KayneCast
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Episode 45

A Market Review of 2016 and an Outlook for 2017

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2016 was certainly a year full of surprises. Despite a terrible start to 2016, equities enjoyed a year of very solid returns. The S&P 500 Index was up almost 12 percent and small stocks registered an even more impressive gain, advancing slightly more thant 21 percent. However, large-cap international stocks struggled in 2016, posting a mediocre return of 1 percent. After a weak first half of the year, stocks began an impressive surge in the third quarter that continued through the fourth quarter, led by the surprise election of Donald Trump. Conversely, the broader fixed income market was very strong in the first half of the year, as the yield on the 10-year Treasury fell from 2.27 percent to below 1.5 percent. However, fixed income ended the year only slightly positive, returning 2.65 percent, as 10-year Treasury rates climbed in the second half of the year from 1.44 percent to over 2.4 percent. High-yield bonds performed exceptionally well, returning over 17 percent. However, California munis were flat, returning -0.14 percent, while intermediate bonds returned just over 2 percent.

What Happened in 2016?

Investors' risk appetite changed dramatically during 2016. For example, the first half of the year was marked by disappointing economic growth, falling bond yields and defensive fixed income and equity positioning on the part of investors. After many commodities—particularly crude oil (up 45 percent for the year)—finally found a bottom after two years of dramatic declines, investors adopted a much more aggressive risk appetite as the economy started to stabilize over the summer and improve into the fall. In November, President-elect Trump's pro-business, tax-cutting and less regulatory burdens agenda further accentuated the outlook that economic growth will accelerate further in 2017.

Stock Selection in 2016

The most recent advance of this long-running bull market is being led by banks, industrials, materials and more deeply cyclical (commodity) types of businesses—and not the former leaders like "bond-proxy" types of equities, such as real estate investment trusts, consumer staples, health care and most technology stocks. As we have repeatedly pointed out over the last couple of years, deep cyclical areas, such as energy, have been in a recession—if not depression—over the last two years. However, we believe these areas have started to recover in 2016 and will continue to recover further in 2017—although it's unclear by just how much.

This shift in stock preferences has led the value indexes to dramatically outperform the growth indexes in almost every category (large, mid and small cap) by more than double for the year. That's because the value indexes tend to be populated with many of these deeply cyclical types of businesses, while the growth indexes contain more of these bond-proxy types of businesses.

The increase in interest rates and the steepening of the yield curve has been accompanied by tightening high-yield credit spreads. This type of rate increase is good for equities overall, as it signals an improvement in future growth prospects. Further, the strength in the U.S. dollar due to rising interest rates, in addition to Trump's unclear future trade policies, have caused large-cap international and emerging-market stocks to not participate meaningfully in this recent rally. Smaller stocks have been the star performers because they aren't as negatively impacted by the strength of the U.S. dollar. They are also the primary beneficiaries of an improving domestic GDP environment and a higher risk appetite on the part of investors.

2017's Outlook

As we peer into 2017, we believe there is more than a usual amount of economic uncertainty. President-elect Trump has no public office track record to assess and judge how effective he will be in getting changes accomplished. It seems highly likely that some form of corporate and personal tax reform, partial Affordable Care Act repeal, increased infrastructure spending and less regulatory burden for many businesses will occur over the next several years. However, the timing of these changes is still unclear. If these events were to occur, we believe the economy may accelerate and grow in the 2.5 to 3.5 percent range for the next couple of years. As economic growth increases over the next year, S&P 500 earnings-per-share growth rate should pick up from the low single-digit range to the mid-to-high single-digit range. The biggest unknown is what type of global trade policy will be pursued by the Trump administration, as meaningful tariffs on trading partners risk retaliation and a trade war, potentially providing a negative impact on the U.S. economic growth rate. Given this foggy outlook for 2017, it's more important than ever for investors to keep a properly positioned, well-diversified portfolio that's reflective of their longer-term risk and return profile. We will adjust your portfolios accordingly over time as many of Trump's actual initiatives become reality rather than just pure speculation. In terms of actual stock selection in our proprietary equity portfolios, we will continue to focus on quality companies with protective moats that can do well in multiple types of economic environments.

Thank you for all your confidence and support, and we wish you a happy, healthy and prosperous 2017.