Market Review & Outlook: Stability or Strife?

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Executive Summary

- *The S&P 500 provided a total return of 11.96% for 2016. Small-cap, mid-cap and high-dividend yielding stocks produced returns as much as double the S&P 500.*
- *The U.S. economy remains on firm footing as we enter 2017 with some evidence of accelerating fundamentals.*
- *In our opinion, U.S. markets will have to deliver on expectations for double-digit earnings growth in order to perform in 2017. We believe they can.*
- *Donald Trump's populist campaign promises raise both opportunities and concerns. We believe that the legislative process will moderate where needed.*

2016 consisted of several distinct episodes, each of which was accompanied by its own set of sensational headlines and prognostications. The year began with a sharp equity market correction and an improbable bond rally on the heels of the December 2015 Fed Funds increase, the first since the financial crisis. The recovery from February lows was broad-based; however, bond yields remained low and high-dividend yielding stocks led the broad market by a substantial margin. The June British vote in favor of leaving the European Union brought a surprise third quarter rally in Developed International and Emerging Market stocks. Finally, Donald Trump's improbable election as President of the United States resulted in an equally surprising U.S. stock market rally dominated by small cap stocks, anything related to infrastructure construction and banks. The final results for 2016 are healthy full-year returns for most risk asset classes, interest rates around where they started the year and a very complicated outlook.

The year was defined by a series of surprises motivating changes to investor sentiment that did not follow forecasts. The year was a text book case for the benefits of diversified portfolios and patience. We believe that creating manageable parameters for each style and region based on risk tolerance and a disciplined process for rebalancing offers the highest probability of being in the right place at the right time without building your house on sand. It would have been a shame to have not owned any small cap or dividend-paying stocks in

Equity Market Index Returns

As of December 31, 2016

Asset Class	Index	4Q 2016 (%)	2016 (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	3.82	11.96	8.87	14.66	6.94
	Russell 1000 Large Growth Index	1.02	7.09	8.56	14.51	8.34
	Russell 1000 Large Value Index	6.67	17.31	8.58	14.79	5.72
	DJ US Select Dividend	4.14	21.98	11.44	14.64	6.72
Mid Cap U.S.	S&P 400 Mid Cap Index	7.42	20.74	9.05	15.33	9.16
Small Cap U.S.	S&P 600 Small Cap Index	11.13	26.55	9.47	16.62	9.03
Developed International	MSCI EAFE Index	-0.72	1.01	-1.60	6.54	0.75
Emerging Markets	MSCI Emerging Market Index	-4.16	11.20	-2.55	1.27	1.84
Commodities	Bloomberg Commodity Total Return Index	2.65	11.76	-11.26	-8.96	-5.58
Real Estate	NAREIT Equity Index	-2.90	8.51	13.37	12.00	5.07
Global Market Cap Weighted	MSCI World Index*	1.85	7.50	3.79	10.41	3.82

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of December 31, 2016

2016, but investors had to suffer a rough 2015 to get there. Similarly, it would have been painful to have overcommitted to the value proposition of emerging market stocks prior to Trump's surprise victory.

The S&P 500 provided a total return of 11.96% for 2016. Small-cap, mid-cap and high-dividend yielding stocks produced returns as much as double the S&P 500. Developed International markets continued to lag the performance of U.S. markets due to excessive debt, fractious politics and the declining value of the Euro. Emerging markets took a turn for the better in 2016 but came under pressure in the 4th quarter following Trump's election which raised the prospects for higher interest rates and protectionist trade policies, potentially reversing a long trend towards more open markets.

The U.S. economy remains on firm footing as we enter 2017. Employment continues to grow at relatively consistent rates and unemployment sits at 4.7%. The addition of 156,000 individuals to payrolls in December was a disappointment relative to expectations, but November was revised significantly higher versus the initial report and the 3 month average monthly increase in payrolls is a healthy 165,000. Recent reports have also seen growth in labor force participation after a long and stubborn withdrawal as discouraged workers reenter a more compelling labor market. Finally, after a stagnant period of sluggish wage growth, wages are rising at a healthier pace. December average hourly earnings saw the strongest year over year increase since 2009 at 2.9%. As with seemingly everything in economics, this can be good and bad for the future. Obviously, having more people with more money increases the ability to buy goods and services. On the other hand, we are starting to hear a lot of discussion of the economy operating "at capacity." "Full employment" is a moving target in a dark room in many ways, but there is a point at which scarce labor drives inflation, which drives interest rates and ultimately stifles growth.

