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A New World to Contemplate and Navigate

Three months ago we noted that 2016 had been a tough year for conventional wisdom. As if on cue, the conventional view took a historic hit with Donald Trump's electoral victory. The stock market staged a three-week rally, quite the opposite of what was supposed to happen if "the Donald" somehow prevailed. The only *confirmed* bit of conventional wisdom is the futility of trying to *time* such market-moving events.

Long-term investors continuously buy the future at what they hope proves to be a discounted present value. By the morning of November 9th the future had taken on quite a different look. It may be distinctly American to believe, at least at first blush, that "different" *might* hold the possibility of better.

U.S. equity markets were quick to respond to the sense of improved domestic prospects. The first dozen post-election trading days saw a nearly unbroken advance that added three-to-five percentage points to the major stock averages.

In the context of the global economy, tepid growth and challenges to the established political order elsewhere make the U.S. look like the best-kept house on a disorderly block. Our persistence at cranking out growth in the 2.0%+ range, adding jobs at an average of about 180,000 monthly, and broadening wage gains looks reassuring if not spectacular.

Elsewhere, the United Kingdom's looming negotiations to sepa-

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Is Europe Teed Up for a Populist Surge?

The past six months have been a rough ride for the west's political establishment. The Brexit and Trump surprises revealed a deeper and more energized strain of discontent over a range of policies associated with political and business elites and the broad trend of globalization.

Electoral Trials Ahead

Italians have soundly rejected a constitutional amendment to reduce the size and power of their Senate along with other reform measures. Centrist Prime Minister Matteo Renzi supported the amendment as a counter to Italy's own brand of political gridlock and government instability. Mr. Renzi promptly submitted his resignation, likely throwing the government into another round of uncertainty with various antiestablishment and anti-EU players looking to gain political ground.

France holds national elections in the spring, and President François Hollande just announced that he'll be the first French chief exec since World War II not to seek reelection. High-profile, antiestablishment candidates such as Marine Le Pen of the National Front may gain traction, while considerable attention has gravitated toward the more traditional conservative, François Fillon, who was prime minister under President Nicolas Sarkozy.

German elections next fall are widely expected to hand Chancellor Angela Merkel a fourth term, but not without an airing of grievances over her government's handling of the refugee onslaught and the slow pace of economic growth.

Remembering Better Days

It would be hard to overstate

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On Rates, *Déjà Vu*

Twelve months ago, as our Winter-2015 issue went to "press," markets were awaiting a mid-December meeting of the Federal Reserve, widely expected to deliver the first uptick in base interest rates in years. And here we are again, anticipating the Fed's mid-December confab. The CME's FedWatch tool reportedly is assigning about a 95% probability that the Fed will hike.

Of course, there are differences from a year ago. The benchmark 10-year Treasury bond yield has already moved from 1.8% to 2.5% since the election, driven by expectations for more growth-oriented policies coupled with increased government spending on infrastructure and tax cuts. Short-run expectations are for larger federal deficits leading to the issuance of more Treasury debt; ergo, higher yields.

The pieces appear to be in place for the Fed to act. Core inflation has been running close to that avowed 2% target, and the unemployment rate is hovering near what the Fed has characterized as "full employment." But they may not want to get too far out in front of global rates, especially given the strength that has already accrued to the dollar. Recent comments by influential Fed officials suggest a willingness to let the economy (and inflation) run a little "hotter" rather than risk impeding the expansion.

Back in the 1950s, Doris Day famously sang *que sera, sera*… whatever will be will be. As we noted a year ago, "the fuller history simply provides too wide a range of outcomes to assign high predictive probability" regarding the effect of a rate increase. The Fed will probably act this December, with markets already having taken rates a bit higher all by themselves. ■

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Emerging Markets *Were* On a Roll, Then Not So Much.

No tour of the altered landscape for global investors would be complete without a look at emerging markets. This inherently volatile sector *was* in the midst of a nice comeback from a 20% loss in 2015. As of election day that Index was ahead 13.6% for 2016.

Since the election it has given back roughly 5%, reacting to fears that interest rates might head higher sooner and/or that a Trump administration might be as hostile toward imports as its campaign rhetoric suggested. So, what was driving investors *toward* emerging markets last past spring and sumer?

Partly it was a simple matter of rotating to what appeared relatively cheap. As the accompanying table reflects, Diversified Emerging Markets have lagged other major equity fund categories badly over the past three- and five-year periods.

The longer-term story hasn't really changed. The World Bank expects emerging-market economies to sustain markedly higher growth than the more mature economies. A major factor is the difference in demographics. By 2025 China, Brazil and India are projected to have, respectively, 2.4, 2.2, and 2.1 working-age citizens for every person not working. That compares to just 1.7 projected for the U.S., 1.6 for Germany, and 1.4 for Japan..

