Marcus Financial Advisors Newsletter

January 2017

Snowflakes are one of nature's most fragile things, but look what they can do when they stick together.

Happy New Year ~ Go Pats

An Interconnected World

Jonathan Marcus

2016 was a year of many surprises. Time and again, the *experts* were proven wrong and unexpected outcomes became the norm. On January 20th of last year, oil plumbed a 12-year low of $27 per barrel, and the S&P 500 was already down 9%. By mid-February, the S&P 500 would be down 10.5% – the worst start to a year on record. After finally raising rates 0.25% in December of 2015, the Federal Reserve anticipated four rate hikes in 2016 as monetary policy returned to interest rate normalization; however, after the stock market selloff to start the year, Brexit in June, and the US election in November, the Fed found ample excuses to delay additional rate increases and only raised rates once. This sole rate increase in 2016 happened to coincide with a strong uptick in US stock prices, the result of which led to core fixed income posting its worst quarterly return (-2.98%) in 36 years as measured by the Bloomberg Barclays US Aggregate Index (source: Raymond James Asset Management Services).

After a challenging start to 2016, market sentiment shifted from pessimism in the first half of the year to unbridled optimism in the second half. In both cases, investors' reaction to the economic data appeared inconsistent with our baseline viewpoint of both stabilizing global growth and significant, ongoing structural challenges to developed market economies. While global growth never looked quite as lackluster as markets feared in the early part of 2016, our forward-looking expectations for growth are not quite as optimistic as markets may currently have you believe. Major reasons for the tempering of our outlook are the significant structural challenges facing not only the US but developed economies across the globe, which we will delve into a little further on.

Overall, the US economy ended 2016 on solid footing and should hopefully improve this year. The Fed has indicated it will raise interest rates three times in 2017 as the march to rate normalization continues. The actual policies of the incoming administration are still a bit of a question mark, but we see clear

Key Points

- US stock valuations continue to look a bit stretched
- Expect additional interest rate increases in 2017
- Trump administration policy uncertainty leads to a wider range of potential economic outcomes

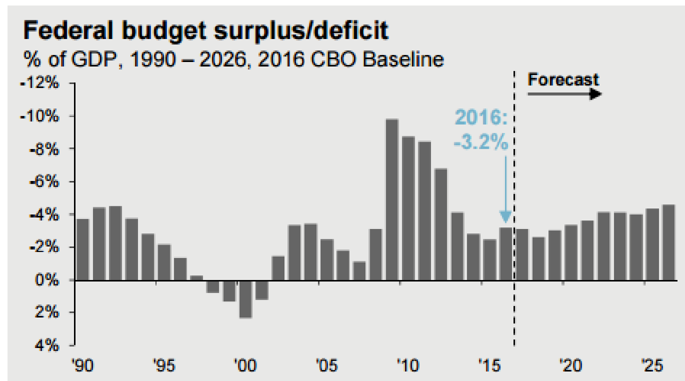
Performance Year to Date

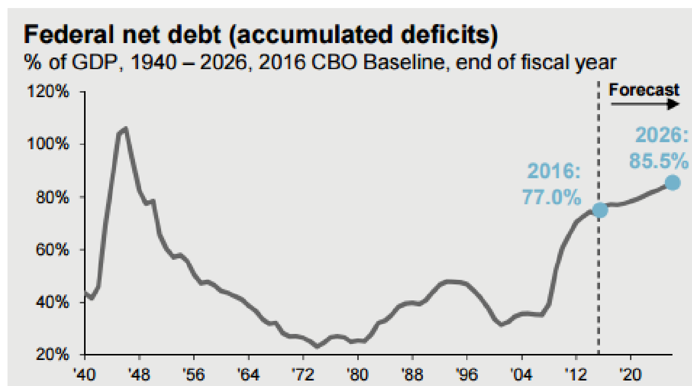
	Returns	
	Weekly	YTD
S&P 500 Index	-0.1%	1.7%
Dow Jones Industrial Average	-0.4%	0.7%
NASDAQ Composite	1.0%	3.6%
Hang Seng (Hong Kong)	1.9%	4.3%
Shanghai Composite (China)	-0.9%	0.9%
MSCI EAFE (non-US developed markets)	0.8%	2.6%
MSCI Emerging Markets	1.7%	3.9%
Bloomberg Barclays US Aggregate (bonds)	0.2%	0.4%
BofA Merrill Lynch 3-Month Treasury Bill (cash)	0.0%	0.0%

