When Campaign Rhetoric...
Met Congressional Reality

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What a difference 100 days makes.

It seems like only yesterday that equity investors were giddy with anticipation of an outsized fiscal stimulus while fixed income investors were heading for the exits. Business and consumer confidence spiked, as did equity market valuations and fixed income yields, as investors were overcome with confidence in what the presidential election meant for the economy, inflation, and interest rates. Equity and fixed income investors appeared uniformly certain that President Trump's fiscal stimulus would immediately set sail and find placid waters in Congress.

Fast forward a mere 100 days and the 10-year Treasury rate is below its level the day before the Fed began its current rate hiking cycle, while inflation became deflation in March as consumer prices declined. As we anticipated in our research piece, "Will 1600 Pennsylvania Return to Economic Relevance", investors are instead faced with increasing uncertainty and unpredictability. The failed attempt to pass healthcare reform revealed previously dormant yet meaningful divisions latent within the Republican party with implications for tax policy and infrastructure spending, illustrating that, even when one party controls the presidency and Congress, policy certainty is not a given. Add to this the increasing gap between the President's campaign rhetoric and his actual governance, including his unwillingness to label China a currency manipulator, toned down expectations regarding NAFTA treaty modifications, and a surprising willingness to engage in military action in Syria and around the world, and political campaigns and the reality of governing can be very different.

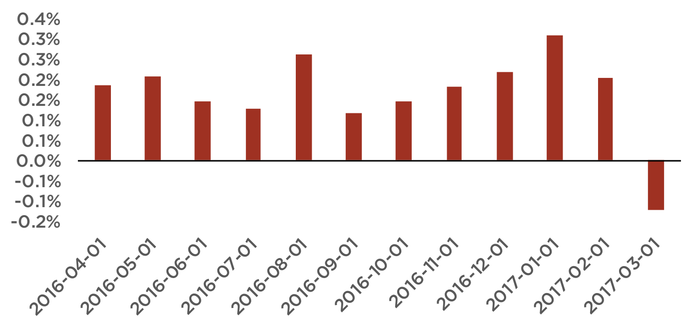
Growth

Fourth quarter 2016 GDP registered a respectable 2.1% growth rate, yet, in what has become an unwelcome recurrence, it is anticipated that the first quarter will once again begin the year with a whimper. While we do not interpret the expected weakness as a change in trend growth, we are keeping a close watch on auto sales, as recent weakness in this sector is the result of more than temporary weather related factors.

Inflation

Reflecting the expected weakness in first quarter economic activity, March consumer prices and core inflation declined, eliminating any arguments that reduced inflation was solely a result of weak energy prices. Absent exogenous shocks, such as a disruption in oil supplies from the Middle East or significant reduction in imported goods, we anticipate continued moderate inflation in the near-term.

Monthly Core Inflation

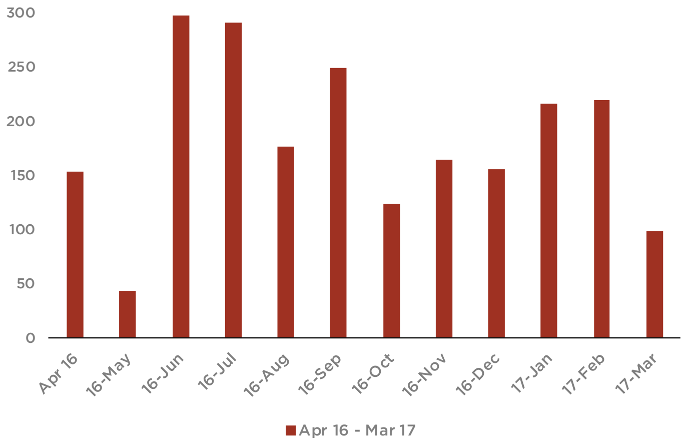


Source: Federal Reserve Bank of St. Louis

Employment and Wage Growth

March employment growth, like inflation, surprised to the downside. Just as January and February employment gains were positively impacted by unseasonably warm weather, March employment numbers were negatively impacted by a return to more normal weather. Despite the weakness, first quarter employment growth was above the fourth quarter's average, and we view March's employment growth weakness to be an anomaly as opposed to a new trend beyond the anticipated gradual deceleration outlined in previous commentaries.

