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Market Overview 4Q 2016

A Very Political Economy

Summary

- Global equities shrugged off the supposed shock of Donald Trump's election victory, posting broad-based gains for the quarter. U.S. real GDP growth in Q3 was revised upward to 3.5%, faster than Q1's 0.8% and Q2's 1.4%. Investors seemed optimistic that the recent corporate profits recession has ended and expect strong earnings gains in 2017.
- Global government bond yields rose from the very low levels reached in Q3, producing a negative quarter for bonds. Credit spreads in the U.S. and in Europe drifted lower in Q4, extending a nearly year-long narrowing trend. The fourth quarter's rate jump came only after a broad interest rate decline through early summer and bond returns remained positive for the year as a whole.
- The gap between years of market gains and anemic growth has been filled for investors by central bank intervention and stock buybacks. 2016's populist rebellions show voters are less satisfied. 2017 appears to offer a gauntlet of political events and challenges that may shape economic and market outcomes.

MARKET REVIEW

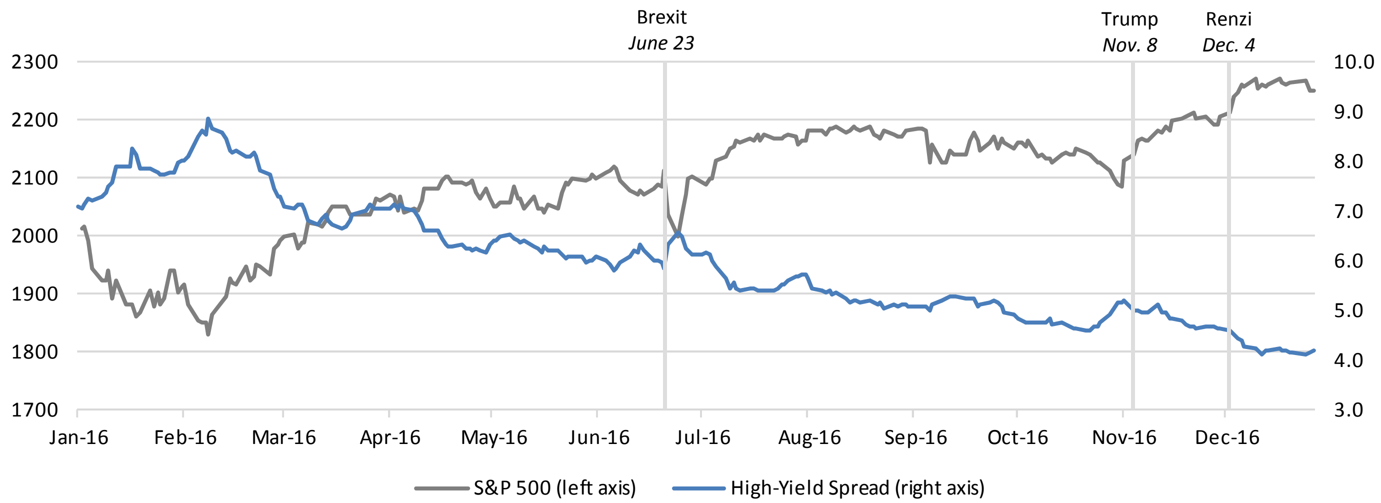
Global Equity Markets

It's hard to know just what will shock the stock market these days. Global equities took only three weeks to bounce back from England's June 23 vote to leave the European Union — widely seen at the time as likely to cause a sharp and enduring downturn. Finance talking heads warned of market doom should Donald Trump defy all expert predictions and win the U.S. presidential election. They were silenced in one day. S&P 500 Index futures fell 5% Tuesday night and global equities sold off sharply, but U.S. stocks opened higher Wednesday, gained 1% by the close and markets across the world followed. Markets also shrugged off a third shock in the form of Italy's early December rejection of Prime Minister Renzi's proposed constitutional reforms, forcing his resignation. Despite two populist political earthquakes (three for the year including Brexit), global equities in Q4 made broad gains. The MSCI EAFE developed market index rose 7.1% measured in local currencies. The S&P 500 advanced 3.8%. European equities gained 5.8% in euro terms. Japan gained 15.0% in yen. Emerging markets lagged as the MSCI Emerging Markets Index lost 1.4%; both China and India declined about 7% in local currencies. The MSCI All Country World ex-U.S. Index (ACWI ex-U.S.), a global index containing developed and emerging markets, gained 5.0%.

