Gyroscope Capital Management Group

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Quarterly Review and Commentary

As we look to establish our expectations for 2017, we begin by reflecting on the events of 2016. The year unfolded with the worst two-week start for the U.S. equity market in history. The market rebounded before the United Kingdom's surprise withdrawal from the European Union caused a stock market selloff and subsequent recovery shortly afterwards. In a bit of a political parallel, populist political outsider and controversial public figure Donald J. Trump defeated Hillary Clinton in November to attain the Office of the U.S. Presidency and, shortly afterward, the U.S. equity market climbed to all-time highs! Who predicted that going into 2016?

Trump campaigned on pro-business, nationalist economic policies that reignited investor and consumer confidence and have fueled expectations that the bull market in equities may yet have legs. The pillars of these economic policies, collectively "Trumponomics", include a massive fiscal stimulus directed at infrastructure spending and expansion of the U.S. military, broad-sweeping regulatory reform, corporate and individual tax cuts, and protectionist trade policies (general position and policy detail references have been derived from donaldjtrump.com).

In order to evaluate the impact of Trumponomics in 2017, we provide our thoughts on each of the main pillars of Trump's proposed economic policies before discussing the potential impacts on corporate earnings growth, inflation, interest rates, and the U.S. equity market and conclude by sharing our market outlook for 2017.

EXPANSIONARY FISCAL POLICY

Trump campaigned on a $1 trillion new infrastructure spending program and a pledge to upgrade and expand the U.S. armed forces. The military improvement goals outlined by Trump include expanding the size of the U.S. Army and Marine Corps, rebuilding the Navy to a targeted 350 ships, and boosting the Air Force's fighter aircraft count to 1,200.

We expect that these expansionary fiscal policies will contribute to an increase in the rate of U.S. GDP growth, corporate earnings, and the prospects of higher inflation. Since the years following the 2008 financial crisis, it has become clear that monetary policy alone has reached its limitations and is now insufficient to facilitate meaningful economic growth. Accordingly, we anticipate that by using fiscal policy to stimulate the economy, Trump has opened the door for the Federal Reserve (Fed) to have more flexibility in monetary policy decisions.

BROAD REGULATORY REFORM

The Trump vision states that it intends to reduce an "already bloated government" by evaluating all governmental departments and eliminating unnecessary regulations. Those regulations specifically identified for the chopping block include the Dodd Frank Rule, the Waters of the U.S. Rule, and the Clean Power Plan. Trump has also vowed to issue a temporary moratorium on new agency regulations and to swiftly repeal and replace the Affordable Care Act.

Our opinion is that regulatory reform of the scale that Trump has proposed will not materialize as identifying burdensome regulations and eliminating/replacing the rules in place is a difficult, time consuming, and costly exercise. Regulations tend to be intertwined and complex – having been created by no single architect and with no single agency having full control and responsibility for enforcement. Adding to the complexity is the fact that many of the most burdensome regulations, particularly those facing small business, are managed at the state and local level, limiting the benefits of broad federal regulatory reform. Trump may be better served by targeting only the most burdensome regulations for full elimination and working with lawmakers and regulators to simplifying the existing regulatory framework to provide businesses with greater regulatory clarity and certainty. In any case, he certainly has an opportunity to make the federal regulatory environment more accommodating for U.S. industry.

AGGRESSIVE TAX CUTS/REFORM

Trump's proposed tax cuts represent the biggest tax reform since Reagan held office and have been a driving force of his popularity. Should they materialize, they may also drive equity markets and corporate earnings. Trump has promised to make the U.S. corporate tax code, which ranks among the least competitive in the developed world, more globally competitive, proposing a limit on business income taxes of 15%, the elimination of the corporate alternative minimum tax, and a repatriation holiday that could bring the estimated $2 trillion in corporate profits held offshore back home at a tax-rate of 10%.

We expect that with the GOP controlling the White House, Congress, and the majority of state governments, Trump will have the political clout to see his tax reforms become reality. Tax reform has been a consistent pledge throughout Trump's campaign and we believe it will be a first-term priority. The proposed corporate tax cuts can be implemented quickly as Trump gathers the wide support of a Republican controlled Congress. Changes to the individual tax code will likely take longer to implement as it is more complex and making amendments, even with political cooperation, is a relatively slower process. However, Trump could elect to push tax cuts as well as other elements of Trumponomics through the budget reconciliation process, which bypasses the requirement of a supermajority, requiring only a simple majority of the Senate.

