Q4 2016 Economic Commentary

"When the facts change, I change my mind. What do you do, Sir?"

--John Maynard Keynes

Prior to the Presidential election, the dominant narrative among most analysts was that a Donald Trump victory, though quite unlikely, would trigger a global equity market decline and a move into low risk government bonds. In the immediate reaction played out over minutes, the Dow Jones Industrial Average dove over 800 points, U.S. Treasury market yields plummeted and the U.S. dollar slid. This market pessimism reversed after the president-elect delivered his acceptance speech in New York, in the early morning hours of November 9. Risk assets began to rally strongly in domestic markets and continued through the balance of the year as bond yields rose quickly to the highest level of 2016 and the dollar strengthened to levels not seen in almost 14 years.

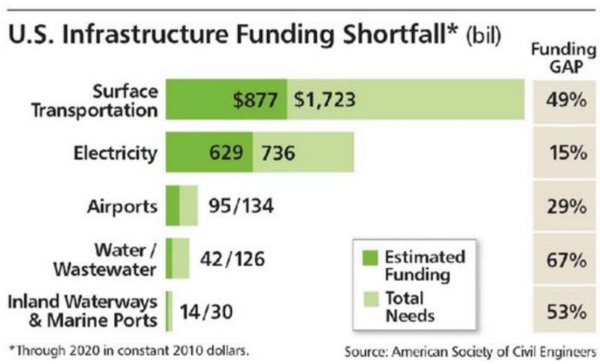
The consensus view of the markets and Wall Street strategists is that following years of hibernation, the U.S. economy should benefit strongly from the staunchly pro-business policies (obviously ignoring the views on globalization and international trade) of a Trump administration. The enthusiasm focuses mainly on the campaign agenda's features of deregulation, corporate and individual tax reform, and infrastructure spending.

From a business perspective, labor and environmental regulation expanded significantly since the financial crisis along with the Affordable Care Act's impact on the healthcare system, which accounts for more than $1/6^{th}$ of our economy. The rollback of legislation is viewed as especially beneficial to the financial sector (specifically banks) and is optimistically anticipated to spur increased lending and engender increased business investing that has been absent for the better part of the last decade.

U.S. corporate tax rates are currently the highest among the 35 industrial nations that comprise the Organization for Economic Co-operation and development (OECD) at 38.9% (though the effective tax rate is closer to 25% with all deductions accounted for) compared with a worldwide average of 22.5%. By direct comparison, Europe as a region has the lowest average tax rate at 18.9% making many domestic companies less competitive with our European neighbors. The Trump plan targets a reduction to a 15% tax level while the GOP version is for a 20% rate with a rollback of most all deductions including interest deductibility. Analyst estimates suggest this would add a net of as much as $8-$10 (or 6%-8%) on a one-time reset to S&P 500 earnings. Additionally, repatriation of overseas assets (currently estimated at nearly $1.3T though almost 50% of which is held by only five technology companies) at a one-time low tax rate would add to the support for earnings growth due to its expected use for share repurchases.

More controversial may be the plan for massive, across the board individual tax cuts and simplification of current tax laws most of which appear to disproportionately favor the wealthy. While this buoys business confidence and market participants (many leaders of which personally benefit), it might do little to spur economic growth as the marginal propensity to consume is much lower at the upper end of the income spectrum who are generally savers. In the plan put forth by President-elect Trump, analyses by both the Tax Foundation and the Tax Policy Center (non-partisan groups) estimate that middle-class families would benefit by an increase in after-tax income of between 0.8%-1.8% while the top 1% of taxpayers would see a gain of between 10.2%-16.0% of after-tax income.

As is said on late-night infomercials, “but wait, there’s more”. President-elect Donald Trump has also proposed an infrastructure program of between $550B to $1 trillion over the next 10 years. A concern expressed is that the plan outlined is more of a privatized tax credit plan that requires immediate profitability which would be more limited in scope than one financed via long-term, low-interest rate bonds. In many prior commentaries we have noted the report from the American Society of Civil Engineers (ASCE) that the nation’s infrastructure (primarily roads, bridges, water systems, schools, and transportation systems) is in “poor” condition and would require an estimated $3.6T of investment by 2020 to maintain a state of “good” repair, with only about half the needed funds committed.



A recent article in Barron’s noted that most academic research finds that infrastructure spending, especially highway funding, has a positive though small effect on real GDP growth over the first two years. The greatest impact is on long term productivity improvements over the subsequent decade. Weak public investment has correlated strongly to slow productivity growth. Despite the obvious benefits, we note this is not a panacea to economic vitality. The Federal-Aid Highway Act enacted in mid-1956 by President Eisenhower still did not prevent two subsequent recessions on his watch in both 1957 and 1960. Japan has spent much of the last two decades spending trillions on infrastructure with little economic growth.

Though more circumspect on the impact of these policies on growth, we feel it is difficult to know the effect more precisely. The closer the U.S. is to full employment (the amount of slack in labor markets is debatable), the more likely there will be an increase in inflation. Without increased productivity, such stimulus is more likely to increase prices than actual output. However, if there is more slack in the economy the impact may be much more considerable with a multiplier effect on policy due to more business investment. We have already seen the ignition of animal spirits in many of the consumer and business sentiment indicators that have soared to post-crisis highs.

Overall, we are optimistic from an economic perspective of the long overdue move to fiscal stimulus that we expect from the Trump administration. However, we differ in that we feel the economy to be very late in the cycle to engender the economic lift that would have occurred even four years prior when excess capacity was large. At this stage of the cycle, government spending competes with the private sector thus potentially crowding out private investing and driving up interest rates. We feel many of the comparisons to a pro-business agenda of the Reagan years are very simplistic and ignore many basic and critical distinctions.

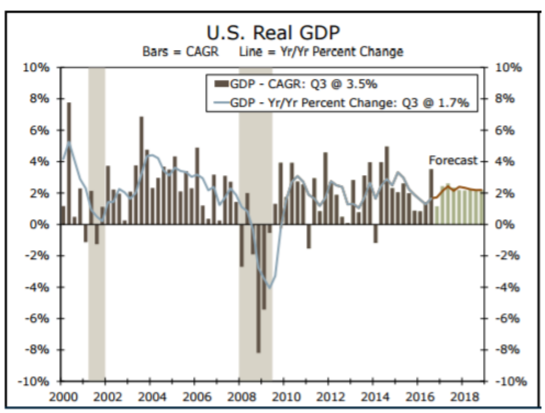
Fiscal policy will not change the demographics of an aging population. Much of the economic growth of the last century was attributable to the enormous baby boom generation entering the work force, and more women joining the ranks of the working. Now, the baby boom is retiring and the proportion of women working is stable. Additionally, and despite the false narrative of deleveraging, global and consumer debt is at or higher than levels of 2007 prior to the financial crisis. Stimulating growth through fiscal policy at these levels of debt is much less likely to succeed.

These secular constraints on growth of demographics and debt will more likely override most of the expectations for stimulating growth. We note the comparisons in many critical areas of the 1982 era of Ronald Reagan to that of Donald Trump on the chart below. It is a vastly different world.

	1982	Today		1982	Today
Fed Funds Rate	18.00%	0.50%	Annual Inflation Rate (CPI)	8.00%	1.60%
10 Year Treasury Yield	15.00%	2.30%	Personal Savings Rate	10.00%	5.00%
Mortgage Rate	16.25%	3.87%	Labor Force Participation	64.00%	63.00%
Household Debt to Income	62.00%	130.00%	S&P 500 - CAPE10	7	26
U.S. Government Debt to GDP Ratio	30.00%	105.00%	S&P 500 - Median Price to Sales Ratio	.50x	2.20x
Total U.S. Debt to GDP Ratio	.90x	3.60x	Median Age Baby Boomers	26	60
Productivity Growth	2.00%	0.25%	Global Trade Barriers	Falling	Rising

UNITED STATES:

Part of the enthusiasm for an expansion of economic growth into the new year stems from the strong jump in 3Q GDP. Following three quarters of GDP growth barely above 1% on an annualized basis and a recovery from the depths of the Great Recession averaging only 2.1% over more than six years, 3Q GDP was recently revised to 3.5% the highest level since 2Q 2014.

