Year-End Review & Outlook

2016 – What a Year!

As we said in September, on the occasion of the 1st Trump-Clinton debate, this presidential election campaign was one of the most unusual in modern U.S. history. As it turns out, it was just one of many unusual events of 2016.

The year began with a panic. The Federal Reserve had just raised interest rates in December 2015 – the first time in a decade. Oil prices were at historic lows threatening a deflationary environment – and there were fears of a global slowdown. By February, U.S. equities dropped by more than 10%, but then recovered. In June, we got the "Brexit" surprise followed by a brief decline and a quick recovery. But nothing prepared us or the markets for the "Trump" surprise. After global financial markets initially plunged, investors' reassessment of Trump's unexpected victory swiftly changed to unbridled optimism for equities and markets recorded new highs.

Source: Finance Yahoo, as of 12/31/2015 - 12/31/2016 – Large Cap US - SP500 Index, Small Cap US - Russell 2000 Index, Emerging Markets - MSCI Emerging Markets (EEM), International Developed Markets - MSCI EAFE (EFA)

We often discuss the dangers of trying to time the market. And last year's unusual events clearly reinforced this basic investing tenet – just when you think you know what's going to happen in the markets, they surprise you.

When it was all said and done, here's how the markets finished the year:

- U.S. Large Cap (S&P 500 Index) = 11.96%
- U.S. Small Cap (Russell 2000 Index) = 21.31%
- Emerging Markets (MSCI EM - EEM) = 10.87%
- International Developed Markets (MSCI EAFE - EFA) = 1.37%

2017 and Beyond – What's Next?

The surprise election of Mr. Trump has caused some uncertainty in the U.S. markets and world markets. And many of our clients have told us that they're anxious and have expressed their concerns about what might lie ahead. And we have felt the same way. Politics aside, Mr. Trump is a wildcard.

But as we said before the election, history has shown that of all the factors that influence the markets long-term – presidents are the least important. And while policies from a more business-friendly Trump administration may help boost corporate profits, they can only help so much. In the long run, we believe that what matters most to the markets are economic factors and asset valuations.

Given the unusual cross-roads of potential policy changes, economic factors, and asset valuations, we thought it would be helpful to discuss our assessment of these variables on the future direction of the markets.

Anticipated Trump Policies

- Increased Government Spending (primarily on infrastructure and defense): Fiscal spending should be beneficial by creating jobs; however, it will take time to see results. If government spending is too large it has the potential to increase the deficit, which is a long-term negative. We believe that with a Republican-controlled Congress (which generally wishes to limit the size of the deficit), there will be an increase in government spending, but it won't be large enough to cause any long-term structural problems.

- Tax Cuts: We believe some version of the Trump tax plan will pass, which could result in lower tax rates on both personal and corporate income. Lower tax rates should increase corporate profits which should be positive for the markets.

- Deregulation: The markets are enthusiastic about the prospect of "less red tape" which can help U.S. companies be more competitive around the world. Generally, less regulation is positive for the markets – except, of course, when lack of regulation fosters an environment of dangerous business practices (i.e., remember the synthetic mortgages and the financial crisis?).

- Trade Agreements: This is our greatest area of concern. Trade among nations is the lifeblood of the global economy, comprising 59% of world gross domestic product (GDP). If Mr. Trump makes good on his anti-trade proposals, it could cause a trade war that could tip the world into the next global recession. The actual impact would depend on how countries respond to U.S. tariffs. But given a generally pro-trade GOP Congress, we believe the most probable outcome is that Mr. Trump will have to soften his campaign promises. We also believe that the negative impact to the U.S. would be muted, given the fact that the U.S. exports only 12% of its GDP.

Economic Factors

- U.S. GDP, Employment, and Consumer Confidence: The U.S. economy advanced at an annualized 3.5% rate in Q3, up from 1.4% in the previous period and marking the highest GDP growth rate in two years. The unemployment rate declined to a 9-year low of 4.6% in November 2016. The steady improvement of the economy throughout the year is also evidenced by the boost in consumer confidence, which reached the highest level since July 2007. We expect the U.S. economy will continue to grow in the 2% - 2.5% range as we maintain "full" employment and consumers remain resilient.

