Trumbower Financial Advisors, LLC
4th Quarter 2016
Investment Market Commentary

Great Expectations

Investors, en masse, are known for manic behavior. Knee jerk reactions carved particularly steep peaks and valleys on the 2016 financial landscape. A robust 1st quarter recovery from February depression was momentarily disrupted by panic over Brexit. Notoriously unreliable OPEC pledges pulled oil prices from the bottom of the barrel – despite persistent excess inventory. It was amusing to watch industry sector performance surge and retreat during the US presidential campaign based on polling results. Most astonishing has been the frenzy over the Trump card.

The 4th quarter started on a sour note. Going into Election Day all benchmark indices were in the red except for Emerging Markets. Futures on election night predicted carnage but stocks catapulted forward emboldened by promises of fiscal stimulus, deregulation and tax relief. Mid and Small Cap US Equities advanced by double digits through year-end. All major US indices hit record highs in Q4. Leadership shifted from Large Cap to Small and from Growth to Value styles.

Q4 US equity performance is mirrored in year-end 2016 statistics. Mid and Small Caps were up 20.7% and 21.3% compared to 12% for Large Cap. Despite a -4% decline in Q4, Emerging Markets finished 2016 up 11.2%.

There are in fact positive fundamental indicators supporting recent enthusiasm. Q3 GDP was revised up to 3.5%. December unemployment stands at 4.7% (just 0.3% higher than the 2007 low) and new unemployment claims hit a 43 year low in late December.

Household incomes and balance sheets have been strengthened by a reported 3% improvement in wages. While inconsistent across regions, housing prices are elevated overall.

US stock market investors seem to have priced in expectations for vigorous economic growth and

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4th Quarter Equity Market Results

	4th Qtr. % Chg.	12-mth. % Chg.
S&P 500	3.82	11.96
S&P 400	7.42	20.74
Nasdaq	1.66	8.87
Russ 2000	8.83	21.31
MSCI EAFE	-1.04	-1.88
MSCI Emg	-4.16	11.19

Stairway to Heaven

Headlines announcing the end of a "30 year bull bond market" may confuse investors focused on income – not total return. The yield on the 10-year US Treasury hit a record low in July at 1.3%, perhaps ending a long and relatively steady slide from its September 1981 pinnacle of 15.84%. Those holding bonds at the beginning of one of many declining rate cycles that persisted during the past 30+ years experienced significant capital gains. Existing Fixed Income portfolios took a hit when the yield on the 10-year bounced up by .57% from its post-election trough to finish 2016 at 2.45%.

This isn't the first time the benchmark Treasury rate has spiked since the 2008 financial crisis kicked off quantitative easing. Investors threw a "taper tantrum" in 2013 when then Fed Chair Bernanke hinted at tighter monetary policy. The 10 year leapt up 0.65% in Q2 and was 1.62% higher at year-end. As it turns out, the "tantrum" was premature. The yield retreated from 3.4% to 2.17% during 2014 and continued to shrink until July of 2016.

We don't know whether the abrupt post-election reaction is warranted or sustainable. Increases at the short end of the yield curve reflect the Fed's second .25% adjustment since it halted "zero target" policies. The first increase in December 2015 had virtually no impact on longer maturities, thereby flattening the curve. It has steepened noticeably since then. If economic growth materializes at a healthy rate and the Fed continues to tighten its reigns, market interest rates should finally emerge from an eight-year hibernation.

Is there a plausible scenario where US interest rates remain mired in the mud? In theory, economic forces perpetually compete with one another in search of equilibrium. We tend to think of equilibrium as the elimination of anomalies relative to historical norms. If the upward trend in US yields continues while the rest of the world sticks with easy monetary policies, the dollar will gain strength. If it climbs too high, pressure on US multinational corporate profits decelerate growth and inflationary expectations shrivel. As a result, interest rates should decline dulling demand for dollars. At the same time, greedy dollar fans bid up the price of US dollar denominated bonds also putting downward pressure on rates. When US debt is no longer competitive, demand for dollar denominated instruments should fade along with the value of the currency – unless reality defies theory.

