Retirement Income Solutions

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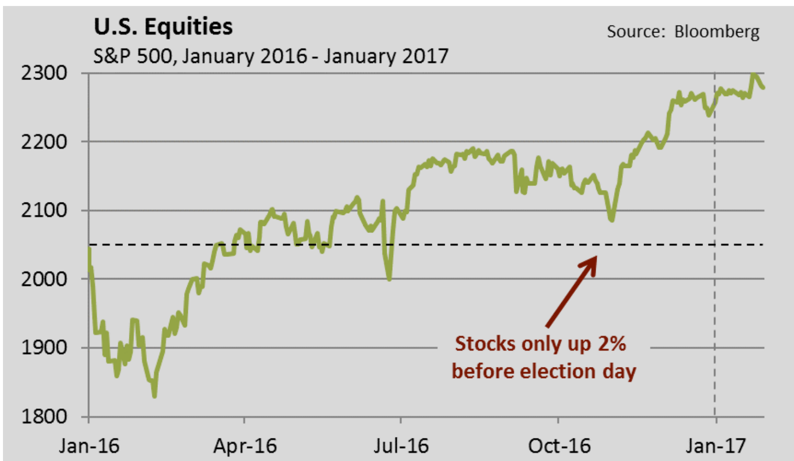
Big League Expectations

February 2017

Summary

It was a roller-coaster year for many investment assets in 2016. U.S. stocks opened with their worst start to a year in history – a 13% drawdown in January and February. Oil prices hit 15-year lows. Many key interest rates in Europe were negative. The UK left the European Union marking the biggest shakeup in the EU since its founding in 1993. Donald Trump defied the polls with an unexpected win. After the dust settled on numerous worries, U.S. stocks rallied late in the year to end up positive for 2016 at 12%. International stocks lagged again but are poised to make up ground. Bonds typically provide safety for investors but saw meaningful losses in the second half of the year as interest rates rose quickly.



Although many challenges and unknowns exist, there is still room for growth in the economy as well as equity markets. Financial markets are likely to generate a bumpy ride as the market has set "Big League" expectations. An early year pullback would not be surprising given the rapid advance since November.

- **The profit recession is over.** Corporate profit growth weakened in 2015 and the first half of 2016 but turned more positive midway through the year. Continued profit growth will be important for equities.
- **The pace of rising rates is important.** A slow pace of increases can be absorbed by financial markets but a further dramatic rise would raise concerns of a recession and potentially a bear market.
- **Economic conditions seem to be turning more positive.** The elongated economic recovery regained momentum in 2016. Economic growth, modest inflation, and wages are more positive.
- **Consumer expectations are very high.** Plans for a new tax code and reduced regulation have boosted equities. Falling short of market expectations could disappoint the stock market.
- **The Fed retreats again**. Each year for four years, the Fed has announced plans to tighten monetary policy only to back off shortly thereafter. A more proactive Fed could create market volatility.
- **New presidents take their lumps early**. There is a nasty history of first-year presidents encountering a recession within 18 months of taking office.
- **Don't fret the dip in bond prices.** Spikes in interest rates that generate bond losses often signal a strengthening economy and positive future stock returns. Also, be picky about bond choices.
- **Political and wildcard risks exist.** Rising interest rates and Trump policy implementation top the list. Many others remain including oil volatility, China growth, dollar strength, and continued populist success in European elections.

2016 Recap – Surprises & Roller Coasters

Investment returns were positive for the year, but many notable events occurred along the way. A year ago, the Federal Reserve increased interest rates for the first time in nine years and projected four more interest rate increases in 2016. The stock market objected, realizing a 13% correction in January and February. The stock market recovered by April and, despite good economic data, meandered until the election.

Election anxiety weighed on the market as stocks fell in nine of the ten days just prior to the election. As of Friday, November 3rd, U.S. stocks were up only 2% for the year. Shortly thereafter, Trump defied the polls, and the U.S. stock market rallied in relief that uncertainty from the election was finally over. Expectations that Republican control would initiate pro-business policies and deregulation fueled a strong fourth quarter for stocks. The main rally for the year started the day before the election, and the S&P 500 rallied to finish the year up roughly 12%.

Politics weighed on markets over the summer as the UK voted to leave the European Union (aka "Brexit"). U.S. stocks shrugged off the news after an initial 6-7% drop, recovering within two weeks. International equities fell by 13% on news of the Brexit vote; they were slower to acclimate – recovering within two months – and finished the year with meager gains. Emerging market posted their strongest effort in four years – up 11%.