Renewed strength in the U.S. dollar eroded global returns for U.S. dollar-based investors. The MSCI ACWI ex-U.S. Index returned -1.2% in dollars while the developed market MSCI EAFE lost 0.7%. However euro-based global investors with U.S. equity exposure gained from dollar strength; the MSCI All World Index gained 8% in euros, supported by an 11% U.S. market surge due in part to the dollar's rise.

Several factors seemed to account for the quarter's strength. The U.S. economy put in a strong third quarter with real GDP rising 3.5%, faster than Q1's 0.8% and Q2's 1.4% and its best quarterly pace in two years. Investors seemed optimistic that the recent corporate profits recession has ended and expect broad gains in 2017. The energy sector has been helped by oil prices that have remained near $50/barrel, well off early 2016 lows

I. The "Shock" Market of 2016 — Brexit, Trump, Renzi



Source: Federal Reserve Banks of St. Louis (FRED website)

under $30/barrel; a late November OPEC production deal and subsequent buy-in by non-OPEC producers seemed to keep investors confident in further energy sector stability. Finally, Donald Trump's election morphed from a dire threat to a market opportunity within hours of his victory; campaign promises of reduced regulation, lower taxes and aggressive fiscal stimulus fomented bullish economic sentiment that overwhelmed concerns about his trade protectionist views. The market's Q4 gains were a smooth extension of the rally that began early in the year, but became a "Trump rally" after election day.

The quarter's rise was led by sharp gains from financials and energy. U.S. financials jumped 21.1% on optimism that more Fed rate hikes and a steeper yield curve will help profitability, which has been crushed by years of near-zero short-term yields and declining net interest margins, and on potential walk-back by a Trump administration of some of the regulations imposed after the financial crisis. Energy gained 7.4% in the U.S. on steady oil prices. Financial and energy also led markets globally, gaining 9.5% and 10.2% respectively in the MSCI EAFE. Strength from financials and energy along with optimism for stronger growth extended value's recovery; the Russell 1000 Value gained 6.7% versus a 1.0% gain for the Russell 1000 Growth. Small-cap stocks had a relatively strong quarter too, with the Russell 2000 up about 9%, also on strength from its financials and energy names.

The fourth quarter capped what turned out to be a surprisingly strong year for stocks after worries about China's slowing economy, plunging world oil prices and fears of a global economic downturn caused a 10% sell-off through February. The S&P 500 gained 12.0% for the year and the Russell 1000 Value returned 17.3%, 10% more than the Russell 1000 Growth on energy and financial sector strength (and avoidance of growth's weak biotech names). Global developed markets gained a more muted 5% in local terms, held back by Japan's essentially flat year, while emerging markets gained about 10% in local currencies, due in part to a more than 35% surge by Brazil and Russia after multi-year declines. The dollar's rise late in the year slightly eroded full-year gains for dollar-based global investors; in dollars the MSCI ACWI ex-U.S. Index gained 5.0% versus 7.6% in local currencies.

Global Fixed Income Markets

Global government bond yields rose from the very low levels reached in Q3, producing a negative quarter for bonds. The 10-year U.S. Treasury yield jumped from 1.6% as Q3 ended to 2.4% at yearend. The German 10-year turned positive, rising from -0.12% to 0.36% by mid-December before closing the year at 0.20%. France rose from 0.20% to 0.68% and Italy from 1.2% to 1.8%. Japan edged above zero, rising from -0.10% to 0.04%.

