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Building Wealth Wisely

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Mirror Images

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The New Year starts off with a level of optimism that stands in stark contrast to the pessimism that ushered in last year. At the beginning of 2016, an alarming deceleration of China's economy, falling oil prices, uneasiness over the Federal Reserve's rate hike, and worries of a potential U.S. recession sent global stocks into a tailspin. Negative sentiment pushed the S&P 500 Index down more than 10% in the first six weeks of 2016 – the worst start to a year for equities in modern history.

Deteriorating fundamentals quickly led the Federal Reserve to hold off on any further interest rate increases. Dovish global central bank policies, improving liquidity, and a stronger labor market subsequently lifted economic growth modestly for the year. As corporate earnings began to recover from a 2-year slump, equities climbed a wall of worry through most of the rest of the year, clawing their way back into positive territory and experiencing only one additional setback after the Brexit vote. Bond yields declined measurably for most of the year.

The investment landscape changed dramatically with the election of Donald Trump. Financial pessimism gave way to economic optimism, leading to an upswing in the equity markets and a reversal of interest rate trends in the fixed-income market. The end of the year turned out to be a mirror image of the beginning of the year. The pattern of yields in the bond market reflected the bifurcated year. The 10-year U.S. Treasury note began the year with a 2.27% yield, declined to a low of 1.36% on July 8th, spiked over 120 bps to 2.6% by December 15th, and settled mostly unchanged for the year. It was a bungee jump worthy of a Cirque du Soleil act.

The S&P 500 rose 195 points for the year, or 9.5% in value, and returned double digits including dividends, much better than 2015's flat finish and 1.4% total return. Diversified portfolios didn't fare as well, as bonds delivered low returns – up 2.8% as measured by the Barclay Aggregate Bond Index – and international equities were mostly break-even with the MSCI EAFE Index delivering only 0.86% in total return for the year. The overall result for most balanced portfolios was mid-single digit returns in 2016.

LOOKING AHEAD

Our nation's economy has been stuck in the doldrums for the past decade. Under the burden of the anti-growth policies emanating from Washington, our country has just completed a record 10th straight year without achieving a 3% growth in GDP. The election of Donald Trump looks to usher in significant changes to tax, trade, immigration, fiscal and regulatory policies. Trump's agenda of lower taxes, less regulation, and increased defense & infrastructure spending should lead to a more productive economy and more prosperous markets.

Corporate America has spent many years squeezing higher profits from cost-cutting. If the Republicans' pro-growth agenda becomes law, it could mean the return of top-line growth at what are currently very lean companies. Indicators are already showing improving business activity. The most recent reading on consumer confidence shows confidence is at a 13-year high, recent holiday sales were up 4.9% over 2015's numbers, and the labor participation rate is finally starting to rise.

Bank stocks, often a bellwether for the economy, have jumped considerably in price since the election. Loan growth remains relatively strong, credit is holding up well, and banks and their customers are in better shape than they were prior to the last downturn with less leverage and more cash. Secular stagnation and deflation fears are giving way to better growth, higher inflation, and rising interest rates.

CURRENT CONCERNS

Financial markets ended 2016 the same way they ended 2015 – with an interest rate hike by the Federal Reserve. It was only the second time in nearly a decade that the Fed moved to raise short-term rates, reflecting the view that easy monetary policy remains necessary to help the U.S. economy recover from the 2008–2009 financial crisis. If interest rates continue to rise, a critical question will be whether an equity bull market that has been driven by liquidity can continue as one driven by revenue and profit growth. Should the bull market in stocks manage to maintain course in 2017, it will become the second longest bull market of record in the post-WWII period.

Another 1 or 2% increase in interest rates would certainly not be out of the ordinary. During the 2013 “taper tantrum,” the yield on the Treasury bond escalated from 1.6% to 3.0% in a four-month period. Several factors could lead to a repeat of the 2013 experience. Bond market participants could grow uncomfortable with rising risk and shun bond purchases. Inflation, another risk, could become a greater concern as the year progresses.

With investors filled with optimism heading into 2017, follow-through on the Republican pro-growth agenda will be necessary to maintain the bull market in stocks. Initial encouragement about the Trump agenda could fade if legislative progress in the coming year is slow to materialize. Furthermore, not all of Mr. Trump's proposed

policies are good for business. His restrictive views on trade could be troubling for the economy and markets. The populist tide that elected Mr. Trump to office is also running rampant around the globe in the form of nationalism and protectionism.