Investment Returns

As of December 31, 2016

	2016	2015
All Country World	7.9%	-2.4%
S&P 500	12.0%	1.4%
Dow Jones Industrial	16.5%	0.2%
Small caps	21.3%	-4.4%
International	1.0%	-0.8%
Emerging	11.2%	-14.9%
Bonds (Barclays	2.7%	0.6%
U.S. Treasury Bonds	1.0%	0.8%
Commodities	11.8%	-24.7%

Source: Bloomberg

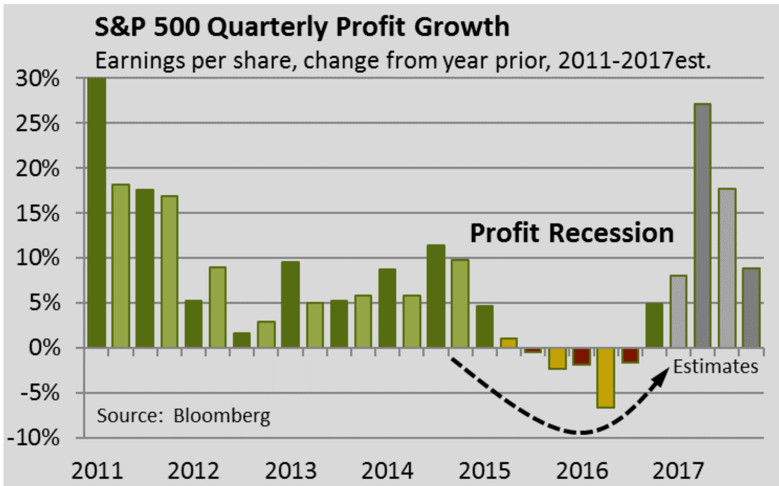
Despite the Fed's plan to increase interest rates, the market had other plans and interest rates fell dramatically by mid-year. Thus, quality bonds started out with solid, positive returns. Interest rates rose rapidly in the fourth quarter, wiping out a large portion of bond return for the year (note: interest rates and bond prices move in opposite directions). Bond losses in the fourth quarter ranged from -3% to -15%.

Oil prices fell to $25 per barrel early in the year, a level not seen in 15 years. Such a drop generated fears of an oncoming recession, but prices quickly doubled back to $50 per barrel. Two years of weak economic data finally reversed with good news on GDP growth, corporate profits, modest but positive inflation and continued wage growth.

Five Indicators to Watch in 2017

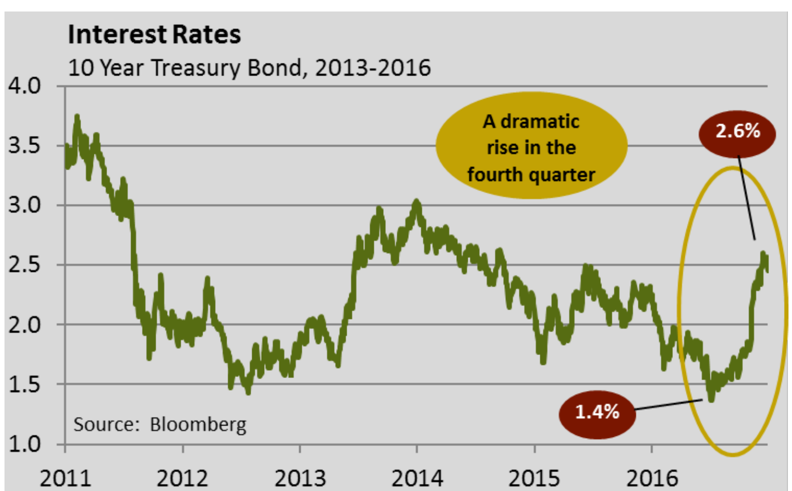
#1 The Profit Recession is Over

Corporate profits weakened significantly in 2015 and 2016, with seven quarters of shrinking profits. Although a full-fledged economic recession did not occur, the stock market struggled for most of that period due to fear that the “profit recession” would turn into a broader economic recession. Earnings in second half of 2016 finally turned positive again, and expectations for 2017 are for a 15% growth in profits for the year. A return to 2-3% quarterly growth (8-12% annual) would be positive for the stock market.