The U.S. Federal Reserve in mid-December raised the federal funds target 25 basis points, to a range of 0.50% to 0.75%, its first hike since December 2015 and only the second in the past decade, and noted three or more hikes are likely in 2017 if economic strength permits. In Europe, on the other hand, the European Central Bank (ECB) extended the horizon of its quantitative easing program from March 2017 to the end of the year, slightly reducing the monthly purchase rate from 80 billion euros to 60 billion but loosening restrictions on bonds than can be bought to include even negative-yielding debt. U.S. government yields jumped across the curve, rising about 20 basis points out to one-year and 70 to 80 basis points as maturities extended.

Yields on an index of Euro government bonds out to the four-year maturity declined further in Q4 and remained negative to eight years, while a 30 to 50 basis point jump in longer yields pulled yields for long maturities back to the levels of Q1, at 0.7% to 0.8%.

Credit spreads in the U.S. and in Europe drifted lower in Q4, extending a nearly year-long narrowing trend. U.S. high-yield spreads in particular remained well below their range in January and February when global growth fears and sharply falling oil prices rattled markets.

The Bloomberg Barclays U.S. Aggregate returned -3.0% for the quarter while mortgage-backed (MBS) and asset-backed (ABS) indices returned -2.0% and -0.7%. U.S. high-yield returned a stronger 1.8%. The Global Aggregate (in euros) returned about -1% for the quarter. On a duration-adjusted basis in the U.S., corporates and high-yield notably outperformed other sectors, followed by commercial mortgage-backed securities (CMBS), while asset-backed (ABS) and residential MBS lagged.

The fourth quarter's rate jump came only after a broad interest rate decline through early summer and bond returns remained positive for the year as a whole. The Bloomberg Barclays U.S. Aggregate returned 2.6% for 2016, ABS and MBS each returned about 2%, while U.S. high-yield returned more than 17% (energy high-yield gained more than 40% for the year). The Global Aggregate (in euros) returned 5.1% for full-year 2016; its Treasury component returned 4.7% while corporates returned about 7.4%. Duration-adjusted excess returns in the U.S. for the year were the same as in Q3: high-yield led returns and was exceptionally strong, corporates also showed strength, followed by CMBS and ABS lagged, while MBS was slightly negative.

Global Economic Review

Rising consumer spending helped spark the U.S. economy's 3.5% Q3 real GDP gain but income growth, consumer spending and inflation slowed going into Q4 and economists see growth reverting to a more sluggish 2% pace. Some analysts in fact cited rising Affordable Care Act insurance premiums as a cause of Q3's consumer spending gains. While inflation measured by the consumer price index ex-food and energy held just over 2% for much of year, the Fed's preferred inflation measure, the personal consumption expenditure (PCE), is closer to 1.5%, well below the Fed's 2% target. The many uncertainties associate with economic policy in a new Trump administration make forecasts even more tenuous than usual, yet market ebullience since the election has not changed the muted outlook for 2017 and 2018, with real GDP growth expected to be just over 2% each year.

Europe's economic lethargy caused the ECB's December move to extend QE through yearend, with a promise to raise the pace of monthly purchases if need be. Eurozone economic strength faded rather than strengthened during 2016, with full year growth estimated at 1.6%, down from 2015's 1.9%, while 2017 growth is pegged at just 1.5%. Pessimism about the economy in the aftermath of the Brexit vote was what declined in the U.K. as the year closed, and the consensus outlook for 2016 real GDP jumped to 2.0% from 1.7% during the summer. For 2017, U.K. growth is expected for slow to 1.1% but that's up from a 0.8% estimate after Brexit. There was little change in prospects for Japan's glacially slow pace of growth — where expectations remained mired in a range of 0.6% to 0.8% through 2018. Asia remains the strongest global region, despite China's slowdown and potential for a banking crisis (which has dogged its outlook for years, so far without much effect). While China's expected 6% growth over the next several years represents its slowest pace in decades, it's one of the world's strongest outlooks. India (despite disruption from its move to restrict cash use) and the Philippines show consensus outlooks for 6%+ expansion and several other south Asian nations appear set for 3% to 4% expansion — yet these economies aren't large enough to pull the rest of the world along.

