January 2017 – Market Expectations under President Trump

"The goal of forecasting is not to predict the future but to tell you what you need to know to make meaningful action in the present."—Paul Saffo—Silicon Valley Technology Forecaster

Stock Market Expectations during Donald Trump's Presidential Administration

This is the time of year when financial publications have articles about what they had forecasted correctly (and sometimes incorrectly) in 2016. Then they fearlessly forecast what stocks they recommend in investing in this year. Our view is that reading such articles isn't useful. However, we are going to address what policies may change, and, therefore, what the pros and cons are for our economic environment and how such changes may affect earnings of companies. The market, as it always does, determines what kind of multiple it will give to such earnings, and we will eventually find out if investors are optimistic (higher multiples) or pessimistic (sadly, lower multiples).

The new Administration's stated goals are to decrease regulation, reduce taxes and have fiscal policies that will more directly stimulate the economy. With Republicans controlling the Presidency and Congress for at least the next two years, they should have the ability to act fairly quickly.

Also, we have experienced very low inflation for a number of years because of historically low interest rates, lower energy prices, a non-robust economy and the strong dollar. With aggressive growth policies as well as interest rate, energy and, possibly, labor cost increases inflation pressures exist.

Tax reform is also a major goal of the new Administration. Although the exact details are unclear, it is likely that corporate tax rates will be reduced and, thus, earnings should increase.

As we have stated previously, we believe that the most important decisions we make for your portfolio to achieve your investment goals with a risk tolerance suitable to you are decisions regarding your allocations. We believe it is more important to get your allocations right than to select the right stock. Stated another way we would say having the right allocation to Energy is more important than selecting between Chevron and Exxon as such similar stocks tend to move together.

For most investors allocations are made among cash, fixed income and equities. There are many factors influencing these allocations such as your investment goals and your risk aversion. As mentioned above, inflation should be higher primarily because of higher interest rates and energy costs both of which have started to increase in price. Labor costs also are increasing because of higher minimum wages and health care costs. In addition, state and local governments are beset with rising costs due to pension plans granted in past years. Such plans are causing ever increasing taxes and reductions in services. Thus, investment decisions must recognize that inflation results in lower intrinsic values for cash and fixed income investments as future dollars become less valuable than current dollars.

In the two months since Republicans were elected, bonds have sold off causing their yields to move higher in anticipation of infrastructure and other promised spending. This provides an opportunity to invest in bonds with higher yields and without taking more risk. Nevertheless rates are still very low and caution should be taken in investing in longer-term fixed rate securities.

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All of the above factors influence how we think about the economic sectors where we invest. Absent an opportunity to invest in a pure play fence building company we have to think about how the new policies are going to affect the economic sectors where our investments are made. The following paragraphs describe the sectors we believe will be most affected.

Less regulation should favorably impact earnings of Financial Service and Energy companies. Financial Service companies should have much lower non-interest costs as Dodd Frank and Sarbanes Oxley have added more costs to public companies generally and Financial Service companies in particular. Non-interest income should also increase as account fees should continue to increase. We have already seen prime rate increases without corresponding increases in interest on deposits.

Energy companies should experience an easing of environmental rules that have added significant costs to energy producers. Coal companies have mostly gone out of business and are very unlikely to return as Utilities have had to turn to other types of supply. Energy prices should continue to increase. However, the world has shown that in the short-term conservation efforts as well as ample supplies should keep oil prices modest. Natural gas prices should increase more rapidly because of infrastructure issues and utilities using less coal. (Pipelines have capacity issues, and activists fight new construction causing long delays and higher costs.) It seems nuclear plants just cannot be built on budget and with a reasonable nuclear waste disposal plan. Renewable energy has been dependent on subsidies which may not continue in an Administration which favors less market interference.

There should also be shift from stocks which have served as “bond-substitutes” as funds will shift to safer bonds. Such a shift would affect traditional high-dividend payers such as Consumer Staple, Telecommunication, and Utility companies. Also Utilities should have higher costs due to the expected increase in energy costs mentioned above.

Health Care companies are the wild card. The Republicans have vowed to repeal ObamaCare, but we don’t know how that will be done. ObamaCare increased taxes on dividends and long-term gains. We don’t know if such taxes will remain in place. It is unclear how healthcare costs will be affected. Certain pundits state that such costs are down, but the increases in health insurance premiums say otherwise. Generally everyone supports universal coverage including pre-existing conditions, but we don’t really know that there is a Health Care Holy Grail out there that will solve the cost part of this equation. Since there are so many unknowns here, we recommend being cautious and not over-emphasizing investments in this sector. However, as our population ages demand will continue to grow rapidly.

In summary 2017 should have more of what we have seen in 2016’s fourth quarter. Thus, we expect to make more investments in Energy and Financials and reduce holdings in Staples, Telecommunications and Utilities. And decrease Health Care holdings until there is more clarity in what will happen in this important sector.

So stay tuned. It will be an interesting year for investors. We will be diligent in managing your portfolios.

As always we thank you for your support and are always grateful for your referrals.

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