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OUTLOOK 2017

The End of the "Managed Economy": The Good, the Bad, and the Unknown

By Rob Stein

CEO, Astor Investment Management

From where we stand with the economy and stock market today, it's hard to believe that the great recession of 2008 occurred nearly a decade ago. During the 17-month bear market between the October 2007 top and the March 2009 low, the S&P 500 lost about 50% of its value. And since that time, much has been written and discussed about what I call the "great experiment of the managed economy," as central banks used fiscal policy (and a few extraordinary measures) to govern the economy. In the process, what the central bankers said and did wielded tremendous influence over stocks, bonds, and other asset valuations.

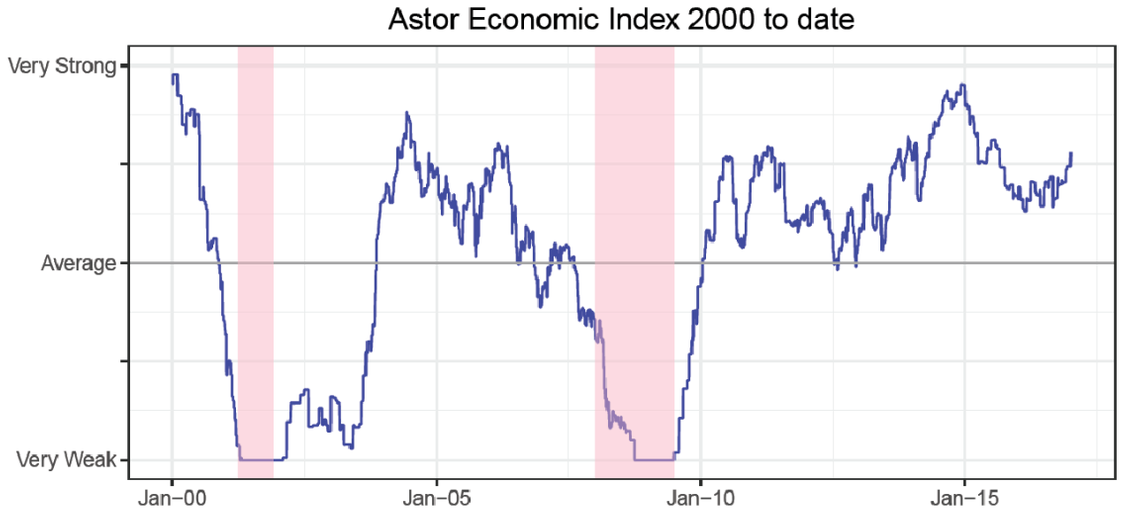
Aware of investors' intolerance for another 30-50% decline in stocks, housing, or general risk assets, central bankers embarked on a managed economy that "cut off the tails." That is, the downside was limited by Fed intervention, quantitative easing (QE), and regulation, while the upside was capped in exchange. Some may not view this as a bad trade. But others believed this central bank "manipulation" would be the end of the free market economy. Ultra-low interest rates, tight regulation on anything speculative, the Fed's QE, and outright purchases of a variety of debt, mortgages, and so forth, all helped control the markets. While I can write until my fingers fall off about the managed economy, QE and my views of the good, bad, and unknown, the reality is, this managed economy appears to be coming to an end.

Looking ahead to 2017, I expect that we'll see less of a managed economy—but not solely because of changes in the political landscape (although this does play a part). The larger reason is it's time!

To be clear, I am not calling for the end of the bull market, which as of this writing boosted the S&P 500 above 2200 and the Dow reaching 20,000.

The S&P 500 Index rallied strongly into year-end 2016.
Past performance is no indication of future results.

Nor am I predicting an economic slowdown. In fact, in its latest reading, our proprietary Astor Economic Index® (AEI®) reflects improving U.S. economic fundamentals that are supportive of investors holding higher levels of risk assets, such as equities.



The Astor Economic Index® (AEI) shows the U.S. economy at above-average levels.

