Bahl&Gaynor
Investment Counsel

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4Q 2016 Review and Outlook

In this issue:

FOMO
"Fear of Missing Out"

The "Fear of Missing Out" or FOMO is a neural response where part of the limbic system, the amygdala, detects something that could be a threat to survival. The amygdala originally had a critical life-or-death purpose. For example, in the hunter-gatherer days, missing a new food source or place of shelter had real implications for survival. Fast-forward to today's society, FOMO is most prevalent in social media. Be it Facebook, Instagram or Snapchat, FOMO presents itself when an individual feels as if they are "missing out" on activities that others are enjoying (a.k.a. selfie-jealousy). For our readers with tweens, this is an unfortunate reality of modern society and the depth and significance of its presence is reflected in the valuation of social media platforms like Facebook (~$345 billion) and Snapchat (~$25 billion).

Source: Deviantart.net, 2017.

FOMO, however, is not isolated to the hallways of junior high school. It is pervasive in the world of investing as well. Most commonly, it manifests itself in forms of loss avoidance: *securing actual losses when liquidating investments in a bear market* (in the hopes of avoiding further losses) or *the lost opportunity of being un-invested in a bull market.* 4Q2016 provided examples of both loss avoidance extremes and their potential consequences. These are described below:

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Bahl & Gaynor Economic Outlook *Continued*

- **Fear of Further Losses:** Heading into the election, the market yielded 10 consecutive trading days of declines from October 24th to November 4th, which indicated skittishness among investors that the hard-earned gains of the bull market dating back to March 2009 were potentially at risk. This mounting bout of selling pressure suggests plenty of investors were exiting capital markets altogether to avoid further losses (while at the same time guaranteeing unrealized losses).

- **Fear of Missing Out (FOMO):** When the world did not end after the Trump victory and capital markets resumed their upward trajectory, investors dumped anything associate with "safety," such as Treasuries, corporate bonds and bond proxy stocks, to buy riskier equities characterized by "growth and hope." Not only did the previously-described group of selling investors likely miss out on the nascent gains of the post-election rally, they also probably invested in riskier securities than those owned just a few days prior when further losses were feared enough to liquidate their invested assets altogether!

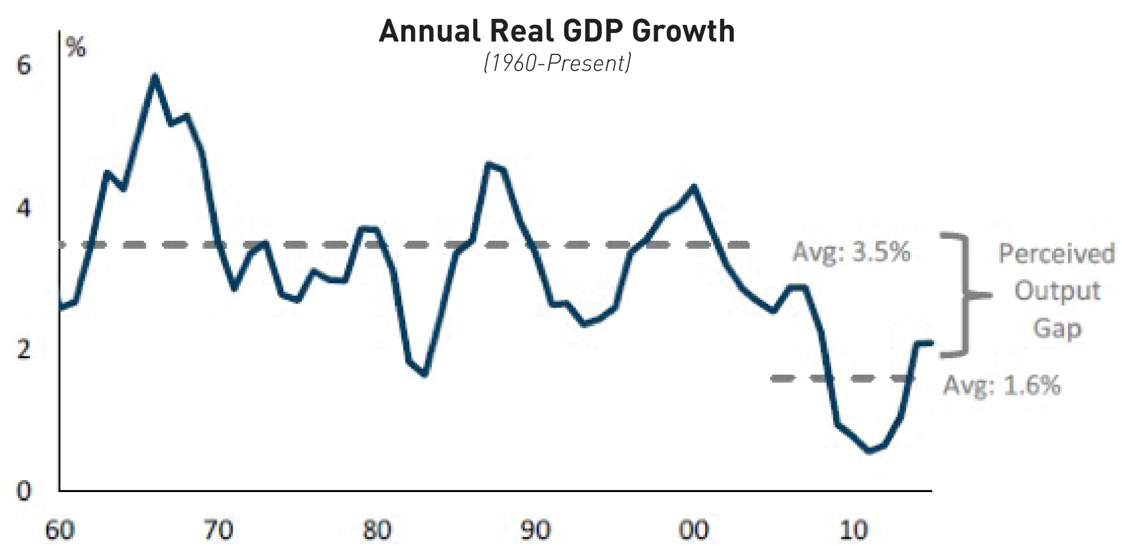
The fear of being left behind (FOMO) and the chase for growth at the expense of safety was the predominant and defining theme of 4Q2016 and what we expect to continue moving into 2017. In this edition, we examine the main contributors to the "Trump Rally" and provide some balance in the form of potential economic headwinds on the horizon.

