TURNER INVESTMENTS COMMENTARY

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WHAT'S NORMAL?

In all likelihood, US interest rates were going to be increased before year-end with or without Donald Trump. However, Trump's surprise presidential victory sealed the fate of the US Federal Reserve. Trump has increased inflation risk and dramatically improved the odds of a raise. Barring something cataclysmic—and Brexit and Trump have likely already combined to use up all the available cataclysm room for this year—the Fed will be bumping interest rates a quarter point on December 14th.

So, we've now (probably) had back-to-back years with only single 0.25 percentage point increases in the Fed's benchmark overnight rate. Hardly the fast-paced tightening cycle that we've seen in years past from the Fed. However, with Trump now part of the mix, the question becomes what will happen to interest-rate policy in 2017 and what will the Fed's ultimate end-point be? In other words, in our new nationalized, protectionist environment spearheaded by a US president with no political experience, what is normal?

PAST TIGHTENING CYCLES

In this instance, history's usefulness for predicting the future is tenuous given how strange our present is. However, it's still important to examine what the Fed's done previously. As we highlighted in our September 2015 newsletter ("What to Expect When You're Expecting (a Rate Increase)"), the past four Fed rate-hike cycles all ended north of 5%. In fact, when Ryan and I started our

Bay Street careers, the Fed's overnight rate was also above 5%. How times have changed: An entire generation of new Bay Street analysts doesn't even know what it means to live in a world with a Fed funds rate higher than even 1%. So, our 2015 conclusion hasn't shifted: in our aging, slow-growth world, the previous highs of other tightening cycles will not be achieved this time around. But, as we also noted, rate increases are virtually never made in isolation—they come in bunches. The past four tightening cycles averaged 10 hikes, ranging from a low of six from 1999–2001 to a high of 17 during the most recent cycle (see adjacent table). So what will be the pace of this cycle? And what is a normalized Fed funds rate? Naturally, what "normal" means is subject to much debate, but it certainly isn't the current 0.50%, which is massively below the long-term, 30-year average of almost 4%. This cycle will likely take longer than usual to play out due to a more delicate global economy and the still lingering effects of the credit crisis, but if it were ultimately to result in 6–7 increases, the low end of the historical range, and we were to get the occasional half-point increase, we could still eventually end up with an overnight rate near 3%—a dramatic shift from where we are now.

Tightening Cycles: Fed's Rarely 'One and Done'

Cycle Start	Cycle End	Number of Days	Number of Hikes
3/29/1988	6/5/1989	433	11
2/1/1994	7/6/1995	520	7
6/30/1999	1/3/2001	553	6
6/30/2004	9/18/2007	1,175	17
12/15/2015	?	350 so far	1 so far
Average (ex current cycle)		**670**	**10**

Source: Bloomberg. A rate-hike cycle is defined as a period of multiple increases in the Federal funds benchmark overnight rate. Any rate cut ends the cycle.

TRUMP AND TRADE

Obviously, the biggest obstacle to accurately forecasting economic growth and the future direction of interest rates is Trump's unpredictability, particularly with respect to foreign policy and trade. He's already indicated that the Trans-Pacific Partnership, the 12-nation trade deal advanced by Barack Obama, is toast, but he's also threatened to tear up many other trade agreements including NAFTA. Further, he has also threatened to impose high tariffs against China and Mexico as well as deny protection to NATO allies if they don't pay more for this protection. As *The Economist* reported after the election:

> *If Mr Trump enacts even a fraction of his mercantilist rhetoric, he risks neutering the World Trade Organisation. If he thinks that America's allies are failing to pay for the security they receive, he has threatened to walk away from them. The result—especially for small countries that today are protected by global rules—will be a harsher and more unstable world.*

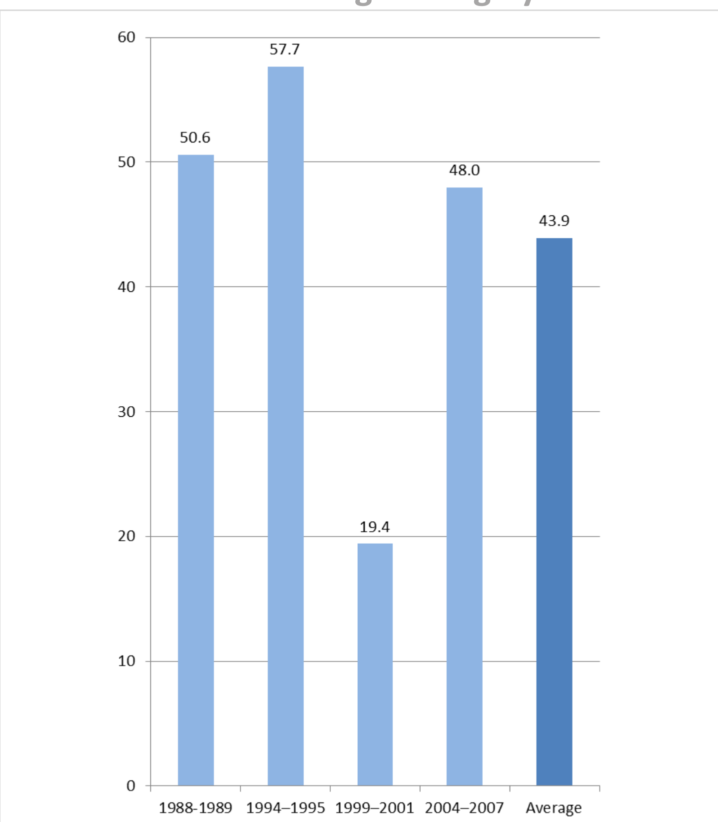
Unfortunately, as president, Trump has the authority to terminate trade agreements without needing approval from Congress. And Trump's so impulsive and reactionary (he just engaged in a 12-hour Twitter rant about the voter recount in Wisconsin) that it's nearly impossible to handicap the possible outcomes.

