

Q4 Key Takeaways

- Global stocks performed well both in absolute terms and relative to bonds this year, with U.S. stocks again taking the lead.
- Emerging-market stocks were also strong performers, gaining 12.2% for the year. Developed international stocks were the big laggards. They returned just 2.7% in U.S.-dollar terms.
- For the year, core bonds produced a 2.5% gain, in line with our longer-term (five-year) expected return outlook for them. Investment-grade municipal bond returns were slightly negative on the year. While 2016 wound up being a poor year for Treasuries and core bonds, it was a good year for riskier fixed-income sectors such as high-yield.
- While we are optimistic about the markets for 2017, several risks are in play that could derail any upside.

Q4 Investment Commentary

As we look back at 2016 and ahead to 2017 and beyond, we'll leave the political discourse and analysis to others and focus our comments on the financial markets. Our expertise is in our objective analysis of investment opportunities and risks; the application of our analytical insights to the construction and management of diversified portfolios; and the disciplined execution of our investment process over the long term. So, whether one is personally happy or horrified—or somewhere in between—with the outcome of the recent U.S. presidential election, our focus as investment analysts is unchanged.

The year 2016 proved to be tumultuous on many fronts. It began with a steep double-digit plunge in stock markets and ended with a six-week equity rally. Fears of rising interest rates, news flow surrounding oil prices and production cuts, and the political upsets of the Brexit vote and Donald Trump's victory in the U.S. presidential election spilled over into financial markets during the year. Equities and bonds experienced intermittent dives as a result. The year also saw reversals in a number of long-running market trends. Amid

the tumult, global stocks performed well both in absolute terms and relative to bonds this year, with U.S. stocks again taking the lead. Large-cap stocks gained 12.0% and small-cap stocks surged 21.6%. (This marked the eighth straight year the S&P 500 Index had a positive return. While streaks of this length have occurred twice before, the market has never had a nine-year winning streak.) Emerging-market stocks were also strong performers, gaining 12.2% for the year. Developed international stocks were the big laggards. They returned just 2.7% in U.S.-dollar terms. For the third straight year, dollar appreciation was a drag on European stock returns. The major currency decliner was the British pound. It plunged 16% versus the U.S. dollar, triggered by June's Brexit vote. The euro fell 3% on the year. Overall, the U.S. dollar index rose around 4% against a basket of developed-market currencies.

Though core bond prices got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, yields then reversed course, and returns finished at a positive 2.5% by year-end. But that hid a 3.2% tumble during the fourth quarter, as rising interest rates resulted in the worst quarterly performance for bonds in 35 years. Expectations for rising inflation, along with the Federal Reserve's December decision to raise interest rates for the first time since August 2015, further contributed to falling bond prices.

While 2016 wound up being a modestly year for Treasuries and core bonds, it was a good year for riskier fixed-income sectors. Fixed-income sectors with more credit risk (and less interest rate risk), such as high-yield bonds, performed very strongly, gaining 17.5%.

We also witnessed a number of sharp reversals in market trends and consensus views during the course of the year. To name a few: value and cyclical stocks beat growth names (for the first time in several years), while "bond-proxy" stock sectors (utilities, consumer staples, and REITs) underperformed. In the commodity markets, crude oil prices rebounded sharply, doubling from their February lows and reversing a dramatic two-year slide. That pattern was true for commodity prices in general, with the Bloomberg

Commodity Index gaining 20% from its January low (up 11% for the year). The reversal in interest rates, as noted earlier, was also significant. Just as with the U.S. presidential election and the Brexit vote results, very few “experts” predicted these reversals. The consensus was surprised and wrong at the inflection points, as it usually is.

Related to this, we often make the point that markets are prone to both momentum (continuation of a trend) in the shorter term and cyclical behavior (reversion to the mean) in the longer term. We don’t think anyone can consistently time markets—buying in just before an upswing, riding the momentum, and then selling at the top. To the contrary, there is a mound of evidence (academic and industry studies, as well as our own observations and experience) that suggests most investors destroy value over time due to perversely bad timing of buys and sells. They are repeatedly whipsawed by shorter-term price volatility—driven into and out of asset classes and funds by emotional reactions, performance-chasing, risk-aversion, and the lack of a fundamentally sound, long-term investment discipline to guide their decisions. If 2016 is a harbinger of what’s to come, that lack of investment discipline may cause financial harm.

Looking Ahead to 2017

In the weeks since Donald Trump’s election, we’ve observed an increasing number of investment strategists refer to a so-called regime shift. The gist is that the U.S. economy is poised to undergo a number of significant transitions:

- from the dominance of monetary policy since the 2008 financial crisis to an increased emphasis on fiscal policy stimulus,
- from a disinflationary/deflationary trend to a reflationary/inflationary trend, and
- from a 35-year trend of declining interest rates to rising rates.

This is certainly one plausible scenario. But there is tremendous uncertainty in terms of what policies the Trump administration and Congress will *actually* implement, the *timing* of those policies, the *magnitude* of the *economic* impact, and finally, how (and when) *financial markets* will react to and discount those potential impacts—not to mention how the financial markets’ reaction can in turn impact the policies themselves. It is a series of continuous, interactive feedback

loops, which is what makes predicting the results so difficult. In her press conference following the Federal Open Market Committee meeting on December 20, Federal Reserve chair Janet Yellen summed it all up as “a cloud of uncertainty.”

In any case, the consensus narrative at the moment seems to be the Trump administration and Republican-controlled Congress will implement fiscal stimulus via both increased infrastructure spending and reduced corporate and individual tax rates. Potential deregulation across many industries is further stoking market optimism that dormant “animal spirits” (and corporate profits) will soon be revived. We believe tax cuts alone will drive this market higher. It has been estimated that a cut in the corporate tax rate from 35% to 15% would increase S&P profits by 20% (in addition to the 11% already expected). We do not feel this is fully priced into the market.

