CLIFFORD SWAN

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WISDOM *for* GENERATIONS

MARKET OUTLOOK

By Peter J. Boyle
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During the 1988 World Series, legendary Los Angeles Dodgers' announcer, Vin Scully, spoke these now famous words: "In a year that has been so improbable, the impossible has happened." He was speaking of baseball, not politics, but he could just as well have been describing surprising global political tides in 2016. In June, British voters narrowly passed a referendum to leave the European Union. Then, in October, Columbian voters shockingly rejected a peace accord that had been negotiated over six years and was meant to end 50 years of conflict. And finally, in November, Donald Trump defeated Hillary Clinton in a hard-fought election. What all three of these elections had in common was their "improbable" outcome. Few, if any, forecasted them accurately and, taken in total, you might call them "impossible."

We will leave it to political pundits and historians to answer the hows and whys and debate whether these results are signs of a broader global movement. Instead, we will focus on this most recent election's potential impact on the domestic economy and financial markets. It is important to note from the outset that Trump articulated few actual policy specifics on the campaign trail. Despite Republican majorities in Congress, ideas need to be turned into bills and laws before we will know true outcomes. Even if plans and ideas become actionable items, the timing is often unpredictable.

Overall, the equity market reaction has been positive since November 8. To set the stage, prior to the U.S. Presidential election, the S&P 500 Index was up about 6.5% for the year, but sold off about 2% in the days immediately ahead of the election. As we pointed out in an earlier note to clients, as election returns were coming in, there was a sharp shift from an initial negative to a more positive interpretation. As of this writing, the S&P 500 is up an additional nearly 3%, bringing the year-to-date return to approximately 10%. While positive thus far, how the market reacts in the medium- to longer-term will be predicated on how effectively Trump can move from divisive campaigning to constructive governing.

As odd as it may sound, the election has increased the possibility of both good and bad outcomes; status quo will not be an option and the future is unknown. The upside arguments point to four key factors: cutting/simplifying taxes, spending trillions on infrastructure, boosting military spending, and cutting business red tape (regulations).

Fiscal spending, as the thinking goes, would mean less taxes (corporate and personal) and more deficit spending (infrastructure, military), which will have a significant simulative impact on domestic growth. This is likely true, but at this point in our economic cycle, the benefits may be more muted than anticipated. Rising interest rates and a strengthening U.S. dollar during the sixth year of the U.S. expansion will have a lesser impact than at earlier points in our economic recovery. Removing tax roadblocks to offshore earnings repatriation could have a more immediate impact, in contrast to longer lead times for meaningful infrastructure projects. Lastly, removing government shackles should allow businesses to grow more quickly. This is especially true for banking, infrastructure, and energy. Ultimately, Trump's and the Republican majority's need and desire to succeed will likely be a motivating force for cooperation on these goals.

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already fragile global economy. Growing nationalism, evidenced by Trump's ascension and the vote for Brexit, is not positive for worldwide trade and growth. Additionally, the net effect of these policies is likely to be rising interest rates and a stronger U.S. dollar—possibly choking off the very growth the policies are meant to stimulate. Since the election, 10-year U.S. Treasury rates have moved up 65 basis points (0.65%) which, even without Federal Reserve action, effectively tightens monetary policy. During this same time frame, the U.S. dollar has strengthened 4.0% relative to other world currencies and is up nearly 9% from its May low. This impact makes imports cheaper, which is good for consumers, but products of U.S. multinationals become less competitive worldwide and earnings growth will be harder to come by for these companies. Finally, while a net positive, infrastructure projects are seldom shovel-ready, and take time to plan, bid, and construct. Their benefits are far from immediate—generally years, not weeks or months, away.

Taken in total, we suspect the election's outcome is slightly positive for both the economy and markets, but only to the extent a Trump administration can be effective in achieving his economic policies and being constructive on trade. If we sense a significant pullback from global trade practices, we would become more concerned about both economic growth, inflation, and the level of the financial markets.

