Investors Face Challenges as Trump Plans Unfold While Stock Valuations Are High and Rates Rising, Analysts Tell CFALA 2017 Forecast Dinner Attendees

LOS ANGELES – Investors face an uncertain landscape marked by dramatic policy changes from the Trump Administration, elevated stock valuations and the likelihood of higher interest rates and inflation, three top analysts told more than 400 attendees at CFA Society Los Angeles' 15th Annual Economic and Investments Forecast Dinner Tuesday.

Expect seismic change in Washington, but also a pragmatic and flexible President Trump who will "build bridges, both literally and figuratively," said Terry Haines, Senior Political Strategist and a Managing Director at Evercore ISI.

"For many years, we've had an inflexible political structure and that's now getting shaken up," he said. "People want things shaken up, and they're going to get their wish. Trump is uniquely positioned to do this because he exists outside the traditional party structure."

It's important to separate Trump's rhetorical statements, often delivered via Twitter, from his actual intentions, Haines said, noting that he agreed with the commentator who observed that while the media had taken Trump "literally but not seriously" his supporters take him "seriously but not literally."

Look for Executive Branch actions in the first 100 days of the new administration on issues such as the fiduciary rule, climate change, broadband, and inversions, Haines predicted, with White House and Congressional agreement possible within the first six to nine months on tax reform, repatriation, and infrastructure spending. Replacing the Affordable Care Act will take two to four years, he said, adding that there's more consensus in Washington than many people realize.

"The Republican Party and Trump happen to agree on top-level stuff such as serious tax reform to jump start the economy," he said. "They agree on repatriation and the need for infrastructure spending, although the details are very sketchy at this point. And Washington agrees on more than it disagrees. Both parties agree that taxes should be lower. They disagree on the numbers, but that's a detail, so I expect an attempt to be bi-partisan on that, as well as on infrastructure and tax repatriation. It's harder to see bipartisanship on health care, but I wouldn't even rule that out."

Beyond specific issues, Haines, a Capitol Hill veteran, says a sea change may be under way in Washington.

“There’s a real sense that we’re in the middle of shift to a new way, something else after the fossilized way things have been done over the last 20 years, and people want to stay on the right side of the new way, even if none of us understand yet exactly what it is.”

David Kelly, Chief Global Strategist and Head of the Global Market Insights Strategy Team for J.P. Morgan Funds, noted that 2016 was a year of economic and financial market progress but also of political turmoil.

“The political decisions of 2016 will result in policy choices in 2017 relating to fiscal stimulus, taxes, health care, regulation, trade and immigration,” Kelly said in prepared remarks. “In addition, global issues including China’s challenges with growth and debt, Britain’s negotiations to leave the European Union, and geopolitical frictions will be important, as will be the Fed’s response to these choices and issues.

“A high degree of uncertainty surrounds the economic outlook for U.S. and the rest of the world. One thing is certain: the reality with fall somewhere in the middle of expectations. Investors will not see all of the positive developments they are hoping for, nor will 2017 represent a realization of their worst fears. Acknowledging this, it will be important for investors to diversify their portfolios to chart a middle course.

“Whatever happens in Washington, the U.S. economy is starting in a good place. This economic expansion has been like a healthy tortoise – slow but steady and is now in its eighth year, making it the fourth longest expansion since 1900. Continued economic growth, which we expect to see in 2017, will both push the unemployment rate lower and drive corporate profits higher. A high dollar will continue to put pressure on S&P 500 earnings, just like in 2016, but the increase in oil prices will likely sustain the earnings rebound. A tight labor market and steady economic growth may also cause inflation to rise faster, making it more likely the Fed will stick to its plan to raise rates three times this year, or even be forced to raise rates more quickly, as the reflationary pressures of wage growth and potential increased fiscal spending could push up prices at a more rapid pace than expected.

“While stock valuations are no longer cheap, very low interest rates still make risk assets generally look more attractive. However, with asset prices now more expensive and financial markets facing multiple risks, the need for broad diversification and careful asset and manager selection will be critical.”

Given the fiscal plans of the new administration, bond yields are highly unlikely to return to their 2016 cyclical lows during Trump’s tenure, said David Zervos, Chief Market Strategist of Jefferies LLC.

“The Fed needs to be prepared for a substantial change, for if they allow a large unchecked fiscal stimulus to enter the economy when we are so close to the stated employment and inflation objectives, there are serious risks of overheating,” Zervos said in prepared remarks.

“Monetary policy will need to recalibrate to this fiscal stimulus change. A flatter curve at higher yields is the most likely path for nominal yields. For 2017, 3% is a very reasonable target in the long end with two to three rate hikes followed by a cessation in the reinvestment of proceeds. The Fed’s balance sheet will become more of a focus than rates in the coming quarters.”

Zervos said he expected a gradual rise in inflation, although a stronger dollar is likely keep it at or below market expectations. The Fed has a tough job on its hands, he said.

“Looking ahead, the Fed faces a nearly impossible task, especially given the perception (and reality) that its easing policies have largely benefited only those at the top of income distribution,” he said. “I can see a storyline developing along the following lines: Just as Trump tries to come in and finally get something going for the middle-to-lower classes, the Fed shuts down the party. Whether you believe that is true or not, it creates messy optics for the Fed.”

Noting that two FOMC positions come open in 2017, as well as the vice chairman and chairman positions in 2018, Zervos said he expected a change in the composition of the Fed as well as its policies.

“We are likely to see these vacancies filled by more rules-based candidates such as John Taylor or those with a similar mindset,” he said. “That on its own makes for a more hawkish Fed and a rise in the path for expected risk-free real rates.”

CFALA’s annual forecast dinner benefits the California Council on Economic Education (CCEE), which provides economic and financial literacy education to K–12 teachers and students to help them make better personal and financial decisions, improving students’ ability to succeed and compete in the global economy. Two teachers received Teacher of the Year awards from CCEE at this year’s dinner: Tina Gauthier of Parkside Elementary School in San Bernardino, and Eunice Lee, of Champs Charter High School in Van Nuys.

Founded in 1931, CFA Society Los Angeles is the local member society of CFA Institute, the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors’ interests come first, markets function at their best, and economies grow. For more information, visit www.cfala.org.

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