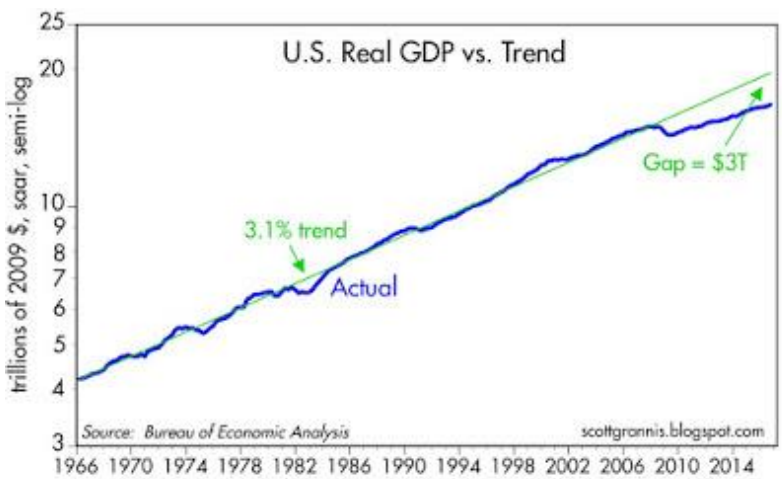
There's something happening here
What it is ain't exactly clear

-Buffalo Springfield

As a new Administration takes office and our collective fears and hopes collide, we are all still left wondering - what did the election mean? Many will contend it meant little as President Trump lost the popular vote by the largest amount ever for a candidate carrying the Electoral College. Others cheer that there is a new form of populism arising calling for new social and economic policies in the country. While the answer certainly is not yet clear, we do know, according to the 1960's rock band Buffalo Springfield, "that nobody's right if everybody's wrong." For what it's worth, we offer our thoughts.

Though we could discuss all day what shifted the vote, as with most elections, we believe the deciding issue was the economy. While the stock market has gone up each of the last eight years, the economy has grown at a subpar pace (as shown in the following chart). This has contributed to growing income disparities and frustrations across a wide portion of our nation. While President Obama leaves office with solid approval ratings, people were also saying by nearly a 2-to-1 margin on election day that the country was on the wrong track. How can this be?



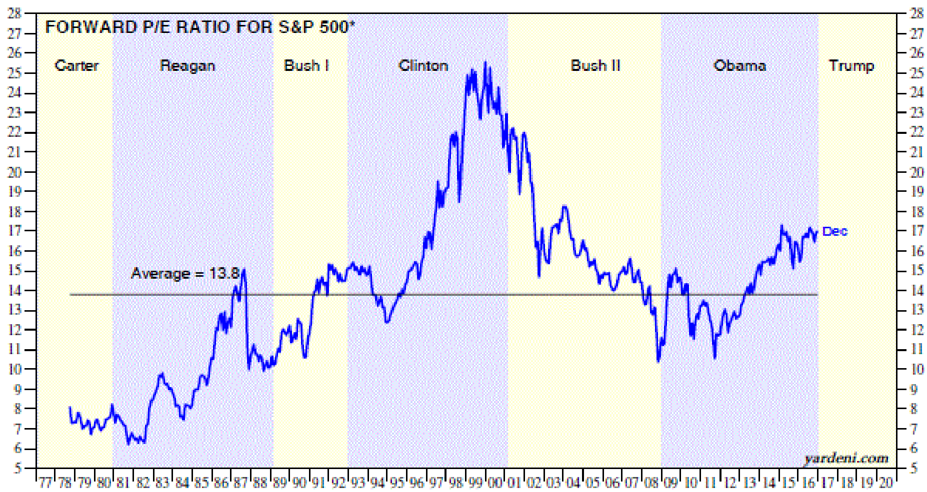
Quite simply, we think the public is saying that President Obama did a good job for the tasks for which he was elected, but now different issues have come to the forefront. The Obama Administration was asked to keep America safe…from the threats of terrorism, the financial crisis, lack of health insurance, discrimination and global warming. Growth was secondary to greater security. But eight years of subpar growth have led to economic frustration and a re-emergence of a need to grow faster.

This development is not unique to our country, but is a wave that we see cresting around the world. Elections in Spain, Japan, India, Indonesia, Argentina, U.K., Brazil, and now, the U.S. have resulted with the candidate (or issue, in the case of Brexit) perceived to be more pro-growth winning, often surprising the pollsters. These elections represent over 40% of the world's GDP! In this respect, we would view the Trump phenomenon as an effect of the underlying change in desires of the electorate around the world, not as the cause of the change.

It is not unusual for elections to have an immediate impact on stock prices as optimism is a powerful force in the short-term. Between election day and the end of 2016, the S&P 500 index rose by 4.6%. In the same time frame, it rose by 3.8% for Clinton, 4.2% for Carter, 5.2% for Reagan, 5.4% for Kennedy, 8% for Eisenhower and 8.2% for Hoover. (It shouldn't go unnoticed that in all these cases except for Clinton, the market was in negative territory one year after the inauguration as reality fell short of initial optimism.)

Optimism is also bubbling in the business community. With promises of less regulation, lower taxes, and fiscal stimulus, initial surveys are showing a drastic change in what John Maynard Keynes first termed the "animal spirits" of the economy. The Small Business Optimism Index rose by a record amount in December to its highest level since 2004. Leading the charge was an increase from 22% to 50% of companies expecting business conditions to improve. This was the highest reading since March 2002. (Again, it shouldn't go unnoticed that there is a gap between what companies are saying and what they are doing. Hiring activity has been relatively flat, and the percentage of companies reporting job openings declined.)

While we have been relatively positive on stocks for a long period of time, we have become a bit more cautious recently as optimism and stock prices have increased. It's not that we don't see a pathway for higher growth, it is that this road may be filled with some rocks (such as oil prices having doubled over the past year) and stock valuations are discounting good news. While much has been made of the comparison of Trump to Reagan, one major difference is that the stock market was selling for a very low P/E ratio of 7.7 when Reagan took office as opposed to the current higher than average P/E of 16.9 that Trump will inherit.



* Average monthly S&P 500 stock price index divided by S&P 500 12-month forward consensus expected operating earnings per share.
Source: Thomson Reuters I/B/E/S.

We recommend maintaining a balanced approach within portfolios as we monitor the evolution of the economy under the Trump Administration. There is likely to be continued volatility as shifts in policy are debated and, possibly, enacted. As always, we will look to make investments in areas that should continue to enjoy healthy and sustainable demand and where we have confidence in managements to navigate shifting economic tides. As the gulf between expectation and reality is negotiated, we expect markets will continue lurching through periods of exuberance and disappointment.