

# Quarterly Economic Update

## Fourth Quarter 2016



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FINANCIAL SERVICES

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For many investors, 2016 was a year of surprises. When viewing the final results of equity returns in 2016, they do not reflect the year's wild ride for both equity and bond investors. In the final quarter of the year, stocks surged, continuing the bull market that is now almost eight years old. Donald Trump's victory as the next President had the investing community thinking about lower taxes, less regulation, pro-business initiatives, and what could be a bumpy ride to unwinding many of the Obama administration's policies.

Since the November 8th election, the stock and bond markets have had large moves. The stock market finished strong after November and December post-election results brought indexes higher and higher almost every day. Some analysts suspect that the late gains in 2016 were so strong that they may have eaten into some expected equity gains for 2017. The Dow Jones Industrial Average may have not hit the elusive 20,000 mark, but it closed out the year 2016 at 19,762.60 on December 30 with a gain of 13.4%.

The S&P 500 closed out the year at 2,238.83, up 9.5%. The NASDAQ closed at 5,383.12 for a gain of 7.5%.

In December, the Fed raised interest rates once again by 0.25%, elevating the U.S. Federal Funds rate to 0.50% - 0.75%. The 10-year Treasury ended 2016 with a yield of 2.44%. The 30-year Treasury closed out 2016 with a yield of 3.06%. On the last day of 2015, the 10-year yield was 2.27% and the 30-year yield was 3.01%.

### *A Review of 2016*

The year 2016 was one that defied predictions. In 2015, the Federal Reserve forecast four rate hikes in 2016, but they only had one. Early in the year, that forecast, along with other economic factors including the dropping price of oil, caused equity markets to have one of the worst starts on record.

When oil hit a low of \$26.21 a barrel in February, some analysts forecasted potential mass oil company



### 8 Key Points

1. 2016 was a year of surprises.
2. Since the Nov. 8 election, equity markets have risen.
3. Many foreign countries still have interest rates at or near 0%.
4. Analysts are expecting low, but positive returns for 2017.
5. Investors need to be watchful of interest rate increases in 2017.
6. Global issues could potentially create challenges in 2017.
7. Volatility is expected in 2017 and investors should be cautious.
8. Investors need to focus on their own situations and objectives.

bankruptcies and a possible U.S. recession, neither of which came true.

One of the next big confusions of 2016 came when polls showed that the United Kingdom was probably going to remain in the European Union when the actual vote was to leave. This event, known as “BREXIT,” caused the markets to plunge. After a sharp two day drop, the S&P 500 started racing higher again.

Perhaps one of the biggest predictions gone wrong was when most polls predicted a victory for Hillary Clinton, but Donald Trump was elected to be the President of the United States. Some felt this would cause an immediate bear market, but instead, post-election investors were treated to a market surge.

Despite all the forecasts of doom and gloom in 2016, equity markets ended the year with strong results. By year-end, the S&P 500 had a gain of 9.5%, mostly due to the post-election hopes that included looser regulations and tax cuts. (Source: Barron's 1/2/2017)

## Interest Rates

Interest rates were on investor's watch lists for 2016. The U.S. Federal Reserve's 0.25% rate hike in December of 2015 was followed by only one 0.25% increase in December of 2016. The year-long prospect

