The Ten Surprises of 2017

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Each year I make a practice of reviewing The Ten Surprises of the year that has passed. Last year's list was on its way to being one of my best and then Donald Trump won the presidential election and everything changed. Before that, oil was in a downtrend, the Standard & Poor's 500 was heading toward its January starting point and interest rates were surprisingly low. After the election, investors decided that growth would be boosted by Trump's plans to lower corporate and individual income taxes; deregulate energy, healthcare and financial services; and offer tax incentives for infrastructure spending. Equities rallied almost every day for two weeks and bond yields moved higher. Even the president-elect could not have expected such a favorable reaction to his victory.

The purpose of The Ten Surprises is to stretch my thinking (and hopefully yours) about what might happen in the coming year. I don't tamp down the Surprises to get a high hit score. Every year there are a number of unexpected events that influence the financial markets and 2016 was a good example. Very few expected Trump to be elected. I certainly didn't. I define a Surprise as an event that the average professional investor would only assign a one in three chance of taking place, but I believe is probable, meaning it has a better than 50% chance of happening during the year. Usually I get five or six of the Surprises more or less right.

My first 2016 Surprise was that Hillary Clinton would win the presidency against Ted Cruz. I knew the Republicans would pick an outsider, but I thought Donald Trump would prove too extreme and unconventional to be nominated. I underestimated Cruz's unpopularity with the Republican establishment and Trump's ability to connect with an electorate yearning for change. He had a clear economic message that resonated with many Americans who felt that Hillary Clinton would not improve the country's growth. I also thought the Democrats would take the Senate, but the Republicans retained control. Other than expecting a low voter turnout, there was no part of the First Surprise that I got right.

I did not do any better on the Second Surprise. I thought earnings for U.S. companies would be disappointing because of a profit margin squeeze and the S&P 500 would end the year in negative territory. Moreover, as I expected, worries about global instability did encourage investors to maintain large cash balances and this hurt the performance of many hedge funds. Profit margins did shrink as a result of a lack of pricing power, modest revenue growth and increased wages. But overall the market shrugged off the bad news and ended the year up by 9.5% on the S&P 500 and 12% with dividends.

Finally, in the Third Surprise, I got one right. I said the Federal Reserve would only raise interest rates once during the year even though they indicated in December 2015 they might raise rates four times. My reasoning was the economy would only be growing at about a 2% pace and be too fragile to endure four rate increases. The Fed's comments remained cautious all year.

The Fourth Surprise was really hurt by the outcome of the election. I had thought that foreign investors would reduce their holdings of U.S. assets including stocks and the dollar would weaken. While the dollar did show some signs of softness during the year, the Trump victory caused people to believe it would strengthen because of renewed growth in America. So I ended up getting this one wrong also.

At the beginning of 2016 there was considerable concern that China would have a hard landing. I thought growth might slow in the world's second largest economy, but overall business activity would still do reasonably well. If the official figures are right, growth was actually stronger than I expected. I also thought the renminbi would decline in value to seven to the dollar and it was approaching that level at year-end. So I got this Surprise essentially right.

I continued to believe that the refugee crisis would destabilize Europe. Certainly concern about immigrants played a major role in the June 23rd referendum in the United Kingdom resulting in Britain's decision to leave the European Union. Refugee issues also influenced the primaries in France, indicating a shift to the right. The European Union ended the year in a somewhat weakened position, which was the thrust of this Surprise.

The seventh Surprise said that oil would languish in the $30s. Languishing in the $40s would have been a better call. I was worried about additional production from Iran and Iraq as well as the drawdown of the huge inventories in place at the beginning of 2016. I also thought OPEC would find doing a deal to limit production to be hard. While I got several of the concepts influencing the price of oil correct, the actual price was more than $10 higher than my estimate.

I did get the eighth Surprise right. I thought high-end real estate in both New York and London would soften and that did happen. In New York, the major factor was an abundance of supply, while in London the Brexit vote cast doubt about that city's role as the financial center of Europe. The Trump victory may renew interest in high-end New York real estate, but at this point that isn't clear.

I was expecting interest rates to stay low in the Ninth Surprise and they did. Even though the yield on the 10-year U.S. Treasury shot up 50 basis points after the election, it still stayed below the 2.5% target in my Surprise. I believe there is a surplus of liquidity throughout the world, keeping interest rates from rising meaningfully above present levels. Investors are willing to endure negative rates in Europe and Japan, and that is restraining the rise in yields in the United States.

Finally, I expected world GDP growth to approximate 2% in 2016. At the beginning of the year, estimates from various institutions monitoring world growth were closer to 3%. With the U.S. growing at 2%, China at 5%–6%, and Japan at 1%, I didn't believe the emerging markets (showing sluggish economic behavior in many cases) would boost world growth much above 2%. Given that actual GDP growth in 2016 is coming in a little over 2%, I put this one in the "right" column.
A number of people provide ideas for The Ten Surprises. George Soros has shared his insights for more than 30 years. (This is the 32nd edition of the Surprises.) My Third Thursday group of former research directors has also been consistently helpful over that time span. Gideon Rose and Jonathan Tepperman of *Foreign Affairs* at the Council on Foreign Relations discuss the surprise possibilities with me each year. Countless friends and associates give me their thoughts. In the end the Surprises are my own and I am accountable for them.

