By Bill O'Grady and Mark Keller

2017 Outlook

Key Points:

1. The economy will avoid a recession in 2017. GDP growth is expected to average 2.8% with core PCE inflation approaching the Federal Reserve's target of 2.0%.
2. Fixed income markets will be challenging:
    a. We expect three rate hikes of 25 bps each by the FOMC;
    b. Due to rising inflation expectations, 10-year yields will reach 3%;
    c. A swing toward equality and higher inflation would be expected to narrow credit spreads.
3. Equity markets should be strong until Q4:
    a. Basis the S&P 500, our base case is for a 9.2% rise in earnings to $119.45;
    b. Our base P/E model is projecting a fair value of 18.4x;
    c. Our forecast for the S&P 500 is 2400 to be achieved sometime in 2017, most likely by Q3;
        i. Earnings should exceed our base forecast because:
            1. We will see a narrowing of the S&P/Thomson Reuters operating earnings spread;
            2. Corporate tax reform should increase earnings.
        ii. Multiples should also expand due to:
            1. Improved investor sentiment over Trump's victory, although this could wane by Q4;
            2. High levels of "sideline" cash.
    d. We continue to favor domestic over foreign stocks;
    e. We have a bias toward value;
    f. We are neutral on capitalization.
4. Commodity prices will tend to struggle due to dollar strength. Oil prices will average around $55 per barrel due to OPEC's actions to reduce supply.
5. The dollar will remain strong. We would expect the EUR/USD rate to approach $1.00.

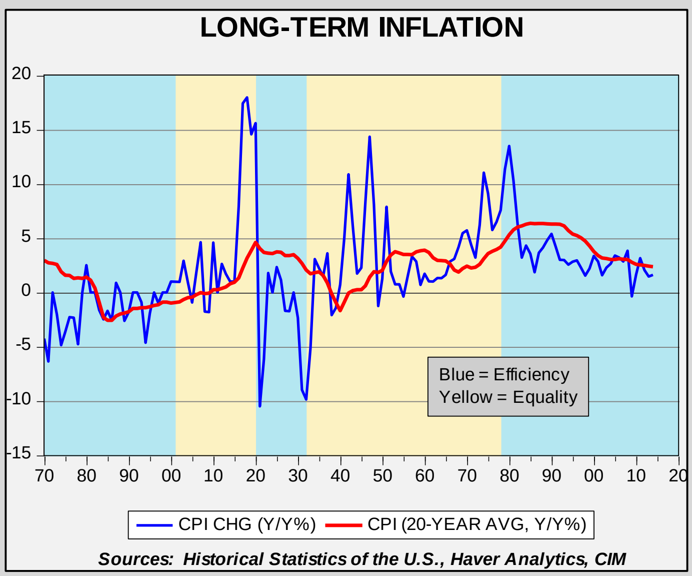
Note: The structure of this report will be somewhat different from our previous forecasts in that we will present a framework for the economy and markets signaled by the election of Donald Trump. We will first offer a basic outline of what Trump represents and use this framework in our forecasts for next year. There are always risks and unknowns about any new president, but the potential for error is elevated as we believe this election clearly signals a change in direction for the economy and the country. Our 2017 Outlook will be affected by these changes, requiring us to discuss at least our initial estimates of the impact of President-elect Trump.

What Trump Represents

There is a natural tendency to assume major changes with a new administration. However, most of the time, the change in power is mostly a continuation of the policies of the previous government. To a great extent, this continuity is necessary to maintain orderly transfers of power. If there were massive policy changes every four to eight years, longer term activities, like investing, would become very difficult. In fact, the founding fathers created a series of checks and balances that temper the ability of an incoming president to make massive changes. At the same time, conditions do change over time and require adjustments. Essentially, to make these adjustments, the political system requires a mandate from the voters strong enough to overwhelm the status quo.

We believe Trump's victory signals that two major shifts are underway. The first is that we are in the process of a change in the "efficiency/equality" cycle. This cycle, best described by Arthur Okun,[1] suggests that American society faces a persistent tradeoff between equality and efficiency. During efficiency cycles, policymakers are focused on building the productive capacity of the economy. In order to boost capacity, policies are created to support supply-side expansion. Marginal tax rates are reduced to foster entrepreneurship. Regulation is reduced to encourage the adoption of new productive methods and technologies. Globalization is often deployed to encourage efficiency. All these measures usually expand the supply side of the economy.

However, these policies carry a cost to society in that they concentrate wealth and income in a smaller portion of households. It is not unusual for lower income households to increase borrowing to maintain their standard of living. Globalization and deregulation weaken labor power. If the process continues, households lack the purchasing power to consume the productive capacity that the supply side of the economy has built. This leads to slower growth and excess capacity that weigh on inflation. Growth weakens further if financial conditions deteriorate, forcing households to reduce debt. Eventually, there is a political reaction against income inequality that leads to a reversal in supply-favoring policies. In other words, we see higher marginal tax rates, reregulation of the economy and trade impediments. These policies reduce income inequality at the cost of constraining the economy's productive capacity. Eventually, inflation begins to rise and the cycle reverses.



Overall, these efficiency/equality cycles can last 30 to 50 years. During these cycles, the policies that foster them become the accepted wisdom and the opposite policies become unthinkable. And so, at inflection points, a shift in the cycle is jarring for investors, workers, politicians and citizens. We believe inflation is the key indicator that signals these shifts.

This chart shows the yearly change in CPI from 1870 forward along with the 20-year average. The average is designed to show the long-term trend in prices. In the absence of accepted cycle dates, we have

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[1] Okun, Arthur (1975). *Equality and Efficiency*. Washington, D.C.: The Brookings Institute.

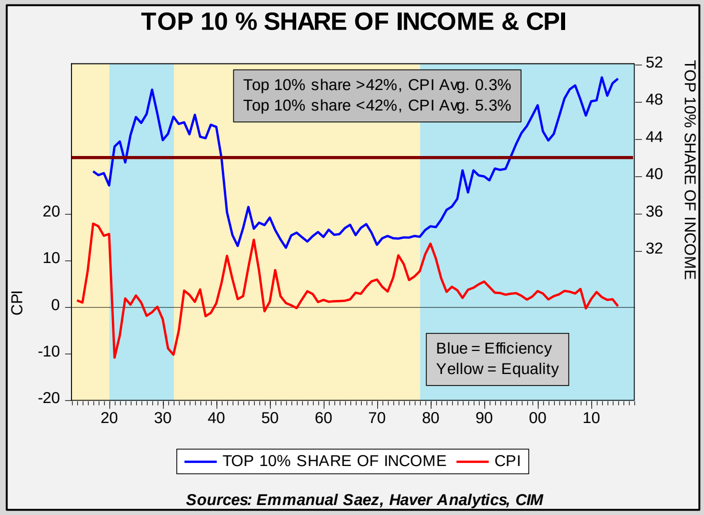
used presidents that marked policy shifts. In general, during efficiency cycles, inflation tends to decline. During equality cycles, inflation tends to rise.

