Equity Market Update

As of December 31, 2016 / Volume 5, Issue 4 / FFTAM.COM

To most investors, 2016 can be summarized as a year of large asset value swings centered on shocking macro outcomes. To start the year, the FOMC's announcement of four potential rate hikes scared the markets. This vastly exceeded consensus expectations, so equities dropped more than 10% in just three weeks. Fearing a Fed induced recession, energy prices plunged with oil bottoming out at $26 a barrel in mid-February. These events ultimately caused the Fed to backtrack and led to only one interest rate hike in 2016. In June, voters in the UK stunned the world by voting to leave the European Union. Finally, in November, Republican candidate Donald Trump defied all major media polls by defeating Hillary Clinton for the US Presidency.

Despite all these shocks, the market had a successful year. Investors who remained calm and allocated capital to the sectors with the best risk-to-reward profiles experienced above average returns. Correlations among individual stocks fell for the first time in many years which opened the door for active managers.

For the year, domestic stocks saw solid gains. The S&P 500 was up 11.95 %, while the Dow Jones Industrial Average jumped 16.50%. The NASDAQ trailed the other two major indexes all year, yet it still improved by 8.97%.

The most impressive gains were in mid- and small-sized companies. The S&P 400 Mid-Cap Index advanced 20.73 %, while the S&P 600 Small-Cap Index zoomed 26.46%. Investors flocked to these areas on improving US economic data, along with hopes for lower taxes and regulations from the incoming Trump administration.

Among economic sectors, energy and financials were the best performers, gaining 27.36% and 22.75%, respectively. Energy reversed its weak performance from earlier in the year when OPEC announced in October they would abandon their 2-year strategy of growing market share. Financials were the largest benefactor post-election. They gained on the prospect of higher interest rates and lower regulation. Industrials advanced by 18.85% on talks of infrastructure spending by the Trump administration. Materials followed suit by gaining 16.69%.

Not all sectors experienced strong returns. Consumer discretionary stocks lagged the overall market as the prospect of higher interest rates loomed. Consumer staples were plagued by high valuation and a strong US dollar. Healthcare was the only sector with negative performance. It fell 2.69% on rhetoric from both Hillary Clinton and Donald Trump about the high prices of prescription medication.

International markets were mixed. Emerging markets were up 11.27%; however, this was far less than their 16.25% total return before the US election. EAFE barely eked out a gain of 1.59%. European and Japanese stocks experienced investor outflows for much of the year. Negative interest rates have put European and Japanese banks in a precarious position. The negative rates act like a tax on the banking system, thereby hurting capital ratios. This is especially worrisome in Europe as many of their banks still have questionable loans and other assets on their books.

Over the past year, total returns on stocks far outpaced economic improvements and earnings growth. Most of the gains occurred after the US election. Donald Trump's victory has ushered in expectations for lower corporate and personal taxes, less regulation on businesses, and increased infrastructure spending. As we enter 2017, very little detail has been given on these initiatives by the Trump transition team. We also do not know how far Mr. Trump is willing to push the anti-trade rhetoric from his campaign.

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It appears equities are data dependent on the Trump agenda in early-2017. If the incoming President is able to achieve most of his pro-growth agenda, inflation expectations will increase. This will make the Fed more active in their pursuit of higher interest rates. If the policy details disappoint the market, stocks are poised to pullback in value. We all know politics is a messy business, so the potential for increased market volatility is present.

Our 2017 total return expectations for equities are low from current levels due to: 1) an elevated price-to-earnings valuation on stocks; 2) choppy corporate earnings growth that is heavily dependent on the passage of Trump's pro-growth agenda, increased energy prices and higher interest rates; 3) lackluster global economic growth outside the United States; and 4) a rising US dollar serving as a headwind for US exports and multinational companies' earnings. Although we expect further improvements in the US economy, which will lead to stronger GDP growth, the big rally in stocks over the last two months has pulled forward a good portion of the gains into 2016.

We still like cyclical over defensive sectors; however, we have recently lowered our cyclical overweight given the post-election rally. Among cyclical sectors, we remain overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare and telecommunications given their attractive valuation paired with underweights in consumer staples and utilities.

We anticipate 2017 will continue to deliver lower correlations among individual stocks. This sets the stage for active management victories. This, coupled with increased volatility, means we intend to be more nimble in our portfolio allocations. We believe any significant declines in stock prices should be bought based on our view of further US economic improvement and a patiently moving Fed. We continue to focus on well capitalized companies that will benefit from long-term, global trends in urbanization, technological disruption, aging societies, and energy independence and efficiency.

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