Turning from a macro discussion to potential investment winners and losers, as you might imagine, we foresee both. From an asset class perspective, in contrast to U.S. domestic markets, both developed international and emerging markets have sold off. This is largely due to concerns about the new administration's trade policies. Global growth and accompanying higher commodity prices ought to, ultimately, benefit the global markets. In the meantime, the price move upwards in more domestically-focused equities is not surprising, but we suspect this rotation to be short-lived.

In terms of economic sectors, Financials are a winner thus far—yet not a clear winner. Higher interest rates should restore growth in a sector which has struggled for growth in the post Dodd-Frank, low interest rate world. There was talk during the campaign about the roll back of this regulation, but it is unclear whether Congress will support such a change.

Industrials have also shown positive gains since the election. The headlines point to increased infrastructure spending, but as we pointed out earlier, these windfalls, should they come, will not be immediate. Additionally, continued U.S. dollar strength will add an earnings headwind. Clearly, this is one area where repatriation could have a significant beneficial impact on U.S. multinational companies.

The impact on Energy has been mixed. On one hand, less regulation ought to favor coal and oil and gas exploration companies to the detriment of renewable energy, but supply and demand implications still exist. These dynamics will likely continue to keep a lid on crude prices, at least in the short-run. Demand for coal continues to decline and any increases in crude oil supply as the result of less regulation will only serve to keep prices low. Not until we see an increase in demand, led by economic growth, will there be a meaningful move upwards in pricing and profits. One area which will likely benefit will be energy infrastructure, including pipelines, as demand does currently exist there despite today's prices and opposition from the Obama administration.

While efforts to amend the Affordable Care Act may benefit Healthcare, it is not all green lights for this sector, wherein the impacts are more subtle. The debate over prescription drug pricing, which has become a bipartisan issue, will continue. Efforts to encourage competition across state lines may increase, but the price toward managed care is likely stalled.

Income-oriented equities, including Utilities, REITs, Telecom, and some Consumer Staples, have been on the opposite side of these early trades. As we have written in the past, when interest rates moved down, investment dollars moved into stocks which paid above-market income. Despite lofty valuations, which drove yields lower and lower, money continued to pour into these sectors. Now, with the prospect of higher yields on the horizon, marginal dollars have been exiting these sectors, putting downward pressure on prices.

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With regard to the markets, the bottom line is that no one knows for certain how or when many of these potential changes might occur. Let us also add that the markets were not inexpensive prior to the election, nor are they in this post-election run. Using a simple price-earnings metric, the market appears fairly valued. To continue to justify additional new market highs, we will need to see believable upward movement in corporate earnings. While volatility has been muted and skewed to the upside, we expect continued volatility as the impact of unknown policy specifics play out. As a result, individual security selection will continue to be critical.

To conclude, the policies articulated by the Trump team suggest lower tax rates, reduced regulation, a more business-friendly environment, and increased infrastructure spending. These provide a positive backdrop, no matter the specifics, and that is what is driving the markets—hopes and expectations. ◆

RADICAL UNCERTAINTY

By Kevin J. Cavanaugh

"The peculiar essence of our financial system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it." —Walter Bagehot

Human beings crave certainty, and our clients are no different in this need. As investment counselors, we understand that no one can know the future and that making predictions about the future is usually a futile exercise. Importantly, we attempt to impart this verity unto our clients. Making definitive predictions can create an illusion of certainty which can lead to confusion and undermine long-term confidence and trust. As Warren Buffett said, "Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

Advanced (successful) economies operate on the basis of trust and rely on the trustworthiness of the economic actors. Trust is a necessary and indispensable precondition for economic advancement. It has been suggested that if one were able to take a measure of the broadest level of trust in an economy (this is being attempted), it would explain the differences between a developed economy and one which is under-developed or not developing. Accordingly, the difference in the per capita income of the USA and Venezuela might be best explained by a certain measure of trust. Obviously, our modern, complex financial markets can only operate effectively when a certain level of trust is maintained; moreover, in our increasingly global and interconnected economy, trust in fair and free markets is necessary to keep the economic wheels moving forward. And there is the rub. What happens if or when there is erosion in the level of trust in a modern market economy?