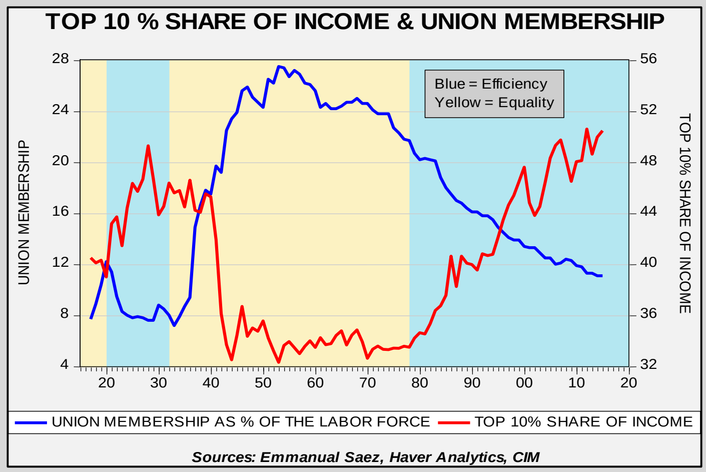
The impact of equality and efficiency cycles is seen on income distribution. Efficiency cycles lower inflation at the cost of rising inequality. Lowering inequality leads to higher inflation due to the weakening of efficiency.

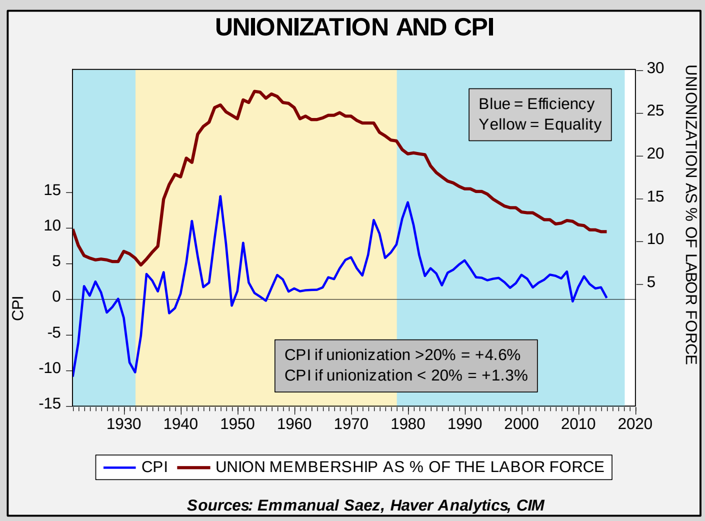
One way that reregulation and deglobalization could be implemented is through regulations that support organized labor.

The bottom chart on this page shows the level of unionization and inflation. In general, higher levels of unionization are accompanied by higher inflation. Again, this is because the policies that foster organized labor often lead to inefficiency by creating rigid labor markets.

The second major shift, which we have been documenting for several years, is that the U.S. appears to be backing away from the superpower role it has managed since 1944. This role entails providing the reserve currency, demilitarizing Europe and Asia and sustaining the colonial borders in the Middle East. Those positions are now in question. The Middle East borders have been unwinding during the Obama administration. President-elect Trump has questioned the need for NATO and has indicated that Japan and South Korea should shoulder more of their own defense. If this trend away from U.S. hegemony continues, the foundations of foreign investing and globalization will be undermined. This will change the risk profile of multinational companies and all foreign investments.[2]







[2] This issue is examined in more detail in our 2017 Geopolitical Outlook.

The Political Trends

Although we didn't predict the Trump Electoral College victory, we did warn that the odds of him winning were higher than the polls were suggesting. We believe the roots of Trump's win can be found in 2008. President Obama's victory was driven by the desire for change—in fact, "hope and change" were the slogans of his campaign. Much of the electorate thought they were getting with President Obama someone more like Sen. Bernie Sanders, a left-wing populist. What they got instead was a center-left establishment president. If the GOP had run a candidate in 2012 that was less establishment than Mitt Romney, Obama probably would have lost. In fact, Obama had a lower voter turnout in 2012, which was unprecedented for a second term president. The bottom 80% of the income brackets want change—they want an economy that creates stable income flows and offers them protection from globalization and deregulation.

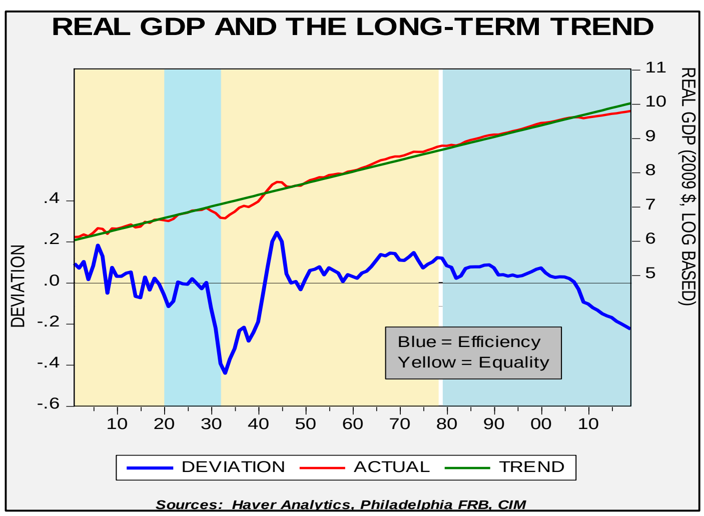
One of President-elect Trump's critical tasks will be to weave together a coalition between the GOP establishment and right-wing populists. We personify this as finding common ground between Speaker Paul Ryan and Steve Bannon, Trump's key advisor, with Ryan representing the establishment and Bannon, the populists. Currently, both sides expect Trump to deliver all their desired policy goals. However, that will be impossible because the policy goals of the establishment (lower taxes, less regulation, more immigration, greater efficiency, more trade) conflict with what the populists desire (protection against globalization which will entail less trade, less immigration and increased regulation). If Trump sides completely with the establishment, he will likely lose in 2020 to a more populist candidate. If he sides completely with the populists, it could seriously damage the economy. Thus, he needs to placate each side which will require giving both enough to make them happy and, at the same time, support economic growth.

We strongly suspect that Trump's proposed policy changes will, to some degree, lead to less efficiency and a steady rise in inflation. If our analysis is correct, it will mean higher interest rates, stronger U.S. economic growth, a more dangerous world and mixed effects on commodity prices, the dollar and equities. It is this backdrop that colors our 2017 outlook.

The Economy

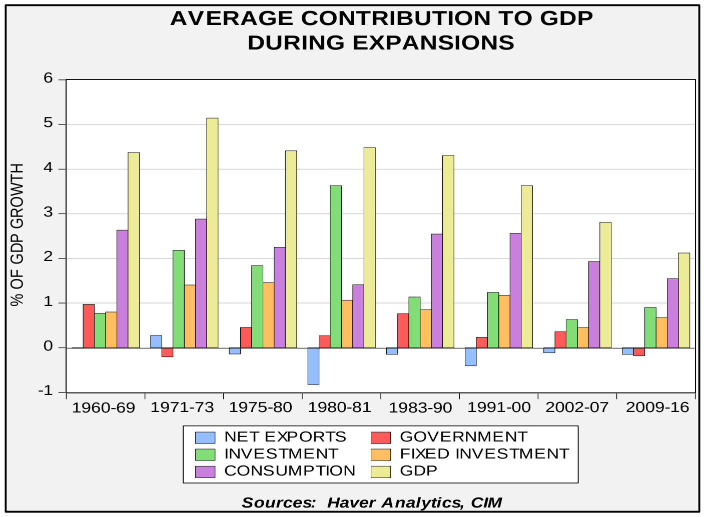
Slow economic growth has exacerbated political tensions.

This chart shows real GDP since 1901 with forecasts from the Philadelphia FRB for the years 2017-19. We have marked the equality and efficiency cycles. The last cycle shift from efficiency to equality occurred during the Great Depression and was characterized by GDP well below its long-term trend. Extended below-trend economic growth increases the likelihood of political tensions.