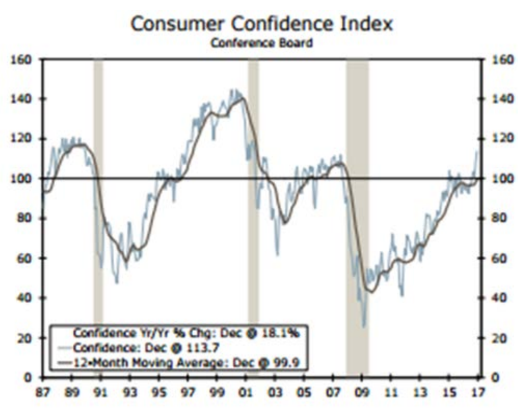


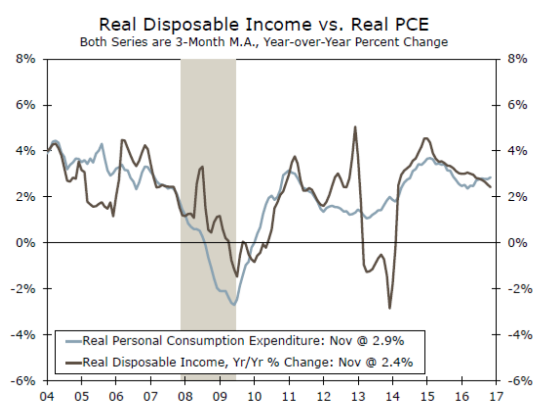
However, details of the report were far less inspiring than the headline as the volatile inventory component added over 0.6% to the total and (with the recent surge in auto inventories) is expected to slow or even reverse in the final 4Q data. More importantly, however, is the anomolous, one-time surge in exports, specifically soybeans. That is correct, soybeans. As we do not expect a secular increase in the demand for edamame, we note that soybean exports from South America (Argentina and Brazil are by far the world's largest exporters) have been very weak thanks to a poor harvest, leaving US producers to fill the gap in supply for large importers such as China. Soybeans alone added 0.9% to the total GDP reading for the period. We interpret 3Q GDP growth as being in the 2.5% area, modestly above trend.

While the increased optimism spurred on by the proposed fiscal stimulus have led many analysts to enthusiastically raise growth expectations for 2017, we are more circumspect. Prior to any of the proposed legislation being enacted, and the impact being felt in the economy, the U.S. will have to face the dampening effects of the recent and powerful rise in mortgage rates and the U.S. dollar (chart below) that should crimp recent strength in housing and exports. We expect that the inflated 3.5% print for 3Q GDP will be followed by slowing growth in the most recent quarter to around 2% (bringing full year 2016 to a 1.7% rate of growth) with further slowing continuing into the first half of 2017. Additionally, gasoline prices have risen over 15% from this time last year while recently announced auto production cuts (due to excess inventories despite solid sales) should detract from growth. Before any positive impacts of fiscal initiatives, the above headwinds should conspire to challenge 1Q and 2Q GDP growth.

Source: Haver Analytics, Gluskin Sheff

Where animal spirits may have the quickest impact might be in consumer spending. Recent readings on consumer sentiment (chart below left) have soared to post-recession highs since the election raising expectations that increased spending will follow. It had been a strong view of ours over the prior two years that tightening labor markets and commensurate rising wages would combine with reduced energy expenses (add declining food inflation to this list) to engender a cyclical upswing in consumer spending. This was accurate in 2014 and through the first half of 2015 as real personal consumption expenditures (PCE) averaged over 3.4%. However, since that point there has been a discernable downshift in spending. The most recent five quarters have averaged only 2.7% (chart below right) subtracting about 0.5% from GDP versus prior spending levels.



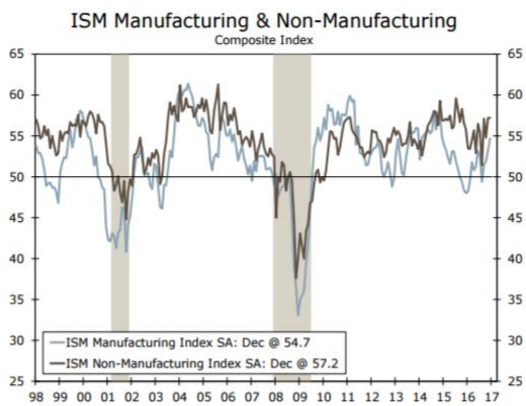


Our expectation of continued rising wages lead us to the view of moderately improved consumption. Still, it is becoming increasingly likely that the consumer (facing high levels of debt and still very low investment income) realizes that the favored way to achieve financial goals is via increased savings. We witnessed this over the last 18 months as the dramatic reducton in energy expenses occasioned a greater increase in savings than spending.

The housing and auto industries have been critical components to growth during the recovery but are showing clear signs of deceleration. After increasing by over 10% in 2015, total housing starts slowed to an increase of 5% in 2016 (though single family starts did increase over 9%). Residential investment (mostly housing starts, home improvement, broker commissions and other transfer costs) feeds directly into GDP. After increasing in excess of 10% on a year-over-year basis from 1Q 2012 through 1Q 2016, we have witnessed a clear curtailing of residential invstment to the most recent rate of 5.3% in 3Q. We still feel that single family homes should continue to grow over the next few years but a clear slowing in the rate of growth of multi-family units will continue to slow the contribution of residential investment.

Auto sales set another annual sales record in 2016 reaching 17.5M light vehicle sales besting the prior record from 2015 of 17.4M cars. Historically, the auto industry has contributed between 3%-3.5% to overall GDP. GDP is calculated on an absolute basis but reported and analyzed on a year-over-year basis. Following two record sales years and starting with the highest inventory levels in four years, the auto industry should also slow the rate of contribution to overall GDP. Will higher levels of consumer confidence lead to greater consumption in these big ticket items? While this is possible, we prefer to look at the raw data and trends and are cautious in extrapolating rising confidence measures directly into consumption increases.

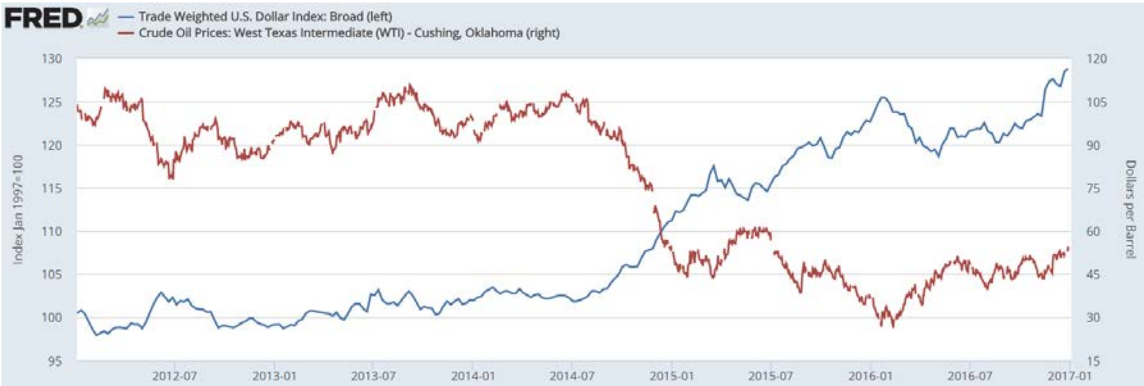
After plummeting into contraction territory during the middle of 2016 due to a powerful move in the U.S. dollar and plunging energy prices, the weakness in the Institute of Supply Management (ISM) manufacturing index rebounded concurrent with the currency and commodity stabilization, The most recent readings (see chart below) have soared and again are largely reflective of the post-election optimism (these are sentiment indices).



