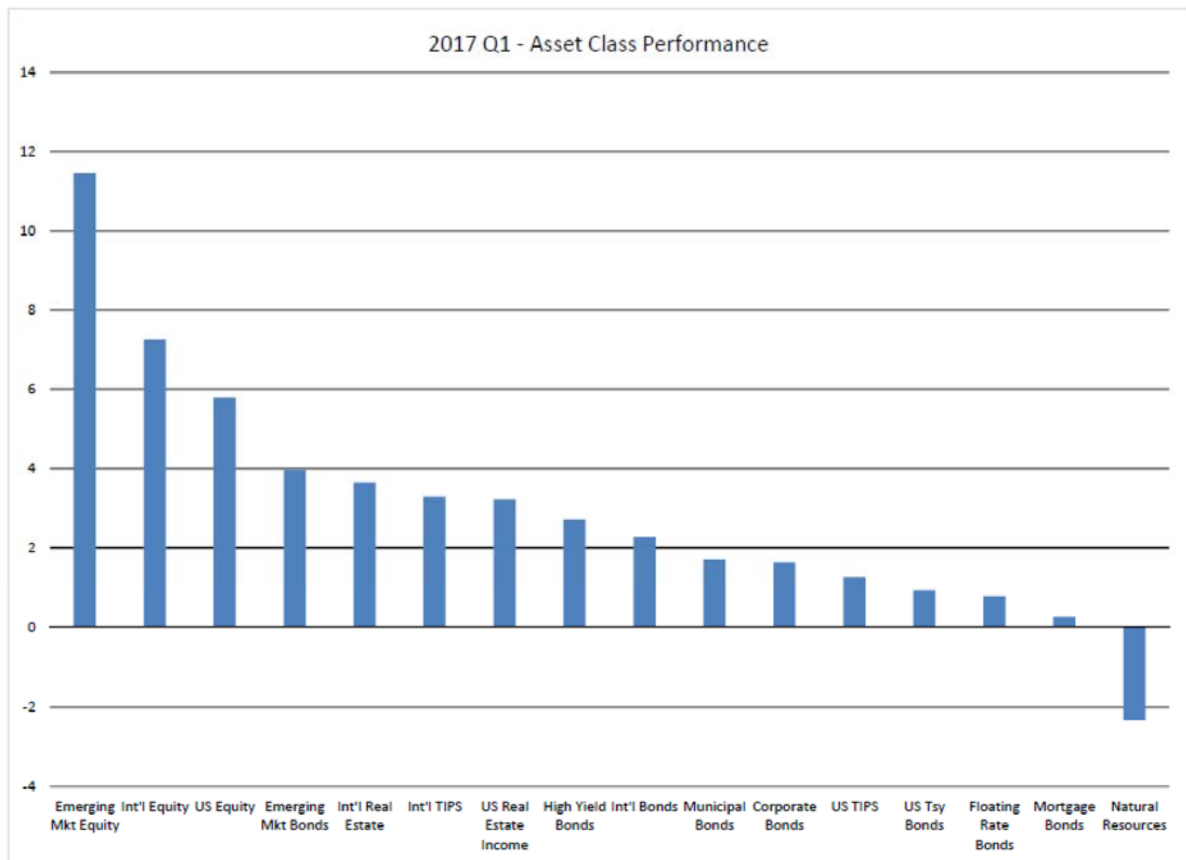
- In terms of Artemis strategy, we are diversifying our international and emerging market allocations to better capture the hoped-for (but not guaranteed) rotation away from the pricier U.S. market. We are also maintaining our focus on taking credit risk rather than interest rate risk in our fixed income allocations.

***1st Quarter in Review***

Global equities delivered robust gains in the first quarter amid an upswing in global economic activity. In the U.S., the overall equity market advanced by 5.8% with growth stocks and large company stocks outperforming value and smaller company stocks. (See Figure 1.)

Such strong gains suggest that investors remained optimistic about President Trump's plans to cut taxes, boost infrastructure spending and reduce the regulatory burden on businesses. Nevertheless, this optimism hit a bit of a roadblock in March following the administration's failure to repeal and replace Obamacare. Indeed, all of the gains realized during the quarter came in January and February.

