—New Albany—
Investment Management

December 27, 2016

Market Insight: Year End Market Re-cap and Forecast for 2017

2016 can be summed up as the year of oddities that has humbled most every participant and forecaster associated with the economy, the global markets, or politics. What was certain never materialized; what seemed improbable became real; what seemed logical was defied. With this backdrop, the financial markets reacted with remarkable speed and magnitude both in direction and sector leadership.

The chart below is a good pictorial of the S&P 500 reacting to the unusual set of events throughout the year. It was indeed an interesting ride from the recession scare lows in February to the reflation hopes highs reached in December.

Source JP Morgan

Some of the highlights:

- Wild Oil: Oil touch a 16yr low at $29 a barrel in February, and was predicted to fall to $20 and stay below $40 barrel for several years. Today, the price is $53 a barrel. The energy sector has been the strongest sector performance this year, up +29%.
- Unreliable Fed: The Federal Reserve stated they would likely raise short term rates two to three times in 2016. Only one move came in late December.

- <u>Historic moves in Bonds:</u> In defiance to the Fed forecast of rising rates, the bond market drove long term rates to all-time historic lows (prices up) in mid-July. Then, the economic consensus view was for continued slow growth for years to come. At that point, US long bonds were one of the best performing sectors of the entire financial market (both stocks and bonds) and saw gains of over 11%. Since late September, the US Bond market has reversed course, giving back ALL of its gains for the year, as the market now views economic growth to accelerate.

- <u>Huge performance gap in Value vs. Growth Sectors:</u> In departure of the previous three years, "Value" trounced "Growth" sectors by over 16%. Part of the reason for this was because the darlings of the tech sector: Facebook, Amazon, Netflix, Google (FANG stocks) saw a very muted performance. But even in the mid-cap and small cap space, "Value" was still the big winner by nearly +19%! Healthcare, which had been a key driver in the "Growth" space for several years, fell off the wagon this year and is currently is down -2.4%.

- <u>Major shift in economic growth forecast causes rapid rotation in stock leadership</u>: Since the US election, investors are significantly more positive about US economic growth and earnings. A drop in the corporate tax rate, reduced regulation on small businesses, and significant spending on infrastructure are the key reasons. Growth is now expected to break out of its 1.7% stall speed and nearly double to over 3%. With less regulations, Small Businesses, in particular, are expected to benefit. The Small cap sector was severely trailing the market during the first quarter, down -10% in February. But since the election it has taken off like a shot and is now one of the best performing sectors for the year, rising +22% YTD.

  The Financial sector is another turnaround story. Plagued by ultra-low rates, the Financial sector has trailed the broad market for several years. But now, with growth expected to pick up, so will interest rates which will be a huge tailwind for Banks as they can earn more money on deposits. At the same time, higher interest rates could negatively impact real estate, as the cost of borrowing increases. The market has reacted accordingly with the Financial Service sector rising +20% and the Real Estate sector falling -6%.

<u>**Turning Point:**</u> At least for the financial markets, 2016 will be remembered both as a very challenging year for investors and a major turning point for the markets. Monetary policy had run its course and global growth was barely above stall speed. For eight years, the market was dependent on low rates to boost earnings and justify higher valuations. But the effect of low rates began to wane by the end of 2014. Corporate earnings stopped growing. Ultra-low and negative interest rates were actually becoming a negative force to growth and caused significant doubt for investors and businesses about the future. This doubt spilled over into the political scene and upended the status quo. Change was afoot.