Are we there? We don't believe we are looking at dangerous rates of inflation based on labor market conditions. First, wage growth has just recently begun to accelerate from disappointing levels and 2.9% is not a problematic rate of growth. Second, inflation remains below the Federal Reserve's target of 2% as the strength of the U.S. dollar has provided an offset preserving the U.S. consumer's purchasing power. Finally, in our opinion, there are other kinds of "slack" in the labor market to be absorbed before full employment results in greater inflation such as underemployment, slower than traditional productivity and immigration.

Yes, about that last one. The market has initially responded positively to Donald Trump's election due to the promise of reduced taxes, ambitious infrastructure spending and less regulation. On the other hand, several of his more populist proposals threaten the growth potential of our economy. Immigration and trade do a lot to increase the "capacity" or total size of an economy. Immigrants contribute meaningfully to growth in the labor force, which is an almost indispensable component of economic growth, particularly the 3% or greater rates of growth that Americans tend to expect. Trade also increases the availability and reduces the prices of goods available to Americans. At 4.7% unemployment, it is difficult to see how we maintain reasonable availability and pricing for the $45.2 billion (per month) in goods and services, for which we rely on foreign production. That is a lot of foregone economic activity. There is much to watch in the policy details that come from the new Congress and presidential administration for both near-term growth and longer-term potential.

Beyond employment, there are signs of strengthening economic activity around the world. Surveys like the ISM Purchasing Managers Index (PMI) are watched closely because they tend to expose inflection points in the more volatile capital spending component of the economy. Recent readings are accelerating following a long period of adjustment. The December ISM Manufacturing PMI improved to 54.7 versus 53.2 in November. Any reading over 50 is an indication of expansion. Similar international surveys are also showing growth with China at 51.4 and the Eurozone at 54.3.

Stronger employment, stock market gains and a healthy housing market have put household finances in good shape. U.S citizens and non-profits have an aggregate net worth of $90 Trillion. Consumer sentiment is running at very high levels. Auto sales remain very strong, with the most recent update from GM forecasting more of a plateau than a peak at this point in the cycle.

The S&P 500 is trading at slightly more than 17x forecast earnings over the next 12 months, which we believe reflects a lot of the good news we are seeing in the economy as well as some expectations that we cannot yet see. The multiple is slightly elevated versus the 5-year average of around 15x, which can be justified by still low interest rates and the consensus forecast for 12% S&P 500 earnings growth in 2017 and 2018 after two flat years. However, there is obviously more at work here than triangulating the correct price to pay based on the formulas from text books. Emotion plays a role in markets on the good days and the bad days. The challenge for a disciplined investor is to determine when the good runs are simply a payoff for a patient effort and when bullishness has turned to euphoria. There is no rule book here, but everybody has an opinion. We prefer a process.

In general, we would characterize the markets as a little bit riskier than they were due to uncertainty about many of Donald Trump's proposals and the clearer runway for interest rate increases by the Federal Reserve. We don't believe that a steady rise in interest rates is itself a risk, particularly from such low levels, but when things are moving there are opportunities for mistakes. We believe the market is capable of absorbing a normalization of interest rates based on fundamentals of employment, foreign Central bank accommodation and moderate inflation expectations. Despite the sharp increase in rates following Trump's election, 10-year treasuries have settled in the 2.4% range, still very low by historical standards. We believe that reverting to protectionist trade and immigration policies does create long-term headwinds to growth potential as well as a lot of capricious winners and losers.

Beyond the bully pulpit, which Donald Trump uses often, there is the reality of a legislative process that has a tendency to slow things down. We believe that the early positioning around promises to repeal President Obama's signature Affordable Care Act offer a picture of the future. Promises to quickly overturn "Obamacare" have been complicated by the political reality that people generally like the benefit, while undoing the funding sources creates unsustainable deficits. A detailed alternative now seems to be a necessary gate to any more advanced discussions about overturning the Affordable Care Act. Whether you like the law or not, the social and economic impact on American citizens will have its day in the political and legislative arenas. Our base case is that the American Government works. While the process will be ugly and contentious, we believe that the dual priorities of fiscal stimulus and controlled spending (and deficits) will moderate the legislative outcomes and perhaps even lead to innovative solutions.

In such an environment, we believe stocks can perform well if earnings live up to the forecast for growth. Current economic data suggests that the likelihood for meeting expectations is pretty good. While bonds are more difficult to like following the back-up in rates, we still believe that a portfolio of investment grade bonds with various maturities over the next 10 years is the most economical and time-tested means of securing protection against a sharp decline in the value of equities. Like 2016, 2017 promises to bring its fair share of new surprises and prognostications which will be sensationalized by the media. However, the need for a decent return on your hard-earned savings over time does not change. A disciplined process and diligent security selection should continue to serve you well.

We hope you have a happy and prosperous 2017. ■