Net trade contributed almost 1% to overall GDP growth during the 3Q period leading to above consensus growth. Still, we would not expect real exports to be a positive contributor to GDP growth on a sustained basis. Overseas economic growth, though improving, should remain lackluster, depressing the trend rate of real export growth. More importantly, the post-election increase of over 6% in the dollar will curtail manufacturing competitiveness and, combined with a higher trend in import growth (from still solid consumer spending in the U.S.), will leave net exports to revert to being a modest drag on U.S. real GDP growth in 2017. In total, we are optimistic that the fiscal intitiatives will add to growth in the new year but this will be a second half of 2017 and 2018 event. We look for a lackluster first half below 2% and a full year GDP growth rate approaching 2.5%

OIL, U.S. DOLLAR & INFLATION:

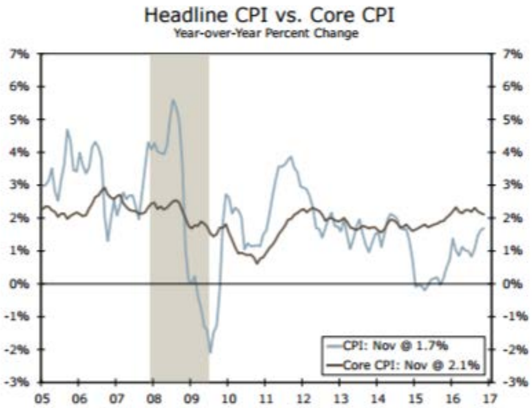
U.S. investors woke up on November 30th to the long discussed but still surprising news that the Organization of the Petroleum Exporting Countries (OPEC) consummated a deal to cut oil production, the first such agreement in eight years. The agreed-upon cut, which reverses a two-year strategy of pumping at will, was OPEC's first since 2008, and the first to include Russia since 2001. OPEC producers agreed to collectively trim production by 1.2 million barrels per day, with non-OPEC producers pitching in an additional cut of 558,000 barrels per day. Russia agreed to make up half of the non-OPEC reduction. The total daily decrease of 1.8 million barrels represents around 2% of total world output. Following news of this agreement, crude oil prices surged 15% ending the year at $53.72 per barrel up from $37.04 entering 2016 (see chart below in red).

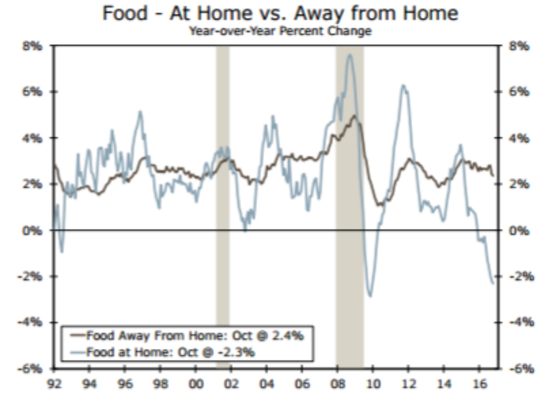


A stronger dollar increases the purchasing power of U.S. consumers and businesses by making imported goods cheaper and reducing the costs of traveling abroad. The recent strength in the dollar may linger as the widening interest rate spread will continue to solicit foreign investment at a time when the yields on Treasuries versus the comparable German bund is now over 200 basis points for the first time in over 25 years. With the ECB and Japan still focused on further stimulative measures, demand for U.S. treasuries should remain strong with the resulting cap on yields and a likely continuing strength in the currency.

After rising 20% year-over-year into early 2016, the dollar stabilized and softened, but a 6% rise since the election (and 12% since May) has now lifted the dollar (see chart above in blue) to a level 25% above where it stood in June 2014 and 34% higher since the U.S. credit downgrade in 2011. U.S. exports are, therefore, less competitive unless prices are cut and profit margins reduced. Depressed GDP and S&P profits figures for much of the past year have already reflected this but a continued increase from here would be a further negative for manufacturing and corporate profits. Though this is a crowded trade and due for a correction, a strong rise in the dollar remains one of the global economy's greatest concerns in 2017.

We noted in our last annual commentary our expectation that the core inflation rates as measured by the Consumer Price Index (CPI) would rise and converge during 2016 with the headline rate near the Fed target of 2%. Inflation has drifted higher over the past year amid a rebound in energy prices and steady rise in services inflation. The Consumer Price Index is now up 1.7% over the past 12 months versus a scant 0.2% rise this time last year with the Core CPI (ex-food & energy) at 2.1% y/y (chart on next page left).





The pickup in inflation has eroded households' real spending power, but one area where consumers have gotten some respite is at the grocery store. Prices for food at home (chart above right) have fallen 2.3% over the past year, which is the steepest one-year decline since 2009. Near record yields have pushed agricultural prices down to some of the lowest levels since the recession ended. That in turn has led to falling feed prices, which has coincided with livestock producers rebuilding herds/flocks after drought or disease crimped supply in recent years. Consumer prices for beef, pork and poultry are down to some of the lowest levels in at least two and half years, while dairy prices are hovering near the lowest levels since 2011. Food away from home by contrast has risen 2.3% over the year due mainly to labor cost increases pressuring profits at most restaurants.

There has been almost universal agreement that the new administration's platform of increased fiscal stimulus and tax cuts to increase spending would engender the reflationary rise missing despite all of the creative efforts of monetary policy. Indeed, expectations of higher inflation have firmed further following the OPEC agreement that boosted crude prices and led to higher prices at the pump (up 15% during 2016 and 7% since the election).

However, we have heard the song about a secular move up in bond yields and inflation for much of the last two decades as debt has continued to climb. We should not forget that the major factors impacting inflation are very long term in nature. Globalization, technological innovation, aging demographics, and excessive levels of global debt are all deflationary and not going away. While there remain cyclical pressures from rising gas prices and wages that should increase the CPI during the early part of the year, many of the proposals from the new administration may also have a deflationary impact.

Deregulation should reduce business costs which should be deflationary. Increasing oil and gas drilling (increasing supply) should also lead to lower prices all things equal. Most importantly, the strong dollar that is ordinarily associated with such stimulus and rising rates would further depress import costs again acting as an inflationary offset. While we foresee a cyclical rise in inflation during 1Q (the average price of oil in 1Q '16 was $34, so the base effect alone will raise inflation readings), which could take the CPI towards 2.3%, we do not project costs to rise much beyond those levels in 2017. Where we might be wrong in this assumption is if either labor slack is much less than we believe, causing faster than expected wage growth, or if trade barriers are enacted, which would clearly increase prices for imported goods flowing through to producer and then consumer prices.

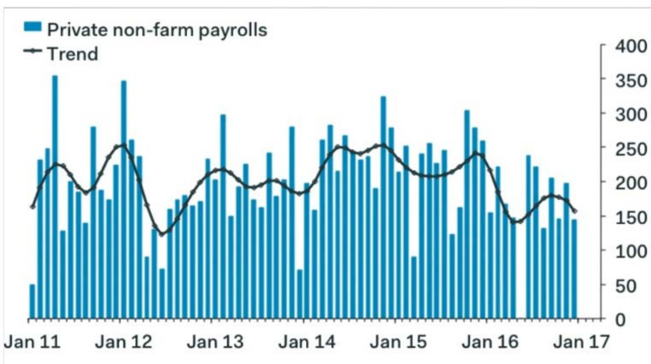
THE FEDERAL RESERVE:

We had postured for much of the last 30 months that the Federal Reserve would not raise interest rates, or just nominally, in any of 2014-2016. Our view was that the Federal Reserve was the only game in town and Yellen was in an untenable position acting not just as the U.S. Central Bank chair but as the world's central bank chair. Due to unprecedented leverage, the global financial system was quite fragile and reliant on continued liquidity. Yet Chairperson Yellen was aware she would be forced into a series of aggressive rate hikes if they were to wait too long to normalize interest rates. This view has changed as potential fiscal initiatives are finally joining the economic policy party.

During Chairperson Janet Yellen's testimony on December 14th (following the now annual increase in the Fed Funds rate), we may have seen a window into her thought process. When asked how monetary policy might be altered due to the likely upcoming fiscal expansion, Yellen was clear that she does not see large-scale fiscal stimulus as appropriate now. Inflation is near the Fed target of 2% and the unemployment rate is 4.6% in contrast to when the Fed was strongly advocating for fiscal stimulus many years ago, when the output gap was much larger. While we have stated our agreement on this point, her remarks indicate to us that the Fed may be more hawkish as the fiscal expansion does go into effect. We expect at least two increases in 2017.

