Retirement Income Solutions

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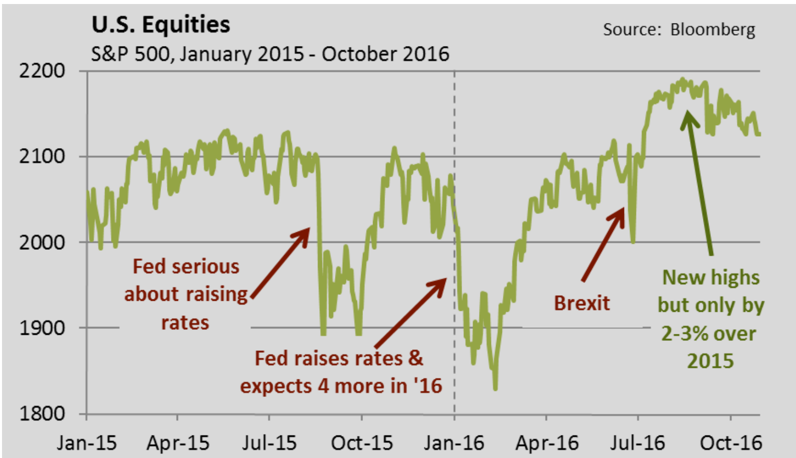
A Joyless Bull Market

November 2016

Summary

It has been a tough year so far, encountering a 13% correction in stock prices, oil price swings between $26 and $50/barrel, Brexit, fears of a hard economic landing in China, earnings declines in the U.S., and a difficult U.S. election between two unpopular candidates (and, of course, the deaths of David Bowie, Glenn Frey and Prince). Despite those issues, U.S. equities are up a reasonable 6% for the year, briefly hitting new highs. However, the new highs were only meager increases of 3% over 2015; the Dow first crossed 18,000 in December 2014, and on November 4th, it sat at 17,900. There has not been much joy in the market advance since plenty of uncertainty remains. Such an environment can test an investor's patience, and this far into a bull stock market, investors are typically more optimistic about the future; however, it is still difficult to shake the memory of the financial crisis that is now over seven years in the past.



Although many challenges and unknowns exist, there is still room for growth. While volatility in equity markets is likely to continue, bigger swings in bond returns may be in store as well.

- **Stocks hit new highs earlier in the year.** The new highs were meager, while international and emerging markets realized bigger swings than U.S. markets.
- **Another bumpy year may be ahead.** The post-presidential election year tends to exhibit more volatility. Historical returns are either strong or negative; none of the past 29 post-election years realized "normal" returns between zero and 10%.
- **Economic conditions seem to be turning more positive.** Although the last recession was over 7 years ago, the recovery is slow but elongated and still has room to continue.
- **Bonds aren't boring anymore!** There are some very interesting occurrences in the bond market. Some investors are buying bonds with 100-year maturities, and some borrowers are getting paid to borrow money (earlier this year, in Denmark, a mortgage *borrower* was paid interest!)
- **The Fed sits in a policy sweet spot.** Near-term Fed action still indicates room for economic growth, not end-of-cycle inflationary prevention. "Lower for longer" is not the same as "zero forever."
- **Post-election years tend to be good for equities.** Hopes for change and improved governance may boost markets for a period of time before the reality of many challenges sets in.
- **The long, joyless stock bull market should continue.** The "pause" in markets over the last 18 months should provide the base upon which future gains can be built. A healthy dose of skepticism is good since it is too much optimism that is usually the downfall of long-term bull markets.
- **Many wildcards exist.** Such potential concerns include the priorities of a Trump presidency, oil volatility, China growth, dollar strength, and continued populist success in European elections.

