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The Trump Rally vs. Long-Term Trends

BY TOM SEAY, MANAGING DIRECTOR, RESEARCH

The election of Donald Trump to be the next president of the United States has significantly stirred the imagination of financial market investors. Trump's desire to lower taxes, minimize the regulatory burden and increase spending on infrastructure and defense have investors bidding up the price of stocks and preparing for the Dow 20,000 celebration. For financial market participants who prefer to win the marathon and not focus on the 100 meter dash, such spikes in performance will cause us to challenge our assumptions and review the thesis that leads us to our current portfolio positioning. Is Donald Trump's election a game changer, or will long term trends overwhelm the euphoria that has been driving U.S. equity markets since November 8, 2016?

Prior to the November election, economic growth expectations predicted more of the same: slow growth, low inflation and muted returns on investments. The Trump policies are intended to let loose the animal spirits of the U.S. consumer and encourage Corporate America to take risk, but such changes do not happen overnight. Following the election, the Federal Open Market Committee (FOMC) barely changed its GDP forecast for 2017 from 2.0% to 2.1%, with no change in 2018 (2.0%) and 2019 increased from 1.8% to 1.9%.[1] Chair Janet Yellen stated in her December 14th press conference "…that all the FOMC participants recognize that there is considerable uncertainty about how economic policies may change and what effect they will have on the economy." Additionally the Chair said, "But we're operating under a cloud of

Hartland's CEFEX Certification Renewed

Hartland pursues the CEFEX (the Center for Fiduciary Excellence) certification because we believe it assures our clients we comply with the highest fiduciary standards. We believe we are one of a handful of firms of our size and type to conform to rigorous CEFEX standards.

CEFEX is an international standards body headquartered in Toronto. The Centre determines whether an Advisor's practices conform to the fiduciary standards of excellence as defined by the *Prudent Practices for Investment Advisors*.

A CEFEX auditor visits Hartland annually and performs a review of representative client records, interviews appropriate personnel and, on a test basis, examines evidence supporting the actions taken by our consultants in providing services to clients. The extensive and detailed audit, performed in November of 2016, found that Hartland was in substantial conformity to the Standard and recommended recertification.

For more information on CEFEX, please go to its website: www.cefex.org, or contact our Chief Compliance Officer, Steve Wolken: swolken@hartland.com uncertainty at the moment, and we have time to wait to see what changes occur and to factor those into our decision making as we gain greater clarity."[2] Many of the pro-business reforms take time to develop; as such, it is doubtful that meaningful changes in corporate strategic planning or consumer spending habits will come to fruition until the tax and regulatory policies are settled and become law.

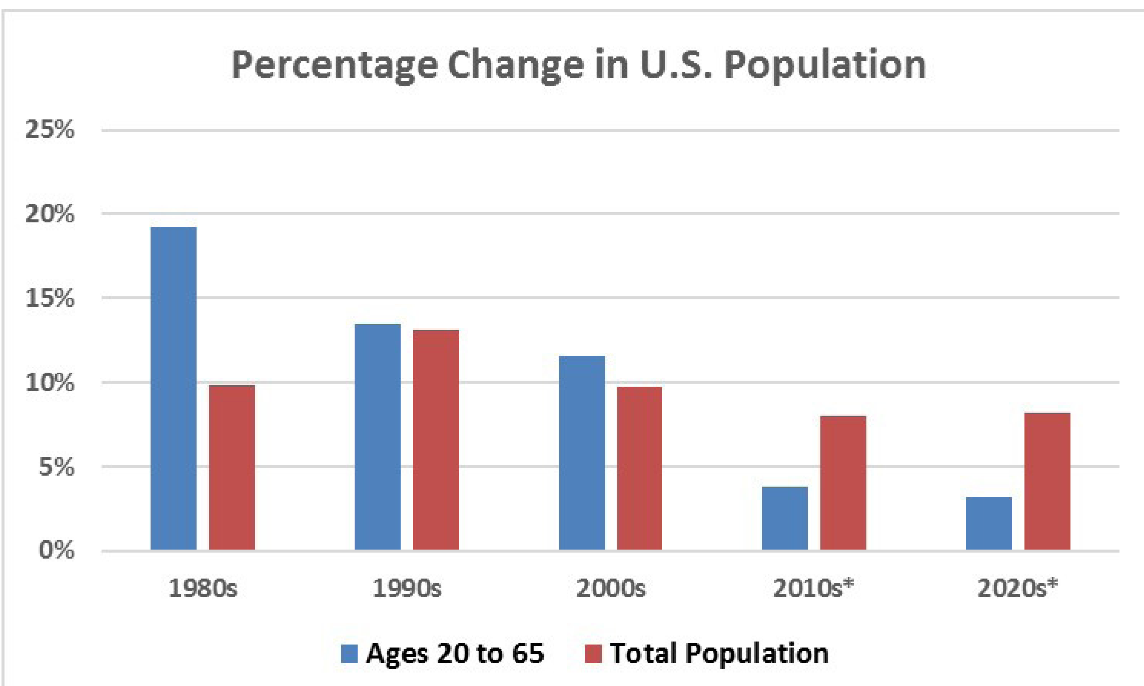
Many long-term trends, such as the 30+-year decline in interest rates, appear to be nearing an inflection point. Trump's policies have the potential to improve the rate of economic growth, lower unemployment and increase inflation; all of which could contribute to higher interest rates. However, two trends that are not easily reversed are a shrinking workforce and declining productivity.

