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Q4 2016 Market Commentary

Another year has come and gone— but this was no ordinary year.

From the surprising results of the UK referendum in favor of leaving the European Union to the dramatic results of the U.S. presidential election, 2016 was one for the history books. From an investment perspective, it was also a year that introduced a new set of opportunities alongside new risks.

After an extended period of sub-par growth, the foundation for improved economic growth trends has been laid. Wages are rising and economic optimism could help fuel a rebound in capital spending. With stock market prices pushing toward historically high valuations, it is important to take a measured approach to investing. How should one respond to today's lofty equity valuations and the complex issues facing the global economy? We lay out our view below.

Where We Are Now

Who would have thought that after the early market correction and the stock market's worst start to a new year (the S&P 500 was down over 10% in January-February 2016) on record that investors would see a 12% total return (index performance plus dividends) for the S&P 500 when it was all over and done with? And all this in a modest-growth domestic economy and an international landscape filled with political landmines and potential economic dangers seemingly lurking around every curve.

In 2016, the stock market was able to steadily climb higher despite experiencing two meaningful pullbacks that were short-lived. One of those pullbacks, based on the UK vote to leave the European Union, was extremely short-lived. The only significant opportunity for investors to take advantage of downturns and put sideline money to work came during the first six weeks of the year when fears that China's economic growth might crumble (it didn't).

And, of course, the Federal Reserve ("Fed") played a big role in the advance of the stock market, not just last year but over the last seven-plus years. Interest rates at virtually zero for an extended period of time and trillions of dollars being pumped into the economy would generally be expected to boost asset prices.

The fourth quarter was a turbulent one for fixed income markets. Yields had started to drift up from the summer onwards, as July likely marked the end of the love affair that investors have had with bonds for the last 35 or so years. It is likely that we will see a less friendly environment to U.S. government bonds and upward pressure on the U.S. dollar. Donald Trump's victory in the U.S. presidential election significantly accelerated the rise in yields, as investors bet his policies would lead to higher growth and inflation, both of which are the enemy of bond prices. The U.S. 10-year Treasury yield has risen by nearly 60 basis points, or 25%, since the U.S. election. The recent increase in yields seems to be driven almost equally by higher growth and inflation expectations, which has not always been the case during other periods of rising yields. Optimists about the global economy could be forgiven for predicting more losses for investors in government bonds as inflation expectations rise further. Historically, interest rates have not derailed the U.S. equity market as long as the rate rises come off a low base. While we are unlikely to see a rapid rise in bond yields from current levels, the bond market has already moved to price in two rate rises in 2017 and equities have responded well to this move with higher rate expectations.

The stock market, in our opinion, is already pricing in the economic and earnings growth we have been expecting in 2017. Other key economic indicators are showing signs of improvement, with consumer confidence hitting a post-crisis high and the number of people signing on for jobless benefits

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at very low levels. The housing market is also showing signs of renewed strength, with the number of new homes being built picking up.

On the other hand, if the Fed decides to let the economy run hot for a while, we could see a classic overheating. Then it's a matter of when the Fed will have to catch up to an overheating economy, a scenario that could lead to a classic end-of-cycle recession.

We now know more about the Fed's mindset after its December 14 meeting. Like most, we expected a 0.25% increase with no material change in forward guidance; i.e., a "dovish" hike. Instead we got a slightly more hawkish tone, with the Fed (through its dots) signaling one additional rate increase (three hikes in 2017 instead of two) for the remainder of the cycle. But who looks at the dots anyway? In the end this shouldn't be a big deal, but it does put the market on notice that the Fed is not going to sit idly by and let the economy run hot. As Fed chairwoman Janet Yellen said in a post-hike press conference, a fiscal boost would have been more welcome a few years ago when the economy had more slack.

The question remains, does the Fed want stock prices rising at this pace every year? Definitely not. But this exercise in monetary policy tinkering has really been an attempt to boost consumer confidence. The Fed certainly does not want to fuel a new price bubble in stocks. Just remember, consumer spending accounts for more than 70% of economic activity in the United States. If citizens are not feeling good about their job prospects, their neighbor's job prospects, the value of their 401(k)s, and the value of their homes, they will be less likely to open their wallets and increase their discretionary spending.

Let Go, or Stay In?

"Fade or follow?" refers to whether one should let go of (sell into) the post-election rally, or continue to participate in it. "Fading" (in trading jargon) means taking the other side of the move. So, investors must decide whether to "fade" the post-election's upward moves in equities, interest rates, and the dollar, or to "follow" the rally in hopes that it might continue. There are arguments to be made on both sides.

For stocks, a pro-growth legislative blitz is likely to unfold in 2017 that should be highly supportive of U.S. equities. Additional good news is that U.S. earnings growth bottomed in the first quarter of 2016 and has continued to grow since then. So, the fundamentals were improving well before the election. Earnings could accelerate higher if the plans to lower corporate taxes and loosen regulations boost corporate America's profit margins or, at least offset lower profit margins caused by higher inflation.

On the other hand policy uncertainty and higher inflation may cause valuation headwinds in 2017. In our view, caution is warranted as valuations, the stock market is currently priced at around 19x trailing earnings, leaves little room for an earnings or policy mistake.

Diversification is Key in 2017

So, that brings us back to the original question: fade or follow? Despite potential valuation headwinds, we are bullish on stocks based on where we are in the earnings cycle. While there appears to be good opportunities for growth in 2017, it would be unwise to overlook the enormous amount of uncertainty that overhangs the markets and economy. A new administration is coming in with a very different agenda than the one of the past eight years. Global markets are nervous about potential trade policies the U.S. may adopt. And it's unclear how stocks will react to an environment of higher interest rates and potentially higher inflation. We simply don't know what we don't know.

For several years, it has been challenging for investors to stay diversified. Pure equity market beta has outperformed a well-diversified approach in recent years. We would stress that the recent past has been historically unusual, even aberrational. The good news for would-be diversifiers is that recent performance shows hints of more historically "normal" patterns of investment returns. Diversifying asset classes such as emerging market equities and high yield bonds, for example, delivered stronger relative performance in 2016. Particularly at a time of elevated U.S. equity valuations and the rise of political risk in the developed world, we see merits in owning a diversified range

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of investments, to tap into the long-term returns of many asset classes and potentially limit overall portfolio volatility. We strongly encourage investors to align with our mindset of investing over the long-term. An impatient and impulsive approach often does not provide the desired results.

Despite the fact that many economists believe the U.S is due for a recession, after seven years of growth, many also have a more optimistic tale that a recession is not imminent. Global economic expansion through 2017 can be expected, mostly supported by fiscal and monetary policies. We tend to get one to two recessions every decade, with the last in 2008. Someday there will be another recession, but it's difficult to predict the next downturn based on current economic conditions.

What happened last year is now history. But what a year it was. American companies, once again, made the most out of a modest economic environment, and investors around the globe put money into U.S. stocks despite the uncertainties. What does seem clear is that this will not be the "just close your eyes and buy" market that we've seen in the past. It's a more challenging and tactical environment in which there is not only upside potential, but also downside risk. To us, this kind of regime shift should be an ideal opportunity for active management. With that said, the search for investment portfolio returns is not going to get any easier in 2017 against a backdrop of record U.S. equity prices, narrow credit spreads and low bond yields.

To discuss this commentary further, please contact us at 914-825-8630.

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