This economic "now-cast" is further supported by the fact that the Federal Reserve's December rate hike was well received (in addition to being much anticipated). Global stagnation appears to have bottomed, and wages and employment trends continue to move in the right direction.

However, I do think that with the central bank and Washington loosening their grips on the reins of managing the economy, we can expect to see more volatility in certain asset classes and, perhaps more importantly, the decoupling of correlations between assets. Even within the same asset classes, such as stocks, there will be a divergence of returns from sectors. In other words, a rising tide will not lift all ships in 2017.

The Drama of 2016

Before looking ahead, it's helpful to think back on 2016 and review the drama that made it a little worse for the weary—or, should I say, the worried.

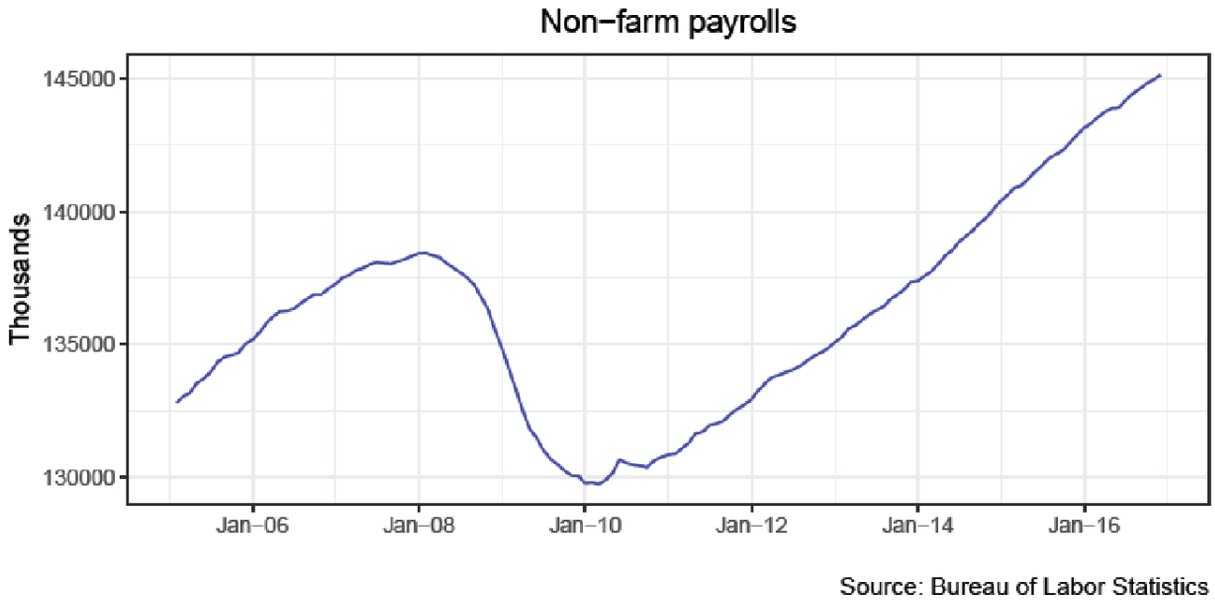
Last year began with a volatility spike and a sell off—the worst start of a new year ever for the stock market. By the February 11 low, the S&P 500 had lost more than 10%, and high-yield bonds were down more than 5%. Crude oil prices were 30% lower, which drove down commodities as a whole. Diminished expectations for China's growth further compounded concerns about the global economy.

But as we assured our clients, we focused not on the fears—but on the fundamentals. As we said in mid-January 2016, the U.S. continued to post moderate growth, as evidenced by both GDP and AEI readings, although some pockets of weakness remained. Despite market volatility at the time, the larger economic fundamental picture remained unchanged and supportive of stock exposure. The market recovered in a few weeks as it had on most occasions during the managed economy experiment.

