

In the early 1900's, Albert Einstein famously wrote, "The definition of insanity is doing something over and over again and expecting a different result."¹ This saying could be argued as the rallying cry a near century later in 2016 for democracies across the globe. Of course, it is too early to say whether the actions of the past year will bring changes desired (or undesired), but it is a certainty that the year of 2016 marks a complete pivot in economics and policies since the last crisis. Since the economic cycle reset in 2008, monetary policy in the US has been 'full throttle' while fiscal policy has been relatively absent. The Eurozone has been in the same boat, arguably to a larger extent. Emerging economies have been battling the same side effects from their larger counterparts for nearly 10 years. Terms like 'new normal' & 'stagnation' (both we have actively used) were solely born because things were being done over and over again and we finally figured out that it wasn't going to produce a different result. Well, it seems 2016 was the year democracies voted to try something different.

Different. Unlike. Change.

These words have no connotation of good or bad, better or worse. They cannot possibly see the outcomes of the future, so there is no way to determine whether the 'actual' change fell short or exceeded the 'desired' change until the effects of said change are realized. This concept is imperative to investing. Markets constantly weigh the probability of future outcomes and adjust as actual results are realized. If a change is very large or is expected to be realized over a long period of time, the higher the chance a market is pricing the said change incorrectly. Now to make this complicated concept into a complex one, imagine a marketplace of investors, inherently emotional & bias, pricing in multiple changes all at once, simultaneously and independently. Hopefully this provides some clarity into Benjamin Graham's famous quote, "In the short run, the market is a voting machine but in the long run, it is a weighing machine."²

Nevertheless, our role as market strategists is to assess all known variables, remove as much emotion and bias as possible, and assign appropriate probabilities to various outcomes. Sometimes when change is marginal or calculated this can be fairly straightforward – this is not one of those years. The Trump Administration and its republican congress, Theresa May and her Brexit plans²,

Scenario	Probability	2016 EPS	2017e EPS	2018e EPS	Fwd. P/E	Y.E. 2017 Target
Bull	30%	\$121	\$133.00	\$162.00	18.0x	2900
Growth		2.50%	10.00%	22.00%		
Base	55%	\$121	\$129	\$148.00	16.0x	2370
Growth		2.50%	6.50%	14.50%		
Bear	15%	\$121	\$117	\$105.00	14.0x	1470
Growth		2.50%	-3.00%	-10.00%		

All numbers adjusted. 2018 takes into account a corporate tax cut.

Source: Doxa Research

¹ Although Einstein commonly receives credit, it hasn't actually been documented to him. The origin is unknown.

² The new British administration has set the first Brexit actions for this spring.

and the German and French populous and their elections³ will all disrupt the status quo in a very large and lagging way. These material changes to the powerhouse economies of the world make a pointed forecast to financial markets near impossible with the information we have today. Hence, our S&P 500 range between the bull and bear case is just over 1400 points – nearly double the spread of last year. We are the first to admit that these ‘targets’ are next to useless since the net cast is so large; however, the underlying message stands strong: material global changes are occurring and a wide range of future outcomes are possible, better or worse than currently expected.

In short, our 2017 theme can be summed up into one sentence: A battle between late-cycle economic forces and Trumponomics⁴. In slightly more detail: wage pressures, inflationary forces, higher cost of capital, and a strong USD (i.e. late-cycle forces) versus the net effect of changes in tax policy, fiscal spending, deregulation, and trade policy (i.e. Trumponomics).

[It is now ok to quit reading]

Casting a Wide Net

As useless as each ‘target’ is in our S&P 500 forecast, each scenario still paints a vivid picture of our 2017 theme. As value (or ‘weighing machine’) investors, we constantly focus on an equation that looks something like this: cash flows + expectation for future cash flows + intangibles = long term value. Every macro data point and policy implication is viewed through the lens of this equation so we can attempt to gauge how different variables may affect the valuation of a current or future investment. Using the table above as an example, our quick rationale for the ‘base case’ is as follows:

<i>(Net effect of deregulation, trade wars, economic headwinds.)</i>	6.5% Earnings Growth
<i>(Assumes effective corporate tax of 20%.)</i>	+ 8.0% Tax Benefit
	= 14.5% 2018 Earnings Growth
<i>(Amount investors are willing to pay for future returns)</i>	* 16
	= 2017 Year End Target

Our bull case assumes larger tax cuts, a more positive net effect of policy changes & economic headwinds, and a greater willingness by investors to pay for future cash flows. The bear case inverses these assumptions, focusing on trade wars, bigger headwinds, and a smaller appetite for risk by investors. Since the degree of ambiguity is more elevated than in prior years, our S&P 500 earnings matrix can provide a helpful way of viewing all the possible combinations of outcomes.

S&P 500 Index Earnings Matrix										
		P/E Multiples								
		14x	15x	16x	16.5x	17x	17.5x	18x	19x	20x
S&P500 Earnings Estimates	\$115.00	1610	1725	1840	1898	1955	2013	2070	2185	2300
	\$120.00	1680	1800	1920	1980	2040	2100	2160	2280	2400
	\$125.00	1750	1875	2000	2063	2125	2188	2250	2375	2500
	\$130.00	1820	1950	2080	2145	2210	2275	2340	2470	2600
	\$135.00	1890	2025	2160	2228	2295	2363	2430	2565	2700
	\$140.00	1960	2100	2240	2310	2380	2450	2520	2660	2800
	\$145.00	2030	2175	2320	2393	2465	2538	2610	2755	2900
	\$150.00	2100	2250	2400	2475	2550	2625	2700	2850	3000
	\$155.00	2170	2325	2480	2558	2635	2713	2790	2945	3100
	\$160.00	2240	2400	2560	2640	2720	2800	2880	3040	3200
	\$165.00	2310	2475	2640	2723	2805	2888	2970	3135	3300
Source: Doxa Research, Dow Jones		Approx. Current Level		Probable Outcome		Less Likely		Less Likely		Tail Risk

³ Both German and French federal elections will take place in the fall.

⁴ This is a take on ‘Abenomics’, which refers to the Japanese PM’s economic plans.

2016 Lookback

While 2016 was very unkind to pollsters, political strategists, and high probability sport bettors (the Cleveland Cavaliers and Chicago Cubs both came back from a three game deficit to win their respective titles in a seven game series), it actually shaped up fairly close to our outlook provided 12 months ago (*yes, we are thankful we do not project political elections*).

What we got correct:

Oil stabilizes in between \$50- \$60 per barrel

As our highest conviction theme in 2016, this proved to be very accurate – albeit not without volatility. We remain very favorable on the oil market for the long term; however, we believe the supply and demand dynamics should remain relatively balanced in the short to medium term.