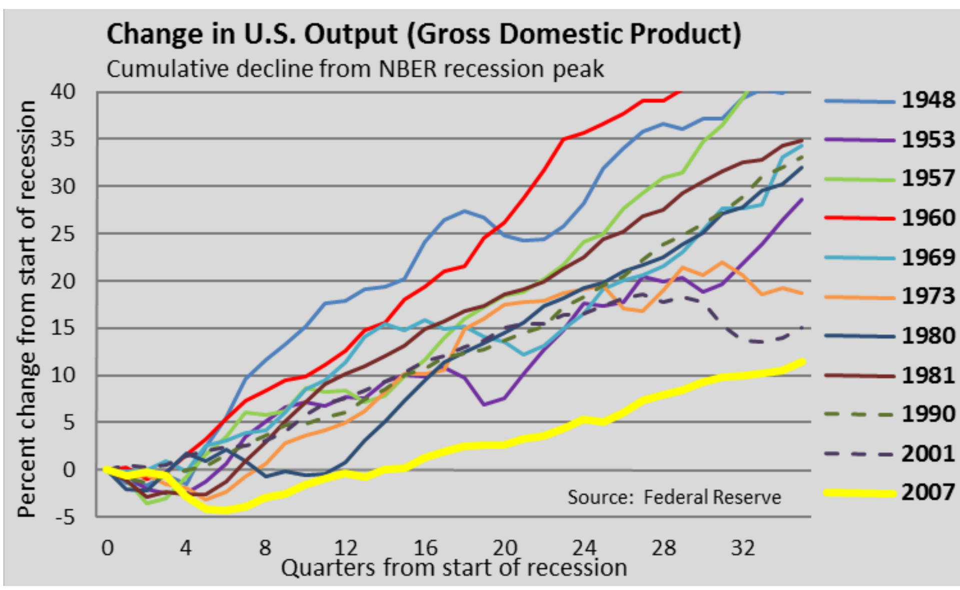
Position Change: Increase in Equity Allocations

Some clients may be distressed about the results of the election and the changes associated with it, but our job as advisors is to look past the politics and emotions to focus on the data. We recall that many people on the other side of the aisle felt similar discomfort eight years ago as Obama took office. Overreacting to those feelings eight years ago would have been a poor investment decision, and a knee jerk-reaction today is likely unwise as well. The future is uncertain, but many factors are more important to the health of the economy and financial markets than who occupies the oval office.

Accordingly, we recently made investment changes in client accounts, moving to “maximum” equity positions. Markets survived several significant hurdles in the past year; that resilience is quite impressive, and most of our forward-looking indicators are positive. Stocks may continue with a bumpy ride but are still more appealing than bonds, which may finally be at a turning point.

Elongated Expansion

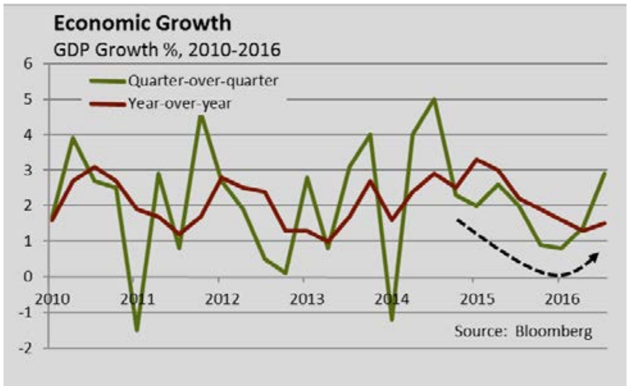
The financial crisis in 2008-2009 was the deepest and longest economic contraction since the Great Depression. Economic growth in the past 10 recessions all recovered within two years from the pre-recession peak. The most recent recovery took almost four years to get back to pre-recession levels.

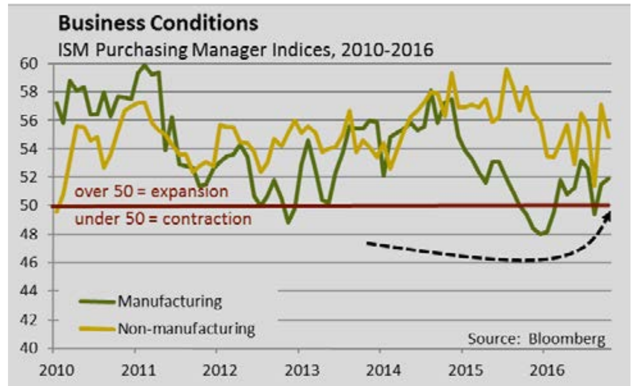


Although the current cycle has lasted 35 quarters (almost 9 years since the 2007 peak), it has also generated the weakest annual gains per year. The average economic gain since the end of recession is 4.4% per year, lasting 60 months. The most recent expansion is only 2.1% per year, lasting 88 months. While length of the recovery is almost two years longer than the average, it is still only the fourth longest of the 11 recessions shown above. Economic expansions don’t run on a clock and don’t die of old age. For an expansion to end, there is typically some trigger that occurs such as tight monetary conditions from an inflation-wary Fed, major oil shock, or a credit-fueled housing bubble. Despite the lackluster economic trend, there is room for the expansion to continue.

