January 2017

Quarterly Commentary

We have framed our discussions over the past year by highlighting the relative attractiveness of equities as compared to bonds. We suggested that moderate economic growth would lead businesses to grow their profits – and that rising profits would support a similar rise in stock prices. We also expressed our concern that interest rates may be artificially low and that bond prices would decline as interest rates rose. That framework was successful in 2016 and we believe will continue to be a reasonable guide for 2017.

Over the past year, equities as measured by the S&P 500, increased by 11.9% while bonds, as measured by the Barclays Aggregate Bond Index, grew by 2.6%. There was volatility during the course of the year, and importantly, a growth scare during the summer that drove the 10-year Treasury bond yield below 1.5%; but, a more accurate, holistic description might be that investors climbed a wall of worry while being emotionally caught up in the coming election.

What may be more telling for the future is that during Q4, equities rose 3.8% while bonds fell by almost 3% (It was an even more dramatic comparison when measured from election night). There was an outsized cyclical rebound in the financial sector as well as strong returns in smaller cap cyclical stocks. We believe that this signals that markets have begun to expect future pro-growth policies including tax reform, deregulation and an infrastructure fiscal stimulus.

New pro-growth policies will take time to implement, and there are other potentially offsetting issues as well, such as trade, healthcare reform and wage inflation. However, the effect so far has been to awaken animal spirits and increase investor confidence. The surprising election result that gave the Republicans control of both Congress and the Presidency provides near certainty that some pro-business legislation will pass. While nothing is certain in today's world, and the market may already be overly optimistic, we nevertheless believe that there will be opportunities for active management as the new economic order is established.

Concurrently, economic activity in the rest of the world continued to improve in Q4. The risks of further economic deterioration in Europe and China seem to have receded for now as investors' and purchasing managers' confidence levels have risen in both developed and emerging markets. The discussion around US interest rates has changed from fears of deflation to the recognition that inflation is the more likely risk. On this front, we believe that the Fed may raise rates a couple of times during the course of 2017 but will try hard not to crimp nominal growth.

Going back to our framework, we believe the existing economic environment will support a rise in earnings as happened in 2016, even before the implementation of potential pro-growth policies. Further long-term growth could also result from corporate investment in productivity (using tax savings or repatriated cash). Even if some of this potential is currently priced into the market, we believe that equities are still reasonably valued and remain attractive relative to bonds.

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