Momentum trades slow & ‘value over growth’

We were early on this call in 2015, but correctly carried it forward to 2016. Market breadth was too expanded for this not to correct itself at some point. Since Election Day, we have actually seen momentum and consumer staple stocks perform worse relative to the overall market.

2140 S&P 500 Index year-end target

Yes, the index will likely end the year nearly 100 points higher due to the post-election rally, but we are going to take a little credit anyways. On Nov. 7, the index came in around 2100 and current year earnings should amount to \$123 versus our \$121 projection.

2.45% Real GDP growth in 2016

While we will not know final 2016 GDP readings until late in the first quarter, the Federal Reserve of Atlanta’s GDP Now tool tracks 2016 GDP at 2.6%. Backing out the unusual boost by soybean exports in Q3 (roughly 0.12%), real GDP seems to be on forecast.

What we got wrong:

Rising wages & healthcare will compress profit margins

This simply did not happen in 2016. Wages & healthcare costs did rise, albeit less than expected, but the index’s net margin actually improved throughout the year. However, this is our ‘early, but not wrong’ call. This should be the biggest headwind to ‘Trumponomics’ going forward.

Favor economies in the early/mid stage vs. late stage

This call is in the ‘wrong’ box merely because there is no way we could have properly executed this idea given the massive currency volatility. Mexican and British markets performed great in their respective currencies, but not so great priced in dollars. The Nikkei (Japan) did well priced in dollars, not so well priced in yen – and in

Reconciling Our ‘Stagnation’ View

More than 15 months ago in “[The New Normal](#)” we argued that US economic growth would continue on a ‘slow but not steady’ pace as the country entered the ‘normalization’ phase of the economic cycle. As additional data became realized, we extended the timeframe of this view, ultimately arguing the US economy was in a period of stagnation – meaning low growth, low unemployment, low inflation, and low interest rates. In our September note, [found here](#), we underlined this thought and maintained that global savings was greater than global investment, making it materially harder for global growth to advance at a faster pace. **This has not materially changed.**

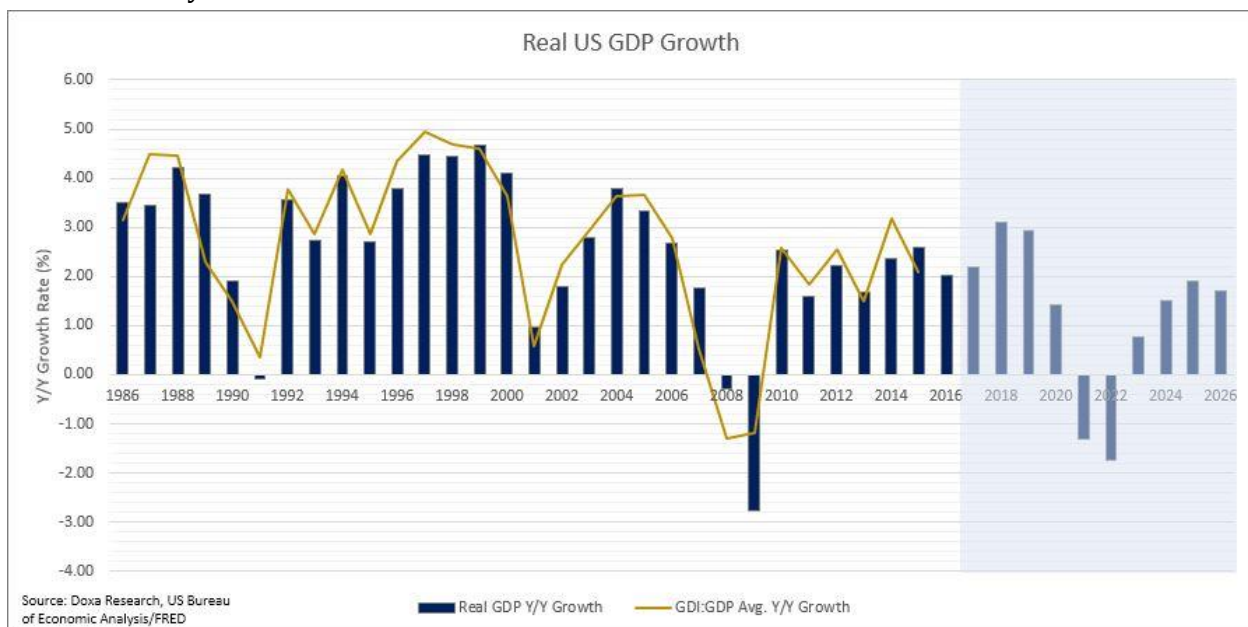
Stagnation events throughout history (especially the global ones) point to one very vague solution: an extraordinary event that raises final demand across multiple regions. In the past this event has most often been large scale wars or drastic changes in comparative advantage. Will massive populous-induced fiscal & regulatory easing take place across multiple OECD nations at once? Will this be enough to consume the excess global savings? Or will regions get a quick bump, only to fall right back into the global savings glut? Our instinct tells us that the answer is somewhere in the middle, but this is more likely a 2018/2019 theme. However, we caution that financial markets can easily be fooled by extrapolating better than expected data falsely into the future.

China, the mainland (Hang Seng Index) outperformed while the Shenzhen Index (Shanghai) underperformed. Luckily we rarely invest in country indices; nevertheless, this call wouldn't have gotten us anywhere.

2017 Outlook

The Battleground

2017 is shaping up to be a head to head battle between late-cycle economic headwinds and a flood of fiscal stimulus measures, with trade policy being the 'wildcard'. As previously laid out, our base case lies in between the two extremes and shows slight bias toward fiscal stimulus gains offsetting the economic headwinds. However, we believe a very large fiscal stimulus at this point in the cycle would have a very high probability of overheating the economy, shown by our above 3% and near 3% projections in 2018 and 2019 respectively. We find the claims for 4%+ real GDP growth to be extremely difficult to achieve.⁵



Disclaimer: US GDP can be influenced by many factors and can change rapidly. Forecasts greater than 2 years out provide little value other than framing an economic cycle.