At mid-year, the markets, and especially currencies, were rattled by the unexpected "Brexit" vote outcome, authorizing the UK to leave the European Union. A selloff in equities reflected fear and uncertainty about what would happen next. Again, we turned to the economic fundamentals, thanks to the AEI, for perspective. As we wrote in our morning-after Brexit analysis, as historically or politically significant as this event was, it was still an "event." Our research has shown that markets tend to recover from "events" if economic fundamentals are solid. The AEI reading at the time still supported a "meaningful weighting" in U.S. stocks.

The U.S. presidential election (one of the strangest in our memory) was not to be undone when it came to drama. Yet, even as the race became more heated and, at times, vile, early market shocks due to uncertainty all but disappeared. The Trump-Clinton contest escalated, with highly divisive campaigns into the home stretch. Making the contest even more emotionally charged, each candidate seemed to personify what partisan voters hated most about the "other side." Sadly, it became polarizing to the point of sparking violence.

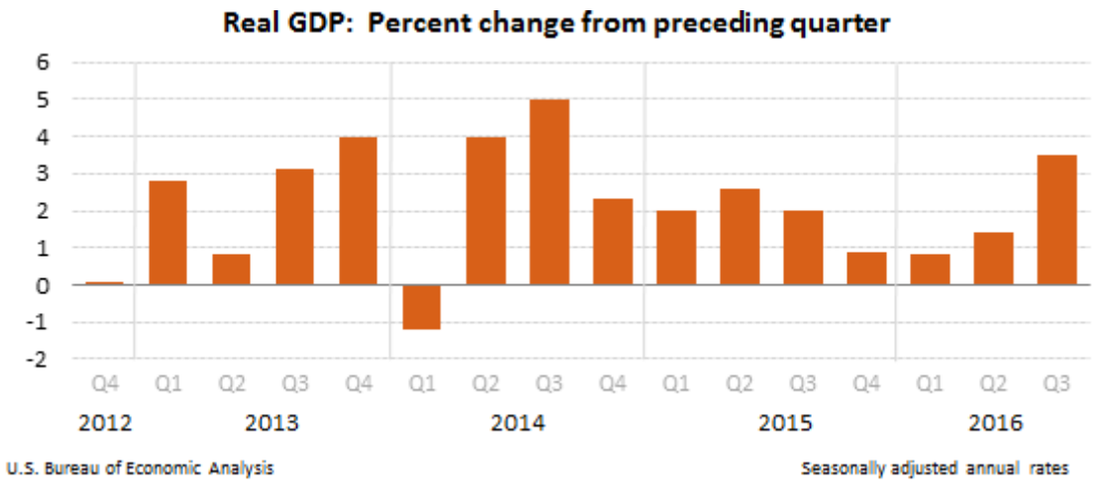
As the election drama unfolded, economic fundamentals were improving. The U.S. unemployment rate dropped below 5% and wages were higher.



Steady improvement in the U.S. employment picture

Improvement in hourly wages

GDP was also being revised upward. For Q3 2016, for example, the third (final) estimate GDP estimates were also revised upward. For Q3 2016, for example, the third (final) estimate was 3.5%, an increase from the second estimate for the quarter of 3.2%, and the advance estimate of 2.9%. The second half of the year also showed increasing output.



U.S. GDP showed quarter-to-quarter improvement in 2016.

At this point in time, given the improving fundamentals, a long-anticipated second rate hike by the Fed was all but in the cards. As election day neared, the market did not flinch with every poll result, as it had in the past.

On election night, however, the market received yet another shock as Donald Trump's election took the pollsters by surprise. Overnight, the market dropped, with Dow futures down more than 900 points at one point. But the equity markets recovered to close higher on the day after the election. And so ensued a market rally that, by year-end, was being called the "Trump rally." Or was it?

Our question was not then (nor is it now) meant to be political. As we've stated, in our view this rally would have occurred no matter who won the election. We believe the rally in stocks is based on the strength of the current economic fundamentals as well as the end of uncertainty following a vicious election and the building of momentum as the economy is finally allowed to run. And, let's not forget that interest rates, while still low, had one of the largest increases in recent memory, as the 10-year Treasury bond jumped from about 1.5% to more than 2.5% in less than a few weeks with little impact on the stock market. In 2017, we'll see what the impact of higher rates will be on other assets such as housing, gold, and corporate debt.

