

The January Effect

The Ancient Romans dedicated the first month of each new year to Janus, the god of beginnings, transitions and endings. Janus was usually pictured as having two faces since it was his job to look at both the past and the future at the same time. While we have long since abandoned belief in a bevy of mythical beings, this tendency to use January as a time of simultaneous reflection and contemplation continues today.



Keeping in mind the theme of looking backward and forward at the same time, we are going to take this opportunity to examine some of the issues that impacted our portfolios last year and also discuss some of the things that could be a concern as we traverse these next months of uncertainty.

The Yin and Yang of Economic Recovery

As the US economy has slowly made its way back since the financial crisis of 2008, the Fed continues to balance two things: using rate adjustments as an effective tool to stimulate the economy and controlling the strength of the dollar to maximize buying potential at home and abroad. While lowering interest rates can spur a lagging economy, as rates approach zero, the Fed's rate adjustments become less and less effective. On the other hand, higher rates in the US relative to other countries attract foreign investment and strengthen the dollar. This makes foreign goods less expensive for American consumers, but it also makes US exports more expensive, thus dampening US economic activity. A strong dollar can also hurt US multinationals as they repatriate their foreign earnings.

Maintaining this delicate balance is an ongoing challenge, especially as surprises occur on the global economic/political scene as they did in 2016.

Brex-uberance

Two major political surprises in 2016 impacted the global markets in opposite ways. In June, the British people voted to leave the European Union which set off a 2-day \$3 trillion sell-off in the world-wide markets. And in November, the US shocked the world by electing Donald J. Trump as its 45th President, sending the markets skyward on a cloud of exuberance. A quick overview of the year in general is important in placing these two opposing jolts to the markets in context.

Around the World in 365 Days

After shaking off the Brexit slump, international developed markets posted impressive local returns with the UK, France and Germany returning 19.2%, 9.2% and 6.6% respectively; however, as the US dollar strengthened against the British Pound and Euro, the return to US investors after currency effects were a paltry 0%, 6% and 3.5%, respectively.

In emerging markets, China's leadership sufficiently tamped down the fears of an economic hard landing, though the chance of a real estate bubble there continues to build. Also, emerging market commodity prices, while still below their 10 year levels, rebounded in 2016 leading to optimism and double digit returns. Even so, emerging market valuations, as measured by the MSCI EM index, continue to be the lowest relative to 25 year averages when compared to US and developing market valuations.

Home on the Range

Even before the election, the US economy continued its upward trajectory following a strong third quarter that saw growth of 3.5%. December wage growth experienced its largest increase in 7 years at 2.9%. Jobs grew for the 75th consecutive month and unemployment remained low at 4.7%. Core inflation continued to remain close to the Fed's 2% target inflation rate and the Fed, as expected, raised the Federal funds rate target 0.25% in December. The Fed also signaled the possibility of three rate increases in 2017, giving more credence to ongoing economic strengthening in 2017.

Returns for the year belied the dramatic U-turns that took place on several fronts. For example, fears of recession drove a sharp decline in the market in the first six weeks of 2016. Defensive sectors led the way and Utilities returned 15.6% in the first quarter alone. Financials were the weakest performers at minus 5.1%. That all reversed in the second half of the year with Utilities posting a 5.9% loss in the 3rd quarter and financials soaring ahead with a 4th quarter return of 21% as investors moved into investments that have less interest rate sensitivity.

Additional reversals occurred with high quality stocks outperforming in the first half of the year and low quality stocks outperforming in the second half of the year. International stocks followed the same trend with a more pronounced shift toward speculative choices in the fourth quarter.

Act III

The third area of dramatic dissonance last year was between growth and value strategies. A simple explanation of the difference between these two strategies is that value strategies tend to look more at fundamentals and price, seeking to buy cheap or at least relatively cheap stocks, while growth strategies rely more heavily on companies' expected growth potential with less emphasis on price. The next chart shows the return differences between Value and Growth in Large-, Mid- and Small-Cap US equities. The return differences of 10.2%, 12.7% and 20.4% were significant.

