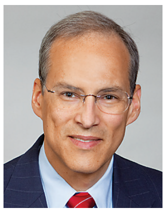
Fasten your seat belts — it's going to be a bumpy year



By Michael A. Tyler, CFA
Chief Investment Officer,
Eastern Bank Wealth Management

In a recent *On Our Minds* commentary, I noted many positive outcomes that investors have attributed to the GOP sweep in November, but I also suggested that "on the other hand," many things could unsettle the emerging consensus view. That commentary got plenty of hostile reactions, mostly centered on the weasel-word phrase "on the other hand." I get paid to have opinions, my correspondents told me, so quit the fence-sitting.

If only it were so easy. We are in uncharted political and financial waters. President Trump speaks directly to voters in a way we haven't seen since FDR or Reagan, which enables him to end-run Congress and to apply pressure selectively to other desired targets. Ideological alignments have been completely scrambled, as Republican Trump has endorsed policies that used to be firmly Democratic while many Democrats are drifting to starboard (especially in states that Trump won in November).

Financially, the world has never lived with ultra-low interest rates for so long; close to $10 trillion of sovereign debt today trades with negative yields. We are eight years into an equity bull market, yet earnings expectations and valuations are not especially expensive. The U.S. dollar has hit multi-decade highs, yet exporters don't seem to be suffering.

It's not that difficult to build a logical progression of outcomes from the current set of economic conditions; hence the rapid formation of a consensus view following the election. Market strategists hold a remarkably narrow range of estimates for 2017 S&P 500 earnings, in light of all the uncertainties that will undoubtedly affect corporate America.

It's much more difficult to identify what can go wrong with a forecast. No politician or investor is an automaton immune to forecasting error; we all have our blind spots and our misjudgments. When I identified some ways that the emerging consensus view might be too optimistic, I was acknowledging that events won't turn out exactly as we think. That's a critical part of the investment process; we aim to protect our clients in a wide variety of possible situations. That's why we focus on risk, not returns: On a bumpy journey, the seat belt is your best friend.

>> PERSPECTIVES ON THE ECONOMY

Consumer confidence crescendos

By Christina Lakich
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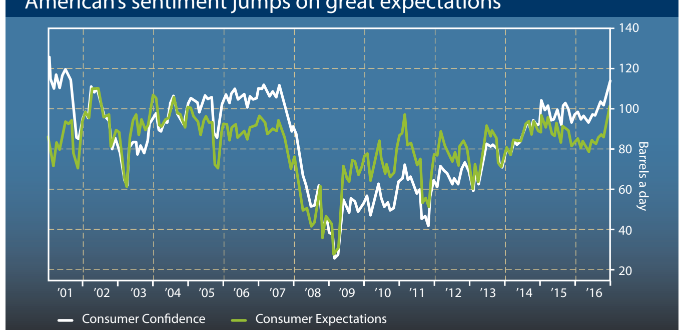
Eastern Bank Wealth Management

Following Donald Trump's presidential victory, both consumer and business confidence soared. The "Trump effect" brought hope that the new pro-business administration will focus on enacting substantial fiscal stimulus in the form of corporate and personal tax cuts, relaxed regulations, and higher infrastructure spending. Even so, we believe that confidence would have increased regardless of the election result, because the U.S. economy and corporate earnings have been displaying solid momentum since well before November 8th.

Throughout 2016, the labor market steadily improved. Jobless claims dropped to a nine-year low in November and the unemployment rate consistently fell, hitting 4.7% in December. In addition, household wealth approached highs not seen since 2006 while credit growth expanded, as households continued to take on more debt. These factors all helped consumers feel more upbeat; by December, consumer confidence about the economy, the labor market, and income was at its highest level in the past 13 years.

Looking ahead to 2017, the continued optimism of consumers, business leaders, and market participants will ultimately depend on the outcomes of battles just now commencing in Washington. Will President Trump deliver on his pro-growth campaign promises? Will Congress scuttle his anti-growth policies (specifically those related to foreign trade and immigration)? If the fiscal stimulus proposals come to fruition, we anticipate GDP growth could expand to around 2.5% in 2017 — still weak compared with prior expansions, but better than the past few years.