Conclusion: At Bahl & Gaynor, we again emphasize the hallmark of long-term investing success: "time in the market" as opposed to "timing the market" builds wealth. We believe that a consistent, all-weather approach whose foundation is built upon dividend-growth equities provides the appropriate balance of "growth" and "safety" to achieve financial goals. These companies have the ability to pay, and more importantly, *grow* their dividends at a rate faster than inflation and with more consistency than the broad equity market through an entire economic cycle – both booms and busts.

Support of the "Trump Rally"

The End of Secular Stagnation

The economic climate for the past eight years can be characterized by one word: *uninspiring.* For the sixty years preceding the Financial Crisis, real GDP growth averaged approximately +3.50% annually. The past eight years have exhibited a continuing struggle to achieve pre-crisis trend growth with real GDP advancing only +1.60% annually on average despite the most accommodative central bank policies in history!



Source: RBC, 2017.

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Trump Rally *Continued*

Trump Rally bulls will point to the following catalysts that will bridge the aforementioned output gap:

1. Lower corporate tax rates and repatriation of overseas cash;
2. Aggressive infrastructure spending;
3. Reduced regulation.

We believe that, of the three, corporate tax reform will have the most immediate effect. Tax reform has bipartisan support and will secure an early "victory" for the Trump administration, gathering necessary momentum to move forward with other major policy initiatives. The implementation of corporate tax reform will provide an immediate lift to cash profits, which is unquestionably positive. We expect these dollars will be put to work quickly, as a permanent tax reduction can be annualized for budgeting purposes. They will likely be deployed as follows: 1) reinvested for future growth, 2) used to execute a moderate amount of share repurchases, and 3) growing dividend payments. At this point, we do not expect reductions in corporate debt levels to be a meaningful use of repatriated cash.

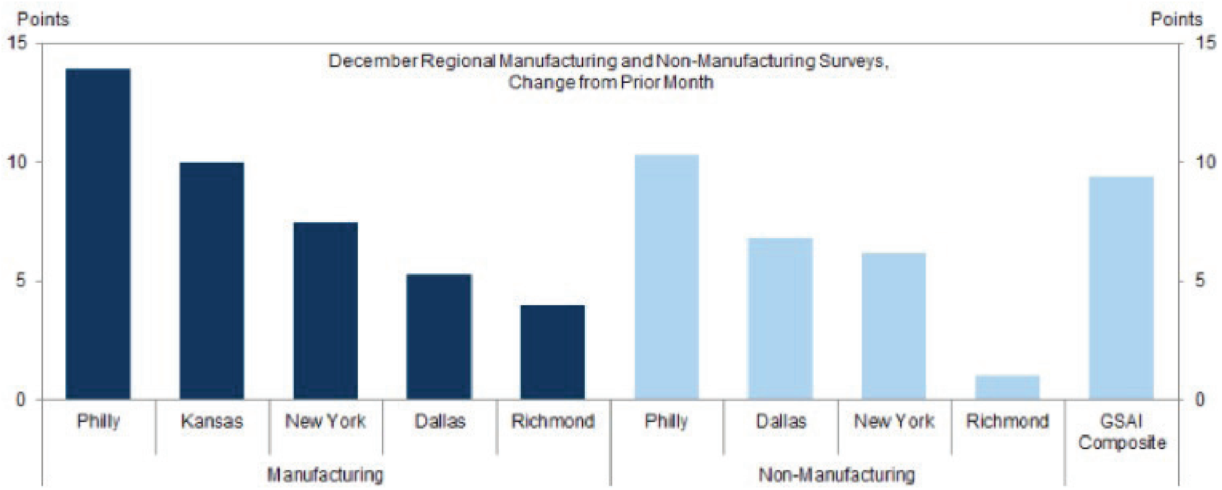
Infrastructure spending and reduced regulation are much cloudier propositions in both their timing and impact. Infrastructure projects will face heavy debate as the benefits of such spending tend to be localized and the perception of government waste (recall the "Bridge to Nowhere") is a discouraging factor. Regulatory reform, most acutely present in the financial sector, will disproportionately benefit smaller community banks as the compliance costs under current law are crippling when not spread over a sufficiently large asset base.

Early Green Shoots of the "Trump Effect"

December marked a strong month not only for capital markets, but more importantly, for business confidence and activity. The regional manufacturing and non-manufacturing surveys showed sharp improvement in December from the prior month with every region registering improvement. Importantly, this uptick in activity was driven by new orders, as opposed to inventory build, as orders-less-inventories have been positive for the past four consecutive months. Should this trend continue, GDP for 2017-2018 has a high likelihood of upside surprise which is another tailwind for corporate profits, overall employment trends and equity markets.

