INVESTMENT OUTLOOK

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FOURTH QUARTER 2016: THE TIMES THEY ARE A-CHANGIN'

Well it ain't no use to sit and wonder why, babe
Ifin' you don't know by now
An' it ain't no use to sit and wonder why, babe
It'll never do some how
-Bob Dylan, Don't Think Twice, It's All Right

Expect the unexpected. Ancients like Heraclitus and Clement of Alexandria counseled us to do so, but it goes against the grain to expect unlikely outcomes. So we keep having to relearn the lesson. How else to explain the many surprises that 2016 held? Brexit—the UK's decision to exit the EU. The Cubbies winning the World Series, after 108 years of failure and heartbreak. Donald Trump's victory over Hillary Clinton. (Could it be as simple as the old saw about second marriages—a triumph of hope over experience?) And even less anticipated? The Nobel Committee's decision to award the Literature Prize to Bob Dylan.

If pundits in the fields of politics and the arts got things so wrong, why would we expect any better from economists? The Fed forecasted that it would lift interest rates four times last year; it barely managed one increase. US economic growth, projected at 2.5%, eked out a gain of only 1.7% for the first 9 months. Predictions of a dramatic slowdown in the Chinese economy proved overstated.

And if economists are subject to being caught wrong-footed, why should we expect financial markets prognosticators to do better? They anticipated earnings growth of 10% for 2016, but we'll be lucky to end the year with flat earnings. They did not see that oil would fall to $26 a barrel in February, and then double in price on a quite surprising agreement by OPEC to cut back production. And they did not see that rates would plummet to record lows, reverse course, and nearly double, all in a 12 month span.

We are reminded of Yogi Berra's observation that predictions are hard, especially about the future.

RISK ASSETS: SHELTER FROM THE STORM

Not a word was spoke between us, there was little risk involved
Everything up to that point had been left unresolved
Try imagining a place where it's always safe and warm
"Come in," she said, "I'll give you shelter from the storm"
-Bob Dylan, Shelter from the Storm

As for the recent past, in the fourth quarter US markets rallied strongly, on a rapid re-evaluation of the prospects for business and the economy following Donald Trump's election victory. The strengthening US dollar, as well as concerns about the outlook for global trade, held back international equities, particularly emerging markets. Interest rates rose on potential faster growth and reflation, driving down returns on bonds and real estate. Commodities rose on a surprise OPEC agreement on production cuts and expectations of higher demand for industrial metals.

For the year, US stocks put up strong gains, with small cap stocks posting exceptionally robust returns. International developed markets marked time, held back by post-Brexit questions about the EU's sustainability

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	3.8%	12.0%
US Small Cap Stocks	Russell 2000	8.8%	21.3%
International Developed Markets Stocks	MSCI EAFE	-0.7%	1.0%
Emerging Markets Stocks	MSCI EM	-4.2%	11.2%
Real Estate	MSCI US Real Estate	-3.0%	8.6%
Commodities	Bloomberg Commodities Futures	2.5%	11.4%
Bonds	Barclays US Aggregate	-3.0%	2.7%
Cash	Citigroup 3 month UST Bill	0.1%	0.3%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, BLOOMBERG, RUSSELL INVESTMENTS

and by continued weakness in the Italian banking system. Emerging markets, however, generated double digit returns, as did commodities—a significant and not widely predicted outcome as this was a noteworthy reversal after several years of weakness for these asset classes. Bond returns were muted, as fourth quarter declines eroded strong gains earlier in the year. Cash continued to represent a parking place, although at year end returns on cash started to rise for the first time in many years.

ECONOMIC ACCELERATION: KNOCKIN' ON HEAVEN'S DOOR?

I am a man of constant sorrow
I've seen trouble all my days
-Bob Dylan, Man Of Constant Sorrow

A general sense of economic malaise, of slow growth, dragging economic productivity, and weak capital spending, has been decried for so long now that good news is discounted or ignored. After all, confirmation bias has us reach for information that confirms our beliefs and reject data that contradict our beliefs. The ongoing narrative since the Great Recession has been that we are doomed to many years of subpar growth, as the price to be paid for a debt-driven recession. And, in truth, the "new normal" growth rate for the US economy has run at an annual rate of 1.5—2%, versus 3—3.5% growth in the years before the housing market crash.

Yet objective evidence suggests a change has been in the offing. US economic growth accelerated notably in the third quarter, advancing by 3.5% from a year ago. This was the strongest reading in a number of quarters, and provided considerable momentum for the final quarter of 2016.

Better growth was evident across a number of data points. The labor market continues to exhibit robustness, with the unemployment rate down to 4.7%, weekly jobless claims at their lowest levels since the 1970's, and hourly wages posting respectable gains. Automotive sales remain strong at 17 million plus new vehicles annually, extending their multi-year advance. Housing data are also constructive, with nationwide house prices rising better than 5% and growing demand from millennials. And consumer spending continues to undergird the economy, driven by rising incomes and improving sentiment.

