Then No Planets Strike…

"Some say that ever 'gainst that season comes

Wherein our Savior's birth is celebrated,

The bird of dawning singeth all night long:

And then, they say, no spirit dares stir abroad;

The nights are wholesome; then no planets strike,

No fairy takes, nor witch hath power to charm,

So hallow'd and so gracious is the time."

(Hamlet, by William Shakespeare, Act 1, Scene 1, Lines 172-178)

Interestingly, for everything else he wrote about, William Shakespeare almost never wrote about anything religious – the above passage is one of his few that that even remotely addressed anything theological or spiritual. We don't know if this is because he was areligious or because he was too savvy to engage in any theological controversy during a fierce Catholic vs. Protestant political regime (we tend to believe the latter).

We share this because the passage above seems to accurately describe current market conditions – "*the bird of dawning singeth all night long…no spirit dare stir abroad…the nights are wholesome…[and] no planets strike.*"

Regardless of your personal or political opinion of Donald Trump, his administration has been very good for business. We've regularly shared our opinion that the market "over-priced" the actualities of Trump's campaign pledges, but the fact is that anti-growth regulations have been rolled back, Congress approved a once-in-a-generation tax reform bill (with tons of flaws and pork, but pro-growth nonetheless – sausage making is an ugly business), economic growth is solidly positive, and the stock market is soaring.

We are reminded of the cliché that "*Equity market rallies don't die of old age, but rather are killed (usually) by Central Banks.*" The current robust and multi-year rally in most global equity markets has some investors concerned that it simply cannot continue, but there is little correlation between the length of any given rally and the underlying causal conditions. There is no question that valuations are high, but we believe that is an indicator of reduced longer-term return expectations than a signal of an impending market correction or collapse.

What an investor earns is explicitly a function of how much he/she pays for the investment, and the public markets are expensive, to be sure. But the benign global economic regime we've described for the past several months remains solidly in place – solid economic growth (especially in manufacturing), strong corporate earnings and revenues, raging equity markets, low interest rates, and an almost frightening level of market complacency.

We have moved (in the US, at least) solidly away from a market regime dominated by Central Bank policy, which we view as a very positive development. The Fed raised rates by 0.25% in early December, and is signaling an additional 3-4 rate hikes in 2018, and the market just chugs merrily along.

One thing we are paying attention to is the shape of the yield curve. Even with a slight steepening of the curve following the announcement that the tax legislation had passed both the House and the Senate, the spread between the 2-year and 10-year US Treasury rates continues to hover below 0.75% -- extraordinarily flat. The Fed actions, of course, are pushing up the short end of the yield curve, but the long end remains low, we think for three fundamental reasons: (1) expectations that economic growth in the US will slow down through 2018 (though there seems to be little expectation of a recession); (2) inflation remains muted, and (3) non-US investor flows into US Treasuries in the face of continued negative real interest rates in many sovereign markets.

We don't believe the yield curve will invert or, if it does, it will not necessarily be an indication of an impending economic slow-down or recession, but rather more of a function of investor sentiment and flows.

The potential economic wild cards continue to be as follows: (1) The Fed raising rates in the face of presumptive but no explicit inflationary pressure – will it put the brakes on the expanding economy?; (2) Fiscal stimulus by way of tax reform injected into an already expanding economy – this seems to put fiscal policy and monetary policy into somewhat of a "push-me / pull-you" situation; and (3) exogenous geopolitical events.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

- The global economy remains solidly positive right now:
    - US Q3 GDP came in at 3.3%, on top of Q2's 3.1%, the first back-to-back quarters of 3.0%+ GDP growth in many years. GDP growth estimates for all of 2017 are now at 2.5% (source: *The Wall Street Journal*);
    - Both the US manufacturing and services sectors remain well in expansionary mode – the ISM manufacturing index came in at 58.2 in November, and the non-manufacturing index came in at 57.4, both slightly down from their October levels but solidly in expansionary territory (anything above 50 is considered expansionary);
    - Inflation remains a question mark – both the "headline" and "core" (which excludes the volatile food and energy sectors) inflation numbers are hovering around the Fed target of 2% YoY, and there are some signals that inflationary pressures are beginning to work their way through the markets, mostly on the wage side versus any spike in commodities or raw materials. The primary drivers of this low inflation continue to be:
        - Slow wage growth – wages are increasing, but not at a pace commensurate with the tightening labor markets, though they seem to be accelerating;
        - Ongoing automation and globalization; and
        - Fairly low and stable energy and commodity prices.
- S&P 500 companies are forecasted to deliver an 8.6% increase in YoY earnings in Q4, on steadily improving revenues (source: Zachs Earnings Report). What we find most encouraging is that earnings are growing despite a decline in "financial engineering" (stock buy backs and dividend payouts), suggesting (a) that top line revenue growth is improving and (b) companies are increasing their investments into capital expenditures, R&D, and hiring – which we believe is essential to sustainable long-term growth;

