Stocks "Trump" Bonds

Market Update – Fourth Quarter

Asset class performance diverged significantly in the fourth quarter. Domestic stocks recorded multiple all-time highs with the S&P 500 Index finishing the quarter with a gain of 3.3%. However, equity market performance results were much different outside of the U.S. In a reversal of last quarter's outcome, international and global stocks underperformed U.S. equity indices by a wide margin. The MSCI EAFE Index (international stocks) declined by 1.0% while the MSCI All-Country World Index (global stocks) advanced by 1.3%.

While the strong performance of U.S. equity markets, or now commonly referred to as the "Trump Rally", was well covered by the press and financial media, little attention was given to the developments in the bond market. Balanced portfolio returns were tempered by a measurable decline in fixed income values during the quarter. Global bonds declined by 4% in November, the deepest monthly decline since the index's inception in 1990. The bond market rout was driven by expectations for a pickup in future growth rates and inflation levels resulting from the incoming administration's fiscal and tax plans. The widely followed U.S. Barclays Aggregate Bond Index finished the quarter with a decline of 3.0%.

Market Update – 2016

The S&P 500 Index advanced by an impressive 9.5% in 2016. This result is in sharp contrast to how the year began. January 2016 started off with a significant market correction which translated into the worst start for domestic equity markets since recordkeeping began in 1897. However, equity markets were extremely resilient in 2016. Stocks not only rebounded quickly from the first quarter drubbing, but also worked their way higher in the face of the uncertainty cause by the mid-year Brexit outcome and a surprise Presidential election result in the U.S.

Similar to the fourth quarter, full-year equity market performance for global and international stocks lagged U.S. indices. The MSCI All-Country World Index (global stocks) advanced by a still respectable 8.4% while the MSCI EAFE Index (international stocks) declined by 1.9%.

Bonds limped across the finish line in positive territory with the U.S. Barclays Aggregate Bond Index posting a full-year return of 2.65%. Bonds performed well and outpaced our expectations for the majority of the year or more specifically up until the election results in November. However, bonds gave back a significant portion of their gains in the final two months of the year as investors shunned safe-haven assets in favor of stocks.

Economic Update

Economic growth has improved moderately from the first half of the year. The final reading on third quarter GDP growth showed a rebound to 3.5% and fourth quarter GDP growth estimates are tracking in the 2.5% range. This is certainly an improvement over the first two quarters of the year which averaged a meager 1.1% growth rate. Economic data related to employment, consumer spending and housing have generally pointed to improvement or stability as well. In addition, corporate earnings growth has turned positive after five straight quarters of contractions.

The post-election confidence surveys were very positive and worthy of mention. Consumer confidence spiked to a 15-year high, small business optimism soared and the corporate CFO optimism survey jumped to its highest level in nearly a decade.

It is interesting to compare the rapid and dramatic change in sentiment and the narrative between the pre-election and post-election periods. Prior to the election it seemed to be the consensus view from market commentators, the media, etc. that a Trump victory would result in an immediate stock market correction. Investor concern over the uncertainties associated with a Trump presidency were also very evident in late October/early November when Trump was gaining ground in the polls and simultaneously, investors were fleeing the stock market resulting in the longest consecutive daily losing streak for the S&P 500 Index in 36 years. Fast forward a few weeks, the improbable outcome does occur and stocks race to new highs and confidence surges. From an investment perspective, the election outcome and proceeding stock market reaction reinforces a few important lessons – It is generally disadvantageous to place too much emphasis on short-term events or market conditions when making investment decisions. And it is extremely difficult if not impossible to "time" markets successfully.

Portfolio Positioning

We started the fourth quarter with a slight overweight to equities and maintained that overweight position for the majority of the quarter. However, as equity markets continued to move higher in the latter part of the quarter, we began to slowly trim back our equity exposure and ended the quarter with an equity allocation at the mid-point of our Investment Policy ranges or more concisely, to a neutral equity stance. The rationale for our slightly more conservative positioning is outlined below;

- Equity valuations are less attractive compared to when we established our overweight position (after the Brexit volatility)
- Investor sentiment may have turned too positive too quickly. Investor sentiment has historically served as a solid contrarian indicator.
- After a brief pause, the U.S. Dollar strengthened appreciably in the fourth quarter. We have written exhaustively about the negative impacts to corporate profits resulting from a strong U.S. Dollar.
- We wanted to raise some "dry powder" or build a cash reserve in order to have the option and flexibility to redeploy capital back into equity markets if/when we see the next bout of volatility.

We were well positioned within the fixed income portion of portfolios for the rising interest rate environment that unfolded in the fourth quarter. Our heavy weighting to short maturity bonds protected capital well on a relative basis compared to intermediate and long term maturity bonds which experienced measurable declines in the quarter due to their elevated sensitivity to interest rate changes. We made little changes to our fixed income allocation in the fourth quarter and anticipate maintaining our short duration stance in the near term.

2016 Performance Attribution

The first quarter of 2016 represented a challenging environment for portfolio returns. The harsh equity market declines that occurred in the first two months presented us with a significant hurdle to start the year. In hindsight, our decision to reduce portfolio risk by trimming equity exposure in January and February detracted from full-year portfolio returns. However, given the backdrop of deteriorating fundamentals and elevated probabilities of an economic contraction during this time period, we felt a focus on capital preservation was the most prudent course of action.

As the year progressed and equity markets rebounded, portfolio returns improved significantly on both an absolute and relative basis. Our allocation shifts during the remainder of the year were generally beneficial to portfolio returns. We end the year pleased with a number of portfolio components – including – solid outperformance from the vast majority of our fixed income strategies, generally a strong showing from our domestic equity funds and while 2016 was not an impressive year for developed international markets, our selected funds posted results firmly in positive territory and dramatically outpaced the broad international benchmark.

Closing Thoughts

As we close the books on 2016, investors are focused on two main issues – what impact will the new administration have on financial markets and what's in store for 2017. Markets are pricing in a lot of positives relating to the new administration's agenda – such as – personal and corporate tax reform, deregulation, an aggressive infrastructure spending plan, a business friendly cabinet and a much less punitive tax penalty for bringing back corporate profits earned outside of the U.S. We recognize these <u>potential</u> positives as well. If this agenda is enacted we could see a meaningful impact to corporate earnings and as a result, a continuation of the recent equity market uptrend.

We do have some concerns that markets are pricing in all of the potential positives and for now ignoring the potential consequences of the new administration's agenda. These potential negatives include – impacts from protectionist trade policies, higher deficits, higher inflation and higher interest rates as well as a headwind to corporate profits from a stronger U.S. Dollar.

Only time will tell how 2017 will unfold. But we are encouraged to be entering the year with some positive economic and growth momentum, favorable forecasts for corporate earnings growth and stability in commodity prices. These favorable fundamentals should provide a supportive backdrop for portfolio returns in 2017. However, given current elevated equity valuations, a still challenging return environment for fixed income markets, a strengthening U.S. Dollar and the potential for political uncertainty, we expect a more volatile environment in the New Year than we have witnessed in the final months of 2016. As mentioned above, we used the year-end equity market rally to raise some cash in portfolios in anticipation of a return to a more uncertain investment landscape. This cash reserve provides us with the ability to take advantage of market dislocations and opportunities when they present themselves. We think this flexibility will prove to be beneficial.

We welcome all Roof Advisory Group clients to attend our interactive online webinar discussion scheduled for 1:00 pm EST on Thursday, January 12th. The purpose of this webinar is to provide a more in-depth overview of the most recent quarter, financial market conditions, portfolio positioning, as well as our firm's outlook going forward. Invitations to register for the webinar are currently being emailed to our valued clients