A further highlight to 2016 was the manufacturing sector, which earlier had been worrisome. Manufacturing strengthened later in the year, with the December ISM Manufacturing survey coming in at 54.7%, an increase of 1.5 percentage points from 53.2% in November. Even the global economy appeared to have bottomed and growth prospects brightened.

Perhaps, though, we have forgotten what we've been through to get here. As Daniel Kahneman observed in his book, *Thinking, Fast and Slow*, "Most impressions and thoughts arise in your conscious experience without your knowing how they got there." As we consider the transition out of a managed economy we would be wise to consider how we got here and what we learned along the way.

Looking ahead, here are some major themes that we believe will be significant in 2017 and their impact that, as of this writing, we can categorize into the good, the bad, and unknown.

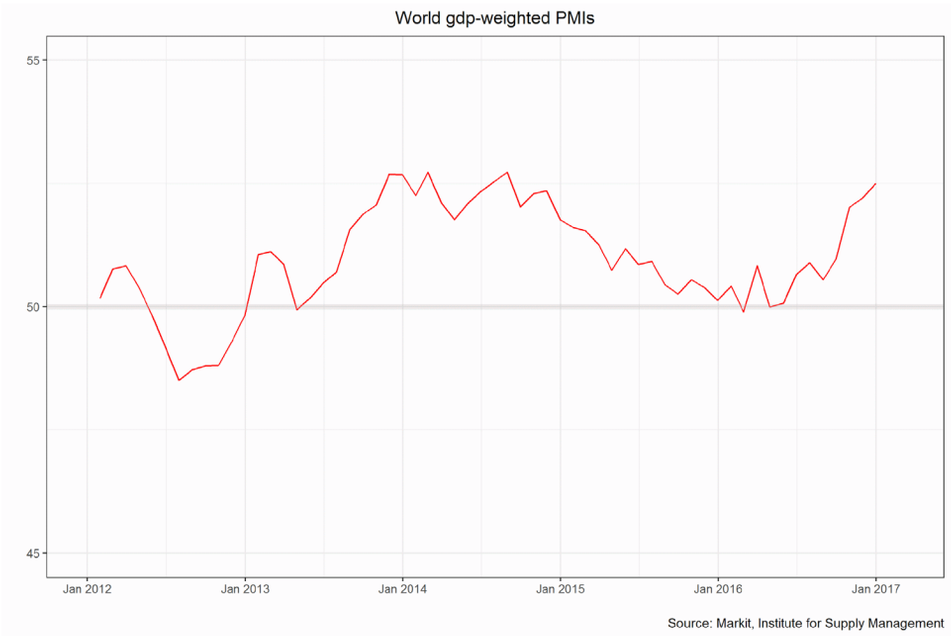
When the Fed finally pulled the trigger in December 2016 to raise short-term rates by 0.25 percentage point to 0.50-0.75%, it was only the second such move since 2006. At a press conference following the FOMC's last two-day meeting for the year, Fed Chair Janet Yellen described the "confidence we

The Good: A "Vote of Confidence in the Economy"

have in the progress the economy has made and our judgment that progress will continue. And the economy has proven to be remarkably resilient, so it is a vote of confidence in the economy."

The AEI also shows above-average growth in the U.S. economy. When it comes to holding risk assets (equities) that is "good" news: As we frequently remind clients, our research shows that periods of economic expansion favor equities. Conversely, periods of economic contraction (recessions) are not favorable for holding equities, and may be more appropriate for fixed income or even inverse equity positions.