The Shrinking Workforce

The aging baby boomers and their impact on the Medicare and Social Security systems are well documented challenges facing Washington politicians and bureaucrats. The challenge facing employers is replacing baby boomer employees. As chart 1 indicates, the growth of the working age population (defined as ages 15-64 who are employed) has steadily declined and is now growing at a rate slower than the overall growth of the U.S. population. The problem is fairly simple: the baby boomer population leaving the workforce is larger than twenty-year-olds entering the workforce.

The growth in working age population has been declining, and changing the direction of this trend is complicated. Americans are simply having smaller families. According to the Pew Research Center, "In 1976, 36% of women in their early 40s had given birth to four or more children, while just 22% gave birth to two children. But according to 2014 data, it's more common nowadays for women of the same age to have two children: 35% gave birth to two children, while just 12% had four or more." Trying to change this trend via government fiat is not feasible in our democracy, our cultural norms need to evolve and this takes time, a lot of time.

Another solution to a shrinking workforce is an expansive immigration policy. Without going down a political rabbit hole, let me just say that U.S. immigration policy has confounded many presidential administrations and building a national consensus has been elusive. Thus, our ability to deal with the shrinking workforce is not easily solvable and any solution would take years before we would see evidence of a shift in this trend.



Sources: Decennial Census Counts, *Weldon Cooper Center National Population Projections

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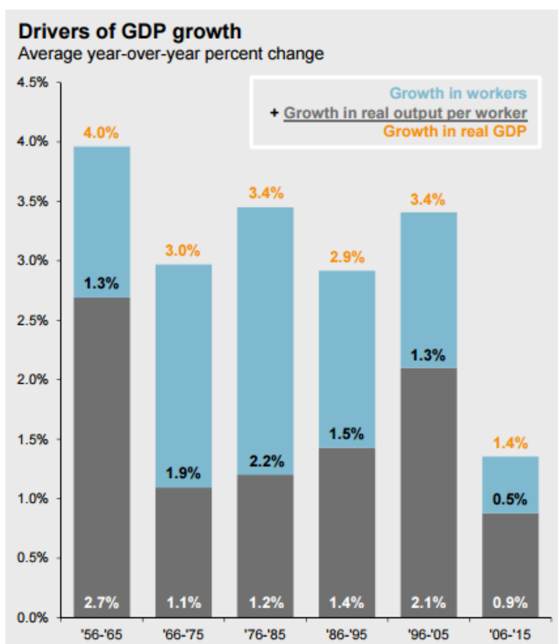
Declining Productivity

"Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."[3] A problem facing America is a lack of corporate investment in machinery, equipment and buildings that are key drivers to productivity improvement. For the final three decades of the last century, U.S. private domestic investment in non-residential fixed assets (i.e. machinery, equipment and buildings) grew at average annual rate of 5.3%. Since the turn of the century the growth rate has averaged just 2.4%, and the trend continues to decline [4]. Although Corporate America has witnessed record profit margins, it lacks the motivation to invest those profits in capital projects that would improve productivity growth. This is an area where government can influence corporate behavior via tax and regulatory policy to encourage more investment spending.

