2016 Fourth Quarter Review of the Markets

Index	4th Qtr Return	YTD Return
S&P 500	3.82%	11.96%
MSCI ACWI Ex USA	-1.25%	4.50%
Barclay's Bond Index	-2.98%	2.65%
Consumer Price Index	0.84%	2.10%

Investment Commentary

2016 ended with a level of optimism that stands in stark contrast to the pessimism that marked the beginning of the year. A rocky first six weeks of 2016 saw nearly a 10% decline in the S&P 500 which was followed by a 23% rally. The index returned 3.8% this quarter to end the year up 12%. The bulk of the return is attributable to increases in valuations.

International equities did not enjoy the same post-U.S. election bounce that U.S. equities experienced, ending the quarter down just over 1.2%. For the year, non-U.S. stocks continued to underperform U.S. stocks, although they posted their strongest year since 2013, returning 4.5%.

Bonds experienced strong returns for the first three quarters of the year, but sold off by nearly 3% during the fourth quarter. The bulk of the selloff's magnitude occurred post-U.S. election in early November. Interest rates rose meaningfully post-election on expectations that Trump's pro-growth policies would lead to higher levels of economic growth as well as higher levels of inflation. Indeed, interest rates bottomed out post-Brexit in early July with the 10 year U.S. Treasury yield falling below 1.37%. By the end of the year, the yield had increased nearly 80% from that low, finishing the year at 2.45%. The index still retuned 2.7% for the year despite the increases in rates.

Economic Outlook

We wrote last quarter that the presidential election had not materially impacted our asset allocation because we didn't know a) who would win or b) what their policies would look like. Since that time, we have gotten our answer to the first question, but the second question remains unanswered. Indeed, President Trump is likely to pursue corporate tax reform and increased infrastructure spending (generally good for corporate earnings). He's also made statements in support of protectionist policies and preventing the offshoring of jobs (potentially bad for corporate earnings). Regardless, market sentiment has been generally positive since Republicans took the White House while maintaining control of Congress. We are careful to point out that this rally has been largely based on sentiment as the specifics of any policy changes are still unknown. Average analyst estimates of earnings on the S&P 500 have only increased by 2% since the election while the market has returned 5%. The bulk of the remainder of the return has come from valuations increasing from below 16 times earnings to almost 17 times earnings at year-end. One final point on our pre-election commentary – we mentioned that even if we knew the winner beforehand, betting on political outcomes can prove to be a fool's errand. Those of you who stayed awake the night of November 8 to watch news reports of equity futures falling 10% as Trump's victory appeared more likely were probably concerned about the value of your portfolio. Those of you with the good fortune to be asleep, uninterested, or otherwise engaged that night, were likely pleased (at least from an investment perspective) when you awoke and saw U.S. stocks responding positively. This reminds us that over the short term, often the markets don't even know what the markets want.

If the stars align for the new administration to carry out some of the many pro-business policies that have been put forth, equities have the potential to do exceptionally well, even from current elevated valuations. On the other hand, interest rates and equity valuations have increased on the back of a "Goldilocks" growth scenario, and any deviation from that could send interest rates and equity markets lower.

We caution clients that even though the post-election equity rally has been exciting, unless and until we grasp whether or not there has been an actual regime shift, we believe that it is likely not the time to extend out on the risk spectrum. Ultimately, the time to take more risk is when one or more of the following characterize the state of the markets: volatility has been higher, sentiment is neutral to negative, and prices (i.e. valuations) are lower. At this point, none of those conditions characterize markets and the possibility of regime shift represents the only real catalyst for strong performance.

With all of the election-related commentary, many have forgotten that the Fed is likely to increase the federal funds rate three times in 2017. This would mark a meaningful acceleration from the post-financial crisis regime. Markets have (incorrectly) anticipated increasing interest rates on longer dated bonds for several years now. It remains to be seen whether or not the increase in rates during the second half of 2016 is the start of a long term secular trend of rising rates or merely a return to more normalized interest rate levels.

Investment Strategy

Looking back on the year, our clients benefited from exposure to high yield bonds, mid-cap U.S. stocks, and energy master limited partnerships. When we added to our clients' high yield bond exposure as those bonds sold off, we did not expect their prices to rebound as quickly as they did. Much of the increase in that exposure was reduced after valuations increased. While our clients remain underweight non-U.S. stocks versus the global opportunity set, holding any developed market non-U.S. equity was a headwind to returns. Additionally, client portfolios were largely devoid of small-cap stocks, which performed very well in 2016, as their elevated valuations increased throughout the year.

Insofar as our clients have exposure to bonds within their portfolios, they had the least exposure to interest rate risk in the middle of the year around the time when rates bottomed out. Conversely, clients had the most interest rate risk at the end of the year when rates hit their intra-year high. We believe that taking on more duration is the prudent thing to do as term premiums (the promised returns on longer maturity bonds relative to shorter maturity bonds) increase and, therefore, that reducing duration as interest rates fall is also prudent.

Our clients' portfolios remain allocated to what we consider a neutral risk allocation, and are positioned for a wide variety of outcomes with the flexibility to take advantage of opportunities as they arise in various asset classes. Although it can be tempting to want to take more risk with the potential positive catalysts out there, we would caution clients that, at current valuations, the risks are elevated. It's important to not just ask, "Will things be better?", but also, "At current valuations, what level of improvement is being priced in by the market?". Expectations have risen significantly without meaningful improvement at this stage. We remain hopeful that pro-business legislation will be passed and that our clients' portfolios will benefit from higher stock prices as a result of real (instead of speculated) earnings growth. However, the overwhelming majority of our clients rely on us to provide some level of protection against adverse events, and it is prudent to avoid getting carried away with the market sentiment currently afoot.

2016 could be characterized as a year of surprises. We hope we demonstrated to our clients that while the unexpected is inevitable, prudence can benefit and protect client portfolios. We wish each of you a healthy and prosperous 2017.