Most interested observers will admit that there seems to be something wrong with the global economy. Investors have been operating within the shadow of the Great Financial Crisis for eight years now. All of the grand economic narratives include or are encompassed by the crisis. The grandest of the narratives describe the crucial role and great economic influence of the omnipotent Central Banks in the developed world and especially our own U.S. Federal Reserve Bank. In fact, for almost two decades now, the U.S. Federal Reserve Board has held sway over the markets and the global economy. They have been given space to operate without too much criticism and have been applauded for damage control and instilling confidence when it was most needed. A recent newspaper headline seemed to us to capture the zeitgeist and what we believe is also a serious problem: "It is all about the Fed!"

For the past eight years, the Fed and the other major Central Banks (the EU, the UK and Japan) have implemented experimental monetary policies that have distorted the financial markets to such an extent investors are wondering whether these entities are now causing more harm than good. More critically, investors (and voters) are questioning the "science" upon which these decisions and policies have been made. Between the activities of the Central Banks and the complex behaviors of the markets lies a theory. Investors are just now coming to question the ideological underpinnings of that theory.

What has all this science and data analytics brought us? For the past two decades, the Fed has been consistently wrong in most of its predictions. They missed the seemingly clear evidence of two economic bubbles (tech and housing). They have been overly optimistic about the outlook for economic growth. They have been aggressive and inaccurate about their predictions for the future level of interest rates. As a result, an enormous amount of wealth was lost in the financial crisis and the financial system was placed on a razor's edge. These experimental policies seem to be amplifying the problems at this point and, as a consequence, the markets are hyper-sensitive and somewhat chaotic.

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To date, investors (and voters) have kept the faith, at least according to the skeptic's definition: Faith is believing contrary to the evidence. Something is wrong with the global economy and this something might just be an erosion of trust.

As some evidence of the loss of faith, the lead article in a recent *Financial Times* op-ed by Martin Wolf was "Democratic Capitalism is in Peril." According to Wolf, a Brit: "Consider the disappointing recent performance of global capitalism, not least the shock of the financial crisis and its devastating effect on trust in the elites in charge of our political and economic arrangements. Given all this, confidence in the enduring marriage between liberal democracy and global capitalism seems unwarranted." There has clearly been an anti-establishment

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sentiment of late. Our recent Presidential election and the Brexit vote provide clear examples of this.

Wolf is not just questioning our elites and technocrats, he is questioning the legitimacy of political and economic orthodoxy; and he is not alone. Earlier this year, *The End of Alchemy: Money, Banking, and the Future of the Global Economy,* was released by Lord Mervyn King, the former governor of the Bank of England from 2003-2013. Lord King was in charge of the Bank of England before the financial crisis emerged and was instrumental in implementing the necessary correctives during and after the crisis. This book provides a critical analysis of the intellectual framework (the science) that supported those activities and guides the actions of the Central Banks around the world today.

The central focus of this book is the economic concept of "radical uncertainty," which King says is a necessary precondition in a capitalist economy. To understand what economists mean by radical uncertainty, consider the distinction between risk and uncertainty. Radical uncertainty is the type of uncertainty that statistical analysis is not at all well-suited to deal with. Admitting radical uncertainty means that, fundamentally, there are things that we do not know or cannot predict because we simply cannot imagine them. Classical economists, on the other hand, say risk can be well-defined and measured against historical data. As a result, economists rely on probability studies to make predictions. King states that, nowadays, economists, financiers and regulators have taken the probabilistic approach too far and into areas where it does not work, generating a false confidence in its predictive capacity.