The Towerpoint Wealth Economic & Market Outlook

- The global macro-economic environment remains benign;
- The global economy is growing, and the probability of recession remains low;
- Manufacturing in particular is expansionary in most major regions of the world;
- In response, oil and commodity prices have risen or stabilized over the past 2-3 months, though we do not anticipate significant price pressure over the next several months;

- Inflation remains lower than expected or desired, though some analysts believe that there are "hidden" inflationary pressures (specifically with respect to repressed wage growth) that have the potential to disrupt the current highly complacent environment;
- The "Goldilocks" economic regime seems firmly in place, barring a highly unexpected exogenous event (e.g., geopolitical);
- The consensus view is that, barring unforeseen events, the Fed will seek to raise rates 3-4 times in 2018, though the market seems to be taking that in stride;
- It now seems almost certain that President Trump will sign into law fairly significant tax reform legislation, which the markets will view as highly positive. Other Congressional issues, specifically the ongoing budgetary arguments, will continue to add some level of market uncertainty as we gear up for the 2018 mid-term elections;
- Solid GDP growth, earnings and revenues, combined with low rates and low volatility, make for a very positive environment likely to continue through at least the first quarter of 2018, but equities still look very expensive to us;
- EM and EAFE markets continue to have better valuations than the US (though they are by no means cheap). The USD trend is the wild card for US investors – we think the persistent slide for most of 2017 is ending, given the growing economy and anticipated Federal Reserve actions;
- The US yield curve remains flat but we do not anticipate an inversion – lower for longer remains the name of the song;
- At these rates and credit spreads, the public credit markets look very expensive to us, though coupons are probably safe as corporate balance sheets are in good shape;
- For investors who can access the private markets and handle some degree of illiquidity, we still believe there are better opportunities in the private markets versus the public markets, even in the face of compressed premiums versus historical levels, driven by huge investment flows over the past 18-24 months;
- 2017 will turn out to be a much better year for alternative investments, with (as we anticipated) hedge funds generally delivering superior performance than their liquid alternative brethren, because of less liquidity and leverage constraints;
- We believe we may see a modest rebound in oil and commodity prices, as global economic growth expands but, generally speaking, global supply continues to exceed demand;
- While we are generally constructive on the global economy and overall market performance, the public markets are not cheap. Clients need to have their expectations managed as to what a diversified portfolio can deliver over a full market cycle.

What are the potential "bearish" risks to this "Goldilocks" market environment?

- **Baby Bear** – Natural Market Correction as Sentiment Changes: Despite the current "Goldilocks" regime, valuations remain high and multiples are expanding faster than earnings growth. If the market begins to "price out" some of the economic stimulus it "priced in" following Trump's election, we may see a slight-to-moderate market correction. **Probability: moderate to high over the next 2-3 quarters**
- **Mama Bear** – Central Bank Noise: One of the better stories of 2017 was the increased focus on market fundamentals, earnings, and growth, and the corresponding decreased focus on Central Bank policy, at least in the US. There certainly is at least the possibility that, this late into the economic cycle and in the relative absence of inflation, the Fed will tighten into an only-moderately growing economy, shutting down the expansion and perhaps even sending us into a recession. Should we enter a recession (or even just visibly slow down), the markets may react strongly. **Probability: low to moderate over the next 3-4 quarters**

- **Papa Bear – Geopolitics:** North Korea remains unstable, as does the consistency of the Trump administration's foreign policy. A major geopolitical upheaval could result in at least short-term market disruptions. **Probability: Low over the next 3-4 quarters**

So, as we review the economic and market landscape, we continue to see many good and positive things – a growing economy, solid earnings, manageable inflation, low interest rates, and at least some level of pro-growth tax reform legislation that will pass in the near future. Barring an unforeseeable geopolitical crisis, we think the current benevolent market regime will continue through at least the first half of 2018.

We wish you a healthy and happy holiday season during which the *bird of dawning singeth all night long…the nights are wholesome, and no planets strike.*

Warm Regards,

Joseph F. Eschleman, CIMA®

President

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