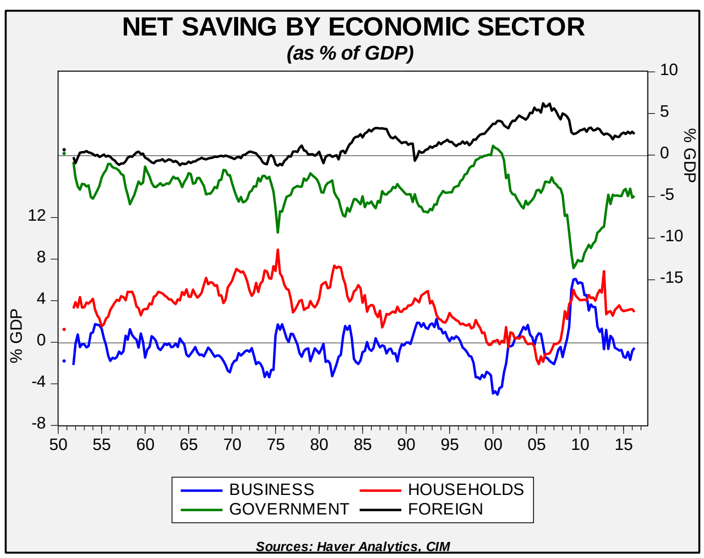
Another way of looking at this situation is through the contributions to GDP growth.

This chart shows the contribution to GDP from the four major sectors, the contribution from fixed investment alone, which excludes inventories, and the overall growth of GDP over each expansion since 1960. Since 1980, when the efficiency cycle became fully operational, net exports have been a persistent drag on growth. Average growth has steadily declined in each business cycle and consumption has steadily become a larger share of average growth. In the first four expansions, from 1960 through 1981, the contribution from consumption accounted for 49.7% of GDP growth. In the last four, this number has expanded to 67.9%. This means, of course, that the other three components of GDP have contributed less to GDP, meaning the economy has become increasingly dependent on consumption.



Rebalancing the economy away from the excessive dependence on consumption, which would require higher government spending and investment and a smaller drag from net exports, would make sense. However, the reserve currency role, as currently structured, requires the U.S. to run trade deficits in order to provide global liquidity for trade. If the U.S. stopped providing dollars to the world via the trade deficit, the U.S economy would likely boost investment to provide goods currently sourced overseas. Of course, this would lift inflation and reduce economic growth outside the U.S., increasing global tensions.[3]

The other obvious action the government could take to boost growth would be to expand government spending. Infrastructure spending was a plank in both parties' platforms this election year. The difficulty is to find public investment projects that generate a positive return. Replacing "crumbling" infrastructure clearly needs to be done but that spending will tend to only lift growth while the work is underway because the positive effects of the initial investment have already occurred. In other words, the positive return from building the interstate highway system can only occur once. So, if President Trump boosts infrastructure spending, we would expect a lift in growth; the longevity of that growth after the spending occurs will depend on the wisdom level of the investment.



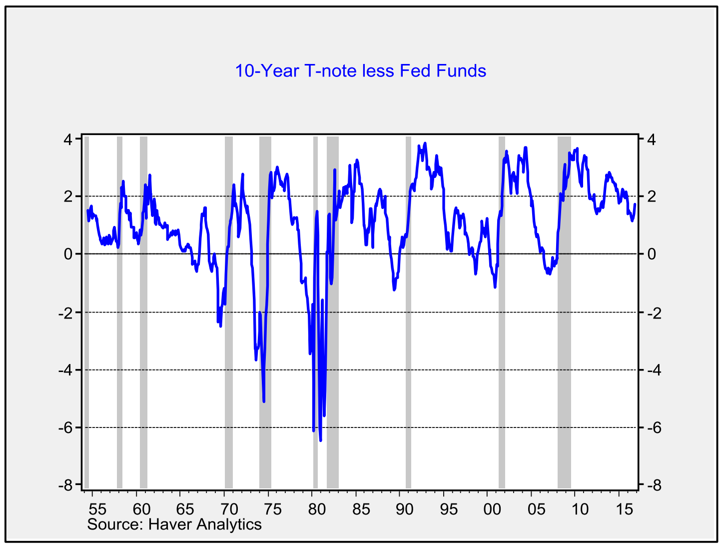
One way to view the potential changes to the economy is by examining the impact on net savings. Macroeconomic identities show that net saving for the entire economy is always zero; one sector's saving is another sector's spending. If Trump's policies change trade policy, it will have an impact on saving/dissaving flows.

Foreign saving is the inverse of the U.S. current account; a deficit is an import of foreign saving. The government sector is

[3] The change in the U.S. hegemonic role is one of the key issues we discuss in the [2017 Geopolitical Outlook](#).

the fiscal balance. Business and household savings are savings that remain after investment. Note that prior to the early 1980s, the household sector provided all the savings required for business and government; the current account deficit was negligible. The increase in foreign saving to the economy after 1982 was absorbed by falling household saving (which eventually led to dissaving just before the financial crisis) and larger government dissaving. The business sector's saving patterns became increasingly erratic over time. If the trade deficit is going to narrow, which will result in less foreign saving, and if the fiscal deficit is going to rise due to increased spending, business and/or household saving will need to increase. Increasing wages to households or boosting after-tax income through tax cuts could accomplish this outcome. However, the important takeaway from this analysis is that Trump's proposals have the potential to bring a serious restructuring to the U.S. economy.

So, what can we expect from the economy in 2017? **We are projecting real GDP growth of 2.8% in 2017. At the same time, the potential for inflation will also increase, with core PCE approaching the Fed's target of 2%.**



We are not forecasting a recession in 2017; the yield curve, whose inversion has predicted the past seven recessions, is comfortably above zero. Our concern about a recession would rise if Treasury yields fall as the FOMC raises its fed funds target. However, we would note that the yield curve has steepened since Trump's election, likely anticipating stronger growth.

Avoiding a recession will depend on how well the economy manages rising interest rates and dollar strength, which are happening currently, without the promised fiscal support, which will take longer to materialize. Our base case is that the economy will manage the transition without a recession, but the chances of recession could rise the longer it takes for fiscal stimulus to kick in (other factors are the uncertainty surrounding the method and size of the stimulus). Thus, this will be an important issue to monitor next year.

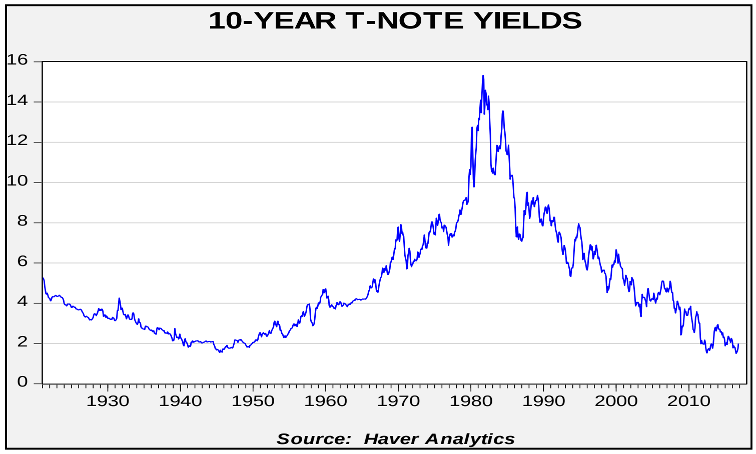
Interest Rates

An immediate impact of Trump's win was a boost in 10-year T-note yields.