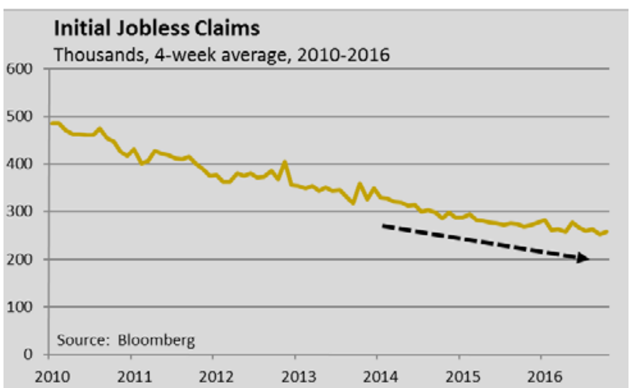
Economic Conditions

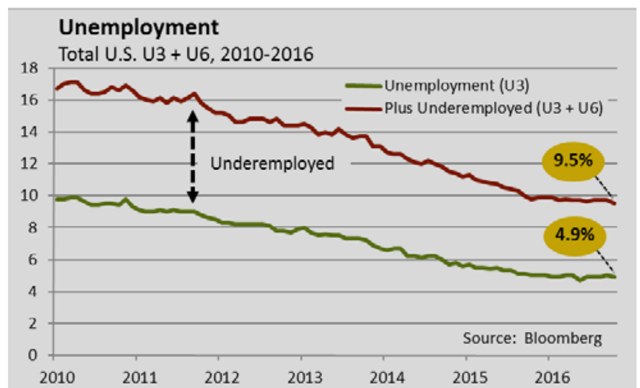
After 12-18 months of slowing, economic growth seems to be reversing in a positive direction. Business conditions as represented by purchasing managers demonstrate expansion and have improved over the last year in both manufacturing and non-manufacturing sectors.



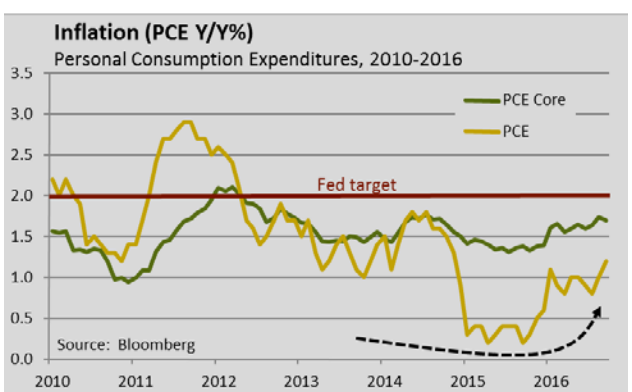


Jobless claims continue to decline, and unemployment continues to tick lower. However, the quality of jobs is still weak. The percentage of workers that are "under-employed" is still quite high (prior to the financial crisis, unemployment including under-employment was typically well below 10%).





Inflation has continuously been below the Fed's target since the financial crisis. Avoiding deflation (negative inflation) was critical, and some modest inflation is a sign of some economic strength. After years of modest gains, wage growth has strengthened, which confirms economic improvement and modest (but higher) inflation expectations.



Asset Class Returns – The "Not So Amazing" Highs

In July and August, the U.S. stock market once again hit new highs. They were the first new highs since May of 2015, and they came in rapid succession with 10 new record highs in a 4-week time span. The new highs were welcome good news, but they also generate a common perception that the equity market is surging. While media headlines repeatedly highlight the new highs, this year's peak was only 2.8% higher than the prior peak in May of 2015. With ten days of records, the average new record was only an increase of 0.28%... not much of a surge!

