Q1 2017
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

SUMMARY

- **The world is in a different place relative to a year ago** when the focus was on China, oil, and global central bank intervention. Most surprising was how quickly the mood of the investor community changed following the US presidential election. While the Trump presidency, Europe without the UK, and anti-globalization/nationalistic sentiment are key concerns going into 2017, our general outlook for the US has not changed. However, key drivers of our outlook have changed.
- **We expect higher market volatility.** Since the US election, markets have reacted positively to the possibility of lower taxes, less regulation and increased spending on infrastructure. With so little detail on implementation of new policies, we remain skeptical and feel what we truly have is an increase in possible outcomes. Further, the market seems to be ignoring the negative impact of higher inflation and associated higher interest rates.
- **We remain optimistic about US equity markets.** Although rising inflation and interest rates could keep US economic growth subdued, we expect rates to remain relatively low. The political and economic environment is likely to be supportive of equities. The Trump administration's trade rhetoric and a strengthening US dollar could be major headwinds.
- **Fixed income under pressure.** Since the global financial crisis, central bank policies have caused bond yields to fall below zero in many countries. It is widely thought that artificially low interest rates worldwide have suppressed market volatility. Looking forward, central banks might decrease their market participation as economic growth continues. Generally, we think this will lead to higher interest rates globally, a negative for bondholders.

2017 KEY DRIVERS

- **Trumponomics and First 100 Days**

  Corporate tax reform, increased infrastructure spending, and less regulation are all part of the Trump administration's campaign promises. How much of those promises will be enacted in the first 100 days and thereafter will be key to investment returns.
- **Global Monetary Policy**

  The Federal Reserve has begun tightening monetary policy while the rest of the world remains accommodative. We will be focused on how central banks react to current global sentiment.
- **US Dollar Strength**

  Since the US election, the greenback has strengthened in line with risky assets in the US. Looking forward, this continued strength could hamper returns, particularly in emerging markets. We think the pace of appreciation will slow.
- **US Corporate Profits and Reinvestment**

  Much optimism regarding growth is currently priced into US equities. Investors will focus on continued growth and ultimately how corporations utilize profits.
- **Emerging Market Growth**

  Despite recent volatility, growth expectations for the Emerging Markets remain very strong and are a rising percentage of global growth expectations.

MIXING POPULISM AND FISCAL STIMULUS

> “It ain’t what you don’t know that gets you in trouble.
> It’s what you know for certain that just ain’t true.”
>
> - Mark Twain

2016 LESSON: EXPECT THE UNEXPECTED

The above quote by Mark Twain in many ways sums up the lesson of 2016: there are no ‘sure’ bets and we should always expect the unexpected. Leading up to the presidential election, polls were nearly unanimous in saying that Hillary Clinton would be our next president. In fact, even the media outlets that were generally skewed in favor of the GOP were pessimistic about the likelihood of a Trump victory. In the end, we all know that Trump won the electoral college despite losing the popular vote.

The US presidential election was not the only event in 2016 that surprised the so-called experts. Pollsters were also wrong regarding the “Brexit” referendum in June, which is triggering Britain’s exit from the European Union. And then there was the December vote on Italian constitutional reform; polls correctly predicted defeat but were caught off-guard by the magnitude. We, too, were surprised by the outcomes of all three events. It remains unclear why polls and experts failed as they did in 2016 but clearly there is global anti-establishment/nationalistic sentiment. Looking ahead, we will be closely watching how politicians and central bankers react to this phenomenon.

MARKET IMPACT

As important, if not more so, market pundits were surprised by the impact on capital markets of the three key events of 2016, particularly since the US election. As with Brexit, market pundits (and yours truly) were anticipating an equity market sell-off and a drop in interest rates due to uncertainty regarding Trump’s policies. However, since the election -- in anticipation of less regulation, lower taxes and increased infrastructure spending -- inflation expectations, the US Dollar, and the yield on the 10-year US Treasury all rose appreciably, in line with the US equity market. Perhaps only increased inflation expectations was correctly anticipated to come with a Trump victory; otherwise, I think it’s fair to say that much of the market reaction came as a surprise to investors.