Figure 1: Market Performance by Asset Class in Q1 2017 (percentage points)



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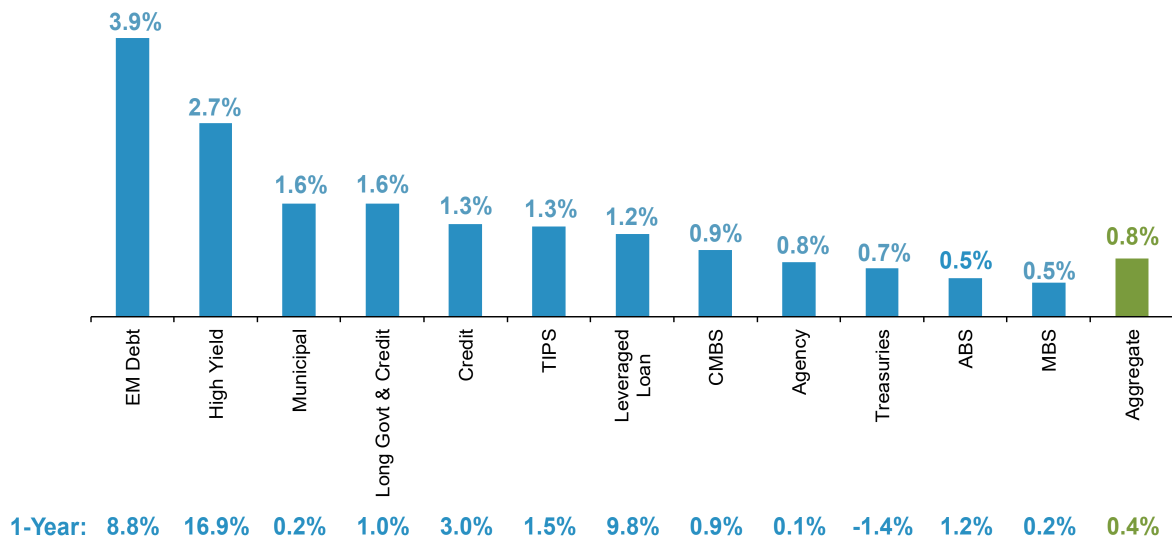
Bolstered by a weaker dollar, non-U.S. equities led the Q1 global stock market rally. Developed markets increased by 7.4% overall, led by strong returns out of Europe. Positive economic data and the failure of the far-right candidate to win the Dutch elections in March helped to buoy the eurozone market.

Emerging market equities significantly outperformed other asset classes, up 11.5% through the end of March on the back of expectations that better global economic momentum will lead to better trade prospects. The weaker dollar also helped, as did the continued rebound in Chinese industrial activity.

Fixed income returns were much more muted but positive in all segments, with the Barclays U.S. Aggregate Bond Index increasing by 0.8%. Against the backdrop of strengthening growth, rising inflation and marginally more hawkish central banks, lower-credit quality categories led the way. (See Figure 2.) This result extends the pattern we have seen over the past year in which lower credit-quality assets have performed far better than their interest-rate-sensitive counterparts. This should not be surprising, given that we are now in an increasing interest rate environment with stable and even accelerating global growth.