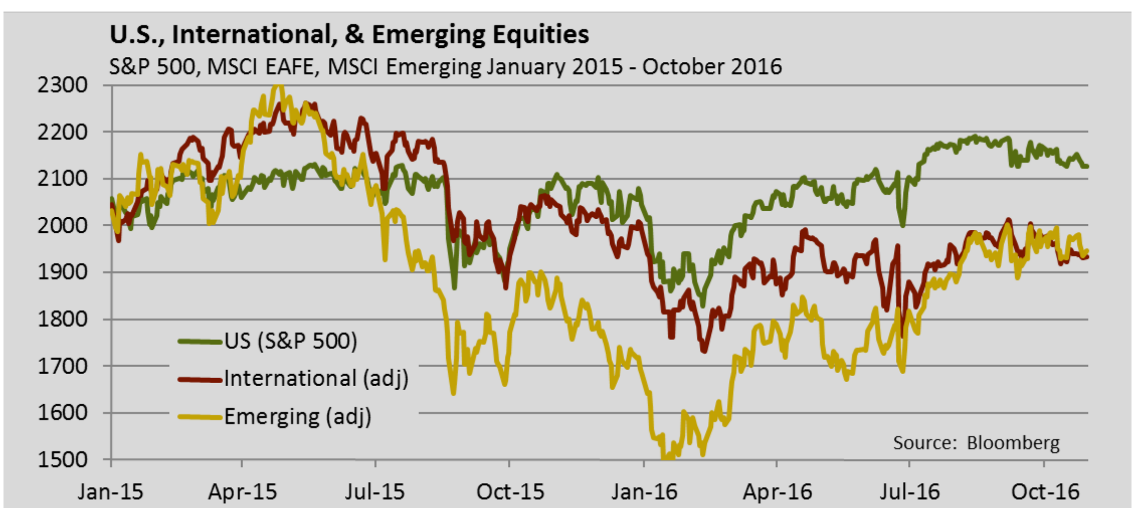
Stock Returns

As of October 31, 2016

	New Record High in 2016?	YTD return
All Country World	No	2.9%
S&P 500	Yes (2.8%)	4.0%
Dow Jones IA	Yes (1.8%)	4.1%
Small caps	No	4.9%
International	No	-2.9%
Emerging	No	14.0%

Source: Bloomberg

This "not so amazing" story is compounded by mixed returns in international equity, emerging markets, small caps and broader world stock indices (see above). While returns are positive so far this year, in many cases they have not exceeded levels reached over 18-24 months ago. For example (see chart below), over the 20 months since January 2015, U.S. equities are up 3.3%, International equities are down -6.2%, and Emerging market equities are down -5.5%.



Bonds have also had a somewhat tumultuous year so far. After a strong start as risk aversion was high in January and February due to oil instability, Brexit, etc., investment grade bonds generated a 5.0% return but gave almost 3.0% back in the last few weeks when interest rates jumped up.

Focus on the Fed

The Fed has maintained an approach of easy monetary policy since the financial crisis. Typically, it takes an extreme environment to warrant such low interest rates and accommodative policy. Since inflation is low while economic growth was slow, the Fed has been unwilling to increase interest rates significantly. This presents a problem for the Fed since they have run out of tools in the event another recession occurs. It is just a matter of time before the next recession comes since they are a natural part of the business cycle.

To be effective in combating a recession, interest rates need to be higher so that the Fed can cut them if (when) a recession ensues. The trick for the Fed has been how to raise interest rates without disturbing the slow but positive economic recovery. This has not been an easy path. In 2015, the Fed finally started to get serious about raising rates, but the market revolted with a 12% correction in equities; the Fed then backed off, and markets recovered (see chart, page 1). The Fed worked hard to convince the market that one rate increase was acceptable. Last December, the Fed finally did raise interest rates for the first time in 9 years; however, they also indicated a plan to raise rates four more times in 2016. The market revolted again with a 13% correction in equities. The Fed, once again, backed off and markets recovered again. So far this year, there have been no increases in Fed-controlled rates.

Looking forward, it seems likely that the Fed will raise interest rates further in December 2016. This will only be the second increase in the Fed Funds rate since 2006. The previous two attempts by the Fed were not received very well, so there is some uncertainty about how markets will react. However, the commentary and positioning by the Fed has changed over the last year. The Fed chair, Janet Yellen, has shown more willingness to let the economy "run hot," and it seems likely that the potential December increase will be moderated by language that is less aggressive in terms of the pace of future interest rate hikes. The context of the December announcement will be crucial to the response of financial markets. The challenge for the Fed is to indicate their guidance of "lower for longer" is not the same as "zero forever."