As we have clearly established, many things **can** take place in the coming years and volatility should be elevated. As we look under the hood at both contenders and the wildcard in our 2017 battle, note that all assumptions are tied in our base case, unless otherwise noted. **Above all, 2017 may be a function of the following equation: $f(x) = \text{wage pressure (-), inflation \& interest (-), strong USD (-), deregulations (+), tax policy (+), fiscal spending (+), \& trade policy (+/-)}$.**

Contender #1: Economic Headwinds

Full employment and subsequent wage growth

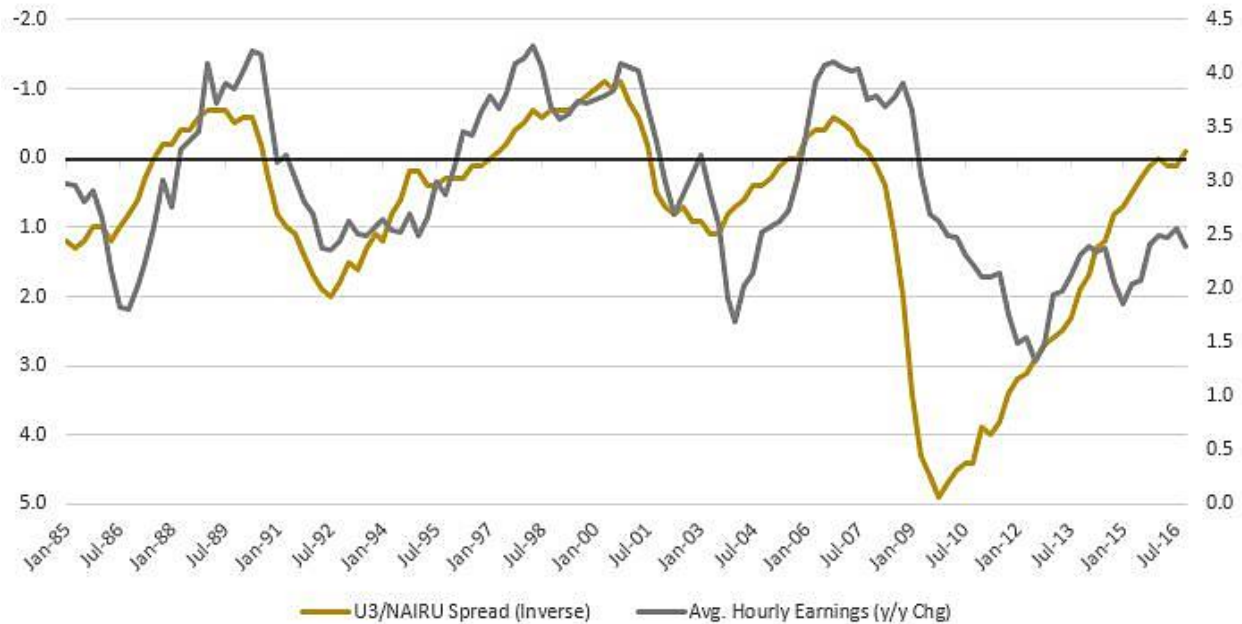
This is the behemoth of our 2017 playbook. Whichever direction the relationship between full employment and wages go, many economic factors follow, including the level of influence certain fiscal programs wield. The chartⁱⁱ below is showing labor market slack⁶ (left axis) compared to y/y

⁵ The absolute growth in dollars it would take to achieve this is very, very large.

⁶ Labor slack is the difference between current unemployment and the natural rate of unemployment

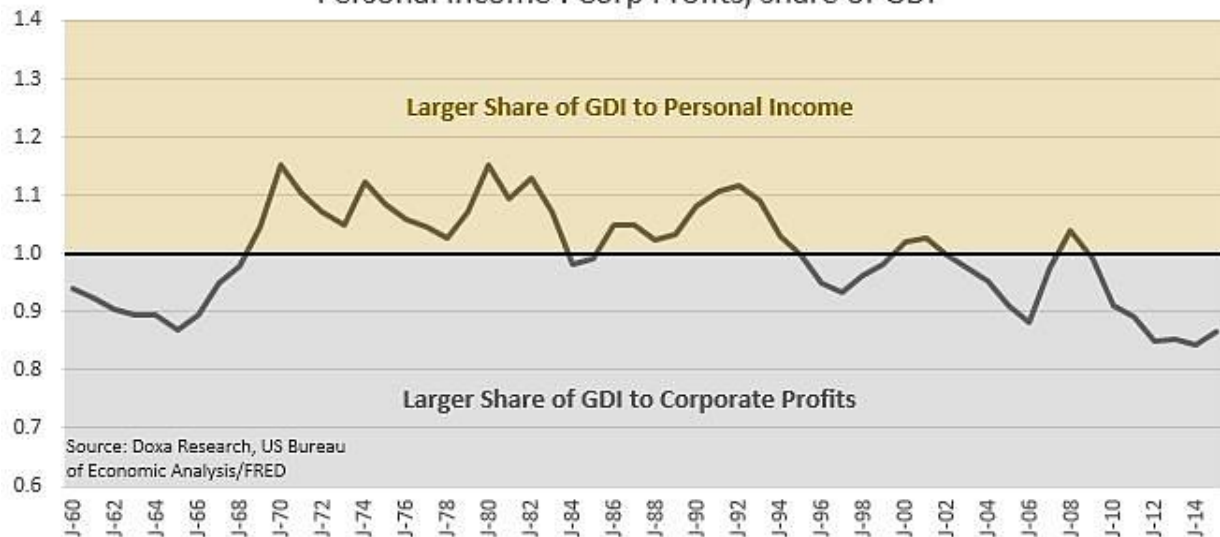
Source: Doxa Research, US Bureau of Economic Analysis/FRED, Bloomberg US Econ Outlook

Employment & Wages



wage gains (right axis). Here, labor market slack is defined as U3 (the commonly quoted unemployment rate) minus NAIRU⁷ (natural rate of unemployment). Put simply – the number of workers displaced in the prior recession that want to go back to work. When this number goes below 0 [note: the axis is inverted], bargaining power shifts from the employer to the employee. This occurs because workers are no longer abundant in the economy, making positions harder to fill. **As shown, 2017 will mark the first full year in this cycle that the US labor market will be without slack – shifting the bargaining power to employees.** Therefore, it is no coincidence that wages increase, sometimes rapidly, near full employment. As employment overshoots, we see no reason why wages would not approach 4% y/y growth as in prior cycles.

Personal Income : Corp Profits, share of GDI



⁷ Non-accelerating inflation rate of unemployment (NAIRU) is commonly viewed as the 'natural' rate of unemployment. In other words, the lowest unemployment can go without creating an excess amount of inflation.

As wages rise due to full employment, inflation most often goes with it. This is because employers are forced to raise prices to meet higher wage obligations. However, in a competitive environment, this is usually not sustainable and employers end up forgoing some excess profits. To quantify this on a macro level, we like to focus on the composition of GDI (Gross Domestic Income), specifically the ratio between corporate profits and personal income. When this ratio is above one, a worker is commanding a higher share of GDI in relation to history – when below one the inverse is true. It should come as no surprise that corporations currently hold a larger share of GDI relative to history seeing as they have had the bargaining power against workers for the last 8 years. 2017 should start a change in this trend.

