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2016 Year End Review and 2017 Outlook

What is the common theme behind capital markets activity, the Chicago Cubs, Clemson / USC / Penn State football bowl games, Donald Trump's presidential election, crude oil, corporate earnings, U.S. small cap and bank stocks, and investor sentiment? All of them experienced dramatic second-half comebacks and stunning 4th quarter rallies!!!

Thankfully, market results in 2016 were generally solid despite the backdrop of heightened volatility, confusion, surprises, and dramatic changes in investor sentiment that dominated markets throughout the year.

2016 EVENTS AND DRIVING FORCES:

- **Global growth** clearly shows consistent improvement which began last summer. The Purchasing Manager's Index "PMI" is a useful barometer of broad economic conditions. PMI measurements >50 reflect growth, while measures <50 indicate contraction. Global PMI is 52.7 in December. Developed market economies reaccelerated (53 PMI in December) after a marked slowdown February – June (50 PMI borderline contraction). Also Emerging Market economies are finally emerging from a two year recession (50.6 PMI expansion in November vs. 48 PMI contraction for most of '15-'16.). Essentially the coordinated stimulus and monetary easing from all major Central Banks, except the U.S. Federal Reserve's modest tightening, has finally taken hold.
- **China growth** seems to be stabilizing around 6.5% GDP after two years of dramatic slowdown, and significant contraction within manufacturing (51.9 PMI expansion Dec. vs. 47-48 PMI contraction for 18 months). The government there continues to re-orient the Chinese economy toward domestic services consumption and away from manufacturing for export. Intentionally the Bank of China (PBOC) continues to depreciate its currency Remimbi/Yuan to gain competitive pricing advantage and thus export deflation to the rest of the world.
- **Political confusion and military chaos globally:** President elect Trump's shocking victory and Republican control of both houses in Congress has dramatically altered investor sentiment from sustained multi-year pessimism, to unequivocal optimism. The U.K. Brexit Yes vote shocked Europe and has bolstered support for other European candidates promoting populist/nationalist platforms in upcoming elections in France and Germany in 2017. War and its collateral damage has compounded investors' anxieties: repeated terrorist attacks in Europe and the U.S.; the military coup in Turkey and subsequent mass arrests; Syria and ISIS war zones and refugee crisis that is ravaging the Middle East and North Africa and is spilling into Europe.
- **The Federal Reserve** raised rates only once in 2016 (December) but is again trying to move toward normalization and higher interest rates in the U.S. in 2017. The Fed's current forecast is to raise rates 3x/year every year in 2017-2019. This diverges starkly with the rest of the world's major Central Banks that are deeply engaged in monetary stimulus with rates close to zero, or even negative rates. Any economic slowdown will likely again compel the Fed to be more dovish and normalize rates more slowly than they would prefer. Also, two hawkish Fed members, who favor more aggressive rate increases and more monetary tightening, are retiring and their two replacements have a reputation for being dovish and prefer to go very slowly with raising rates and policy tightening.
- **Bond Yields worldwide** have rebounded since September after they plunged to record lows by the summer of 2016. (U.S. 10 year Treasury bond yield 2.35% now vs. 1.35% in July; German Bunds yield 0.32% now vs. -0.04% in July; Japanese JGB's yield 0.04% now vs. -0.27% in July). Central Banks (Europe, Japan, England, China) massively ramped up their highly accommodative stimulus measures to combat deflation and jumpstart growth and seems to be gaining traction. The 35 year Treasury bond market rally that began in 1982 appears to have

peaked last summer, and should experience falling prices/rising yields over the next several years.

