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GROUP
Investment and Financial Consultants

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2016 REVIEW AND OUTLOOK FOR 2017

The stock market ended 2016 in a much different manner than it began as excessive pessimism ultimately was replaced by extreme optimism. At the beginning of the year, the stock market plunged due to concerns regarding deflation, sharply declining oil prices, the potential for rapid interest rate increases by the Federal Reserve Board, and a slowing global economy. Stocks recovered from their February lows, but became volatile again during the summer as a result of the Brexit vote in Great Britain. The stock market then settled into a neutral trading range until November as investors were unwilling to take significant risks prior to the contentious election. However, once the election was over and decided, a year-end relief rally ensued. As a result of these late-year gains, the S&P 500 Index finished 2016 up 9.5%, while the Dow Jones Industrial Average gained 13.4%. Conversely, due to rising interest rates late in the year, traditional bonds regressed from their strong start to the year and the Barclays Intermediate U.S. Government/Credit Bond Index returned only 2.08% during 2016.

It is said that financial markets do not like uncertainty, and one of the primary producers of uncertainty in 2016 was the U.S. presidential election. On November 8th, when it looked as though the election results differed from the pre-election polls, stock index futures plunged, signalling a potentially dramatic market decline the next morning. However, stock indexes surpisingly reversed and finished the day-after positively. The post-election rally continued for several weeks as investors cheered the prospect of lower corporate and personal income taxes, increased spending on infrastructure, and deregulation under an undivided Republican-led Congress and Presidential administration. This also led to forecasts of stronger economic growth going forward, which could lead to more robust corporate earnings, on which stock prices are based. Towards year-end, many investment managers began buying stocks for fear of missing out on what was quickly turning out to be a much better year for the stock market than most expected.

Furthermore, since the election, a noticeable shift in the returns of various asset classes has taken place. For example, small- and mid-size U.S. company stocks have performed particularly well versus large company stocks after underperforming for several years. One reason for this is that more restrictive international trade policies proposed by the new administration could lead to less competition from foreign companies and their imports, benefitting small-size U.S. companies who primarily manufacture and sell products in the U.S. Also, the U.S. dollar has continued to strengthen. A stronger U.S. dollar may negatively impact the earnings of large U.S. companies that do business overseas without negatively impacting small company earnings. Financial company stocks have also been outperforming other sectors of the economy after underperforming in the past. The potential deregulation of the financial industry and rising interest rates are seen as positives for the financial sector. Further examples exist of previously underperforming sectors of the stock market suddenly outperforming.

In addition to the post-election stock market surge, interest rates in the bond market spiked after the election. One possible reason that interest rates have risen so quickly is that bond investors sense that economic growth will accelerate in the future as a result of the new administration's policies. Another possible reason for rising interest rates is that investors may not only sense economic growth, but also

the potential for inflation in the future. Interest rates in the bond market rise when investors anticipate inflation because fixed-income investors demand a higher interest rate to compensate them for the higher cost of goods and services. Investors also anticipate that if inflation rises faster than previously expected, the Federal Reserve Board will be forced to raise interest rates rapidly to stop the expansion. It is also conceivable that interest rates have increased because bond investors are sensing that the country's debt level will continue to increase, making the U.S. less credit worthy to potential bond-buyers.

Rapidly rising interest rates could lead to a negative outcome for bonds, stocks, and the economy down the road. When interest rates rise, the values of existing bonds typically decline because investors can buy similar, newly-issued bonds that pay higher interest rates. Stocks may also decline as investors eventually move money from the stock market back to fixed-income investments because they can now earn a higher fixed rate of return on cash, bonds, and CDs than they have been able to earn in many years. The economy could also suffer if individuals and corporations have to pay higher rates of interest to borrow money. For example, rising mortgage rates, auto loan rates, student loan rates, and corporate loan rates could negatively impact the housing market, consumer spending, and corporate earnings, leading to lower stock prices. As long as interest rates do not rise too quickly, economic growth should continue and not become a threat to stock or bond prices.

We will continue to keep an eye on stock and bond prices to see how they react as new fiscal and international trade policies are proposed and potentially passed in Congress. We will also monitor the Federal Reserve Board's monetary policy changes this year. Economic growth without inflation would be preferable and would give the Fed time to raise interest rates slowly without harming the financial markets. In the meantime, we continue to favor short-term bonds over long-term bonds because short-term bonds tend to hold their value more than long-term bonds when interest rates rise. We also continue to favor U.S. stocks over foreign stocks. We are beginning to feel more comfortable taking a bit more risk investing in domestically-oriented small- and mid-size companies for the first time in several years. If inflation rears its ugly head, we may begin to look to commodities as an inflation-hedge.

In the meantime, please call us if you have any questions or concerns regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Barclays on December 31, 2016.*

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