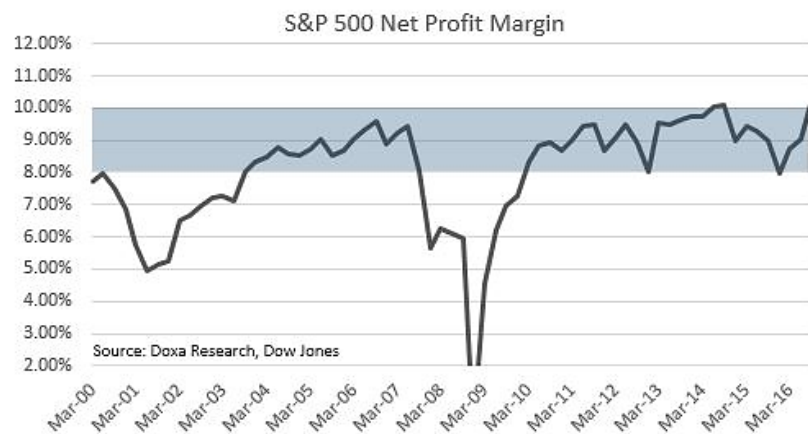
This section somewhat describes the inner workings of the 'Phillips Curve'.⁸

Implications...

Labor market slack has vanished. Wages will climb higher. Inflation will rise in tandem, which will cause the US dollar to weaken. Interest rates will move higher to combat expected inflation, but strengthen the dollar in the process.

...in financial markets?

What's good for workers is usually bad for profits – sometimes. The coming environment is one where casting a large net on all stocks may not work like it has the past 8 years.ⁱⁱⁱ When workers make more money, they spend more money (*we are Americans after all*) – but this is where it gets complex. The post-2008 consumer is more price conscious & brand aware. Millennials are shifting from downtown lofts in San Francisco to homes in Seattle. Grocery stores will trump restaurants.⁹ The 'spending ramp' from higher wages should create disparity between companies – half will see margins degrade as demand does not keep up with wages, while the other half sees demand exceed higher wage costs. **Those who have pricing power¹⁰ and/or hold profit margins should be clear winners in the coming years.**



Contender #2: Trumponomics

Pillar 1: Fiscal Spending (specifically infrastructure spending)

We start here because the potential benefit of infrastructure spending is directly related to employment and wages, which we just covered. Rebuilding America's infrastructure is a concept all political parties have been rallying behind, and for good reason. US infrastructure needs help. But a government doesn't just spend \$500bn+ because of need, they also utilize it as a way to stimulate the economy – in other words, a large infrastructure bill would kill two birds with one stone. Bridges, roads, pipes, etc. would be refreshed and the government would inject money into the economy by way of creating paying jobs (see: FDR or Eisenhower)¹¹.

⁸ The Phillips curve illustrates the economic relationship between unemployment and inflation.

⁹ These are anecdotal examples illustrating the shift in buying patterns.

¹⁰ Pricing power refers to demand elasticity of a certain good or service.

¹¹ Referring to FDR's 'New Deal' and Eisenhower's focus on the interstate system.

This is at least three years too late.

We argue that a hefty infrastructure bill might do more harm than good. As illustrated in the section above, the US economy does not need jobs.

*Yes, this contrasts with rhetoric elsewhere, but for a proper perspective look at the math: Take the lowest unemployment reading since 1954 of 3% and multiple that by (US population * Labor force participation), or $0.03 \times (330 \times .64) = 6.3$ million.*

So even at drastic overemployment¹² (3% U3), 6.3 million people will be without a job and will not get one (for multiple reasons). This is not a bad thing.

Despite the lack of need for jobs, we assume the new administration and congress will pass a bill anyways – meaning a tight labor market is about to becoming tighter. We believe this will be a huge drag on productivity because workers will leave their current job for a better paying (& safer) government one, yet there are no excess workers to fill the void these workers leave behind. To use an anecdotal example:

An avocado grower quits to become a wall builder (gov. paying), but no one to steps in and grows the lost supply of avocados. Either 1) we import the lost supply of avocados, 2) avocado prices soar to attract more growers, which pull these workers away from other industries. This cycle would continue until the weakest industry dies (ultimately by imports), or 3) consumers decide they do not want avocados anymore.

This silly example ultimately demonstrates that any stimulus provided is offset by an increase in imports. And then the drag hits when the stimulus expires (project completed) and the workers return to their less paying jobs.

Secondly, most tax payers want their money to be spent wisely. Again to reiterate the point from the prior section, 2017 will be the year where workers have bargaining power. A large infrastructure bill would certainly go much farther if this were not true, as it wasn't the past 8 years.

Clearly, it would be much more advantageous for a large infrastructure plan to be done at the start of the next recession, but we don't work on Pennsylvania Ave. Therefore, we expect this 'stimulus' to occur soon and do everything but stimulate.

Pillar 2: Tax Policy

This one seems simple. Cut all taxes. Everyone makes more and spends more. Corporations invest more. Economy does great. Next. *If economics worked like this, these quarterly notes would be one page.*

Since the 'Laffer Curve' was accepted in 1974¹³, the US has only seen two material tax changes – Reagan in 1986 and Bush in '01/'03. Corporate tax cuts were only seen in '86, so history doesn't lend much of a guide here. **We don't see how widespread tax cuts could hurt, but in fairness, history does not show material signs of boosting overall GDP either.**^{iv}

Nevertheless, we feel like the desired policy changes will boost some

S&P 500 Corporate Tax Scenarios

	Current	Scenario A	Scenario B
Eff. US Tax Rate	26%	20%	15%
Potential EPS Benefit	0%	8%	14%
Source: Doxa Research, GS Global Inv. Research			
Scenario A 20% Effective Rate	Larger Effect	No Change	Negative Effect
	US Retail	Healthcare	REITS
	Financials	Technology	Int'l Industrials
	Transportation	Energy	Utilities
	Domestic Services		Conglomerates
	Telecom		
Scenario B 15% Effective Rate	Larger Effect	No Change	Negative Effect
	US Retail	Int'l Industrials	REITS
	Financials	Conglomerates	Utilities
	Transportation		
	Domestic Services		
	Telecom		
	Healthcare		
	Technology		
	Energy		

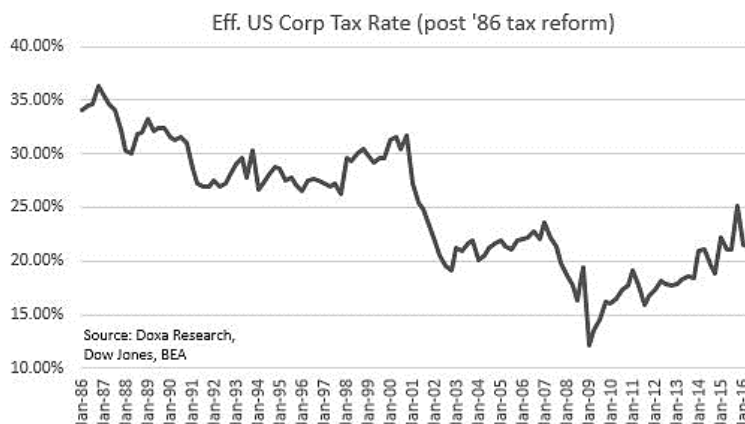
¹² Referring to an unemployment rate being lower than the natural rate of unemployment.