The trick has been to translate that secular growth story into returns commensurate with the volatility emerging market investments have dished out. As with other sectors with a penchant for exaggerated pricing cycles (e.g., oil, precious metals, biotech stocks, etc.), chasing performance can be dangerous to portfolio health. The table below amplifies the wild ride one had to endure to eke out a 3% annualized return for the decade 2006-15.

The Emerging Markets Rollercoaster

Diversified Emerging Markets Funds: Category average total return

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
32.1%	36.7%	–54.4%	73.8%	19.3%	–19.9%	18.2%	–0.1%	–3.0%	–13.8%

Source: Morningstar

Perhaps more problematic has been the tendency for those gains and losses to amplify rather than offset the ups and downs of mainstream equity markets. Still, some close observers see improved fundamentals and a more benign environment with the uptick in oil prices, better economic numbers out of China, and as long as the rise in U.S. interest rates is contained. We'll see if all that holds. ■

Social Security's Miserly Bump for 2017

The Social Security Administration recently dished out the news that 2017's cost of living adjustment (COLA) would be just 0.3%. That's a monthly raise of $5 for the average retiree receiving benefits, or $6 for the average couple – not bad as long as one doesn't eat.

Medicare's Trustees estimate that several million Social Security recipients could see Part B premiums rise by more than *$50* monthly. And the Part B deductible may be up as much as $38 monthly for 2017.

Social Security's COLA is based on the overall Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Some question the use of this index, which surveys spending patterns of younger workers with less weight given to healthcare and housing, seniors' two largest spending categories. The Bureau of Labor Statistics pegs the rise in medical goods and healthcare services at 5.2% and 4.8% over the past year, while housing costs rose an average of 3.4%.

The BLS has devised an Experimental Price Index for the Elderly to reflect the spending of households over age 62. But it's unlikely to replace the CPI-W anytime soon. For more than a few retirees, a little belt tightening is in order. A higher rate of interest income wouldn't hurt. ■

Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	--- Annualized through Dec. 5, 2016 ---			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Blend)	6.2 %	7.6 %	12.8 %	6.0 %
Mid-cap Stocks (Blend)	9.8	6.8	12.8	6.6
Small-cap Stocks (Blend) †	13.8	5.4	13.0	6.5
Foreign Stocks (Large Blend) †	− 2.9	− 1.3	4.9	0.6
Diversified Emerging Markets †	4.8	− 3.0	0.5	1.5
Specialty Natural Resources †	21.5	− 2.7	− 0.2	0.9
Specialty Real Estate †	4.6	10.7	10.9	3.7
Cons. Allocation (30-50% Equity)	4.3	3.1	5.4	3.9
Long-term Bond	4.6	6.5	5.0	6.3
World Bond †	2.9	0.4	1.4	3.5
High-Yield Taxable Bond †	9.2	3.0	6.1	5.8
Long-term Municipal Bond	− 0.5	4.3	3.7	3.5

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

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D.C. Power Shift Puts Taxes in Play

There may be no more salient feature of the Republican electoral sweep than the prospects for broad-based tax restructuring. On the other hand, history shows that effecting truly meaningful change in the tax code can be a tortuous path with plenty of surprises along the way.

Both the Trump campaign and House Republicans advanced detailed proposals on individual, corporate, and estate taxes. They'll need to converge those plans to move legislation against resistance from the Democratic minority.

With 2016 drawing to a close, investors may wonder if any special strategy is called for regarding 2016 income and deductions. The simple answer is probably to simply consider the same steps that generally make sense under current law.

For most individuals, that means that if income can easily be delayed until 2017, it probably makes sense to do so. And if there are deductions you can productively use *this* year, get them done. After all, the one thing that now seems quite unlikely is a rise in marginal tax rates next year, and you know that saying about a bird in hand.

Meanwhile, we'll watch with high interest the deliberations of a new Congress, and maybe we'll have some definitive details to discuss in our Spring *Quarterly*. ■

Battles Over the Budget Set to Resume

One issue conspicuously absent from this year's political debate was the federal budget, a matter of mutual convenience with both sides pitching spending increases, albeit in different areas. Now that one party will control Congress and the White House, the loyal opposition may be expected to raise budgetary concerns to challenge at least some of the majority's tax proposals and spending initiatives. And they'll have a few hard facts to work with.

Fiscal year 2016, which ended September 30th, saw a reversal in the four-year trend of narrowing deficits. Total federal revenue was essentially flat year over year, ending a string of healthy gains that saw annual receipts rise a cumulative 50% from 2010 to 2015. Meanwhile, outlays jumped 4.5% in 2016 after a five-year period that saw almost no annual increase. The 2016 deficit totaled $587 billion, $148 billion more red ink than in fiscal 2015.