- Monetary Policy: Despite expectations for several interest rate hikes in 2016, the Fed remained dovish throughout the year. Then, in December the Fed raised interested rates for the first time in 2016 and signaled that more increases are to be expected in 2017. While raising interest rates is perceived as a vote of confidence in the strength of the U.S. economy, a rapid rise in rates could put downward pressure on both the equity and bond markets.

- Oil Prices: As we've discussed before, low energy prices are great for the consumer. And we believe there has been a structural shift that should prevent oil prices from reaching those previous highs for some time. This is due to a plentiful supply of oil around the world, less demand from China, and technological advancements. All of which should help keep prices on the lower end of their historical ranges – a strong positive for consumer sentiment and consumer spending, which controls 2/3 of the economy.

- Dollar: The dollar has been strengthening for the last two years and spiked further following the election and the Fed's decision to raise interest rates. A strengthening dollar raises concerns that it could derail economic momentum as it could negatively affect the profits of companies that do business overseas. However, if the dollar's strength is backed up by investors' belief that U.S. economic prospects are more attractive than those around the globe, it is likely to have a positive effect on the markets.

Valuations

- U.S. Markets: As we've said, U.S. equity valuations are high. In a recent report, Goldman Sachs noted that by most metrics the S&P 500 index continues to trade at the upper range of historical price-to-earnings (P/E) ratios. This is not a surprise given the fact that we're 8 years into our bull market recovery (since the market bottomed in March 2009). On the bond side, after more than 30 years of declining and low interest rates, rates have started to rise, which will put pressure on bonds – especially those with long maturities.

- Foreign Markets (equities and bonds): Both developed and emerging markets are trading at historically low valuations due to many economic and geopolitical challenges. Because of this, and their clear under-performance relative to the U.S. markets over the last several years, we believe that foreign markets present increased investment opportunities and potentially higher returns.

What Does It All Mean?

Investors' expectations may be overly optimistic on what the new president can deliver. On balance, while Trump's proposed policies may be positive for the markets, we believe their potential impact has already been priced into valuations.

As we said earlier, the larger impact on the direction of the markets will be economic factors and valuations. At this point, most of the economic factors are very positive for the market. But there's no denying that U.S. equities are on the high side of their historical valuations – and until increased earnings materialize, we believe that U.S. stock prices will be constrained.

After an 8-year bull market, there's an increased probability that U.S. equities will either move sideways or experience a decline. Domestic bonds may also struggle – especially long-term bonds, which are more sensitive to changes in interest rates. But these constraints should be balanced by stronger returns in the international markets. We believe investing in a global portfolio of equities and fixed income is important now more than ever.

We believe that your portfolio is well positioned for what lies ahead. It is well diversified in many different asset classes (stocks, bonds, alternatives, and cash) – all based on your specific needs and risk tolerance.

We'd like to acknowledge that the unusual events of 2016 and the exhausting election cycle may have caused some distress and uncertainty. In addition to the items we've already discussed, there are many unanswered questions on the potential repercussions of other policy changes (e.g., Affordable Care Act, Social Security, etc.). But it is premature to forecast any outcomes at this point. As always, we will continue to monitor substantive congressional policy proposals – and will update you accordingly based on actual legislation.

To help put this all into perspective, we'd like to end with this quote from Warren Buffet, "*The stock market will be higher 10, 20, 30 years from now.*" That's what he said following the recent election as he told reporters that his investing decisions had been unaffected by the election – and he was a Clinton supporter!

We don't want to minimize the uncertainty that lies ahead, but the quote underscores our message that you're investing for the long-term – not just next year or the year after that. There will always be market volatility and periods of declines. The key is to have a well-diversified portfolio, to stay invested, and to stick to your plan to reach your goals.

Please let us know if you have any questions about our outlook or your portfolio.

303 Vintage Park Drive, Suite 100 □ Foster City, CA 94404 □ Tel: (650) 548-9200 □ Fax: (650) 548-9209
www.neumanncapital.com