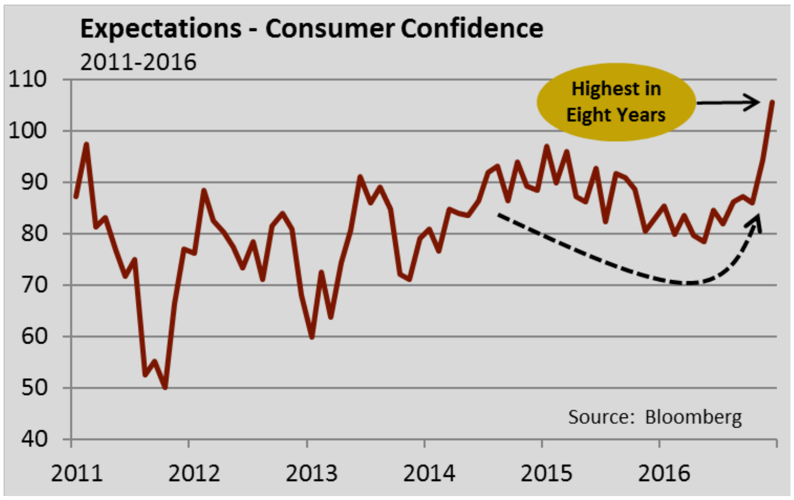
#2 The Path to Higher Interest Rates

Interest rates, which represent the cost of borrowing money, rose rapidly in the back half of 2016. While most interest rates are still abnormally low, higher rates would be positive since they signal the return of a more normal business cycle. Such higher borrowing costs can be absorbed, but they need to occur at a moderate pace. The 10-year Treasury Bond rate almost doubled from June to December. Such a fast pace of increases could be detrimental to economic growth. This can be illustrated by the impact of mortgage rates on a family purchasing a home. A $1300 per month mortgage payment could buy a $300,000 home in June 2016 (at the prevailing rate of 3.5%) but the same monthly payment can only afford a $250,000 home in December (since rates had moved up to 4.5%). A slower pace of rate increases will be easier for the economy to absorb.



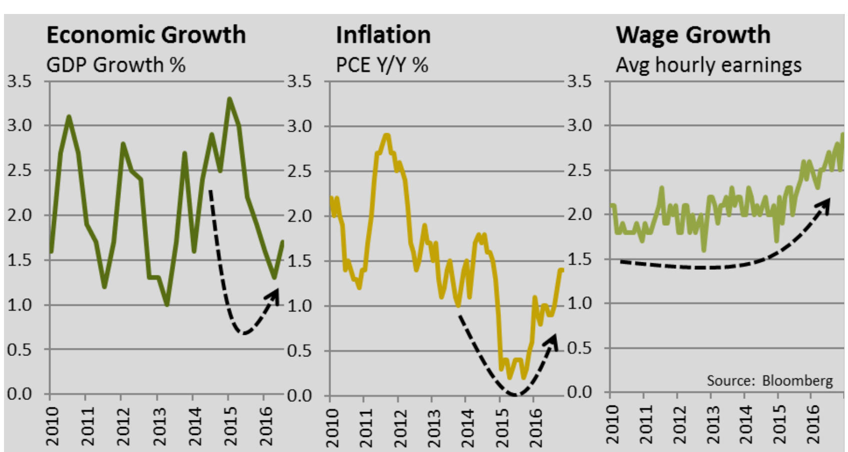
#3 Expectations are Very High

A change in party in the White House is usually accompanied by increased hope for a better future, and the most recent election fits that mold. Since November, consumer expectations for the future have soared based on the Consumer Confidence survey that measures expectations for future business conditions, employment and income. The December reading was the highest since the financial crisis in 2008. While increased optimism can be a positive, lofty expectations that are not achieved turn into disappointments that can weigh on financial markets. Sustained confidence will be important for market advances.



#4 Economic Conditions Slowly Positive

Although markets waited until after the election to rally, many economic indicators were turning more positive over the 6-9 months prior to the election. After declining five quarters in a row, GDP growth finally turned up again in September. Inflation, which declined significantly in 2014 and 2015, was trending towards a deflationary environment; the trend has reversed and is now moving towards the Fed's stated inflation target of 2%. After years of weak gains, wage growth has picked up. This is a sign that the economy has returned to full employment (when unemployment is high, workers are just happy to have a job; when unemployment is low, employers must increase wages to keep workers or they will seek higher wages elsewhere). These early trends need to continue in a positive manner.



