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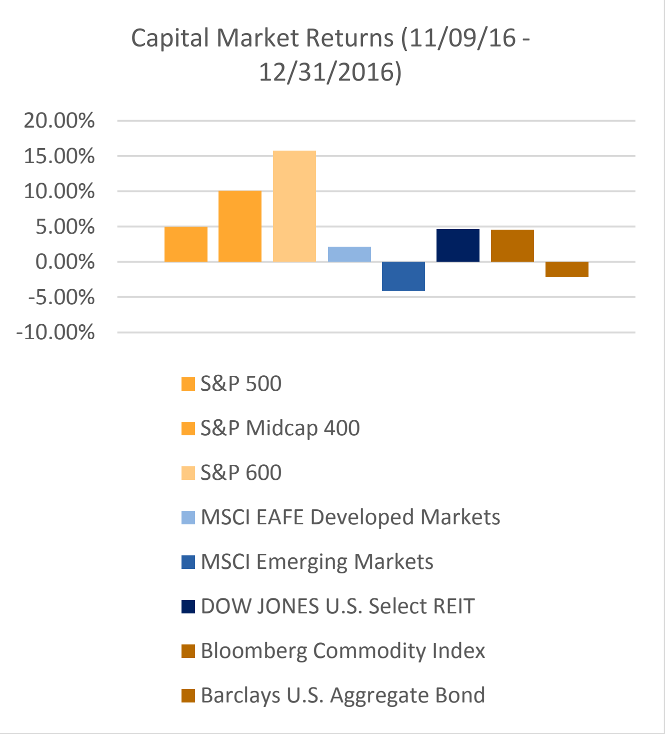
MARKET COMMENTARY: 2016 Q4

It should come as no surprise that heading into the Presidential election we were focused on the potential outcomes and perceived impacts on capital markets and portfolios. As advisors our recommendation is often to "stay the course" and not "market-time" but it can be difficult to focus on the long-term when stakes seem so high in the short-term. The question is, what is *short-term*? If Mr. Trump won, many Pundits cautioned that we could immediately expect a "Brexit-like" outcome (referring to the U.K. referendum earlier this year) when global markets sold-off sharply. Indeed, the Dow Jones Industrial Average (DJIA) futures were down almost 900 points in the early morning of November 9th and many were right in the *very short term*. The surprise factor came from the subsequent rally on that same day which lead to the DJIA finishing up 257 points. Ever since that date, many equity markets have been on a tear through the end of 2016.



Most economic indicators in the U.S. during Q4 were positive enough that the Federal Reserve raised their target Federal Funds rate 0.25% at their December meeting. It had been a year since their last hike and, interestingly enough, in December of 2015 the expectation was that the Federal Reserve would hike quarterly in 2016. We then experienced wide-spread market volatility in Q1 2016, followed by Brexit and then uncertainty around the Presidential election which, over the course of a year, contributed to a stalling Federal Reserve in 2016. On a positive note, third-quarter GDP was revised upward to 3.5%. Consumer spending, which makes up the largest percentage of GDP, increased from 2.8% to 3.0%. Perhaps more importantly was business investment from the third-quarter that was revised upward from 0.1% to 1.4%.

As we closed out 2016 the unemployment rate was at its lowest point to end a year in a decade. That is only partly inspiring since many part-time workers want full-time jobs and we must consider those disenchanted workers who dropped out of the labor force. With unemployment low and wage gains on the rise (wages increased 2.9% in December from a year earlier) productivity becomes increasingly important. Much of the mainstream discussion around economic growth focuses on labor but that is somewhat short-sighted and has decreasing marginal benefits since companies will not continue to hire and expand the wage base if we do not see productivity gains. For long-term and sustainable growth a developed economy needs to see productivity increases; this is a stark contrast to developing economies (like emerging markets) where labor has a much larger impact on output.

