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FINANCIAL MANAGEMENT STRATEGIES

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# And the Winner is…the Markets?

**January 2017**

My Dear Client:

The last quarter of 2016 was very easy to describe; investor sentiment was positive, and prices improved. Markets began to move higher leading up to the U.S. election, in anticipation of less uncertainty (either way, we were going to get a new president and an emerging policy platform). On November 9th, we had a very brief, but extremely negative, reaction in response to the election of Donald Trump as the 45th president of the United States, with the Dow futures market dropping 800 points in the hours after his victory was declared. However, when the markets opened the next morning, many investors appear to have come to the conclusion that most of the policy measures he espoused will have a favorable effect on corporate equity prices. The post-election rally continued into the end of the year with very little pullback. Between November 10 and December 31, the Dow, S&P 500 Index, and Nasdaq rose sharply pulling each to close at their high mark for the year. An important side note to the rally occurred on November 30, 2016. The Organization of Petroleum Exporting Countries (OPEC), along with non-OPEC member Russia, agreed to the first oil production cut in 8 years. This deal has stabilized and raised the price of oil which always deeply impacts stock markets.

## Fourth Quarter Review


For the year, the major events of 2016 were driven by reactions to political and policy events. Normally, investors consider that political risk emanates from less mature governing institutions in emerging and frontier markets. *However, 2016 turned that conventional wisdom on its head*, as the risks that rocked global markets primarily originated from surprises in developed markets. I expect these volatility risks to remain unabated in 2017. The U.S. national election was the second of <u>**five** major political elections</u> in the world's largest developed economies between 2016 and 2017. The first of these to shock the world markets this past year was the United Kingdom (U.K.) referendum – Brexit – vote to leave the European Union, which occurred on June 23. Following the U.S. election in November, Italians voted in December to block constitutional reform, leading to the resignation of Prime Minister Matteo Renzi. Coming next in 2017, France and Germany will also hold important elections. Thus far, voters have cast ballots that demonstrate alignment with populist sentiments: rejecting establishment government leaders and policies like globalism, and less-restrictive immigration, as well as a rising hint of nativism. We will need to monitor political events throughout 2017 to determine how this populism, driven by citizen concerns about their economic present and future conditions, affect public policies and influence the direction and volatility of financial markets.

Post inauguration investors have chosen to focus on the positive aspects of policy measures that should bolster corporate profits: deregulation, corporate tax cuts, currency repatriation, and possible large-scale spending on infrastructure. These are powerful influences that likely will fuel U.S. growth, as corporate capital expenditures spending (CAP-EX) has lagged during the recovery. U.S. equities, especially small-capitalization stocks, have appreciated sharply since the U.S. election.

Although the markets have pushed into positive territory over the last three months, we remain cautious and expect volatility to temper these gains. Jeremy Klein, chief market analyst at FBN Securities said, *"I suspect that the inevitable difficulties to be encountered by the GOP in hammering out the details of a massive stimulus policy and newfound uncertainty surrounding the Fed as a consequence of a major shift in fiscal policy will precipitate a wave of more violent moves for equities that mirror some of the skittishness already exhibited by other asset classes."* I believe the stock market has not yet considered the potential negative effects of more aggressive policies that restrict trade and immigration. As always, we will also keep our eyes on the bond market, which has made swift negative adjustments to potential inflationary effects of these potential policies.

## U.S. Equity Market


In the fourth quarter 2016, the broad U.S. equity market (as measured by the Russell 3000® Index) rose 4.2%, and the large-cap focused S&P 500® Index rose 3.8%. For the full year, the Russell 3000® Index and the S&P 500® Index gained approximately 12.7% and 12.0%, respectively. All major strata of market capitalization (large, mid, small, micro) and style considerations (value, blend, growth) posted positive returns for the fourth quarter and full-year 2016. Still, the rally in stocks was concentrated in small-capitalization stocks and value-oriented stocks. Of the 11 economic sectors within the S&P 500 Index (which provides a proxy for the equity market), one sector posted a double-digit gain in the fourth quarter: Financial Services.

Only three sectors posted losses for the period: Real Estate, Health Care, and Consumer Staples. For the full-year, the Energy sector posted the strongest double-digit gain while only one sector—Health Care—garnered a loss.