Source: Nuveen, Morningstar Direct and Bloomberg as of 1/13/2017. All index returns are shown in US Dollars. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

areas in which both the White House and Congress appear likely to devote their time and energy. I will address some of these issues and try to provide context for what we should reasonably expect to see from the US government and global capital markets this year.

Assuming no major economic changes, the United States will experience its third longest economic expansion since 1900 as of this March. Without question, this expansion has been slow and sluggish and has not benefitted all socioeconomic groups to the same degree, but it has been rather long. Unfortunately, the speed of this expansion may be unlikely to change because it could prove difficult to increase our economic growth rate dramatically. The US federal debt and deficit have been on an upward trajectory, which limits the amount of extra money available to meet increased government spending, either in the form of infrastructure projects or unfunded tax cuts.



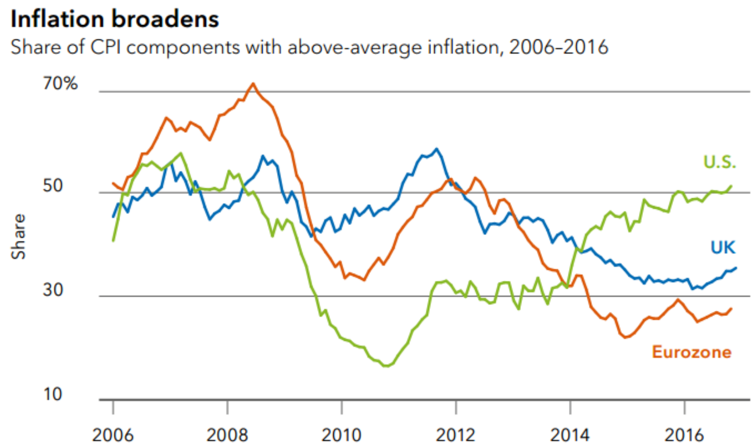


Source: CBO, J.P. Morgan Asset Management, BEA, Treasury Department. 2016 Federal Budget is based on the Congressional Budget Office (CBO) August 2016 Baseline Budget Forecast. Years show are fiscal years (Oct. 1 through Sep. 30).

Despite general policy uncertainty, one clear area of focus for President-elect Donald Trump has been tax reform and an overall reduction in both personal and corporate taxation. A potential increase in economic growth may help pay for some of these tax cuts, but the broad proposal of tax cuts and increased government spending described by President-elect Donald Trump has the potential to balloon the deficit. As noted above, both the federal net debt and the federal deficit have been growing over the past few years, so there is not much additional money in the till, so to speak, to pay for these spending increases without relying heavily on net borrowing. The deficit hawks in Congress may blanch at such a plan, so the amount of fiscal stimulus the US economy receives may be more limited than optimists are hoping for.