Regardless of relative yield, financial disruptions and declining confidence can also spark extraordinary demand for high quality US debt – compressing rates. The "fear factor" has helped contain the yield on Treasuries to a great extent over the past decade. Some of the new administration's policies may negate its pro-growth agenda stifling reflation. Higher interest rates are usually a positive indicator unless they get out of hand and the rising cost of debt service impedes economic activity. The result? Inflationary expectations dwindle pushing interest rates back down again. Our point is that a gradual, moderate rise in market interest rates - while desirable and possible - is not a slam dunk.

Certain types of securities and strategies fare better than others in rising interest rate environments. Floating or adjustable rate bonds, for example, are less price-sensitive because yields tied to market indicators adjust contractually. Historically, floating rate issuers have tended to be companies with lower credit ratings and prices will suffer if the rising cost of debt service tarnishes their financial statements. Investment grade companies began issuing floating rate securities to meet heightened demand and the US started offering floating rate Treasuries in 2014. US government agencies offer floating rate Mortgage Backed Securities.

Strangely enough, High Yield corporate bond prices tend to hold up a little better when rates climb because a significant portion of the return is related to credit quality – not duration. If market rates are rising because economic conditions are improving, issuers' balance sheets may strengthen as well. But rate hikes are not indicative of prosperity for all companies and

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default rates tend to go up as the cost of refinancing rises.

The short-term high quality laddered portfolios ("CFI") we favor are designed to accommodate changing market conditions well. 20% to 30% of the securities in a typical ladder will mature within one year (we shortened our standard 1-4 year laddered approach while rates hovered near historical lows). Prices stabilize as the maturity date approaches. Even if market values decline in the interim, the strategy anticipates holding to maturity. Future market rates will exceed the ladder's yield to maturity – but not for very long. Returns become more competitive as redemption proceeds and coupon interest in excess of liquidity needs are reinvested at higher rates. Q4 performance statistics aren't pretty, but we stand behind the laddered approach as a safe haven in times of change. To confirm our convictions, we updated an ongoing empirical study.

The Base-Case portfolio is equally weighted to mature over 4 years. We computed returns over 10 year periods under a variety of hypothetical future interest rate scenarios. Yields in year 1 are equivalent to US Treasury security offerings of the same maturity at the end of 2016. We compared total returns for the Base-Case to portfolios simulating a "wait and ladder" approach and "sit in cash". The wait and ladder investor believes rising rate trends will continue and holds out for a target before committing to longer maturity schedules. The all cash portfolio assumes return on capital is equal to the yield on the 1-year Treasury less 0.50%. It starts at a generous 0.35%, well above current money market returns.

Scenario 1: Rates go up 0.75% per year until the 1 year Treasury yields 5% (Year 7). Rates then stabilize with the 4-year Treasury stalled at 5.91%. This is a faster pace and results in a higher end-point rate than the Federal Reserve's latest projection. CFI ladder delivered an annualized return of 3.86%. Our wait and ladder prognosticator held cash until the 1-year note hit 5% and then laddered out for an annualized total return of 3.61%. The paralyzed portfolio sitting in cash for 10-years suffered an opportunity cost of .73% or almost $100,000 on $1 million.

Scenario 2: Rates spike 2% in year 1, 1.5% in year 2 and 0.65% in year 3, similar to the pattern of adjustments that occurred after 1994. When the 1-year Treasury reaches 5% (Year 5), rates remain stable with the 4-year again topped out at 5.91%. These two examples illustrate different rate adjustment paths that end up in the same place. The "wait and see" approach holds a razor thin edge to CFI ladder – 4.56% vs 4.53%. Both added significant value over an all cash portfolio that returned 3.8%.

Scenario 3: Modifies Scenario 2 assumptions with modest rate declines of -0.5% and -1% in years 6 and 7. Final 1 and 4 year Treasury rates were 3.5% and 4.41%, respectively. CFI ladder returned 4.09% annualized against 4.13% for the "wait and ladder" investor. Both are nearly a full percentage point ahead of cash at 3.15%.

These examples stacked the cards in favor of the prognosticators by assuming perfect clairvoyance – i.e. they jumped in at what proved to be a rate peak. We ran simulations on a hypothetical 4-year ladder using the actual year end Treasury rates from 2008 through 2016. The investor who laddered from the start achieved a 1.16% annualized return – more or less in line with inflation. The "wait and ladder" investor sat in cash for the entire period anticipating a rise that never materialized. If the prognosticator lowered expectations and started to ladder after 4 years, the portfolio returned just 0.55%, annualized.

