BAILEY WEALTH ADVISORS

The Year of Surprises?

January 27, 2017

Dear Valued Client,

CBS News recently dubbed 2016 as "The Year of Surprises." Most people would agree. As the year unfolded, there seemed to be one stunning event after another. In January, a decline in Chinese growth pushed down oil prices and rattled global markets. The European Union faced a major defection that caused wild currency swings. The Zika virus threatened to spread. The contentious 2016 Presidential election ended with an outcome that most didn't expect. Even the Nobel Committee got into the act: they named Bob Dylan as the 2016 Nobel Laureate for literature.

% Return as of 12/31/2016			
Equity Indexes	**4th Q**	**1 Yr**	**3 Yr**
S&P 500	3.8	12.0	8.9
Russell 2500	6.1	17.6	6.9
MSCI EAFE	-0.7	1.0	-1.6
Emerging Market	-4.2	11.2	-2.6
Wilshire REIT	-2.3	7.2	13.8
Bond Indexes			
TIPS	-2.4	4.7	2.3
Aggregate	-3.0	2.6	3.0
Governments	-3.7	1.0	2.3
Mortgages	-2.0	1.7	3.1
Investment Corporate	-2.8	6.1	4.2
Long Corporate	-5.0	11.0	7.0
Corporate High-Yield	1.8	17.1	4.7
Municipals	-3.6	0.2	4.1
Cash Equivalents			
3-Month T-Bill	0.1	0.3	0.2
Consumer Price Index	0.9	1.7	1.1

In our opinion, the media may be misleading with labeling 2016 as the "Year of the Surprises." There have been international intrigues, threats from disease and contentious elections many times before.

In the first five trading days of 2016, the Dow Jones Industrial Average fell over 1,000 points. This marked the worst five-day start in market history. The media and market pundits sounded shrill warnings. By March, equity markets stabilized and turned positive. Then, British citizens stunned the world by voting to withdraw from the European Union. The market reaction was swift and predictable. In the two days following the vote, the S&P 500 slumped 5.3% and the MSCI Developed Market Index dropped almost 10%. Again, the sell-off didn't last. By August, domestic stocks had recovered to new highs.

A 5% decline in the S&P 500 occurs, on average, about every five months. A 10% correction occurs about every 1.3 years. So, from a market perspective, maybe 2016 wasn't so surprising. Perhaps it could be more accurately described as the "Year of Change," just like most years before it.

Speaking of change… President Donald Trump.

After months of unsettling leaks, accusations and attacks, the day finally came. Media pollsters had their ever-confident predictions in hand. Much of Wall Street readied their forecasts as well. Many predicted that in the unlikely event of a Trump victory, we could expect a quick and deep sell-off in the stock market.

What actually happened is that by the US market open on November 9th, stocks were roughly unchanged. By the end of the trading day, the market actually rose over 1%.

From that point on, the S&P 500, a basket of large stocks, rose and ended the 4th quarter up over 3.8%. The Russell 2500, an index of small and midsized companies that underperformed in 2015, jumped 6.1% for the quarter (See % Return table as of 12/31/2016).

We believe there are two parts to the "Trump" rally:

1. A Republican President and Republican control of both the Senate and the House of Representatives increases the chance of passing a spending bill. This could be positive for several industries, like infrastructure and capital goods.

2. Treasury bond selling pushed federal government bond interest rates sharply higher[i]. As Investors sold U.S. Treasuries, presumably to buy stocks or other inflationary assets in anticipation of lower taxes. You may remember that bond prices and interest rates move in opposite directions.

Not all asset categories benefited from the 4th quarter "Trump Rally", the MSCI EAFE, a measure of large and mid-size companies around the world, declined by 0.7% but managed to stay into positive territory for the year. Emerging markets declined more than 4% for the quarter, and ended the year 11% higher. The increase was not enough to bring the 3yr performance above other major asset classes.

Bonds fared the worst in the 4th quarter, declining from 2%-5% across inflation protected securities, government, corporate and municipals. The one exception in the bond category was corporate high-yield, rising 1.8% for the quarter and over 17% for the year (See % Return table as of 12/31/2016).

Benjamin Graham (author of The Intelligent Investor) said "In the short run, the market is a voting machine but in the long run, it is a weighing machine" That is why we do not make short-term political or market forecasts. It is our job to be disciplined and prudent stewards of generational wealth. The benefits of that approach should be obvious "You don't need a weatherman to know which way the wind blows." – Bob Dylan

Summary

We are certainly not saying the election was not important but we should put it into perspective. An examination of the math is helpful. Dr. Jonathan Lemco, an analyst with Vanguard, studied stock market returns from 1853-2015. He compared the average return of equity markets and the party controlling the White House. He found that over this 162-year period, the returns were identical for each party! It is industry and the ingenuity of people that drive markets, not politics.

That being said, President Trump's pledges and policies could affect the markets in the short-term by altering existing trade agreements, changing immigration, enacting tax reform, decreasing regulation, and investing in infrastructure. The first two are isolationist in nature (could have negative implications), whereas the last three could stimulate economic growth.

At this point in time, we can only speculate on how the market and the economy will react to a Trump presidency. However, if climbing stock, bond yield and dollar prices are any indication; investors believe President-elect Donald Trump's policies will be stimulatory.

Please let us know if you need anything. We are here and ready to help.

Sincerely,
Bailey Wealth Advisors

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[i] https://www.nytimes.com/2016/11/15/business/dealbook/ahead-of-trump-presidency-global-investors-sell-bonds-and-grab-stocks.html?_r=0