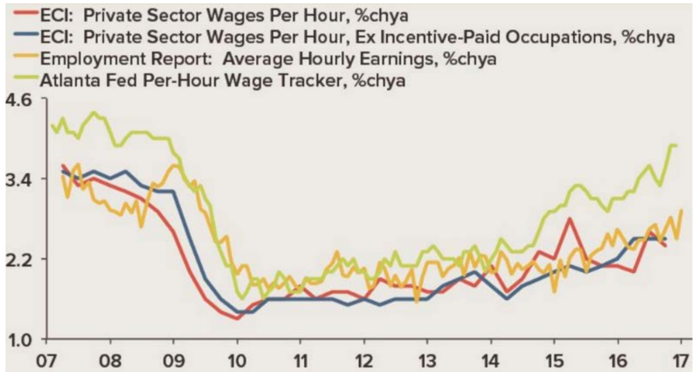
EMPLOYMENT & WAGES:

The December employment report released in early January from the Bureau of Labor & Statistics (BLS) highlighted the unemployment rate ending 2016 at 4.7% near the lowest level since August of 2007. Employment growth for the year ratcheted down from the 251K and 210K per month levels of 2014 and 2015 to an average of 173K (chart below). Additionally, the 3-month trend continued to soften throughout the year and now stands at 165K. All of this is expected for a late cycle economy. What has been missing but long anticipated by us has been sustainable wage growth which, though improving, is doing so at a glacial pace.

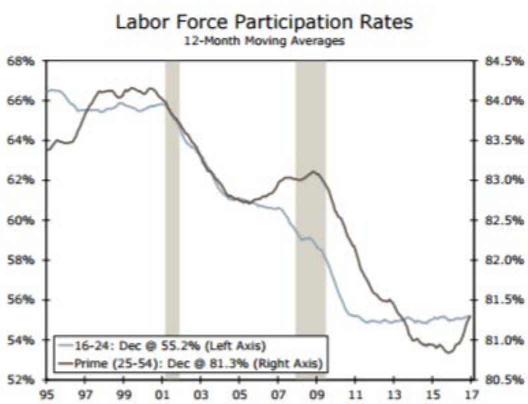


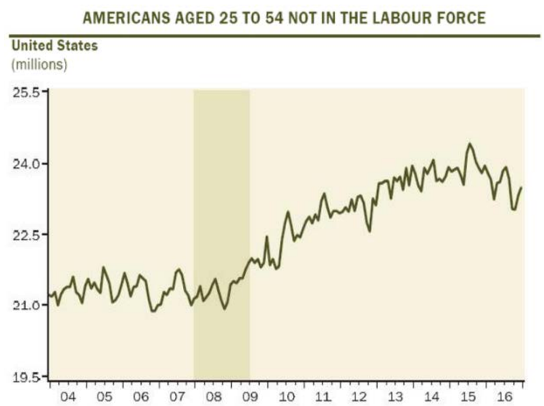
The lack of meaningful upward pressure on wages has many economists believing there remains excess spare capacity in the labor markets that officially show only 7.5M as unemployed. However, the latest reading on the broader U-6 unemployment rate (includes all those unemployed as well as persons marginally attached to the labor force plus the total employed working part time for economic reasons) is still 9.2%. This includes almost 5.4M people considered outside of the labor force who are not actively looking but would take a job if offered one, 5.6M working part-time as they are unable to obtain full-time work and another 400K discouraged workers who have stopped their job search. Full employment (as measured by this metric) based on prior cycles would be closer to 8%.

We have felt the labor market to be much tighter than the U-6 data might otherwise indicate due to mismatched skill sets and demographics, and this has led our call for rising wages. Recent data appears to be confirming this view and this has important implications both for Federal Reserve policy and potential inflation. The December report indicated that average hourly earnings were up 2.9% on a year-over-year basis and a 3% annualized rate since August. Growth has been even more pronounced when looking only at the wages of workers who have been employed in the current and prior year (factoring out higher paying new hires), as evidenced by the methodology employed by the Atlanta Fed Wage Tracker. This metric has now increased at a three-month moving average of 3.9%. Both readings represent cycle highs as shown in the chart on the top of the following page.



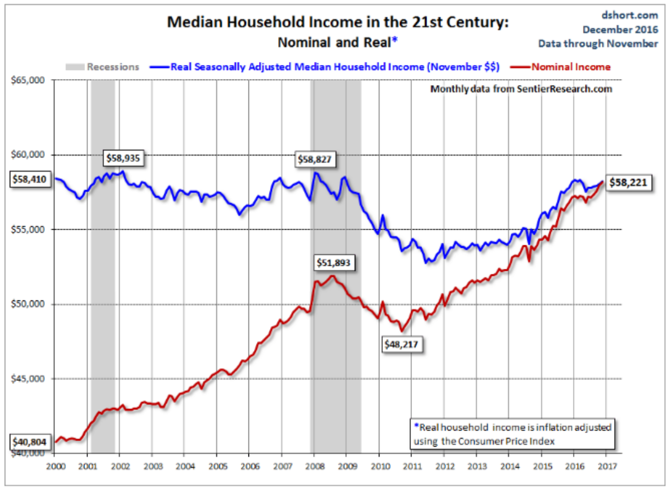
We still feel that the economy can use a further boost to demand. While overall labor force participation rates should have declined from prior levels due to an aging demography, the percentage of the prime age population (ages 25-54) that is employed is still down by 2 full percentage points from pre-recession levels and four points from the year 2000 peaks (chart below left). With job openings at all-time highs, the increase in unemployment in this age group (chart below right) indicates that, though tightening, we may still have some labor slack. We continue to expect a slowing pace of overall hiring in 2017 with moderately increasing wages.



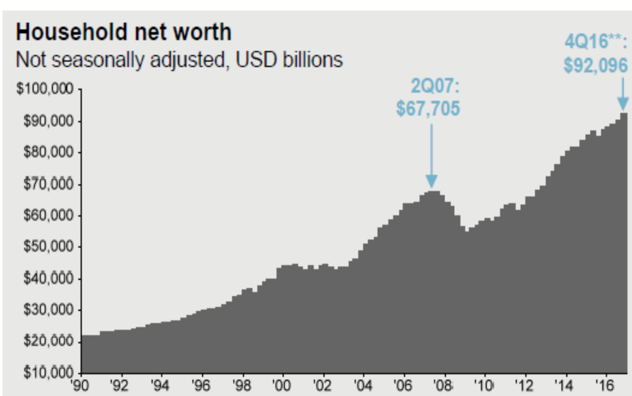


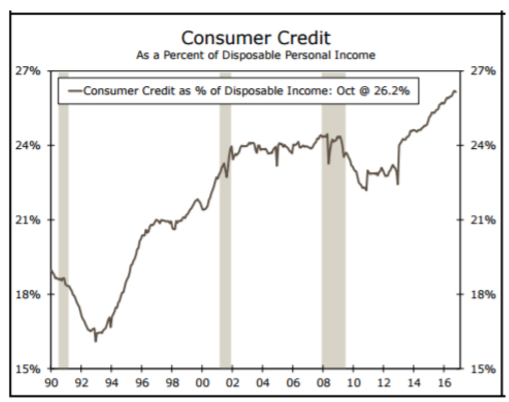
CONSUMER:

When reviewing the state of the U.S. consumer, we continue to gain confidence in our long-held view of the secular shift from capital to labor though the transition may at times be barely perceptible. Per Sentier Research and data derived from the monthly Current Population Survey (CPS), real (inflation-adjusted) median household income for November 2016 was $58,221 (see blue line on chart on next page). This continues a solid upward trend that started in August of 2011 which marked the lowest readings following the Great Recession. The current reading is now 10.1% higher than the lows and has also exceeded the $57,723 level just prior to the onset of the recession. Importantly, as this is aggregate data, the most recent release from the Census Bureau show that the largest gains inured to those in the lowest income percentiles.



Aggregate household net worth climbed to a record $90.2 trillion in the third quarter (chart below left), led mostly by continued gains in both real estate and stocks. The report shows that U.S. households, in aggregate, had tremendous assets at their disposal, about $105 trillion against about $15 trillion of debt. It is the level of debt that is starting to concern. Consumer credit is at record highs when viewed as a share of disposable personal income (chart below right). This has occurred largely as a result of a shift away from mortgage debt and toward others forms of credit, particularly student loans, which have exhibited steady, uninterrupted growth in recent years. Student loan debt is now nearing $1.4T from less than $0.5T 10 years ago. Delinquency rates show few signs of distress and depict a positive trend in managing household debt. However, much of this relief in debt service is due to the historically low servicing costs as absolute levels are obviously elevated. With rates poised to increase even modestly, this bears close watching.