December Regional Manufacturing and Non-Manufacturing Surveys

(Change from Prior Month, December 2016)



Source: Federal Reserve, Goldman Sachs Global Investment Research, 2017.

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The Great Rotation

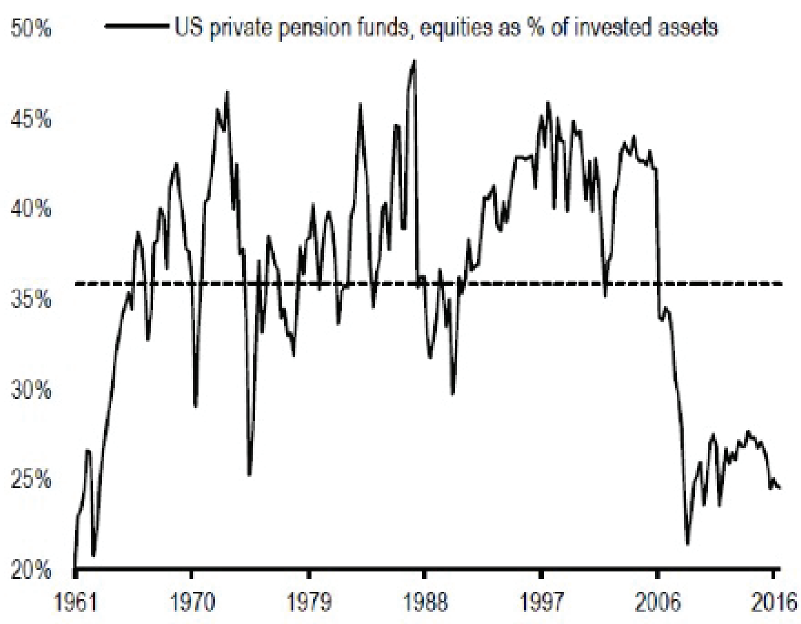
Statements of Fact:

1. Equity allocations of many traditional asset allocators are at secular lows;
2. Fixed income yields are at secular lows and have potentially reversed their downward trend;
3. The median return assumption for pension funds remains approximately +7.50% annually despite the aforementioned observations.

Traditional asset allocation models (think the 60/40 equity/bond mix) have performed phenomenally well with a downward secular path for interest rates. Any study back-tested over the last 35 years highlights the high Sharpe ratios of fixed income allocations. However, looking forward, the starting point for fixed income allocations makes prior assumptions dangerous. Consider the following: to achieve a +5.00% annual return on a 10-year US Treasury note, an investor would require 2.50% of income (yield) and +2.50% of capital appreciation annually. To achieve +2.50% of appreciation, prevailing 10-year yields must drop by ~35 bps. Should yields increase by 35 bps, a year's worth of coupon evaporates through principal loss, derailing the achievement of the total return objective. Putting a ±35 bps fluctuation into context, the 10-year US Treasury note traded in a range of ±125 bps in 2016 alone!

Against this backdrop, US private pension fund allocations to equities are near 50-year lows despite maintaining an average return assumption of +7.50% annually. Two alternatives exist for these institutions to achieve their stated return assumptions: 1) trustees can *significantly* reduce their forward return assumptions, or 2) the allocation to higher-return asset classes can be increased. The first option is unpalatable because reducing the assumed rate of return increases the present value of all liabilities and any associated shortfall. In some cases, it could also mandate additional contributions on the part of the plan sponsor. Instead, we expect capital to gradually migrate from fixed income to equities in order to satisfy the second alternative of increased allocations to higher-return asset classes.

U. S. Private Pension Fund Equity Allocations Near Generational Low



Source: Thomson Reuters, Credit Suisse research, 2017.