My Radical Allocation Portfolio was positioned somewhat defensively, so I thought it was in reasonable shape in case the financial markets reacted badly to a Hillary Clinton victory in the Presidential election. As it turned out, Donald Trump won and equity markets responded favorably. Given that the Radical Asset Allocation was essentially "all equity," it did well. I believe asset allocations should be shifted gradually. I am reducing Hedge Funds and Fixed Income by 5% each and adding 5% to "Other U.S." and 5% to Japan to start 2017.

Now here are The Ten Surprises of 2017. I will discuss them in detail in my February essay.

1. Still brooding about his loss of the popular vote, Donald Trump vows to win over those who oppose him by 2020. He moves away from his more extreme positions on virtually all issues to the dismay of some right wing loyalists. He insists, "The voters elected me, not some ideology." His unilateral actions throw policy staffers throughout the government into turmoil. Virtually all of the treaties and agreements he vowed to tear up on his first day in office are modified, not trashed. His wastebasket remains empty.

2. The combination of tax cuts on corporations and individuals, more constructive trade agreements, dismantling regulation of financial and energy companies, and infrastructure tax incentives pushes the 2017 real growth rate above 3% for the U.S. economy. Productivity improves for the first time since 2014.

3. The Standard & Poor's 500 operating earnings are $130 in 2017 and the index rises to 2500 as investors become convinced the U.S. economy is back on a long-term growth path. Fears about a ballooning budget deficit are kept in the background. Will dynamic scoring reducing the budget deficit actually kick in?

4. Macro investors make a killing on currency fluctuations. The Japanese yen goes to 130 against the dollar, stimulating exports there. As Brexit moves closer, the British pound declines to 1.10 against the dollar, causing a surge in tourism and speculation in real estate. The euro drops below par against the dollar.

5. Increased economic growth, inflation moving toward 3%, and renewed demand for capital push interest rates higher across the board. The 10-year U.S. Treasury yield approaches 4%.
6. Populism spreads over Europe affecting the elections in France and Germany. Angela Merkel loses the vote in October. Across Europe the electorate questions the usefulness of the European Union and, by the end of the year, plans are actively discussed to close it down, abandon the euro and return to their national currencies.

7. Reducing regulations in the energy industry leads to a surge in production in the United States. Iran and Iraq also step up their output. The increased supply keeps the price of West Texas Intermediate below $60 for most of the year in spite of increased world demand.

8. Donald Trump realizes he has been all wrong about China. Its currency is overvalued, not undervalued, and depreciates to eight to the dollar. Its economy flourishes on consumer spending on goods produced at home and greater exports.

Trump avoids punitive tariffs to prevent a trade war and develops a more cooperative relationship with the world's second largest economy.

9. Benefiting from stronger growth in China and the United States, real growth in Japan exceeds 2% for the first time in decades and its stock market leads other developed countries in appreciation for the year.

10. The Middle East cools down. Donald Trump and his Secretary of State Rex Tillerson, working with Vladimir Putin, finally negotiate a lasting ceasefire in Syria. ISIS diminishes significantly as a Middle East threat. Bashar al-Assad remains in power.

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Every year there are always a few Surprises that do not make the Ten either because I do not think they are as relevant as those on the basic list or I am not comfortable with the idea that they are "probable."

11. Having grown weary of Washington after a year in the presidency, Donald Trump moves the White House to New York from April to December and to Palm Beach from January to March. He makes day trips to the Capitol on Air Force One for legislative and diplomatic purposes.

12. The Democratic Party is sharply divided on strategy, with Bernie Sanders and Elizabeth Warren arguing for a shift to the left and others wanting to remain in the center. A lack of leadership gives rise to widespread speculation about sharp losses in the 2018 congressional elections.

13. Donald Trump's intimidation tactics prove effective in discouraging companies from moving some U.S. manufacturing abroad, but he fails to bring jobs back. The wage differential is just too great. This becomes his biggest first-year disappointment.

14. Trump's first major international confrontation comes, not unexpectedly, from North Korea. Kim Jong-un threatens to set off a nuclear bomb in the mid-Pacific, calling it "a test." Trump's advisors try to restrain his desire to punish the country severely.

15. India comes back into the investment limelight. Its economy grows at 7% and corporate profits for established companies are strong. Its stock market leads other large emerging countries, along with China.

16. Trump's efforts to get out of the Iran deal fail. The other countries signing the agreement believe Iran's weapons-grade nuclear production has been restrained and force the U.S. to remain a participant.

depending on their specific investment objectives and financial position.
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