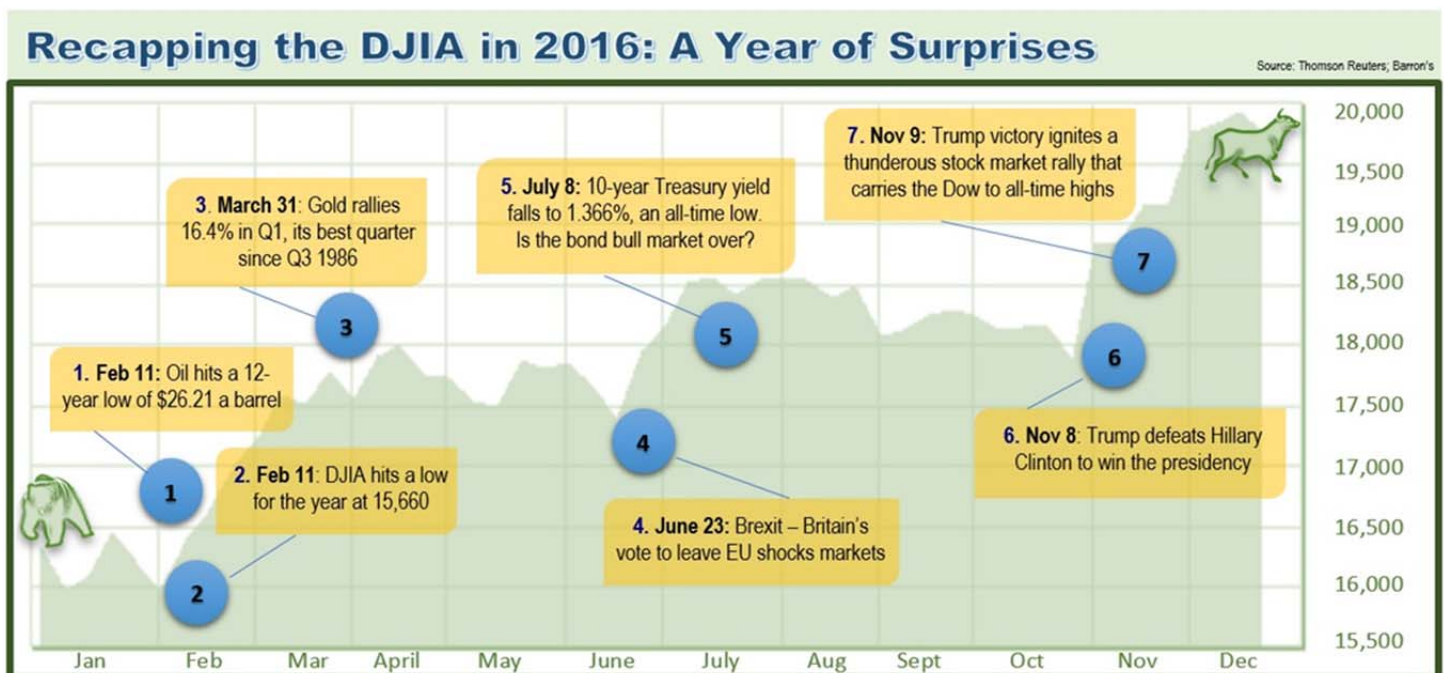
of rising rates had many investors paying careful attention.

The central bankers' ongoing ability to consider and offer negative interest rates is a very important story from 2016. It started back in June of 2014, when the European Central Bank (ECB) first offered negative interest rates at -0.10%.

Rather than demanding that the central bank pay interest to borrow its money, banks now had to pay the central bank to lend it money. Over time, the ECB reduced rates even further into negative territory. By March 2016, deposit rates were as low as -0.40%.

Negative rates grew widespread in Europe and also appeared in Germany, Denmark, Sweden, and Switzerland. In fact, Switzerland held a target rate of -0.75% for most of 2016. Following this trend, the Bank of Japan (BOJ) began charging interest to deposit funds at a rate of -0.10% in January 2016 and continued that trend throughout the year.

Many 10-year government bonds also saw low rates in 2016. Germany's 10-year government bond opened the year yielding 0.63%, falling steadily to a low of -0.19% by July. The rate then rallied and finished the year in the positive column at about 0.36%.



Japan's 10-year government bonds followed a similar path. Starting 2016 at 0.26%, they dipped to a low of -0.29% by mid-year, only to recover to 0.09% by year-end.

In Switzerland, the 10-year government bond yield actually started the year at -0.06% and fell to a low of -0.63%. In the wake of Trump's victory in early November, this rate rebounded with year-end yields at approximately -0.07%. This left rates in Switzerland essentially where they started.

