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It's a Whole New Ballgame for Economics and Markets.

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The results of this year's historic election changed the policy landscape dramatically by providing a policy platform that could give a dramatic boost to economic growth and lay the groundwork for a new, higher octane, secular bull market trend. That doesn't mean that the current risks of a major bear market have evaporated by any means.

The stock market rally and bond market sell-off that have occurred over the last week or so are based on investors' hope for concrete stimulus policy development based on campaign promises. We won't have a clear understanding of what the Trump administration's policy platform looks like until early next year. This early market enthusiasm may fade as the reality of a December Fed rate hike is factored into the market equation. And even though third quarter reports indicate a slight uptick in economic activity for the year, investors have to keep in mind that historically, Q3 and Q4 are the strongest quarters of the year, and typically stronger than weak first-half activity.

We believe the outlined combination of tax cuts to stimulate consumption and fiscal stimulus to rebuild the failing U.S. infrastructure are just what the economic doctor ordered. Yet, we still have to see if the President Elect will soften his stance somewhat on trade and immigration, as recent speeches and comments by Mr. Trump and staff seem to indicate. Any dramatic tightening in global trade could partially offset a boost in GDP growth gained from a positive change to tax and spending policies.

Economic and market risk are still very high by historical standards given the backdrop of anemic economic growth, a recession in corporate earnings and revenue growth, overvalued stocks trading at near historic high levels, government, corporate, and personal debt near or at all-time highs, and a shift by the Fed from monetary policy accommodation to tightening rates in order to achieve policy normalization.

Over the next few pages, I will outline what we believe are the core impediments to faster growth for the U.S. economy and higher quality returns for investors in stocks. We will also explain why bond investors may suffer as interest rates rise as pro-growth policies drive higher rates of economic growth. This may, in turn, allow the Fed to normalize interest rates as real economic growth drives up income and wages for U.S. workers. Investors may want to buckle their seat belts as we explore what can happen to stock market returns when pro-growth policies are combined with extremely accommodative monetary policy.

Why Has GDP Growth Been Anemic?

The annualized growth rate of this recovery is the worst in history averaging just 2.03% for the first full year of recovery in 2010 through 2015.[1,2] Economic growth in the U.S. is driven by consumer spending (69%), business investment (16%), government spending (18%), and net exports (-3%).[3] In this recovery, consumer spending growth has averaged 3% per year or about 58% of its average historical growth rate of 5.6% per year over the past two recovery cycles.[3] Business and government, on the other hand, have only averaged 22% and 35%, respectively, of their historical average growth rates.[3] Their underperformance or lack of contribution to growth has been one of the major culprits of the poor economic performance in this recovery.

So far in 2016, through the first three quarters, we are running at 1.8% growth on an annualized basis.[3] That includes the 2.9% growth rate for the third quarter that was released just before the election.[2] While the quarter showed a healthy pop in growth, the report indicated that consumption fell off dramatically. We would be concerned if U.S. consumer spending, which drives 69% of economic activity, continues to weaken. Then the Q3 uptick in growth — which included stronger business investment due to inventory rebuilding, an uptick in government spending to create window dressing for the election, and a surprise jump in net imports — could turn out to be an anomaly.

The typical recovery provides growth rates that average 3.5% per year or higher.[3] High growth rates allow the economy and financial system to overcome the systemic problems that cause recessions, but without enough growth, problems tend to linger and fester. We are concerned that the damage that was done to economic and financial systems have never been overcome because growth in this recovery cycle has been so weak. This is true not only in the U.S. but is even of greater concern for Europe and Asia's developed economies. Creating and implementing policies to increase economic growth is the key to stabilizing and balancing financial systems, improving opportunity for citizens, and creating better returns on invested capital.

Can Trumpenomics' Policy Platform Give Us More Growth?[4]

President-Elect Trump's economic policy platform seems to have the right combination of tax reform, tax reduction, and fiscal stimulus to dramatically accelerate economic growth rates. Let's break it down to see how proposed policy might affect growth:

Individual Tax Rates

The plan for personal income taxes is to simplify the tax code by collapsing the current seven tax brackets to three while reducing the tax rate for each bracket with the top rate being reduced from 39.6% to 33%. These rate reductions would be combined with a 240% increase in the standard deduction.[5] The plan as outlined also incorporates other major changes including a reduction in capital gains tax, a cap on itemized deductions, increased child and elder care credits, and an elimination of the carried interest exemption and alternative minimum tax. The plan and specific policy changes may need to be made as negotiations take place in Congress. The bottom line for taxpayers should be reduced tax rates. It seems clear that taxes will be cut and that should help drive consumer spending to new levels by allowing people to keep more of what they earn and that will in turn, drive consumer spending and economic growth. We believe that proposed individual tax reform has the potential to increase GDP growth by 0.50%-0.75% per year.

