Economic and Market Review

Economy – The Presidential election dominated the news in 2016 and culminated with the surprising election of Donald Trump. Despite the avalanche of media coverage, the true impacts to the economy and financial markets are still largely unknown. Markets reacted to the shocking result with a strong equity rally and a significant increase in interest rates, presumably due to a more favorable business environment and potentially greater federal deficits. Much is still unknown about the Trump agenda, how he will work with Congressional leadership and the challenges he will face both domestically and internationally, so forecasting the impacts on the markets is difficult and therefore we remain alert.

During the 4th Quarter many economic indicators continued to show tepid, albeit consistent, growth. While the current expansion is one of the longer on record (90 months), the average growth rate has only been 2.1%, well below past expansions and even below the 2.8% average growth rate of the past 50 years. The labor markets continue the modest, yet unusually persistent growth. The housing market also showed some strength, as have retail sales and consumer confidence. Gauges of industrial production showed mixed results further cementing the view of continued slow economic growth with persistence being the only remarkable feature. The Goldilocks economy (not to hot, not too cold) has finally built up enough momentum for the Fed to consider moving from a zero interest rate policy towards more normal levels.

Interest rates – Interest rate fluctuations may have been one of the more thought-provoking and underappreciated stories of the 4th quarter. Rates began to rise during the third quarter from all-time lows (10 Treasury – 1.37% on 7/8/2016) and continued to increase modestly during the fourth quarter into the election. After the election there was a sharp increase in interest rates across the board. Analysts attributed the sudden shift in sentiment to the potential of wider deficits from Trump's proposals and a more robust business climate. The Fed reinforced the move in rates by increasing the Fed Funds rate in early December and signaling more increases in 2017 then the markets had anticipated. Bond prices reacted negatively, especially at the long end, for example the Vanguard Long-Term Bond ETF (BLV) was down 8.3% for the quarter. With the markets and the Fed moving towards "normal" interest rates (3 to 4%), the question remains, has the 35 year downward trend in interest rates been broken?

Equity Markets – US equity markets finished the year on a strong note with a solid rally of 5.0% after the election. Post-election rallies are the norm as uncertainty is resolved; however this case was unusual given the surprise winner and the potentially disruptive nature of Trump's policies and the limited details of his proposals. Many investors were cautiously positioned going into the election which may have accounted for the strength of the rally. For 2016 the US Equity markets managed low double digit returns (S&P 500 – 12.5%), driven by higher valuations and firming earnings as the Energy sector rebounded. Value oriented stocks outperformed Growth as Financials and Energy did well. Mid and small cap issues also performed well, while developed international markets were flat and emerging markets finally showed some signs of life with mid-teens returns.

Commodities – Oil closed the year above $50/barrel, up nearly 50%, which helped spark a rebound in oil related stocks. Gold returned modest high single digit returns which masked the roller coaster price movements during the year. The US Dollar showed significant strength throughout the 2016.

Outlook

Economy – Despite an abundance of media coverage and prognostication, very little is understood about the specifics of Trump's plan for the nation and specifically his economic agenda. On one hand there are encouraging signs for the business climate while the specter of trade wars and immigration battles also loom. For the most part, his cabinet selections have been heartening with many successful, business oriented leaders willing to join. Long on corporate acumen but short on Washington experience, it remains to be seen how effective he and his team will be. Tax reform could be a major positive for the economy, while trade policy and immigration could be negative and it is anyone's guess what the impact of a repeal of Affordable Care Act will be.

The sheer length and persistence of the current slow growth recovery has finally led to improvement in the labor markets and the initial signs of inflationary pressures. The Fed has reacted by increasing rates and signaling further increase on the path to a more "normal" interest rate environment. One thing to watch carefully is the impact higher rates may have on the US housing and related markets, not to mention bond holders who have not experienced a significant interest rate increase in a long time.

Equity Markets – Post-election rallies have historically turned soft after inauguration as the rubber meets the road and the realities of governing begin to take hold. While S&P 500 earnings have firmed and show signs of growth, the US equity markets are stretched from a valuation standpoint so we see limited upside at this point and potential for a correction. Foreign markets, developed and emerging, continue to offer attractive valuations after years of underperforming the US markets.

Fixed Income – Prospects are improving for investors seeking income as current yield levels are beginning to offer returns which are meaningfully different for zero. Prior to the run-up in rates, income investors were faced with a difficult choice, zero return on the safety of cash or significant principal risk for relatively small increment yields as they moved out the curve. With the rise in rates, some of the initial principal risk has been lessened and it may be time to start putting some Cash earmarked for Fixed Income to work and extend durations modestly.