After the election, the bond and stock markets ended 2016 moving in opposite directions. Stock prices went up and bond prices went down while yields increased. For investors, some major questions are: Will the central banks be able to keep markets stable as the Fed tries to lift rates? Will the markets erupt and force the central bank to reduce rates back down towards zero? The year 2017 should give us that answer.

(Source: Seeking Alpha 12/26/2016)

## *2017 Outlook*

Due in large part to recent gains, investors need to be watchful of the current valuations of equities. The year 2017 starts with the S&P 500 index trading at 19 times last year's earnings. Based on historical results, this is considered ambitious, but not ridiculous. Recent corporate earnings have shown slight growth after a year of shrinking and energy stocks are still not near their all-time highs. FactSet tallied estimates for earnings growth of 12% in 2017, but Goldman Sachs is less optimistic. They feel that investors have ridden the bull market for eight years, and while they don't expect the ride to end in 2017, they are warning investors to stay vigilant. They are predicting that U.S. equities will increase by 3% in 2017.

(Source: Barron's 1/2/2017, Goldman Sachs 2017 Outlook)

## *All eyes on interest rates*

The underlying strength of the labor market and the steady improvement in the economy have led the Federal Reserve to forecast several interest rate

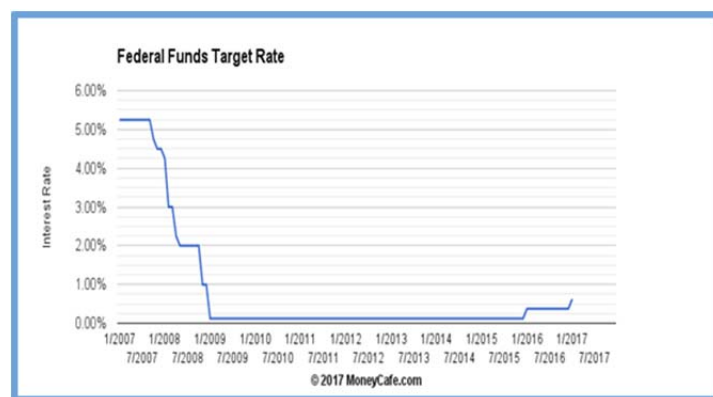
increases for 2017. Interest rates hit a low of 1.36% for a 10-year Treasury in July of 2016 and increased to over 2.4% by year-end. In December of 2016, the Fed's so-called "dot plot" showed the central bank penciled in three rate hikes in 2017 instead of two under its prior forecast.

Although Chairwoman Janet Yellen called the shift "very tiny," she acknowledged that Fed officials took President Trump's economic plan into account when making this new forecast. Still, she suggested that higher inflation and a lower unemployment rate than the Fed had expected were bigger factors in the change. What's more, she stressed the Fed would take a wait-and-see approach for now since the outlines of Trump's plans were not finalized. "I wouldn't want to speculate until I were more certain of the details and how they would affect the likely course of the economy," she said.

(Source: MarketWatch.com 12/14/2016)

These projections are not a firm commitment and Forbes editors feel that, most likely, they will hike rates another quarter point in early 2017. They think that will come probably at their March meeting or possibly at the January meeting. They forecast that further interest rate hikes are unlikely because after March some disquieting news will come out about business capital spending.

(Source: Forbes 12/14/2016)



David Payne, Staff Economist at Kiplinger's Magazine, feels that, "despite the Fed's expectation of three rate hikes, figure on just two in 2017 because economic growth won't be strong enough to warrant a faster rise in interest rates. The fiscal stimulus effects

of President Donald Trump's proposed tax cuts will be mostly pushed into 2018, while the high value of the U.S. dollar and rising long-term interest rates will weigh on the economy in 2017."

(Source: Kiplinger 12/16/2016)

Diversified portfolios usually have exposure to bonds or interest rate-sensitive investments. Even in a rising rate environment, interest rate-sensitive investments could play a role in most portfolios. At times, they have offered investors the potential to possibly offset losses in the event of a stock sell off. Investors need to monitor their bond and yield sensitive exposures in 2017 because rising rates can cause bonds to experience a short-term price loss.

