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"By The Way"

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Vice President

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In the last letter I got off to a strong start by suggesting the pollsters and the media were underestimating the positive response Trump was getting from middle Americans, who would vote for him to affect change in Washington despite his many obvious faults. But then I expressed a concern such a result would be neutral for markets if not a negative. How wrong I was. It was another example that despite economic and geopolitical risks such as Brexit and the election campaign, the resilience of stocks, in particular the S&P 500, has been impressive. Markets have come a long way since last February when the S&P was experiencing its worst start to a year in history, and was down 20%+ from the highs, but in the face of some weak economic reports, negative world news and now a raise in rates by the Fed, the market is up almost 13% year-to-date. While the rate of increase since the election is unsustainable and a pullback or consolidation makes sense, there are now a growing number of fundamental reasons to remain positive for 2017.

We noted in the last letter there has been an improvement in Purchasing Manager Indices in many countries. Now we can add that Leading Economic Indicators around the world are also showing signs of growth (Even Canada is showing an LEI of 100.1 – up 0.7% in the last 6 months.) Perhaps most importantly for the S&P is the better outlook for earnings per share. The current first call estimate for 2016 is $118.25, which is almost exactly that same as the $118.78 earned in 2014. However, the estimate for 2017 is now at $131.00, which is about a 10% increase year-over-year. In addition, the Citigroup global "Earnings Revision Index" reported estimates were higher by 10% for the week ended December 9th after increasing 7% the previous week. Having an earnings driven market with a stable valuation base, is more compelling than one fueled by an overabundance of liquidity. Technical indicators are almost uniformly positive, although extended. One concern is that sentiment indicators are at levels that suggest too many people are bullish, which is a contrarian indicator. A quote from Mark Twain seems appropriate: "Whenever you find yourself on the side of majority, it is time to pause and reflect."

I think we can all agree Mr. Trump is a game-changer, for good or bad. I am alternately amused, aghast, anxious and angry by his outbursts, and no one can be comfortable with the way he treats certain people or groups of people. Still, this is not a letter about social issues, and at least on the surface this is an administration that should be business friendly. He is unpredictable and prone to changing his mind, but here are my best guesses on what will transpire in the next year that will affect markets:

Trade: He will withdraw from the Trans Pacific Partnership. NAFTA will be reviewed. I believe this will be more of an issue for Mexico than Canada (and the Keystone Pipeline will be approved). This in my mind is a big area of risk, since the potential for a trade war could become very real if Trump goes too far. History strongly suggests protectionism on the part of the U.S. in the 1930's turned what was a severe recession into the Great Depression.

Taxes: Rates will be reduced. The U.S. currently has the highest corporate tax rate among developed nations at 35%. The best guess is the new rate will be lowered to 20%, (a recent Thompson Reuters study stated that for each 1% decrease S&P earnings per share would increase by $1.30) but that will be mitigated by a significant decrease in deductions. Also the plan will have to be revenue neutral to be approved by his own party in Congress.

Regulation: Trump wants to effect a large decrease and he can begin by unilaterally revoking any regulation that Obama instituted by executive order. Anything more will have to be approved by Congress, but any amount of decline in regulation is a positive for U.S. companies, and therefore stocks.

I believe the Trump victory and Brexit should not be viewed as aberrations, but rather as part of global movement referred to as "populism". The revolt of the "have-nots" or "left-outs" in society is no longer just about protests and sit-ins on Wall Street, but has moved to the voting booth where its effect will be more powerful. The implications for financial markets are difficult to predict but this trend deserves to be a factor in everyone's investment outlook.

The markets could use a pullback or consolidation in the new year to gather renewed strength, but barring a major negative geopolitical event, (of which there are many possibilities, elections in Europe, Brexit being triggered, Trump tweets) improving fundamentals and technicals continue to argue for higher markets in 2017, Mr. Twain notwithstanding.

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