Also in the category of "good news," the Trump Administration's plan for infrastructure build-out is likely to be productive, if financed correctly. As someone who believes not all spending is bad, I view such expenditures and, yes, even borrowing to spend, as being capable of producing positive economic results, as well as greater efficiencies and cost savings over time. And let's not forget the new administration's theme of lower tax rates, which could create some short-term stimulus for the U.S. economy.

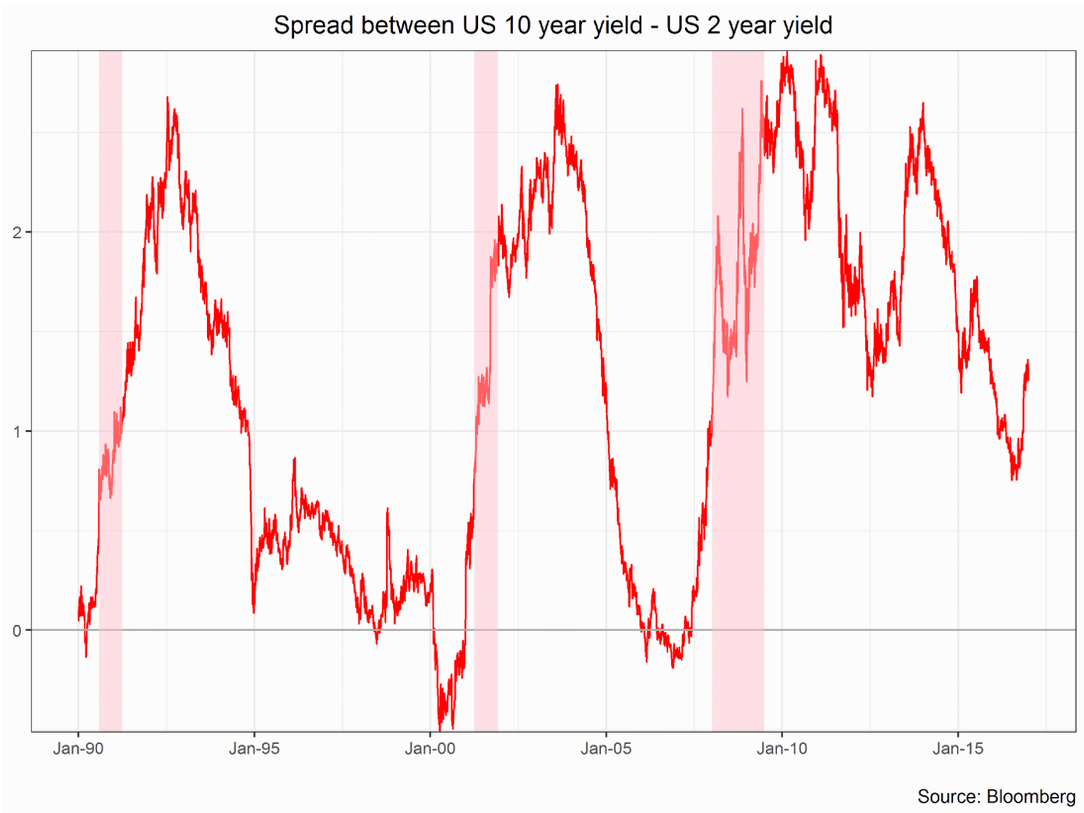


Global manufacturing is on the rise, as shown in this GDP-weighted index.