LOOKING AHEAD

Our portfolios have been positioned for higher interest rates for some time while remaining largely neutral to equities. Our emerging markets positions underperformed as the dollar strengthened, which also was a headwind for our developed market equity allocation. Surprises like we saw in the 4th quarter of last year demonstrate why we maintain diversified portfolios, which we believe is the best defense against the unexpected. While the best analysis can lead you to make a certain allocation, we remain humble knowing markets can and do surprise investors. We will make tactical decisions when markets present opportunities but accept the notion that we can be wrong and will react accordingly.

For now, markets seem to be focusing on the positives of a Trump administration and ignoring the risks associated with increased deficits, trade policies, and US dollar strength. We believe that as the market begins to price these risks, some of the post-election optimism could begin to fade.

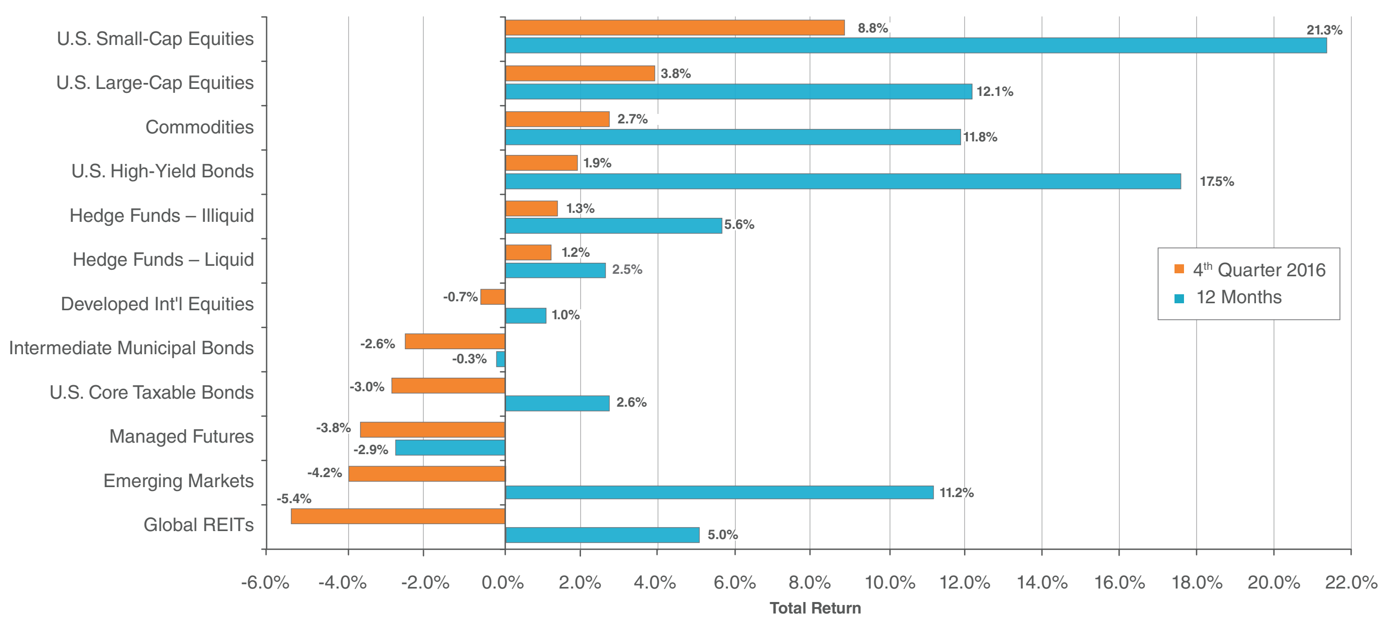
US treasury yields are one of the key building blocks in our assessment of expected returns. Yields in the US have moved higher since the election but remain at relatively low levels; hence, we are maintaining our base case of relatively low returns. That said, we do believe the current environment to be broadly supportive of equities and credit, and generally negative for interest rate sensitive securities. This year could prove to be a gradually more bearish year for bonds, as we believe the pace of yield increases will intensify as interest rates move higher.

