UNCHARTED WATERS:
WILL POLITICAL RIPTIDES THREATEN PORTFOLIO RETURNS?
January 2017

As our new president once tweeted, “What separates the winners from the losers is how a person reacts to each new twist of fate.” We couldn’t agree more.

And with that, I proudly present Uncharted Waters, our annual Capital Markets Forecast for 2017, where we reveal our outlook for the coming year against the evolving backdrop of our decade-long projections that we shared last year.

The first theme explores U.S. economic growth expectations and a passing of the mantle from monetary to fiscal stimulus. After years of unimpressive expansion, we welcome the prospect of picking up pace with President Trump’s growth-stimulating policies. However, as we press on and the pedal gets closer to the metal, we are concerned about the long-term toll it will likely take on our already-soaring national debt. Over the next year, we believe the increasing growth and debt will keep the U.S. dollar on a generally even keel.

Our second theme spotlights the increasing importance of the income portion of total return and the notion of “income inequality,” i.e., the effect various economic policies can have on the interest-bearing capabilities of stock dividends and bond coupons. Certain sources of income pose outside risks as rates rise, while others do not.

And finally, we revisit the vast and widely variable space of emerging markets equities. Certain emerging markets are reemerging sooner than others, and transitioning at different rates from “old economies”—focused on mining, chemicals, and power—to “new economies”—focused on e-commerce, mobile hardware, and consumer-oriented financial services. In particular, we believe Brazilian financials, energy companies, and Asian e-commerce and semiconductor companies are primed for opportunity.

I encourage you to meet with your Relationship Manager to discuss the investable options and ideas that might be suitable for your portfolio in light of the various themes expressed in this commentary. Members of my team and I will also be hitting the road again as part our annual Capital Markets Forecast series of events and hope to meet you or see you again. And if that is not possible, I hope you will listen in and even ask a question on one of our client conference calls.

Until then, on behalf of the Investment Management team and the entire Wilmington Trust family, I wish you a healthy, happy, and prosperous 2017.

Best,

Tony Roth
Chief Investment Officer, Wilmington Trust Investment Advisors
conservatives. Similarly, the “repeal and replace” drumbeat around the Affordable Care Act might in the end amount to a mere lessening rather than an elimination of the economic burdens that the law imposes on U.S. businesses. Still, some important set of stimulative fiscal policy changes is likely to become law and positively affect labor markets, wages, and consumer spending. Likewise, capital expenditures (business investment) could benefit from the lower corporate tax rate, repatriation of overseas cash, and movement toward a simpler tax system.

In order to assess the possible economic lift from these various Trump initiatives, it behooves us to first take a close look at the state of economic growth at the time of the election and the long-term trajectory that brought us there. Critical to this effort is gaining a clear understanding of the behavior and the impacts thereof—both positive and negative—of the Federal Reserve ensuing from the 2008 credit crisis.

Initially, the central bank responded with sharply lower interest rates and later incepted years of “quantitative easing,” which aimed to increase the money supply and bolster the fledgling recovery. To be sure, this extraordinarily accommodative posture played a key role in avoiding an outcome that might have been far worse than the Great Recession and placed the economy on a good path. Over time, however, the benefits have given way to a largely unexpected and paradoxical set of outcomes, starting with elevated savings and reduced spending attributable to a significant reduction in interest income available to savers (Figures 2 and 3). Low rates of return on safe investments may prompt consumers seeking to build a nest egg to stash away more dollars instead of spending. This, of course, decreases consumption, the largest component of GDP.

Similarly, low rates have failed to generate the desired jolt to businesses. This is reflected by weak capital expenditures, with stagnating productivity the result (Figures 4 and 5). The reasons for weak capital expenditures: 

- Overleveraged households were able to refinance debts and repair their balance sheets. There was a low interest cost for big-ticket spending.
- Companies were able to repair balance sheets.
- Savers are being penalized with low returns and therefore need to save more, which curtails spending. Stock market gains are not translating to more spending.
- Banking and insurance firms have been hit very hard by low rates. Pension costs are high.

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**Early in the recovery the benefits of low rates far outweighed the costs.**

**BENEFITS**

- **Consumers:** Overleveraged households were able to refinance debts and repair their balance sheets. There was a low interest cost for big-ticket spending.
- **Firms:** Companies were able to repair balance sheets.