Investment in physical capital is not the only way to improve productivity growth. Innovation that changes lives – the transformation from a rural economy to industrial cities. Skills evolve – the assembly line where multiple workers do repetitive tasks from nine-to-five has transformed to a single computer engineer that can run a fully automated assembly line. There are various drivers to improve productivity: some can be influenced by government policy, or skills that require advance education or the innovative ideas that evolve from risk takers willing to fail but never giving up (i.e. Steve Jobs, the oil field wildcatter, Elon Musk), but the transformative change that could bend the productivity growth rate trend line up again takes time.

The GDP Growth Dilemma

Now that we know the issues of a shrinking workforce and declining productivity growth, let's discuss the impact of these challenges on GDP growth. The following chart from J.P. Morgan Asset Management simplifies the long-term determinants of growth in real GDP to growth in workers plus growth in real output per worker (i.e. productivity). The trends in workforce growth and productivity need to improve if the objective is "Let's Make America Great Again" and achieve the growth rates witnessed from 1955 – 2005. Many of the President-elect Trump's policies are pro-business and may influence the growth in workers and improve productivity, but these long-term trends are difficult to reverse and require more effort than a clever campaign slogan.



Sources: Guide to the Markets (as of 9/30/2016) J.P. Morgan Asset Management; Bureau of Labor Statistics

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Conclusion

As I sit here on the last trading day of 2016, the Trump Rally has produced almost an 8% return for the Dow Jones Industrial Average since the November 8th election and many a pundit is prognosticating on how the markets will perform in 2017. I will leave what happens next year to the short-term traders and focus my thoughts on long-term developments.

The United States is not alone facing the challenge of a shrinking workforce and declining productivity growth. According to a 2015 McKinsey report, "its (Japan's) working-age population will decline from 79 million in 2012 to 71 million in 2025 …" and "Japan's labor productivity growth has been stalled below 2 percent for much of the past two decades"[5]. The Japanese have tried fiscal stimulus and monetary policy maneuvers, but to date they have little to show for their efforts as these trends persist. Since 1995 Japan's annual GDP growth rate has averaged 0.9% and the Nikkei 225 (Japan's main stock market index) has produced an annualized return of 1.2%.[6]

The United States is not Japan. The U.S. population is more diverse and less restrained by traditions and cultural norms that dominate Japanese society. But, long-term trends are difficult to change and will require innovative solutions that may prove unpopular to the voting public. President-elect Trump's pro-business policies may plant the seeds that motivate the animal spirits, but much more needs to be done before the prosperity enjoyed in the last half of the 20th century is witnessed in the 21st century.

Investors with diversified portfolios have become accustomed to annualized returns in the high single digits during the 21st century's low growth environment. Our intermediate-term outlook is for a continuation of relatively low interest rates and modest equity returns delivering similar to lower returns. The good news is that the challenges of a shrinking workforce and slowing productivity growth have been recognized, solutions are being developed and strategies implemented to achieve more robust economic growth. The United States has a long history of looking at difficult challenges as opportunities to lead in order to achieve long-term success. The Trump rally may be a bit too optimistic, but the seeds being planted may deliver the long-term growth we once took for granted.

Sources:

(1) Federal Reserve press Release December 14, 2016
(2) Transcript of Chair Yellen's Press Conference December 14, 2016. federalreserve.gov
(3) Paul Krugman (1994). The Age of Diminishing Expectations. MIT Press.
(4) Bloomberg. Bureau of Economic Analysis
(5) McKinsey Global Institute, March 2015. The Future of Japan: Reigniting Productivity and Growth
(6) Bloomberg

MARKET BENCHMARK RETURNS

December 31, 2015		1M	3M	12M	YTD
US Large Cap	S&P 500	2.0%	3.8%	12.0%	12.0%
US Small Cap	Russell 2000	2.8%	8.8%	21.3%	21.3%
Developed Intl	MSCI EAFE	3.4%	-0.7%	1.5%	1.5%
Emerging Intl	MSCI Em Mkt	0.3%	-4.1%	11.6%	11.6%
Real Estate	NAREIT	4.2%	-2.9%	9.3%	9.3%
Core Fixed	BarCap Agg	0.1%	-3.0%	2.6%	2.6%
Short Fixed	BarCap 1-3Yr	0.1%	-0.4%	1.3%	1.3%
Long Fixed	BarCap 10+Yr	0.7%	-7.8%	6.7%	6.7%
Corp Debt	BarCap Corp	0.6%	-3.0%	5.6%	5.6%

Source: Bloomberg

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.