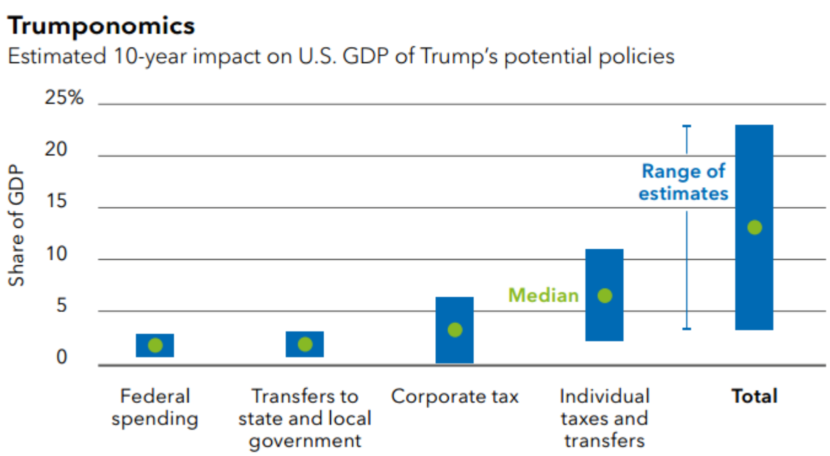
If economic growth is necessary to pay for potential future spending, the good news is that global growth estimates have been rising. The global Purchasing Managers' Index (PMI) for manufacturing shows an acceleration in this sector, which reinforces the consensus view that growth is picking up. With an increase in growth expectations comes a rebound in inflation, led by the US. With a tighter US labor market, average hourly earnings are increasing at the fastest pace since 2009. Though behind the US's inflation rise, the Eurozone and UK appear to have bottomed out from their deflationary predicament and have finally seen their own inflation boost.

Not only has inflation been gaining steam, but overall consumer and business sentiment has improved. Over the past few years, consumers have been feeling rather good, but small business owners have not. Now, both parties appear to be on the same page as consumer sentiment and small business optimism have been on the rise. With both small business owners and consumers feeling better, the likelihood of continued wage increases becomes stronger, which also leads to an increase in inflation.



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, UK Office for National Statistics and Eurostat, November 2016. The lines show the percentage of CPI basket components with seasonally adjusted, month-on-month inflation above the average since 1999. The indexes capture 77 components in the U.S., 94 in the Eurozone, and 85 in the UK.

Against the backdrop of stabilizing and improving economic data, we have a new, incoming administration in Washington. As I wrote a few months ago, anyone who claims to know exactly what President-elect Donald Trump will do is almost certainly lying to you (or to themselves). Not only is there little consensus or clarity about what the new administration's principal policy issues will be, there is little consensus about the benefit these possible policies, such as increased federal spending, tax reform, changes to trade, etc., might have on the economy. Markets appear to have priced in *stimulative* policies (tax cuts and infrastructure spending) while discounting policies (trade protectionism and lower immigration) that could slow the economy. Of course, economists, financial analysts, and market prognosticators will always debate the merits of particular economic policies, but the range of outcomes with the Trump administration is unusually broad.



Forecasting the impact of fiscal changes to economic growth is challenging to begin with; however, the range of estimates that each dollar of fiscal expansion may have on GDP varies from 3% to 23% over the next 10 years, according to the Congressional Budget Office. We could see economic stimulus or we could see minimal effect. Without a clearer agenda, variability will remain high, which could lead to market volatility as well.

Source: BlackRock Investment Institute, Congressional Budget Office and Committee for a Responsible Federal Budget, November 2016. The chart shows estimates of the impact of President-elect Donald Trump's policies on U.S. GDP over the next 10 years, measured as a percentage of 2015 GDP. The estimates are derived by applying Congressional Budget Office estimates of fiscal multipliers of different tax and spending policies to estimates of the fiscal impact of the President-elect Donald Trump's policies produced by the Committee for a Responsible Federal Budget. The bars represent the range of estimates, which are driven by different fiscal multipliers.