Yet optimism persists on the corporate profit front. S&P 500 earnings are set to rise 11% to 12% in both 2017 and 2018, according to analysts estimates at yearend. Corporate earnings in Europe are pegged to be up 15% in 2017 and 10% in 2018. The disconnect between economists' growth and analysts' profit expectations remains a wildcard for earnings outlooks in 2017.

A Very Political Economy

Last quarter's letter chronicled the wide gap between years of market gains and frustratingly anemic economies that have crimped corporate profits and embittered developed nation citizens marginalized by globalization and global finance. This gap has been filled for investors by central bank intervention and corporate stock buybacks financed by low-cost debt. Global voters have been less satisfied and their frustration was evident in 2016's three political "shocks." A study by Princeton and Harvard economists ("The Rise and Nature of Alternative Work Arrangements in the U.S., 1995-2005") published in September gave substance to the populist anger that took mainstream pundits and politicians by surprise, finding that nearly all job gains in the past decade came from the "gig economy," a mix of independent contractor, freelance and contract company jobs that lack the structure and protections of nine to five full-time employment. The "deplorables" seem to have reason for their rage.

2017 appears to offer a gauntlet of political events and challenges that may shape economic policies and market outcomes. Donald Trump's "Make America Great Again" campaign slogan nostalgically echoed Ronald Reagan's "Morning in America" from the early 1980s. Since his election, Mr. Trump has skillfully cultivated a Reagan-like optimism. But President Reagan took charge after a recession, with interest rates near 20%, a stock market PE of 12 and U.S. debt less than its GDP. Mr. Trump, who called the stock market a "bubble" during his campaign, faces an opposite, uphill climb on all fronts, and budget hawks within his own party who may impede his plans.

Europe is struggling with a refugee crisis and terrorist attacks in addition to economic weakness. A French presidential election and Dutch parliamentary elections in spring 2017 and German parliamentary elections in the fall all have potential for populist or nationalist anti-EU drama. Europe has so far been able to contain Italy's banking crisis, carrying 360 billion euros of bad loans (about 20% of Italy's GDP) with a mix of bureaucratic maneuvers and ECB support. Europe navigated a continent-wide fiscal crisis in 2012, but has found no enduring solution to its problem of a common currency without a common fiscal framework. The structural economic differences and complex frustrations between European core and periphery, and increasingly within nations at a remote EU bureaucracy, may yet produce another crisis. Or they may not.

Global politics in 2017 will also have to contend with U.S. and Russian tensions, now at their worst since the cold war, and China's tensions with Taiwan, Japan and its muscular territorial claims in the South China sea which have intimidated its neighbors. A Trump administration's protectionist policy toward China will have uncertain ramifications.

Economics was called "political economy" before being overrun during the 20th century with a mathematical formalism that borrowed heavily from the methods of classical physics, including its nomenclature. But money is a social construct and ultimately a form of social imagination. It is not a particle with mass, density, velocity and momentum. Money is everywhere and always a political phenomenon. Economic laws are culturally determined, not absolutes of nature like gravity or the speed of light. Economic models and equations can only go so far to explain, let alone predict, the human condition. As both a form and product of social cooperation, money is ultimately an expression of political success or failure. Can political institutions, and their leaders, navigate the challenge and tensions that seem certain to afflict economies in 2017? That would seem to be the biggest question for investors in the year ahead. Markets will likely be driven by political events, perhaps to a degree greater than any year since the financial crisis of 2008/2009.■