2016 US Total Returns ¹	Value	Growth	Value Outperformance
Large Cap	17.3%	7.1%	10.2%
Mid Cap	20.0%	7.3%	12.7%
Small Cap	31.7%	11.3%	20.4%

¹ Total returns are based on Russell-style indexes. Large Cap Value = Russell 1000® Value index, Large Cap Growth = Russell 1000® Growth index, Mid Cap Value = Russell MidCap® Value index, Mid Cap Growth = Russell MidCap® Growth index, Small Cap Value = Russell 2000® Value index, Small Cap Growth = Russell 2000® Growth index.

Value nearly tripled growth returns in mid- and small-caps. It is also interesting to note the significant difference in returns based on capitalization size – small-caps nearly doubled the return of large caps.

The international markets, as represented by the All World Excluding US Index (ACWIexUS) had a similar divergence with value outperforming growth by 9.1 percentage points.

The Flip Side of Exuberance

After falling precipitously in overnight trading on election night, the S&P 500 did an about-face and rose 5.4% immediately following the election of Donald Trump as President. This rise was likely fueled by Trump's pro-business promises of greater infrastructure and military spending, less regulation and lower taxes. Developed international equities (MSCI EAFE) also rallied 2.0% post-election. With these growth bursts and the anticipation of imminent rising rates, the bond market took a hit of 2.3%². We will discuss this further later in this report.

Growth expectations based on Trump's promises have led to a dramatic 12.5% jump in consumer sentiment in just two months to a level unseen since January 2004³. This, in combination with US equity valuations rising above their 25 year average, warrants concern about whether this exuberance can be sustained. A rapid rise in consumer sentiment often has been followed by a sell-off or low returns in the following 12 months especially when compared to the returns following a nadir in consumer sentiment.

When ⁴	Level	Subsequent Change in the S&P Index	Sentiment Peak or Low
Aug. 1972	95.2	-6.2%	Peak
May 1977	90.2	+1.2%	Peak
Mar. 1984	101.0	+13.5%	Peak
Jan. 2000	112.0	-2.0%	Peak
Jan. 2004	103.8	+4.4%	Peak
Jan. 2007	96.9	-4.2%	Peak
Jan. 2015	98.1	-2.7%	Peak
Feb. 1975	57.6	+22.2%	Low
May 1980	51.7	+19.2%	Low
Oct. 1990	63.9	+29.1%	Low
Mar. 2003	77.6	+32.8%	Low
Oct. 2005	74.2	+14.2%	Low
Nov. 2008	55.3	+22.2%	Low
Aug. 2011	55.8	+15.4	Low

² Bloomberg Barclays US Aggregate Bond market index change in the 37 trading days post-election.

³ University of Michigan.

⁴ University of Michigan, JP Morgan Guide to the Markets, US 1Q 2017, pg. 32.

The expectation of interest rate increases in the US creates a dilemma for many investors who may be questioning if they should continue to hold bonds in their portfolios while interest rates are rising.

We believe that bond ownership has a place in most portfolios because of the diversification benefit. Bonds are generally less volatile than equities and their returns continue to be negatively correlated to equities; meaning when equity returns fall, bonds tend to go up in value and mitigate some of the loss. While the diversification benefit of bonds has been dampened because of declining interest rates in the last seven years, the reverse will be true in a rising rate environment as a greater portion of return will come from income (higher interest rates) and a smaller portion (if any) from appreciation.

Positioning Portfolios for Flips and Flops

As we look forward, we can expect to see additional about-faces, turnarounds and switcheroos in the markets and on the political scene. As always, diversification remains a priority and our goal in 2017 is to continue to manage portfolios that respond well when things are going smoothly and that provide protection when the markets start flip-flopping.