MARKET COMMENTARY – DECEMBER 1, 2016

*We made it. We made it! Russell, we could float right over there.
Climb up. Climb up! ~UP (2009 Disney movie)*

So says Carl Fredrickson, the lonely and grumpy home owner who uses balloons and a few thousand cubic feet of helium to lift his house off its foundation and fly to South America. He makes this exclamation when he, at last, lays eyes upon his destination, Paradise Falls, which now seems just out of reach. If you have not yet seen this film, please make time to do so. It speaks to young and old alike. In short, it is marvelous.

We were reminded of this particular tale because we have entered a period some may call the Great Reflation. Like the curmudgeon in the movie, Carl, who empties helium canisters in order to raise his house, fiscal and monetary policy may soon work in concert. Interest rates and, perhaps, inflation will go…UP and UP.

Regular readers may recall that we have advocated for incrementally higher interest rates for some time. The economy wasn't burning too brightly, but it was healthy enough for marginally higher rates. In 2015 the Fed raised rates just once. We thought at least two were in order. They've held rates steady all this year. The meeting in December is likely to produce a small increase. We expect rates to go steadily higher as we move through 2017, especially the second half.

Why the sudden change from wide open monetary policy? Rates have been low for a very long time and did not spark significant inflation (unless one counts stock and bond prices, but we'll leave that for another discussion). The recent election of the president is the major catalyst for change. The potential for new policies surrounding tax (lower), regulation (less burdensome), and spending (higher) are thought to provide more than enough political and growth cover that the Fed is no longer 'forced' to keep rates low. Barring unforeseen economic events, they will raise rates accordingly.

The way the market has reacted positively to the election over the short run makes some sense. Lowering corporate and individual tax rates puts more money into the hands of those who spend it. Reducing unnecessary regulation and its unintended consequences allows business to focus on, well, business. But the incoming administration has also promised a rather huge infrastructure spending plan. This, too, has the potential to spur growth (though it's not likely to be as much as some believe).

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These events may only be good to a point, however. The nation's debt-to-GDP ratio is at its highest level since WWII. As rates climb, the amount spent on the interest of Treasury debt will be greater than what is spent on defense. These facts reduce the flexibility of the government no matter who is president. They also have the perverse effect to create a potentially vicious cycle of propelling borrowing costs much higher than any of us care for them to go. But keep in mind, this is a worst-case scenario and we are still a long way from this point!

Our forecasted best-case scenario sees the pro-growth side of future policies having a greater effect than the pro-deficit side of the policies. If that occurs, we would expect a normal business cycle, with rates climbing to the point where they spur a brief and shallow recession in the coming years – and the subsequent recovery, of course. The most likely outcome is somewhere in the middle.

November brought a small rally to large company stocks and a huge rally in small caps. Bonds, for the most part, sold off in anticipation of higher rates. The last of 3Q earnings came in. Earnings growth was the best in a long while, but expectations for the coming quarters have waned. The reality of those future earnings may prove to outshine expectations in light of the new pro-growth fiscal outlook.

Last month, we briefly mentioned a growing credit expansion in China. It is not in any immediate danger of popping. However, if it continues to grow over the coming years, it will burst in a bumpy fashion. We are not out of the woods in this regard, but Beijing authorities are taking measures to rein in credit expansion in what seem responsible ways. We will keep abreast of the situation.

So, will the warm, fuzzy, and cheerful feelings that the markets have today stay with us for years like they have after watching UP? Or, will our helium-inflated balloon land just shy of our own financial version of Paradise Falls?

Ultimately, whether or not the ending to the Great Reflation turns out to be as happy as the ending to UP remains, well, if we may say, up in the air...

Stirling Bridge Wealth Partners, LLC remains committed to providing customized investment solutions and robust financial planning for our high net worth clients throughout the country. We thank each of you for your dedication to us, for your trust, and for the referrals you've sent our way.

Sincerely
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