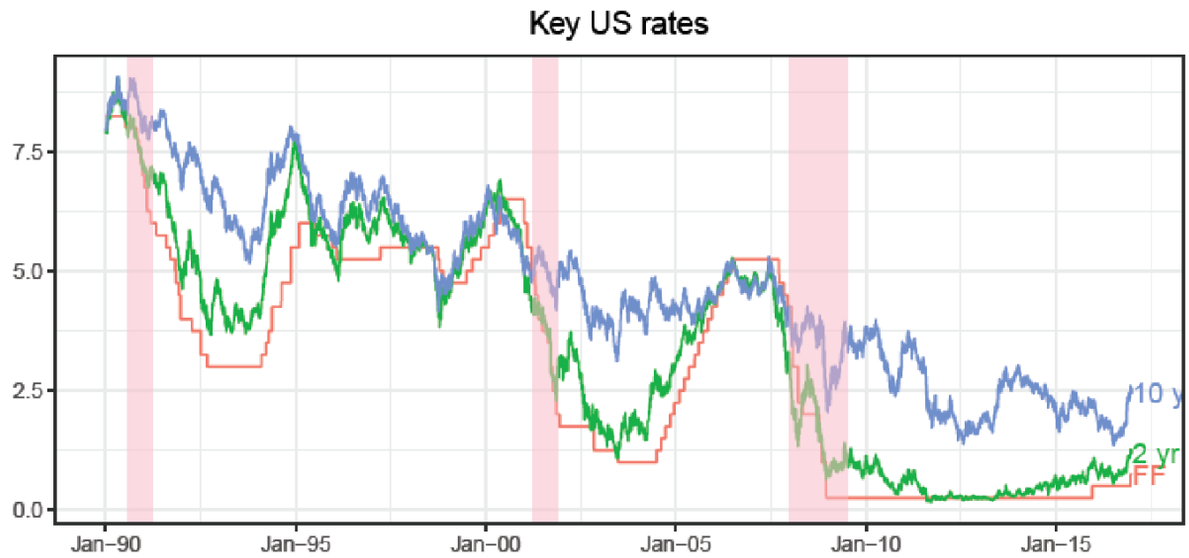
The Bad – Bond Prices Take a Beating

Bond prices have dropped precipitously. Since July 2016, the 10-year yield has risen by more than 1 percentage point—marking only the fourth time it has risen that fast since 2009. This shift was felt across the global markets, including in bonds; in November 2016, the Barclays Global Aggregate Bond Index had its worst month since the summer of 2003. Combined with an almost 1% drop in October, the two-month move in bond prices is on par with the so-called "taper tantrum" of 2013, when yields rose dramatically over a period of four months while government bonds came under significant pressure.

As we look ahead, we see inflation picking up and rates rallying. This has translated into a steeper yield curve, which I expect to be flattening toward end-2017 as short-term rates rise faster than long-term yields.



While the yield curve has steepened, our outlook is for a flattening curve toward end-2017.



Source: Bloomberg

A snapshot of key rates shows recent strengthening.

(blue line, 10 year; green line, 2 year, and red line, Fed Funds)

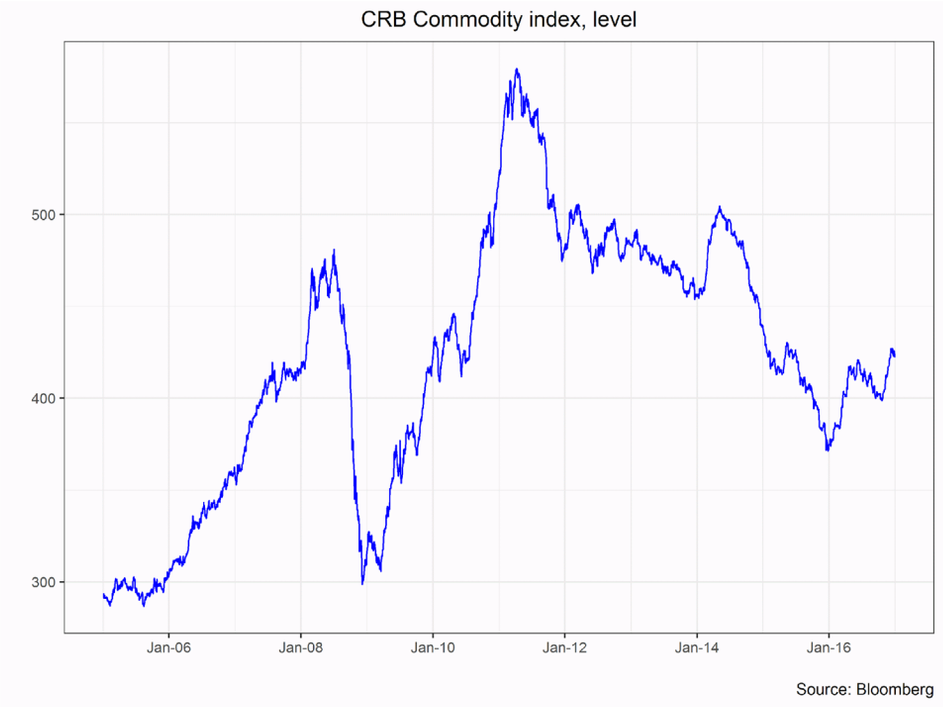
As we look ahead, in addition to a strengthening economy and expectations for more Fed rate hikes, changes in credit quality could also cause rates to rise. Higher rates as well as potentially higher-than-expected inflation could pose some challenges for corporate bonds, especially non-triple A issues.

