Fourth-quarter 2016 commentary and recap of the year

Chances are good that no gift you gave or received this holiday season delivered anywhere near the surprises we saw in 2016. The UK voted to leave the European Union, an underdog candidate won the US presidential election, oil prices stabilized after record declines in 2015, and markets rallied significantly after an election outcome that many experts predicted would cause dramatic declines, leaving the Dow within striking distance of 20,000 by the end of the year.

In the background, we have seen several trends in economies and markets throughout the year. Populism has been on the rise globally (e.g., Brexit and Trump) and has at times inserted a level of uncertainty about our basic institutions. Markets often dislike uncertainty and can react severely when the status quo gets shaken up, but they can also recover quickly. The Federal Reserve implemented a rate hike late in 2016, and this pushed many “safe” bond prices down by several percentage points, even causing the Barclays Aggregate bond Index to post a negative total return for 2016.

While the US continues to eye tighter monetary policy on improving economic data, other economies continue to lower rates and even engage in the equivalent of the “quantitative easing” (QE) policies followed by the US after the recent crisis. In fact, if we think about it, in recent years the main performers have been the beneficiaries of QE around the world. A problem with QE here in the US began to develop in late 2015 when we reached a state of fatigue whereby QE did not produce additional GDP growth. As the U.S. pulled back the levers of QE, the US dollar rose against foreign currencies, making the equity and bond rallies even stronger due to the influx of foreign capital seeking asset and currency appreciation. This void had the effect of depressing international and emerging financial markets. Given the trade deals President Trump is seeking, we will go on record to suggest he would be helped in this endeavor by a weaker dollar. For now the divergence in rate policy is serving to hold up the dollar.

While valuations in developed international countries appear favorable relative to US equities, keep in mind that the currency interaction can wipe out gains. We have favored US equity and fixed income assets for this reason. Emerging economies have faced headwinds in that their currencies have depreciated against the US dollar, and as noted above, invested capital moves quickly to benefit from currency divergences. Recently we have seen flows back into US assets, though this can quickly normalize if the dollar begins to weaken. Of note is that many less-developed countries lack the ability to pursue aggressive stimulus policies to reboot their own economies without global investment. And when those countries produce dollar-denominated commodities for the global market, their earnings also fall when the dollar rises.

Our investment committee follows a structured process for analyzing several third-party views from respected commentators and financial institutions. By combining these with our own observations, experience, and judgment we have distilled the following 2017 outlook. Please note that markets are always changing, so the outlook is as of early January. We will of course update our views for new developments.

Equities
After Donald Trump's surprise victory in November, equities have rallied in anticipation of a more pro-business climate, including assertions by many highly successful business luminaries such as Donald Ross, Carl Icahn, and Anthony Scaramucci (now an advisor to Trump) that President Trump intends a more sensible government regulations environment, lower taxes, and more balanced trade deals, favoring those creating jobs in America. While some commentators were quick to jump on the bandwagon of higher expected returns for 2017—which is entirely possible given the high consumer confidence rating and as-yet-unknown reforms of a President Trump, we view current valuations cautiously. While very few assets are actually "cheap" using historical measures like the price-to-earnings ratio, and the enthusiasm in today's stock market could quickly dissipate on bad news such as missed earnings forecasts in the first quarter or unexpected negative surprises associated with government policy change, such as renegotiating international trade deals. We should also note that if these renegotiations and policy changes show promise, financial markets could reignite. Our best advice is to retain equity market exposure consistent with your risk tolerance but to use other types of products in the mix as well as some intelligent tactical rotations to help protect on the downside.

Bonds
We do not favor holding traditional bond funds at this time. Given the expectation that the Federal Reserve Board will hike rates a few more times in 2017, the bond market faces headwinds. Bonds already on the market reprice downward when the current rate goes up. This means investors who merely index the market or hold long US Treasury debt may suffer losses, and it takes time for bonds to make back losses given today's low interest rates. Our investment committee has selected bond managers who can focus on areas less likely to suffer a negative impact from interest rate hikes, such as floating-rate bonds and funds with short interest rate positioning (*i.e.*, returns go up when prices go down). We recently participated on a conference call discussing bond market valuation where the discussion of yield and bond prices determined that at a 2.5% yield, the 10-year US Treasury bond would require 40 years to pay 100% of your invested capital in income; that is, the 10-year Treasury trades at the equivalent of a 40 P/E!

Cash and cash alternatives
As short-term rates increase, the nominal return on cash from things like money markets and very short-term bonds will likely go up; however, this will likely be against the backdrop of higher inflation, meaning the purchasing power may not increase at all. We have been keeping cash defensively and waiting as a risk hedge for an entry point into assets with a better outlook. We did already deploy a portion of the cash in the third quarter, however.

Commodities
Dollar strength has hurt the prices of commodities priced in dollars, although lower prices have benefited US consumers. Most of the returns to a long commodity fund depend on the shape of the "futures curve." In short, these funds buy futures contracts at one price and sell them prior to maturity. If the slope between the current price and the future price goes up, they make money on this "roll yield." But if the slope goes the other way (called "contango"), then the roll yield is

negative and places a drag on returns. They thus become more dependent on prices going up post-purchase to see positive returns. Right now long commodities funds remain exposed to the risk that a continued rise in the dollar will hurt price returns. To reduce this exposure, we use a managed futures fund which can go long or short the commodities and financial markets to take advantage of long-term trends without requiring that prices always go up.

In closing, it is said that valuation is the ultimate arbiter of returns, and as we noted above US equity markets continue to be expensive. The Russell 1000 is priced in the 18th percentile relative to historical valuation over the last 25 years. From these valuation levels in the past, year-forward returns have averaged approximately two to six percent. The Russell 2000 is in the 13th percentile, meaning it's been cheaper 87% of the time relative to history, and this corresponds with flat year-forward returns historically. This does not mean we lack the ability to seek returns on invested capital; several of our specialty fixed income allocations in our clients' portfolios in 2016 were made precisely for these reasons, as they held a large percentage of floating-rate bonds or allowed short selling of bonds.

As always, we are focused on thoughtfully managing risk appropriate portfolios for our clients. If your circumstances have changed, please let us know so that we can review and update our financial planning and portfolio management services accordingly.

Be well.