(Source: Bloomberg)

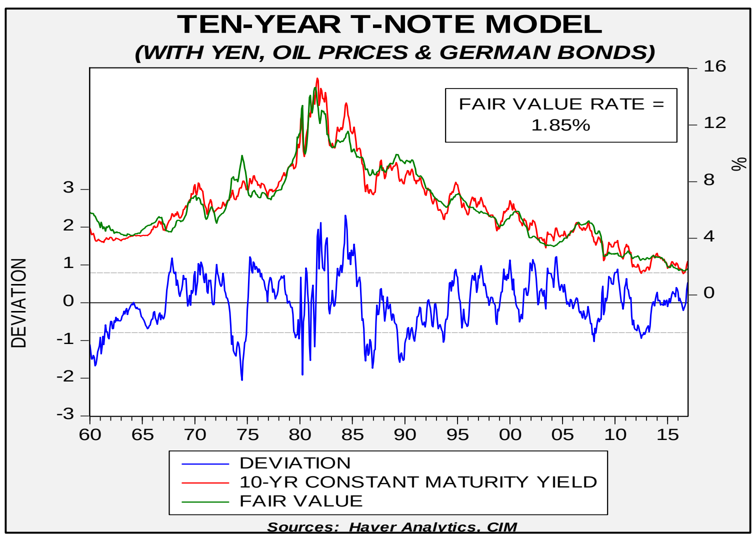
A week before the election, 10-year yields were just below 1.80%; in the aftermath, rates have jumped over 70 bps. Although this reaction is probably a bit excessive, it does suggest the financial markets are expecting that the combination of fiscal spending, improving GDP growth and rising inflation will lead to higher interest rates. The above analysis that suggests the U.S. is shifting to an equality cycle does raise the likelihood that the bond bull market that began in the early 1980s is probably over. That doesn't necessarily mean that interest rates will spike higher, but it does suggest that rates will steadily rise over time.

This chart shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Our base case is that we will see a similar bear market cycle develop in bonds, meaning that yields will rise gradually over time. However, inflation expectations could lead to a much stronger reaction from the interest rate markets.



In the short run, we believe this move in Treasury rates is excessive and we would expect to see a retreat in long rates.

Our basis bond model that uses fed funds, an inflation expectations proxy, the JPY/USD exchange rate, oil prices and German bond yields is projecting a fair value. Ten-year Treasury notes are a bit undervalued at current levels. In fact, a yield of 2.40% has already factored in fed funds at 1.25% and German bond yields of 1.0%. Oil at $65 per barrel only increases the fair value yield to 2.45%. Thus, current yields have already discounted a good bit of bearish news.

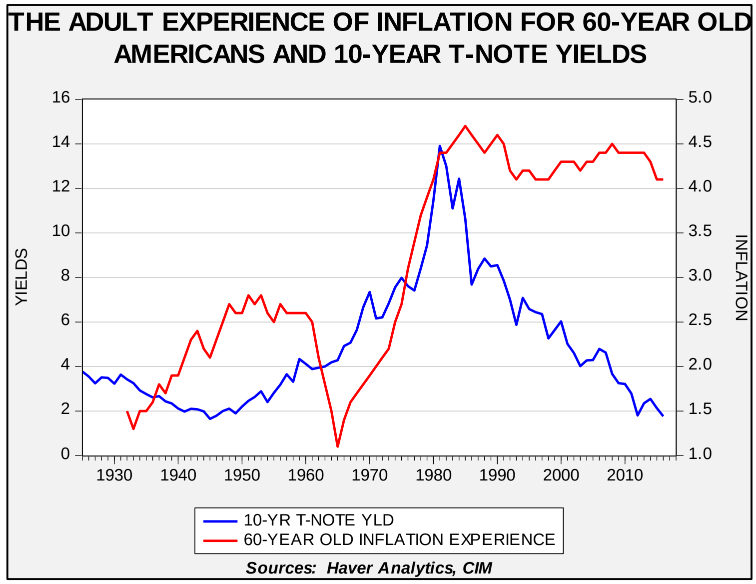


One of the key elements of monetary economic theory is that nominal yields = real yields + inflation expectations. Over the years, the actual real yield[4] has averaged 2.0%. Inflation expectations tend to be established over a lifetime of experience.

In terms of inflation expectations, we took the annual CPI rate from 1872 to the present and calculated the average inflation rate that a 60-year-old has experienced from ages 16 to 60. We use 60-year-olds because we assume that this age group has the greatest influence on economic and monetary policy.[5] Simply put, most senior policymakers are around this age meaning that their experience will tend to color their inflation expectations.

[4] Real yield = nominal yield - y/y% change in inflation.
[5] It has nothing to do with the fact that both Mark and Bill turned 60 in 2016. Really.

One of our concerns is that when we began the last bond bear market, the inflation experience of 60-year-olds was less than 3.0% and stable. Not only that, but by the early 1960s, the "Depression Generation" was in charge of policy and they had an adult experience of very low inflation. This experience would be expected to lower their inflation expectations, making them less concerned about rising current inflation and thus more willing to buy bonds at lower yields compared to the current inflation rate. From the mid-1960s into the early 1980s, each new cohort of 60-year-olds had experienced higher inflation which led to rapidly rising bond yields. Using the aforementioned 10-year T-note model and inflation expectations of 4.2% (consistent with a 60-year-old adult's experience of inflation), fair value is nearly 4.0%.



So, why did bond yields steadily decline despite persistently high inflation expectations? As we note above, economic and regulatory policy were designed for efficiency. Monetary policy, especially in the early 1980s, led to high enough rates to woo assets into fixed income, and regulatory policy supported globalization and deregulation, which kept inflation persistently below the inflation experience of this key age cohort.

The problem markets could face is that if we are in the midst of a change to an equality cycle, which presages higher inflation, the inflation experience of 60-year-olds could trigger a form of "inflation panic." In other words, Americans in their late 50s and early 60s directly experienced the 1970s inflation crisis and demand higher yields at a much quicker pace than their predecessors. Again, this is not our base case but it is an issue we will be monitoring closely. If rates move faster than we expect, it could adversely affect the economy as well.

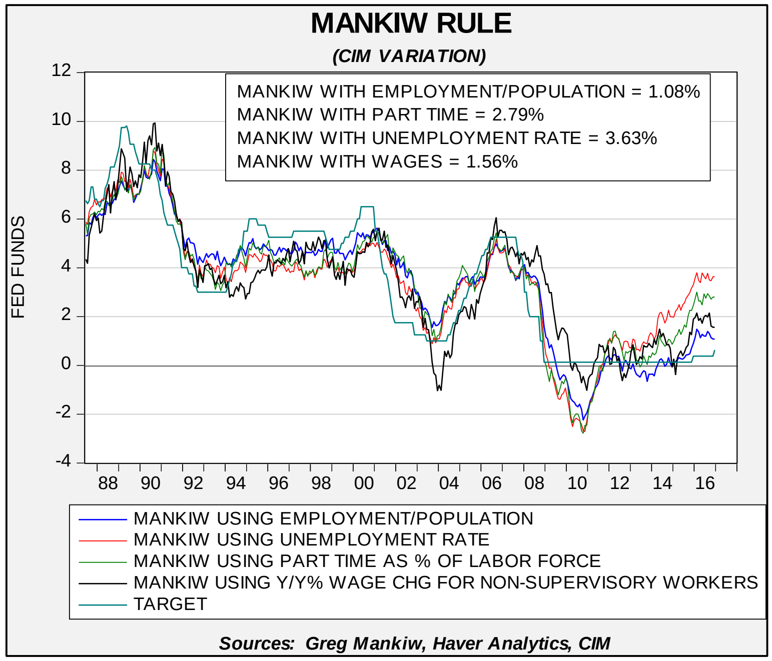
Our base case for the 10-year T-note through 2017 is to see yields at 3%. That assumes a rise in inflation expectations to 3%, a fed funds year-end target of 1.375%, oil prices at $55 per barrel, a JPY/USD exchange rate of 120 and German bond yields at 75 bps.

