VERITY
Asset Management

Commentary

December 31, 2016

As we assess the potential economic effects of a new administration, it is worth noting that the market has delivered to date a very multifaceted response to the Trump election.

- Fear stage – In the months ahead of the election, the general feeling in much of the investment community was that a Trump election would be disruptive to trade and unpredictable for businesses in general. As a consequence, it was no surprise when the U.S. equity market dropped for six straight days following the surprise October 28 announcement by FBI Director James Comey that he was again reviewing Clinton email, in the process enhancing the plausibility of a Trump election.
- Opportunistic stage – After the futures markets plummeted even more sharply on election night as the result became clear, they abruptly reversed course in the predawn hours, launching a powerful five week rally driven by the prospect of renewed economic vitality.
- Wait and see stage – Then, in mid-December, the market paused, fluctuating within a very narrow range for nearly six weeks as investors apparently weighed both the opportunities and the risks amidst the backdrop of cabinet selections and early indications of policy.

Though an oversimplification, it could be suggested that, after reacting in fear of the potential negatives, markets flipped their focus to the potential positives, and then paused to see how things would begin to actually play out following the inauguration. As this is written, we are now moving into what may be considered the “reality” stage.

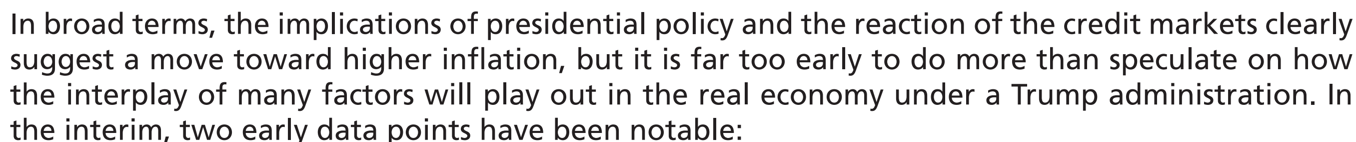
The economy that President Trump inherits, though not robust, is in reasonably solid shape heading into 2017. Auto sales accelerated through the second half of the year; new home construction has been in a multi-year uptrend; unemployment claims remain near historic lows; the massive services segment of the economy is showing solid growth; and the previously anemic manufacturing sector began to show signs of forward movement in October, with the ISM Manufacturing Index posting in December its best score in two years. Most importantly, with the quarterly earnings season well underway, it seems clear that corporate earnings will post a second consecutive quarter of growth after the sustained downtrend of the previous five quarters.

In its post-election rally, the market envisioned the growth opportunities presented by the possibility of:

- Reduced regulation
- Reduced corporate taxation, and
- Increased infrastructure spending

As the market subsequently paused during the weeks ahead of the inauguration, attention was also on the challenges, among them concerns that:

- Interest rates are trending definitively higher, progressively increasing the cost of capital for companies and the affordability of mortgages for home buyers.
- A strengthening dollar will put pressure on revenues of companies which rely on overseas buyers.
- Disruption of trade will be damaging to corporate revenues.



In broad terms, the implications of presidential policy and the reaction of the credit markets clearly suggest a move toward higher inflation, but it is far too early to do more than speculate on how the interplay of many factors will play out in the real economy under a Trump administration. In the interim, two early data points have been notable:

- Following the election, **consumer confidence** numbers surged to levels last attained in 2001. Unfortunately, any visible economic follow through from this psychological boost has not shown up yet. In the words of the NASDAQ Econoday Report, "Confidence may be sky high, but holiday spending really wasn't that great, unless you count cars as gifts" (*Simply Economics,* January 13, 2017). Core retail sales (which exclude autos and gasoline) had the weakest December since 2008. It's very early in the game, but consumers are so far hanging back a bit.
- Perhaps more importantly, **small business optimism** soared in November and December to the highest level since 2004, with marked increases in the number of small businesses viewing this as a good time to expand and to increase capital spending. Concrete results of this nature can be expected to take a little longer to show up, but those sentiments currently bode well for future economic activity.

Whatever the potential positives and negatives, very few things in the equation are simple. As but one example, despite the logical conviction that the U.S. economy could truly thrive if we could produce more and better jobs, job openings already stand at 5.5 million, far exceeding pre-recession levels. Yet employers are having trouble finding qualified workers to fill open positions, and the pool of available workers has continued to shrink.

The housing market, one of the key drivers of the American economy, was hampered during much of the past year by a shortage of supply, due in part to a shortage of qualified labor. The problem here was not a lack of jobs, but a lack of qualified workers.

Into this complex economic environment steps a new Chief Executive who, in both ideas and style, has begun to boldly and intentionally disrupt the status quo. Some oppose it; some applaud it; some simply hope for the best. As investment managers, our first job is to dispassionately ask, "What are the opportunities, and what are the risks?" From an investment perspective, we recognize that disruption brings volatility and risk, but it also introduces material opportunities.

For investors, the look and feel of the Trump presidency promise to be very different from what we have seen before. His "tweets" can abruptly move markets and at least temporarily wreak havoc with prices of individual companies. As of January 10, he had launched tweets targeting, by one count, sixty-one different companies, making it difficult to predict what may be abruptly affected on any given day.

Given the additional elements of unpredictability, we recognize that it will be even more important than before to have a strong grasp on the fundamentals of individual companies, across the spectrum of equity and income producing securities, and are prepared to execute in a disciplined manner from that foundation.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future.