2017 Market Outlook

As we look forward to 2017, we see selective opportunities for positive returns across risk assets, with a continuing preference for the United States. Our optimism is tempered by the recognition that it is highly dependent on the actions of President-Elect Donald Trump and the Federal Reserve, and the growing influence of populism globally. In formulating our views, we continue to reflect on what dominated the headlines and drove markets over the past year. 2016 got off to a very rocky start with the MSCI World Index falling by 2 percent on the first day and U.S. equities recording the worst-ever start to a year. Concerns about the Chinese economy sent global markets into a tailspin. But at the risk of overusing a tired turn of phrase, it was a "tale of two markets" as trends reversed in the second half of the year, as investors moved past the surprising results of the Brexit referendum and Mr. Trump's presidential victory to push indexes to new highs. To wit, several of these market drivers may prove to be prologue to what unfolds in the New Year.

With global markets as our playing field, there is always a lot to consider. It is an ongoing battle to separate the noise from the real context and substance. What looks like an opportunity today could be tomorrow's cautionary tale. Our due diligence efforts focus on factors including asset valuation, corporate and economic fundamentals, market technical analysis as well as the geopolitical climate and investor psychology. After weighing all that, we also need to consider how markets move in relation to each other.

U.S. equities have been on a tear since Mr. Trump's surprise victory on November 8th. Although markets moderated in the closing days, the S&P 500 Index increased by nearly 5% on a total return basis while the Russell 2000 Index jumped an impressive 13%. The equity rally has been broad-based and valuations are admittedly high but there are reasons to believe that the trend can persist. Mr. Trump's growth-oriented policies focusing on tax reform, regulatory reversal and fiscal stimulus (the so-called "reflation trades") could jumpstart the tepid economy.

Wilde Capital Management, LLC, 60 Morris Turnpike, Summit, NJ 07901, 866-894-5332
www.wildecapitalmgmt.com

Mr. Trump's stated policy agenda is compelling and investors have obviously embraced it. But there are a lot of "what if's" to be considered:

- **Priority** – Mr. Trump and several of his cabinet members have stated that dismantling the Affordable Care Act ("Obamacare") is at the top of their focus list for his first 100 days in office. Will this issue dominate his attention and sidetrack his growth agenda?
- **Approvability** – With limited exceptions (e.g., he can rescind executive orders enacted by the previous administration), Mr. Trump cannot act unilaterally to engage on his policies. He requires the approval of Congress to proceed with his various initiatives. Even with a Republican-held Congress, these approvals are not assured as fiscal deficits persist.
- **Timing** – The legislative process can be slow and tedious. Even with bi-partisan approval, it will take time to implement these initiatives and then time for them to take effect.
- **True Impact** – With the U.S. labor market continuing to tighten, can these initiatives truly move the growth needle? Or worse yet, could they stoke inflation more than growth?

Furthermore, much of the media/market focus has been on Mr. Trump's policies that could positively impact our economy. But it is important to consider his stated policy stances that are arguably anti-growth including his protectionist/isolationist views on trade and an aggressive approach regarding illegal immigrants and border protection. We can start to form some views regarding what a Trump presidency looks like based on his commentary since the election and the build-out of his administration. While Mr. Trump has diluted some of his more controversial views, he has generally been consistent in his direction, as seen by his cabinet nominees. While we believe this direction should bode well for many sectors of the U.S. economy including Financials, Energy, Industrials, and Materials, we will reserve full judgment (and requisite portfolio positioning) until Mr. Trump has taken the oath of office and initiated on his policy rhetoric.

Outside the political realm, there are other reasons for optimism regarding U.S. equities. After five consecutive quarters of decline, corporate earnings growth turned positive in the third quarter of 2016. We expect further growth with the caveat that earnings could be hampered if the U.S. dollar continues to strengthen. Consumer sentiment, as measured by the Conference Board and the University of Michigan surveys, is at the highest level in over a decade. Americans are optimistic about the economy, the labor market, and their income potential. Based on healthier consumer balance sheets, a resurgent housing market, and signs of meaningful wage growth, we are confident that the U.S. economy can grow 1.5% - 2.0% in the near term without Mr. Trump's stimulus package.

The actions of the Federal Reserve are also squarely in our (and everybody else's) sights. In its latest statement, the Fed telegraphed three interest rate hikes in 2017. There is information there but, like Mr. Trump's policies, there could be a lot of variability in what they actually do. Interest rate hikes could serve to control an overheating economy but could also stifle growth in an inflationary environment. The path of interest rates is an acute risk because of the broad impact across the U.S. economy, including servicing the increasingly unwieldy national debt burden, housing sales and new business investment. But the impact also extends to non-U.S. markets, affecting capital flows and dollar-denominated debt as well as commodities including crude oil. The Fed is showing signs of becoming more hawkish and we will continue to monitor these signals closely.