In terms of monetary policy, based off the Phillips Curve,[6] the FOMC is behind the curve and needs to raise rates.

One of the ways we measure policy is through the Mankiw Rule. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers. In all cases, our models indicate

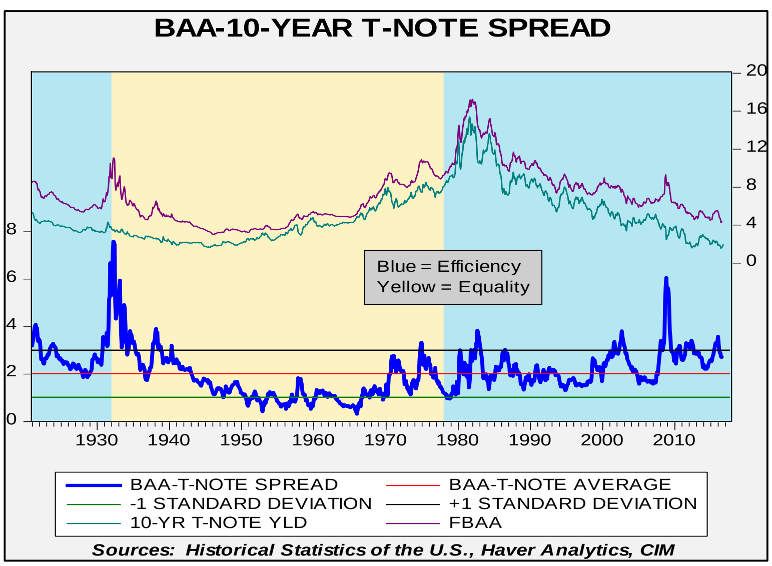
[6] The theory that there is a tradeoff between unemployment and inflation.

that the FOMC needs to raise rates as there is only modest slack in the economy. How much slack depends on which one of the above numbers best captures the degree of slack. The doves on the committee tend to rely on the employment/population ratio; the hawks usually opt for the unemployment rate. For now, we expect a moderately dovish Fed and a 2017 year-end rate of about 1.375%.



However, this is another area where President-elect Trump could affect policy. There are two governor openings on the FOMC that will likely be filled by the incoming president. Most early commentary presumes that Trump will fill these positions with hawks, a position consistent with the establishment wing of the GOP. However, given Trump's background in real estate development and the need to support populists, we think this expectation may be premature—it's quite possible Trump will opt for doves. Perhaps these appointments more than any others will offer the clearest signal as to how Trump will manage the Ryan/Bannon poles.

Fixed income investing is really about managing two risks, duration and credit. If we are moving into an equality cycle, investors will want to shun duration risk and accept credit risk. Fiscal stimulus and rising inflation favor debtors over creditors. Thus, default risk should ease while long-term interest rates rise.

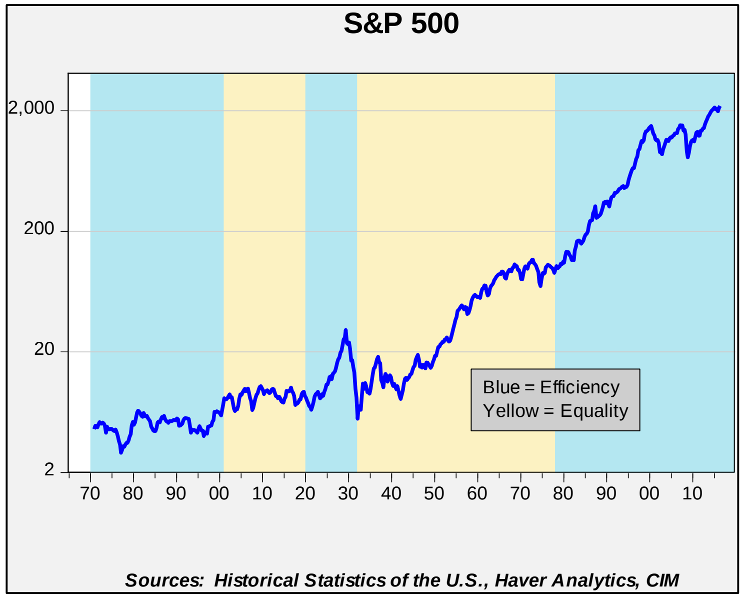


This chart shows the Baa-10-year T-note relationship. Note that credit spreads narrowed persistently below average during the last equality cycle. We would expect narrower spreads in the coming years with higher overall interest rates.

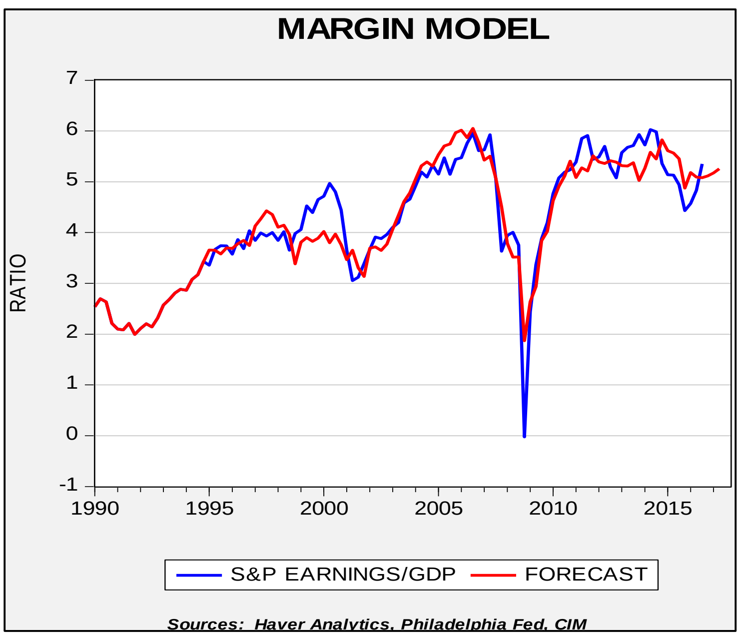
Equity Markets

Although it would stand to reason that the equity market should favor efficiency cycles because of low inflation and policies designed to favor capital over labor, the actual behavior is rather nuanced.

In the last three cycles of either type, equities eventually performed well. A case can be made that equities tend to stall in a very mature cycle of either type. This may be due to the fact that in the late stages of either an efficiency or equality cycle it begins to become apparent to investors that change is necessary. It is possible that the last efficiency cycle ended in 2008 with President Obama's election. If so, the efficiency cycle ended with a period of sideways market action. Note that the last equality cycle tended to end in a similar fashion.



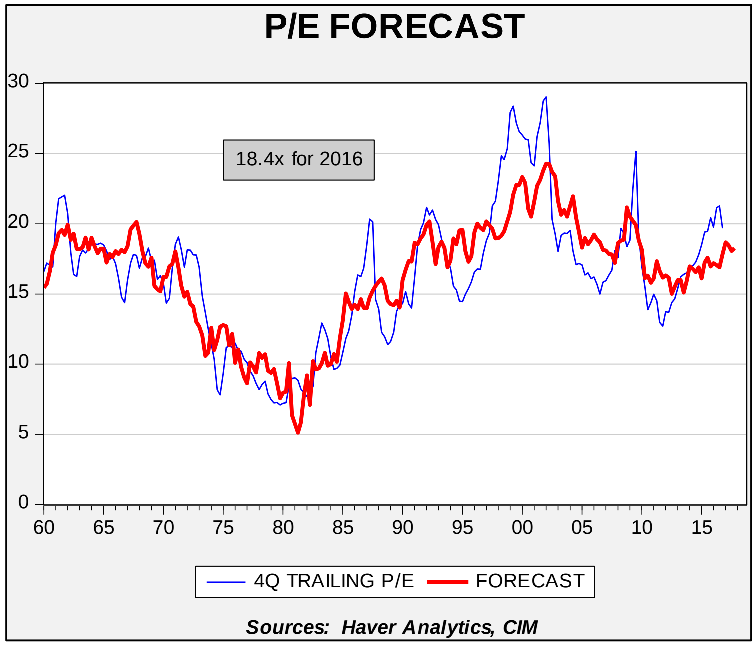
For 2017, basis the S&P, we expect continued strong margins.