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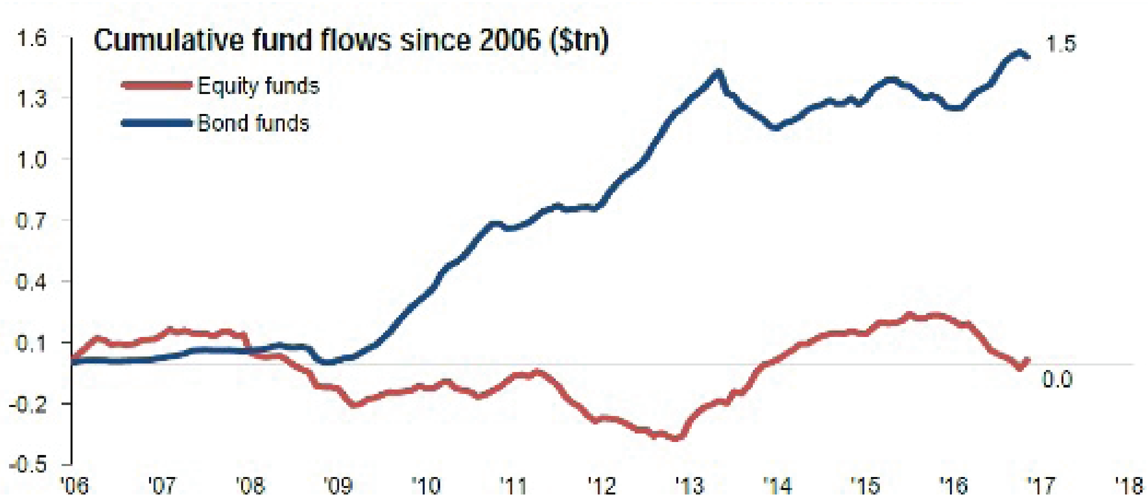
The Great Rotation *Continued*

On the retail side, evidence of the same equity under-investment fact pattern exists. Since 2006, there have been cumulative inflows of $1.5 trillion (yes, *trillion*) into bond funds and net *zero* flows to equity funds.

Cumulative Bond and Equity Fund Flows



Source: BofA Merrill Lynch GIS, EPFR Global, 2017.

Areas of Caution

Monetary Policy Rapidly Shifting from Accommodation to Restrictive

The monetary policy fact pattern has shifted very quickly since the election. Inflation and growth, which were previously perceived to be scarce, are now both viewed as plentiful. The Fed's elusive 2.00% annual inflation target now appears squarely within reach and risks have shifted from disinflation/deflation toward a more normal posture of slightly-above-target inflation.

5-Year Inflation Expectations

Source: Bloomberg, 2017.

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Areas of Caution *Continued*

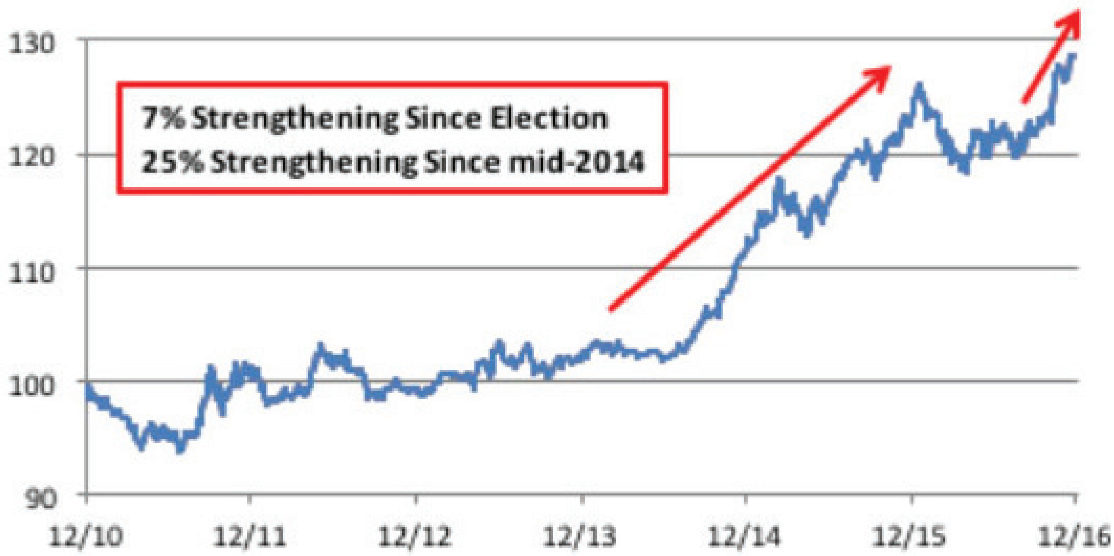
The combination of sub-5.00% employment, above-target and rising inflation expectations and growing animal spirits in capital markets has put Yellen and the Fed on the offensive with regard to removing accommodative policy. The Fed increased its 2017 rate hike projection from two to three hikes, which caught many by surprise. While the absolute fed funds rate (currently 0.50% – 0.75%) remains low, a shift in dialogue could prove to be a wet blanket on equity market valuations. Further, the effects of more restrictive policies on dynamics outside of US borders cannot be ignored.