We believe global growth will continue to be led by the US; however, we believe growth in the US is limited. GDP in the US rebounded in the 3rd quarter of 2016 as US consumer spending (which we continue to view as the key driver of growth) grew at an impressive 3%. Business investment remains low as corporations used growing earnings to repurchase equity and pay down debt.

The bottom line: 2017 will be a year of transitions, in our view, as monetary policy transitions to fiscal policy, inflationary concerns take the place of growth concerns, de-regulation replaces increased regulation, and a global political transition toward populism and away from globalization and free trade. These will be key points for each asset class that we will continually revisit throughout the year as we monitor these transitions.

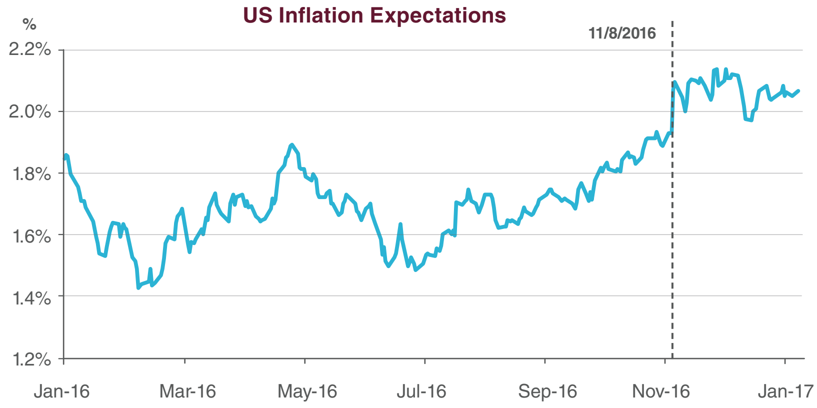
2016 Performance of Asset Classes

4th Quarter and 12 Months (through Dec. 31, 2016)



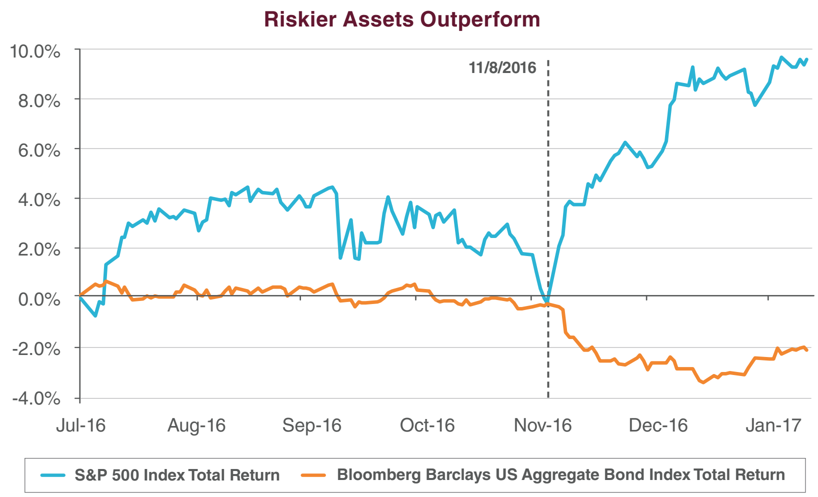
SOURCE OF DATA: Morningstar, Bloomberg, Hedge Fund Research.