¹³ While around for a while, the concept was put to action until the 70's. Previous tax policies were inefficient.

corporate bottom lines, at the least. Here, we have attempted to illustrate how different rates^v would affect profits and sectors, independently. Lacking further detail, three important themes to consider are:

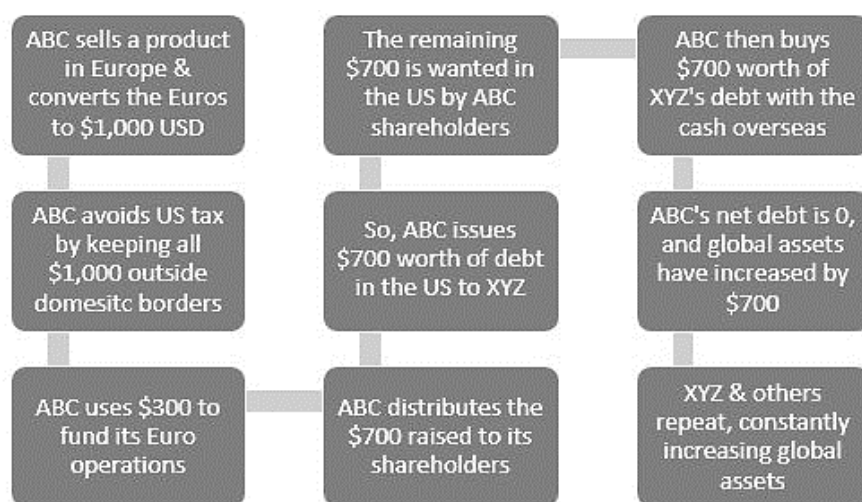
- 1) REITS and Utilities will be very hard pressed to see a benefit, if any.¹⁴
- 2) Large retail, transports, and financials should benefit the most.
- 3) Smaller C-Corps (not LLC's) may see a smaller benefit than expected.¹⁵

Many of our colleagues see tax policy changes adding roughly 8% (or \$10) to the S&P 500's earnings per share in 2018, and we have no reason to disagree. This is incorporated in our base case.^{vi}



Just as we cannot see how tax cuts could hurt, we also cannot see how a 'deemed repatriation' policy could help. **In short, we believe this could send large wrinkles across the fixed income market and would shrink total global assets.**^{vii} ^{viii} Deemed repatriation means all foreign profits (deferred tax liabilities) would be taxed at a specific rate, regardless of where the money is at the time. There is roughly \$2.5 trillion in deferred tax assets parked overseas, which is significant because an amount that large can influence markets easily. As the flow chart here shows, companies effectively move money around the world by issuing dollar dominated debt to one another. This constantly increases the size of global assets without creating excess leverage. Additionally, the interest earned often offsets the interest paid.

So if a deemed repatriation occurred, company ABC would pay a tax and be able to move cash freely. They would have no reason to own XYZ's debt and XYZ would have no reason to own ABC's. **We are worried that this will have consequences across the bond markets. Is there enough global demand to swallow ~\$1 trillion worth of sell orders?** Additionally, we do not feel comfortable knowing the global asset base will shrink. Looking to the flow chart for further clarity:



ABC's \$700 actually created \$1,400 worth of value. \$700 went to shareholders, \$700 created capital for XYZ (through debt). Unwinding all these positions would revert the \$1,400 back to \$700.

We have not assumed any implications from this in our models, simply because we do not know how. Global market participants may digest an unwinding just fine. Corporations may decide

¹⁴ These two sectors currently have an effective tax rate much lower than 10%.

¹⁵ Small corporations have a lower effective tax rate than larger ones. LLC's fall under different assumptions.

Healthcare and 'TrumpTweets'

It may come as a surprise, but we have chosen not to include the ACA as a 'deregulation' item. We see this more of a 're-regulation', e.g. ACA is not going anywhere. Instead, we believe it will be renamed (TrumpCare really wouldn't be surprising?) and retooled – ultimately providing all the same benefits as before, but at different prices and without mandates.

Using past legislation as reference, incoming DHH Sect. Dr. Tom Price and much of Congress support a larger degree of freedom in plan selection, expand HSA functionality, establish federal grants for high-risk pools, encourage cross-state competition, physician tort reform to lower cost, and scrap the medical device tax.

These changes won't be perfect and will certainly lower the cost for many individuals and companies, but greatly increase the cost for some. We very much expect the coming amendments to the ACA to be just the first of many over the next decade.

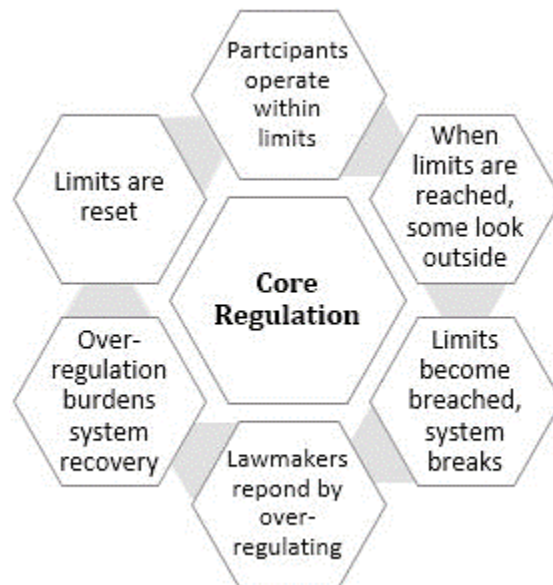
Sticking with the healthcare theme, DJT has transformed Twitter into a market moving machine – especially when it comes to drugs. Many corporate annual reports will now have to cite 'Adverse Presidential Tweets' as a business risk. However, it should be emphasized that when DJT is asked 'would you negotiate?' or 'is x price too high?', his answer will always be 'yes, we'll get it down.' This should not come as a surprise seeing as he authored a book titled "The Art of the Deal". Point being, we assign very little merit to drug price tweets and see great value in some fragments of the sector. We will caution however, the 'pay-for-value' approach will intensify making the investing landscape very different than in the past few years.

to not unwind or take a long time doing so [most likely]. Maybe not. This will be a focal point to watch throughout the year.

