INVESTMENT PARTNERS ASSET MANAGEMENT

10 Station Place, Metuchen NJ 08840 Tel: 732-205-0391 Fax: 732-205-0395

Thoughts For 2017

As 2016 fades into the history books, and we focus on the next 12 months, this year's motto appears to be as follows: "Laissez les bon temps rouler" or "Let the good times roll."

It's unclear at this point, though, as to whether one can interpret "rouler" to mean "roll on" (i.e. that markets will continue with the momentum of the past 8 years) or "roll over" (i.e. that bonds and equities will finally take a breather from their upward trajectory, or even recede in value).

With the U.S. Presidential election behind us, euphoria is currently in full swing on Wall Street because, thus far, it is widely felt that impediments to future growth will be modified or eliminated by an incoming presidential administration intent on making America more competitive and Americans more prosperous.

The so-called promise of "Making America Great Again", at first blush, seems noble. The phrase implies a goal of unifying our country and imbuing it once again with national pride. It has also become a rallying cry for many citizens in the nation's manufacturing *rust belt* who have not participated in the economic recovery of the past 8 years. In fact, the slogan seems to evoke the spirt of the 1950's when family values and economic optimism surged after years of post-war sacrifice.

The reality, however, is that the task of prioritizing America's domestic agenda faces the structural problems of large public debts, declining productivity, fewer high-paying jobs, anemic global growth, a politically-polarized citizenry, and the awareness that we live in a complicated, interconnected world. Additionally, the U.S. is not the only superpower striving for *greatness*, experiencing a ground swell of populism, or expecting to win at a zero-sum game.

So, with that as the backdrop, here are a number of our forecasts for 2017:

First Forecast

Reformation will initially be welcome and expected in the US, but unwelcome in many corners of the world.

The market seems willing, for now, to give the new administration some time to deal with complex economic and societal challenges. The compass direction has been set as we prepare for massive legislative changes domestically. The foreign policy implications of our desire to prioritize our national interests, however, will be felt in all corners of the globe.

The first place where expectations have manifested themselves is Wall Street, where unfettered capitalism is, so far, perceived to do the most economic good. In early 2017, the promise of relaxed regulations on business, restoring banking confidence, providing truly affordable health care, and enacting tax relief for the corporate sector are part of a credo, or belief system. The theory is that we will go back in time to an America where prosperity was the reward from hard work, savings, and personal sacrifice.

The traditional manner that made America "Great" was through risk taking, investing for sustained prosperity, and reinvestment. America today however, is not the America of the 1950's. Americans are, by nature, optimists and can be patient up to a point as long as they remain confident about the future. However, the government does not have the balance sheet it had 60 years ago. With $20 trillion in public debt, the U.S. is not in the position to enact fiscal stimulative economic policies for an indefinite period of time in the hopes that such efforts can instill enough confidence for companies and consumers to take long-term risks continually. Therefore, it remains to be seen if the market's initial perception of optimism will become a demonstrable economic reality.

Second Forecast

Unfortunately, the restoration of confidence will take time… a lot of time. And frequent tweets are not helpful in that process.

Markets have been conditioned to expect significant positive changes all at once without study of specific policies and programs and the evidence that they can produce positive results. There has been a rapid re-pricing of assets, anticipating winners and losers based on rhetoric and personalized warnings using a system of rewards and punishments delved out by edict. While change itself can be upsetting, change imposed by someone who has a flair for the dramatic can set off unanticipated emotional responses that detract from its effectiveness.

As a result, we can expect that 2017 will see more than its fair share of controversy at home and globally.

It is highly unlikely that things will go along without a hitch, politically or economically. This is particularly the case when markets are affected by daily tweets where the risk of personal communication can be, at best, misperceived. It is our belief that frequent such communication will produce a spillover effect into the capital markets with unintended consequences.

Third Forecast

The U.S. Equity Markets will be quite volatile, potentially with wild swings adding to an already supercharged environment.

Volatility is the product of increased perceived risk. Market participants can live with risk in search of reward – but they do not like uncertainty or controversy. What markets also find difficult is interference from Federal Reserve policy vacillation, cyber-attacks, imbalances in the supply-demand relationships in energy markets, and tariff and border restrictions to name a few examples. This year may have a number of such disturbances.

Fourth Forecast

The problems and challenges are more daunting than expected because the world in 2017 is more interconnected, hence any change can imbalance a system that is increasingly fragile.

There is a belief that global growth is expanding - the pie is getting bigger and everyone's slice is larger. Our view is that global growth, at least for now, has been impeded and is not yet accelerating. The problem with the growth thesis has been described by Ruchir Sharma in his book Rise and Fall of Nations. In essence, he sees the following as forces that could impact long-term economic expansion:

De-population

De-globalization

De-leveraging

De-democratization

He points to a net decrease in the world working age population, trade contraction with discriminatory trade measures, a slowdown in cross-border banking flows, net migration from emerging markets to developed markets, de-leveraging headwinds in China and the Eurozone, de-democratization with declines in freedom, and the emergence of nationalism and populism.

The net result is that there are a growing number of world hotspots, each of which may require delicate diplomatic measures to keep the world stable. We see the geopolitical market environment as filled with risks that may become increasingly difficult to successfully navigate.