US ECONOMY AND FIXED INCOME



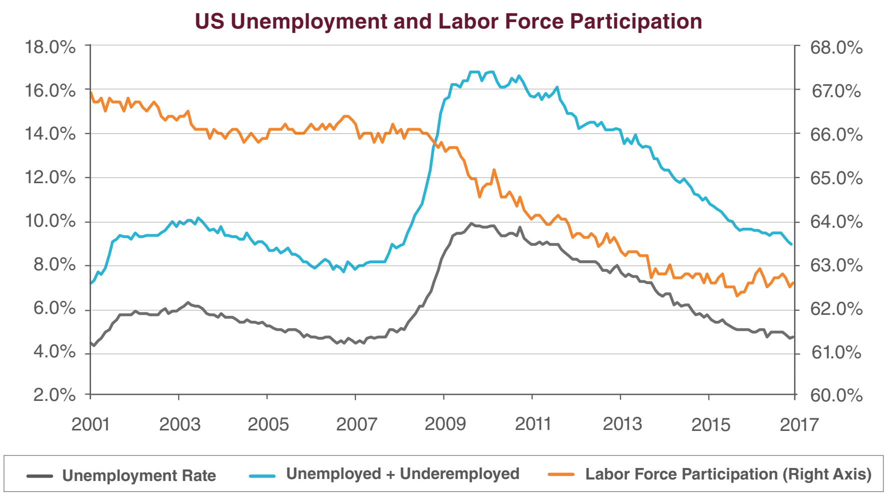
SOURCE OF DATA: Bloomberg.

US inflation expectations are up significantly since the presidential election, on stronger growth in GDP in Q3 2016 and recent wage gains. This could usher in higher interest rates and more rate increases by the Federal Reserve.



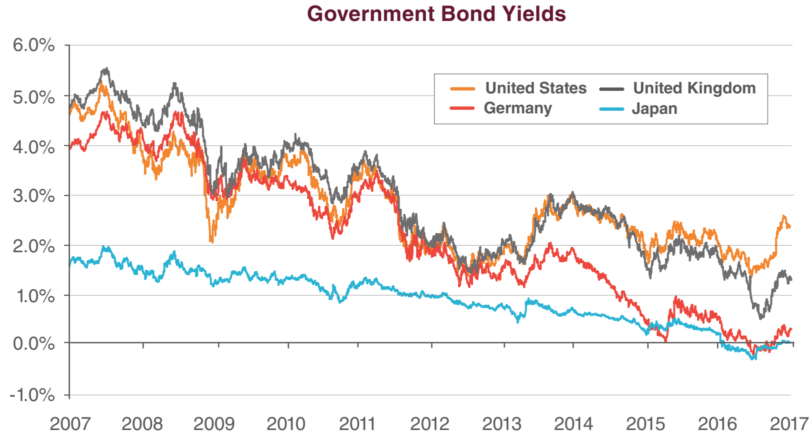
SOURCE OF DATA: Bloomberg.

It's a tale of two markets since the presidential election, in anticipation of pro-growth policies under Trump: US equities and risk assets have rebounded; most bonds and other interest-rate sensitive securities have sold off. We think the markets could be overly optimistic about Trump policies, as implementation brings unforeseen risks.



SOURCE OF DATA: Bloomberg.

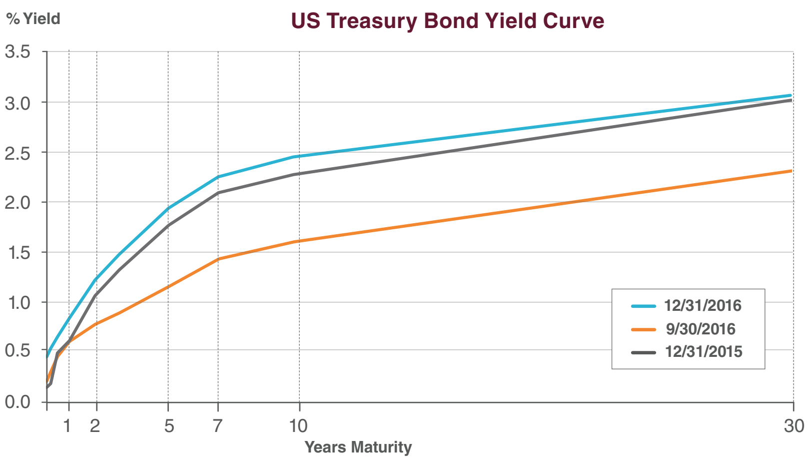
While the US economy is officially at full employment, the labor force participation rate is hovering near a multi-decade low. We think the recent trend in rising wages could attract more Americans back to work, helping to keep a lid on inflation and interest rates.