In our opinion, the real driver of market outcomes in the 4th quarter was less-so about economic fundamentals and more-so about market expectations. Markets feed off of pricing in future events in such a way that the very driver of performance (think future expectations) can come back in a haunting fashion (through actual outcomes). Said another way, we feel a lot is "priced in" at current levels in terms of what the market expects to happen but hasn't happened yet. Considering the following:

- Markets were expecting corporate tax reform that could greatly benefit corporate growth and earnings. For this to lead to higher future growth corporations will need to commit to new capital projects.
- Markets were expecting fiscal policy easing in the form of infrastructure spending. This spending will generally occur at a lag and its utility for growth depends on where it is spent. Logically our deficit will increase (cut taxes, increase spending) unless economic growth is sufficient to counterbalance the deficit.
- Regulatory reform is expected and the idea is that a lot of red-tape that stifles our economy will evaporate. The objective is to have the net regulatory burden (cost of regulation less economic benefits) be positive or consider another path. The issue is that some regulations are socially important (and arguably "responsible") although not economically justified.
- Trade reform is expected in a move that will likely promote protectionism. Despite perceived domestic job gains and deals that are "fairer", it is inevitable that some reforms will be passed on to domestic consumers in the form of higher prices.

Across most of the global landscape, ultra-low interest rates are still the norm with 33% of all sovereign debt trading below 0% and slightly over 70% of all sovereign debt trading below 1%. International developed markets measured by the MSCI EAFE, which is weighted mostly to European, Japanese and U.K. equities, ended up 1.0% in 2016. There is still a high level of uncertainty in the Eurozone and the U.K. amid aggressive Brexit discussions but unemployment has been improving as has manufacturing in the Eurozone. Japan, on the other hand, is pushing full-throttle for growth with increased stimulus from both monetary and fiscal policy, a trend has been alive for some time now. Based on growth dynamics and valuations, we are still favorable on international developed markets, particularly after a muted 2016.

Emerging economies ended the year up 11.2% and were aided by a recovery in commodities, better fundamentals and an improving international marketplace. Emerging markets are exposed to changes in U.S. trade policy, particularly where we have a trade deficit. Mexico, as an example, derives about 80% of its export activity from the U.S. and is very vulnerable to the Trump administration. We still feel Emerging Markets are an important part of a diversified portfolio based on long-term growth prospects and historically attractive valuations.

Trade reform was previously mentioned as one of the factors that contributed to market optimism in the fourth-quarter. As we think about things from a portfolio perspective we should consider trade policy and how it may promote protectionism. In recent years the benefits of diversification have been questioned and not all agree on how best to diversify. The economic backdrop is euphoria surrounding the "U.S. can't lose" – if we are doing well, no one will be doing as well. If we are doing badly, we will still be better off than others who will be doing worse. So questions arise such as "is it worth investing in International Developed markets versus U.S. markets"? We know that in times of heightened market crises that correlations rise and the benefits of diversification can breakdown. In a similar but reverse fashion, we could assume the benefits of diversification (statistically speaking through risk reduction) will only increase to the extent the new administration seeks to close boarders and nix trade agreements. Said another way, global correlations are already moving back to pre-crisis levels and diversification is key in this environment.

As always, I appreciate your continued trust and confidence and welcome any question you may have.

Wishing you a safe a prosperous New Year,

Jeff

Disclosure:

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GDP: Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. Though GDP is usually calculated on an annual basis, it can be calculated on a quarterly basis as well. GDP includes all private and public consumption, government outlays, investments and exports minus imports that occur within a defined territory. Put simply, GDP is a broad measurement of a nation's overall economy.

S&P 500® Index: Capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The total return version of the index is used, which reflects the effects of dividend reinvestment.

S&P 400 Index: The S&P Mid Cap 400 Index is the most widely used index for mid-size companies and covers approximately 7% of the U.S. equities market.

S&P 600 Index: The S&P Small Cap 600 Index is a market-value weighted index that consists of 600 small-cap U.S. stocks chosen for market size, liquidity and industry group representation.

MSCI EAFE Developed Markets Index: The Morgan Stanley Capital International Europe, Australasia, and Far East (MSCI EAFE) Index is composed of all the publicly traded stocks in developed non-U.S. markets. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

DJ US Select REIT Index: The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S. The indices are designed to serve as proxies for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

Bloomberg Commodity Index: The Bloomberg Commodity Index (BCOM), formerly the Dow Jones-UBS Commodity Index, is a highly liquid, diversified and transparent benchmark for the global commodities market. It is calculated on an excess return basis and reflects commodity futures price movements.

Barclays U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Brothers U.S. Aggregate Index) is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.