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**Figure 3**

Low rates have become a net negative

**Figure 2**

Low interest rates and high savings

Low rates of return on safe investments prompts consumers to save more to reach savings goals

**Figure 1**

Principal drivers of the changing economy

**Table 1**

Pre-crisis, growth was fueled by low credit standards. When the crisis ensued, extraordinary monetary and fiscal policy measures were needed to rescue the economy. Since that time, the fiscal arena has largely been absent while the monetary environment has morphed into a headwind. Going forward, we expect both the normalization of monetary policy and Trump’s policies to be drivers.

Source: WTIA

**Table 2**

The average savings rate from 2010 to 2016 was 5.9%—about 1.5% higher than the average from 2000–2004. That amounts to a $200 billion shift from spending to savings.

Sources: Bureau of Economic Analysis, Bankrate
To that, we can now add an expected approximately 1% of additional economic activity resulting from a probability-weighted assessment of the Trump proposals. As shown in Figure 6, we attribute that incremental lift in our economy as coming from tax reform, less business regulation, and infrastructure spending. In terms of the U.S. stock market, we believe valuations are currently only slightly overextended given our growth forecast and, in particular, expect the financial services and technology sectors to perform well in a higher-rate, less-regulated, more tax-favorable pro-growth environment.

We should note that last year’s commentary did express concerns for still tepid growth to possibly dissolve into a fresh recession. Now with a Trump presidency and our expanded growth expectations, these concerns are largely forestalled, and certainly so in our base case scenario. In fact, we expect U.S. economic performance to exceed that of international developed markets.

Accordingly, we continue to hold a preference for U.S. stocks to those of international developed nations, though only a mild one due to the relative cheapness of the latter’s equities. In Europe, there is potential uncertainty from further populist movements like that which propelled Trump to a victory—driven by self-perceived disenfranchised and struggling populaces. France, Germany, and Holland all go to the polls to choose presidents this year. As we learned from our own election, as well as Great Britain’s curveball vote to exit the European Union (“Brexit”), surprises can happen. With that said, and ever mindful of the election upsets of 2016, we do not expect a European political cataclysm in 2017. Instead, we believe there to be meaningful albeit limited upside to European stocks as key 2017 elections come and hopefully go without realizing the possibly acute disruptions. And apropos developed markets, it is worth noting as well that anemic growth, along with a

expenditures are myriad, but start with companies opting for stock buybacks instead of investing in new ventures, as well as those forced to raise their pension contributions due to low rates. In addition, certain industries, especially banking and insurance, have been facing the combined headwinds of low rates of return and a debilitating regulatory environment. On the positive side, low rates have helped consumers, homeowners, and corporations benefit from lower borrowing costs, but most of these advantages came early in the recovery and have since waned considerably.

Fast-forward now to the months before the presidential election, when signs of an improving economy and firming inflation expectations led markets to build in multiple central bank rate increases over the forthcoming 12 months. Indeed, the Federal Reserve followed suit with an expected bump in December and, to the surprise of many, telegraphed a base case of three additional rate hikes for 2017. It is critical here to appreciate that the normalization of the rate environment does more than just signal the central bank’s estimation of an improving environment. The anticipated resulting increase in market rates, rather than tapping on the brakes as conventional thinking might have it, should actually stimulate economic growth through the improving fortunes of savers, banks, insurers, pensions, and municipalities. These developments were already in play before the election, signifying the beginning of an important transition to a more robust growth and inflation environment.
weak euro and yen, make it unlikely that the European Central Bank or the Bank of Japan will suspend their quantitative easing programs entirely.

Our optimism for the U.S. economy is not eternal, however, and our longer-term concerns include a slowing labor force (America is still graying) and the toll on the mounting deficit that reduced tax revenue and increased spending can take. Debt as a share of GDP has already more than doubled (35% to 74%) since the recession and is projected to rise to 86% in 10 years according to the Congressional Budget Office. Additionally, it estimates that the gross U.S. federal government debt is estimated to be $19.5 trillion at the end of the fiscal year 2017. And if President Trump’s near-term pro-growth policies are deficit-financed, these problems will only loom larger. Ultimately, the debt piper will have to be paid.