PROTECTIONIST TRADE POLICY

In what we view as inconsistent with Trump's other economic policies, his proposed trade policies focus on protecting U.S. industry while limiting imports and punishing U.S. companies that choose to manufacture goods abroad. Trump has vowed to stop the Trans-Pacific Partnership, renegotiate or scrap NAFTA, label the Chinese a currency manipulator, and impose duties and tariffs on any other countries that "cheat." While perhaps politically beneficial, such policies are clearly not conducive to attracting foreign capital investment or supporting domestic business activity. For example, scrapping NAFTA could threaten many of the estimated nine million U.S. jobs that depend on trade with Canada and the five million that depend on trade with Mexico, as well over $500 billion of U.S. goods that Canada and Mexico import every year.

We share the markets' view that Trump will not make good on his more severe trade threats. Indeed, we expect that he intends to renegotiate trade deals and is posturing for future negotiations and does not intend to implement trade restrictions of the magnitude he has proposed. However, Trump has been consistent in his pledge to protect U.S. manufacturers, and should Trump take a more aggressive stance on trade than the market anticipates, U.S. (as well as Chinese and Emerging Market) stocks are likely to suffer.

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The following table depicts the effects we anticipate Trump's proposed policies will have on U.S. corporate earnings (EPS) growth, inflation, interest rates, and the U.S. equity market.

	U.S. EPS Growth	Inflation	Interest Rates	Equity Markets
Expansionary Fiscal Policy	Accelerate / Increase	Accelerate / Increase	Increase	Increase
Broad Regulatory Reform	Increase	Ambiguous	Increase	Increase
Aggressive Tax Cuts	Accelerate / Increase	Increase	Ambiguous	Increase
Protectionist Trade Policy	Decrease	Increase	Decrease	Decrease

U.S. CORPORATE EARNINGS

We expect that Trumponomics will drive corporate earnings higher. Consumers should receive higher levels of disposable income resulting from tax cuts and higher wages as Trump's aggressive fiscal policy increases aggregate demand and wage inflation. Corporate earnings should also receive a boost from additional revenue streams and a reduction in compliance costs from Trump's regulatory reforms. Corporate companies' financial and operating leverage will likely amplify the profit-enhancing impact of a substantial cut in corporate taxes. Of course, these conclusions assume that proposed trade policies do not fully offset these positive effects.

INFLATION

All of Trumps policies have the potential to drive inflation higher. Expansionary fiscal policy enacted during a period when the economy is near full capacity, the labor market is tight, and consumer confidence is strong is likely to drive inflation higher as more dollars chase the same amount of goods and services. An increase in economic activity created by the absence of burdensome regulations could drive inflation higher, although this increase could be offset by the deflationary forces of deregulation, which result from lower compliance costs and efficiency gains. Tax cuts should prove inflationary in an economy near full capacity, driven by higher disposable incomes. Another potentially significant cause of inflation is Trump's protectionist trade position. Should Trump deliver aggressive taxes and tariffs on imports, the effect will most certainly be acceleration in the rate of inflation as the prices of imported (particularly durable) goods increase. Trump's immigration plans could also prove inflationary as they would reduce the labor force, and further fuel wage inflation.

INTEREST RATES

After years of ultra-low target interest rates, The Fed will have an opportunity to "normalize" interest rates. For several years now, inflation has been below the Fed's targeted two-percent level and the Fed has been more concerned with deflation/disinflation. A stable uptick in inflation would assist the Fed in achieving its mandates and allow the Fed to raise rates to a level at which it could again use interest rates as a policy tool by lowering rates if the economy is heading into a recession. Alternatively, as inflation has been on the uptick on its own, the introduction of inflation could cause a steep surge in prices. A rapid increase in inflation could force the Fed to raise rates higher and faster than expected, which could ultimately reduce overall economic activity. In either event, we expect Trumponomics to facilitate several rate hikes in 2017, with the potential for rate increases to exceed market expectations in terms of number, timing, and magnitude.

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U.S. EQUITY MARKETS

Overall, we believe that Trumponomics will be beneficial for U.S. equity markets, which appear to be focusing on the bullish elements of Trump's proposed policies, expansionary fiscal policy, broad regulatory reform, and aggressive tax cuts. During Trump's first year in office, we anticipate increases in consumer spending, business spending and government spending. We expect that companies which generate the bulk of their profits domestically and those with insulation from inflation will be particularly strong in 2017. A repatriation holiday should also be beneficial for the U.S. equity market as companies will have additional capital for investment in profitable projects, share repurchases, dividend increases, and acquisitions. However, the market does not appear to have priced in the potential for devastating trade policies that Trump consistently purports to favor and his actions suggests he is laying the foundation for. However, if Trump ultimately reveals himself as a pragmatic negotiator who is merely posturing for future negotiations, we anticipate his other policies will drive equity market strength.

As always, we welcome your questions/comments and are available at your convenience to discuss the Portfolios.

Thank you for investing with us!