# SkyView Investment Advisors:

# The Times They Are A Changin' - 2017

December 29, 2016

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## The Times They Are A Changin'

It would be difficult to describe 2016 as anything but unpredictable. For all of the year's ups and downs, investors head into 2017 with more optimism than we've seen in a number of years. The University of Michigan Index of Consumer Sentiment ended the year at 98.2 up 6% for the year leading to the highest level of the Sentiment Index since January 2004. An all-time record number of consumers (18%) spontaneously mentioned the expected favorable impact of Trump's policies on the economy. The prior peak (9%) was recorded in 1981 when Reagan took office. These "animal spirit" forces helped drive the S&P 500 approximately 6% higher from election day through year-end. Investors anticipate that friendlier fiscal policies will provide a shot in the arm to sluggish growth.

"I can't change the direction of the wind,
but I can adjust my sails to always reach my destination."

- Jimmy Dean (actor, singer, sausage maker)

Over the past eight years, aggressive monetary policy provided a strong tailwind driving equity markets higher. However, times they are a changing. The Federal Reserve's ability to boost asset prices will be diminished as we transition away from the great monetary policy experiment of the past eight years. Investing over the next few years can be framed in the context of two opposing forces (Bull vs Bear) that will impact economic growth with significant implications for all investors. These forces operate simultaneously and accelerate at various rates thereby leading to higher volatility for investors. For these reasons, our dedication to the principles of asset class diversification remains paramount for successfully navigating through these risky and fickle waters.

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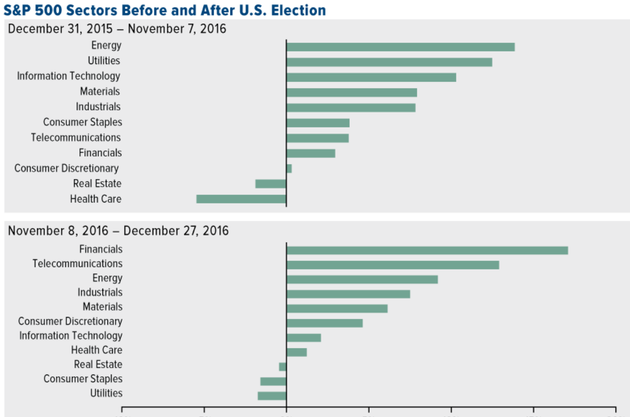
## The Bull Case (shorter term)

*The Bull case supposes that upcoming US fiscal policies and deregulation will move our economy out of sluggish growth, and into sustained higher growth.*

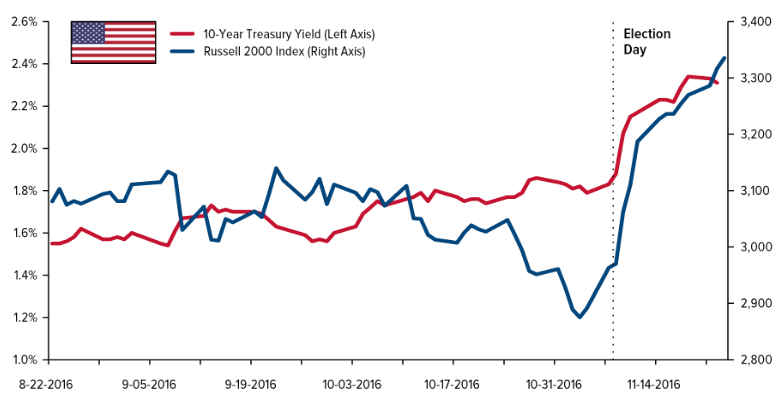
The Bull case supposes that upcoming US fiscal policies and deregulation will move our economy out of sluggish growth ("Lower for Longer") into sustained, higher growth ("Higher and Stronger"). "Lower for Longer" prevailed since the financial crisis in an economic environment dominated by monetary policy and increased regulation. Monetary policy tools proved blunt and ineffective at spurring sufficient economic growth. However, in the absence of any constructive fiscal policy, it was the only game in town. Now, that has changed where the new forces combining aggressive US fiscal policy with deregulation will result in higher and sustainable growth along with a stronger dollar and higher interest rates. The expectation for infrastructure spending, tax reform, and repatriation of foreign cash will ignite the economy and boost corporate earnings. The recent rally in risk assets anticipates this case. The charts below illustrate how since the election these expectations impacted interest rates (increasing) and equities (cyclicals and small caps leading the way higher).

