



Economic and Market Insights

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By Scott Colbert, CFA
Chief Economist, Director of Fixed Income
The Commerce Trust Company

Financial Markets, Businesses and Consumers Adjust to a New Political Landscape

The surprise election of Donald Trump as the United States' 45th President has been characterized as a sea change in economic policy. Although there are still few specifics about the future policies of the new administration, several broad proposals have raised expectations for a boost to growth in both 2017 and 2018. These include large increases in infrastructure, energy and defense spending; significant cuts in individual and corporate income taxes; reductions in regulations; and a repatriation tax break on overseas profits. There are scant details and significant uncertainty regarding the timing and implementation of these initiatives, as well as their financing – and as we all know, financial markets have a tendency to work faster than Congress. Nevertheless, all indications at this time are for at least a moderate boost to growth in 2017, and a stronger pickup in 2018. We thought it was a good moment to talk with Commerce Trust Chief Economist Scott Colbert, CFA, about what to look for next.

- Q. Once the initial drop-off stabilized after Donald Trump's election, markets seemed to respond favorably. Do you see this trend continuing in 2017?**
- A.** Three key financial trends have largely emerged: U.S. stocks have risen, interest rates have increased (10-year Treasury yields up 0.7%) and the dollar has increased 5% relative to a basket of foreign currencies. We expect stock prices to continue on an upward path into 2017 as the economy continues to improve and the corporate earnings momentum continues its rebound that began in earnest prior to the election. Interest rates will also gradually trend higher, but they have already jumped considerably and this pace will slow materially as low European interest rates make our higher-yielding bonds more attractive. The dollar also will continue to advance, particularly relative to the euro, but with the dollar at a 14-year high, its ascent should also slow considerably.



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Q. What advice would you give to investors heading into 2017?

- A. First, investors should make sure their investment portfolios have an appropriate asset allocation given their tolerance for risk. The typical investor we see might have 5% to 10% in shorter-term savings, 60% of their portfolio in fairly aggressive risk-like assets (typically stocks or higher-yielding bonds/REITS) and 30% in investment grade bonds.

Second, with stocks up more than 10% this year and bonds down about 5% recently, it would be a great time for investors to rebalance their portfolios.

Third, most investors are very U.S.-centric, but value is cheaper overseas. We recommend that investors have about 30% of their equities invested internationally split 25% in the developed markets and 5% in the emerging markets. Despite the fact that the dollar might strengthen a bit, international stocks have materially lower valuations (Price/Earnings ratios) and higher dividends. Plus they have grossly underperformed our domestic stock market. Over the past four years, the S&P 500 has beaten a broad-based international equity portfolio by almost 70%. Just this past year alone, the S&P 500 has returned about 11% while the Vanguard ETF for European stocks (ticket VGK) is down 2%. So investors should make sure to have some international diversification.

Finally, for those in the higher tax brackets, municipal bonds have cheapened considerably. It is not hard to find intermediate-maturity municipal bonds with 3.5% tax free yield. While this is nothing to write home about, bonds anchor a portfolio and provide insurance from a stock market rout. Over the past 16 years, we've watched stocks melt down by over 50% twice. While we do not see any near-term warning clouds on the horizon, our new President can't outlaw the business cycle no matter how much he tweets.

Q. How do you believe the job market will look in 2017 and what will that mean for wage growth?

- A. We expect job growth to nearly keep pace with last year's level of about 180,000 new jobs per month. Since we only have about 80,000 new job entrants every month, this will likely put continued upward pressure on wages and salaries as businesses try to attract discouraged workers to re-enter the workforce. Wages and salaries are currently growing about 2.5% to 2.7% on average and we expect that to accelerate to something closer to 3%.

Q. What would be the best way to boost economic growth in 2017?

- A. We believe that lowering the corporate tax rates would likely have the largest impact on financial markets, while a combination of tax simplification/reduction and a modest "deficit" spend on infrastructure improvements could kick-start economic growth from its current 1.9% pace to something closer to 2.5%. While that is not great by historical standards, it's a marked improvement from the slow but stable growth rate we've experienced after the 2008-2009 recession. Finally, some regulatory relief is also likely to boost economic momentum, particularly in the banking and energy industries.



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