capital markets review

HAMILTON CAPITAL MANAGEMENT
Future In Sight™

Winter 2017

Economic Outlook

The Good, The Bad And The Ugly

Executive Summary

Through thick and thin, the economy has stubbornly remained near a 2% growth pace. That said, the Trump administration and 115th Congress are bringing us new angles to consider. We would aggregate them into the (potentially) Good, Bad and Ugly.

Opportunities include regulatory relief and improved governance, a better tax regime and a fiscal boost. These could help banks emerge from excessive regulatory enthusiasm and simplify a complex tax framework that distorts capital allocation. Further, we may see a fiscal boost that, if properly designed, could take the baton from monetary policy, though severe constraints exist as to its magnitude.

A second set of policies falls into what we would describe as "…hard to improve upon, could be a neutral and has the likelihood of being a mild-to-severe negative."

Finally, there's a category that will almost certainly be a challenge for the economy and financial markets: inflation and interest rates. This is probable because the wheels were set in motion for a problem long before any election, and new policies are likely to accelerate this direction.

Before we ask about politics, can you help us better understand whether the economy is improving or deteriorating?

Of course. In essence, it's neither. Although volatile from one quarter to another, growth remains quite close to a 2% glide path, with a recent rebound from what had been several weaker quarters.

Although 2% growth is lower than what we typically see, it's occurring with less of the private sector's typical excessive borrowing. This helps prevent growth spikes near term and a sharp pull-back later. That's why we've stressed that "moderate may equal sustainable." So far that's proving correct. We now have a recovery that, while far from inadequate, has succeeded in sharply bringing the labor market to near "full employment," with little inflation, record profits and near-record durability.

It sure hasn't felt that way – the headlines portray one disappointment after another. But we now have a new administration and Congress all controlled by one party. What do you see coming out of that?

Much has been said during the campaign. Some of it will inevitably go down in history as hyperbole, but we see hints as to future policy preferences. Though

Continued inside

The Interviewees

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Tony Caxide, CFA®
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The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Managing Director, Portfolio Management, Srinath Sampath shortly after the end of the fourth quarter of 2016.

Economic Outlook

(Continued)

we won't know for some time what actually becomes law, we've grouped key factors into five areas. In turn, we've taken some dramatic liberty and identified these as the Good, the Bad and the Ugly – all potentially. The White House and the Congress, in reality with significant differences in perspective, will be working through these, probably at a slower pace than promised.

We enjoy Clint Eastwood movies as much as anyone. So, in the spirit of hope for a new administration, can we start with the Good?!

Sure. We feel there are two broad measures (from the five mentioned above) that have the potential, even the likelihood, of helping growth. Somewhat. All else being equal.

We label the first **Regulatory Relief and Governance**. We feel this can offer a modicum of relief particularly to banks, which have been under unrelenting regulatory scrutiny for years. That said, we see this as likely a moderate improvement. In recent years, banks have been growing their book of loans and leases quite strongly, at close to 9.5% a year. This is remarkably close to the growth rates seen in the 1990s and 2000s, when banks were aggressively leveraging their balance sheets. Thus, the regulatory burden on banks may not have been as heavy as generally thought, and the room for a sudden release of "animal spirits" in lending may be smaller than many forecast.

We also see room for an improved tax regime that is simpler and less distorting – one that increases the role of allocating capital by the private sector, driven by the opportunity for returns rather than tax advantages.

Secondly we anticipate that we will see a **Fiscal Boost** of some sort for infrastructure and defense spending, as well as tax cuts, though here, too, we would caution that it won't likely be as sizable as post-election euphoria might suggest.

So, your "Good" is constrained. Talk a little more about your caution on that last point, fiscal stimulus. Why the caveat?

Any fiscal boost will only matter if it is unfunded. In other words, if we increase, say, bridge and road building while at the same time reducing spending or increasing taxes by a like amount elsewhere, then the impact on growth is likely to be small. If there were no offset to the new spending, then we're talking. But that would also increase our deficit and our debt.

Think back a couple of years. Remember the cries from many conservatives in Congress? "The federal government debt clock is rapidly approaching $20 trillion…we are irresponsibly going to burden our children and grandchildren with an unpayable amount of debt." That was the result of 2008-crisis decisions to sharply increase government spending, which took our federal debt (as a share of the economy, the best way to measure it) to levels we hadn't seen since (nor ever before) the second World War.

Well, those same Republicans may now be asked to again increase our annual deficits, which inevitably will accelerate the debt clock and increase our debt. In fact, it's worse than that – even before we legislate any further spending, we're already nearly certain to see sharply higher debt levels in the future (yes, far above the WWII historic peaks) because of unavoidable higher costs from Medicare, Medicaid and Social Security.

So, if managed properly, a fiscal boost could provide some relief from excessive reliance on monetary stimulus while providing our economy with the improved infrastructure that it needs – if it's crafted carefully, spent wisely and avoids waste and corruption. But we have to recognize that we are constrained, that this government starts with debt that is two to three times higher than what Reagan and Bush faced before their tax cuts, and that the size of deficits can only reach so high.