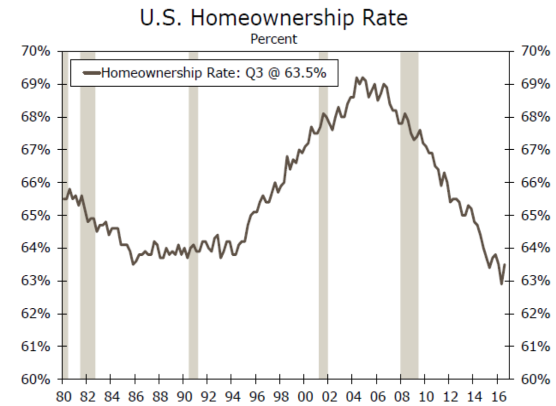


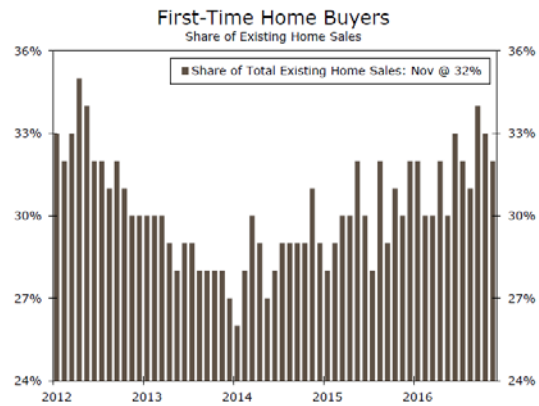
Though the devil will be in the details, many economists remain skeptical that top-heavy income tax cuts will impact aggregate spending. In 2014, the most recent year for which the data is available, more than 40% of all tax payers paid no federal income taxes at all. Additionally, those in the middle (within the 40^{th} and 60^{th} percentile of wage earners) paid an average of only 5.9% in federal income taxes. Overall, more than 60% of all wage earners will truly not benefit from the proposed reduction in income tax rates. As the top 20% of all wage earners account for over 80% of all taxes paid, such tax relief always appears to inure to the benefit of the higher wage earners who have a greater propensity to save thus diminishing the expected benefit.

Interestingly, the proposed corporate tax cut may provide greater relief for wage earners. Studies by the Federal Reserve have noted a strong correlation between changes in corporate tax rates and wages as rising rates have resulted in reduced wages to offset the reduction in after-tax profits. As rates are cut, we would expect the corollary with further increases in wage growth benefitting spending greater than income tax relief.

HOUSING & AUTOS:

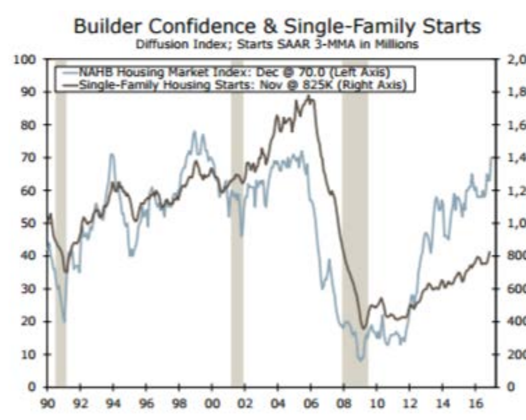
The most important considerations for the housing market as we enter 2017 center upon the impact of rising mortgage rates, increases in new home construction to mitigate current low inventories and whether there will be a rise in the home ownership rate (currently at 50-year lows-chart below left) led by first-time home buyers. These are critical issues for housing to return to previous levels of contribution to overall economic growth.

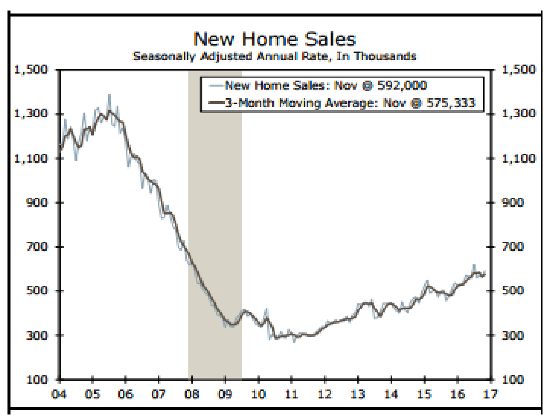




Though builder confidence has soared to the highest post-crisis levels, the recovery in single-family housing starts is still at levels below those normally associated with a recession (chart below left). Through November 2016, single family housing starts are on pace for 781K, an increase of 9.7% compared to the 713K starts in 2015. For a sobering perspective, the 30-year average prior to the housing collapse was 1,158MM units!

New home sales (chart below right) also continue higher, up 12% in 2016 through November, to an annual pace of 562K. This compares to a 30-year pre-crisis average of 760K. The return of the first-time household is key for the housing market to return to its longer-term averages. However, lack of inventory remains a roadblock.

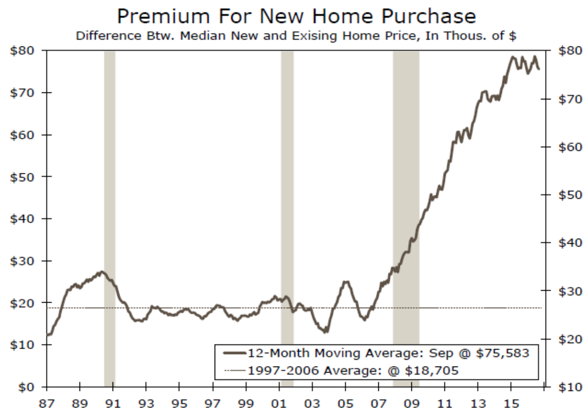




Home prices and sales have risen since 2011 with prices nationally surpassing their 2006 highs, before adjusting for inflation. But new construction collapsed so drastically during the bust that, as noted, sales of new homes are still running about 30% below the average between 1978 and 2007 and are lower than every one of those years except for the recession of 1990-91. Rising costs associated with building new homes are keeping inventory low and, perversely, driving home prices higher.

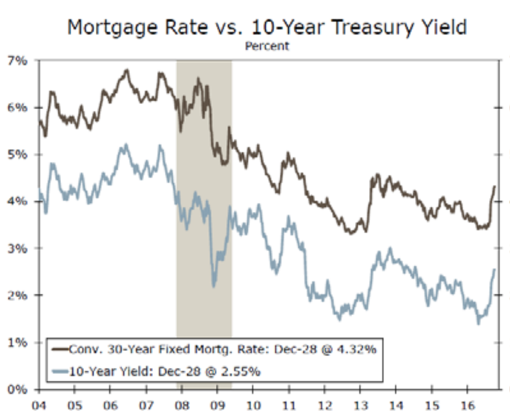
Builders face many cost constraints that were mostly absent during prior periods. Labor shortages are pronounced with builders reporting a serious dearth of qualified construction workers following the aftermath of the housing crisis and exacerbated by tightened immigration laws and the aging of many skilled workers.

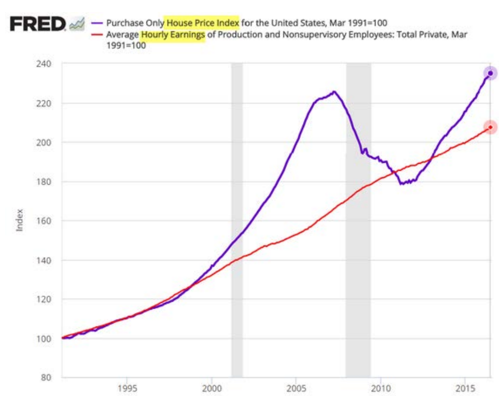
This is increasing the cost of hiring and retaining workers at a time when the lack of buildable land adds to these cost accelerations. Additionally, the costs of government-mandated "impact fees" that fund the local infrastructure needed to support a growing population (schools, transportation, environmental mitigation, and utilities) crimp new home construction. These fees were raised by cities following the housing crisis to make up for declining revenues and are now up 45% since 2005. At a current national average of around $21,000 per unit, they represent approximately 6% of the average selling price. As these fees are flat, the impact on margins is far higher on entry-level homes than on higher end homes, and it has engendered a price gap between the price of new and existing homes that is stagnating the market.