The Unknown: Politics and Policies and China

While the end of the presidential election drama put to rest one unknown (we know who won), there are many other uncertainties. As we've noted, some investors are interpreting the Trump agenda as being supportive of the economy. Some proposals, however, could hurt stocks, such as limitations on international trade. In addition, increased spending and lower tax revenue could lead to a larger deficit, while policies that could accelerate interest rate hikes would make it harder for corporations to float debt.

While much remains to be seen about the specifics of Trump's fiscal policies, a Republican-led Congress likely will cooperate with him. But for all Trump's ideas that could stimulate growth (e.g. infrastructure investments), at least in the short run, keep in mind that it takes a lot for anyone to execute a plan into action.

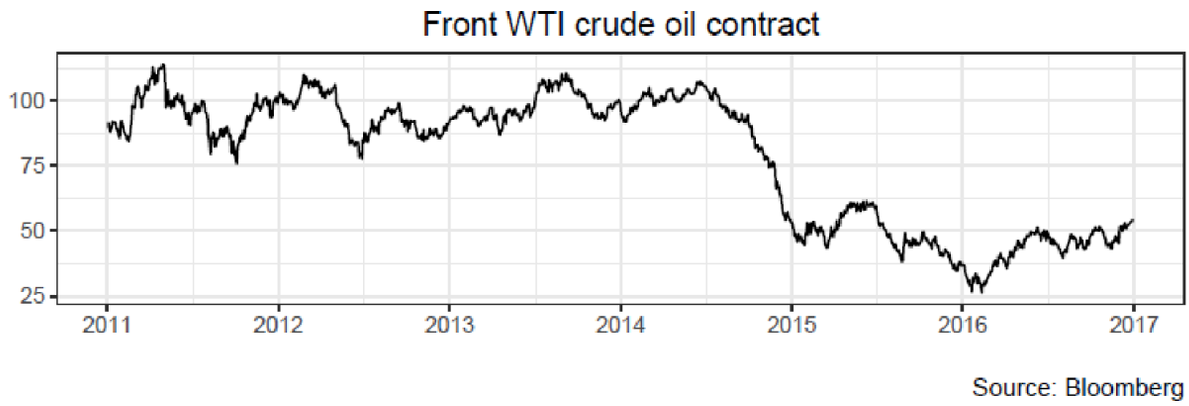
In the global economic picture, China appears to be struggling, while the rest of the developed world is showing signs of improvement. A strong U.S. dollar will help with China's exports. Commodity prices are on the rise, which could also be helpful for China's economy. The bigger unknown is U.S. trade policy moving forward.



Commodity prices improve overall.