If these are the "Good," we hesitate to ask. But let's move forward. Tell us about the "Bad."

So the label "Bad" is a little exaggerated. But they didn't make a movie called "The Good, the Maybe-Neutral-or-Maybe-Bad, and the Ugly…"

There are two broad areas that have been very positive for growth and financial markets in recent decades, and they could hardly be any better but could definitely become negatives.

The first one is **Central Bank Independence**. Central banks that are exposed to interference from the executive or legislative branches often become puppets of the "government." They seldom, if ever, produce sustainably good outcomes for financial markets or the economy. In fact, they predictably generate high inflation and lower wealth for workers and investors.

Our central bank, the Federal Reserve or "Fed," currently depends on appointed technocrats with oversight by Congress. We think this is hard to improve upon. Any shift to greater/effective control by elected officials, all else being equal, would leave us, and most sophisticated investors, rather nervous about growth, inflation and financial assets.

The second relates to the **Flow of Goods, Services, Capital and Labor.** In recent decades, we've operated in a framework that's relatively benign. We feel it's unlikely that we will make it more supportive. We also feel that tweaks to existing trade agreements could be harmless. But genuine protectionist policies, should they become reality, could become a material negative for corporate profits, jobs, wages, inflation and many investments.

Well, that's cheery. So what's the "Ugly"?

We're already in an environment of rising **Inflation and Interest Rates**. Should actions on trade, fiscal deficits and/or the central bank generate higher inflation, this may well further increase interest rates, producing losses for savers and handicapping business with higher borrowing rates. It's hard to imagine a scenario that generates a positive outcome here, unless you're a heavy borrower or a pension plan.

Want To Learn More?

If you'd like to take a deeper dive into Hamilton Capital's proprietary research or better understand our top-down, forward-looking investment process, join our Investment Team for one of our upcoming market briefings:

February 16
Lunch
Scioto Country Club

March 16
Lunch
The Refectory

Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.

Equity Portfolios

Post-Election Exuberance, As Usual

Executive Summary

Triggered by the presidential election, stocks rallied strongly in November and December on the hope that a new administration brings.

Stronger stocks after an election is not uncommon. In fact, the median of the last eight elections since the 50s is a 4% gain from election through inauguration day. This cycle's gain is a little higher but certainly consistent with the behavior of past elections.

Sadly for fans of stocks, the post-election optimism tends to give way to post-inauguration sobering, as stock prices tend to fall.

We wouldn't make a decision on portfolio construction on such simple historical correlations. But it puts in perspective the recent rally and helps investors recognize that we now need fundamental factors to buttress recent price gains, or they could reverse.

We remain cautious as to whether those will emerge strongly enough. Thus we continue to increase our emphasis on absolute returns (vs. relative performance) in our asset allocation. And we're OK if we're early with that view as we seek to balance growth and capital protection for our investors.

"Yippee!" That just about says it, don't you think?

Succinct and accurate. We couldn't have said it better!

Indeed the election of the "45th" and a new Congress all from the same party has led to post-election enthusiasm. A combination of hope for a fiscal boost/tax cut, regulatory relief and the possible benefits of a new trade regime – at least for some – has triggered a positive reaction, particularly for small-sized companies.

At this point investors are bidding up stocks "…and asking questions later." This is a fairly typical reaction. A recent analysis by DoubleLine concludes that in the eight presidential elections since the early 50s, the S&P 500 has produced an average gain of near 4% between election day and inauguration day. So it's true – hope does spring eternal!

This time around the gain has been a little higher, but within the range of "typical" gains.

Wait, don't tell me there's another shoe to drop?

Sort of. The same analysis also shows that stocks tend to drop over the weeks after an inauguration. So prices appear to thrive on hope and emotion between election day and the inauguration, and then get back to business in a more somber mood, again focusing on data, earnings and interest rates, and all those underlying causal factors of sustained stock prices.

So do you anticipate selling stocks?

We view this analysis as an exercise in correlation, rather than the more helpful causality. It's superficial in that it doesn't go into the causal factors leading to a given shift in stock prices. We prefer to have a deeper and better understanding as to why prices went up or down, and sustainably remained there. So we wouldn't take any action, buying or selling, because these events have historically been associated with each other, unless there was a sustained, causal link between them. Right now, the only relationship appears to be one of early enthusiasm followed by reality.

But we do feel this provides needed perspective, particularly for anyone who could conclude that stocks are off to the races. They could be, but only if underlying fundamental factors so warrant.

That makes sense. So let's ignore what tends to be temporary emotion. Do you see real benefits ahead?

At this point it's impossible to know what will actually be done by the new Republican domination of the executive and legislative branches of government. But we have identified the most important factors to watch in our Economic Outlook (above) and integrated the existing tensions within the Republican party arising from differing views on deficits and trade, in particular.

