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INVESTMENT MANAGEMENT

Market Perspectives

INVESTORS FOCUSED ON "START" POLICY CHANGES

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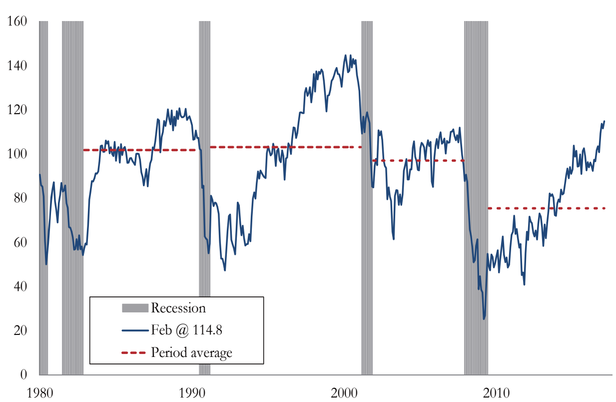
Going into 2017, the U.S. economy was likely to grow about 2.0% to 2.5%, not counting the potential benefits of policy changes promised by the Trump Administration. **Investors focused on those potential benefits have driven equities to record levels on the belief that economic growth and corporate earnings will rise significantly** as reductions to individual and business tax rates, increased infrastructure spending, and regulatory rollbacks are enacted.

Broadly speaking, **there are five key areas where policy changes will impact GDP, earnings, and the markets**. They can be grouped under the acronym START. Let's take a look at each one:

- **S – Stimulus** from Washington in the form of increased defense and infrastructure spending would have a significant impact. However, higher defense spending would be much more meaningful as the federal government does not spend that much on infrastructure.
- **T – Tax** reductions for individuals and businesses can have a very positive impact – if the reductions are targeted correctly. The key is to alter tax rates and regulations in ways that make it likely that those receiving the additional income will increase their spending and investments, thus benefitting the overall economy.

Figure 1. Conference Board Consumer Confidence Index



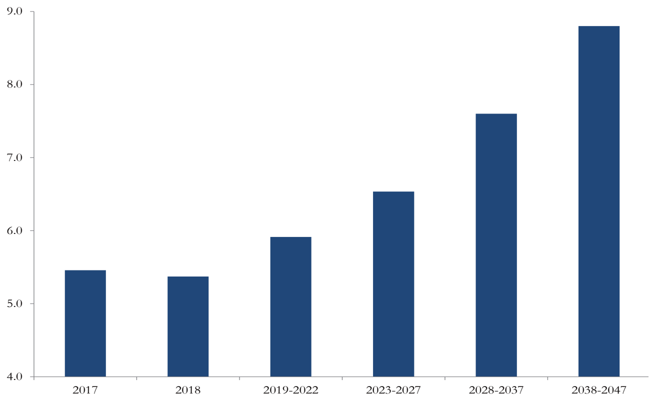
Source: The Conference Board Inc. As of February 2017.

- **A – Attitudes** matter. Individuals and companies spend and invest largely based on their confidence – or lack thereof. Higher confidence (*Figure 1*) across the board will generate favorable and self-fulfilling momentum for economic growth.
- **R – Regulatory reform** can create enormous long-term benefits – again, if the reforms are targeted correctly. In this regard, we believe the conduct of regulators is much more important than the rule books themselves. As one example, prudent but reasonable implementation of bank regulations could unlock billions in potential lendable capital. Handled correctly, regulation can benefit consumers as well as create stronger economic activity.
- **T – Trade policy** is a delicate area where significant changes should be considered carefully to guard against negative consequences. For example, tariffs meant to protect domestic industries can invite retaliatory tariffs from other countries that hurt U.S. exporters, while complicated "border adjustment" policies can impact global value chains and raise prices for consumers. We are monitoring this area very closely.

Another area we are watching carefully is health care reform, a highly complicated issue that could consume Washington for the next few months and thus delay passage and implementation of the important policy changes summarized as START. Republicans have unveiled a new plan that, among other things, would end Obamacare's mandate that most Americans obtain health coverage, repeal the requirement that larger companies provide health insurance to full-time employees, and also eliminate most of the current health law's taxes starting in 2018.

There is no way to estimate the economic effects of what will finally emerge as the new health care system. In a perfect world, the new system would shrink overall healthcare expenses as a percentage of GDP over the next 25 years and thereby finally take a stand against at least one area of unsustainable federal spending. We will see what we actually get (*Figure 2*).

Figure 2. Projected Federal Spending for Major Health Care Programs (% GDP)



Source: The Congressional Budget Office. As of January 2017.

It is worth noting that **while investors have driven stock prices to record levels based on their belief in positive outcomes in START's key areas, they have not done so in a vacuum**. Although GDP growth has been steady, corporate earnings are rising, payrolls have increased for 76 straight months, unemployment has been at or below 5.0% for a year, inflation and interest rates remain low, and there are signs of economic expansion around the globe.

If START is implemented correctly, we will see continued positive effects on the economy, earnings, and stock prices. However, we are also at the beginning of several interest rate hikes promised by the Fed, which will impact bond prices, and the timing and extent of START policy changes remain unknown. Where that leaves us is to anticipate volatile markets and a potential pullback in stock prices if investors lose faith in Washington's ability to focus on what really matters, but also with the promise of even higher prices for equities a year or so out if things go well.

Index Definitions

The U.S. Consumer Confidence Index is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending. Global consumer confidence is not measured.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

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