Note: We have heard "Companies with large foreign cash piles will increase buybacks!" We cannot imagine this to be correct. As shown above, companies are fully capable of issuing debt against cash to repurchase shares (and have done so at an astounding rate). Repatriation simply omits a step.

Pillar #3: Deregulation

Deregulation is potentially the most significant economic booster Trumponomics embraces, yet is unfortunately the one we know least about. At this point, we have detailed out late-cycle headwinds, ripped through fiscal spending, added an 8% profit bump because of tax policy, and discarded repatriation. **Basically, the 'big economic stimulus' has amounted to if tax savings will offset wage pressure.** We have 'deregulation' and 'trade policy' yet to review, but in terms of our base case we assume the two are negate each other. This is mainly adopted because of the uncertainty surrounding each, and broadly assumes deregulation helps unique sectors and adverse trade policy hurts unique ones.



Although not influencing our current outlook, the direction that the new administration takes on 'deregulation' will be one of the most important themes to watch in 2017. At a high level, removing red tape and cumbersome regulations should cut costs (sometimes drastically), encourage more competition (lowering the barriers to entry), and promote free market forces. Of course many regulations are very beneficial, but it is too early to speculate about specific cause and effects at this stage. **It should be underscored that resetting**

certain regulations should provide positive near term effects, with consequences realized at a later date (when participants push set limits).

As shown by equity prices since the election, financials, small corporations, and energy companies should see the greatest benefit since they have shouldered a larger regulation burden in recent years. Yet, it is way too early to accurately assess the size and scope of any deregulation benefits, much less determine the amount of value this may add to a certain corporation. It is also very important to note:

Regulation often achieves its intended objective (which most likely needs to be addressed). It is the unintended consequences that may cause a burden larger than the initial problem. This remains true when the process is reversed.^{ix}

As long term investors, we are constantly in search of unintended consequences. While short term market movements can easily be attributed to policy commentary, the *real* market moving effects are usually buried under the surface.

The Wildcard: Trade Policy

Trade policy goes in our wildcard slot for 2017 primarily because we have no idea what direction to take. Honestly, we do not know what 'NAFTA has got to go' actually means, nor can we interpret, 'We'll get better deals.'^x However, we are 99% certain that a trade war (embargo, tariff, etc.) with a major US partner¹⁶ would send most OECD countries into a recession, potentially a deep one. It is for this reason that we would be very surprised to see anything materially altered on this front (outside of political showmanship). In other words, we have faith that the current team assembled would not blindly steer the US economy off a cliff. If you catch yourself asking why a trade war would be so harmful, consider these three points:

- 1) The US is consumer dominated (e.g. 'service-oriented'). America has wide and vast resources, but we still could not maintain our current level of GDP if we had to do it all ourselves. Google comparative advantage.¹⁷
- 2) The US is a net importer and 'finished good' focused.¹⁸ Basically, we import cheap raw materials, making something out of it, and sell it. No cheap parts = no cheap goods.
- 3) The US government can only control just that, the US. If we tariff washing machines, the reciprocating country will embargo the raw materials needed to make the washing machine. Nonetheless, we will continually monitor for marginal developments along this front and wouldn't be surprised to see some minor casualties along the way. A couple of final points to note:

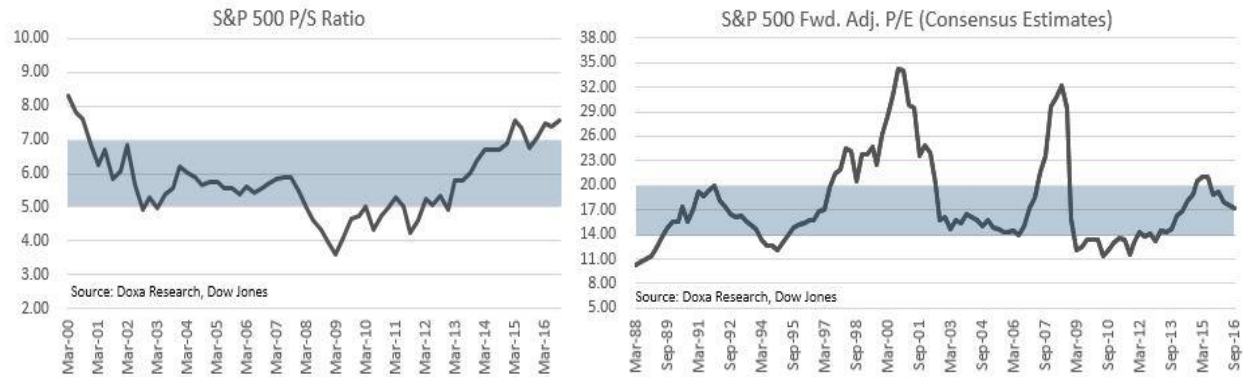
- 1) China does a lot of things, but purposefully devaluing the yuan is absolutely not one of them. Since 2014, the USD has appreciated against nearly all major currencies in the world for a variety of reasons, the yuan included. In fact, market forces would like to depreciate the yuan further, but China is holding it up – they are actually appreciating their currency compared to the market! This is shown by the huge decline in China's currency reserves, roughly \$1 trillion since the beginning of 2014.^{xi}
- 2) Since 1979, the US has displaced (lost jobs + jobs never created) 25 million manufacturing workers due to productivity gains.¹⁹ Since 2001, the US has lost 3.2 million manufacturing jobs to China. Bring back manufacturing jobs? Stop innovation.^{xii}

¹⁶ Depending on the good, the US could most likely substitute small countries that export to the US.

¹⁷ Comparative Advantage (n.) – the ability of an individual or group to carry out a particular economic activity more efficiently than another activity.

¹⁸ Over 50% of US exports are 'finished goods'.