With projected rate hikes on the horizon, investors need to be cautious. Even with a rate increase, the bad news for savers is that there still isn't a lot of yield to be found, at least not from investments that are safe enough to be considered as an equivalent to cash. We also need to monitor how interest rate increases impact equities.

Interest rates are an area that we will watch closely in 2017.

### ***Global issues also need to be watched***

Investors need to be watchful in 2017 for a potential global recession caused by possible blow-ups in China and Europe. The 2nd and 3rd largest economies in the world enter 2017 facing many obstacles.

China's main challenge is making the shift from an export economy to a consumption economy. There are numerous obstacles in the way. Right now, the biggest problem is the weak yuan. Chinese investors are scrambling to convert their cash into dollars and move it out of the country - sapping the treasury of funds needed to make the transition to a more mature consumption-based economy.

In Europe, there are a slew of elections due to take place in 2017. Also, there is the potential for bank

failures in Italy - Europe's third largest economy - which would cause big problems for Europe and possibly the entire globe. Any major global crisis will only add to uncertainty and investors know that the equity markets do not like uncertainty.

(Source: Seeking Alpha 1/11/2017)

### ***Conclusion: What Should an Investor Do?***

Investors are concerned about the market for 2017. The year kicks off with a new president, higher rates, stocks at all-time highs and new risks and opportunities. In their 2017 Outlook, Goldman Sachs predicts that, "while we recommend clients remain invested, we have modest return expectations. We expect that a moderate-risk well diversified taxable portfolio will have a return of about 3% in 2017."

(Source: Goldman Sachs 2017 Outlook)

Russel Kinnel from Morningstar.com cautions that, "With transitions in the White House, Fed policy, and the inflation outlook, it feels particularly precarious to make predictions. On the plus side, investors have enjoyed tremendous gains in recent years as equities have had one of their all-time great runs, especially in the United States. In addition, unemployment and inflation are low." He adds that, "given the cyclical nature of markets, the chances for a bear market grow the longer a rally lasts. There are signs that inflation is on the rise, and the Federal Reserve has acted accordingly. It raised rates in December and signaled it expects to raise them three more times in 2017. That doesn't mean that markets or the economy will hit the brakes, but it could signal more sobriety in the markets. The bond market has noticed the potential for even more inflation and rates are rising." His advice is that, "the best response to uncertainty is diversification." (Source: Morningstar.com 1/10/2017)

A USA TODAY review of predictions from 15 Wall Street strategists finds that America's fortunes won't add up to big stock market gains in 2017. They report that the group's average year-end 2017 price target for the Standard & Poor's 500 should produce a gain of

approximately 4.5%. One prognosticator sees the S&P 500 gaining more than 10% next year, on top of the gain it has posted in 2016. Not one of the 15 strategists sees the stock market posting losses next year. The lowest 2017 year-end price target — 2300 — equates to a gain of less than 2%.

(Source: USA TODAY 12/27/2016)

John Velis, Vice President of Global Macro Strategy for State Street Global Markets warns investors that in 2017, caution is warranted because markets are betting big on the best possible developments in fundamentals. He feels that at this time it's unclear what form the new president's policies will take and how much his policies will be accepted by Congress. He also maintains that investors need to beware of analogies between 1981 and 2017 when stocks took off under Ronald Reagan. In 1981, interest rates were historically high and set to fall for several decades. The opposite is true now. Also, stock market valuations were orders of magnitude cheaper than they are now, too.