Also on Our Radar

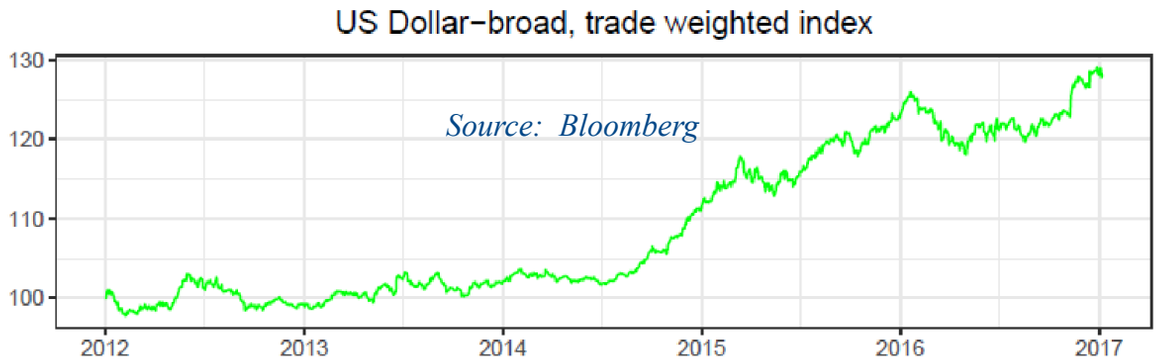
- **Commodities**: Oil prices, which have been under pressure since mid-2014, strengthened for much of 2016. In fact, the energy sector outperformed last year, largely due to OPEC oil production cuts. If OPEC members adhere to quotas in 2017, this sector should also see some recurring strength as the global economy improves.



Oil prices recover in 2016 and early 2017

Gold and other precious metals, meanwhile, have retreated due to a stronger dollar and expectations that the Federal Reserve will raise interest rates at a more aggressive pace than in the past year. Gold typically compete with yield-bearing assets, and becomes less favorable in the eyes of investors as rates begin to rise. Recent history has shown that gold's performance typically lags expectations during periods of modest but rising inflation.

- **Currencies**: The U.S. dollar's rally continues, but at a more moderate pace. On the first trading day of the New Year, the U.S. dollar hit its highest level in more than 14 years, thanks to strong economic data and expectations of higher interest rates. While it has retreated some from its highs, a strong dollar could hurt U.S. exports.



The strengthening U.S. dollar

- **Housing:** The housing market remains solid, bolstered by growth in wages. Higher mortgage rates are also pushing fence-sitters to act. Later in 2017, however, higher rates will likely cool this market.

- **Emerging markets recover:** The outcome of the U.S. election, and fears of both protectionism and a strengthening dollar, hurt emerging markets (equities and currencies). These concerns were especially felt in Mexico, which had been the target of Trump's punitive stance toward U.S. manufacturers relocating production to that country. A stronger dollar and higher U.S. interest rates also impact emerging markets as many are borrowers of foreign capital. However, there is some evidence that emerging markets are recovering as investors are looking for value in this international sector.

Time for Dynamic

As 2017 brings about what we expect to be the end of the "managed economy," there will likely be more uncertainty and increased market volatility. In this investment environment, investors' attention is turning increasingly to diversified portfolio solutions. Among them is taking a dynamic approach to asset allocation. At Astor, we take a macroeconomics-based approach to dynamic asset allocation. We believe a dynamic approach to be preferable for producing solid returns over time, while managing risk, than index-based passive investing.

Investors may still benefit from having a portion of their portfolios dedicated to "cheap beta"—that is, market exposure that is far easier and cheaper to capture with an ETF that replicates the S&P 500 or another index. However, we believe that active investing has a role to play in overall portfolio strategies. In fact, active investing, in our view, could very well be an answer to the essential question for investors (one that has become muted in the rush to passive investing): *What is my long-term portfolio objective?*

Taking a dynamic approach allows investors to be more mindful of opportunities among asset classes or sectors. We do not advocate market timing, trying to pick tops and bottoms; however, we do believe that greater flexibility may be key to identifying those sectors that are more likely to perform favorably over the next several quarters or years. While passive investing still has its place, in our view the time has come, once again, for taking a more dynamic approach to asset allocation as part of overall diversified portfolio solutions.

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Macroeconomics-Based Asset Allocation

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Definitions:

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2017-17