Individual income tax collections came in slightly higher than the prior year, while payroll taxes (Social Security and Medicare) rose by $50 billion. That was mostly offset by a $41 billion drop in corporate taxes due to the well-documented profits recession.

Nearly all of the increase in spending is attributable to entitlements, with Medicaid leading the way. The Affordable Care Act has expanded eligibility for Medicaid benefits, which have now ballooned by 40% in just three years.

The new administration and an energized Republican congressional delegation have wide-ranging plans. The economy will have its say as well. After all, the federal budget is an ocean liner with considerable momentum, influenced by shifts in the prevailing currents but hardly designed to turn on a dime. The deficit picture may not have been an issue during the campaign, but it's bound to find its way into the political battles ahead. ■

Federal Revenue & Expense
by fiscal year in billions of dollars

	2010	2011	2012	2013	2014	2015	2016
Receipts	2,163	2,303	2,450	2,775	3,021	3,249	3,267
Outlays	3,457	3,603	3,537	3,455	3,506	3,688	3,854
Deficit (-)	-1,294	-1,300	-1,087	- 680	- 485	- 439	- 587
% of GDP	- 8.7%	- 8.5%	- 6.8%	- 4.1%	- 2.8%	- 2.5%	- 3.2%

Source: Congressional Budget Office

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rate from the European Union could feed protectionist fires on both sides of the Channel. Many of our key trading partners continue to pursue (or allow) weaker local currencies through very low or even negative interest rates.

Proponents of free trade had to be discouraged by the rhetoric from *both* presidential contenders, but it remains to be seen whether Mr. Trump's actions on that front will match his aggressive campaign stance. Meanwhile, Germany, an exporting powerhouse faces acute demographic challenges, unsettled politics, and capital concerns in its banking sector. Japan and China also have struggled to squeeze a little more growth from government stimulus and credit expansion.

One fresh reality delivered by the election is the fact that we won't be dealing with the D.C. gridlock we've been accustomed to – or at least not the traditional gridlock. Mr. Trump is hardly a traditional Republican and may pose challenges to the leadership on both sides of the congressional aisle.

So, on what policy matters might they find enough common ground to move legislation? Infrastructure spending, repatriation of cash held overseas by U.S. corporations, and certain other pockets of tax reform are cited as areas that may not face unified, reflexive opposition.

For now, Mr. Trump's promotion of growth and Republican control of Congress appear to have overshadowed concerns over trade wars, geo-political hot spots, and budgetary challenges. But *market* honeymoons don't last forever either. ■

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the enthusiasm with which investors anticipated the 1992 integration of the European Economic Community. Back then, Western Europe's 23 democracies boasted total population a third larger than the U.S. with combined gross domestic product on a par with ours. In the immediate afterglow of German reunification, and with prospects for a freer flow of goods and capital across an integrated Europe, stocks trading on those countries' exchanges looked like bargains.

That enthusiasm would soon succumb to armed strife in the old Yugoslavia, economic stress on Germany in absorbing the much poorer East Germany, and the abiding challenge of trying to drive fiscal and economic reforms within Europe's prevailing social welfare state model. The 1990s also turned out to be a tough time to match the dynamic rise in U.S. stocks.

More recently, European equities have seen negative results for the past one- and three-year periods. However, investors with a longer time frame and contrarian leanings might note that Europe-focused stock funds averaged 6.4% annual total return for the past *15* years, just shy of the 6.6% for the average Standard & Poor's 500 Index fund. Markets appear to have already discounted some of the concerns outlined above, so one of these days it may be Europe's turn again. ■

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Billionaires Look to Regain a Little Mojo

Apparently, the rich *don't* just get richer. A recent study by UBS and PricewaterhouseCoopers reported a significant drop in billionaire wealth in 2015.

Just five individuals joined the ranks of U.S. billionaires in 2015, and America's 538 billionaires saw their aggregate wealth slip from \$2.6 trillion to \$2.4 trillion. Global billionaire wealth took a \$300 billion hit, dropping to \$5.1 trillion spread across 1,397 billionaires worldwide.

One might assume that such super-sized wealth would be easy to sustain across generations. However, studies indicate that 70% of billionaire heirs drop below the 10-figure threshold during their lifetimes. Another 20% drop out of the club by the third generation. Further reflecting the dynamics of wealth in America, for the first time in ten years, the average wealth of *self-made* U.S. billionaires (\$4.5 billion) topped the average wealth (\$4.3 billion) of those *born* into the "B" club.

With this year's better tone in financial markets, we might assume that billionaire net worth will show gains for 2016. A cheery note heading into the holidays. ■