Corporate Tax Rates

One of the more exciting aspects of the Trump plan is the revisions to the corporate tax code. Proposals include reducing the business tax rate to 15% from 35%. The U.S. corporate tax rate has been the highest of any developed country handicapping U.S. companies from being more competitive.[6] The new lower tax rate should eliminate the need for corporate inversions and cash hoarding by America's largest companies. The plan also includes a deemed repatriation one-time tax rate of 10% on the estimated $2.5 trillion of untaxed profits parked offshore. This could allow that capital to flow into the economy as businesses increase capital spending, which would provide a much-needed boost to economic growth as business investment reaches normalized levels.

The new 15% corporate tax rate will apply to all corporate entities including Sub-S, LLCs, and LPs, commonly known as pass-through entities, which had been taxed at higher personal income tax rates. This new lower rate could help the millions of small and mid-sized businesses — that traditionally drive a large portion of new job creation and economic growth — to grow faster by allowing them to retain more profit in the business.

Business investment is a key component of capital formation and plays a material role in determining the long-term quality of any business cycle. Tax reduction allows profits to be reinvested in businesses, which can stimulate growth not only in the business, but also in the economy more broadly. We forecast that the proposed corporate tax reform has the potential to increase GDP growth by 0.50%-1.00% per year.

Fiscal Stimulus

The Trump plan pledges to invest $550 billion in infrastructure and has also indicated increased defense spending.[7,8] We believe the country's aging and failing infrastructure will require a significant long-term commitment to increasing government funding and partnering with private industry to modernize transportation, hospitals, energy, utility, defense, and technological infrastructure. The proposed spending is a good kick-start to the estimated $3.6 trillion in spending required by 2020 to avoid catastrophic consequences.[9]

We have one of the most accommodative monetary policy footprints in history and, by adding fiscal stimulus, we cannot only avoid deflation and another financial crisis, but can lift the economy to faster growth and full potential. We believe that proposed fiscal stimulus has the potential to increase GDP growth by at least 1.00% per year.

Fed Balance Sheet and Interest Rate Normalization

A hidden benefit to the Fed's expanded balance sheet under Quantitative Easing (QE) programs is that it artificially inflates our deficit by making it look larger than it really is! Every month the Fed collects interest income from the U.S. Treasury on the $3.7 trillion the Fed bought in bonds from private investors.[10] At the end of each month, the Fed, by law, has to turn around and pay the interest it collects back to the Treasury. In reality, there is no interest cost, and you really can't owe yourself money, so from this standpoint, the Fed and Treasury are really one and the same. So in the real world, the U.S. deficit is about $4 trillion less than the headline number indicates.

We believe the Fed has to not only normalize interest rates as the economy shows signs of renewed growth and inflation, but they also have to reduce their bloated balance sheet. In 2007, before the Financial Crisis, the Fed's balance sheet totaled $900 billion in assets; today the total stands at a whopping $4.5 trillion.[11,12]

As the economy strengthens, wages and prices should be able to move moderately higher without creating the risk of high inflation. The Fed has to be cautious not to get ahead of the curve by tightening the Fed Funds Rate and Discount Rate too quickly,[13,14] which could shut down economic growth. However, they should be able to adjust the yield curve by selling the treasuries on their balance sheet back to investors to normalize interest rates and their balance sheet at the same time. They could return the cash they borrowed to buy treasury bonds from investors to support QE operations back to the Treasury. While the net amount of treasury bonds in the marketplace doesn't change, the Treasury receives a fresh cash infusion that could be used to fund fiscal stimulus spending without increasing our budget deficits further.

What is the Likely Effect on Stocks and Bonds?