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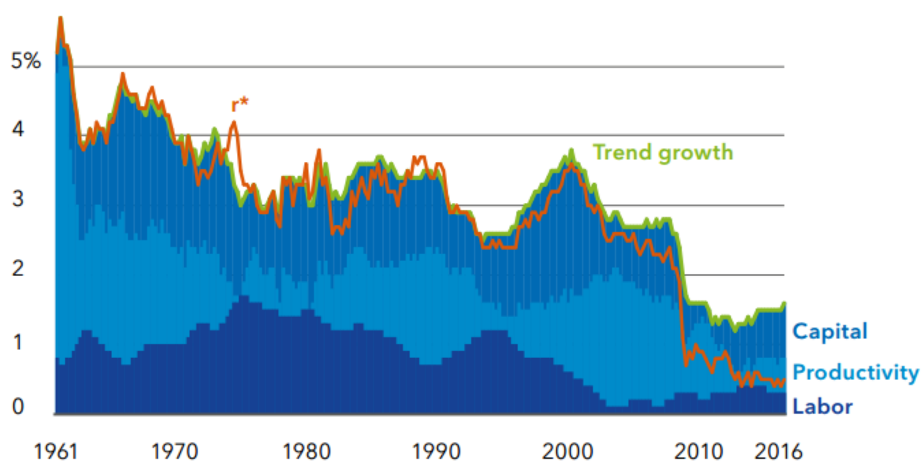
As was our position last year, we expect economic and market returns to maintain a low trajectory. Economic trend growth has been heading lower for decades, which could lead to a structurally low interest rate environment. Comprised of growth in the labor force; the total capital stock; and productivity, trend growth can be thought of as the natural speed limit of economies. With a graying population no longer contributing in the same way to labor force growth and with capital spending and productivity providing mediocre growth, the overall economic growth rate for the US (and other developed countries) has been falling for decades.

With the neutral interest rate (r*: the level at which rates neither stimulate nor hinder growth) falling to 0.5%, we should expect the nominal (before inflation) neutral rate to be about 2.5%-3.0% if we believe in the Fed's 2.0% inflation target. Looked at this way, lower trend growth may limit how high bond yields can climb unless spending and deregulation manage to push trend growth higher than it is now. Proponents of President-elect Donald Trump's administration believe his team's policies can achieve higher growth rates while opponents remain quite skeptical.

Low for no longer?

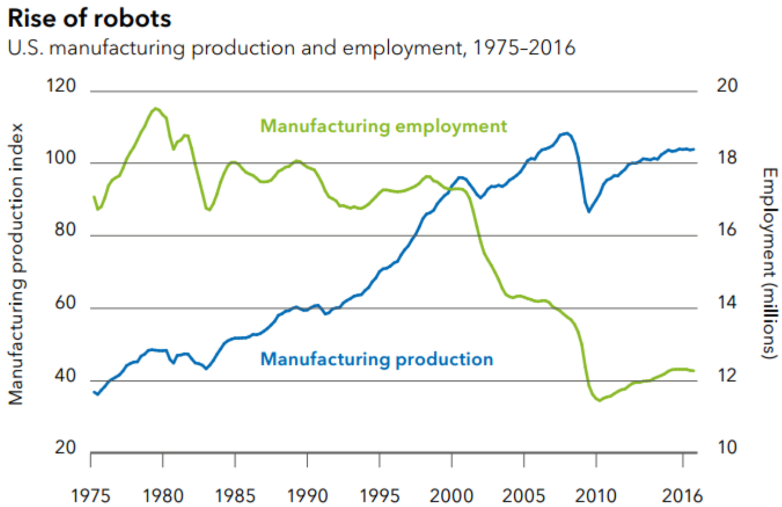
U.S. trend growth and neutral rate, 1961-2016



Source: BlackRock Investment Institute and Federal Reserve, December 2016. The chart shows trend GDP growth broken down by contribution and an estimate of the real neutral rate, called r*. We derive r* estimate via a similar methodology used in the August 2106 Federal Reserve study (Holston, Laubach, Williams. r* is modeled as the sum of trend growth and other factors that have historically played a smaller role, such as global excess savings.

Though lower economic growth may appear to be problematic, it is actually not that unusual once we adjust the current growth rate for leverage (i.e. borrowing). Today's growth rate should be viewed as fundamentally sound rather than abnormally low after accounting for structurally lower population growth and excluding the debt-fueled boost to growth between 1980 and the Global Financial Crisis. Said another way, after accounting for these factors, our trend growth rates makes sense.

