Economic Review

The year began with the eventful transition to the new Trump Administration in Washington. As politics dominated the headlines, the equity markets continued to climb steadily higher. The S&P 500 rose 5.5% during the quarter bringing the total gains since election day to 11% (Chart 1). We attribute this general market optimism to Trump’s pro growth agenda and relatively strong economic growth in the second half of 2016. However, the Administration’s failure to gain enough support in Congress to deliver the repeal and replacement of the Affordable Care Act has created some uncertainty about the ability to implement future policy. Trump appears to have moved on to focus on tax reform as his next priority but it is also possible that he circles back in a second attempt to pass health care legislation. Either way, the stakes are now higher for him to show he can make progress on his agenda.

The fixed income markets were up slightly during the quarter as yields dropped modestly and most major sectors exhibited slightly tighter spreads during the quarter. The Fed decision to raise rates 25 basis points at the March FOMC meeting was largely expected and had already been priced into the market. There has been a flattening of the yield curve as the short end of the curve moved higher while gains at the long end of the curve were more muted (Chart 2).

Overall, the US economy remains healthy. The labor market appears robust as the US approaches full employment. Wage growth has improved to around 2.5% for the past year after hovering closer to 1% in prior years.* The housing market also remains healthy even as interest rates have moved materially off last summer’s low. In general, US consumer confidence is high (Chart 3) and consumers remain willing to spend which has been a critical component of the recovery for the past five years.

Outside the US, economic conditions in Europe are still fragile. Economic growth in the region has been below 2% for a number of years and European Central Bank efforts to stimulate the economy via monetary policy has produced limited gains. An additional headwind has been introduced to the region with the UK’s decision to exit the European Union. “Brexit” was formally triggered by UK Prime Minister Theresa May’s signing of Article 50 in March which opens a formal two year transition for Britain to leave the EU. The political and policy uncertainty in Europe has been stifling growth and this trend is likely to continue with a number of important elections coming in the next few quarters.

China has exhibited signs of stabilization with growth around 6.5% for the prior year. This has been welcome news to the financial markets and has been a contributing factor to the overall rise in emerging markets over the past 6 months. One area of concern, however, has been the rising pace of capital outflows from China. The Chinese government holdings of US treasuries have declined by over $130B in 2016 as the government tries to defend the weakening Yuan currency.**

Overall, there was very low volatility in the financial markets during the quarter. This is likely a result of the lingering effects of central bank intervention and potentially a degree of complacency by investors. This bears watching as the political landscape and economic policies appear to be rapidly changing here in the US and abroad.

* Source: Bloomberg, March 2017
** Source: Autonomous Research, December 2016

Please review the "Important Disclosures" on page 5.
Assessing the landscape for the remainder of 2017, we see three major influences on the market and economy; politics, policy, and profits. Opportunity and risks are abundant in each of these areas but we view the glass as half full and are optimistic that, in aggregate, these influences can have a positive impact on the economy and markets.

Most people would agree we have experienced an eventful and volatile start to the Trump Administration. As mentioned, our view is the markets are optimistically pricing in Trump’s pro growth agenda ahead of any tangible accomplishments. As such, it has become increasingly important for Trump to book a “win” either through passage of tax reform legislation or a second attempt at healthcare reform. The other highly anticipated item on Trump’s agenda that could provide a significant boost to the economy is the proposed $1B infrastructure investment program. We await details around a plan but this could be a program that is broadly supported by both political parties. One area the Administration seems to be making immediate progress on is rolling back regulations in the financial sector which is being viewed positively by the markets. The risks from a political perspective are still elevated because a number of Trump’s ideas are protectionist and anti-globalization, which the market views negatively.

As it relates to policy, we think the Fed will have significant influence on market sentiment this year as they continue to signal a tightening stance. The question remains how aggressive they will be in their efforts to normalize interest rates. Our view, which is fairly in line with consensus at this point, is they follow the March rate hike with 2-3 more this year and another 3-4 next year. If this path is executed, the Fed Funds rate would be around 2.25-2.5% by the end of 2018 (Chart 4). Fed Chair Yellen has recently indicated it is also possible that the Fed pauses rate hikes next year to focus on balance sheet management. Both of these actions would put the Fed in a better position to react to an economic downturn. The clear risk to this outlook is near term economic weakness either in the US or abroad that causes the Fed to slow or even cut rates.

The consensus outlook for corporate profits is for double digit earnings growth. We see risk to this forecast especially since we expect the first quarter to be shy of 10% growth, creating an even higher hurdle for the second half. With the S&P500 trading well above the historical average trading at over 18x forward earnings (Chart 5), we would expect any earnings short fall to be a catalyst for a market pull back. We believe the three “P’s”; politics, policy, and profits will drive the direction of the markets and interest rates for the foreseeable future. Generally, we see an upward bias to rates but given the wide scope of potential outcomes, we would not be surprised if volatility increases as the year progresses (Chart 6). As mentioned, equity markets appear rich making markets vulnerable to a pullback if corporate profits fail to meet or beat expectations.
We sat down with Tom Girard, Head of Fixed Income Investors, to get his insights on the current market and his outlook on interest rates.

IQ: Tom, as we approach the 100 day mark of the new Trump Administration, what is your assessment of their progress as it relates to the economy?