According to King, economists and policy-makers should recognize that we are not able to identify the probabilities of all future events and do not have economic equations that explain how people react to that uncertainty. He believes the crisis was, "a failure of a system, and the ideas that underpinned it, not of individual policymakers or bankers, incompetent and greedy though some of them undoubtedly were." King also warns, "Without reform of the financial system, another crisis is certain, and the failure ... to tackle the disequilibrium in the world economy makes it likely that it will come sooner rather than later…Only a fundamental rethink of how we, as a society, organize our system of money and banking will prevent a repetition of the crisis that we experienced in 2008."

What is unique about Lord King's book is that he radically dissects the reigning theoretical orthodoxy and demystifies modern monetary practice. Additionally, he offers sound advice for those who are willing to listen. His proposals start with bank reform and the creation of money. He calls for a simplification of bank regulatory schemes and offers ideas to reduce financial leverage and improve banks' balance sheet liquidity, as well as reframing the role of Central Banks as lenders of last resort. Changing prevailing theory and practice, he warns, will be challenging. He worries that the experts appear locked into using the same mathematical models and have not learned from experience. Hopefully, it will not take another financial crisis for the current practitioners to undertake the rethink.

From our perspective, while there will surely be another crisis, in some form, down the road, we look forward to taking advantage of the investment opportunities that will come along with it. In the shorter-term, however, there are reasons for optimism. First, and foremost, there are indications that the world's central bankers may be starting to adjust their thinking. Second, an opportunity for change is being presented in the form of the pending transition of power in Washington, D.C. The President Elect has been a harsh critic of the current Federal Reserve Board, accusing its chief, Janet Yellen, of a politicization of monetary policy by encouraging excessive speculation and asset bubbles that are only benefitting Wall Street.

Over the next eighteen months, the President Elect can greatly impact the makeup of the Federal Reserve. He can fill a majority of the seven-member Federal Reserve Board with his own nominees and can immediately fill the two open seats on the Board. This Board holds the majority of the decision-making power over a larger group called the Federal Open Market Committee, which sets monetary policy in the United States and influences monetary policy globally. In addition, Fed Chairwoman Yellen's term ends in February 2018 and Fed Vice Chairman Stanley Fisher's term ends in June of 2018, allowing a change in leadership.

For some time, the Federal Reserve Board has been encouraging Washington to consider adding some form of fis-

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cal stimulus to the current easy money policies. President Elect Trump appears amenable to this idea. It is likely, however, that Congressional Republicans will be calling for change. Republicans have already put forth proposals to constrain the power of the Fed and have been highly critical of the "misguided," "inconsistent," and "opaque" nature of current monetary policy.

As mentioned earlier, there are indications that the current group of global monetary policy-makers is adjusting its thinking, possibly incorporating some of Lord King's advice. Policy-makers and practitioners around the world have been taking the first step, admitting fallibility and positing that the reigning economic orthodoxy may not have the solid theoretical footing once taken for granted. A sound science is self-correcting. The debate is not over! In our view, this admission is a positive turn which opens the chance of renewed confidence and trust in the enduring marriage between liberal democracy and global capitalism. Ultimately, how do we address this "radical uncertainty"? As Cormac McCarthy in "The Road" noted, "If trouble comes when you least expect it then maybe the thing to do is always expect it." ◆

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CALIFORNIA-REQUIRED GIFT ANNUITY RESERVES CHANGE IN ASSUMPTIONS

By Kenneth H. Dike
Esq., CPA, CLPF

The California Department of Insurance has changed the way gift annuity reserves are calculated. The required reserve for gift annuities received after 2016 will be based on the 2012 Individual Annuity Reserve Table and a 4% discount rate. This change will increase the required reserve for remaining life annuitants age 50 to 80 by 12% to 14% for females and 14% to 18% for males. At age 90, the reserve for females increases by 10% while the male reserve stays about the same. These increases only apply to gift annuities received after 2016; the required reserves for gift annuities held on 12/31/2016 are not affected by this change.