Outside the U.S., we are less sanguine regarding the prospects for investment. European equities performed poorly relative to other developed markets in 2016 and, with the exception of a currency hedged U.K. position, we do not currently have any direct exposure in our portfolios. Per Mark Sloss' blog post published on Dec. 28th, investing in the European broad market is becoming more challenging for a number of reasons. We would advise reading Mark's post in detail. Suffice it to say that there are a number of concerns including the lack of fiscal coordination, key upcoming elections, the continued emergence of the nationalist/populist movement, and cultural tensions that remain on a slow boil. However, there is some room for optimism based on corporate earnings growth, improving employment numbers and continued monetary support from the ECB. The Euro has been on a downtrend – continued weakness would support those companies that do export business. As Mark concluded, certain regions and industries within Europe may represent compelling opportunities but investors need to do their homework.

Looking further east to Asian markets, Japan remains challenged on the surface based on poor demographics, a large debt burden and bloated, non-competitive companies. However, Prime Minister Abe continues to implement fiscal and monetary policies in an attempt to eliminate the malaise. His economic policies, along with corporate reforms and a weakened yen, have been supportive of equities. Abe was re-elected in mid-2016 and continued implementation of his policies and the Bank of Japan's equity exchange traded fund (ETF) purchases should provide an underpinning for equities in the near-term.

As the second largest global economy, China demands attention. Concerns about the growth trajectory of the Chinese economy was one of the major drivers of the global market selloff in early 2016. More recently, China has been a target of Mr. Trump as he labelled them a "currency manipulator" and derided their trade policies as protectionist. It is not clear what actions Mr. Trump can and will take regarding our trade partnership with China, but they are most likely to be muted compared to his rhetoric. Based on the data they release, China appears to be on track regarding an objective of 6.5% - 7.0% GDP growth. Accommodative monetary policy and infrastructure spending are supportive of their economy and China appears to be on stable footing. We do have concerns about the growing credit bubble that has financed much of the recent investment but that is somewhat mitigated by China's $3 trillion in foreign currency reserves.

Moving beyond China, we saw a resurgence across the broad emerging markets in 2016. That performance moderated in the aftermath of Mr. Trump's victory and we believe there are more challenges ahead as yields increase in the U.S., attracting more external capital flows. We recognize that the days of trading EM in the aggregate are done – these have become established, diverse economies that trade independently. A number of countries including Brazil, Russia, and India should benefit from changes including currency devaluations, a completed tightening cycle and policy reforms. There is a lot to keep track of across this market segment but astute investors can be rewarded. Valuations look attractive in many regions, relative to both history and the rest of the world. These countries continue to offer the most attractive growth profile but investors need to look beyond that high-level metric to truly understand where the opportunities lie.

With regard to fixed income, we are among the chorus of voices that says that the 30+ year bull market in bonds is finally over. However, with our asset allocator hats firmly in place, we believe in the benefits of holding fixed income instruments for diversification purposes. Based on confidence that U.S. interest rates will continue rising in 2017, we believe that investors are best positioned opportunistically in areas including Treasury Inflation-Protected Securities (TIPS), floating rate vehicles and corporate credit – all at the shorter end of the curve to mitigate duration risk. High yield credit has had a strong year, with the resurgence of the energy patch as a big driver. However, the spread over Treasuries has compressed and returns in this segment could be more muted going forward.

We do not have much of an appetite for fixed income instruments outside the U.S. With negative interest rates across sovereigns in many regions, there is very little yield play to be had. Emerging markets could be attractive based on continuing structural improvements including currency devaluation and policy reforms. Based on a bullish stance on the U.S. dollar, our positioning would most likely be through dollar-denominated instruments.

Beyond asset classes and regions, there are a number of broad issues that concern us. While not an exhaustive list, here are three that are very much top of mind. First, global sovereign debt, elevated by aggressive central bank policy, is at historically high levels. These obligations are being serviced at today's artificially low interest rates but rates are set to increase, putting a greater burden on the global economy. Second, with limited exceptions, global equity valuations are high relative to history, which typically does not bode well for investors going forward. Third, the continued spread of populism globally. As evidenced by the success of the Brexit referendum and Mr. Trump's victory, citizens are looking to move away from the status quo. While change is not inherently bad, this trend could stoke xenophobia and create more isolated economies, reversing the benefits of globalization achieved over the last half century.

With recognition of these broader risks, we continue to see attractive opportunities for investors to be rewarded for engagement across global markets. The U.S. is on firmer footing as it enters its eighth year of economic expansion and remains our highest conviction market. Europe is showing some signs of finally emerging from the shadows of the financial crisis, but investors should be selective within the region. China remains on a steady growth path, albeit with a growing credit bubble. As investors seek out pockets of opportunity, the importance of due diligence cannot be overstated.

Sources: *Wilde Capital Management, Bloomberg, Schroders, JP Morgan Asset Management*

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