SOURCE OF DATA: Bloomberg.

The US Federal Reserve raised interest rates only once in 2016, after starting the year forecasting up to 4 hikes. We think we will see 2 hikes in 2017, and 10-year Treasury yields will begin to reflect higher expected inflation. However, we think US interest rates will remain relatively low by historical standards.

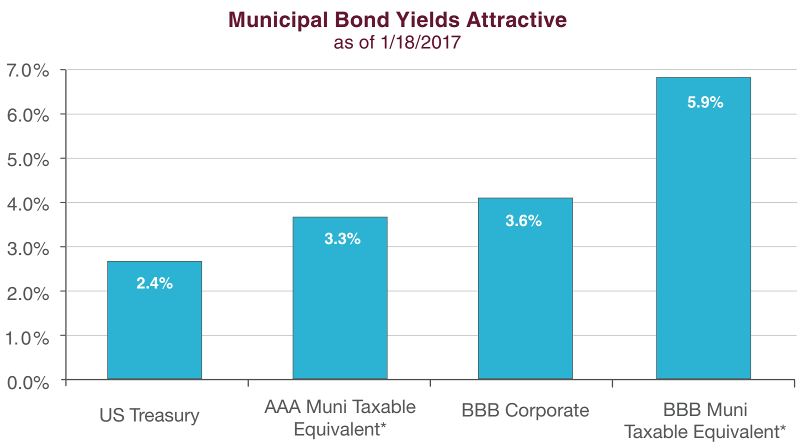
FIXED INCOME MARKETS



SOURCE OF DATA: Bloomberg.

Year-over-year, US interest rates have not changed all that much. However, rates moved significantly lower mid-2016 and very quickly rebounded toward year-end. In 2017, the upward move in yields could pick up pace, as yields move through certain thresholds.

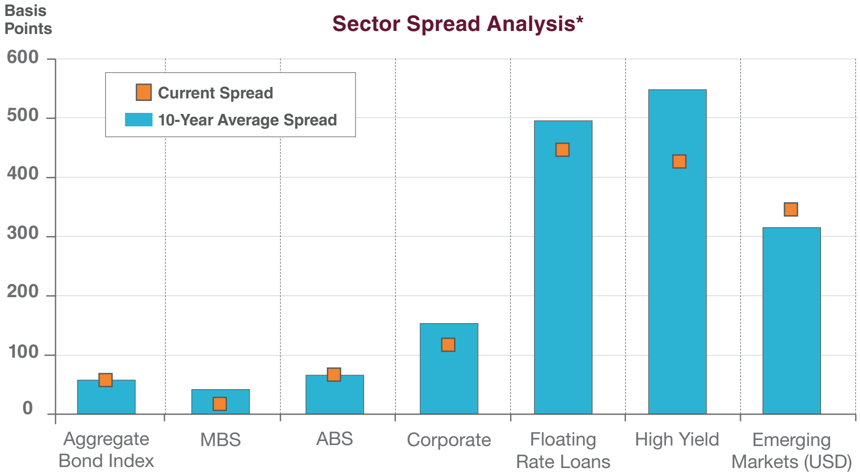
MUNICIPAL BONDS



SOURCE OF DATA: Bloomberg. *Tax-adjusted with 35% tax rate.

As interest rates rose during 4th quarter 2016, intermediate municipal bonds had a rough go of it, ending the year with a slightly negative total return. We believe the muni bond market remains healthy. Additionally, the tax-free yields on municipal bonds make them more attractive than taxable bonds of similar risk. Consequently, we maintain sizeable muni bond positions for taxable client accounts.