Fed Cycles & U.S. Stock Market Returns

S&P 500 (1961-2015)

Environment	Mean	Median
Low rates + Fed hiking	+10.6%	6.8%
High rates + Fed hiking	+2.5%	6.2%
High rates + Fed cutting	-8.7%	-9.1%
Low rates + Fed cutting	+23.0%	18.2%

Source: BCA Research

More broadly, the impact of near-term, Fed-driven increases in interest rates is unlikely to be very damaging to the economy or financial markets. BCA Research analyzed past Fed rate hikes and concluded that Fed rate increases are not necessarily bad for the stock market. When monetary policy is still friendly (rates are low), Fed rate hikes are associated with relatively strong annual equity returns of 6.8% (see table above). This likely occurs since modest rate hikes are associated with growing economic strength. When interest rates are high, rate hikes are intended to slow the economy and reduce inflationary pressures; this type of rate hike is associated with negative annual equity returns of -9.1%. While the Fed lingers in the monetary policy sweet spot (low rates with a plan for slow increases), there is still more room for economic and stock market growth.

Presidential Election Cycle

Although most polls indicated a tightening race and roughly a 50-50 proposition, it was still a surprise to most that Donald Trump was elected president. In some ways, this outcome should not be a surprise. Historically, it is quite difficult for the incumbent party to hold the presidency with a new candidate after two terms of the same party. Since 1900, this has occurred only four times: William Taft (1908), Herbert Hoover (1928), Harry S. Truman (1948), and George H.W. Bush (1988). Truman and Bush are notable since they followed presidents with extremely high popularity (FDR and Reagan). Interestingly, none of the four were elected for a second term.

Election years with low or negative returns also tend to be problematic for the incumbent party. The last three elections that generated a change in party all had weak or negative returns. Clinton's first election in 1992 saw +4.5% gain in stocks; Bush's first election in 2000 saw -10.1% losses; and Obama's first election in 2008 saw -38.5% losses. Prior to the election this year, as of Monday, November 7, the S&P 500 was up a reasonable 4.3% for the year but had fizzled with an eight-day losing streak leading up to election day. The stock market is probably a better predictor of the presidential election winner than vice versa.

On the topic of what comes next related to the election, the post-election year can generate a bumpy ride for investors (see chart above). A first-term president typically takes their lumps early so they can blame the predecessor and have time for the economy and markets to recover. Gridlock is normally good for financial markets since it reduces the potential for surprises. Single party control in Washington could create some anxiety for markets since it is not quite clear what Trump will pursue in the early days of his presidency. However, since Trump is not a typical Republican, there may still be some gridlock, just inside the Republican Party instead of the broader legislature. The presidential cycle indicates there is some room for growth of the stock market in the post-election year (optimism occurs early in year one and then the challenges become reality in year two).

As mentioned previously, the global economic expansion seems to be reviving, and a different president will not have much of a direct impact on that trend. The impact of specific policy changes on financial markets is hard to gauge since it is unclear how those specific items will be rolled out and when. However, investors should consider why Trump was elected. BCA Research summarized this perspective well, "It wasn't his messages on immigration, law and order, race relations, and especially not the tax cuts he added to his message late in the game. It was his left-of-center policy position on trade and fiscal spending. Trump is beholden to his voters on these policies, particularly in the Midwest states that won him the election."

This is important since Trump has not supported the typical Republican positions on fiscal austerity (spending reduction) or entitlement spending. In fact, he proposed major infrastructure spending as a form of economic stimulus. Since Fed-driven monetary policy seems to be decreasing in effectiveness, increased fiscal spending could be an important factor in continued economic growth. Although the anti-establishment Trump will have to negotiate with the establishment legislature to gain acceptance of any infrastructure spending, what shape those compromises will take is unknown. A few of the likely policies up for discussion will be cutting corporate taxes, repatriation and taxation of overseas profits, and the Affordable Care Act. Most of the policies under consideration would be viewed as pro-growth tactics which would be supportive of continued economic growth.