There is nothing to compare to the years ahead as interest rates climb out of the lowest point in recorded history. Fluctuations in market values may be more dramatic than traditional duration statistics suggest. We are confident that the short-term super high quality ladders we recommend will gradually capture the upside, mitigate a subsequent reversal and avoid loss of capital through default. The CFI ladder can be structured to deliver liquidity as needed and is certainly preferable to cash.

Expectations

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corporate profitability. Have they overrated the new administration's ability to turn hot air into effective policies? Are they marginalizing the potential negative backlash stemming from restrictive immigration and protective trade regimes – areas where the President has some degree of latitude to act without Congressional approval?

The Tax Policy Center estimates that Trump's tax reduction wish list alone will increase Federal debt by $6.2 trillion over 10 years. The absence of a clear plan for financing tax cuts and infrastructure spending are likely to hamper swift passage of legislation (despite the Republican majority) or result in haphazard budget neutralizers that dilute stimulants.

Punitive threats may help keep US companies closer to home and might even entice more foreign corporations to protect their access to US markets by bringing production here. Japanese automakers set this precedent years ago. This could help narrow an otherwise burgeoning trade deficit and increase wages for US workers. Stricter enforcement of immigration laws should further tighten the US labor market – especially among less skilled, lower paid employees. These are happy prospects for families who ignite growth through consumer spending. The US unemployment rate already stands at a multi-year low, however, and many American jobs have been lost to advances in technology and automation – not foreigners.

Overly optimistic expectations breed major disappointment. Drastic increases in the cost of labor, retaliatory restrictions on US exports and erosion in overseas income when converted into stronger dollars could seriously pinch corporate profits – UNLESS the promised stimulus is sufficient and materializes in a timely manner. Investors demonstrated some awareness of these risks in their preference for smaller companies that are generally less reliant on overseas business. Extreme wage inflation caused by an inadequate labor supply could sabotage the end game by constraining profit margins or increasing the cost of goods and services too sharply.

Post-election market interest rates soared in euphoric anticipation of reflated global economies. The 10-year Treasury bottomed out at 1.3% in July then shot up 76 basis points after the election to over 2.6% before relaxing to end 2016 at 2.45%. These are big swings in percentage terms and took a hefty toll on fixed income security prices. There is already evidence that the November spike was overdone, but interest rates may resume the climb in step with inflationary expectations and tighter monetary policy.

Wouldn't it be great if real growth and healthy inflation allowed central banks to turn off the easing spigot that has done more to distort financial markets than to foster productivity? In spite of modest GDP recovery among selected Eurozone countries, the ECB is still keeping a lid on interest rates – definitely through April and longer if necessary. As the Fed hikes rates and the US economy heats up, the yield gap will widen and further bolster the dollar. The question is, how high can the greenback fly before it chokes the stimulants out of US multinationals? Heartier **global** growth would help keep the dollar in check.

Extreme dollar dominance unsettles the rest of the world. Yes, foreign exports to the US become more competitive – but much less so in the face of tariffs. Several Emerging stock markets suffered as the probability of restrictive trade agreements rose. More expensive US dollar denominated debt service and policies undertaken to avoid disruptive capital outflows undermine fragile economies. These conditions do not foster widespread prosperity. If Trump's tough talk turns into more than just a negotiating tactic, global recession is not out of the question. We hope the new team recognizes the degree to which international economies are interdependent.

Investors may have acted on unrealistic expectations for flourishing economic expansion, more disposable income and a record breaking bull stock market cycle. We have noted just a few scenarios that could derail lofty aspirations. Ideally, legislative and economic checks and balances will help avoid damaging extremes and investors won't be let down.

We believe portfolio allocations driven by individual circumstances and adequate diversification are the best defenses against uncertainty. Prospects for change may offer profitable opportunities. Once there is evidence that the new administration can successfully implement a stated intention, experienced stock pickers with deep research benches may be in a position to accurately predict the impact on a particular company or industry and place smart bets. Wise managers will avoid jumping the gun based on highly questionable outcomes and/or take advantage of major shifts that have already been instigated by investors acting on hypothetical expectations. Active fund managers may finally have a chance to shine. We will be watching ours closely.

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