On the monetary policy front, as the markets expected, the Fed raised the federal funds rate 25 basis points in December (to roughly 0.625%). The Fed also signaled it expects to raise rates three more times in 2017 and another three times in 2018. The Fed has been woefully inaccurate in prior years’ forecasts of rate hikes. A year ago it thought it would raise rates four times in 2016 but did so only once. If it is finally at least in the ballpark for 2017, this would clearly represent a shift from the highly accommodative and unprecedented policies in place since 2008.

The Risks

Government Policy

The run-up in the market since the election may have moved too far too fast. There is no guarantee that the policies discussed, such as corporate tax reform, will get passed. If the stimulus bill costs too much, there may be Republican opposition which would prevent passage. If these events were to occur, they would not be market friendly.

Inflation

Inflation had been gradually moving higher in 2016 prior to the election. Trump’s policy agenda suggests further inflationary pressure is likely. From the perspective offered

by a simple Economics 101 supply/demand framework, fiscal stimulus should shift the aggregate demand curve outward—leading to higher economic growth and rising price pressures. To the extent Trump also carries through on his protectionist trade rhetoric, that would shift the aggregate supply curve inward, at least in the near term. This would also be inflationary but negative for growth.

Trade War

Although an all-out trade war can't be ruled out, it would clearly not be in the country's or U.S. corporations' interest. (With Trump, it seems pretty much anything and everything is on the negotiating table.) It seems likely the demand-expanding effects would outweigh the supply-contracting effects with the net effect being positive for U.S. growth. But again, the timing is uncertain.

Strengthening U.S. Dollar and Rising Interest Rates

The dollar, highly correlated to U.S. interest rates, hit a 14-year high in December while the 10-year Treasury yield hit a two-year high. It is not obvious how much further they will move from here—or even in which direction they'll move. Further complicating things, financial markets are global markets. Policy decisions and outcomes in other countries impact the United States, and vice versa. Treasury yields can only rise so far if other government bond yields with similar risk aren't also rising. The consensus does not expect the European Central Bank or the Bank of Japan to tighten monetary policy any time soon, and with those countries' rates at rock-bottom levels, that should constrain U.S. rates.

While the initial rise in interest rates and the dollar would reflect optimism about stronger U.S. economic growth, at some point higher rates and a stronger dollar become headwinds to such growth and are disinflationary. Higher rates and Treasury yields mean higher variable and fixed mortgage rates, which would hurt the housing market and ancillary industries. Higher rates for consumer and business loans depress demand and spending. Higher rates and expanding government budget deficits from fiscal stimulus also pose risks given the already-high levels of government debt—by raising the nation's debt servicing costs. A stronger

dollar hurts exports and the competitiveness and profits of U.S. companies that do business overseas, hurting S&P 500 earnings growth, as we saw in 2015. Ned Davis Research estimates that a sharp appreciation in the dollar could cut in half the positive growth impact of fiscal stimulus. Rising wages, driven by further tightening of the labor market, which is already at or near the Fed's definition of "full employment," could further cut into profit margins and earnings growth. These are all meaningful uncertainties.

Concluding Comments

As in 2016, we remain bullish for 2017. Yes, the market's valuation is above historical averages, but shouldn't it be if the expectation for economic growth is to accelerate? The tax cuts alone would take care of the market's premium valuation. And there is hopefully a stimulus bill to come that would increase growth further.

While we do cite uncertainties in the market for 2017, what's new? There is always uncertainty in the markets, but over time, the markets prove to be resilient. Looking back to all the occurrences in 2016, it is hard to believe one would have predicted a double digit return for stock markets. Yet, despite all the dooms-dayers, here we are near all-time highs in the market.

Expert predictions of the future are usually no better than educated guesses. (One prominent analyst screamed "sell all your stocks" just prior to the election.) Sometimes they are right, often they are wrong. And the experts who are right one year are often wrong the next. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which themselves are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

We stress the importance of ignoring the "experts" and view investment performance from the perspective of long-term wealth planning. This broader lens is critical in keeping you on track to meet your overall financial and life goals and in not overestimating the impact of any one quarter's, or even one year's, returns. We work closely with our clients both in building and adjusting investment portfolios suited to their

individual risk tolerance as well as in tailoring broader wealth management strategies.

If you would like to discuss recent market events or have questions specific to your financial situation, please do not hesitate to contact us.

On Two Separate Notes.....



One organization we support at Northern Oak is Make-A-Wish® Wisconsin. The Wisconsin Chapter is one of the best performing chapters in the country and in 2016, hit its goal of sponsoring more than a wish per day. Northern Oak and its employees have been involved with the organization for over 20 years. If you are looking to get involved with a great not-for-profit, Make-A-Wish® is one of the best. The organization is always looking for help at its many events held throughout the year as well as wish granters. A wish granter is one who works with wish families from start to finish. For those who cannot donate the time, Make-A-Wish is running a Constellation Campaign where those who donate a minimum of \$500 can have their name and a message engraved on a star that is placed on the walls inside the Make-A-Wish Chapter office in Wauwatosa. We have included a donor form for those interested.

And Lastly....

In addition to services we offer here at Northern Oak, we also team up with professionals in other areas when we think they can add value for our clients. One of those partnerships is with Matt Dunder who can help you with your home financing needs. Matt has 28 years of experience in the mortgage industry. Feel free to reach out directly to Matt at 414-254-4616.



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