The proposed combination of tax cuts and fiscal stimulus reminds me of the policies enacted by President Reagan during the 1980s. The proposed corporate tax reform adds an additional exciting new level of stimulus to the current plan. In 1981, when I entered the financial services industry, the Dow Jones Industrial Average Index opened the year at 777 after hitting a closing high of 1,000 on February 1, 1966.[15]

The ravages of Vietnam War, Stagflation,[16] and the Oil Embargo drove stock market returns down for a decade and a half. The newly appointed Fed Chairman, Paul Volcker (appointed in August 1979), decided the government should get out of fixing interest rates and let the markets determine where rates were supposed to be to allow the economy to reach its potential. Rates initially soared for several years and then moderated over the next three decades providing the backdrop for the greatest bull market in bonds ever. To stimulate the economy to overcome stagflation, Volcker's more accommodative monetary policy was combined with massive tax reductions and fiscal stimulus. These policy prescriptions helped create the greatest bull market in history for the next 18 years. The Dow Jones Index increased in value 14-fold to 11,497 in 1999.[15] Could markets respond in a similar fashion this time?

Stocks

While there are striking similarities in policy to what is proposed by a Trump administration and Reaganomics, conditions are different. Back in 1981, the stock market was at a low point with stocks trading at a tremendous value.[17] Today, the market is trading at all-time highs due to an artificially low interest rate environment fostered by the Fed. Slow economic growth has compromised corporate growth rates which have led to a recession in earnings over the past couple of years, implying stocks are currently overvalued based on trailing P/E multiples. Because markets are starting from a higher place, we expect the potential increase in markets to be muted compared to the '80s and '90s run with the potential to double or triple in value over the next decade. An increase is not to imply a linear rise — we expect there might be some big bumps along the way.

Bonds

Interest rates moved from lower government fixed rates to an all-time high point before falling dramatically for decades (from 1980 to present), providing a tremendous tailwind for bond prices to appreciate. Today, interest rates are near historic lows, and bond prices consequently are near all-time highs. With increased economic growth, interest rates are likely to rise providing a stiff headwind to bond prices. The long awaited bear market in bonds has probably arrived, and we expect bond investors to be challenged for the next few years as interest rates normalize to new higher levels that reflect real growth in the economy and a modest increase in inflation that normally accompanies higher growth.

At WBI, we seek to actively protect capital invested in bonds and stocks while providing consistent capital growth over the long term in good and bad market cycles. We hope for a much brighter future for investors over the next ten years as return sets reflect real economic growth, not the stagflation growth and Fed distorted bubble policies that we have had since the Financial Crisis. ■

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[1] Jeffrey, Terrence. "U.S. Has Record 10th Straight Year Without 3% Growth in GDP." CNS News. *CNS News,* 26 Feb. 2016. Web. 17 Nov. 2016.

[2] "BEA News Release." *U.S. Department of Commerce,* 29 Sept. 2016. Web. 13 Oct. 2016.

[3] "FRED Graph Observations." Federal Bank of St. Louis. *Federal Reserve Bank of St. Louis,* 2016. Web. 11 Aug. 2016.

[4] Nitti, Tony. "It's Clinton Versus Trump: A Comparison of The Final Two Tax Plans." Forbes. *Forbes,* 8 June 2016. Web. 1 Nov. 2016.

[5] **Standard Deduction:** a dollar amount that non-itemizers may subtract from their income and is based on filing status.

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[10] Michel, Norbert J., and Stephen Moore. "Quantitative Easing, The Fed's Balance Sheet, and Central Bank Insolvency." *The Heritage Foundation.* 14 Aug. 2014. Web. 19 July 2016.

[11] "Speech." FRB: Bernanke, The Federal Reserve's Balance Sheet: An Update. *Board of Governors of the Federal Reserve System,* 8 Oct. 2009. Web. 17 Nov. 2016.

[12] "Quarterly Report on Federal Reserve Balance Sheet ..." Federal Reserve Board. *Federal Reserve Board,* Aug. 2016. Web. 17 Nov. 2016.

[13] **Federal Funds Rate**: the interest rate at which banks and credit unions lend reserve balances to other depository institutions overnight.

[14] **Discount Rate:** the minimum interest rate set by the Federal Reserve for lending to other banks.

[15] "Closing Milestone of the Dow Jones Industrial Average." Wikipedia. *Wikipedia,* Web. 17 Nov. 2016.

[16] **Stagflation:** rising prices, or inflation, combined with high unemployment and slow economic growth.

[17] Lohr, Steve. "1980 A VERY GOOD WALL ST. YEAR." The New York Times. *The New York Times,* 1980. Web. 17 Nov. 2016.

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