The average interest rate on a 30-year fixed mortgage moved from around 3.5% to as high as 4.25% in the weeks following Donald Trump's election (chart below left), thanks to a huge sell-off in the bond market. In only a matter of weeks, the average cost of a home moved higher by more than $16,400. It now takes 21.6% of the median income to buy the median priced home, the highest share since June 2010.

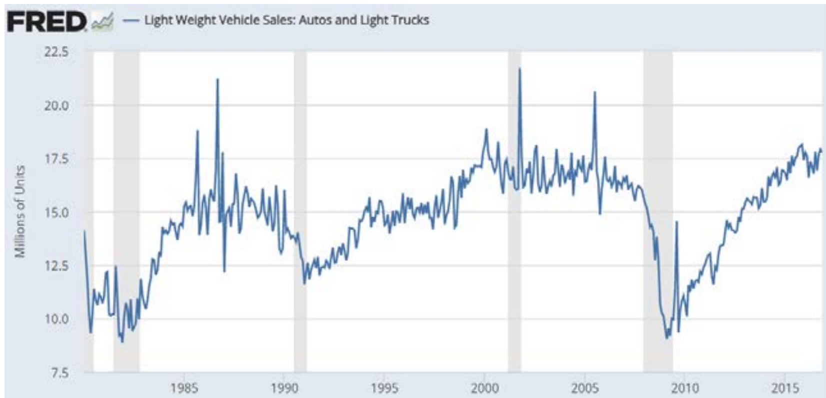
Despite still low historical mortgage rates, it is important to understand the marginal impact on this recent rise. The 75-basis point rise equates to about a 9.5% increase in monthly mortgage payments. When added to the annual increase in national home prices of 5.1%, the monthly mortgage cost rises over 14.5% compared with an annual increase of around 4% in nominal income. The chart below right shows the increase in home prices far outpacing earnings growth during this recovery and this will be further challenged with the recent increase in mortgage rates. We are hopeful that rising wages may offset this but feel it to be more likely that the pace of housing starts and new home sales will decelerate.





Sales of light vehicles in the U.S. have now increased for seven straight years. After touching a record 17.4M units in 2015, we noted our view of peak auto sales and through data to November, this appeared to be accurate. November's stockpile of 4 million vehicles, or a 73-day supply, was the highest level recorded for a November per WardsAuto.com which noted that auto makers would need a strong sales performance in

December to keep first-quarter production schedules intact. They got it with an annualized sales pace of 18.3M cars bringing the annual sales to 17.5M units.



How they got to that pace is something auto makers swore off when emerging from the recession, tremendous discounting. Average incentives, including rebates and discounts, reached a record $3,542 per vehicle this year, according to market-research firm J.D. Power. With gas prices much cheaper in 2016, customer migration to pickups and SUVs from cheaper cars moved average purchase prices to a record $31,044 for the year. The 11.4% discount offered on those vehicles exceeded the previous high set in 2008, when sales were collapsing.

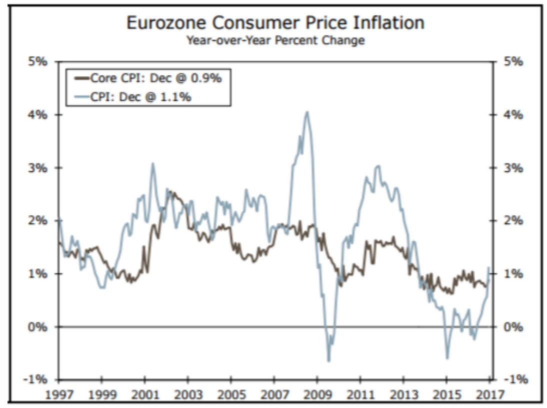
Additionally, J.D. Power notes that auto finance companies are making deals with an increasing number of buyers who have negative equity on the cars they are trading in with 31.3% of buyers in November owing more on their trade-in than the vehicle was worth. Buyers are rolling this negative equity into the new purchase. To make the math work, lenders are stretching out terms on loans to keep cars as affordable as they were a decade ago. We maintain that auto makers are bringing forward future sales and the largest inventory increase since 2013 concerns us. We reiterate our 2016 view of peak auto sales.

INTERNATIONAL:

Developments in Europe, which faces a series of potentially destabilizing political events in the next few months, will be particularly consequential. Four of the six founding European Union member countries will hold elections in 2017 with the populist forces gaining traction in all. We already know that with Francois Hollande removing himself from re-election that there will be at least one more major regime change following the removal already in Italy of Prime Minister Matteo Renzi. Extreme anti-Europe, left or right-wing populist parties could come to power in both France and Italy and possibly other parts of Europe. Even more so than in the U.S., the shadow of the financial crisis hovers over European politics and the rage that swept Donald Trump into office appears even stronger across the ocean. These possible political events may override any current expectations we have for many countries.

EUROZONE:

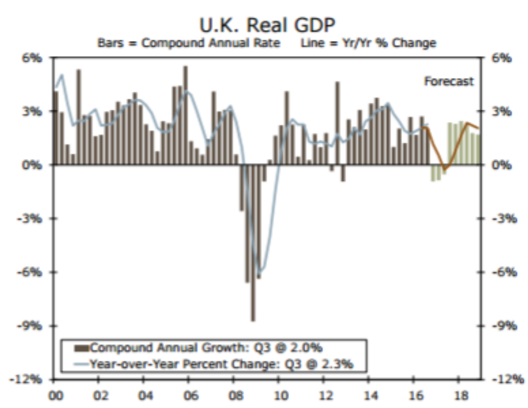
When one looks at the last five years in the Eurozone, the economy has been amazingly stable despite the challenges of a sovereign debt and still on-going banking crisis, constant threats of terrorist attacks, an ongoing immigration crisis, and the political upheavals of Brexit and the Italian referendum. The most recent 3Q GDP reading showed an economy growing 1.7% y/y (see chart below left). Though modest, many key economic statistics have improved with inflation finally exceeding 1.1% on a year-over-year basis in November (chart on next page below right). The unemployment rate dropped to 9.8%, a level that is still elevated but the best since the crisis. Additionally, real household disposable income grew by 2.3% in 2016, the fastest pace in nine years.



In early December, the ECB committed to continuing the asset purchase program under which both private and public sector securities are to be purchased to reduce the risks of a prolonged period of low inflation. The stability noted above and lift in inflation readings gave confidence to the European Central Bank to modestly reduce the size of these monthly purchases from €80B per month to €60B, a modest taper as they feel the greatest risks of deflation to have subsided. We envision a continuation of improving growth in 2017.

UK: When British voters decided to leave the European Union (EU) via the Brexit referendum at the end of June, many analysts, including ourselves, expected that the ensuing uncertainty would cause growth in U.K. economic activity to weaken, if not turn negative. Though this was only a referendum still requiring the triggering of Article 50 of the Treaty of Lisbon to formally withdraw from the European Union (EU), we feared that the capex plans of many businesses would be mothballed pending further clarity. With the economy of the U.K. and the other 27 members of the EU extensively intertwined and entirely new trade agreements and economic relationships needing to be redefined, the risk was clearly to the downside.

Almost seven months later, there are few indications of an imminent recession in the United Kingdom. With 3Q GDP only modestly slowing to a 2.0% annual rate (chart below left) and driven mostly by a still strong consumer, many analysts have now removed a recession from 2017 forecasts. We are not so sure. The formal process of withdrawing from the EU should occur at the end of the first quarter and Prime Minister Theresa May has reaffirmed her intention to start the two-year process of exit talks. Though investment has only modestly weakened, we expect that to increase over the upcoming quarters.