In addition, as mentioned earlier, Trump’s fiscal cornucopia does bring with it inflationary risks which, if realized too quickly, could lead the Federal Reserve to quicken the trajectory of short-term interest rate hikes. While this is not our base case scenario, it ironically could risk upending the country’s long-standing recovery and, along with it, the rest of the slow global expansion.

Last, given President Trump’s saber-rattling on trade, particularly with China, one cannot take lightly the risk of a negative growth shock due to a political miscalculation. Our greatest concern directly implicates the U.S.–China relationship, which is no doubt rife with complexity and sensitivity on many levels and therefore more apt to suffer from some form of executive or other type of misstep.

**“Income inequality”—finding the yield sweet spot**

Stronger U.S. economic growth aside, we remain in a low-growth, low-return world. Coupled with rising market rates, this creates peril within income-oriented asset classes. While income will comprise a higher portion of total return than might be the case in a world witnessing broader capital expansion, rising rates can cause many income-oriented holdings to drop in value. This tension must be carefully negotiated to boost portfolio returns while sidestepping risks that could well mark the start of a bond bear market.

As one would expect, rising inflation bodes well for Treasury inflation-protected securities (TIPS), particularly compared to Treasuries or many nominal bonds (Figures 7 and 8). We prefer shorter-duration TIPS since, the further out you go, the greater the potential to be impacted by interest rate movements. Rising interest rates could prove difficult for taxable and tax-exempt investment-grade markets, as their lower yield levels provide little protection against diminishing principal values. High-yield markets offer more income protection, so these investors are more likely to attain positive real returns. Note also that the likelihood of economic stimulus in 2017 should contribute to extending the credit cycle, which means default rates should stay low and manageable.

**Stocks: income generators with upside?**

On the stock front, dividend-thirsty investors have pushed up market prices of some traditional yield-oriented investments to levels that are now vulnerable to significant price depreciation in the face of rising interest rates and inflation mean investors will need to tread carefully. A flatter yield curve seems most likely to evolve over 2017.

Sources: WTIA, Barclays Capital, Bloomberg

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**Figure 7**

**Treasury curve**

- **Yield curve flattening**
- **Projected year-end 2017**
- **1-year forward curve as of 12/15/16**

**Figure 8**

**CPI inflation**

- **Inflation continues to move up and will likely lead to more Fed rate hikes.**
- Source: Bloomberg

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rates. Especially exposed are the rate-sensitive utilities and consumer staples sectors, which have indeed underperformed markedly since the election. By contrast, the earnings "recession" we experienced over several quarters in 2016 appears to be behind us and we expectsolidly higher earnings for 2017 (Figure 9). This bodes particularly well for sectors that have been historically strong dividend payers and are also poised to especially benefit from the regulatory relief expected under the new administration, including financial services and potentially healthcare.

International stock markets may be another place where income plays a bigger role in total return. With growth rates in Europe and Japan likely to remain challenged in the year ahead, price gains in stocks are prone to being somewhat limited. That these markets generally provide greater dividend yields than do U.S. stocks, however, along with their relative cheapness as noted earlier on, leaves them reasonably attractive (Figure 10).

Other bond proxies
We believe the following niche areas will provide attractive income with comparatively little downside exposure to rising interest rates:

• Floating rate instruments. With the Federal Reserve already talking about three rate hikes this calendar year, it could prove valuable to hold income streams that will move in line with the central bank.

• Multi-strategy income solutions. Using opportunistic credit, this strategy can take advantage of a broad array of credit instruments, including structured credit and non-U.S. bonds, to deliver better returns while playing defense against rising rates.

• Nontraditional solutions. Alternative means of accessing value such as private market investments (for qualified investors), may provide opportunities for income insulated from higher yields. Also, for qualified non-taxable investors, relative-value hedge funds can offer good income opportunities although careful selection is paramount.