Tom: So far, I think the Trump Administration’s impact on the economy is still based on optimism rather than accomplishment. There continues to be a general sense of optimism that the Trump Administration will deliver less regulation and lower taxes which will lead to stronger economic growth. I agree that less regulation and comprehensive tax reform should help spur economic growth but agreement on these issues, especially tax reform, will not be easy. The inability to pass a health care package, in my opinion, makes tax reform even more difficult. After the vote for the health care plan was pulled, the Administration announced that it will pivot towards tax reform. A comprehensive tax reform package along the lines of what has been discussed so far will not be an easy task. In fact, the pursuit of the reform of health care was purposefully done before tax reform because they needed the savings from health care to help pay for the tax cuts. Without that savings and with the failure to agree on health care looming fresh in everyone’s mind, I remain a bit concerned on what can be accomplished with regard to tax policy and even if they can find common ground, it’s possible that the planned overhaul becomes a watered down version which leads to market disappointment. As the health care vote started to look less likely, the markets reacted quite negatively (S&P 500 down 1% plus on March 21st) which could start to erode the optimistic feelings since the election.

IQ: Markets are always moving in and out of balance. Any particular dislocations out there today in fixed income?

Tom: Two areas where I see dislocations are in the US equities market and high yield market. I think equities continue to look expensive on many levels and the rally since the US Presidential election has only added to that richness. 1st quarter earnings season will begin shortly and I think that will be pivotal towards justifying current levels. Recall, earnings are forecast to grow double digits in 2017 and the promise of a more robust economy was going to help contribute to that growth in the back half of the year. If tax reform gets bogged down, if earnings growth falls short of expectations, and if optimism turns to pessimism, a correction in the equity market is likely. At the same time, a strong 1st quarter earnings season would send a very positive signal and buy time to allow progress to be made on tax reform. As for high yield, we are experiencing a mini correction as we speak. Like equities, high yield has had very strong performance since the election and a correction is probably warranted. The recent down trade in oil has undoubtedly contributed to a bit of widening in high yield spreads but in addition, the news on health care has also had an impact. Lastly, the front-end of the US Treasury curve is potentially vulnerable to a more aggressive tightening campaign by the Federal Reserve. The front-end of the curve is barely pricing in 2 more tightening from the Fed, which is what the FOMC is currently predicting. If economic growth were to surprise to the upside and Fed officials saw the need to move 3 more times in 2017, which is not out of the question, 2 year treasury notes would be vulnerable. Having said all this, the back drop remains very constructive for financial assets as economic growth is forecast to continue to chug along at a modest pace, inflation is not expected to be problematic, and the Federal Reserve appears to be intent on raising rates at a gradual pace. These are all good ingredients for longer term performance for riskier asset classes such as equities and high yield.

IQ: You have noted the saw tooth pattern exhibited in US GDP growth over the past few years. Is that trend continuing? Why?

Tom: Yes, I think it is continuing as 1st quarter growth in the US appears to be somewhat weaker than 4th quarter GDP. (The final read on 4th quarter GDP comes Thursday, March 30th and a modest upward revision of .1% is forecast which would make the final reading 2%) Presently, the Atlanta Fed GDP Now forecast is calling for 1st quarter growth to be 1% and many forecasters have recently lowered their estimates to something between 1-1.5%, so once again it appears the 1st quarter of the year will see tepid GDP growth. I think this trend is emblematic of an economy that is growing sluggishly. What I mean by this is that when growth is trending higher and faster, economic data tends to come out consistently stronger. When economic growth is slowing; the exact opposite happens. The growth that the US has experienced over the last several years has been steady but not robust; hence uneven economic data is the result.
In the Spotlight: NYL Investors

IQ: The 10 Year US Treasury rates have moved 100 basis points off last summer's historical lows. What is your rate outlook both near term and over the next few years?

Tom: Over the next couple of months, I can see rates moving modestly lower and I think part of that is happening as we speak. I do think that 1st quarter GDP will be around this 1% level and if earnings disappoint; we are likely to get a modest correction in risk assets, which would push rates a touch lower in the near term.

As I look out over the course of the year and into 2018, I still believe that rates will move somewhat higher. I believe the FOMC will look to raise rates 2 or 3 more times in 2017 and that should nudge low rates a bit higher. I'm a believer that the economy will stay on a growth trajectory of between 2-2.5% and that will enable the Fed to continue to push rates slightly higher into 2018.

I think that at some point, the Fed will go too far with their hikes and the economy will slow and they will have to pause or even reverse some of their rate hikes. This will be critical and somewhat dependent on the fiscal policy that is enacted or not enacted for that matter. Most slowdowns in economic activity result from the Fed tightening a bit too much and if faced with the prospects of looser fiscal policy; they may feel the need to be more aggressive. This could be a 2018 or 2019 event. My point is that although I think rates are moving higher; it's a modest move higher. It will not be a bear market for the ages which causes investors to flee the asset class.

IQ: The US dollar has given back some of the gains experienced over the past year. What factors have contributed to this recent weakness?

Tom: The dollar, as measured by the US dollar index, is down approximately 3% ytd. I think this is a function of two things. First, other economies outside the US are doing better than expected. The Euro zone and Japan have both seen improvement. In the case of the Euro zone, there is speculation that the ECB will be able to trim back on their easing measures sooner rather than later. China's economy has held up better than anticipated so I think the better underlying performance of these economies has put some downward pressure on the dollar. Whether this is sustainable or not remains to be seen but so far I think the surprise has been the better performance of these economies.

The second reason is the performance of the US economy and the performance of the Trump Administration. As noted above, the US economy appears to be going through a bit of a sluggish 1st quarter. The “Trump Bump” is stalling a bit especially since the health care proposal was pulled and people have begun to recalibrate their likelihood of tax reform and infrastructure spending being successfully passed. In addition, the noise surrounding trade policy and protectionism also weighs on the dollar. The difficult start to the year has certainly contributed to the slightly weaker dollar in the first quarter.

IQ: Thanks for sharing your thoughts with us today Tom

Tom: My pleasure.
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