U.S. Stock Market Returns

Dow Jones Industrial Average, 1948-2015

	Post-election year	Mid-term year	Pre-election year	Election year
Percentage positive	53%	65%	94%	75%
Mean return	5.7%	6.7%	15.8%	4.8%
Median return	10.9%	7.5%	16.4%	5.8%
Rank in cycle (median)	2	3	1	4

Source: Ned Davis Research

Historically, post-election years generate stock market returns that are average (a mean of 5.7%), but big swings can occur from year to year. [Technical note: when mean and median averages differ, it is typically because there are major outliers in the data that skew the mean return higher or lower. The median return is typically a better indicator of "average" since it portrays the middle of all of returns.] In the four-year presidential election cycle, the post-election year has the second highest median return of 10.9%; however, it also can exhibit some volatility with only 53% of post-election years realizing positive returns.

To demonstrate the volatility further, since 1900, returns in a post-election year are either strongly positive or negative… very few come close to the mean. Of the 29 post-election years since 1900, 14 years saw negative returns, 15 years created double-digit positive returns (over 10%), and zero years realized returns between 0% and positive 10%. Interestingly, 9 of the 14 negative outcomes included recessions that occurred in the post-election year. At this point, very few of our indicators are signaling a recession. Regardless, the bumpy ride from 2015 and 2016 is likely to continue.

Take Note of Bond Market Excesses – Is This Time Different?

Extreme Duration in the Bond Market

Ooh, I want to tell you, it's a long run
You know I don't understand why you don't
treat yourself better
do the crazy things that you do

- The Eagles, "The Long Run"

Many governments have been taking advantage of the extreme lows in interest rates. The cost of financing is low, and they can lock in a low rate for a long time. Italy, for example, recently sold $5.8B of 50-year bonds. In late October, Austria sold $2.2B in bonds with a 70-year maturity at roughly a 1.5% yield! The majority of the purchasers of those bonds will not be alive to see them mature, and they get paid less than 2% each year regardless of inflation, interest rates, etc.! For governments, these bonds help fix costs at a low rate for a long time; for investors, these bond offerings do not appear to be a great bargain.

Recent Government Bond Issuances

Country	Rate	Amount	Maturity year	Duration
Austria	1.52%	$2.2B	2086	70 years
Belgium	2.30%	$0.1B	2116	100 years
France	1.75%	$3.3B	2066	50 years
Ireland	2.35%	$0.1B	2116	100 years
Italy	2.85%	$5.6B	2067	50 years
Spain	3.50%	$7.4B	2067	50 years

Source: Bloomberg, Wall Street Journal, Fitch

Typically, an investor is considered taking more risk the longer the duration of a bond. This is because if interest rates rise, current bond holders are stuck holding a bond that pays less for a long time. Selling bonds that last for a century would seem to fit that bill. However, Ireland recently issued a 100-year bond that only pays 2.35%. This is even more surprising when viewed in the context of recent history. Just a few years ago during the 2011 European debt crisis, Ireland was viewed as such a risky issuer that it had to offer a 14% rate on its 10-year bond. Most investors should treat themselves better and watch out for those extreme long bonds.

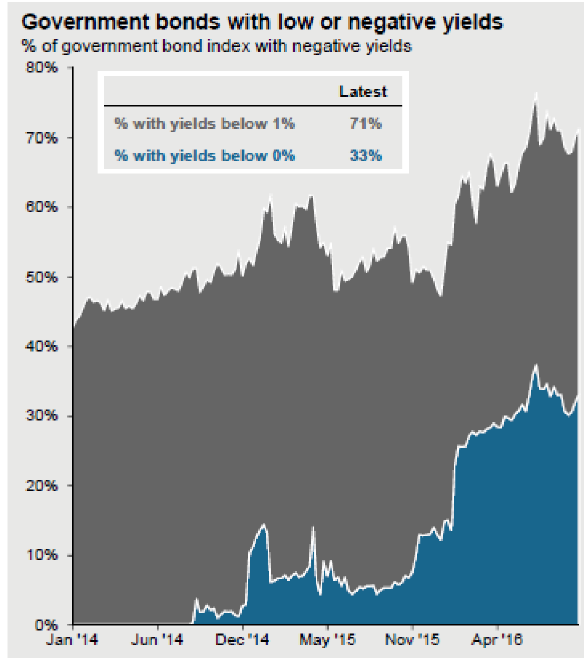
The Trend in Negative Interest Rates

There's something happening here
But what it is ain't exactly clear

- Buffalo Springfield (Stephen Stills), "For What It's Worth"