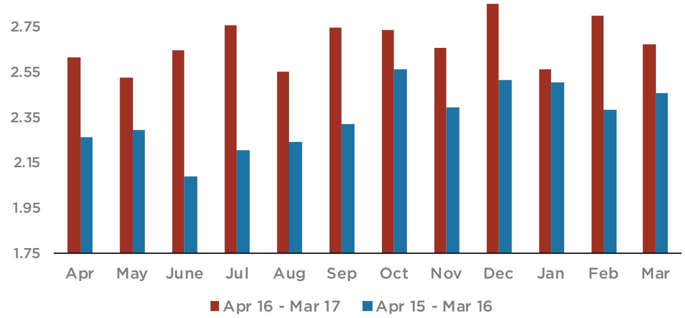
Monthly Employment Change
(in thousands)



Source: Bureau of Labor Statistics

Similarly, wage growth was weaker than anticipated in March, but remains above its 2016 pace, signaling a tighter labor market that can support continued acceleration.

YOY Wage Growth (%)



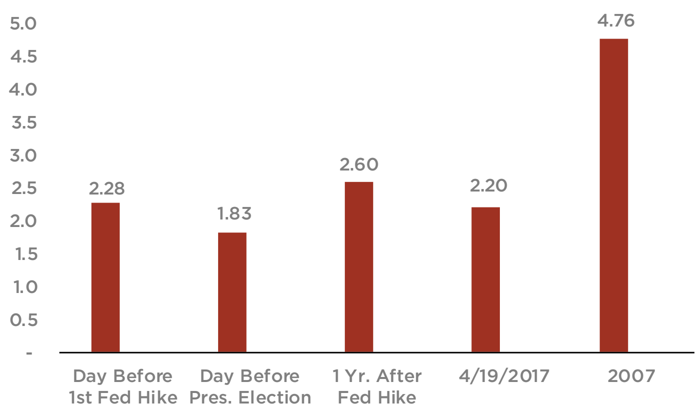
Source: Bureau of Labor Statistics

Interest Rates

While the increase in the LIBOR rate has generally mirrored the increase in short-term rates by the Federal Reserve, the same cannot be said of long-term rates. Even with the Fed raising short-term rates 75 basis points, the 10 year Treasury is now below its December 15, 2015 level when the Fed started the current rate hiking cycle. This divergence reflects several factors, including increasing skepticism by long-term bond investors about a robust fiscal stimulus package and a general flight to safety given the increase in global tensions.

Absent the passage of a surprisingly robust fiscal stimulus package, spike in inflation or selling of U.S. Treasuries by China in an attempt to sustain its currency valuation, we anticipate that the Fed will stick to its stated plan of gradual rate increases while moves in long-term rates will be moderate in nature.

U.S. 10 Year Treasury Rates



Source: U.S. Treasury

Business Confidence and Investment

A significant portion of the anticipated fiscal stimulus following the presidential election rested on tax reform. However, the unsuccessful effort to repeal the Affordable Care Act demonstrated the difficulty in transforming campaign rhetoric into governing reality raising questions regarding the likelihood of both quick and significant tax reform. This has potential downward implications for equity earnings and valuations as well as potential negative implications for business confidence and investment.

If there is a continued divergence between Federal Reserve rate increases and the business community's fading belief in a supportive fiscal policy environment, anticipated economic tailwinds may not materialize while credit headwinds form. We will be closely watching fiscal policy changes and how they impact demand for real estate.

Investment Strategy Implications

If there is one certainty coming out of the first quarter, it is the high degree of policy uncertainty. With our expectations relating to increased policy uncertainty confirmed and the new element of heightened military engagement globally, the prudent course of action remains the disciplined, balanced course set following the presidential election. Given the heightened degree of uncertainty, making large-one sided bets appears to be unwise so long as the future direction of policy implementation remains opaque.

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