Figure 2. Fixed Income Returns in Q1 2017 by Segment




Source: Fidelity

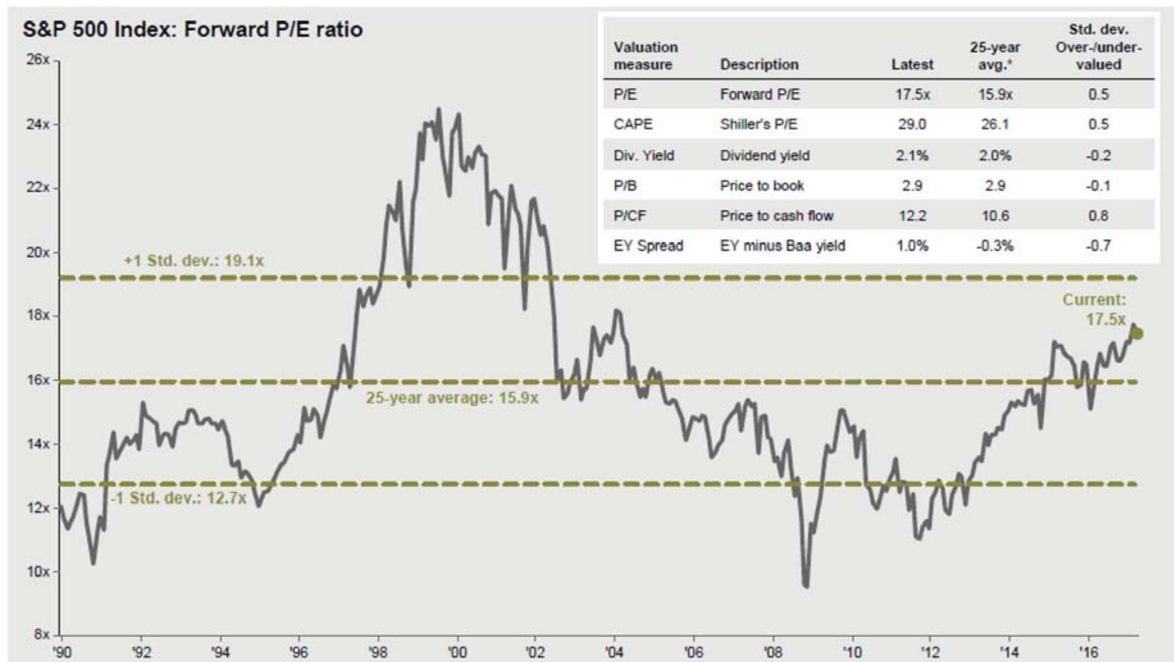
Commodities were the only asset class to see a negative return for the quarter, led mostly by faltering oil prices as concerns over inventory levels in the U.S. weighed on sentiment toward future supply/demand dynamics.

**Is the Party Over?**

A key question is whether the entire narrative regarding U.S. stock market strength, a strong dollar and bond price weakness is over. Much depends on whether there is going to be any fiscal stimulus through tax reform and infrastructure spending – both of which are key Trump promises – and whether monetary policy will remain accommodative.

The problem today is that much of this positive growth expectation is already baked into the market. As shown in Figure 3, the price-to-earnings ratio for the S&P 500 is now over its 25-year average. Any further increase is going to have to be driven by actual improvement in corporate sales and earnings growth.

Figure 3. Forward Price-to-Earnings Ratio for the S&P 500




| Valuation measure | Description | Latest | 25-year avg.* | Std. dev. Over-/under-valued |
|---|---|---|---|---|
| P/E | Forward P/E | 17.5x | 15.9x | 0.5 |
| CAPE | Shiller's P/E | 29.0 | 26.1 | 0.5 |
| Div. Yield | Dividend yield | 2.1% | 2.0% | -0.2 |
| P/B | Price to book | 2.9 | 2.9 | -0.1 |
| P/CF | Price to cash flow | 12.2 | 10.6 | 0.8 |
| EY Spread | EY minus Baa yield | 1.0% | -0.3% | -0.7 |

Source: JP Morgan

Unfortunately, while confidence may remain high, the so-called "hard" economic data are not looking so good. Retail sales have been declining for the last two months, bank loan growth is slowing, and the Federal Reserve Bank of Atlanta just recently lowered its projection for first-quarter economic growth to a disappointing 0.5% pace. Even if growth recovers handsomely for the rest of the year, such a slow start will make it difficult for the economy to do better than the roughly 2.0% annual pace recorded since mid-2009.

Moreover, the political situation has admittedly become more complicated. The debacle over repealing and replacing Obamacare laid bare the enormous divisions within the GOP, in addition to those already existing between them and the Democrats. More recently, we have seen Trump do a complete about-face on foreign policy and America's role in the world. These two factors alone make it almost impossible to predict where we will end up in terms of his signature growth initiatives.

A more worrying issue is that even if Trump does succeed with tax reform (or at least tax cuts) and increased spending, one has to wonder whether all we end up with is inflation. The reason is simple: we are running out of qualified workers and need to actually increase immigration if we want to accelerate real economic growth (versus just create inflation).

