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Wenning Investments, LLC

# Wenning Advice


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## Changes Coming

With a new president about to be sworn in, changes will be taking place. What will those changes mean for you and your investments?

Some expect that President-elect Donald Trump's pro-growth policies will boost stock prices ever higher, while rising interest rates will have a negative impact on bonds.

These conclusions are not necessarily true. While stock prices have been hitting new records since the election, the Federal Reserve Board's zero interest rate policy (ZIRP) has been pushing the market to new highs for many years now.

As a result, stocks are severely overvalued. Even if the economy produces higher growth and higher corporate profits under President Trump than it has under President Obama, it's not clear that stock prices will go much higher.

The current market is dysfunctional. For years, its surge has been driven not by the performance of the private sector, but by the actions of the Fed. Weening the Fed from control of the economy and of the markets will be healthy, but it could be painful as markets return to functioning normally, given that prices are so out of line with what they realistically should be.

## Unrealistically High Valuations

Shiller'™s cyclically adjusted price/earnings ratio (CAPE) demonstrates just how overvalued stocks are today. Since 1870, the CAPE as a mean average for all stocks has been 16.7. Today, it's at 27.2, which puts prices as a ratio to earnings in the 95th percentile. In comparison, when Ronald Reagan became president and a market rally began in August 1982, the CAPE was just 6.6, which is in the fifth percentile.

As David Stockman has said on his "Contra Corner" blog, "Valuation, what you pay for an investment, is the single biggest determinant of future returns. In other words, it is not 'IF' you should invest, but 'WHEN' you

invest that is the differentiator between achieving your investment goals or not."

*Shiller's cyclically adjusted price/earnings ratio (CAPE)*

### Tighter Monetary Policy

The high valuations are a result of historically unprecedented loose monetary policy. But the Fed has now begun tightening - a 0.25% hike in the federal funds rate in December was just the second rate hike in a decade, as the Fed increased rates by 0.25% to 0.5% a year earlier.

The December 2015 rate hike shook the stock market, which became especially volatile and ended the year down a little. The latest rate hike surprised virtually no one, but stock prices initially dropped, before recovering.

When Fed Chair Janet Yellen announced the rate hike, though, she also announced that the Fed expects to increase rates three times in 2017, to a rate of 1.4% by year's end. The Fed previously projected just two rate hikes next year.

Of course, she also said that Fed actions will be determined by what the new president and Republican-controlled Congress does in the new year. As president, Donald Trump is unlikely to be as passive on economic matters as President Obama has been. If the economy becomes overheated, the Fed will likely take action.

### Stronger Dollar

Rising interest rates and anticipation of growing economic strength are already making the dollar stronger. Meanwhile, other countries continue following loose monetary policies, so the dollar is likely to continue strengthening.

A strong dollar is good for consumers, as it makes foreign goods less expensive and keeps the price of American-made goods in check. Increased foreign competition, though, is contrary to President-elect Trump's expected trade policies.

A strong dollar also makes American goods more costly abroad. The weak dollar that prevailed through most of the Obama presidency enabled American companies to compete abroad, even though corporate America is taxed at the highest rate in the industrialized world.

But add on a stronger dollar and American exports will drop, increasing our trade deficit, reducing corporate profits and making it more difficult for the economy to grow. That would cause a drop in employment and American workers would, yet again, have to wait to see their salaries increase.

*U.S. dollar index published by the Federal Reserve (Macrotrends.net)*

It will be difficult for President Trump to convince foreign countries to buy more American goods if the dollar continues to strengthen.

"Expectations of higher growth and higher interest rates are likely to accelerate the flow of capital to U.S. assets, making the dollar more expensive," according to LiveMint. "This will at some point start affecting economic activity in the world's largest economy."

### Recession Ahead?

If the Fed is correct, President Trump would complete his term with lower growth than President Obama. During his eight years in office, President Obama was the only president to not have economic growth reach at least 3% during any year he was in office.

Lower tax rates and less regulation should spur capital investment and economic growth, but keep in mind that the economy is in one of its longest recoveries ever and may be overdue for a recession, which is a period when the economy doesn't grow, but contracts.

The average recovery since the end of World War II has been 58 to 61 months, depending on whose numbers you use. The current "recovery" reached the 58-month milestone in April 2014, which was 32 months ago. The only recovery that was significantly longer took place during a 119-month stretch in the 1990s.

### Investing Under President Trump

Under President Trump, some sectors will, of course, perform better than others. Financial, pharmaceutical and energy stocks are likely to be among the winners.

The financial sector would benefit from the potential repeal or loosening of new regulations. The Dodd-Frank Act has forced financial firms to spend billions on regulatory compliance, while stifling innovation. The new Department of Labor fiduciary rule, which would add another layer of regulations, is likewise likely to be repealed or watered down under a new DOL.

Pharmaceutical companies would have been a target if Hillary Clinton were elected president, as much attention was focused on overpricing of drugs. Increasing competition by reducing the regulatory burden would potentially

do more to control drug prices. The Food and Drug Administration has been bureaucratic and could benefit from the appointment of a commissioner and staff who make approval of new drugs a priority.