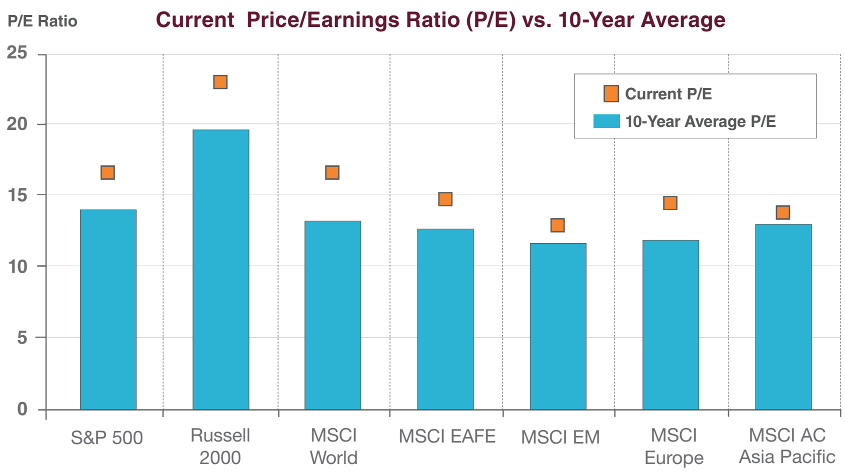
HIGH YIELD BONDS



SOURCE OF DATA: Eaton Vance. | *Spread is difference between average yield in the sector and US Treasuries.

High yield corporate bonds look expensive relative to historical levels. Gains in high yield for 2016 rivaled some of the best in history. Interest coverage ratios remain strong; however, leverage is up. We believe security selection will be key in 2017 as the rally in credit seems to be in its later stages.

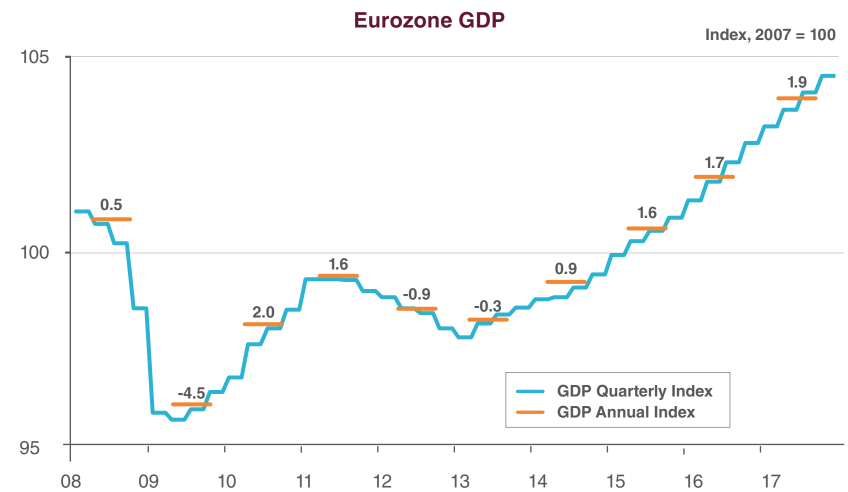
GLOBAL EQUITIES



SOURCE OF DATA: Eaton Vance, Factset.

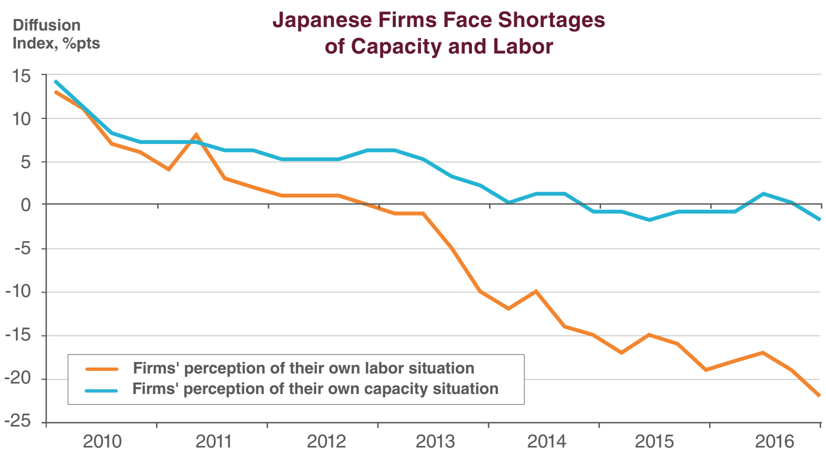
Except for Asia, equity valuations around the globe are above historical averages. Efforts by the Trump administration to stimulate growth could be positive for US equities. Small caps should continue to benefit from improving fundamentals and are not as negatively affected by a stronger US dollar. Our allocation to US small caps remains tilted toward value-oriented strategies in high-quality names.