#5 Actions Taken by the Federal Reserve

The Federal Reserve has garnered a lot of attention since the financial crisis. Their job, to set short-term interest rates balancing between employment and inflation, has been a challenge. The magnitude of this challenge is evident upon comparing the forward-looking consensus of expectations for future policy with what action they actually took (or did not take). Reviewing the guidance over the past few years shows the Fed tendency to take an aggressive stance and then back off over time. For instance, the last three December meetings each set expectations for 3-4 rate hikes in the upcoming 12-month period. In 2015, the Fed backed off and only raised the Fed Funds Rate one time. The same occurred in 2016. The consensus of the December 2016 meeting was similar, projecting three rate increases in 2017. The Fed backed off in 2015 and 2016 due to weak growth, deflationary forces, dollar strength and global instability. If the Fed, for the first time in five years, follows through on its guidance, financial markets may be surprised at this more aggressive stance and stock market volatility could follow.

Federal Reserve Forward-Looking Guidance

Fed Funds Rate 2012-2016

Meeting Date	Consensus on Future Actions	Outcome
December 2012	No rate hikes for 2 years	No rate hikes for 3 years
December 2013	No rate hikes for 1 year	No rate hikes for 2 years
December 2014	Expect 3-4 rate hikes in 2015	One increase in December 2015
June 2015	Expect 2 rate hikes in next 6 months	One increase in December 2015
December 2015	Expect 4 rate hikes in 2016	One increase in December 2016
June 2016	Expect 2 rate hikes in next 6 months	One increase in December 2016
December 2016	Expect 3 rate hikes in 2017	???

Take Your Lumps Early – The Luck or Strategy of a New President

The impact of the presidential election on financial markets was apparent again in 2016. As election polls tightened in the early fall, markets fell slightly as uncertainty increased. The U.S. stock market fell 4% in September and October, including nine straight negative days before November 7th. After the election, markets rallied in response to decreasing uncertainty. The presidential election cycle also seems to line up with recessionary periods. The cause and effect is less clear here, but it is an important trend of which to be aware.

New Presidents & Recessions

1950-2016

President	Election Year	First Month in Office	Recession Period	Months in Office Before Recession
Dwight D. Eisenhower	1952	January 1953	July 1953-May 1954	+6
John F. Kennedy	1960	January 1961	April 1960-February 1961	-9
Richard Nixon	1968	January 1969	December 1969-November 1970	+11
Jimmy Carter	1976	January 1977	January 1980-July 1980	+36
Ronald Reagan	1980	January 1981	July 1981-November 1982	+6
George Bush	1988	January 1989	July 1990-March 1991	+18
Bill Clinton	1992	January 1993	None	
George W. Bush	2000	January 2001	March 2001-November 2001	+2
Barack Obama	2008	January 2009	December 2007-June 2009	-13

While the risk of a recession is growing, the onset of such a negative period seems unlikely until 2018 or 2019. However, the arrival of a new president is an important factor to consider. Of the nine presidents since WWII, seven were greeted with a recession within their first 18 months in office. Only Carter and Clinton were exceptions; both were likely spared since recessions occurred in the year before the election (Carter in 1975 before the 1976 election year and Clinton in 1991 before the 1992 election). This is understandable since presidents like to take their lumps early. If policy actions could have a negative effect, it is better to take the hit early in their term so that the economy and markets can recover before the next election cycle. While it is extremely important to note that recessions do not run on a clock, it is hard to ignore the correlation between new presidents and recessions.

Bond Beating Aftermath

Most U.S. bonds took a beating at the end of 2016. In the fourth quarter alone, quality bonds in the Barclays Aggregate fell by -3% while long-term Treasury Bonds fell by -12%. Bond prices move inversely with interest rates (when rates rise, bond prices fall). In the summer of 2016, the 10-year Treasury Bond was briefly yielding 1.3%, and, by the end of December, that same rate had almost doubled to 2.5%. For more background on bonds and interest rates in this environment, please refer to the prior commentary "A Joyless Bull Market" from November 2016.

There are no guarantees that rates will continue to rise, but investors must consider the impacts of such changes on portfolios. The prospect of rising interest rates and lackluster bond returns is a concern for a diversified investor. Historically, bonds provide stability to an investment portfolio, but there are some rare periods where they add volatility and weigh on returns. The fourth quarter of 2016 is a prime example of one of those periods.

There is some good news associated with higher interest rates. Such increases signal optimism for an improving economy and would indicate a return to a more normal business cycle. There are many factors that influence interest rates. One important influence on interest rates is expectations for inflation; concerns of higher inflation are often caused by stronger economic growth. In the current environment, both inflation and growth are too low, so increases in rates due to those factors are a welcome development.