When we review stress tests of demographic shifts (e.g. baby boomers retiring, potential decreases in immigration, automation and technology, etc.), these factors negatively impact portfolios because of their projected net detraction from economic growth in the short-term. Limiting immigrant (or deporting immigrants) could result in reducing the labor force and shift labor force growth lower. As much as populists decry globalization and the detriment of offshoring manufacturing jobs to lower wage countries, technology has had far greater impact. Since 2000, the number of US manufacturing workers has declined by 30% while manufacturing output has increased over the same period.



Source: BlackRock Investment Institute, Federal Reserve and U.S. Bureau of Labor Statistics, November 2016. The base year (100) for manufacturing production is 2012.

We believe technological change will continue to accelerate, not decelerate, so we should continue to see disruption across blue-collar and white-collar industries. While the rise in automation has helped limit inflation by keeping prices low, if the trend towards automation continues, we should expect populist politicians and populist policies to persist.

Overall, we have an economy that is doing reasonably well but constrained by the structural challenges of an aging population and technological advancement. In the short-term, several of the Trump-era policies (e.g. tax cuts, infrastructure spending, and deregulation) could prove stimulative to the economy, but these agenda items do little to address the aforementioned structural challenges facing the United States. Despite being in the midst of a very long economic expansion, it would be incorrect to believe we are *due* for a recession. Expansions do not die of old age; rather, recessions occur when economic shocks amplify the dislocations and excesses that build up over time during an expansion. Oftentimes, a shock that begins in one sector of the economy spills over into others as optimism turns to pessimism. We do not know what shock will initiate the next recession; however, we have identified three scenarios below that could lead the US economy in that direction.

The Collapse of Global Trade

Causes could be a sharp move toward trade protectionism in the United States and a trade war; gridlock and the breakdown of Brexit negotiations within the European Union; and uncertainty surrounding anti-EU movements in euro-area countries, particularly the French and German elections.

Aggressive Monetary Policy

A sharp acceleration of rate hikes through 2017 could be triggered by an unforeseen flare-up in inflationary pressures and a rise in long-term rates due to expansionary fiscal policy (extensive infrastructure spending and tax cuts). This in turn could cause dislocation in asset markets and affect investor sentiment and confidence.

China Hard Landing and Systemic Financial Crisis

Capital outflows intensify in spite of capital controls, leading to a collapse in the yuan and affecting key sectors of the Chinese economy, such as real estate, local government finances, and the stock market. Global spillovers affect emerging markets via trade linkages and developed markets via financial volatility and increased risk aversion.

Source: Vanguard Economic Outlook 2017

These risks to the global economy and client portfolios are real but not assured. Taking a closer look, we can distill these scenarios to three specific topics: the US economy overheating, Europopulism, and China. Let us take each of these topics in turn.

First, the US economy overheating. Should President-elect Donald Trump succeed in stimulating growth through tax cuts and infrastructure spending, we should expect to see higher interest rates. However, with structural challenges to the growth rate of the US economy, it may be difficult to generate enough growth to pay for such spending. Until we have a better idea of Trump's and Congress's actual policy agenda, one can only speculate about the likelihood of this risk; however, we do not believe there is a high probability of recession for these reasons in 2017. Should we experience a negative outcome from these policies, we would expect the consequences to be felt in 2018 or 2019.

Second on our list is Europopulism. With general elections in the Netherlands on March 15th, a self-imposed Brexit talk deadline of March 31st, French presidential elections on April 23rd (first round), and general elections in Germany in the fall, there is the potential for quite a shakeup in Europe. At this time, we believe 2017 will *not* see the dissolution of the European Union, but we will probably see populist political parties do well in the upcoming elections. More likely, populist parties and possible populist electoral victories will lead to more future uncertainty and investor consternation rather than actual policy change in 2017.