This chart measures S&P earnings relative to GDP. Our forecast, shown in red, is indicating that S&P earnings should reach about 5.25% of GDP. Given our expectations for nominal GDP, that would put earnings at $119.45.[7]

[7] This calculation is basis operating earnings from S&P; the media mostly quotes operating earnings data from Thomson Reuters. Although the difference between these numbers is usually slight, the difference recently has been significant at $15.79 per share through Q3 on a rolling four-quarter basis. We believe the S&P data is more reliable; however, using the Thomson Reuters data will bring a lower P/E than what we will be showing in this report.

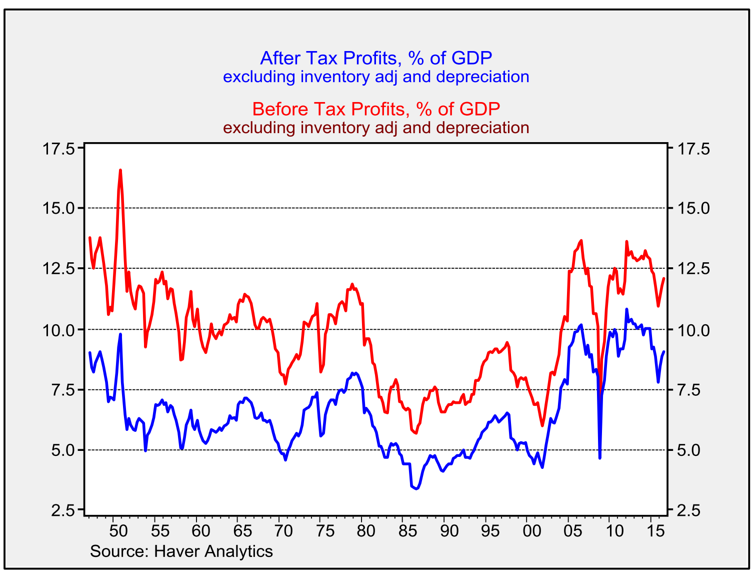
Our P/E model, which uses demographics, credit spreads, fed funds, inflation trends and consumer sentiment, projects an 18.4x multiple for the S&P 500.



Using this P/E and our earnings number generates an S&P 500 value of 2197.88. **However, as we will outline below, there is a strong case to be made that margins may rise; this increase leads us to forecast the S&P 500 at 2400 next year.**

Here is why we think earnings may exceed our baseline expectations. First, as discussed in footnote #6, the spread is significant between S&P and Thomson Reuters operating earnings numbers. The current Thomson Reuters consensus estimate is $132.61, which implies some narrowing of the spread between the two sources, but using our P/E would generate a forecast of 2440. Simply put, if the spread between the two reporting agencies narrows toward the Thomson Reuters level, earnings will grow faster than our margin model is indicating.

Second, corporate tax reform could boost earnings as well. President-elect Trump campaigned on lowering corporate taxes.

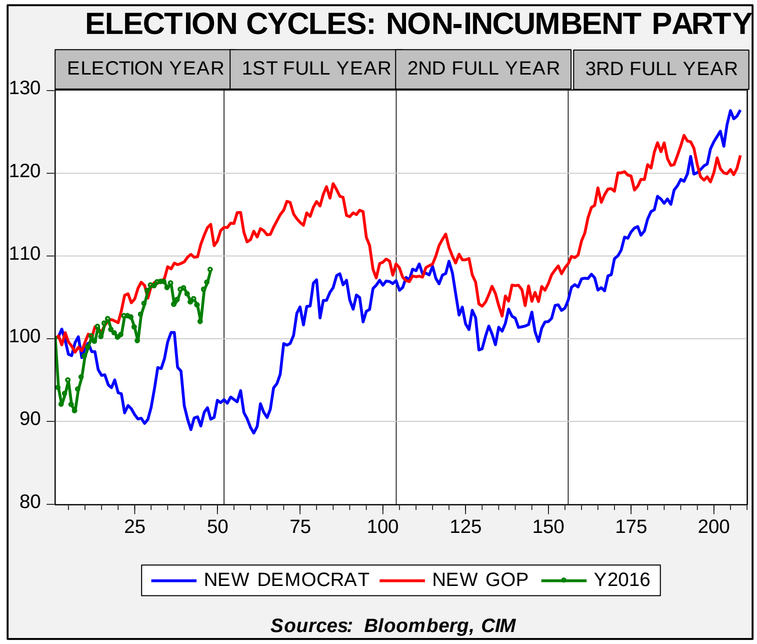


This chart shows the difference between before- and after-tax profits from the National Income and Product Accounts.[8] The current spread is around 300 bps. If corporate taxes are reduced, it would directly add to S&P earnings. Of course, until legislation is passed, there is no way to determine with any degree of accuracy how the tax adjustment would raise earnings. But, we would expect equity investors to anticipate higher earnings from tax reform. Until the tax reform occurs, this expectation would be expressed by multiple expansion.

Third, there is usually a bit of "euphoria" with a new GOP president.

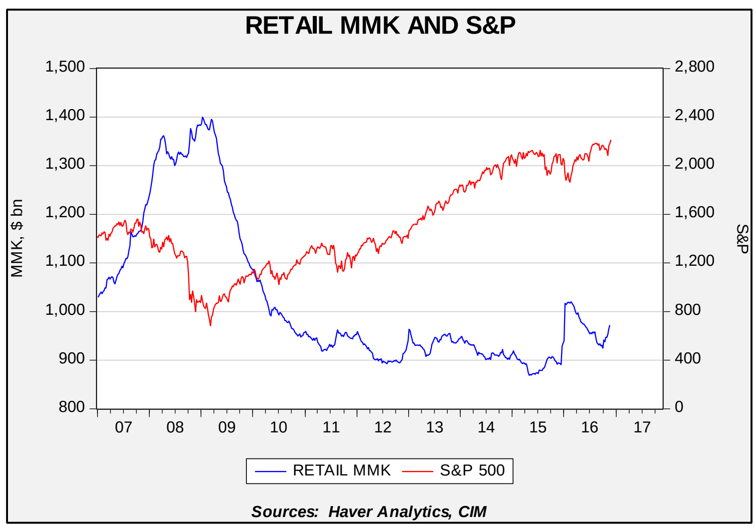
[8] From the GDP data.

This chart looks at the weekly indexed behavior of the S&P 500 beginning in 1928. We index the data to the first Friday close of the year of the election, meaning that the actual results are not known until Q4 of the first year on the chart. As this chart shows, party changes for president tend to favor Republican presidents. Again, two Democratic Party presidents, Franklin Roosevelt and Barack Obama, came into office in the face of a bear market. Still, the data does show that equity markets, at least initially, tend to prefer new Republican presidents. This data projects an S&P 500 level of 2370.97 in Q3 2017; the year-end target would be 2235.33.