Our sense, currently, is that we could see some "bump" in earnings from public policy, particularly from tax reform and cuts, and other fiscal expansion. But it will be constrained by an existing large debt burden, one that is two to three times more severe than what Reagan and Bush faced just before they implemented their tax cuts.

And this theme of "constraint" seems to apply to other factors. Hence, our scenario analysis suggests that we could see some improvement in earnings – beyond what we're already observing from stabilizing commodity prices – but that it will likely only go so far, and it could be hindered by an increase in inflation and interest rates that's likely to come along with any looser fiscal stance.

And what does that mean for your asset allocation?

Day in and day out we are seeking to juggle two client goals that don't always fit together very well: the need for growth and the desire to protect capital.

Our work suggests that reasonable scenarios for higher earnings, in the context of the likely interest rate environments that they could trigger, are not sufficient to justify current levels of prices.

Thus, we are more inclined to increase our emphasis on protecting capital. For the time being we still seek to participate in market increases, from a position of moderate caution. We think that this focus on absolute return, rather than return relative to our other benchmarks, will best serve our clients' long-term goals.

In Other Words

"The investment landscape today is an unprecedented one, where we believe...that almost all asset classes are priced at valuations that seem to guarantee returns lower than history."

— Ben Inker, GMO

Fixed Income Portfolios

We Still Prefer Credit Risk To Interest Rate Risk

Executive Summary

Through many twists and turns the U.S. Treasury market in 2016 trudged toward modestly higher yields. This rising rate environment may well continue in 2017. Inflation and inflation expectations have crept gradually higher, creating an unfavorable environment for bonds.

We continue to maintain a shorter duration in our portfolios than the benchmark, and are overweight U.S. high-yield bonds.

Wow – what a year 2016 turned out to be! Brexit, the U.S. elections, stock and bond market swings…

Amen. Surprises at every turn, and nary a dull moment in the fixed-income arena. Stock market declines in the first quarter. The UK vote to withdraw from the European Union. Cliffhanger U.S. elections. Prognosticators everywhere coming up short. And, of course, through all this, bond market zigs and zags.

But then, when the ink on the final trade of 2016 was dry, the 10-year U.S. Treasury bond, which began 2016 yielding a paltry 2.27%, ended the year at 2.44% – posting a 'whopping' 0.17% rise in yield. However, along the way, it tested 1.36% in early July, following the surprise 'Brexit' vote. In early November, the 10-year yield stood at a mere 1.85%. But the U.S. elections were a lightning rod, causing yields to soar on the prospects of higher inflation, fiscal stimulus and spending, and the possibility of protectionism. Meanwhile, the Federal Reserve, data-driven, clear-eyed, and undaunted, stayed the course and raised the Fed Funds rate by a quarter percent at its December meeting.

What do you reckon is in store for bonds in 2017?

The Fed has indicated that there would be three rate hikes in 2017. Recently its forecasts have been optimistic, so one could conclude we might see no more than three rate hikes this year. Remember that the Fed mainly controls the short end of the Treasury yield curve. Inflation, and the expectation of inflation, are more potent factors as to where long rates will ultimately go. In this regard, the Fed's preferred measure of core inflation is running at about 1.5%, whereas headline inflation, which includes food and fuel, is already nearer 2%. Multiple measures from the Treasury Inflation-Protected Securities markets also suggest inflation of at least 2% over the next 10 years. This is an unfriendly environment for bonds at current prices.

How is our portfolio positioned to weather these crosscurrents?

Bonds suffer in an environment like this one, where interest rates are poised to rise and inflation may increase. The reason is that the periodic coupons that any bond pays out will be discounted at higher rates, leading to a decline in the bond's market value. To protect portfolios from the risk of a rising rate environment, we continue to maintain shorter durations (or maturities) in our strategies than our benchmark, and remain modestly overweight U.S. high-yield bonds, which have lower exposure to rising interest rates.

THE HCM ADVANTAGE

The largest investors often have the benefit of sophisticated internal investment departments led by a qualified Chief Investment Officer to design and manage their investment portfolios.

Unfortunately, most investors can't maintain an internal team of that caliber. But if having an external investment team of that sophistication is something you could gain from, then we're here to serve.

We function in a fiduciary capacity as an external Chief Investment Officer for our clients. Our structure is similar to the investment departments of large, sophisticated institutional investors, and our team has extensive global investment experience. In fact, several of our team members have received national recognition for their abilities and accomplishments.

Each day, we diligently apply our disciplined investment process to the design and continuous, forward-looking supervision of your portfolio. Our goal: To build a complete investment solution for you.

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Change In Your Financial Circumstances: If you face changes that could affect your financial circumstances, please call us so that we can discuss any appropriate adjustments to your portfolio.

Form ADV: If you would like to receive a copy of our current Form ADV, Part 2A and 2B, please contact us.