January, 2017

Show Me Time

2016 will go down as the year of unexpected outcomes. It was not a good time to be a pollster, pundit or prognosticator. This theme was also true in the financial markets. Perhaps the most interesting aspect of this phenomenon is that following the unforeseen events, markets behaved in ways no one would have predicted.

In December of 2015, the Federal Reserve embarked on raising interest rates. Conventional wisdom suggested two, possibly three rate hikes in 2016 allowing for global rates to begin to normalize. Economic growth in the US would continue at 2%-3%, driven by growth in housing, sustained strength in autos, and real income growth due to a tightening labor market. This consumer led strength was expected to sustain global growth for the year.

Politically, the anticipation was for Hillary Clinton to win the presidency and Republicans to maintain control of the House and Senate. Like her husband, she would govern from the middle offering a better environment for business and potentially higher growth rates for the economy.

With the major variables "known," market participants were expecting a relatively benign landscape with stocks, bond yields, and commodities all moving higher as the year progressed. Disillusionment came in early January as China weakened, commodity markets remained in free fall, and the Fed took further rate hikes off the table. Suddenly the anticipated outcomes of moderate growth and calm markets were shattered.

In response to these developments investors quickly built a new set of expectations. The new outlook called for slow growth, low inflation and low interest rates for an extended period of time. Markets quickly adapted to this theme by driving 10-year Treasury Bonds to 1.60% and German and Japanese bonds into negative yield territory. In this environment, stocks that provided dependable, growing dividends were deemed a scarce resource. "'High confidence" issues (utilities, consumer staples, and blue chip growth names) were the most prized assets, trading upwards of 20X earnings. Conversely cyclical companies such as General Motors traded at six times earnings and even with a 5+% dividend yield a rebuilt business model and a strong balance sheet the stock could not be "given away".

The investment landscape was again shaken when the United Kingdom unexpectedly voted to withdraw from the European Union on June 23rd. The ballot results caused treasury rates to fall sharply from 1.6% to 1.4% and equity markets to be rattled for a short period of time. Despite this, the European economy did not come to a screeching halt. Concurrently, short cycle economic data in the US and Asia finally showed signs of synchronized growth, setting the stage for the US election, the biggest surprise of 2016.

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Most pollsters and poll aggregators predicted a Clinton presidency. By the time polls opened on November 8th, FiveThirtyEight gave Clinton a 70% chance of winning, the New York Times had Clinton with an 84% probability, and the Huffington Post predicted Clinton had an almost certain 98.2% chance of victory.

We all know what the outcome and next eight weeks brought to the country and to the investing landscape.

The past year highlights the fickle nature of markets and the investors who drive them. Today the expectations built into pricing assets are that the new administration, along with Congress, will shape public policy that enhances economic growth, drives US employment and incomes higher, all while keeping deficits under control. We will also solve our health care problems, enhancing access and lowering costs. These tasks will be handled quickly and flawlessly and we will all live happily ever after.

Call us skeptics, but the certainty priced into today's market is more tenuous than many of the scenarios envisioned heading into 2016. As free market proponents, we are pleased with the policy changes being promulgated in Washington. A more rational tax system, less regulatory burdens, and fair, free trade are the building blocks for economic growth and real income gains. These proposals have already begun to unleash the animal spirits that are vital to get risk capital put to work in our economy. According to November and December surveys, consumer and business confidence has significantly strengthened. This confidence is the welcome change needed to rekindle economic growth. If we are able to implement these policies successfully and in short order, the duration of this recovery will lengthen and pace will accelerate.

The challenge we see in this logic and pricing of equities is that there is limited room for error in execution. Given our cynicism of government, especially in Washington, we expect some challenges in policy implementation as the New Year begins. These challenges, in our opinion, will provide real opportunities for investor sentiment to change course, quickly and violently. It is with this expectation set that we have structured portfolios.

We have rebuilt sizable cash positions by trimming positions in financials, industrials, and other economically sensitive names. We started this process in December for tax deferred accounts, selling the same issues in the first week of January 2017 for taxable accounts (hoping for better tax treatment). These are the stocks that have led the so called "Trump Rally". In fixed income, we selectively added to longer duration assets in the fall, a mistake given the election outcome. We prefer shorter duration bonds and preferreds and will continue to add to positions as appropriate.

2016 was a terrific investment year. We have decided to put some hay in the barn and watch what will no doubt be an interesting time in D.C. and in the markets. For us, it's "Show Me Time".