As I have written about before, real U.S. GDP growth is driven by two engines: the growth rate of the labor force, plus the growth rate of output per worker (productivity). As shown in Figure 4 on the next page, slow growth of the labor force – only 0.4% on average annually over the last 10 years – is one of the key reasons why U.S. growth has averaged only around 2.0% since the last recession. Based on current rates of immigration and demographic trends, the growth of the labor force over the next 10 years is expected to decline further to average only 0.3% annually. And keep this in mind: *fully 85% of that total will come from immigrants*. If Trump succeeds in slowing legal immigration (not to mention illegal immigration), we will be in serious trouble in terms of achieving any kind of growth.

**Is America Getting Ripped Off?**

Unfortunately, President Trump's views on immigration are not my only concern. My other concern is his views on trade and trade deficits specifically. (A trade deficit arises when a country imports more goods than it exports.) Getting either immigration or trade policy wrong spells trouble for prospective U.S. stock performance.

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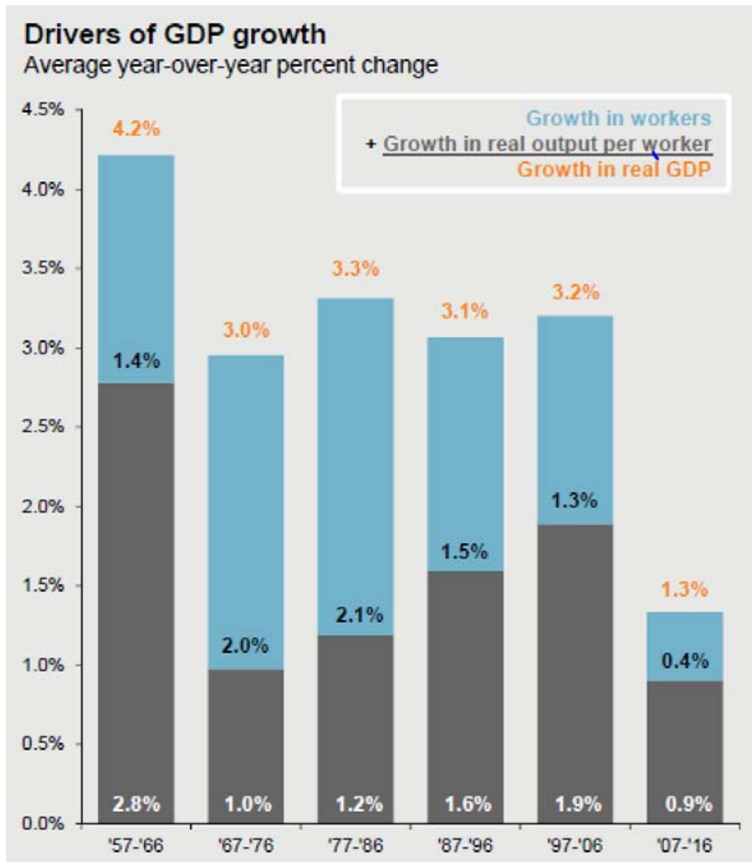
Figure 4. Drivers of Real GDP Growth in the U.S.




Source: JP Morgan

The heart of the matter is that Trump thinks running any kind of a trade deficit is bad and that America has been "ripped off" by those countries with whom we have been running persistent trade deficits. As Peter Navarro, the head of Trump's newly-formed White House National Trade Council, recently stated:

*"The economic argument that trade deficits matter begins with the observation that growth in real GDP (a.k.a. national income) depends on only four factors: consumption spending, government spending, business investment and net exports (the difference between exports*

*and imports). Reducing a trade deficit through tough, smart negotiations is a way to increase net exports and boost the rate of economic growth."*[1]

Mr. Navarro is referring to the classic national income accounting identity that all students learn in their first macroeconomics class:

**GDP = Consumption + Investment + Gov't Spending + Exports – Imports**

Alas, the sign in front of imports is a negative; hence, according to Navarro, more imports equals lower growth! The problem with this analysis is that imports need to be subtracted from the equation, because they have already been counted in the other components of income such as consumption expenditures or business investment and so it would be double-counting not to do so. That Navarro, who has a Ph.D. in economics, would make this mistake is worrying enough, but the point is that a higher trade deficit does not necessarily make the U.S. poorer.

