{PMFA} Special commentary

plante moran FINANCIAL ADVISORS

May 25, 2017

JIM BAIRD

CPA, CFP®, CIMA®

Partner,
Chief Investment Officer

EXECUTIVE SUMMARY

- *In recent weeks, a number of headlines and allegations have unfolded within the political arena and appear to have temporarily shifted focus away from President Trump's policy agenda.*
- *While the overall direction of the administration's pro-growth policy remains relatively clear, what's changed is the political reality. It will be hard for the administration to push its proposed reforms through with the sharpening focus on the investigation and its increasingly bipartisan support.*
- *Early hope for changes by the end of 2017 is giving way to an increasing probability that any significant changes are likely to be pushed back to 2018. That alone could create additional challenges, as Democrats are unlikely to be motivated to support the president's agenda in the months leading up to mid-term elections.*
- *Despite ongoing investigations, increasing geopolitical tensions, and likely delays in policy implementation, investors still appear to be largely unfazed. Equity market volatility remains very low and stocks have continued their upward trend, supported by a broadly positive economic backdrop. Still, the potential for increased volatility exists.*
- *Most measures of optimism remain high today, but as the window to get things done in Washington narrows and the potential benefit of economic stimulus is delayed, it's too soon to tell what the impact will be. The new administration and Congress may need to walk the political tightrope to justify recent optimism.*

BLOG

For other up-to-date economic perspectives, visit PMFA's Market Perspective's Blog at market-perspectives-blog.pmfa.com.

PMFA SPECIAL MARKET COMMENTARY

Beltway uncertainty: What it means for the economy and investors

As pundits were analyzing President Trump's first 100 days, news was breaking rapid-fire: the dismissal of former FBI director Jim Comey, allegations that the president gave classified information to Russian diplomats, the appointment of a special counsel to investigate the role of Russia in the 2016 election. Multiple headlines have continued to unfold; it's hard to keep up.

These developments have shifted the focus of policymakers and the media in recent weeks. Although, President Trump's policy agenda — regulatory reform, infrastructure spending, and tax reform, all expected to stimulate economic growth — hasn't changed, the timeline for implementation of those policies likely will.

The president's first attempt at regulatory reform, the repeal and replacement of the Affordable Care Act, lacked enough support to make it to the House floor to vote, facing resistance from both Democrats and the more conservative wing of his own party. The administration and House Republicans went back to the drawing board, and version 2.0 narrowly passed in House and is now in the Senate for, likely significant, amendments and potential approval.

Dodd-Frank, another key initiative on the regulatory front, recently cleared the House subcommittee and is awaiting consideration by the full House. It's highly likely that Congress will try to make some modifications to the law, but outright repeal seems less likely, and many details surrounding reform remain unanswered.

Infrastructure spending offers a glimmer of hope of bipartisan support yet, here too, the devil will be in the details. Total actual investment amount, where the money will come from, how it will be allocated, and when the spigot will open - will all determine the impact on job creation and degree of economic lift.

Turning to much-anticipated tax reform, on the surface the president's brief, high-level proposal represents large tax cuts, which would reasonably be expected to provide some near-term stimulus. However, without complementary spending reductions, the cuts would also likely expand the budget deficit, which is both a short-term political hurdle to clear and potentially a long-term drag on growth. Many details need to be fleshed out before the bill becomes law and before conclusions about the likely impact can be drawn.

While the overall direction of the administration’s pro-growth policy remains relatively clear, what’s changed is the political reality. It will be hard for the administration to push its proposed reforms through with the sharpening focus on the investigation and its increasingly bipartisan support.

Several geopolitical developments have also drawn the president’s attention, as tensions have risen in Syria and North Korea. Geopolitical risks are always a potential wild card, and escalation in these regions could distract from the domestic agenda and heighten the record-low volatility we've seen in the capital markets.

The extent of what the president and Congressional Republicans will be able to accomplish remains to be seen, as does the speed and timing of reform, particularly in light of continued revelations and outstanding policy questions. Early hope for changes by the end of 2017 is giving way to an increasing probability that any significant changes are likely to be pushed back to 2018. At that point, it's also unlikely the Democrats will want to hand the president any victories in the months leading up to mid-term elections, making any substantive legislative changes more difficult.

In the interim, the administration may need to aim for smaller victories, consolidate support within his party, and court moderate Democrats — particularly from districts that supported the president in 2016 and may still lean Republican — by focusing on key areas with bipartisan support, such as corporate tax reform and infrastructure.

To date, investors have appeared to be largely unfazed by increasing geopolitical tensions. Since the election, investor sentiment has been running high in what's been dubbed the "Trump trade." Stocks have rallied, the dollar has strengthened, and both inflation expectations and long-term interest rates have risen. More recently, the recognition that the pace of change may be slower than initially hoped has led to a bit of a reversal in some of those market trends, although equity market volatility remains very low and stocks largely continue to move gradually higher.

We should note that improving economic data, which had already begun to surprise to the upside before the election, has also supported risk assets — it hasn't only been the Trump trade buoying the market. The manufacturing sector was perking up, labor conditions had been tightening, and inflation had been edging higher even before the election. Economic data broadly appears to paint an expansionary picture today, and the Fed seems poised to continue its tightening cycle in the coming months, despite a soft first quarter GDP reading.

While Trump's policy agenda may have lost some of its initial luster, as the window to get things done in Washington narrows and delays the anticipated stimulus, it's too soon to tell what the impact will be. Most measures of consumer, investor, and business optimism remain high, and the overall economic backdrop is positive. Still, valuations, particularly in the United States, are elevated today and volatility has been exceptionally low. Even against the backdrop of a growing economy and a generally upbeat mood, the potential for an increase in market volatility cannot be ruled out.

For now, Republicans enjoy a narrow majority in both the House and Senate, and the pro-growth agenda of tax reform, infrastructure investment, and regulatory reform all still stand to provide some boost to economic growth. To date, the market has continued to respond favorably. Now, the administration and Congress will need to walk the political tightrope to justify it.