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WEALTH MANAGEMENT

Fourth Quarter 2016 Market Commentary

The US stock market survived several slumps in 2016, including the worst start to any year for stocks, two corrections within a five-month period, and a collapse in oil prices.

An improving US economy and employment market, as well as stabilizing oil prices and solid corporate earnings growth, helped turn the market around. And the result of the November presidential election provided a kick that drove the market to new highs.

The victory of Donald Trump in the November election solidified the rally in US stocks on expectations that his plans for higher government spending, lower taxes and fewer regulations will create more economic growth, higher inflation and, potentially, rising corporate profits.

The S&P 500 – a proxy for large US stocks – finished the year up over 9%, after rebounding from a decline of over 10% in February. That 20% swing mirrored a wider recovery in global asset prices after a brutal start to the year.

Small cap stocks, considered by some a gauge of economic activity, surged in 2016 – the Russell 2000 index rose 13% just since the election.

Image courtesy of the Financial Times

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US banks were the biggest beneficiaries of higher Treasury yields and a steeper yield curve. Banks and other financial services companies are expected to earn more money from lending as long-term fixed rates for loans and mortgages climb further above overnight and short-term borrowing costs. Banks are also expected to benefit from looser regulations under the incoming Trump administration.

Higher commodity prices were the driver for the US energy sector's recovery, with Brent crude – the international oil benchmark – up 90% from its February low.

Benchmark Returns

For comparative purposes, the S&P 500 index (a proxy for large US stocks) returned +9.5% for the twelve months to December 31, and rose +3.3% in the fourth quarter.

The Russell 2000 (a proxy for small US stocks) returned +21.3% for the twelve months to December 31, and rose +8.8% in the fourth quarter.

The Wilshire 5000 index (a proxy for the broad US stock market) returned +13.0% for the twelve months to December 31, and rose +4.3% in the fourth quarter.

The MCSI EAFE index (a proxy for large international stocks) returned -1.9% for the twelve months to December 31, and fell -1.0% in the fourth quarter, as measured in USD. Measured in Euros, the performance was better: +1.0% for the year and +5.4% for the fourth quarter.

Finally, the MSCI Emerging markets index returned +8.6% for the twelve months to December 31, but fell -4.6% in the fourth quarter.

In the fixed income segment, the BarCap US Aggregate Bond Index returned +2.7% for the twelve months to December 31.

Looking Forward

Politically, if not economically, 2016 was a tumultuous year. It is difficult to interpret the surge in global populism – best exemplified by the UK's vote to leave Europe and the election of Donald Trump – as making the world more predictable, and yet the global markets reacted with indifference or mild optimism. But the UK has yet to set a timetable for enacting Brexit, and Trump hasn't entered office. Once these and other events happen, the possibility of disappointment may increase significantly.

In the first half of 2017 it will become clear how serious Trump is about infrastructure spending, and how serious the Republican congress is about fiscal discipline. If a corporate tax cut and the repatriation of international profits are the best Trump can deliver, the effect on the economy is likely to be modest at best. Companies and the wealthy are already cash-rich; the global economy needs investment.

Improving economic growth and the prospect of fiscal expansion are driving inflation expectations higher. Interest rates may well rise to reflect this reflation, which will push bond yields up and deliver losses to investors in longer maturity bonds.

The global economy's capacity for relatively rapid growth seems to be limited, at least temporarily. A combination of ageing populations, government debt levels, budget deficits, lower productivity growth and excess savings are likely to depress investment returns.

Meaningful risk-free income is not available, and the "safest" stocks – US large caps – are trading at all-time high valuations. Investors should continue to be able to generate higher returns over time by "tilting" their portfolios to capture the premiums offered by the small cap and value factors. However, those unwilling or unable to accept low- to mid-single digit returns on a balanced portfolio may have to reconcile their risk aversion with their long-term investment growth needs.

At Springwater, we continue to advocate a prudent, proven investment approach that is focused on controlling what can be controlled – asset allocation, diversification, taxes, expenses and, most importantly, emotions. Over the long-term, investors have historically been rewarded for taking stock market risk with higher returns. We see no reason to expect that this will not continue.

As always, we remain available to answer any questions or comments you may have, and committed to helping you navigate the periodically choppy seas of successful long-term investing.

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