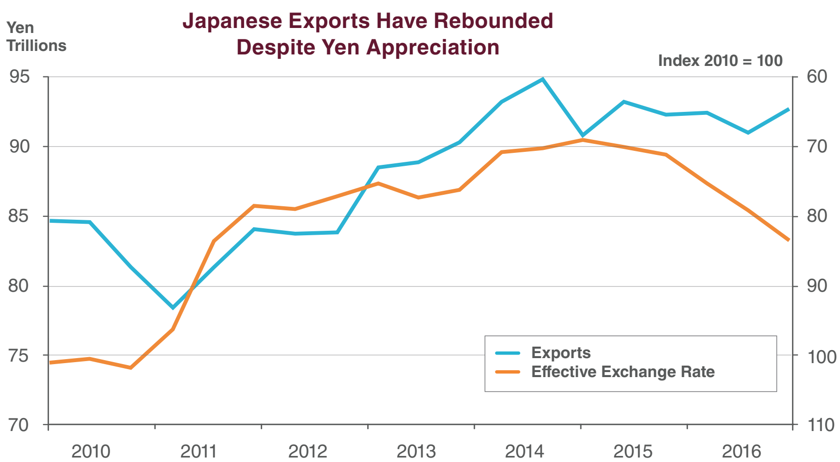
DEVELOPED INTERNATIONAL EQUITIES



Figures above horizontal bars are annual growth rates.

SOURCE OF DATA: IMF.





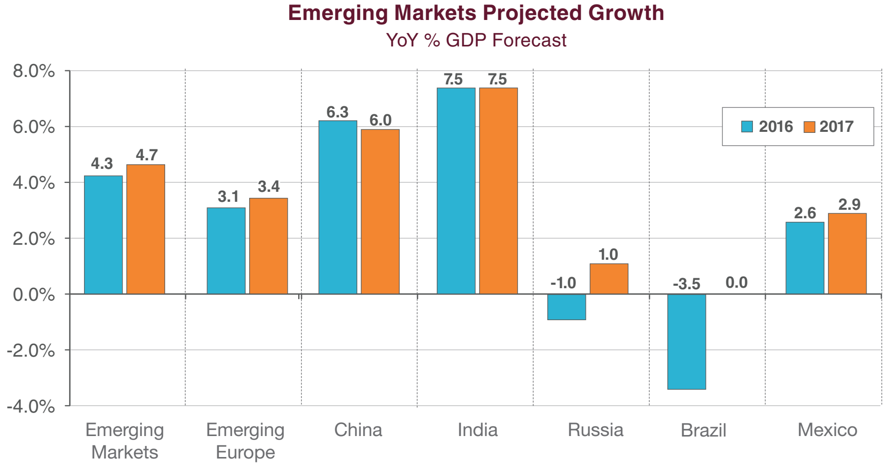
SOURCE OF DATA: OECD Economic Outlook 100 database, Bank of Japan.

We expect growth to pick up in the Eurozone and Japan, where equity valuations are attractive relative to the US. Therefore, we are maintaining our overweight to developed foreign markets.

EUROZONE: GDP growth rebounded to 1.6% in 2016, and is expected to tick a bit higher in 2017. Brexit and 2017 elections in France, Germany and the Netherlands are potential volatility drivers.

JAPAN: Decades of accommodative policies are beginning to show results as GDP growth estimates have turned positive. We remain selective in our exposure due to Japan's aging population and shrinking workforce, which will continue to be a drag on growth.