Third on the list is China. Despite the often-repeated belief that China is eating our lunch, the Middle Kingdom is striving to reorient itself from a manufacturing, export-driven economy to a domestic service economy. In doing so, the Chinese government has propped up state-owned companies (the weakest part of the Chinese economy) in an effort to maintain high employment. Several years ago, we wrote about rising wages in China, and it is no surprise that today China is no longer the cheapest location for manufacturing. In order for China to increase its economic productivity, they will need to adopt new technology and automation much as developed countries have. Though there are concerns about surging Chinese debt and clear challenges facing the yuan in a strong dollar environment, we do not expect a Chinese meltdown in 2017.

Together, this confluence of forecasts, predictions, and potential risks leads to some conclusions. With fairly high stock valuations and a low-interest rate environment, investors should continue to expect lower asset class returns going forward. Secondly, expect to hear more about the *interconnected world* as populist policies fail to work as well as expected. The world has gone global and that reality has not been part of the populist dialogue except as a pejorative. Politicians touting simple solutions to complex national problems have a poor record of implementing positive change when actually in office. That is not to say there is no room for improvement in government or that populist campaigners cannot become pragmatic policymakers once in office, but it would not be surprising to see optimism turn to pessimism should policies fail to deliver upon campaign promises.

Thank you again for your continued trust and confidence in us.

Personal Section

New Year's Resolutions – the best chance to keep them is to start well before January 1st. I started working out with a personal trainer in November. I wanted to lose a few pounds and gain some strength and flexibility which should help my golf game. Perhaps the hardest part was submitting my *Food Journal* of everything I ate over two weeks. As you might imagine, the trainer was not impressed. I had a lot to learn about portion control and healthier choices. My friends Ben & Jerry must miss me very much, since I have cut out my daily bowl of ice cream. I'm down 6 pounds *after* December's holiday food festival and right back on track with daily exercise.

We sure had great opportunities to eat while our daughter, Kate, visited for two weeks from Bangkok with her friend Richard. He is a scientist with an Oxford University institute in Bangkok whose research is focused on malaria. Of course, Kate had favorite foods on her list of *must-haves*. Debbie also prepared a feast of Swedish holiday favorites for Richard who hails from Gothenburg. Richard made the holiday Glogg. God Jul!

We had a whirlwind of activities with them for two weeks, visiting family and friends, including Kate's first visit with her new nephew. Highlights included the Kennedy Library, a Boston Bruins game, sight-seeing on Cape Ann, Debbie's mother's Yankee Swap on Christmas, candle pin bowling, trivia night with Jon, Debbie's baked stuffed lobsters, visits with Kate's college friends, learning how to play Kubb, a Swedish outdoor game, and a visit to Vermont with marshmallow-roasting around the fire under a million stars. Debbie, Kate, and Richard also spent an afternoon at the Ipswich River Wildlife Sanctuary in Topsfield, MA – a family favorite place for many years. Kate was determined to fit this in.

The Ipswich River Wildlife Sanctuary is a beautiful spot where magic happens. Approximately 40 years ago, someone coaxed chickadees to eat sunflower seeds from people's hands. Over the years, succeeding generations of chickadees have learned hand-feeding and have been joined by nuthatches and tufted titmice. Simply stick out your hand with a few sunflower seeds, hold still, and you will soon have a pert, little chickadee land in your palm. It will look you in the eye, grab a seed, and fly off to a nearly bush to crack it open. Jon and Kate have fed the chickadees there since they were toddlers. When Kate was too little to hold her hand still, we used to put the seeds on her hat. The magic of feeding the chickadees never gets old. Richard loved it! The sun was setting on this splendid winter afternoon when they finally took the trail leading up to the meadow and back to the parking lot. A small herd of seven deer crossed the trail right in front of them to graze in the meadow. Splendid!

Our unconventional New Year's Eve was bitter-sweet. We counted down to midnight as we sent Kate and Richard through TSA Security for their long flight back to Bangkok. Things are quiet now. We miss them!

Skiing so far has been quite good with conditions in December and early January exceeding all of last year. Let's hope for more snow right where it belongs, up north!

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"Caring for you and your family is one of our greatest pleasures. Please feel free to share our name with your family and friends."