With the seemingly interminable election coming to a decisive conclusion in early November, both consumer and business confidence took off, achieving levels not seen in years. It would appear that the economy is ushering in the new year with good potential to surprise to the upside.

Which is not to suggest an end to troubles seen. The spottiness of the economic recovery—the highly unequal distribution of income and wealth growth—of the post-recession era, doubtless a source of Mr. Trump's election victory, has left both public and private sectors with higher debt levels. Public assistance programs—SNAP/food stamps, long term unemployment rolls, disability and other welfare benefit schemes—remain at recessionary levels. Median household income levels, while just beginning to improve, have trailed inflation for many years. This is the source of the old narrative, and it is still being told even as it may be old news.

MARKETS ROCK: IT'S ALL GOOD

Big politician telling lies
Restaurant kitchen, all full of flies
Don't make a bit of difference, don't see why it should
But it's all right, 'cause it's all good
It's all good
It's all good
-Bob Dylan, It's All Good

Markets wobbled in October, amid maximum election uncertainty, but entering November they anticipated a resolution to the long campaign season (even if not the actual, eventual outcome), rallying before November 8th and rallying in earnest thereafter. It's not unusual for markets to take off following presidential elections, as greater clarity emerges. The jump this year was unusually large, as market participants came to believe that president-elect Trump would advance a more pro-growth agenda and a more business-friendly environment. Proposals that include lower corporate tax rates, less regulation, and increased spending on infrastructure projects and the military are seen as promoting faster economic growth and increased corporate profits.

From a fundamental perspective, third quarter earnings grew 3%, breaking a multi-quarter streak of year-over-year profit declines. Expectations for further profit expansion run high for the just-finished fourth quarter. This set the stage for particularly sizable appreciation for smaller US companies, likely to benefit from domestic expansion and gentler tax liabilities. Cyclical sectors that require better economic times to shine—industrials, financials, and materials—were stand-outs. Thus, the bears went into an early hibernation, and the old saw that stocks climb a wall of worry gave way to a new paradigm in which stocks climb a wall of optimism.

Mr. Trump's surprise victory, and the markets' surprise reaction, also spilled over to other markets. The US dollar strengthened on expectations not only of faster growth but of higher inflation, too. Consequently, interest rates rose, and interest sensitive assets declined—not only bonds, but real estate and emerging markets as well.

ECONOMY 2017: TOMORROW IS A LONG TIME

Never no more do I wonder
Why you don't never play with me anymore
At any moment you could go under
'Cause you're driftin' too far from shore
-Bob Dylan, Driftin' Too Far From Shore

The start of a new year is inherently awash in optimism—that's the only environment in which resolutions can flourish. For it is only in advance, in anticipation, that we can convince ourselves that this year, finally, we will lose ten pounds, that we'll exercise more, that we'll work smarter rather than harder.

So, too, we enter the year with high enthusiasm for economic rejuvenation. Markets appear to be pricing in a lot of good economic news—arguably, that all of the pro-growth initiatives Mr. Trump campaigned on will be executed, and executed swiftly. These include reducing the regulatory burden on businesses, reducing both individual and corporate taxes, and stimulating the economy with increased spending on military preparedness and infrastructure improvements.

Some of this, perhaps much of it, is likely to come to pass. Cabinet and agency appointments announced so far are likely to support this agenda and, arguably, the Republican Congress is more beholden to Trump than the other way around. There is bipartisan consensus on infrastructure spending, and hardly anyone would want to oppose strengthening the military in this era of mounting geopolitical tensions and terrorist threats. Corporate tax reform also enjoys fairly widespread support; individual tax reform may be a tougher slog but could prove to be an interesting demonstration project to observe The Art of the Deal in action.

But we may well be drifting too far from shore on this sea of optimism. Market participants seem to be ignoring the warnings of trade wars and tariffs, of decreased immigration, of too-loose fiscal policy leading to higher deficits, of rising inflation and tightening labor markets leading to higher interest rates, of a too-strong US dollar leading to a growing trade deficit. Or maybe they just don't believe the negatives will come to pass. Maybe we'll get all the benefits of reflation and none of the drawbacks. Maybe not, but maybe that's tomorrow's problem…and tomorrow is a long time.

MARKETS 2017: GETTING AND GIVING BACK

But she said, "Don't forget
Everybody must give something back
For something they get"
-Bob Dylan, Fourth Time Around

With the market's new narrative, the change from secular stagnation to growth acceleration, comes a new perspective on potential winners and losers. As we look ahead, the reset in asset markets and sectors that began in the fourth quarter seems likely to have legs. That is to say, transitions—from interest sensitive stocks to cyclical stocks, from growth stocks to value stocks, from deflation fears to reflation—may well be sustained. The transition from the domination of monetary policy to the ascendancy of fiscal policy should proceed, if unevenly—and how welcome it would be to move away from equity markets driven by central banks' low interest rate policies to markets driven by earnings growth. Better prospective US growth, however, is unlikely to be a sufficiently powerful locomotive to pull global growth faster.