Added to this complexity is the level of debt required to produce an increase in GDP, the interrelationship of currencies pegged to the U.S. dollar, currency manipulation, stealing of intellectual property, and further border tariffs and barriers to fair trade. The behavior of leaders in specific countries should be watched with close attention. Alliances are more necessary than ever as we foresee more meddling in the affairs of nations contributing to further imbalances.

Fifth Forecast

Large fiscal stimulus, funded by increased borrowings, may not produce expected growth, and monetary policy is becoming more restrictive. The Fed is likely to raise short-term rates at least twice in 2017 as long as inflation and commodity prices remain steady.

Already, markets around the world have reacted to the prospect of the enactment of fiscal policy with a sharp rise in the value of the dollar along with an increase in bond yields. Inflationary expectations are on the rise with the Fed announcement of gradual expected rate increases for the next three years. The aggressive stance is based on the anticipation of improving economy with job creation, productivity enhancements, and stable prices.

Assuming everything turns out as expected, we have to wonder how much longer the U.S. stock market can maintain its relative outperformance versus the rest of the world, which is already running notably long (at nine years and counting.)

We see some of the enactment of trade restrictions actually penalizing consumer spending, while interest costs rise, negatively affecting growth in spite of reductions in certain taxes. The U.S. economy is not an island unto itself. The global debt crisis will take its toll because central banks around the world have been unwilling to raise rates while believing that growth would be impeded if they were to do so.

Thus, the world finds itself, for now, in a "Debt Trap" where the way out, near term, is perceived to be more debt and systemic reform. While reduced taxes, deregulation, and fiscal stimulus may all help to kick start growth, there is no sustainability to this policy long-term unless a bi-partisan consensus develops to deal with fiscal imbalances.

Sixth Forecast

The dollar's value as the reserve currency of the world may be called into question by our trading partners who see the need for devaluations to compete.

Along with a restrictive monetary policy is the concomitant negative effect on global growth caused by a much stronger dollar. As long as the dollar remains the reserve currency to the world and is dominant in global trade, global growth will be kept in check.

In an era of future massive government spending domestically, the U.S. will attempt to issue government bonds while the Chinese and the Russians are divesting themselves of U.S. paper.

We believe 2017 may see the making of a Russian-Chinese alliance with gold in a basket of currencies at the IMF and the creation of new Special Drawing Rights with the intent of creating a competing, basket-based currency.

Seventh Forecast

GDP growth in the US may be, at best, 2 ½%

With the monetary policy being slowly de-emphasized, the economy will be left to stand on its own two feet. Fiscal policy (primarily infrastructure projects) will likely take time to ramp up and in the meantime, earnings growth may remain lackluster until at least the fourth quarter despite optimistic forecasts by Wall Street economists. Nevertheless, equity valuations may remain at historical highs (in excess of historic norms) for the time being in anticipation of future growth prospects.

Eighth Forecast

Advances in medicine come at an accelerated pace with less regulatory review, but pharma companies face the prospect that prices charged for drugs will be more set by the government and insurance companies than the marketplace.

There is significant promise in the treatment of three major diseases: coronary health, cancer treatment, and nervous-system disorders. The linkage of DNA profiles to therapies indicates that our own immune systems can ward off disease. The paradigm is shifting to wellness from treatment after a disease develops. Much of the research findings in clinical labs here and throughout the world are now being shared in ever greater affiliations aimed at cutting through the time for testing and eventual approval.

However, the fear in the medical community is that government may try to bend the cost curve through controlling spiraling health care costs. While that stance would naturally represent a welcome savings to consumers, lower profits could stymie innovation, research, and investment.

Ninth Forecast

The technological revolution led by innovators and disrupters becomes the hope upon which growth can propel the economy, as long as regulatory and legislative roadblocks are lessened.

When we look back at the last ten years, it is clear that living standards throughout the world have been improved by the use of smart phones in communication, near instant availability of goods and services by internet purchases, automobiles that seem like electronic transportation vehicles, and twentyfour/seven linkage to information sources anywhere in the world. While some of these developments seemed hard to imagine just a decade ago, we believe we are at just the beginning of the "internet of things" revolution.

Tenth Forecast

2017 should be volatile, but on balance we expect it to be a year of modest positive domestic equity performance (led by financials, energy, and technology). Foreign markets may discount improved financial conditions and therefore may outperform after years of lackluster results.

Provided that rates remain relatively low, trade is not impeded, protectionist policies are not pursued, and military excursions are avoided, we believe that 2017 will ultimately produce modest positive results for U.S. indices. The U.S. equity markets are still among the deepest, best regulated, most liquid markets in the world, and therefore represent a relative safe haven for equity investors. Furthermore, the current environment of low interest rates and high equity valuations could provide a window of opportunity for U.S. companies seeking to grow through acquisition - which could provide a lift for mid-cap and smaller-cap companies. Outside of the U.S, however, equity valuations generally seem more compelling relative to their U.S. peers, and therefore we expect foreign markets could attract capital this year in the hope of better future returns.

The caveat to the above, however, is if protectionist rhetoric is made concrete with restrictive trade policies. In that instance, we would expect foreign countries to respond in kind. Trade wars, historically, have typically resulted in reduced global economic output. Furthermore, a dramatic and rapid increase in interest rates on sovereign debt would also be an unwelcome development. Finally, a marked level geopolitical instability or military conflict represents another wild card that could disrupt our base case. In any of these scenarios, we would expect negative returns for global equity markets (both in developed markets and emerging markets).