



John Evans, Director

## Trump's Air Compressor

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Have you ever found an old basketball lying around in the garage? Dry. Dusty. Cracked. Deflated. Eager to get outside and enjoy the warm spring air, you excitedly hook it up to an air compressor to inflate it. While you are hopeful that with a little air that old ball can return to glory, you know that there could be a leak that slowly deflates the ball over time, or, if you inflate it too much, the ball could burst. It seems as though the US economy is similar to that same fragile basketball that policymakers and investors are desperately trying to reflate.

Just a year ago, there was concern over growth stalling and secular stagnation, culminating with the market correction in January and February 2016. From December 31, 2015 to February 11, 2016, the S&P 500 returned -10.3% (total return).<sup>1</sup> Last summer, market sentiment shifted from fears of a growth stall to optimism that reflation was taking root. Investors became more confident about the ability and willingness of governments to stimulate growth via fiscal policy. These trends accelerated with the election of Donald Trump and his promise of tax cuts and higher infrastructure spending. The "Trump reflation trade" had begun. Since the election on November 8, 2016, the S&P 500 has returned 11.4% through March 31, 2017 (total return).<sup>1</sup>

As we have seen recently, however, Trump's "air compressor" is a delicate tool. It is unclear whether reflation is here to stay, whether the air of the rally will slowly leak out, or whether a dramatic burst is in store.

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But what is reflation? What are some potential economic outcomes? And what does this mean for your portfolio?

## Defining Reflation

Reflation is the concept that a stimulation of economic growth through monetary and/or fiscal policy, combined with a pick up in inflation, will cause risk assets such as stocks and commodities to rise. Current expectations of reflation are associated with so-called "Trumponomics," which is comprised of: <sup>2</sup>

Principle	Policies	Impact
Demand Economics	Tax cuts, tax credits, and tax holidays, including corporate cash repatriation	Increases both personal and corporate incomes
Supply Economics	Infrastructure spending, deregulation, and energy independence	Fiscal stimulus through increased government spending; increased consumer and corporate confidence with less regulation
Political Economics	Renegotiating trade agreements and tariffs, overhauling immigration policies	Impact unclear; global growth might be hampered through less free trade

Many details of Trump's policies are still unknown, and it is unclear what policies will actually get implemented. However, we think it is important for our clients to understand what the potential outcomes could be if reflation is sustained (or turns out to be unsustainable), and understand how we think about such outcomes in a total portfolio context.

## Potential Economic Outcomes

A reflationary period is typically characterized by accelerating economic growth and rising inflation as the output gap closes and wage pressures mount. As governments shift from monetary to fiscal stimulus, typically interest rates rise and the yield curve steepens.

While there is no definitive evidence that we have entered a reflationary environment, there are some encouraging signs. The labor market has remained resilient. Although March nonfarm payrolls came in below expectations at only 98,000 jobs, the trend has been strong with an average of 182,000 jobs added per month over the past 12 months. The unemployment rate fell to 4.5%, the lowest since May 2007. Average hourly earnings in the private sector rose 2.7% from a year earlier, a sign that the tightening job market is pushing employers to raise pay.<sup>3</sup> The Institute for Supply Management's headline manufacturing Purchasing Manager's Index (PMI) registered 57.2 for March, the seventh consecutive month of expansion (a reading above 50 indicates that the manufacturing economy is generally expanding).<sup>4</sup> Consumer and business sentiment surveys have also been strong.

The inflation signal is mixed. For the 12 months ending in February 2017, the Consumer Price Index rose 2.7%, trending upward since a July 2016 trough of 0.8%. However, much of the rise in year-over-year headline inflation is due to the impact of recovering energy prices. Core inflation, which excludes the impact of food and energy, rose 2.2% and has been hovering around 2% for the past 18 months.<sup>5</sup> Now that oil prices appear to have largely stabilized, the market is looking for evidence that a tight labor market with rising wages will result in higher core inflation.

Despite many positive data points, there is little sign that overall GDP growth is picking up, and many forecasters expect another quarter of sub-2% GDP growth due to a wider trade deficit, moderate consumer spending, and low levels of business investment. It will take some time to see if the positive data signals eventually feed through to the overall economy.

What assets benefit in a reflationary environment? One approach is to purchase equities and sell fixed income. Reflation could benefit equities in a few ways. Higher nominal growth should improve the outlook for corporate earnings. Rising interest rates should encourage a rotation from fixed income to equities, further supporting equity prices. Better wage and headline growth numbers could further embolden the "animal spirits" that fuel consumer confidence and further the cycle. In particular, cyclical sectors such as banks, materials, and industrials, along with value stocks have historically been favored.

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As growth and inflation rise, the Fed may likely consider increasing interest rates, as seen in December and March. Higher interest rates and rising inflation expectations will act as a headwind to fixed income returns. Rising interest rates and a strong US macroeconomic backdrop could lead to a strong outlook for the US Dollar. Commodities could be a mixed bag; in oil markets, demand growth and higher inflation would be a benefit, but more supply from US producers and US Dollar strength could be a drag.

But what if the reflation theme proves unsustainable? As we saw at times in February and March, some argue the euphoria around the reflation trade is over. There are several risks to the continuation of the reflation trade. Some of Trump's protectionist and immigration policies could weigh on growth, or US policy makers could fail to deliver. If the Fed acts too aggressively, it could undermine growth, but if it takes too long to act, it risks allowing US inflation to rise too quickly. Political gridlock in Washington could derail hopes for growth-friendly policies. Looking abroad, the market will continue to digest Brexit, and there are several European elections on the horizon. Geopolitical tensions in places like Syria and North Korea are also potential risks.

