CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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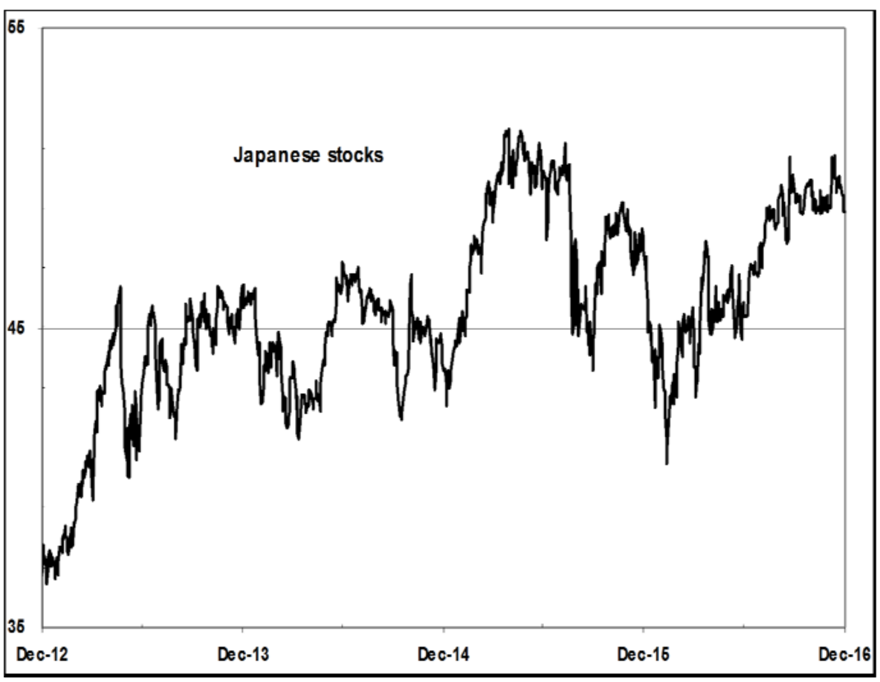
Uncertainty as the Year Turns

After a perplexing 2016, we enter 2017 with a new president about to take office. Stock markets rallied after his unexpected election.

What's next?

2016 is in the books, a tumultuous and surprising year in politics. The June referendum in Britain about leaving the European Union--a very unwise political gambit by David Cameron--was expected to result in affirmation of the UK's continuing in the EU. Nope. Then, in our own presidential election, the widespread belief, which I shared, was that Donald Trump was barely a serious candidate for the Republican nomination and that, once having secured the nomination, he would likely fail in the general election. Wrong again. The very confident prediction of stock market analysts as the November election approached was that, if Mr. Trump should win, the stock market would fall. Oops. The stock market rallied sharply from election day until mid December, when it began to level off.

Given this, is it plausible to make predictions about 2017? There is one prediction about which one can have reasonable confidence: Uncertainty lies ahead. The *post hoc* explanation for the rally was that the incoming Trump administration, supported by Republican majorities in both houses of Congress, would cut burdensome regulatory requirements on businesses, commence large-scale infrastructure projects, and reform tax policy, especially by cutting taxes on corporations. Indeed, some of this may be accomplished and the result may be that corporate profits rise, underpinning the US stock market. A president may, without Congressional approval, change some existing regulations. However, for many, statutes prescribe the means to regulate and de-regulate. Changing regulations may require public comments and the changes may be challenged in courts. Reformation of tax policy is a legislative matter. Congress enacts tax legislation; a process that surely takes time. And, as for infrastructure spending, Congress barred Obama administration attempts at public works; Republican leaders in both houses have fairly recently expressed disapproval of more infrastructure spending. Mr. Trump, though now a Republican, is not cut from the same cloth as most Republican House and Senate members, and many policies he put forward during his campaign are not traditional Republican ones.