OPTIMISM IS A DOUBLE EDGED SWORD

Investor sentiment on the heels of the presidential election is more optimistic than it has been in a number of years. What investors expect the stock market to do next is usually shaped largely by what it just did. After the post-election run-up, expectations for the future are now high. This is clearly in contrast to last February, when equities were down near their worst levels. At that time individual investors were the most pessimistic they had been since March 2013, according to a number of surveys. In hindsight, it was actually a good time to add to equities (as we did for many client portfolios).

Investors tend to be complacent when they should be worried and afraid when they should be optimistic. The more stocks go up, the more likely it is investors will expect continued gains. From 2006 through mid-2008, as many as 58% of financial professionals thought the chances of an imminent crash were nil. Right on cue, the worst bear market in a generation began shortly thereafter. Institutional investors then turned maximally pessimistic in February 2009, near the bottom of the market and shortly before a new bull market took off.

No wonder the great analyst Benjamin Graham wrote, “The investor’s chief problem – and even his worst enemy – is likely to be himself.” Speed forward to today, and the current mood of investors is lifting in lock step with stock prices. While we aren’t predicting a downturn for the market, it is clearly in a position to disappoint investors.

WINNING OVER TIME

As investment advisors, our challenge is to build portfolios that do well over time and also avoid a permanent impairment of capital. We do our best to maintain a balanced and long-term approach. What matters is what happens over the long run – when emotions carry no weight and facts prevail – and those with staying power generally triumph. Winning over time doesn’t mean winning all the time.

A portfolio’s path to success is almost never a straight line. In our quest to perform well over the long run, we need to be prepared to endure bouts of underperformance in some investment categories, sometimes for uncomfortably long periods of time. Success stems not necessarily from picking today’s winners but from understanding how different types of investments complement a diversified portfolio and also finding managers and strategies that have achieved long-term success based on a sound and repeatable process.

A good example of this is the recent performance of international stocks. U.S. stocks have significantly outperformed international markets throughout the current market cycle. Over the trailing 5-year period, U.S. stocks have generated about 10% higher annualized returns than foreign stocks. Many clients might wonder why we should ever own foreign stocks based on these types of returns. It's a legitimate question. We humans are an impatient group, so it can sometimes be difficult to appreciate the merits of diversification when presented with performance numbers like this.

To complete the picture above, the performance spreads in the 5-year period ending in December of 2001 were fairly similar to the ones we see today. Over the next 5 years those numbers had completely reversed, with international stocks outpacing U.S. stocks by a 7% annualized margin. We think market cycles will bring the same reversion to the mean in the coming years for disciplined investors.

KEEPING OUR EYES ON THE PRIZE

All things considered, we think investors can continue to prosper over the long run, albeit somewhat more modestly than usual for a while. We continue to expect a better – but slower than normal – growth environment. There will be pressure on interest rates to rise, but we doubt rates will rise to excessive levels. Given full valuations in the equity and fixed-income markets, investors would be wise to maintain modest expectations for the foreseeable future.

Even with the approaching milestone of achieving the second-longest bull market in history, investor optimism isn't generating the type of exuberance seen at major market peaks. As a rule, recessions end bull markets, not exuberance. During the last downturn, our nation was mired in deep economic trouble. We do not have that today. Stocks are fully valued, but the value is not illusory.

Due to demographic trends and obstacles to growth around the world, it will be difficult for our country's economy to get back to a multi-year stretch of +3% expansion. But on the positive side, with more pro-growth policies in Washington and continued strength in the job market, a recession seems unlikely in 2017.

For our clients who have a solid financial plan and a well-diversified portfolio, we plan to ignore the shifting sands of the day and focus instead on long-term goals and objectives. Responding effectively to the inevitable ebbs and flows of the financial markets and rebalancing one's portfolio in a disciplined manner is a behavioral challenge for many investors – it goes against our emotional instincts as humans – but it sits at the center of how we help clients keep their eyes on the prize.

As always, let us know if you have any questions, comments or concerns about your portfolio or investment strategy.