Instead of a reflationary environment, we could see a return to the stagnant environment that has characterized the post-recession recovery. In this scenario, economic growth remains sluggish and the Fed is forced to reduce the pace of its tightening. Another scenario could be stagflation, where fiscal policy fails to boost economic growth, yet inflation rises. We have outlined some of the potential impacts of these scenarios in the US in the chart below.<sup>6,7</sup>

Scenario	Characteristics	Economic Impact	Market Impact
Reflation	<ol style="list-style-type: none"><li>1. Accelerating economic growth</li><li>2. Output gap closes</li><li>3. Shift from monetary to fiscal stimulus</li></ol>	<ul style="list-style-type: none"><li>• GDP growth picks up</li><li>• Sentiment improves</li><li>• Wage growth</li><li>• Rising inflation</li><li>• Fed raises rates to prevent economy from overheating</li><li>• Re-pricing of steeper yield curve</li></ul>	<ul style="list-style-type: none"><li>• Stocks outperform bonds</li><li>• Cyclicals, banks, and materials outperform bond proxies and defensives</li><li>• US Dollar appreciates</li></ul>
Secular Stagnation	<ol style="list-style-type: none"><li>1. Anemic economic growth</li><li>2. Lack of inflation</li></ol>	<ul style="list-style-type: none"><li>• Expectations of higher growth are unmet</li><li>• Return to sluggish growth</li><li>• Low inflation</li><li>• Fed forced to temper pace of rate hikes</li></ul>	<ul style="list-style-type: none"><li>• Long duration bonds outperform</li><li>• Muted stock returns</li><li>• Defensives and staples outperform cyclical</li></ul>
Stagflation	<ol style="list-style-type: none"><li>1. Low growth</li><li>2. High inflation</li></ol>	<ul style="list-style-type: none"><li>• Fiscal policy fails to materialize and boost growth</li><li>• Tight labor markets squeeze wages and profit margins</li><li>• Inflation rises above expectations</li><li>• Rates increase</li></ul>	<ul style="list-style-type: none"><li>• Correction in equity and bond markets</li><li>• Equity valuations fall</li><li>• Commodities outperform</li></ul>

## What Does this Mean for Your Portfolio?

As the past year has demonstrated, there are no certain outcomes in today's world. From Brexit and the election of Donald Trump, to the Patriots' comeback in Super Bowl LI and the Cleveland Cavaliers' rally to win the 2016 NBA Finals, the past year has been surprising. Whether the reflation theme continues or not is unclear.

At Hartland, we think it is important for our clients to understand the current themes, potential outcomes, and inherent risks. At the same time, we are not short-term traders or market prognosticators. Our philosophy is to help clients build portfolios that help achieve goals over a long time horizon, with appropriate risk, and in a low-cost manner.

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Portfolios can be organized around four main purposes: growth, absolute return, inflation protection, and income. Growth assets are intended to generate high returns for the portfolio and help drive growth of the portfolio and purchasing power over time, albeit with higher risks. Growth assets can include public and private equity, long/short and event driven hedge funds, and MLPs. Absolute return strategies have a primary purpose of mitigating volatility and providing diversification, and generating growth as a secondary objective. Absolute return can include market neutral, relative value, merger arbitrage, and fund-of-fund hedge funds, as well as tactical asset allocation strategies. Inflation protection helps the portfolio withstand unexpected inflation, and can include public and private real estate and Treasury Inflation-Protected Securities. Income oriented assets have the objective of generating income, preserving capital, and reducing the volatility and drawdown risk of the portfolio. Income oriented assets can include core fixed income, non-US fixed income, non-investment grade debt such as bank loans and high yield, and cash.

We think this purpose-oriented approach results in diversified portfolios that can help navigate different market environments, and ultimately achieve clients' long term goals. As Tom Seay reminded us in the January edition of Standpoint, we "prefer to win the marathon and not focus on the 100 meter dash."

I recently moved back to Cleveland after spending six years in New York City. I am grateful to be home and for the opportunity to join a firm like Hartland. Now that I have more than 550 square feet to live in plus a driveway and a backyard (a luxury!), I recently grabbed an old basketball out of the garage. On the first shot, the ball got stuck between the rim and the backboard. Thinking about the earlier analogy, I am not sure what this means for the US economy. But what I do know is that I need to work on my game. Happy spring.

#### Sources:

- 1 - Bloomberg
- 2 - Kames Capital, Viewpoint, January 19, 2017. Trump's Reflation Trade
- 3 - Bureau of Labor Statistics, Employment Statistics
- 4 - Institute for Supply management, Report on Business
- 5 - Bureau of Labor Statistics, Consumer Price Index
- 6 - Goldman Sachs Global Investment Research, September 1, 2016. Global Strategy Paper No. 21: Any Happy Returns: The Evolution of the 'Long Good Buy'
- 7 - Blackrock Investment Institute, Global Macro Outlook, January 2017. Waking up to Reflation

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*The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.*

#### MARKET BENCHMARK RETURNS

March 31, 2017		1M	3M	12M	YTD
US Large Cap	S&P 500	0.1%	6.1%	17.2%	6.1%
US Small Cap	Russell 2000	0.1%	2.5%	26.2%	2.5%
Developed Intl	MSCI EAFE	2.9%	7.4%	12.2%	7.4%
Emerging Intl	MSCI Em Mkt	2.5%	11.5%	17.7%	11.5%
Real Estate	NAREIT	-1.4%	3.0%	6.3%	3.0%
Core Fixed	BarCap Agg	-0.1%	0.8%	0.4%	0.8%
Short Fixed	BarCap 1-3Yr	0.1%	0.4%	0.7%	0.4%
Long Fixed	BarCap 10+Yr	-0.6%	1.6%	1.0%	1.6%
Corp Debt	BarCap Corp	-0.2%	1.3%	3.0%	1.3%

Source: Bloomberg

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