What we should be asking is what causes trade deficits, and when do they make us richer and when do they not. **If you remember nothing else from this essay, remember this: trade deficits are often caused by factors in the macroeconomy that are not directly related to trade**.

A good example of this is China. Between 2000 and 2007, gross savings in China soared from 37 percent to nearly 50 percent of GDP. (By comparison, gross savings in the U.S. is around 17% currently.) About half of this rise financed additional domestic investment, and half financed a rise in the trade surplus. As Martin Wolf argues in a recent *Financial Times* article, when the financial crisis hit in 2008, China decided that the world was no longer able to buy Chinese exports at previous levels. Instead, the Chinese government started to raise domestic investment by promoting explosive domestic credit growth. This change helped a great deal to soften the global impact of the crisis and temper China's large trade surplus with the rest of the world.[2]

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[1] Navarro, Peter. Address before the National Association of Business Economists in Washington, D.C., March 6, 2017

[2] Martin Wolf. "China Faces a Tough Fight to Escape Its Debt Trap." *Financial Times*, April 12, 2017

Germany is another good example. In 1990, Germany was running a trade surplus of almost $50 billion annually in the aggregate, but it switched to running a $20 billion annual trade deficit the very next year. What happened? By 1991, Germans started investing heavily in the former East Germany and saw this as a better opportunity than sending its deutsche marks abroad. This switch left foreigners with fewer deutsche marks with which to buy German exports.

**In both cases, the countries enacted no change in trade policy or suffered any sudden loss of competitiveness**! What happened had all to do with changing rates of savings and investment.

It is true that persistent trade surpluses can be exacerbated when countries engage in unfair trading practices such as providing subsidies to their exporters or manipulating their currency. However, those who have studied this issue in detail tell us that global capital flows stemming from changing rates of saving and investment have in the last decades grown much faster than trade flows, suggesting that capital flows are primal.[3]

For this reason, trade policy in the form of tariffs or U.S. House Majority Leader Paul Ryan's idea of a border adjustment tax won't do much to end our persistent trade deficit with the rest of the world because trade policy is not driving capital flows. What increased trade protectionism will do is deprive foreigners of the dollars they would have earned by selling more into the U.S. market. With the supply of dollars down in the international market, the price of the dollar relative to other currencies will increase, making our products more expensive to foreigners. This will reduce the demand for our exports. Eventually, the volume of exports will fall along with the now-tariffed and more expensive imports, and the trade deficit will remain largely unchanged. (We are going to be hearing a lot about this in the next months.)

**Bottom line:** The overall trade deficit in the U.S. reflects the fact that Americans consume more than they are willing to save, purchasing from foreigners who in turn invest those dollars in the United States. If steadily increasing foreign ownership of our assets is a problem – opinions do vary – most economists would at least agree that it is best addressed with tax policies and incentives to save, rather than by impeding trade. And note, foreign capital inflows do create jobs by raising demand for U.S. products and services!

