Market Perspectives | A Glance at How the World Affects You

Pause or End to the Equity Rally?

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America was highly attuned to the U.S. political backdrop last week as Donald J. Trump was sworn in as the nation's 45th president. Investors are betting that President Trump will deliver on some of his pro-growth policies. He is focused on several things, taxes being at the top of that list. Still, financial markets were rattled (only slightly) by his comments that some parts of the tax plan are "too complicated" and the U.S. dollar is "too strong." Nevertheless, 8 of the 11 sectors in the S&P 500 Index traded higher last week.

Opening the week, stocks fell on Monday morning amid uncertainty over President Trump's economic policies. However, the new President implied he would be able to cut business regulation by 75% and he kept his promise (through executive orders) on Monday to withdraw from the Trans-Pacific Partnership and renegotiate the North American Free Trade Agreement. The first 90 days in office will provide greater clarity on President Trump's ability to get things done. Investors might want to keep in mind that equity markets often experience a downturn after a new president is sworn in. In fact, U.S. stocks have declined in February, 8 out of the 11 times a new president has taken office, with an average drop of 4%.

Working through the first month of 2017, corporate earnings have improved, thanks to higher interest rates and strengthening business confidence. A tightening labor market will also increase pressure on the Federal Reserve to raise rates. Roughly 80 companies in the S&P 500 have reported fourth quarter earnings and so far, they are beating expectations. Assuming the pace of positive surprises continue, earnings could increase significantly.

How will new leadership in Washington effect the recent improvements? Growing optimism over the Trump agenda seems focused on tax reform, reducing regulation and infrastructure spending. Indeed, these are pro-growth but then comes reality. Rarely do things get done quickly in Washington. Nevertheless, it is reasonable to expect swift action on the tax front while other initiatives will take longer. The success of these new policies will require some level of harmony between Trump and Congress.

Since the election ended, markets have continued higher with little or no resistance. Recently, markets have moved sideways in what looks like a pause of higher highs. Investors are asking, "is this the end of the rally"? We think the pause is temporary and far from over.

Before the November elections, we saw a turnaround in U.S. economic data. The picture started to improve and corporate earnings reached a bottom and began turning up. These factors led stock prices, bond yields and the value of the U.S. dollar on a steep trajectory. The day after elections, stock prices continued their strong advance as investors anticipated that Donald Trump and a GOP-controlled Congress would be aggressive about enacting pro-growth economic policies. As we moved into the new year we have seen a modest reversal on financial trends.

Some say the “honeymoon period is over and investors appear to be growing more cautious about the political backdrop. Hoping for expedited implementation of new policies, differences between the new president and Congress may lead to a protracted outcome. Political uncertainty is usually a negative for equities and other risk assets, but we are maintaining our pro-growth, pro-risk investment stance. The passing of new legislation may take longer than expected and may not be exactly what president Trump promised. Nevertheless, we are optimistic that some pro-growth legislation will be passed. They may not be in perfect harmony, but the president and Congress have plenty of reasons to produce changes that promote political goodwill among their constituents.

The Bottom Line: The economic and earnings backdrop remain positive for stocks, though we believe 2017 will be more of a stock picker’s year due to timing and implementation of promised legislation. Bond yields rose at an astonishing pace but that rally appears to be on pause. This should take immediate pressure off of the Fed and allow them to maintain a more accommodative policy. Finally, global monetary policy is set to remain extremely supportive. We have experienced a significant increase in equity prices since November. Whether you call it a fundamental advance or “the Trump Rally”, a pause or pullback should come as no surprise.

Best Regards,
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President & CCO