Higher Rates + Stronger Domestic Growth → Significantly Stronger Dollar

The uninspiring global economic recovery of the past eight years has brought with it coordinated central bank policy. Every major central bank has uniformly engaged in accommodative practices, either through lower interest rates, asset purchases or both. With the most recent Fed hike and a course charted for three hikes in 2017, the US has "broken rank" with other central banks in its aggressiveness to normalize policy. The combination of the policy divergence and the prospect of stronger growth has resulted in the USD strengthening materially since the election.

US Trade Weighted Dollar

(Index Base = 100)



Source: Bloomberg, 2017.

For domestically-focused corporations and net importers, the stronger dollar benefits results. However, we exist in a global economy with approximately 35% of aggregated S&P 500 revenues generated outside of the US for large, multinational corporations, the stronger dollar represents a significant headwind. Earnings releases of many companies throughout 2015 lamented the rise of the USD and the recent +7.00% strengthening since the election foreshadows potential earnings disappointments in the year ahead.

"Balanced Budget"... Not In Trump's Vocabulary

The current economic agenda runs counter to most economic theory which recommends aggressive fiscal policy when the economy is in or emerging from a recession. Eight years into the current economic expansion, reducing government debt either in absolute terms or relative to GDP is usually prescribed in the playbook. Trump's policies, on the other hand, appear to significantly increase the deficit in what is potentially the later innings of the current economic cycle. The danger surrounding rising deficits at this juncture would be the arrival of a recession in the near future and limited firepower to offset the drop in consumption with incremental deficit spending. We acknowledge this is not a "today issue," but by the time it becomes an issue, it will be too late...not dissimilar from attempting to purchase homeowners insurance on the eve of a hurricane. Good luck.

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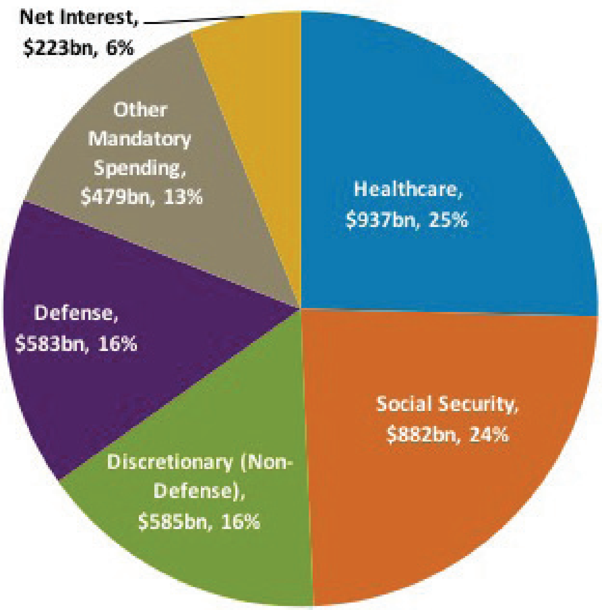
Areas of Caution *Continued*

The issue with the Federal budget is that at least 75% of spending could be classified as "mandatory," so where are the cuts going to come from should our hand be forced to balance the budget?

Federal Budgetary Expenditures
(2016 Fiscal Year)



Source: Federal Budget, Mauldin Economics, 2017.

Conclusion

The sum of pro-growth Trump policies is a huge unknown, both positive and negative.

For now, the market has been focused on the immediate positive impacts of a reduction in the corporate tax rate and repatriated cash. Incrementally, the potential for sustained above-trend growth through productive infrastructure spending and increased corporate incentives provides promise beyond 2018. Finally, the "Great Rotation" offers a structural tailwind to equities absent a recessionary or deflationary scare.

While optimism currently reigns supreme, we would caution that the ultimate implementation and effects of these policies will not be known for some time, perhaps into 2019 and beyond. The byproducts of aggressive fiscal policy, such as a more restrictive Federal Reserve, strengthening USD and burgeoning deficits, loom as potential issues for the market.

It is important to note that consensus thinking isn't always wrong. However, should evidence prove contrary, the unwind of popular positions is swift, violent and painful. At Bahl & Gaynor, we urge our clients and partners to avoid the pitfalls of FOMO and pursue strategies that are designed to provide solid risk-adjusted returns through an entire market cycle. Our view remains that a diversified portfolio of high-quality companies that pay, and importantly grow, their dividends is the foundation of such a strategy.

We wish all of our clients and partners a prosperous 2017 and may your income grow!

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Disclosure: