

Market Review and Outlook—January 6, 2017

So how did 2016 measure up? Mixed, but well overall. The chart below shows that only municipal bonds fell in the past year (after being one of the few winners in 2015). Double digit gains were earned by US stocks, technology, and natural resources (which had fallen over 22% in 2015). Foreign stocks managed a gain, but only a slight one.

Rags to Riches—Despite starting the year in free-fall, energy prices surged in 2016. We began the year with heightened concerns that China’s slowdown would worsen, and drag down oil prices with it. We ended the year with high expectations for strengthened US growth, pulling oil prices up with it.

Riches to Rags—Bonds did well for much of the year. The economy’s growth remained very low, supporting the Fed’s continued near-zero rate strategy, “Lower for Longer.” The surprising win by President-elect Trump in the November election brought plans for a substantial infrastructure spending program, expected to lead to greater economic growth, and higher interest rates. Bond prices fell sharply in November, with municipal bonds feeling the most pain. The red ink in the **3 Months** column shows the 4th Quarter declines in bonds, foreign stocks, and elsewhere.

O Dollar, Where Art Thou? The US dollar rose over 10% in both 2014 and 2015. The dollar fell early in 2016, down over 4% by April, but ended the year up almost 3%, having risen 2% in each of the last three months. The dollar’s value affects foreign stock returns, US company’s foreign sales, how much foreign goods are purchased by US consumers, and the global bond market. The dollar’s rise of over 26% during three years has been drastic. You can reasonably argue that foreign stocks would have fully kept up with US stocks over the past three years, were it not for the sharp climb in the dollar.

While balanced investors did not achieve the double digit gains of the US stock market, they earned some of this and thus were able to earn a solid full-year gain. This is no time to rest on your laurels, however. The investing world changed dramatically in the past three months, as shown by the red ink and strong positive gains in the 3 Months column. These changes are providing investors with a great opportunity to lock in gains and purchase depressed investments. On the following page we will share our thoughts and suggestions for rebalancing.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.04%	+0.09%	+0.04%	+0.03%	+0.86%
Intermediate Term Bond	-2.56%	+3.22%	+2.74%	+2.64%	+4.13%
Intermediate Muni Bond	-3.52%	-0.21%	+3.20%	+2.62%	+3.41%
Large-Cap Stock	+3.86%	+10.36%	+6.78%	+13.17%	+6.07%
Mid-Cap Stock	+5.28%	+14.11%	+5.85%	+13.34%	+6.74%
Small-Cap Stock	+9.48%	+20.71%	+5.89%	+13.50%	+6.81%
Foreign Large-Cap Stock	-2.22%	+0.79%	-2.09%	+5.77%	+0.58%
Real Estate	-2.68%	+6.76%	+11.77%	+10.81%	+4.35%
Natural Resources	+5.14%	+26.38%	-4.49%	+0.21%	+1.34%
Technology	-0.64%	+10.80%	+9.58%	+14.79%	+8.53%
Moderate Allocation (60% stocks)	+0.98%	+7.32%	+3.94%	+8.11%	+4.84%

The data in this table comes from Morningstar and is as of December 31, 2016.

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Far better results in 2016. Five of the seven predictions came through for 2016 (marked in blue), some wildly so. I expected smaller US stocks to do well, and better than large US stocks. They gained over 16% in 2016. I expected high-yield bonds to do well—they outperformed intermediate-term taxable bonds by 10%. There were two poor calls (in red), though. I expected foreign stocks to outperform US stocks. Not only did they fail to keep up with US stocks double-digit gains, they barely broke even. I expected growth stocks, which began the year appearing quite cheap, to outperform value stocks. Instead, value stocks outperformed growth by over 11%. I correctly predicted that real estate would have only an OK year, and that general bonds would be quite mediocre.

Sector	2016 Prediction	2016 Actual	2017 Prediction
Large-cap US Stocks	More than +5%	+10.4%	More than +4%
Smaller US Stocks	More than +6%	+16.3%	More than +6%
Non-US Stocks	More than +8%	+0.8%	More than +8%
Growth vs Value	Growth outperforms	Growth +3.2%, Value +14.7%	Growth outperforms
Real Estate	Less than +8%	+6.8%	Less than +6%
General Bonds	Less than +5%	+3.2%	Less than +5%
High-yield bonds	More than +6%	+13.2%	More than +5%

2017 Predictions—Overall, I expect a good year for risk in 2017, with stocks doing well along with economically-sensitive bonds. I expect a ‘reversion to the mean’ for foreign stocks, which have done very poorly in recent years. In fact, I am ‘doubling down,’ continuing the same two 2016 predictions which failed for 2017, for foreign stocks to do very well, and for growth to outperform value. My conviction in these two calls has risen due to their 2016 failure, especially for the foreign stock prediction.

Why the Optimism?—I can list several factors that argue for caution: US stock prices setting records, a market recover of almost 8 years (3rd longest in history), uncertainty regarding a new Administration, ISIS/Syrian refugee crisis, trade war concerns, etc. These concerns actually strengthen my optimism. In investing, markets move more by (positive and negative) surprises. Beware when everyone is optimistic, and prepare for gains when no one expects them.

Global news is promising. Global manufacturers are optimistic, almost uniformly. Of 19 major countries, only five country manufacturing indices are below 50: Greece, Indonesia, South Korea, India, and Brazil. Six are above 55: UK, Germany, Spain, Ireland, Australia, and Taiwan. Europe unemployment is falling and loan demand is rising. Global inflation is trending upward, which from the current levels is positive. Here is a big IF—if the US dollar declines in 2017 from its current high level, this will be quite positive for many foreign economies and markets. While rising US interest rates are often thought as enticing foreign dollars, when those rate increases are tied to rising US inflation, the attraction of US bonds for foreign investors evaporates.

Oil and Commodities—The broad global growth indicators will put upward pressure on most commodity prices, which have provided miserable results for several years. They are thus well-positioned for attractive increases. This can be quite helpful for emerging foreign markets, not to mention neighboring Canada.

Inflation—Many of us remember the double digit inflation from the 1970s. No one wants that to recur. However, core inflation of under 2% since the 2007-2008 crisis has been artificial, well below the 4% fifty-year average. With very low current US unemployment levels, US wage growth has begun to rise, which will likely help drive up US inflation, along with rising commodity prices.

The Great Unwind—The Federal Reserve Bank has kept short-term US interest rates near zero for eight years. They are beginning to unwind that, and the rest (longer-term end) of the bond market is following suit. This is healthy, as interest rates have historically stayed a bit higher than inflation. This unwinding is likely to take a few years, and create a headwind for quality bonds. This is the reason for my renewed pessimism for General Bond returns in 2017. However, remember that “**a bear market for stocks is a grizzly, while a bear market for bonds is a koala;**” The 4th quarter saw a 3½% loss for municipal bonds. In 2008 stocks feel ten times as much.

Rising interest rates can be good for opportunity bonds. It is the country’s renewed economic strength that enables the Fed to step back from their steady fiscal stimulus. This economic strength is helpful to all companies, weak and strong. High-yield (junk) bonds are borrowings by weak companies, and the interest rate they pay is a reflection of their weakness. As the US economy’s growth rate rises, these weak companies should strengthen, the interest rates on their bonds should fall, and their bonds should rise. This is the reason behind my continued optimism for high-yield bonds in 2017.

Foreign Stock Recovery—Foreign companies did well in 2016, but the US dollar’s surge eliminated the gains. I expect 2017 to bring stronger gains, perhaps enhanced by a drop in the dollar. A strong dollar brings a great time to travel overseas. It is also a great time to invest overseas. Rallies are easier from low levels, which is why I expect more from foreign stocks than US stocks in 2017.