Fourth, it appears that households are still holding rather large cash positions. Positive sentiment toward the new president will likely bring some of this money into equities.

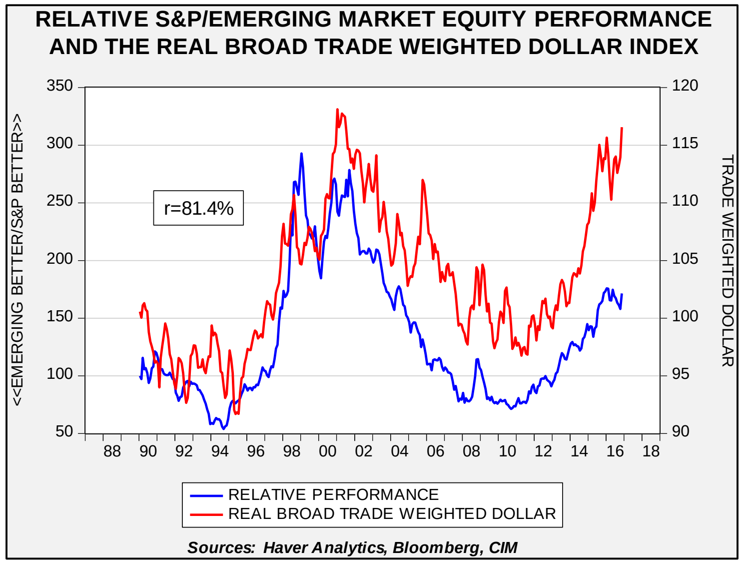
Since the crash, the "stall point" for equities tends to occur when retail money market funds fall to $900 bn or less. Late last year, money market funds jumped as the FOMC raised rates; cash levels have remained elevated, although they have declined since Q1. Going into the election, it appears that households built up their cash positions. With $972 bn in retail money market holdings, there appears to be ample liquidity available to lift equity values.



For equities, 2017 will have a rather large set of "known/unknowns." We could see weakness develop if inflation fears trigger more rate hikes than the market expects. Currently, expectations call for three hikes next year. The dollar's rise and higher long-term interest rates are tightening financial conditions; if this environment continues, it will be difficult for equities to make further headway. **Overall, we believe that the election cycle data is a reasonable pattern for 2017; if true, we will start the year with equity gains that will fade into year's end. This would fit the notion that, at present, investors are projecting their best expectations on the new president. By Q3, some degree of disappointment is likely to emerge.**

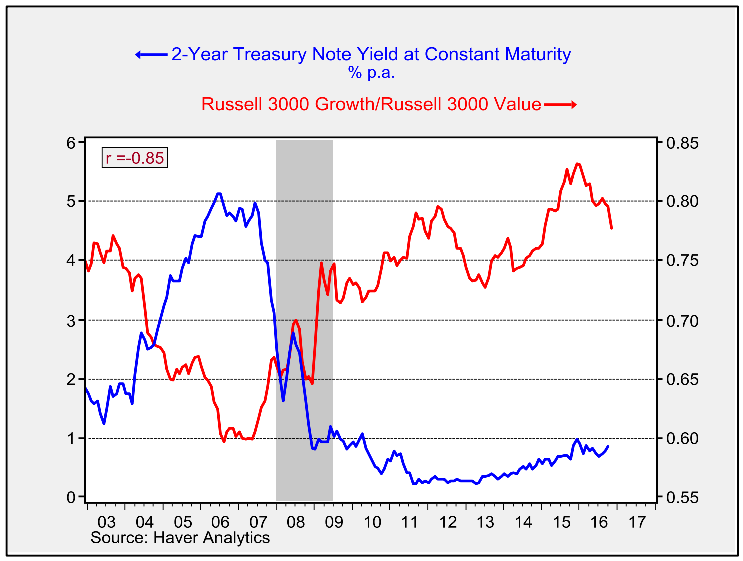
In terms of other areas of equities, we expect foreign markets to face the headwind of a stronger dollar. Dollar strength is particularly critical for emerging markets.

This chart shows the relative performance of the S&P 500 compared to the MSCI Emerging Market Index along with the JPM Dollar Index. As the chart shows, domestic equities tend to outperform during periods of dollar strength. There are two reasons for this condition. First, many emerging market nations are commodity producers and dollar strength tends to weaken commodity prices. Second, emerging economies often borrow in dollars to reduce debt service costs. As long as the dollar is stable or weaker, this is an attractive strategy. However, during periods of dollar strength, this strategy leads to rising borrowing costs.



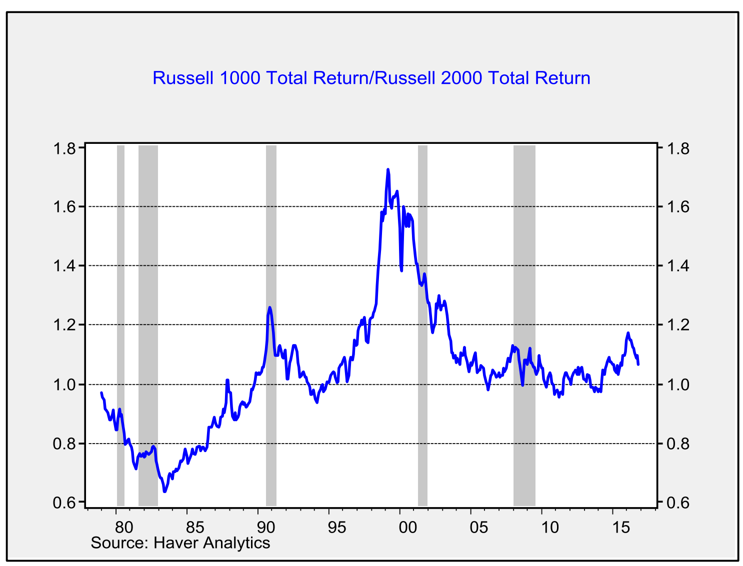
In terms of growth and value, accommodative monetary policy tends to favor growth on a trend basis.

This next chart shows the Russell 3000 growth/value ratio with the two-year T-note yield. The correlation between the two is -85%, suggesting that rising short-term rates favor value.



In terms of capitalization, there is not an obvious bias in 2017. In the past, a stronger dollar has tended to favor small caps but tighter monetary policy was better for large caps on a relative basis. However, the underlying trend between the two has been mostly sideways.

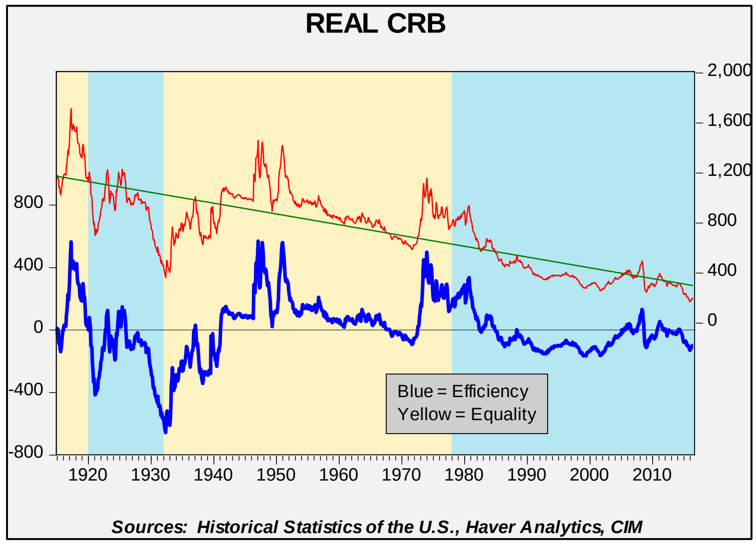
Since 2013, as monetary policy started to tighten (as Bernanke introduced QE tapering), large caps have tended to outperform. However, this year, small caps have performed better. We are clearly not seeing the secular trend favoring large caps as we saw from 1983 to 2000. For this year, we would carry a neutral bias toward the two classes.