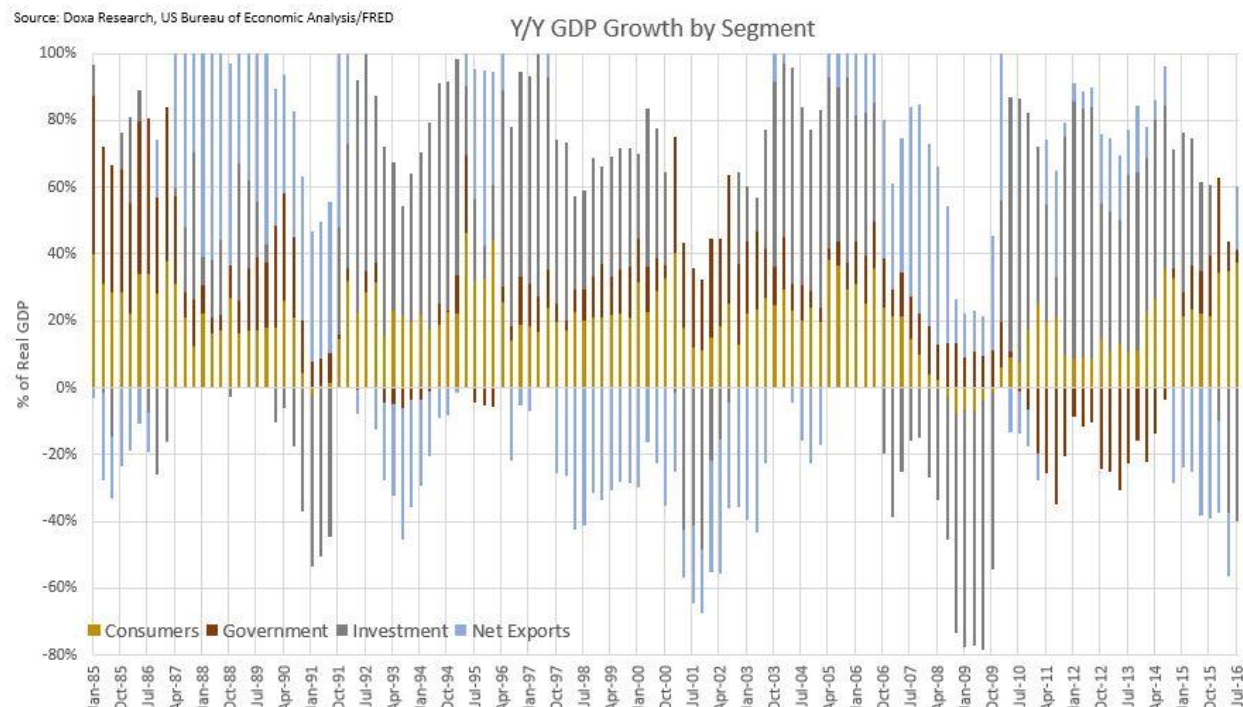
¹⁹ Calculated by taking the current level of manufacturing output and dividing it by the level of manufacturing productivity in 1979.



Valuation

Since Election Day, the financial markets have been on a tear, with every index gaining ground – even Mexico. We are not going to put as much emphasis on this section than in prior years because ‘animal spirits’ seem to have taken over in the near term. Many investors were incorrectly positioned for the recent rally, making it seem more violent than usual. Secondly, when a change is very large or is expected to be realized over a long period of time, the higher the chance a market is pricing the said change incorrectly at the onset. We are seeing this currently. If we wanted to, we could build a solid case for every one of the outcomes in our S&P 500 earnings matrix – the uncertainties at this stage are just too large. With that being said, we can make a couple of high conviction points:

- 1) The P/E multiple will be lower in the future than it is today. It is hard to imagine why the equity multiple would increase with increased economic uncertainty.
- 2) If one is true, then equity returns will be a product of earnings growth.
- 3) Current index valuations are fair. It is always hard to know what is priced in, but we assume a healthy tax cut, a 2-3% tailwind from deregulation, and maybe a 1-2% tailwind from fiscal policy and wage growth are priced in.



- 4) We would not be surprised to see a tumultuous first quarter, but assume the 'buy on dip' mentality remains unless the earnings outlook materially changes.
- 5) The biggest risk to derailing the US economy remains consumer retrenchment. This risk is constant year over year, but extra emphasis is being used this year. As the chart above illustrates, the consumer is hardly getting any help from other GDP constituents.

The Weighing Machine

As the greatest investors in history continue to teach us, investing while focused on the 'voting machine' (short term market movements) yields far inferior results than investing while focused on the weighing machine (long term fundamentals).²⁰ In the simplest argument, the weighing machine requires only a few accurate variables, whereas the voting machine requires many (and often more difficult to predict). Obviously, Doxa Capital regularly favors the weighing machine over the voting machine as 1) the equation is simpler to predict, 2) it is driven by fundamentals, and 3) it has proved to be superior. As previously noted, the input to the weighing machine can be viewed as: cash flows + expectation for future cash flows + intangibles = long term value of asset. We persistently remind all of our investors to view changes through this lens.

Politics do not solely determine cycles, earnings, and fundamentals. While policies can certainly create headwinds or tailwinds, they cannot make a bad business great again. As we navigate through 2017, focus will undoubtedly remain on earnings, economics, and politics. In doing so, we will continue to favor those investments that meet our three mandates: pricing power or economic tailwinds, diversified product or geographical revenue, and a healthy valuation that shows a clear upside.

Chase Lee

Director of Research

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²⁰ This is an opinion, not a fact.

ⁱ Graham, Benjamin, *The Intelligent Investor*, 1949

ⁱⁱ Doxa Research recreated this chart based on the 'US Economic Outlook' presentation from the Bloomberg US Equity team, Dec 2016

ⁱⁱⁱ Sen, Conor, So Much for Autopilot. Now Active Investors Get a Turn, <https://www.bloomberg.com/view/articles/2016-12-06/so-much-for-autopilot-now-active-investors-get-a-turn>

^{iv} Samwick, Andrew, & Gale, William, Effects of Income Tax Changes on Economic Growth, <https://www.brookings.edu/research/effects-of-income-tax-changes-on-economic-growth/>

^v The rates used are from the Trump Tax Plan, found here: <https://assets.donaldjtrump.com/trump-tax-reform.pdf>

^{vi} Goldman Sachs Investment Research and Morgan Stanley Investment Research

^{vii} New River Investments, <https://medium.com/new-river-investments/profit-repatriation-and-the-bond-market-708bfa7f7d40#9kwk4nugl>

^{viii} Sen, Conor, Markets Would Struggle to Digest Corporate Tax Reform, <https://www.bloomberg.com/view/articles/2016-11-22/markets-would-struggle-to-digest-repatriation-of-corporate-cash>

^{ix} Dimon, Jaime, 2011 Letter to Shareholders, https://www.jpmorganchase.com/corporate/investor-relations/document/JPMC_2011_annual_report_letter.pdf

^x Trump's Twitter account?