## Emerging Markets

Emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), had been posting solid increases for the first three quarters of 2016, but stumbled during the fourth quarter with a 4.2% decline. Still, emerging markets ended up posting an 11.2% return for the full-year 2016. International developed markets stocks, as measured by the MSCI EAFE Index (net of taxes) did not have a good year, posting a -0.7% return for the fourth quarter and only a 1% return for the full-year.

## U.S. Bonds

Bond markets fared poorly in the fourth quarter, with the Bloomberg Barclays U.S. Aggregate Bond Index declining -3.0%. However, almost all major indices managed to eke out gains for the full-year 2016 period, and the Bloomberg Barclays U.S. Aggregate Bond Index posted a 2.7% gain. The yield on the 10-year U.S. Treasury note ended the year at 2.45%, up from 2.27% at the end of 2015. Yields have nearly doubled since July 8, 2016 when the 10-year U.S. Treasury yield was 1.36%. Most of the sell-off in the bond market occurred after the U.S. presidential election in November (yet the slide had been underway since the summer), as the market assessed the reflationary aspects of likely policy choices espoused by the incoming administration. Reduction in taxes, along with big increases in defense and infrastructure spending, are likely to spur rising interest rates, a stronger dollar, and an upward spike in inflation.

As a citizen, I am very supportive of increasing the number of jobs in the U.S. However; I am concerned about the recent discussions of the return of manufacturing jobs to the U.S. as the answer. Auto manufacturing is simply not the _job growth industry_ of the future. *Marina Whitman, a professor of business administration and public policy at the University of Michigan, who was an adviser to President Richard Nixon and GM's chief economist from 1978 to 1992, rRecently stated, "But as the industry automates, factories don't create jobs like they used to. The American auto industry last year [2016] produced more cars than it ever had before, but they did it with somewhere between one-third and one-half the number of workers that they had decades ago."*

In life, there is no “free lunch;” policies that appear to be beneficial, but are weakly vetted or improperly considered, often have unintended consequences that can grow disproportionately. If plans to increase taxes on imported goods, slash corporate taxes, and eliminate personal exemptions – including deductions for mortgage taxes, charitable contributions, and estate transfer payments – are implemented, then other government services will be reduced, and average citizens will bear increased costs and expenses.

Lastly, in a globally interconnected economy, Trade and Currency wars can have multiple unintended and unforeseen consequences. While other global political uncertainties will undoubtedly arise during 2017, thus far markets are shrugging off global concerns and discounting most looming policy changes with possible negative implications. An example of an under-reported action from abroad last quarter was India’s cancellation of 85% of its currency. The country’s highest denomination notes, 500 and 1000 rupees, were declared no longer legal tender to rein in corruption and the underground economy. This move makes me question if India’s concerns about its underground economy are just another example of brewing populist unrest by citizens.

While uncertainty around the global policy outlook will continue to jostle markets, the U.S. election, for one, has been resolved in a way that could likely benefit corporate equities. Still, I question: What will these policies ultimately look like? How long will these policies revive economic growth? Also, how much of the future good news has the market already discounted?

## A Look Ahead

I continue to maintain my longer-term investment outlook with a focus on risk mitigation through disciplined asset allocation. I am more concerned that recent rallies have pushed valuations and speculative emotional energy to levels that make future market returns look a lot less attractive than they did just a few months ago. While investors have reason to celebrate the set of policy choices that look to bolster corporate expenditures and profits, I believe the difficulties in enacting these policies could be considerably more contentious than currently anticipated. Further, the market has moved higher since March of 2009, and the Dow recently crossed the 20,000 threshold. It’s extremely unlikely, based on history and arithmetics, that the market will rise at the same pace for the next eight years. While the future cannot be accurately predicted, history shows us that the assets that were cheapest become expense; those that were in favor inevitably become out of favor; and, most importantly, markets do not continue rising forever. I would recommend letting your portfolios tilt:

1. to value versus growth,
2. to small caps versus large caps,
3. to energy and industrial securities,
4. to selected illiquid private investments, and
5. to short duration and floating rate bonds

Importantly, over the course of 2017, I advise you to stick to your asset allocation discipline rebalance from U.S. to non-U.S. equities & non-public equities, in addition to monitoring the impact of rising interest rates on your fixed income investments.

With a new year upon us, this may be an opportune time to review your financial objectives and goals, as well as your risk tolerance, unique circumstances, and time horizon, to determine whether the asset allocation we still have in place is suitable for you. As always, I look forward to continuing to work with you toward achieving your investment goals. I wish you health and happiness in the New Year.

Appreciatively,

*Walid L. Petiri*

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Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board