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MARKETCOMMENTARY

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2016: A down ... and up year

Moving forward into 2017: Expectations versus Outcomes

Optimism grows on news of President-elect Trump's business-friendly policies

FOR the year 2016, the S&P 500 delivered investors a surprisingly good return at 11.96 percent. After a rough start to the year, and a slow recovery to reach positive mid-year territory, nearly all of the year's gains were seen in the second half of the year as fears of a slowdown and potential recession subsided. Additionally, oil prices rebounded further from their February lows. The muted rally gathered steam after the election of Donald Trump on November 8, with nearly half of the year's gains realized in the last eight weeks of the year.

The year's stronger than expected returns were largely driven by a few key factors: The Federal Reserve held off raising rates until mid-December in 2016; and the election of Mr. Trump led to expectations of more business-friendly policies such as tax reform, loosening regulations, fiscal stimulus, and ultimately, stronger GDP growth. Fortunately for investors, stocks finished the year much stronger than they started. The beginning of 2016 was marred by the worst 10-day start ever for the S&P 500 largely driven by concerns about China's economy, potential aggressive action by the Federal Reserve, and falling commodity pricing.

By Daniel Wildermuth

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Last year's equity market struggles in January followed a disturbingly familiar pattern. In 2014, 2015, and 2016, the S&P 500 fell at least three percent during the year's first month. For 2017, the late-year stall in the post-election rally raises concerns that the start of the year could again see equity markets struggle in January. Optimism regarding business-friendly policies may fade as implementation challenges grow clearer or if President elect Trump's less growth-oriented policies such as trade restrictions gain unexpected traction.

More mundane issues could also trigger a temporary equity market pullback ... such as profit taking after the recent run-up and investors who waited until 2017 to sell winners. Many of these sell offs were in hopes that profits will be taxed at a lower rate this year under a Trump administration.

Beyond the very short-term, economic growth is broadly expected to be modest in 2017, or similar to 2016. Not surprisingly, investors expect the S&P 500 to rise modestly in 2017 as well, with gains projected at mid-single-digits, according to a December Reuters poll. The muted expectations incorporate several warning signs including, somewhat expensive valuations for stocks; a stronger dollar; bullish investor sentiment resulting in fewer people on the sidelines who can buy into markets and drive them higher; and projections by the Federal Reserve to raise interest rates several times this year.

Predictions for the path to next year's returns vary considerably, but focus consistently centers on expectations versus outcomes for Trump's presidency. It appears likely that 2017 will see market volatility disproportionately impacted by the success or failure, perceived or real, of Mr. Trumps policies.

Continued ...

Job growth: Employers, optimistically continue to add jobs

Looking at more fundamental and longer-term issues, much of the news remains positive. Going into the holiday season, sentiment among U.S. consumers remained at the highest level of the year driving strong retail sales with an extra boost from surging online sales and last-minute shoppers. Estimates from retail research firms suggest sales growth for the holiday period — November 1 to December 31 — should outpace that of recent years, and spending rates appeared to reach levels not seen since the mid-2000s.

The housing market, long a weak spot in the anemic recovery, continues to be steady and contribute to economic growth. A late December report from the Commerce Department showed permits for single-family home construction, the biggest segment of the market, rising to a nine-year high in November.

The labor market remains strong and employers continue to add enough jobs to meet population growth. Job growth has even been strong enough to lure many long-time unemployed workers back into the labor force, and the percentage of Americans in the workforce is slowly climbing back up toward historical norms.

Internationally, China's official gauge of factory output, the manufacturing purchasing managers index, matched its post-2012 high, driven by monetary and fiscal stimulus. In Japan, corporate profits rebounded by over 11 percent in 2016 following a broad global pattern in which corporate "earnings recessions" end without causing an economic recession.

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In the euro-zone, joblessness fell to 9.8 percent in October, its lowest level since July 2009. Industrial output in the euro-zone also accelerated at its strongest pace in almost three years in November, suggesting the weaker euro is stimulating production and export volumes. Similarly, purchasing managers indexes (PMIs) for Spain, Italy, France, Austria and Germany are slowly, though, unevenly improving. And PMI readings for the Netherlands, and Russia are at the highest levels since the financial crisis. Numerous global trends suggest stronger global growth which should help U.S. exports and at least partially offset the strengthening U.S. dollar.

Manufacturing in the U.S. expanded in November at the fastest pace in five months, underscoring the healthy outlook for domestic consumer demand.

Finally, the treasury yield curve steepened and the six-month moving average of the Leading Economic Index (LEI) increased. These two fundamental economic measures indicate recession risk is very low over the next six months and essentially, not a concern.

Since recessions tend to be the primary driver of sustained and deeper stock market declines, the low probability of a recession is particularly relevant to equity investors given all the unknowns surrounding a new president with an ambitious agenda. Without a recession driving down markets, stock market declines tend to be short and less severe.

Against this backdrop, it can also be wise to consider the cost of holding cash rather than investing. This strategy has consistently lost money over time and almost every year too. The average annual inflation rate over the last 100 years is 3.22 percent. At this seemingly harmless rate, the value of cash declines by about 50 percent every 20 years versus equities which have generally tripled in real value over the same time-period. Obviously, markets can and will go down, and this next year seems likely to deliver some extra volatility given the unknowns of a new administration. Yet, for investors with an appropriate time frame, numerous factors suggest equity markets continue to look reasonably attractive heading into 2017.

We wish you a Happy and Prosperous New Year.

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