Finally, in terms of sectors, we have seen violent shifts since the election. Interest-rate sensitive sectors, such as utilities and telecom, have suffered. Cyclical sectors, such as energy and industrials, have lifted on expectations of stronger growth. However, financials have seen the most impressive shift as they are expected to benefit from the combination of higher interest rates and regulatory relief. Working from the usual pattern after the election of a new GOP president, we would expect these trends to continue into 2017. However, some moderation is likely as we head into late 2017 as a degree of disappointment filters into financial markets.

Commodities

Although commodity prices, adjusted for inflation, tend to fall over time, they tend to spend more time above trend than below during equality phases.



This chart shows the CRB commodity index, deflated by U.S. CPI. We have regressed a time-trend through the data. Currently, commodity prices are running below their long-term trend. Note that in the last equality cycle, prices from 1940 forward were mostly above trend. Obviously, war played a role in boosting commodities but, in general, equality cycles tend to lift inflation which is supportive for commodity prices.

For next year, there are two key issues we are watching closely, monetary policy and the dollar. Since the election, the dollar has been rising and this would be a bearish factor if it continues. Related to dollar strength is the path of monetary policy. If the FOMC raises rates faster than three hikes next year, the dollar will likely move significantly higher. To weaken the dollar, the Fed would have to make clear that its plans include either only one hike or no hikes.

OPEC has made an agreement that has lifted oil prices. Although the cartel's action is bullish for oil prices, current oil prices have discounted over 100 mb of inventory declines in the U.S., assuming a steady dollar. Simply put, oil prices have gotten a bit ahead of themselves and if the inflation that follows from higher oil prices leads to tighter monetary policy, it will be difficult for oil prices to hold their gains. Thus, we expect oil prices to stabilize after recent gains until there is evidence of tightening supply.

As long as the dollar remains firm and monetary policy is on track to tighten, the outlook for commodities is bearish. Similar to what we expect for equities, we may easily see commodities struggle until later in 2017. Commodities could rally later in the year if it appears that monetary policy won't tighten further and the dollar weakens. However, outside of oil and perhaps industrial metals (the latter benefiting from infrastructure spending), dollar strength and rising interest rates will have a dampening impact on this sector. Gold is especially vulnerable to a stronger dollar and tightening monetary policy. At the same time, if trade frictions rise or the incoming president's foreign policy leads to geopolitical uncertainty, gold may find support later in 2017.

Foreign Exchange

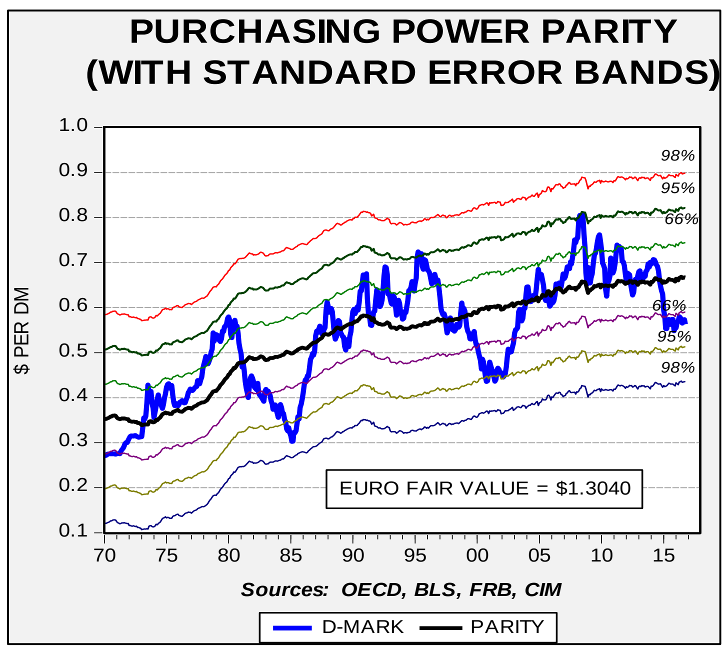
The dollar's strength since the election has mostly been due to an analog narrative; market commentary is leaning toward a repeat of the Volcker/Reagan policy mix of tight monetary and expansionary fiscal policy.

Trump campaigned for fiscal expansion, which could include both infrastructure spending and tax cuts. The expected fiscal expansion could lead to tighter monetary policy and this particular combination is usually thought to be bullish for the dollar.

Monetary/ Fiscal	**Austerity/spending cuts, tax increases**	**Expansion/spending increases, tax cuts**
Tight monetary policy	Modestly dollar bullish (Quadrant 1)	Strongly dollar bullish (Quadrant 2)
Loose monetary policy	Dollar bearish (Quadrant 3)	Strongly dollar bearish (Quadrant 4)

This box describes the expected outcomes from the interplay of fiscal and monetary policy. This is a rough guide; the actual outcomes are mostly driven by the degree of policy adjustment. In the early 1980s, the combination of real fed funds of nearly 8.5% and a fiscal deficit of almost 6% of GDP led to a very strong dollar (the "Volcker dollar" shown in quadrant 2). Market behavior may be anticipating a repeat of this outcome.

However, this assumption depends on the FOMC moving to tighter policy, almost a "hard money" stance of the Volcker years. As discussed above, we don't know for sure whether this will be the outcome. The political struggle in the Trump administration between the GOP establishment, represented by Speaker Paul Ryan, and right-wing populists, personified by advisor Steve Bannon, has not yet been resolved. The markets and most pundits seem to be arguing that Trump will fill two open governor positions on the FOMC with hard money types. If that is the case, we would see a quadrant 2 outcome on the above table. On the other hand, if Bannon's wing wins, it is possible that we will see doves appointed to the Federal Reserve. That scenario could lead to a quadrant 4 outcome, which would be quite different from what the market expects.



The policy situation isn't the only supporting factor for a stronger dollar. It is estimated that over $2.0 trillion is held by U.S. companies offshore in order to avoid corporate taxes. If corporate taxes are reformed, at least some of this money will come back home which would lift the dollar. If Trump were to put up trade barriers as promised, the current account deficit would shrink, which would reduce the supply of dollars and boost the dollar's value as well. Thus, for now, we expect the dollar to get the benefit of the doubt and likely continue to appreciate.

This chart shows a purchasing power parity model, which values exchange rates based on relative inflation rates. We use the D-mark and German inflation as a proxy for the Eurozone (after 2000). Currently, the D-mark is undervalued, running below one standard error of parity. If we reach two standard errors, the Euro/dollar rate would be $1.00. Note that in 1985, at the peak of the Volcker/Reagan dollar bull market, the D-mark actually fell below two standard errors. For now, we would expect the dollar to move toward parity with the euro.

Conclusion
Although we do not expect a recession this year, this expansion is now the fourth longest on record and will reach the third longest if a recession doesn't occur early in 2017. We believe the elections of 2008 and 2016 signal a shift from efficiency to equality. This is a significant long-term factor that will have some impact on the economy and markets in 2017, and a larger effect in the coming years. This shift will lead to higher inflation over time which will adversely affect financial markets.

It should be noted that this process will take a number of years to develop; although the shift will make investing more challenging, we do believe that the changes can be managed with an understanding of underlying trends.

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This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.