**S&P 500 Sectors Before and After U.S. Election**




Past performance does not guarantee future results. **Source:** Bloomberg, U.S. Global Investors

**Big Moves in Small-Cap Stocks and Treasury Yields Since Trump's Election**

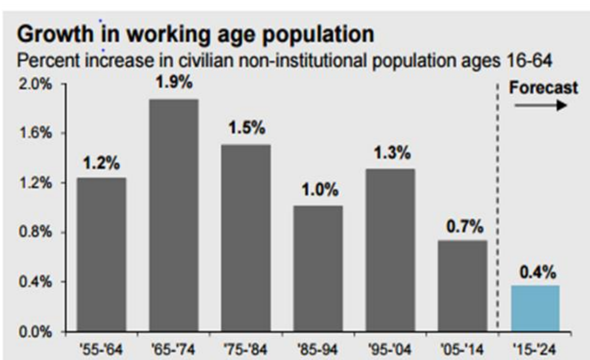


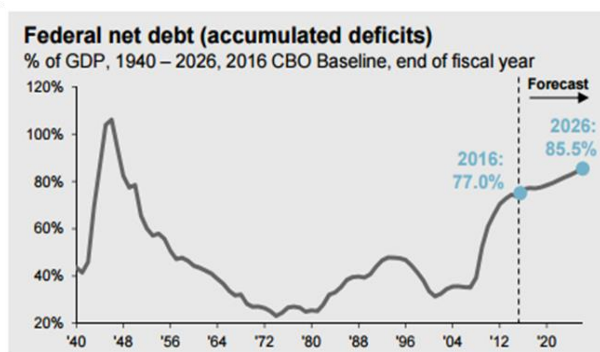

Past performance does not guarantee future results. **Source:** FTSE Russell, Federal Reserve, U.S. Global Investors

## The Bear Case (long term)

The Bear case supposes that intractable issues relating to Debt, Demographics and Protectionism produce overwhelming structural challenges that threaten long-term growth. Debt and Demographics frame the two main forces. According to the International Monetary Fund (IMF), total global debt surged to record levels last year surpassing $152 trillion (225% of world GDP). Nothing indicates a change in this trajectory. This debt combined with an aging population, declining workforce and modest productivity (potentially reduced by protectionism) produces a toxic mix of structural problems resulting in lower growth. According to the United Nations, last year the world's advanced economies reached a critical milestone. For the first time since 1950, their combined working-age population declined, and by 2050 it's projected to shrink another 5%. The ranks of workers will also fall in key emerging markets. The Bear case supporters view the recent rally in risk assets as unsustainable and slowing economic growth inevitable. The US is not immune to these trends as illustrated in the charts below (though to a lesser degree than many other nations).

*Debt combined with an aging population, declining workforce, and modest productivity produces a toxic mix of structural problems…*




Source: J.P. Morgan Asset Management, BLS, Census Bureau, DOD, DOJ, and BEA. Future working age pop calculated as total estimated Americans from Census Bureau, controlled for military enrollment, growth in institutionalized pop and demographic trends. Data as of Dec 31, 2016.

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## The Known Unknowns

*We can't predict the next sell-off, but we can attempt to protect for potential future volatility.*

Donald Rumsfeld, the former US Secretary of Defense, said: "There are known knowns; there are things we know that we know. There are known unknowns; that is to say there are things that we know we don't know. But there are also unknown unknowns – there are things we don't know we don't know."

*We can't predict the next sell-off, but we can attempt to protect for potential future volatility*

We believe Secretary Rumsfeld's quote appropriately frames the current frustrations many investors face when constructing portfolios:

1. Known knowns
    a. past aggressive monetary policy has boosted asset prices and mitigated downside risks as part of "Lower for Longer", now we begin the change to constructive fiscal policy and "Higher & Stronger";
    b. the Fed will transition to a less accommodative policy;
    c. traditional "safe-sources" of yield no longer provide the potential return or protection investors experienced for over 3 decades;
2. Known unknowns:

    the ultimate impact all this will have on the risk profile of equities and cross-asset class relationships as monetary authorities transition to less accommodation.
3. Unknown unknowns:

    geopolitical, economic dislocations, and other exogenous shocks that could disrupt markets and the financial systems precipitated by extraordinary global monetary actions.

Peter Bernstein, author of the magnificent book "Against the Gods: The Remarkable Story of Risk", wrote: "Probability has always carried a double meaning, one looking into the future, the other interpreting the past; one concerned with opinions, the other concerned with what we know."

## Can the Bull and the Bear Case Co-Exist?

We believe, yes. The result being we expect equities to move higher through the quarter while interest rates rise. However, these combatting forces will create greater volatility across asset classes. As we identified in prior letters, we remain concerned about the risks associated with rising rates. Therefore, we continue to prudently diversify among both equity and fixed income sectors to mitigate these risks. The shift from focusing on monetary policy to fiscal policy is underway. Moving into the second half of the year, we expect greater clarity regarding these changes and their impact on the economy and investing. Best wishes for a prosperous New Year.