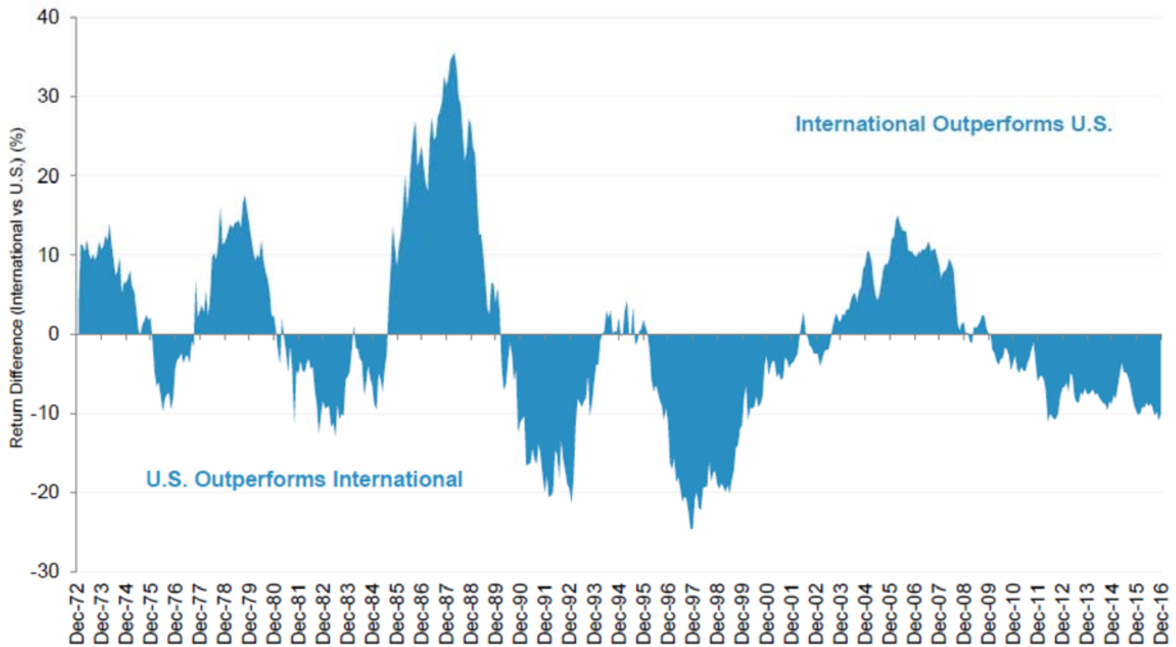
[3] For a technical but very good analysis on this point, see Michael Pettis' blog, "Is Navarro Wrong on Trade" Carnegie Endowment for International Peace, February 2, 2017.

Obsessing over the wrong thing is more than likely going to cause policymakers to make bad policy. Policy intervention that addresses the trade account without addressing the capital account can easily create unexpected and damaging distortions for the country that implements the policy. Let's remember, President Trump got elected to help those who have lost jobs due to automation and trade liberalization. Putting a damper on growth via reducing global trade simply isn't going to help them much, but it will make the world poorer overall.

**Artemis Portfolio Strategy**

So, what should we do? Reading my missive above, one might argue in favor of reducing any overweight position to U.S. equities (our current position) and rotating more into international and emerging market equities, or reducing equity exposure all together. It is true that global equity market leadership rotates, and the U.S. has outperformed the rest of the world for quite a stretch recently. (See Figure 5.) As a result, U.S. equity market valuations are higher than they are in most other countries suggesting the latter will outperform on a 3-5 year time horizon.

Figure 5. Relative Stock Market Performance: U.S. vs. International (Developed) Markets



I do agree with this view, but my desire to tilt Artemis portfolios strongly toward international markets is tempered by the fact that most other developed economies are facing the same (or worse) demographic and anti-immigrant trends as we are in the U.S., and still face many more structural headwinds (that's jargon for rigid labor and other laws and policies that slow growth) than in the U.S. Moreover, Europe's political environment is messy, to say the least. As for emerging markets, they are looking better recently and performance has been solid. But the asset class as a whole is still dependent on China, and Chinese debt can't keep increasing forever.

Hence, I am neither aggressively positioning for a Trump-induced growth spurt nor for above-average trend growth out of the rest of the world. But given that global growth impulses are good at the moment and bond yields are low, we're fully invested at our targets.

What we have been doing is very modestly increasing our international exposure, focused on emerging markets (e.g., most of you will notice we re-established an allocation to emerging market debt early in the quarter). We are also ensuring international equity exposure is at its target (reducing U.S. exposure as need be) and further diversifying our overall international exposure. For example, we are adding to our international small company exposure. We are also continuing to favor credit risk over interest rate risk in our fixed income allocations, thereby favoring high yield, emerging market debt and floating rate debt.

What I don't believe in doing is running for the hills. Absent the potential onset of war with North Korea, there are few signs of an impending recession, and they are notoriously hard to predict in any event. What this report has really emphasized is that prospective returns over the next decade are going to be lousy at best. We got a Trump bump in the short term, but his policies either do not address structural causes of our slowing growth (weak productivity gains and an aging population) or may actually do harm (e.g., slow the growth in the working age population and stymie global trade). Either way, it's not going to be fun.