NORMALCY?

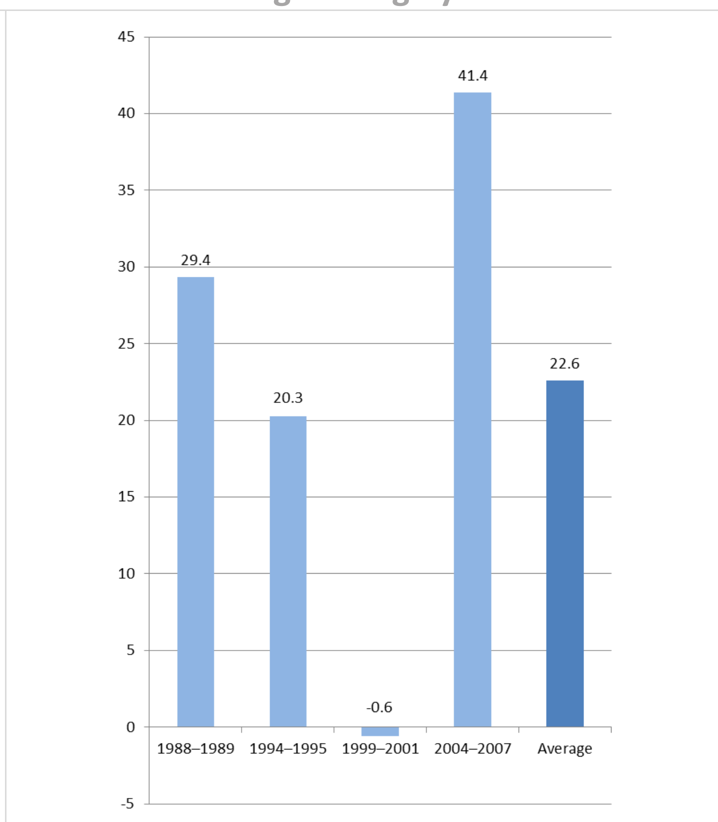
Though Trump misleads to the point of being indecipherable—he was rated 2015's *Lie of the Year* by PolitiFact because more than 75% of his statements were either 'mostly false', 'false' or 'pants on fire'—we must still make forecasts. So, we're assuming that his domestic policies—including cutting corporate taxes, increasing spending (particularly on infrastructure), reduced restrictions on the energy sector, etc.—will be largely implemented and will have a positive economic effect during at least the first two years of his presidency. Being able to further his free-spending, stimulative agenda is not a certainty, but Republicans do have control over both the Senate and House of Representatives. We'll further assume that he gets sensible counsel and refrains, at least initially, from confrontational and draconian trade proposals.

With these assumptions in mind, we are forecasting two Fed interest rate hikes in 2017. We think this is a reasonable assumption given the existing strength of the US economy and the tendency for the Fed to raise multiple times during a tightening cycle. We're also being conservative—this would bring the total to four increases over about 700 days; normally, we'd have 10 over roughly the same period. We also don't think that two 2017 rate increases will derail the current bull market as corporate profitability and the market overall tend to do just fine as the Fed raises rates (see charts below). The S&P 500, incidentally, is up 10% since the Fed started the ball rolling last December.

S&P 500 Earnings Growth (%) During Previous Fed Tightening Cycles



S&P 500 Returns (%) During Previous Fed Tightening Cycles



Source: Bloomberg, Turner Investments. Earnings growth and market returns not annualized. Total return. A rate-hike cycle is defined as a period of multiple increases in the Federal funds benchmark overnight rate. Any rate cut ends the cycle.

TRUMP'S UNBALANCED, WHICH IS WHY YOUR PORTFOLIO SHOULDN'T BE

While we freely admit that we predicted neither the outcome of the US election nor the positive short-term market reaction, the truth is that our balanced, globally diversified portfolio was designed to control risk either way. You may not like the negative impact that a Trump victory has had on your bond positions, but the equity component has more than offset this decline. Besides, you'll like those bonds a lot more if Trump does something truly unpredictable and economically destructive down the road. Naturally, Trump's policies demand constant monitoring, but, in our view, it's still reasonable to assume that interest rates will move gradually higher next year. And from a market perspective, at least so far, things haven't been nearly as bad as many feared.

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