The pharmaceutical industry will also benefit if tax reform enables American companies to return their foreign profits to the U.S. without being double taxed at current rates.

Engineering companies, industrial equipment companies and others could benefit from a proposed $1 trillion investment in rebuilding U.S. infrastructure. Defense contractors could likewise benefit from a potential increase in military spending.

What about losers?

Companies dependent on Mexican or Chinese goods could also see a negative impact, given President Trump's hard stand on trade with the two countries. Some also believe tech companies will be affected, because they may see greater restrictions on the use of foreign workers. As cited earlier, the Republican Congress will hopefully stop the new president's most reckless policies; it makes no sense to further restrict the use of foreign workers by tech companies, who need their skills. And tech companies, like other American businesses, should benefit from tax reform.

## YTD

Here's how securities performed in 2016:

| Index | Ticker | 12/31/2016 |
|---|---|---|
| S&P 500 | $INX | 9.54% |
| Dow Jones Industrial Average | $INDU | 13.42% |
| Russell 2000 | $RUT | 5.89% |
| **International ETFs** | | |
| Emerging Markets | EEM | 8.76% |
| MSCI EAFE | EFA | -1.69% |
| Europe | IEV | -3.24% |
| Japan | EWJ | 0.78% |
| Latin America | ILF | 30.16% |
| **Bond ETFs** | | |
| 1-3 year U.S. Treasury | SHY | 0.11% |
| 3-7 Year U.S. Treasury | IEI | -0.08% |
| 7-10 Year U.S. Treasury | IEF | -0.73% |
| 20+ U.S. Treasury | TLT | -1.20% |
| US Agg Bond | AGG | 0.05% |
| Investment Grade Bonds | LQD | 2.78% |
| High Yield Bonds | HYG | 7.41% |
| **Yield Reaching** | | |
| US High Dividend Equity | DVY | 17.86% |
| Lev Loans | BKLN | 4.29% |
| Utilities | XLU | 12.22% |
| High Dividend Global | SDIV | 5.53% |
| MLPs | AMLP | 4.56% |
| **Alternatives** | | |
| Gold | GLD | 8.09% |

### Where to Invest

Our investing decisions will continue to be guided by economic data, rather than emotion.

We face a great deal of uncertainty in the coming months, as some of President Trump's proposals may encounter resistance, even within his own party. His efforts at deregulation, for example, could stimulate additional economic growth, but many new regulations are being added, even in the final days of the Obama administration. Deregulators will only be able to do so much deregulating.

In addition, headwinds that existed before the election have not disappeared. The retiring of baby boomers is not going to change, Europe is going to remain sluggish and Japan's deflationary pressures will continue into the future.

After the inauguration of President Trump, we're likely to enter a less bullish phase of the market. The first 100 days of President Trump's term are going to come with challenges. Repealing the Affordable Care Act is likely to be President Trump's top priority, followed by renegotiation of trade deals. President Trump has picked Peter Narvaro, author of *Death by*

*China*, to oversee American trade and industrial policy, and Wilbur Ross, a critic of the North American Free Trade Agreement, as Commerce Secretary. Efforts to renegotiate trade policies could result in trade wars that could be costly not only to the U.S. economy, but to economies worldwide.

We will continue to own the dollar ETF (UUP) as President Trump's policies are likely to remain pro-America and bullish for the U.S. Dollar. A strong dollar bodes well for small-cap stocks, like the Russell 2000. We will be looking to buy the Russell 2000 on pullbacks.

During the second half of 2017, President Trump and Congress will likely focus on the budget resolution. This is the exciting part, because tax reform, repatriation of dollars from overseas and infrastructure spending could lead to higher gross domestic product (GDP). These are the goodies the market has already priced into Trump's presidency. Will Congress be supportive and, if so, how quickly will it act?

TLT, the 10-year U.S. Treasury ETF, was last year's darling, yet after President Trump's surprise victory, markets immediately started to price in economic growth; bonds sold off and stocks soared. Thus far, consumer confidence and business surveys are showing optimism for the economy, which could translate into higher GDP.

Consumption represents a large part (70%) of GDP. If business leaders are feeling optimistic, they should make investments in their businesses, instead of buying back their stock, and consumers will likely spend more. If the first 100 days of our new leader are met with uncertainty, markets will see increased volatility.

Between now and June 30, GDP growth is likely to remain sluggish. The 10-year Treasury yield could pull back to 2%, which will create an opportunity to trade some of our TLT holdings, reducing our long-bond exposure. If and when economic data accelerates, we will sell our full TLT position.

We will be watching U.S. relations with China and Mexico to see how Trump's policies play out. Global economies will continue to face secular headwinds and we may not see the level of inflation bond investors are worried about. A strong dollar is likely to put a lid on inflation.

The market has priced in optimistic earnings expectations and acceleration in growth, but we believe the market is ahead of itself. Many hedge funds were chasing performance into year-end; will they take profits in 2017?

## Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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