- **U.S. corporate earnings** resumed growing in 3Q '16 after emerging from an earning recession that started 4Q '14 and lasted 18 months. Recovery in the Energy sector and stabilizing crude oil prices, combined with U.S. $ appreciating more slowly are the fuel behind the earnings recovery. Improving global growth, weak year ago comparison periods, steeper interest rate curve, and prospects for reduced taxes and fiscal spending on infrastructure are the fuel for rising earnings estimates (+10% - +15% in 2017).
- **Stock Markets** rallied dramatically post the U.S. elections given a huge improvement in investor sentiment that anticipates rising corporate earnings, business friendly policies emanating from Washington with reduced dysfunction, lower taxes and regulations. Earnings are improving in the U.S. and international developed markets (Europe, Japan, Asia), and Emerging Markets are finally rising from a multi-year recession, and their stock prices have depressed valuations that are attractive. The improved psychology is in sharp contrast to the collapse in markets in 1Q that reflected slowing growth globally and contracting corporate earnings and revenues. Increased volatility, and frequent sector rotation is the new normal as stock market valuations are already modestly expensive.
- **Oil** seems to have found price support in the $40s as OPEC producers, and several non-OPEC member states, finally agreed in November to production cuts. Crude's stabilization is also in sharp contrast to the collapse in prices to $26/barrel in January/February when OPEC refused to agree to production cuts and global inventories were rising from U.S. shale producers ("frackers") flooding the market. The 2½ year collapse in energy prices seems to be complete. Expect a slow modest recovery for crude prices as US shale producers can easily resume production and increase rig count, which should cap and inhibit prices from rising dramatically.
- **Industrial Commodities** prices rebounded modestly in 3Q/4Q as global growth slowly recovers. This rebound is also in stark contrast to the stunning collapse in prices last winter as demand for metals melted in step with the global economic slowdown.

Many of the actions and forces that drove markets in 2016 have established the foundation for 2017. After vigorously polishing our crystal ball with Sham-Wow, these are some of the visions and themes that are emerging with slightly increased clarity for this year.

- **2017 Opportunities**
  - ✓ U.S. equities rally, but unevenly during the year with biggest winners being cyclicals: banks, energy, industrials, materials, tech, mid-cap/small-cap companies, and IPO resurgence
  - ✓ Japan and Asian Developed Market equities rally, but currency hedge is important to offset Yen weakness
  - ✓ Emerging Market equities rally, but not if U.S. $ appreciates rapidly
  - ✓ European equities rally only modestly, and currency hedge remains important to offset Euro/Sterling weakness
  - ✓ U.S. High Yield "Junk" bonds rally
  - ✓ Commodities rally modestly from depressed levels and improving demand
  - ✓ The Fed only raises rates 2x (June and December) and requires legislative progress by June (corporate tax rate cuts, regulations loosened especially for Energy and Financials, infrastructure spending outlined)
  - ✓ Low Bond Yields globally persist and anchor rates lower than normal which support equity prices despite stretched valuations

- **2017 Risks**
  - ✓ Increased Volatility whose sources include sector/asset class rotation, stretched U.S. equity valuations, and political risks

- ✓ European political uncertainty around the U.K. Brexit terms, multiple elections and rising populist/nationalist sentiment that is anti-European integration and anti-immigration
- ✓ U.S. Legislative uncertainty whose sources include ACA "Obama Care" repeal, Trump trade policies
- ✓ U.S. $ rapid appreciation
- ✓ Long Duration rate sensitive bonds (treasuries, municipals, agencies, sovereigns), REITS, utility stocks, are vulnerable as interest rates slowly rise further
- ✓ Big terrorist event in Europe

With this capital markets and geopolitical backdrop for 2017, our Investment Policy Committee and research team remains focused on these important investment fundamentals:

- We are carefully monitoring and scrutinizing actively managed funds for tax/cost efficiencies, and to assess the compatibility of their sector allocations relative to the new investing environment
- Expect increased volatility in investment markets globally. . .stay calm and don't freak out
- Asset Allocation is critical and an ongoing focus of our research attention and investment portfolio designs
- Each client should assess their risk tolerance profile to assure their comfort levels in the upcoming months that may periodically be bumpy but should also be financially rewarding

I hope 2017 will be noteworthy for reduced "drama" relative to the year just ended. If there are significant surprises, my wish is that they be pleasant and to the upside for all!

As always I encourage you to contact me to discuss any of the above, and how we can help you leverage this information.

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