WHAT IS A GIFT ANNUITY RESERVE?

A gift annuity is created when a donor transfers assets to a charity in return for the charity's promise to make future payments, often for a remaining life, to the donor or donor-designated beneficiary. The Department of Insurance regulates gift annuities in California. They require each charity to maintain a separate custody account with assets sufficient to make all future payments required by the gift annuities issued by the charity. The amount required to make all future payments is the state-required gift annuity reserve.

HOW IS THE GIFT ANNUITY RESERVE CALCULATED AND HOW HAS IT CHANGED IN CALIFORNIA?

A gift annuity reserve at a point in time is the present value of the required future annuity payments. Aside from the amount of the annuity, the present value is determined by an assumed return on reserve investments (discount rate) and the expected duration of any remaining lives (mortality table). Both of these

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Discount Rate and Mortality Table by Issuance Date

Date issued	Discount rate	Mortality table
After 2016	4.0%	2012 Individual Annuity Reserve Table
2005 to 2016	4.5%	Annuity 2000 Mortality Table
1992 to 2004	6.0%	a-1983 Table
Prior to 1992	2.5%	1937 Standard Annuity Table

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variables are prescribed by the Department of Insurance and depend on when the gift annuity was issued.

WHAT IS DIFFERENT ABOUT THE *2012 INDIVIDUAL ANNUITY RESERVE (2012 IAR) TABLE?*

The 2012 IAR table is the first mortality table that adjusts each year for projected improvements in mortality. Created by the National Association of Insurance Commissioners (NAIC) from mortality data collected on owners of commercial annuities from 2000 to 2004, this dynamic "generational" table incorporates an *improvement factor* that is applied to each year following 2012. The result is an age-specific reserve that increases each year the reserve is calculated. For example, the 2027 California reserves based on the 2012 IAR mortality table will be greater than those calculated for 2017 by 1% to 3% for females and by 2% to 4% for males holding all other variables constant, including the age of the life annuitant and 4% discount rate.

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HOW ARE GIFT ANNUITIES REGULATED?

Not all states regulate gift annuities, and those that regulate do so to varying degrees. About a third of the states do not require a gift annuity reserve or a minimum asset value. Another third requires that the charity maintain a minimum asset value regardless of the number of gift annuities issued. The remaining third requires that the charity maintain a reserve based on the gift annuities issued. About two-thirds of the states do not require an annual report from the charity on their gift annuity program.

California is considered a highly-regulated state that requires the charity to (1) register their gift annuity program prior to the issuance of any California gift annuities, (2) register all individual gift annuity contracts issued each quarter, (3) maintain a minimum reserve in a segregated account, (4) invest the reserves in accordance with certain asset mix guidelines, and (5) submit a detailed annual report on the activity of their gift annuity program and other issues. Only gift annuities paying California residents, when issued, are considered California gift annuities subject to these regulations. Gift annuities issued by a California charity paying a non-California resident are excluded.

CALIFORNIA SEGREGATED ACCOUNT AND OTHER REQUIREMENTS

The California Department of Insurance requires that a charity maintain its required reserves in a segregated account and any amounts in excess of the required reserve may be removed from the segregated account at any time upon a resolution by the charity's board of directors. Furthermore, the charity is not required to put the full amount received for a gift annuity in the segregated account; only the reserve amount must be added to the account.

"Not all states regulate gift annuities, and those that regulate do so to varying degrees."

As an aside, given the ease and discretion of moving funds out of the segregated account, it is difficult to understand the need for a 13-page legal-size annual report with a 15-page instruction booklet and periodic debates over peripheral issues such as the inconsistent treatment of what expenses may be paid from the segregated account. Why not simply require proof that the segregated account is invested correctly (50% government-backed bonds) and that the minimum reserve value is met?

Whatever the state reporting and other requirements may be from time to time, it is our role at Clifford Swan to counsel our nonprofit clients on the technical and reporting requirements involved in administering their planned giving programs effectively. ◆

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