KEIM ASSET MANAGEMENT, LLC
Preserving Your Lifestyle

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The Trump Honeymoon Rally

Dear Investor:

As we all know now, Donald Trump is our President elect. After a short, but very negative reaction on election night, the stock market has taken off. The S&P 500 was up over 6% by Dec 23rd. That's a big move. I'm calling this a honeymoon rally because a lot of promises have been made but nothing concrete has really happened yet. As in a real marriage, the work to keep those promises begins when the honeymoon is over. The main themes that are driving the rally are the strong possibility of tax cuts, more fiscal spending, and a more business friendly approach to regulation. These are expected to create an environment where growth will accelerate, companies will make more money, and people will do better. The idea behind strong growth is that a rising tide lifts all boats. Only time will tell if this is indeed how things will play out. It would be great if they do, but we know there will be many big challenges ahead.

You may remember that my last letter discussed the slow growth we have been experiencing in the US economy. Fortunately, things turned up notably in the third quarter. Growth came in at an annualized rate of 3.5% powered by strong consumer spending and higher business investment. This was a very substantial improvement and the strongest reading in two years. Business investment in particular has been very soft, so it was good to see an increase there. The Atlanta Fed is currently forecasting a 2.9% growth rate for Q4. If that ends up being close, we will be back over 2% growth for 2016. If the policies mentioned above do indeed bear fruit, we may be able to get above a 3% growth rate in coming years. At that level, there may be a welcome acceleration of corporate profits and more tax revenue flowing into the Treasury. Economic growth is also improving around the world. According to data from JP Morgan, manufacturing is picking up in China, Europe, and Japan.

The other big news in the quarter was the interest rate increase by the Fed. On December 14th the Fed raised short term rates by a quarter point. The market was expecting this, and the yield on bonds had already risen dramatically. It's very sobering to realize that this is only the second rate increase in ten years. Ten years is a long time, and it shows you just how serious the financial crisis was. While things are much better than they were several years ago, we are still living in an environment of artificially low interest rates for everything we do. The Fed also holds an enormous balance sheet and has done nothing yet to let their holdings mature and roll back into the public markets. We clearly have further to go. The Fed also got the market's attention with a more hawkish outlook heading into this year. They are forecasting the possibility of three more increases in 2017. This is based on rising expectations for both growth and inflation. Inflation has been firming all year and is much closer to the Fed's 2% target.

Of major importance to stock market investors, SP 500 corporate earnings are increasing again. We know that the energy and materials sectors have been a drag for many quarters. Energy is more significant as it's a bigger component of the index. It's possible that oil has bottomed and seems to have found some equilibrium in the $50 a barrel range. You likely know that OPEC agreed in November to cut production. How much stock to put in this is always an interesting question with no sure answer. All of these nations have multiple agendas they are pursuing. Cheating has always been common and hard to police. We do know that the price has firmed, and this has helped the earnings outlook of the big oil companies that we invest in individually and through index type funds. We also see that firming prices have brought some of the US shale oil producers off the sidelines. The rig count in the US has gone up by around 140 rigs in the last three months. Over 120 of these are the horizontal rigs used for fracking. If the US keeps adding supply to the market, I would expect this to help contain prices.

There's a good chance the years of our declining budget deficit have come to an end. The deficit rose this year for the first time in the last five years. It was $587 billion dollars, up over $148 billion. We talked about this in our meetings on several occasions, as I thought the recent years of declining deficits were a bit of a "safe harbor" that could not last. The demographics of the US and our insistence on spending more money than the government takes in are a huge problem that we can't seem to get away from. If the economy does improve substantially, the cost of servicing our enormous government debts will continue to rise as interest rates increase. We can only hope that we will have an even bigger increase in tax revenue flowing into the government to help pay for it.

The rise in rates will have an effect on the housing market for sure. Rates are now running around 4.3% for 30 year mortgages. We know this is high compared to what borrowers have come to expect in recent years. However, the Housing Affordability Index is still low which indicates that potential homebuyers should be able to handle these rates. According to the S&P Case – Shiller National Home Price Index, home prices have finally risen above the levels they reached before the Great Recession. This has taken over a decade to achieve. This reflation is very good news for those who own homes and held onto them through the crisis. Many who were under water with their mortgages now have positive equity again. This will likely boost the economy. It's not great for first time buyers as they need to come up with substantial amounts of money to buy a home in many markets.

In summary, to me it feels like it's been a long decade. It's taken ten years to get everything going again which shows you how serious the crisis was. There are many people who will never recover their losses from all that happened. There are still many others who are struggling. Employment is much better, but the U6 rate shows that many people are still looking for better jobs and are underemployed. If the new administration is successful in helping to create more good jobs in America, that would be welcome indeed. The market is high right now in my opinion, and the honeymoon rally is most likely over. If the new government is successful at creating economic growth, I would expect investors to do well the next few years. Please feel free to contact me anytime to discuss your portfolio.

Best Regards,

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