S&P 500 Percent Change After Long-Term Bond Losses

1973-2016

Start Date	Long Term Bond Loss	2 months later	6 months later	12 months later
August 1974	-10.2%	2.4%	13.1%	20.4%
October 1979	-10.8%	6.0%	4.4%	25.2%
May 1984	-10.7%	0.1%	8.7%	26.8%
July 1987	-10.0%	1.0%	-19.3%	-14.6%
April 1994	-11.4%	-1.5%	4.8%	14.1%
June 1999	-10.8%	-3.8%	7.0%	6.0%
May 2006	-10.1%	0.5%	10.3%	20.5%
June 2009	-12.9%	11.0%	21.3%	12.1%
February 2011	-11.4%	2.7%	-8.2%	2.9%
July 2013	-11.4%	-0.2%	5.7%	14.5%
December 2016	-12.0%	?	?	?
Median		**0.8%**	**6.4%**	**14.3%**

Source: Bloomberg

The theory of increasing interest rates signaling improved economic and market conditions does seem to be supported by prior historical examples. There have been ten cases since the 1970s when long-term bond prices fell dramatically (more than 10%) in less than a year. The general stock market reaction is for a short-term pause while markets absorb the change and new environment; this is followed by growing acceptance and double-digit gains one year later. In eight of the ten cases, the market was strongly higher one year later, with only one year of losses. Median stock market gains two months later were 0.8%, six months later were 6.4% and 12 months later were 14.3%. The sole loss year occurred during the market panic of 1987 when the U.S. stock market fell by 20% in one day. Typically, interest rate increases (and bond losses) point to strong stock market returns on the horizon.

Key Risks in 2017

The fourth quarter is typically the strongest period of the year for stock returns, and that trend held true at the end of 2016. Over the summer, anxiety over the election uncertainty kept a lid on market returns. The election removed that uncertainty and allowed good economic news from the summer to be translated into positive stock returns in November and December.

Many economic indicators turned more positive midway through 2016 (see page 2 and page 3). The stock market absorbed the election results quickly and with little reservation. Republican control of the White House and Congress combined with President Trump's policy trifecta of increased fiscal spending, reduced corporate taxes, and reduced personal taxes has created a surge in optimism (see page 3) about the future of economic conditions. Conditions for the stock market look positive this year; however, there are several key risks to be monitored:

1) Interest Rates Rise Too Quickly

As discussed previously, rising interest rates are generally a positive indicator of future stock market conditions. However, if interest rates rise too quickly, it could slow economic growth and increase the risk of a recession. It has been eight years since the last economic downturn, and a normal business cycle typically sees recessions occur every five to six years. There is no "recession clock," but that risk seems highest for 2018 or 2019. Higher rates make it more expensive to borrow money and impact many areas including home buyers, corporate borrowers and the U.S. government budget. If rates rise too quickly, positive activity in those areas could reverse and the timeline to a recession could shorten.

2) Strong Optimism Followed by Disappointment

President Trump was an unconventional political candidate and not a typical Republican. It is unclear how candidate Trump will transition to President Trump. Expectations are high that Trump's proposed policies add to an already strengthening economy. Despite Republican control in Washington, Trump still has significant opposition from his own party on many issues. If those high expectations are not met, investor disappointment could precipitate a downturn in the stock market.

3) Political Risks & Trump Wildcard

Big political surprises occurred in 2016. The Brexit vote was unexpected; Trump was well behind in the polls just a month before the election. Populist political pressures are increasing in many countries in Europe. It is unclear how these populist (potentially protectionist) movements will impact the economy. Additionally, it is unclear how Trump's administration will impact government relations around the world. This impact is quite difficult to assess. Trump was quite aggressive on many issues during the campaign. Most new Presidents moderate somewhat after taking office – but what will happen this time? A prime example is his unorthodox view on trade. If Trump truly plans to address the trade deficit, it requires a change in approach with China (which represents roughly 80% of the trade deficit). An aggressive approach on trade policy could cause swift and damaging reactions from around the world. It is unclear how this new mix of world politics will impact the economy and financial markets.

There are always other risks both known and unknown. Often, it is the unknown risks that pose the greatest challenge to stability in financial markets.

Summary

2016 was a year of reversals and surprises. Throughout the year, U.S. stocks, international stocks, oil prices, interest rates all started in one direction and finished in another. Political surprises in the U.S. and UK created anxiety for investors but were eventually absorbed by financial markets. Fears of a recession in the first half of the year transformed into the highest level of expectations since the financial crisis.

After conservative positioning for most of the year, client allocations were moved back to maximum equity levels just after the election. The post-election equity rally was strong and should continue, so client allocations remain at high equity levels. However, the recent rally and expectations are so high that it would not be surprising to see a modest pullback in the next month or two.

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