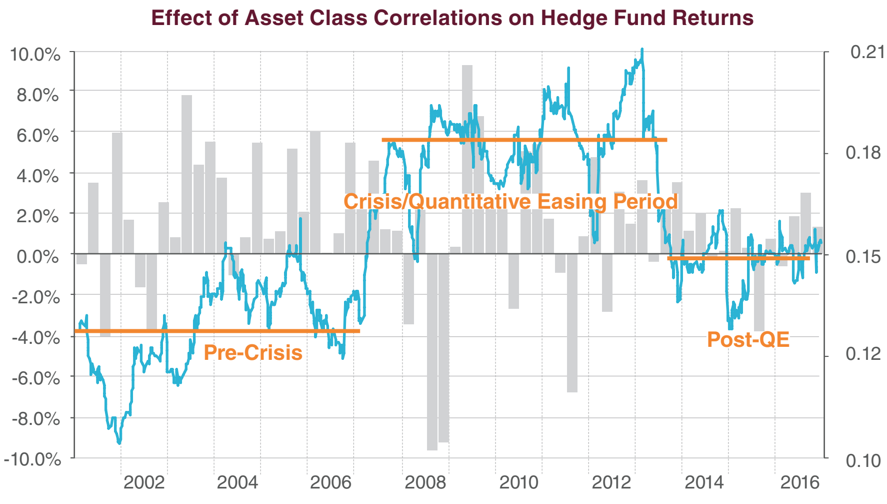
EMERGING MARKETS



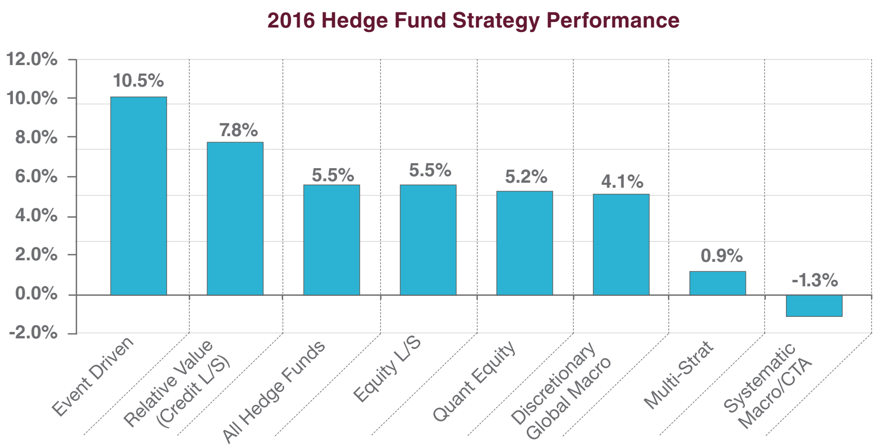
SOURCE OF DATA: Bloomberg.

Fears of a stronger US dollar and protectionist trade policies under President Trump pushed emerging market equities down toward year-end 2016. These continue to be valid concerns; however, we believe conditions for growth in many emerging markets remain intact and our current allocation should benefit from exposure to select countries that are continuing to transition toward consumer driven economies.

ALTERNATIVE ASSETS



SOURCE OF DATA: Bloomberg, PIMCO analysis as of 8/2016



SOURCE OF DATA: Hedge Fund Research..

2016 was a very challenging year for hedge funds and will likely close as the worst year of performance other than 2008 and 2011. Event driven and credit long/short strategies were the best performers. Within credit, distressed managers fared best as they capitalized on the rebound in energy prices and a resurgence of liquidity in the credit market after the difficult first quarter of 2016.

Looking forward, cross-asset correlations have fallen, which should lead to a more attractive opportunity set for hedge funds. In the 3rd and 4th quarters, we continued to adjust our liquid hedge fund portfolio and expect more changes to both liquid and illiquid allocations in the first quarter of 2017.

ABOUT THE AUTHOR

GINO PERRINA, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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