The British pound has now declined over 17% since the referendum (chart above right) and is now over 30% lower than in early 2014. Though the UK is the ninth-largest exporter in the world, they are much more of a consumption-based economy that benefits less from more competitive exports due to a declining currency. A plummeting pound will increase import costs (the U.K. is the sixth largest importer) causing inflation-adjusted wages to decline, pushing down living standards. For 2017, the most likely scenario is one of stagflation as a negative supply shock combines with very low productivity as inflation rises and growth declines. Recession remains a strong possibility.

ITALY: The referendum in Italy in early December was more than a vote on constitutional reform but another opportunity in the Eurozone to reject establishment politics. While populist trends all over the globe are moving power away from centralized governments, Prime Minister Matteo Renzi sought to consolidate Italy's national government. Following more than a decade of a flatlining economy, Italians are looking for somebody to blame. The problem is not new. Ever since Italy reconstituted itself as a republic in 1946, a year after the fall of Benito Mussolini, it has churned through governments. In the 70 years since, Italians have had over 65 governments, each one lasting for a little more than a year on average. All of this in an economy that is the 8th largest in the world and 3rd largest in the Eurozone.

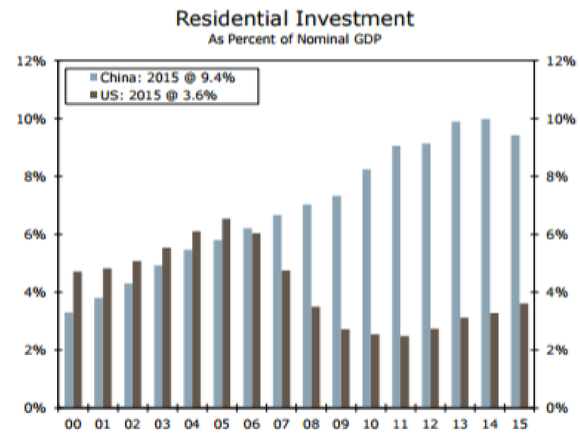
Traditionally among the most enthusiastic proponents of European integration, ordinary Italians are furious at the EU's failure to share the burden of the huge migration surge to their southern shores. Lectures from Brussels on the need to cut public spending and balance budgets, given the desperately straitened times, have added insult to injury.

Though the "No" vote is of little surprise, Italy must move quickly to establish a new government. Questions about the health of Italian banks, however, remain open and far more critical. A sharp rise in the cost of financing Italy's colossal non-performing bank debt (currently estimated at €360B in soured loans) could spell disaster. Prolonged uncertainty over the formation of a new government could discourage investors and compromise needed capital increases, which in turn could have repercussions for other troubled Italian lenders. Banks need to mark down the value of the loans and raise equity to shore up their balance sheets. We are not optimistic that the stomach exists for such aggressive action and the odds of a banking crisis in Italy are high.

CHINA:

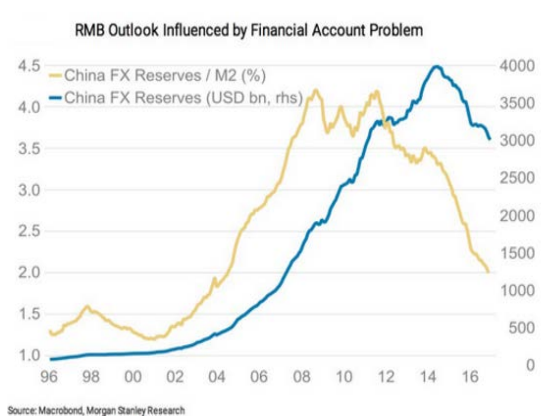
China continues to face many challenges as they attempt to engineer a transition from a growth model based on massive investment and construction, fueled by state-directed bank lending, to one based on household consumption and services. This coordinated deceleration in investment spending has recently stabilized, largely due to a boom in residential investment. Over the prior two years, The People's Bank of China (PBOC) had guided interest rates lower, and the government had instructed banks to relax lending standards. As may be seen in the chart on the next page on the right, residential investment as a percent of GDP in China moved to levels that dwarfed those in the U.S. and that were even 50% higher than during our housing bubble.

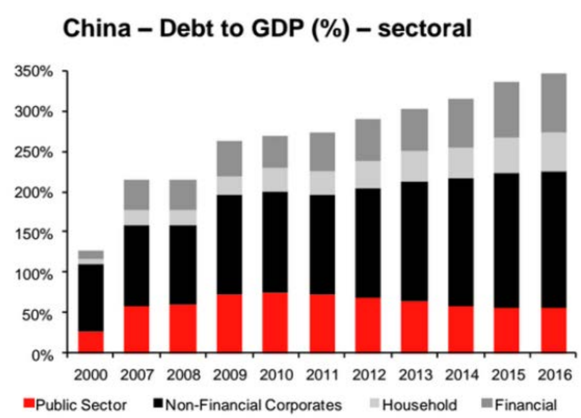
Though Chinese banks are not exposed to the same potential mortgage crisis experienced in the U.S. (the use of mortgage debt is far lower), lending standards are again being tightened at the margin to arrest this trend and continue to charter the "soft landing" course that has slowed GDP growth to 6.7% over each of the most recent three quarters (chart on next page left). But larger concerns on the currency and debt cloud the intermediate term picture and deteriorating U.S.-China relationships from changing trade and foreign policy heighten risk.



After increasing in value versus the U.S. dollar by over 25% in the prior decade, the People's Bank of China (PBOC) decided to try to tie the value of the yuan to the dollar. With the dollar soaring over the last two years against both the euro (China's largest trading partner) and the Japanese yen (China's largest export competitor), Chinese exports struggled to compete in global trade. To stem this, the PBOC chose to allow the yuan to float in late 2015 creating turbulence in global markets fearing escalating deflation. It has declined over 10% versus the dollar since (almost 4.5% since October alone) though still much higher versus other major currencies.

For China, the rising dollar is exacerbating capital outflows as local companies and investors seek to diversify their currency holdings mostly to the U.S. dollar. Chinese bond markets plunged in reaction to December's Fed meeting, at which the U.S. central bank decided to lift rates and signaled several more boosts. Chinese regulators injected money to allay a possible credit squeeze using over $300B of its stockpile of reserves to slow the yuan's decline against the dollar. Foreign reserves have now declined from over $4B in early 2014 to just over $3B currently (see chart below left). As China continues to transition their economic model, the management of the currency versus an ever-powerful dollar represents one of their largest challenges.



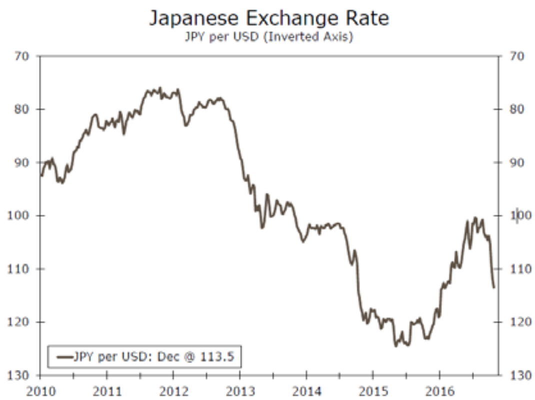


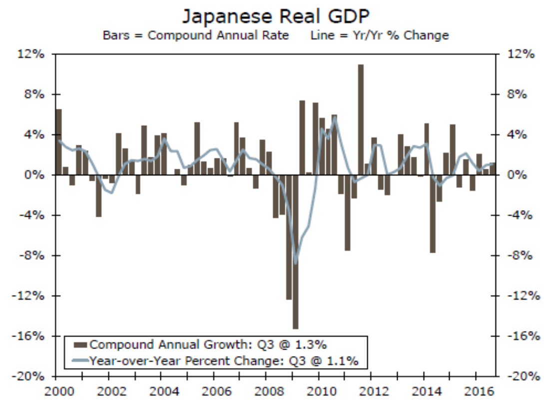
The greatest concern, however, may be the elevated levels of debt-to-GDP (see chart above right) which may be the greatest imbalance of any major developed economy. Though high savings rates and a government control have always given us some confidence in the ability of the PBOC to make the transition to a consumer-driven economy, it is not there yet. Rapidly rising levels of debt combined with the increasing capital outflows and reduced foreign investment foster concern. As the volatility of the yuan has widened, over $1.3T of capital has left China. Though capital controls are in place, trade (exports plus imports) represents over 35% of GDP and such controls will slow growth. We look for a further engineered slowdown to 6% GDP growth in 2017 with a risk to the downside should relations with the U.S. deteriorate.

