2016 WAS ABOUT TRUMP AND OIL

Financial markets were not only surprised by Donald Trump’s election to the presidency of the United States, but with the Republican Party winning control of both houses of Congress, they reacted sharply to the high probability of his policy agenda being implemented. Investors began betting that Trump’s agenda to cut personal and corporate taxes, increase infrastructure spending, tighten our borders, and renegotiate trade deals would be reflationary and lead to higher inflation and higher growth. The five-year inflation swap rate, a market measure of inflation expectations, jumped to levels not seen since July 2015. The biggest reaction came in the bond markets where yields rose rapidly and prices fell. On the other hand, Trump’s pro-growth agenda led to a strong post-election rally in global stock markets. Small market capitalization companies based in the U.S. led this rally on expectations that Trump’s promised corporate tax cuts would benefit these companies most.

In early 2016, oil prices fell 30 percent in six weeks to $26 a barrel. Much of this was due to panic selling and momentum trading. But as production in the U.S. shale region declined as a result of lower prices, market fundamentals pushed prices above $40 a barrel during the first half of the year. Later in the year, OPEC and non-OPEC countries agreed to almost two million barrels a day in production cuts, driving prices even higher to the end of the year at $53.72 a barrel, or a gain of almost 45 percent for the year. The reversal in oil prices also helped high-yield bonds deliver 17.1 percent returns in 2016 due to recovery in prices of low CCC-rated energy company bonds.

STOCKS: POST-ELECTION, SMALL COMPANY AND FINANCIAL STOCKS RALLY MOST

Trump’s promise to cut corporate taxes would most benefit companies who derive the majority of their earnings from within the U.S. These tend to be small companies that are based in and focused on the U.S. market and represented by the Russell 2000 Index. The Russell 2000 Index of small-capitalization stocks rose 8.8 percent in the fourth quarter and 21.3 percent for the year. Markets considered Trump’s pro-growth, anti-immigration, and anti-trade agenda to be inflationary, which caused bond yields to rise significantly after his election. Trump has also promised to roll back Dodd-Frank regulation, which has dampened returns on banks and other financial companies since 2010. Higher rates and the potential rollback of regulations caused stocks of financial companies to rally 21.1 percent during the fourth quarter of 2016.

For the year, U.S. stocks posted strong returns. The Dow Jones Industrial Average delivered a total return of 16.5 percent and the broader Standard & Poor’s 500 Index delivered a total return of 12 percent. The energy sector was the best performing sector as oil prices rebounded from very low levels, helped by an OPEC agreement to cut production. The industrial and materials sectors also did well on the back of a Chinese stimulus package to help its domestic economy.
In international markets, emerging market stocks were boosted by higher oil and commodity prices and a Chinese stimulus package. Emerging market stocks broadly rebounded from oversold levels as the MSCI Emerging Markets index rose 11.2 percent in 2016. Within emerging markets, Brazil and Russia were the strongest performers, aided by rising oil and commodity prices. The Chinese market suffered from the devaluation of its currency and Mexico from Trump’s anti-trade rhetoric, while the Indian economy stalled due to poor implementation of its demonetization program.

Performance in the developed international markets was fairly muted due to the strength of the U.S. dollar against the euro, the yen, and the British pound. The MSCI All-Country World Index-ex U.S. rose 4.4 percent for the year. European and U.K. stocks were flat for the year while Japan was up 2.4 percent. Commodity exporting countries like Canada and Australia did better and were up double-digits.

**BONDS: WORST QUARTER FOR GOVERNMENT BONDS SINCE 1987**

The bond market “took it on the chin” post-election. Trump’s proposed policies of cutting corporate taxes, proposing increased fiscal stimulus, and rolling back regulations are considered pro-growth. Markets consider his anti-trade stance and tightening of immigration policies as inflationary. Pro-growth inflationary policies are bad for bonds. The day after the election, the yield on the 30-Year Treasury rose 0.25 percent to 2.85 percent, or an increase of 9.6 percent. This was the largest increase in a single day, on a percentage basis, ever recorded. The yield on the 10-Year Treasury rose from 1.78 percent before the election to a high of 2.6 percent on December 15, 2016, or rise of 46 percent, before ending the year at 2.48 percent. This was a far cry from June of 2016, when post-Brexit Treasury yields hit a new low and over $11.5 trillion in government bonds around the world supported negative yields.