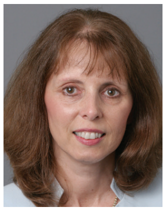
BRIGHTER DAYS AHEAD
American's sentiment jumps on great expectations



Consumer confidence and expectations have soared heading into 2017.

>> FOCUS ON EQUITIES

Will the surprises just keep on coming in 2017?



By Rose Grant-Brooks
Equity Strategist,
Eastern Bank Wealth Management

In many respects, 2016 was one of the most surprising stock market years in recent memory. The equity markets began the year with a high level of uncertainty, reflecting a host of concerns that included falling oil prices, declining earnings trends, and disappointing economic data at home — along with an overabundance of international worries. Yet the U.S. equity markets surprised investors by shrugging off shocking news, such as the Brexit vote and the unusual U.S. Presidential election. As last year began, deflation and recession were top-of-mind concerns; but by year-end, inflation and improved economic growth were the new catchwords. The resilience of the domestic equity market was remarkable, with the S&P 500 index of large-cap companies closing the year up 11.96% including dividends.

Although much of the year's gains were credited to the year-end "Trump rally," the foundation was put in place much earlier in the year: Economic growth was already improving months before the election, and third quarter earnings were a catalyst to ending the 18-month stalemate in the equity markets. The stabilization in commodity prices (especially energy) indicated that the "earnings recession" had come to an end, breaking a string of five straight quarterly declines on a year-over-year basis.

As we proceed into 2017, there are many reasons to be optimistic. Earnings should continue their current upward trend and will be an important driver for the equity markets. President Trump's proposals regarding corporate and individual tax reform, repatriation of cash by U.S. corporations, infrastructure spending, and regulatory pullback are expansionary in nature and should aid economic growth along with corporate earnings.

However, investors can always expect that some risks will befall the equity markets. The passage of the proposed policies has not yet occurred and there is a chance there may be significant changes along the road to enactment. Other downside risks include continued strength of the U.S. dollar and a faster Federal Reserve trajectory toward higher interest rates. Any of these risks could impede corporate earnings and weigh on the equity markets.

Over the next year, we believe the positives of improved economic growth and higher earnings will outweigh the fears and the bull market will continue.

>> FOCUS ON FIXED INCOME

Is the U.S. Treasury bull market finally coming to an end?

Tom Bussone
Fixed Income Strategist,
Eastern Bank Wealth Management

U.S. Treasury yields spiked in the fourth quarter of 2016. A new consensus emerged that President Donald Trump would spur faster economic growth along with higher inflation. The 5-year T-Note yield jumped from 1.33% on Election Day to 1.93% by year-end, a 45% increase in less than two months. After rallying almost 4% through July, the Barclays Intermediate Government Index ended the year up just over 1%.

Although we believe the 30-year bull market in U.S. Treasuries is finally coming to an end, we note three factors that may prevent a significant sell-off. First, President Trump is pro-business, favoring deregulation and tax cuts. However, the timing and execution of any policy changes remain unknowable as Congress takes up its new agenda. Second, the success of these policies is far from certain. Will GDP and inflation both jump immediately, or will changes ripple through the economy more gradually? Finally, will demand from overseas buyers limit the downside in the Treasury market? Yield spreads between comparable U.S. debt and European bonds are extremely wide, almost 250 basis points between U.S. and German 10-year debt. This should attract a steady flow of money from foreign investors.

Despite all of the uncertainty, we expect Treasuries will come under pressure in 2017. To help offset the risk of rising interest rates, we have added a Treasury inflation-protected securities exchange traded fund (ETF) and a short-duration high-yield mutual fund to our client portfolios. We also continue to hold an investment-grade corporate bond ETF holding floating-rate securities.

FIVE-YEAR TREASURY NOTE YIELD

The yield on five-year Treasury Notes has jumped sharply just since the election.