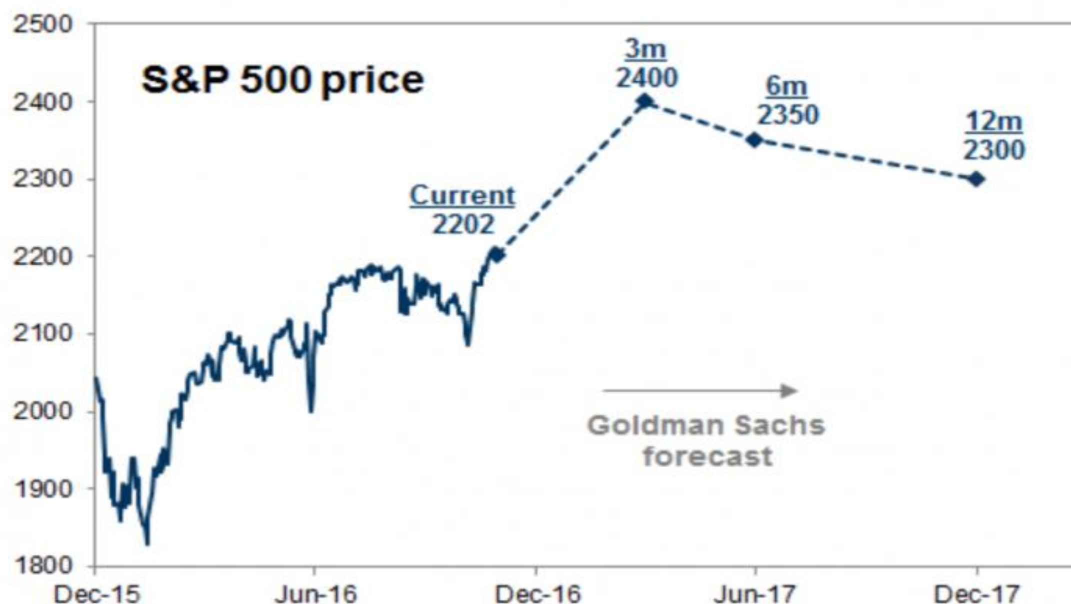
Now, with the dramatic change in political leadership in England, Italy, and the US, hope is running high that these newly elected officials will deliver. Fiscal policy is in the driver seat. The global markets are expecting government to steer the economy on a new course that will provide a positive backdrop for growth in productivity and earnings. Of course every 'talking head' is offering their 'expert' opinion on the validity of this hope. But as this past year has revealed, expert opinions can be wrong, quite wrong! Only time will tell where this new course leads us.

What to Expect in 2017: As the markets transition from an interest rate driven market to a fundamental/earnings driven market, valuation will once again matter. This is good and bad news. In the US, the good news is that there is legitimate reasons for earnings to improve if indeed the Trump administration delivers on its promises. The prospect of lower corporate taxes, repatriation of overseas cash, reduced regulations, and fiscal stimulus are solid reasons for earnings to improve. The bad news is that the recent rapid appreciation has stretched valuations, with the forward P/E ratio of the S&P 500 sitting at 17.1x and well above its long-term average. In addition, the U.S. dollar has reached its highest level in 14 years in the wake of the presidential election; and a strong dollar has traditionally been a headwind for the earnings of large companies with significant international exposure.

"**Stock market 'hope' will be followed by 'fear' in 2017**" According to Goldman, "'hope will dominate through 1Q 2017 as S&P 500 climbs by 9% to 2400…" "The inauguration occurs on January 20 and our Washington economist expects much legislation will be proposed during the first 100 days." But, "expect no policy details available until March 2017 at the earliest…. And as history shows, things are never as clear cut as initially envisioned as both political and economic hurdles materialize."

> "'Fear' is likely to pervade during 2nd half and the S&P 500 will end 2017 at 2300, roughly 5% above the current level," …Goldman's economists "expect inflation will reach the Fed's 2% target, labor costs will be accelerating at an even faster pace, and policy rates will be 100 bp higher than today. Rising inflation and bond yields typically lead to a falling P/E multiple. Congressional deficit hawks may constrain Mr. Trump's tax reform plans and the EPS boost investors expect may not materialize. Potential tariffs and uncertainty around other policy positions may raise the equity risk premium and lead to lower stock valuations in 2H."

The chart below gives a pictorial of their forecast.



Investment Strategy: It's a new ball game indeed, but it will take most of 2017 to see how things really shake out in terms of new fiscal policy initiatives. The market will be even more animated than what we have experienced over the last eight years as competing views and political comments take on much more weight. **For stocks, expect higher volatility and continued rapid sector rotation as the market tries to digest and interpret the eventual impact on earnings. Diversification is key**! **For Bonds, the trajectory of inflation and growth will dictate bond prices.** Right now, the bond market believes the Fed is behind in their rate hikes and thus long term rates are continuing to push higher (prices lower). Thus bond exposure is short term. However high yield exposure is still a good place for income with credit quality not a big concern in a strengthening economy.

2017 will be another interesting year indeed! Please contact me with any questions or concerns.

May the blessing of peace and freedom in our great nation be received and appreciated each day in the New Year. Happy New Year!

Kind Regards,
Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139 www.newalbanyinvestment.com