The Barclays U.S. Aggregate bond index fell 3.0 percent in the fourth quarter of 2016. U.S. Treasurys fell 3.8 percent, their worst quarterly performance since 1987. Within the broader market, only high-yield bonds — those of companies rated below investment grade — did well. High-yield bonds were up 1.8 percent for the quarter. These bonds are more correlated with the stock market than the bond market. For the year, the recovery in oil prices and an improved corporate earnings outlook helped high-yield bonds deliver a total return of 17.1 percent.

**CURRENCIES: BREXIT HITS THE BRITISH POUND**

In June 2016, the British surprised the world by voting to exit from the European Union. The pound lost 16 percent to the U.S. dollar and 11.7 percent to the euro on the prospect of businesses and capital leaving the United Kingdom. The U.S. dollar, supported by an improving economy, tightening Fed, and Trump’s pro-growth agenda, rose 3.1 percent against a basket of major currencies.

**COMMODITIES: FIRST YEAR OF POSITIVE RETURNS SINCE 2010**

The rebound in oil prices from very low levels combined with promised production cuts by OPEC and non-OPEC countries helped oil prices rise 45 percent in 2016. Along with oil, natural gas and diesel prices rose by 58 percent and 54 percent respectively. In addition to OPEC’s production cuts, pullback in investments by energy and mining companies and ongoing reforms in China to reduce excess capacity helped prices of coking coal rise by 189 percent, iron ore by more than 100 percent, and zinc by 75 percent. The Bloomberg UBS commodity index, which tracks 22 commodities, rose 11.8 percent in 2016. The index posted its first year of positive returns since 2010.
OUTLOOK 2017: BETTER ECONOMIC GROWTH BUT MORE MUTED RETURNS

We expect the Republican controlled Congress to pass President-elect Trump’s policy agenda of cuts in personal and corporate tax rates and increased infrastructure spending. The fiscal stimulus from these actions along with a less stringent economic environment should boost U.S. economic growth in 2017. Improving growth in the U.S., better economic fundamentals in Europe, and stable oil prices also suggest global growth should improve compared to 2016. Improving growth and accelerating wages should help the Fed hit its 2 percent inflation target in the U.S. The rest of the developed world could continue to struggle to generate inflation in the face of structural disinflationary factors such as excess capacity, unfavorable demographics, and the impact of technology. We expect the Federal Reserve to raise rates gradually while the rest of the central banks maintain more “dovish” monetary policies to combat these disinflationary forces.

We expect the bond market to offer low-single-digit returns and prefer credit and high-yield sectors over government bonds. Low growth, low inflation, and accommodative monetary policy are good for the stock market but the equity bull market is entering its eighth year and we expect muted results for U.S. stocks due to high valuations and peak margins. We expect increasing interest rates and a potential roll-back of Dodd-Frank regulations to benefit the banking and financial services sector. Healthcare stocks are cheap due to uncertainty around how the Republicans plan to repeal and replace the Affordable Care Act. Longer-term, healthcare stocks could offer some of the best returns.

Valuations are cheaper outside the U.S., particularly in Europe, where the European Central Bank remains accommodative. But as “Brexit” has shown, there are significant political risks with upcoming elections in France and Germany. Also in Europe, earnings growth has been anemic. Emerging market stocks, currencies, and local bonds did well in 2016 but the credit quality of many government and corporate borrowers is deteriorating, suggesting possible trouble ahead. China remains the biggest source of risk for emerging markets due to its high levels of debt, capital outflows, and a potential trade war with the U.S.

We expect that the improving U.S. economy and Fed tightening should help the dollar continue to strengthen in 2017 against a basket of currencies. Trump’s desire to offer tax incentives to repatriate cash on corporate balance sheets should also benefit the dollar. Production cuts should help oil prices in the first half of the year, but higher oil prices are also likely to increase U.S. shale oil production and cap prices below $60 per barrel. The remaining commodities face headwinds of a slowdown in China, a stronger dollar, and muted inflation.

Key risks:

U.S. – policies on trade and immigration could result in severe backlash from other countries.

China — a hard landing in China poses one of the biggest risks to stocks and other risk assets.

Federal Reserve - tightening at a rate that is faster than what the market expects.

Europe – populism and the potential for anti-Euro parties to come to power.