The song "For What It's Worth" was an anti-establishment song that seemed to fit with the current political environment. In the context of bonds and interest rates, it is also anti-trend and a good descriptor for the current bond environment. For 30 years, interest rates have fallen consistently almost without fail. As many investors recall, home buyers in the early 1980s saw mortgage rates of 15% or higher! Interest rates have fallen perpetually since then and have neared zero in many cases. In fact, many bonds currently have a *negative* interest rate. If that is a hard concept to comprehend, it is understandable since many academics thought such a situation was impossible until just a few years ago. Imagine your credit card company paying you interest on your balance!

For a period of time, negative interest rates were an interesting piece of trivia, like a sideshow at the circus. However, the sideshow has moved to the main stage since roughly 33% of government bonds now have a negative interest rate. As of September 2016, $11 trillion of government bonds had yields of less than zero. Germany, Switzerland, Netherlands, Denmark, France, Austria, Sweden, Finland, Belgium, and Japan all have bonds with yields less than zero.



Source: JP Morgan

With recent central bank purchases of bond assets there is some logic for negative yields on government bonds. For example, if an investor buys a bond at -1% yield and rates fall to -2%, the bond price goes up. In addition, many pension funds are required to have specific bond allocations (regardless of price). So, there is some logic to purchasing these securities; however, it is still an abnormal environment. Earlier this year, a couple in Denmark received a mortgage with a negative interest rate. Yes, that means the bank pays the couple interest to loan them money.

A Turning Point in Bonds?

And the first one now will later be last
Cause the times they are a-changing
- Bob Dylan, "A Times They are a-Changin'"

The intricacies of bond pricing and negative yields will have to be covered in another format. They key point is that there are some odd, potentially extreme, things happening in the bond market. And when logic does not apply to an investment, consider the alternatives.

Turning points in markets often occur after markets overshoot and investor beliefs become extreme. At these times, the old rules don't apply because "this time is different." However, usually the situation is not different, and it pays to take note. A few examples:

- Technology Bubble: In the late 1990s, technology companies received huge valuations. The poster child of this era is Pets.com which received a market valuation over $300 million on sales of only $600,000. The company is infamous for being listed on a public stock exchange for only 268 days. This extreme valuation was not uncommon with S&P 500 price-to-earning multiples rising to 35 (two times the long run average of 17).
- Japanese Real Estate Boom: In 1990, the peak of the real estate boom in Japan, the Emperor's palace was said to be worth more than all of the real estate value in California.
- U.S. Real Estate Boom: In 2005, 42% of first time home buyers made no down payment on their home; 33% utilized an interest only mortgage; and 80% of subprime (i.e. "risky") loans were made without any documentation.

In the past, when investors seemed euphoric about situations where "this time is different," they often turned out poorly. Could the extremes in the bond market last for a long time? Yes, they could. Does past experience indicate that investors should be wary of extremes? Absolutely… non-equity allocations need careful construction to reduce interest rate sensitivity while achieving a meaningful return.

Summary

Economic conditions seem to be turning more positive. Although the last recession was over 7 years ago, the recovery is slow but elongated and still has room to continue. Another bumpy year may be ahead for both stocks and bonds. The Fed sits in a policy sweet spot, indicating "lower for longer" is not the same as zero forever. The long, joyless stock bull market should continue. Accordingly, on November 14th, we made investment changes in client accounts, moving to from "neutral" to "maximum" equity positions.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

K. Larry Hastie
Managing Director

R. Griffith McDonald
Managing Director

Margaret Kephart
Sr. Vice President

Pamela Loduca-Massa
Sr. Vice President

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These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P Mid-Cap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about $2 billion to $10 billion. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. High-Yield is represented by the Barclays U.S Corporate High-Yield Index, which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. TIPS are represented by the Barclays U.S. Government Inflation-linked Bond Index, which includes publicly issued, U.S. Treasury inflation protected securities that have at least 1 year remaining to maturity. Commodities are represented by the S&P GSCI is a world-production weighted index designed to track investable commodities representing the price movements of the world economy.