Emerging markets—opportunity on the doorstep
In emerging markets, we are witnessing a sustained expansion of the purchasing power of middle-class consumers. While this trend is occurring throughout emerging markets, it is particularly evident in Asian economies, especially China and India. It presents solid opportunities for the emerging markets companies that serve this growing consumer demand. A recovery in commodity prices is helping energy and mining companies in this space; however, their contribution to aggregate emerging markets stock returns is modest. Political risk is always a concern in emerging markets, but it is differentiated: Brazil has improved, but Turkey and Russia are of concern. Fortunately, at this time, the political situation in most of Asia remains stable. Many of the government-started “old economy” heavy industries focused on oil and gas, metals and mining, capital goods, chemicals, and power producers find themselves constrained by stressed facilities, high sensitivity to volatile commodity prices and currency rates, and other factors (Figure 11). In fact, these industries are now receding at a pace faster than we anticipated. By contrast, “new economy” industries are rapidly coming to the forefront—a fact that only deepens our original conviction, as expressed in last year’s commentary. This new economy paradigm mainly comprises companies that fall into the e-commerce, mobile hardware, and consumer financial services arenas. Less dependent on infrastructure and less sensitive to commodity volatility, their progress has quickened, bringing robust return opportunities into play.
Last year, emerging markets growth gained pace as commodity prices began to level off, the Federal Reserve announced its intention to slowly raise rates, and political stability improved (Figure 12). Markets initially reacted negatively to the U.S. election outcome, due to fears over trade wars and a stronger U.S. dollar, but the slump was not too severe and, in certain respects, it improved the buying opportunity. We do not believe the emerging markets space will continue to be hamstrung by those influences. Brazil in particular is working to lift itself out of recession and may soon be primed for greater exposure.

China has managed to restore calm to its domestic stock and currency markets and stimulate its economy by boosting the expansion of business credit, which allowed growth to pick up toward the end of 2016 (Figure 13). To be sure, as discussed earlier, President Trump’s policies present a real threat to trade between the largest and second-largest economies in the world. For example, if his proposed punishing 45% tariff becomes a reality, it would certainly jack up the prices of many U.S. consumer goods—China is the largest source of our imports and our third-largest export market—thereby hurting both countries. Brazil in particular is working to lift itself out of recession and may soon be primed for greater exposure.

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MSCI Emerging Markets Index’s sector weightings by market capitalization, showing “old economy” industries receding while “new economies” are expanding.

Manufacturing and services economies like most of Asia have outperformed commodity exporters such as Russia and many African and Latin American countries. Recovering commodity prices helped narrow this gap in 2016, but we expect it to persist.

China’s official GDP statistics are thought to overstate the country’s true economic growth. Consulting firm Capital Economics provides an objective “China Activity Proxy,” which rose in 2016 (due to China’s stimulus measures).

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Risks to our outlook

U.S. dollar appreciation
- Rate hike cycle and higher returns in the U.S. could drive strong dollar appreciation
- Very damaging to export industries and manufacturing
- Lower oil prices and renewed challenges for the energy sector
- Lower inflation from imported goods

European elections
- European elections could further threaten the European Union (EU), euro currency, and globalization
- French elections in April and May could include a nationalist candidate determined to leave the EU
- Netherlands’ election in March features an anti-EU candidate who has gained popularity
- German election in October will be a test of Angela Merkel, who has gained popularity

Higher U.S. inflation
- Accelerating inflation would likely prompt the Fed to hike faster than markets expect
- Faster rate hikes would likely bring a turn in the credit cycle more quickly than anticipated
- Tightening credit would increase the chances for a recession and potentially destabilize emerging markets

Navigating the waters ahead
We are heartened that the trends we expressed in our forecast a year ago have largely unfolded as anticipated, yet we know only too well that nothing is certain. It is for this reason that we remain diligent in diversifying portfolios—never putting too many eggs in any one proverbial basket—as we stay nimble and dynamically prepare to try and capitalize on market opportunities or sidestep challenges, as the case may be.

Through markets both bull and bear, we have carefully preserved and enhanced wealth for decades and generations, through the cycles of life, business, and legacy transitions. We continue to implement our repeatable, consistent, and flexible investment process in an effort to deliver the advice and solutions that will guide you in fulfilling your objectives.

We encourage you to meet with your Relationship Manager to discuss the investable options and ideas that might be suitable for your portfolio in light of the themes expressed in this commentary.

For more on our 2017 Capital Markets Forecast, including video content featuring our senior executives, please go to www.wilmingtontrust.com/cmf.

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