JAPAN:

Japan has been unsuccessfully fighting deflationary pressures and rolling recessions in their country for the last 30 years enduring over a quarter century of virtually zero total growth. Nominal GDP is barely higher than where it stood in 1989! The internal struggle with an aging population, lack of savings (a 24% rate in 1974 and less than 3% now) and accelerating debt/GDP ratios (now over 250% of GDP) continue to plague economic prosperity.

Upon taking office in late 2012, Japan Prime Minister Shinzo Abe promised unprecedented monetary easing looking to kick-start growth and spur inflation. In concert, the Bank of Japan (BOJ) flooded the economy with cash by kicking off a bond-buying program. As expected, the yen declined almost 50% against the dollar (chart below left) from October 2012 to June 2015 allowing exporting companies to compete more aggressively in global trade. However, both fiscal and monetary policy did not engender the desired economic growth and Abe was not done.





Upon introducing negative interest rates into their policy toolkit last January to reduce further borrowing costs of consumers and businesses, the Bank of Japan (BOJ) perversely witnessed the decline of the yen by over 18% versus the U.S. dollar. Additionally, the flat yield curve inhibited bank margins and profits and precipitated an almost 30% decline in stock prices. In now targeting a 0% 10-year yield, the BOJ endeavors to make the yield curve steeper (short rates are negative) and lending more profitable for the banks. The early returns have also witnessed the resumption of the decline in the yen, retracing over half the prior increase.

Fueled by the tailwind of the lower yen and the concurrent trade boost, 3Q GDP in Japan grew at an annualized rate of 1.3% (chart above right) marking a third consecutive quarterly expansion not experienced since 2013. Despite improved growth, inflation for the full year remained negative (-0.4%) at the core level pushing the target of the BOJ further from reality. We feel this may change in 2017 as the ratio of job openings to applicants (indicating labor market gap) has tightened to levels not seen in 20 years.

EMERGING MARKETS:

The movement of the U.S. dollar has been a common theme throughout this commentary, exemplifying the significance of the currency for the global economy. Nowhere is this viewed more critically than in emerging markets where the likelihood of fiscal stimulus and monetary tightening in the United States in the wake of the recent presidential election has caused the dollar to strengthen versus most emerging market currencies and bond yields in those countries to rise.

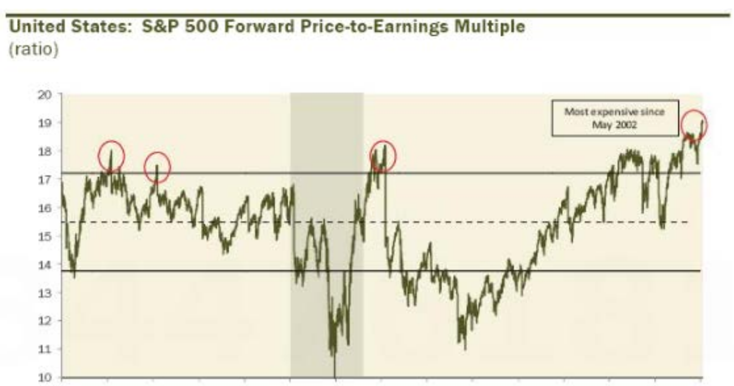
Following a very challenging 1Q period where the fears of a China devaluation combined with the lows in the energy complex, economic activity in the emerging markets improved throughout the year led by the rebounds in the oil-centric economies of Brazil and Russia. For the full year, GDP grew at 3.9% which was the lowest reading of the last 15 years outside of the financial crisis in 2009. While we anticipate a continued resurgence in Brazil and Russia, a slowdown in China remains the biggest risk in 2017 along with currency concerns of the dollar and the yuan.

MARKETS:

As long-time readers know, we are very valuation conscious when analyzing the attractiveness of the markets, and artificial interest rates (due to global central bank policies) can wreak havoc with these analyses. Stocks, bonds, and real estate are considered long duration investments as their current value is based on the sum of all future cash flows (dividends, earnings, interest payments and rents) discounted back to the present. This discounting is predicated upon the risk-free rate so as global central banks lower interest rates to 0%, the present value of these financial assets rise. Each of these asset classes have been major beneficiaries of global central bank policies as they have moved near all-time highs.

Our long-noted concerns about current valuations in the markets stem from this pronounced increase in the present value of these assets without a commensurate increase in expected future cash flows. Asset prices have not risen based on rapidly rising earnings or dividends or the future expectation of this. We have brought forward expected future returns to the present virtually assuring that future returns will be much lower than they otherwise would be.

Corporate profits, as defined by S&P 500 operating earnings, rose at an annual rate of over 24% from 2009-2011. Since the beginning of 2012, earnings have grown just over 3% per year. The over 80% increase in the S&P 500 since the end of 2011, has been driven in large part by the expansion in the P/E multiple from 11x to almost 18.5x forward expected earnings (chart below). This metric compares to a 10-year average of 15x. A resumption of earnings growth is needed to warrant such elevated prices. As we anniversary the devastating earnings recession in Energy and anticipate corporate tax reductions and repatriation, we may just be getting some of this.



Unfortunately, our call for flat earnings (below consensus for 6%-8% gains) over the last two years has been fairly accurate. Data from Factset indicates broker-adjusted earnings for 2016 should end the year around $118, in line with 2015. Consensus estimates for 2017 have been quickly bid up post-election in anticipation of many pro-business initiatives to around $132 for a 12% gain.

The corporate tax plan currently promulgated by the Trump administration incorporates a 15% statutory federal tax rate. This compares with the plan promoted by House Speaker Paul Ryan for a 20% federal rate with both plans incorporating a repatriation of untaxed foreign profits at a one-time reduced tax rate of 10% or less. We estimate the tax rollbacks and repatriation (mostly used for share repurchase) may add about $8 to overall earnings which were already looking up as the Energy sector rejoins the earnings party. However, we view currency as a negative offset and foresee a full year estimate around $125-$128.

The post-election rally in domestic equity markets turned a solid year into a strong year. The closing 5% gain in the S&P moved the total return for 2016 to 11.96% with the more Financial sector-centric Dow Jones Industrial Average gaining 16.5%. Small Cap stocks as measured by the Russell 2000 index benefitted from their domestic orientation and soared to a 21.31% gain. The Nasdaq index was weighed down by the heavy weighting in biotechnology stocks (the piñata of both parties during the election rhetoric) and lagged, though with a still solid return of 7.5%.

Overseas was a mixed picture. Emerging markets, especially Latin America, were the early beneficiaries of a stable dollar and rising commodity prices. The MSCI Emerging Market Index returned 11.2%, but the MSCI EAFE Index of developed countries inched ahead only 1%. The total MSCI ACWI ex-USA (our favorite indicator as it includes about 85% of the world stock market ex-USA) gives a clearer picture of the returns of a globally diversified portfolio and gained 4.5%.

Despite the increase in rates over the back half of the year, yields were essentially flat over the entire period. The Barclays Aggregate Bond Index gained 2.65% but the leader in fixed income was the Barclays Aggregate Corporate High Yield index with a gain of 17.13%

While we are more circumspect regarding the impact of the fiscal initiatives on a late cycle economy (especially as it applies to 2017), we are much more optimistic on the longer-term benefits of both infrastructure spending and the growing confidence that a pro-business agenda will have on corporate America and small businesses in incenting a return to business investment. We have long noted the correlation between declines in business investment and our long-discussed concerns about declining productivity as it is essential for productivity to return towards historical levels if we are to arrest secular stagnation.

We may see a change at the margin from public companies that will be more likely to reinvest profits back into the business. This may be a sharp departure from the policies of the last decade or more of handing back cash to shareholders in the form of dividends and share repurchases but is necessary if the U.S. economy is to return to sustainable growth levels.

A slow growth economy alongside elevated valuations present greater challenges for investors. This is precisely why we at Coho Partners always strive to construct a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick S. Wayne, CFA

Eric Hildenbrand, CFA