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Investment Review and Outlook

As we entered the fourth quarter, the stock market had begun to discount the advent of Hillary Clinton winning the presidential election. Moreover, most market prognosticators believed that a Trump victory would wreak havoc on the global financial markets. In fact, as soon as it became clear on election night that Mr. Trump was the likely winner, the markets responded with a brief, albeit sharp sell-off. Ultimately, the pundits were proven wrong once again and the stock market began to surge the very next day.

A clearer view of the Trump political agenda is unfolding and the picture appears quite encouraging. Despite Mr. Trump's caustic rhetoric against countries like China and Mexico, and despite verbal assaults on a number of corporate executives, investors are anticipating that regulatory relief, lower taxes and increased infrastructure spending will be potent drivers of accelerated economic growth.

We are somewhat skeptical that the Trump rallying cry of "Make America Great Again" will shortly become a reality as promised. Can we achieve accelerated economic growth without inflation? Will Trump work on creating barriers to trade or will he just attempt to negotiate improved trade deals? Will the anti-China and anti-Mexico rhetoric prove to be mere posturing or will Trump levy tariffs and erect trade barriers? Undoubtedly, the path to prosperity will be tortuous. For example, a large fiscal spending package will not necessarily sail through a generally fiscally conservative Congress. Moreover, we are skeptical regarding the magnitude and timing of improved economic growth. Trump's ability to work with Congress and to effect his economic plan will soon be put to test – and likewise, investors' current ebullient sentiment.

My Fair Market

To the surprise of many, the stock market rallied strongly and the fixed income market sold off sharply following the election of Donald Trump. Asset allocation theory posits that when this combination of events occurs, the stock market is prone to corrections as investors are incentivized to take profits on their stock holdings and pour more money into bonds. But this effect would also presume that the stock market was fairly valued entering the post-election period. In fact, it can be argued that the market was indeed undervalued prior to the election, perhaps due to investor queasiness in light of the divisive and highly charged campaign.

There is an objective method that can determine whether stock market valuations are stretched. A wonky measure, known as "equity risk premium," sheds light on whether stock investor euphoria has become pervasive. The equity risk premium, defined as the excess return that stock investors demand over the risk free rate, has vacillated mainly in a range of 2.0%-6.0% over the past 65 years. According to NYU Finance Professor Aswath Damodaran, the long term mean equity risk premium has been around 4%. The market saw its highest equity risk premium (stock prices most undervalued) during the banking crisis in 2008, when that measure temporarily broke above the 6% level. The low (stock prices most overvalued) occurred in 1999 when the dot.com boom lifted technology stocks to unsustainably high valuations.

By our calculation, the equity risk premium is currently around 3.5%, below the long term mean, but not yet at a level we consider worrisome. We will maintain our focused on the fixed income markets in 2017. The 10-year Treasury note yield has risen about 100 basis points (or 1%) since the mid-2016 record low. Even if the stock market trades in a narrow range this year, an additional 100 basis point rise in yield would drive the equity risk premium closer to 2.5%. That would lead us to consider a more guarded posture toward equities.

But we see the normalization of interest rates as a gradual process. We believe the secular deflationary forces of aging demographics, global deleveraging and continuing advances in technology as three very potent forces that will keep a lid on the rise in inflation and interest rates.