(Source: Forbes 12/17/2016)

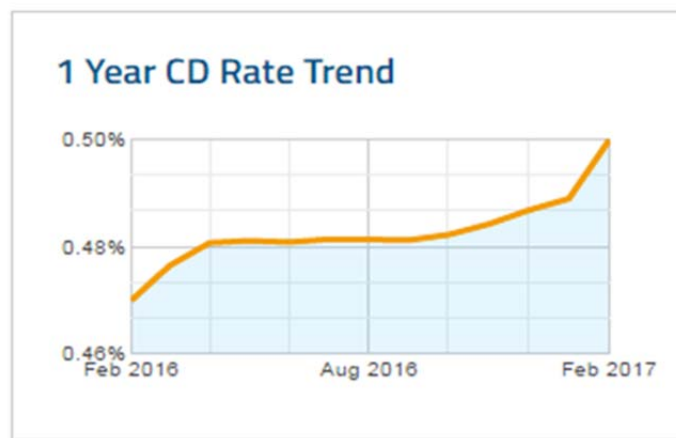
### ***CAUTION is still necessary for investors.***

Michael Sonnenfeldt, the Founder and Chairman of TIGER 21 feels the only certainty in 2017 is uncertainty. He shares in Forbes that, "perhaps the biggest lesson of 2016, one which certainly carries over into 2017, is that there is no safety in safety. The traditional assets investors sought refuge in for predictable cash flow, dividends or distributions have all been bid up to the point where their returns are no longer considered as attractive or safe." Still, the fact remains that in a low-interest rate environment, if you are trying to stay "even" by sitting on the sidelines and not making any investments, you are probably going backward on an after-tax, inflation-adjusted basis.

(Source: Forbes 12/17/2016)

Many analysts are predicting a volatile ride in equities for 2017. They feel that investors need to be prepared for equity market pullbacks and /or corrections.

Sadly, safety comes with a price. According to Deposit Accounts January charts, the rates on one year certificates of deposit (CD's) were 0.50%. Investors' portfolios do not grow fast when they concentrate on interest rates of less than 1%.



(Source: www.DepositAccounts.com)

For many investors, today's fixed rates will not help them achieve their desired goals. Most investors attempt to build a plan that includes risk awareness. Many times this can lead to safer but lower returns. Traditionally, bonds have been used as a nice hedge against market risk, but with interest rates projected to rise investors need to be extremely cautious.

**For 2017, let's revisit YOUR Strategy.** Investors need to be prepared. Market volatility should cause you to be concerned, but panic is not a plan. Market downturns do happen and so do recoveries. This is the ideal time to ensure that you fully understand your time horizons, goals and risk tolerances. Looking at your entire picture can be a helpful exercise in determining your strategy.

**We focus on your own personal objectives.** We try to understand your personal goals so we can offer suggestions that fit your personal situation.

**Now is the time to make sure you are comfortable with your investments.** Equity markets will continue to move up and down. Even if your time horizons are long, you could see some short term downward movements in your portfolios. Rather than focusing

on the turbulence, you might want to make sure your investing plan is centered on your personal goals and timelines. Peaks and valleys have always been a part of financial markets and is highly likely that trend will continue.

### *Discuss any concerns with us.*

Our advice is not one-size-fits-all. We will always consider your feelings about risk and the markets and review your unique financial situation when making recommendations.

#### **We pride ourselves in offering:**

- ✓ consistent and strong communication,
- ✓ a schedule of regular client meetings, and
- ✓ continuing education for every member of our team on the issues that affect our clients.

**A good financial advisor can help make your journey easier. Our goal is to understand our clients' needs and then try to create a plan to address those needs. We continually monitor your portfolio. While we cannot control financial markets or interest rates, we keep a watchful eye on them. No one can predict the future with complete accuracy so we keep the lines of communication open with our clients. Our primary objective is to take the emotions out of investing for our clients. We can discuss your specific situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial matters.**

## ***Help us grow in 2017!***

**This year, one of our goals is to offer our services to several other people just like you!**

**Many of our best relationships have come from introductions from our clients.  
Do you know someone who could benefit from our services?**

**We would be honored if you would:**

- ➔ **Add a name to our mailing list,**
- ➔ **Bring a guest to a workshop,**
- ➔ **Have someone come in for a complimentary financial checkup.**



**Please call Sharon Easton at 281-357-8788 and we would be happy to assist you!**

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