Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook - 2017 Begins

Review of 2016:

Entering the final weeks of 2016, it looked like we would have another year of lackluster economic expansion. The year ended with its share of hits and misses after sluggish growth during much of the year. However, there was an upward revision in gross domestic product growth for the third quarter, from 3.2% to 3.5%. Gains in both new and existing homes sales, a solid increase in consumer confidence and a small rise in consumer spending contributed to the upward revision. But, December also showed a decline in housing starts, lower building permits and flattish results in durable goods orders and personal income. Since early 2016 saw slow growth, full year GDP will likely show about 2% growth when final numbers are reported.

When the Presidential Election "intervened" in November, the economic and emotional landscape in the U.S. changed dramatically. As a result of the unexpected election of Donald Trump, we witnessed a sharp advance in the stock market with new expectations of stronger economic growth supported by hopes of substantial infrastructure spending, a more business-friendly environment, less regulation and a revised tax code for both business and individuals. Interest rates remained at historic lows throughout 2016 until the Federal Reserve increased the Fed Funds rate on December 14th by ¼ of 1% to a targeted range of ½ to ¾%.

Outlook for 2017:

Expectations are high for the U.S. economy as we begin 2017. The pickup in consumer sentiment, rise in wealth created by the stock market gains, and improved job creation levels all suggest that the New Year is getting off to a faster start than the year earlier. Rising optimism is critical, as consumers and businesses typically spend more as confidence builds. The economy is on fundamentally-based solid ground as the new administration commences its work. Manufacturing and non-manufacturing, corporate profits and consumer confidence are all at or near multiyear highs, attesting to a broad-based, positive business environment in the months to come. The hope is for staying power of the current expansion during 2017 and into 2018.

On balance, the consumer outlook is decent and sentiment surveys are upbeat. Retail demand continues to strengthen for internet-related purchases, while auto and building materials dealers are also seeing firm demand. However, retail activity is lagging badly at "brick-and-mortar" department stores and traditional shopping malls, underscoring the ongoing weakness at old-line chains that continue to announce store closings as they restructure their business models as competition with online retailers grows more intense.

Our sense is that GDP growth will continue to be about 2% during the first half of 2017 and then climb at a faster pace for the balance of the year, perhaps 3% or more. However there may be a lag between improving sentiment and actual realized economic gains pending congressional action on the ambitious agenda of the new administration, i.e., cutting taxes, rolling back regulations and funding new infrastructure projects.

We will also be watching signals from the Federal Reserve about additional interest rate hikes. The Fed has already shifted to a slightly tighter monetary stance. Given a brighter U.S. economic outlook, they have room to raise interest rates during 2017. The Fed Funds rate stands at a historically low level of less than 1%.

Longer-Term Outlook:

Beyond 2017, the economy may be less certain, in large part due to questions regarding the timing and eventual impact of fiscal stimulus measures that will likely be proposed by the new President. Also, the Fed may continue to tighten monetary policy that could raise concerns relating to the sustainability of economic growth. We think growth in the U.S will be sustained for the next couple of years at a more rapid pace than what we saw during the past several years and that price inflation will be well contained.

We should also expect unsettling developments from abroad. International trade policies and our global relationships will be critical. Oil prices may be vulnerable if OPEC's output curbs fail to take hold. Also, if recent sanctions placed on Russia are sustained, we may see inter-country tensions revert to the "Cold War" era. Overseas developments will play a major role in U.S foreign policy and economic growth, particularly as Russia and China "flex their muscles." This will require a skilled approach to navigate these choppy waters.

Stock market:

So far, stocks are holding up well in the early going of 2017. In the months ahead, there is likely to be a "balancing act" with an improving U.S. economy, supported by a more business-friendly environment, the potential for a somewhat higher level of inflation, and the likelihood of additional rate increases. Earnings season is well under way with results generally continuing to be good with energy, financials and IT leading the way. A reduction in the corporate tax rate would enhance profits even further. Going forward, the bull market remains intact but a path to significantly higher equity prices may be bumpier than in the recent past.

Investment Strategy:

As my mentor, Sir John Templeton, frequently reminded me: "Fred, there is always a good value in the stock market at anytime, somewhere in the world, even when markets have run for some time. Go do research."

At this point in the economic cycle, with the up-trending interest rate environment coupled with the results of the recent Presidential election, some areas for investment are more clearly defined than they were just a few months ago. In recent weeks, we have been shifting our investment strategy to accommodate the policy changes that have occurred and those likely to happen in the months or years to come. We have identified both attractive investment vehicles and also economic sectors where growth prospects will be more difficult.

Areas with promising opportunities include: infrastructure-related companies, benefitting from a massive investment on the way, both governmental and private sector, materials and commodities, including energy, (in recovery mode) and supporting large-scale construction projects, information technology, especially those supporting productivity enhancement and social media-based innovations, financials, benefitting from higher interest rates, and defense, benefitting from large governmental, rebuilding expenditures. Companies that are less attractive and that are likely to face "head winds" include: healthcare-related, due to the overhaul of the Affordable Care Act and coming pricing pressure on drug companies, device manufactures and medical services, consumer-related, such as big box and traditional retail store formats, and consumer franchises that largely depend on imported products and possibly face higher prices due to any new trade policy alignment.

In Summary, our time-tested research disciplines have always been the hallmark of Schroeder Capital Management as we focus on investment opportunities that create wealth for our clients, regardless of the landscape before us. 2017 will be no different as we continue to make portfolio choices based on keen research that dovetail with the current, unusual times and position our managed assets for the period ahead.

G. Frederick Schroeder
President and Chief Investment Officer

January 25, 2017