By

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As a result, the somewhat euphoric stock market reaction to Mr. Trump's election may not be well founded or it may have been premature. We will know more about all this after January 20th when we see the interplay between Congress and the new administration and when we see what precisely Mr. Trump puts forward.

On the first page is chart of Japanese stocks, which receive singular support from Japan's central bank. Among other assets, the central bank is buying Japanese equities. We have an investment in Japanese stocks.

Another uncertainty may arise from actions by adversarial countries to 'test' the new president. Consider China: it has asserted control over vast areas of the South China Sea, far greater than recognized by international law. The United States has resisted China's efforts by sending its naval vessels into such areas. Shortly after his election, Mr. Trump had a telephone conversation with Taiwan's president and, afterwards, disparaged the One China Policy, to which the United States has subscribed since the late 1970s. He suggested that adhering to it might be subject to negotiation. Thereafter the Chinese navy picked up a US underwater drone within international waters but within the area that China claims as territorial waters. The vessel was returned to the United States in a day or two, but China appears to be sending a message to Mr. Trump. What might it do after January 20th? Consider also Mr. Trump's campaign threats to impose large tariffs on Chinese goods. As president, Mr. Trump could do so on his sole initiative. A trade war between the world's two largest economies is an unnerving prospect.

North Korea? It has frustrated the efforts of President George W. Bush and of President Obama, joined by Japan, Russia, China (without much vigor), to stop its nuclear bomb and intercontinental ballistic missile development programs. What might the young President Kim Jung-un try next? Russia? Mr. Trump made admiring comments about Vladimir Putin during his campaign and since his election. He has mocked the conclusions of the US intelligence community that it was Russia that hacked various political entities and persons and sought to influence the election. One suspects that Vlad the Revanchist takes the actions he does not out of warm personal regard for Mr. Trump, but because he deems the actions to be in Russia's interests. When the ostensibly admiring Mr. Trump is sworn in, what may Russia do?

Unexpected geopolitical disturbances may present Mr. Trump with some head-scratching dilemmas. But the strength of the US economy and the steady stewardship of monetary policy by the Federal Reserve and the other major central banks will likely keep financial markets reasonably healthy.

I put forward these ideas not so much to discuss US politics and geopolitics, but to note the vulnerability, at least for the next few months, of the stock market. Notwithstanding this vulnerability, the US economy is strong, employment is still growing well and, happily, wages are increasing after a long, long spell. Although higher labor costs necessarily reduce corporate profits and, to that degree, suggest less robust stock market valuations, there is another side to this coin: To the extent workers are paid more, after a long period of rather depressed compensation, that is morally a good thing. Economically it is a good thing also, in that with increased pay will come increased spending and a generally stronger economy. The stronger economy will strengthen corporate profits and will support higher stock prices. A virtuous circle.

Our central bank, by raising short-term interest rates by one quarter of a percent last month, signaled its view of the strength of the US economy. At its December meeting, it suggested that 2017 would see three more quarter-percent rate increases. This contrasts with the situation in Japan and Europe, where economies are weaker and whose central banks are still engaged in aggressive monetary easing and asset purchases. These differences in monetary policy and economic activity account for the strength over the last two and one half years in the US dollar. The divergent policies of the developed countries' central banks suggest that the dollar will become somewhat stronger in 2017. It is also probable that the decent economic strength in the US will persist; indeed, if the hoped-for Trump policies come to fruition, the rate of growth may increase. In Europe and Japan there will probably be modest growth, as well.

Despite weaker growth in Europe and Japan, their stock markets offer better value than does the US market. In part, this arises from the weaker performance of those markets over the couple of years when compared to the American market. We have a modest investment position in Japanese stocks already. Given the large positions in cash and bonds in many of Core's clients' portfolios, we have the funds available to add to these investments when opportunity presents itself.

The festive season draws to a close soon. We wish to express our gratitude to you for the opportunity you have given to Core to supervise investment of your capital and to wish you a happy, healthy, peaceful and productive new year.

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