^{xi} Bloomberg News, 12/7/2016, <https://www.bloomberg.com/news/articles/2016-12-07/china-foreign-reserves-drop-most-in-10-months-as-yuan-slumps>

^{xii} Marks, Howard, Economic Reality, pg. 10, <https://www.oaktreecapital.com/docs/default-source/memos/economic-reality.pdf?sfvrsn=6>, Oct. 2016

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Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to subprime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities, directly or indirectly, is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

ECONOMIC INDICATORS AND FINANCIAL DEFINITIONS

GDP / Economic Expansion – GDP (Gross Domestic Product) measures the total market value of a nation's output of goods and services during a specific time period. It is usually measured on a quarterly basis. Current GDP is based on the current prices of the period being measured. Nominal GDP growth refers to GDP growth in nominal prices (unadjusted for price changes). Real GDP growth refers to GDP growth adjusted for price changes. Calculating Real GDP growth allows economists to determine if production increased or decreased, regardless of changes in the purchasing power of the currency.

Inflation – The Consumer Price Index (CPI) NSA (non-seasonally adjusted) measures changes in the price level of a market basket of consumer goods and services purchased by households. This indicator value represents the trailing year over year % change in the CPI index as of last month-end.

Beggar-thy-Neighbor - an economic policy through which one country attempts to remedy its economic problems by means that tend to worsen the economic problems of other countries.

C + G + I + NX – this common equation refers to the composition of GDP. C = consumer spending, G = government spending, I = domestic investment, and NX = total imports less total exports.

Recession - A period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters.

Depression - a sustained, long-term downturn in economic activity in one or more economies. It is a more severe downturn than an economic recession, usually identified by a fall in GDP for four consecutive quarters.

Populism - a belief in the power of regular people, and in their right to have control over their government rather than a small group of political insiders or a wealthy elite.

Stagnation - a prolonged period of little or no growth in an economy. Economic growth of less than 2 to 3% annually is considered stagnation, and it is highlighted by periods of high unemployment and involuntary part-time employment.

Aggregate Demand - In macroeconomics, aggregate demand (AD) or domestic final demand (DFD) is the total demand for final goods and services in an economy at a given time. It specifies the amounts of goods and services that will be purchased at all possible price levels.

Aggregate Supply - In economics, aggregate supply (AS) or domestic final supply (DFS) is the total supply of goods and services that firms in a national economy plan on selling during a specific time period. It is the total amount of goods and services that firms are willing and able to sell at a given price level in an economy.

Neutrality Acts - laws passed in 1935, 1936, 1937, and 1939 to limit U.S. involvement in future wars. They were based on the widespread disillusionment with World War I in the early 1930s and the belief that the United States had been drawn into the war through loans and trade with the Allies.

Monetary Stimulus - an attempt to use monetary or fiscal policy to stimulate the economy by lowering interest rates and/or quantitative easing.

Monetary Policy - the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.

Yield - The yield of a bond is inverse to its price: as bond prices increase, bond yields fall. For example, assume that an investor purchases a bond with a 10% annual coupon and a par value of \$1,000. The yield on this bond would be its par value divided by the interest it pays.

Unemployment – The Bureau of Labor Statistics measures employment and unemployment of all persons over the age of 15 using two different labor force surveys conducted by the United States Census Bureau (within the United States Department of Commerce) and the Bureau of Labor Statistics (within the United States Department of Labor) that gather employment statistics monthly.

The S&P 500® Index - is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

Capital Expenditures (Capex) - A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life extending beyond the taxable year.

Multiple / Price to Earnings Ratio (P/E) - a ratio for valuing a company that measures its current share price relative to its per-share earnings.

Quantitative Easing - is a type of monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

High-Yield Bond - A high paying bond with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

The Dow Jones Industrial Average - a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

Corporate profit - also called net income, the amount remaining after all costs, depreciation, interest, taxes, and other expenses have been deducted from total sales.

Liquidity - the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.

Wages - monetary compensation (or remuneration, personnel expenses, labor) paid by an employer to an employee in exchange for work done.

R-squared (R²) - a statistical measure of how close the data are to the fitted regression line. It is also known as the coefficient of determination, or the coefficient of multiple determination for multiple regression.

Adjusted EPS / Pro-forma EPS - otherwise known as non-GAAP earnings, this EPS number factors in currency effect, D&A, & non-recurring expenses.

Profit Margin / Net Margin - the percentage of revenue left after all expenses have been deducted from sales. The measurement reveals the amount of profit that a business can extract from its total sales. The net sales part of the equation is gross sales minus all sales deductions, such as sales allowances.

Structural - of or relating to the arrangement of and relations between the parts or elements of a complex whole.

Developed Economy - countries with high gross domestic product (GDP) per capita and industrialization; countries in which the tertiary and quaternary sectors of industry dominate would thus be described as developed.

Emerging Economy - progressing toward becoming more advanced, usually by means of rapid growth and industrialization. These countries experience an expanding role both in the world economy and on the political frontier.

Potential Recession Causes:

- 1 High-interest rates. When rates rise, they limit liquidity, or the amount of money available to invest. The biggest culprit was the Federal Reserve, which often raised interest rates to protect the value of the dollar. The Fed raised rates to battle stagflation, causing the 1980 recession. It did the same thing to protect the dollar/gold relationship, worsening the Great Depression.
- 2 A stock market crash. The sudden loss of confidence in investing can create a subsequent bear market, draining capital out of businesses.
- 3 Falling housing prices and sales. As homeowners lose equity, it forces a cutback in spending as they can no longer take out second mortgages. Over time, it will cause foreclosures. This was the initial trigger that set off the Great Recession, but for different reasons. Banks that lost money on the complicated derivatives based on underlying home values.
- 4 A slowdown in manufacturing orders. Orders for durable goods started falling in October 2006, before the 2008 recession actually hit.
- 5 Wage-price controls. Fortunately, this only happened once, when President Nixon kept prices too high, cutting demand. Employers laid off workers because they weren't allowed to lower wages.
- 6 Slowdown after a war. This caused both the 1953 recession, following the Korean War, and the 1945 recession, following World War II.
- 7 Credit crunch. This occurred when Bear Stearns announced losses thanks to the collapse of two hedge funds it owned. The funds were heavily invested in collateralized debt obligations. When Moody's downgraded its debt, it, banks who were in a similar overinvested condition panicked. They stopped lending to each other, creating a massive credit crunch.
- 8 Asset bubbles: This is when the prices of internet companies, stocks or houses become inflated beyond their sustainable value. The bubble itself sets the stage for a recession to occur when it bursts.
- 9 Deflation, which encourages people to wait until prices are lower. This aggravated the Great Depression.