We have been re-positioning portfolios to reflect the changing landscape. We remain over-weight US equities, with increased exposure to small cap value stocks. In US large cap equities, we have increased exposure to value stocks, particularly in the financial and consumer sectors, and reduced exposure to health care stocks where we think the new Administration may pressure drug prices as part of its populist agenda. (At some point, a contrarian trade into health care stocks could well be warranted.) We remain under-weight REITs, given rising interest rates, and have increased exposure to commodities to reflect the ongoing reflation trade. Cheaper valuations in international developed and emerging markets are warranted by less attractive growth dynamics and US dollar strength.

Interest rates may drift back down modestly, but in all likelihood we reached a multi-year low in yields this summer, and absent a recession we expect upward pressure in inflation and, therefore, interest rates to rise. We have shortened duration in bond portfolios, with the most attractive yields in short to intermediate term bonds (maturities between three and six years). The sell-off in municipal bonds is, in our view, excessive, and there is more value in tax exempt bonds than we've seen in a number of years.

These generally pro-cyclical portfolio adjustments do not signify an excess of optimism. There are numerous risks to higher equity prices; some of them include elevated valuations, rising interest rates, a shifting and uncertain Trump administration agenda, rising nationalism around the world, upcoming elections in France, Germany and the Netherlands, confrontation with China, potentially ballooning federal budget deficits. But in investing, we have to maintain a long term perspective, recognizing that periodically we give something back for what we get…

MARKETS 2016: THE YEAR IN REVIEW

You try so hard
But you don't understand
Just what you'll say
When you get home
Because something is happening here
But you don't know what it is
Do you, Mister Jones?
--Bob Dylan, Ballad of a Thin Man

In this year of multiple surprises, most investment professionals were caught offsides one way or another—it was, alas again, a challenging year for active managers. In fact, one could call it an annus horribilis—the phrase Queen Elizabeth II used to describe her 1992, a year that saw a destructive fire in Windsor Castle, Prince Andrew's separation, Princess Anne's divorce, Prince Charles' and Princess Diana's affairs revealed, and so on.

2016 was about macro trends which were not foreseeable: interest rates declined to record lows, and then rebounded dramatically; oil plunged to $26 a barrel and its subsequent doubling; the Brexit vote; the Trump victory. (The Trump victory: yes, Mrs. Clinton won the popular election by about 3 million votes, but she won less than 500 counties compared to Mr. Trump's 2600 counties.)

We, alas, were not more clairvoyant than our peers. With our dual mandate to protect and to grow capital, we were positioned more for the former than the latter; as a consequence, we participated in the markets' rallies but less fully than we would have liked.

We were not surprised by the market's correction in February, but with no recession in sight we did not anticipate the dramatic decline in yields in the first half of the year and the concurrent levitation of high dividend/bond substitute stocks. In the second half of the year, evidence of economic strengthening and the Trump victory boosted value stocks; high quality growth stocks in our core portfolio lagged the performance of cyclical stocks, even though underlying operating results remained sound.

Our under-weighting of top-performing energy and telecom stocks was not constructive on a relative basis, and our health care stock exposures faced challenges too—health care stocks were the worst performing sector, falling 3%, despite solid fundamentals and favorable demographics. Still, we held positions in three of the five best-performing Dow stocks—and, regrettably the worst-performing Dow stock.

The raging debate today in investment circles focuses on the possible death of active investing, stumbling under the dual weights of higher costs and recent years' under-performance. Passive investing, by contrast, has been the beneficiary of billions of dollars of funds flows. This is not the forum to debate the respective merits of active and passive, or index, investing, but a few points are worth recalling. We have previously noted the lack of a risk management function in passive investing, and the distorting effects of central banks' policies which have disproportionately benefited lower quality stocks. And, of course, there are fads and cycles in investments just as in other fields. They can last for an extended time…but not forever.

The set-up is very constructive for active managers who are able and willing to invest in a very select group of stocks that are clearly differentiated from the overall market. There are numerous industries undergoing unprecedented disruption, and only passive investors who invest in the whole market need to own challenged companies who will be tomorrow's Eastman Kodaks—once great businesses undergoing secular decline and, ultimately, extinction. We think this is a terrific time to be a fundamentally driven investor, with a sufficiently long time frame to take advantage of broad changes, be it in retailing, automotive technology, biomedical discoveries, data analytics, and so on.

Certainly, companies that will be winners from these developments are represented in indices. But so are many companies with poor fundamentals and inappropriate valuations. Their flaws will be more apparent in the next downturn. So, too, will the flaws of passive management, which favors asset class exposure over investment judgment and values lack of deviation from a benchmark over managing losses.

All of that said, it was a good year for most market participants. Our commitment to multi-asset class portfolios was gratifyingly successful, as previously out-of-favor asset classes like commodities and emerging markets rewarded steadfast investors with double digit gains, and our tactical positions in fixed income generated returns well in excess of bond benchmarks. And so we turn the calendar and, like Mr. Tambourine Man, forget about today—until tomorrow.

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