AMB Newsletter
4th Quarter 2016

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<u>2016 Overview</u>

Looking at the 12% gain in the S&P during 2016 might make one forget that 2016 was a volatile year filled with surprises. January started out exceptionally rough, being the worst start to a year for the market. At one point in February, the market, measured by the S&P 500, had fallen nearly 15% from recent highs. This seemed to be due to a culmination of factors. Oil fell to $23 per barrel, which was down from $100 in 2014. Additionally, the FOMC initiated a rate hike for the first time in a decade. Moreover, global slowdown concerns mainly connected with China and stretched valuations of the overall market. Together, this created a recipe for disaster early in the year. As these events calmed down and investors realized the world was not coming to an end, the market reversed strongly off of the February lows and posted a positive return for the 1st quarter.

The next bout of volatility was at the end of the 2nd quarter. Markets were hit with the shock of the UK referendum vote known as Brexit, in which the UK voted to leave the European Union. This took the market by surprise and led to a steep sell-off in risk assets. However, as we expected, this was short lived and the markets recovered during the 3rdquarter. In our previous letter, we stated, our belief in that the market would finish the year strong. Once the election was determined, that is what happened. In October, leading up to the U.S. election, the equity markets were in negative territory for the quarter. November 8th was another surprise not many saw coming in that Donald Trump won the electoral vote over Hillary Clinton becoming the President Elect of the United States. The initial reaction was limit down in US equity markets overnight. Attitudes quickly took a 180 degree turn, and the market moved dramatically higher led by financials and healthcare into year end. The 4th quarter also gave us volatility in interest rates. After moving lower all year, a massive reversal took place, which took the intermediate and longer end of the curve back to where it started the year. Even with the move in rates, most fixed income portfolios still posted a positive return for 2016.

<u>1st Quarter 2017</u>

US Economic growth continues to improve, albeit, at a very sluggish pace. The US posted another year of sub 3% GDP growth in 2016, but things may begin to turn. Growth in the 3rd and 4th quarters picked up from the slow pace seen in the first two quarters. The labor market also showed continued improvement into the end of the year. The incoming administration is planning on increasing fiscal stimulus, reducing burdensome regulation, and lowering tax rates, which could help drive growth in the coming years. Since the election of Donald Trump, inflation expectations have been on the rise, with the expectation of growth driven by fiscal (public spending and taxation) instead of monetary stimulus (interest rates and reserve requirements). This is a massive change of guard and will take some time to implement.

In our view, US growth and inflation prospects will continue to track wages and business spending. Although proposed policies from the new administration will perhaps drive growth and inflation, we believe 2017 will continue to show sluggish gains in economic growth. Wage growth did increase in 2016, but we are not sure these gains are sustainable.

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We are already seeing massive layoff proposals to start 2017, and further wage growth gains may be few and far between. We maintain wage inflation will continue to be the key to domestic growth for the simple reason that 70% of the US economy is made up of consumer spending. Until we see a steady improvement in wage inflation, US growth and inflation will remain subdued. In our view, the problem with wages lie, not in the number of jobs being added in the economy, but in the quality of jobs added. Low quality jobs have comprised a major portion of job additions since the financial crisis, which will not fuel additional economic growth or inflation.

We do see a very positive driver for the US economy based on the incoming administration's campaign promise, which is fixed business investment, absent since the financial crisis. The burden companies faced from ACA, tax rates, and other regulations could begin to lighten as we move forward. Capital expenditures may be a major driver for future growth and with the amount of cash on company balance sheets, it could help push the US economy out of the malaise we have endured since 2009.

Federal Reserve – The Federal Reserve has dominated headlines since 2009 because of the deployment of unconventional monetary policy tools to help spur economic growth. The accommodative policies implemented over the past few years have included Quantitative Easing (outright buying of bonds) and ZIRP (Zero Interest Rate Policies). These programs have moved rates lower and driven money out of fixed income investments and into risky assets.

The Federal Reserve increased rates for a second time in December, which is what we predicted going into 2016. In their last statement, they projected three rate hikes in 2017, which we believe is too aggressive. In their statement, they seem uncertain of the impact of fiscal stimulus the new administration is projecting. It may increase economic growth and spur inflation, but it will also add to the already massive U.S. debt. Any increase in rates could cause the US economy to stumble, which will push the Fed to once again become accommodative.

We believe the Federal Reserve's policies will continue to have a lesser impact on the market. This seems to be the consensus even within the Central Banks themselves. However with the US Congress in deadlock and the EU implementing austerity reforms, the burden of spurring growth has been on the shoulders of Central Banks; however, their ability to move markets is waning. The market's resopnse to President-Elect Trump's promises of infrastructure spending, tax and healthcare reform even without actual specifics shows the readiness for a different approach. It seems market participants are ready to see if fiscal stimulus can pull the US economy out of the slow pace of growth we have seen since 2009.

Equity Market – In our previous newsletter, we stated, *"After the horrific start to 2016, the equity markets have made a nice turn around, setting us up for another solid year of returns. So far, this year the equity market, measured by the S&P 500, is up approximately 7.5%. As we stated after the February selloff and the rough first quarter we were optimistic on the equity markets going forward. We were able to use the beginning of the year as a pretty good entry point to reduce cash in our model holdings and add positions that we believed to be undervalued. We will continue to employ this strategy and use downside volatility in the markets as entry points."*

This strategy paid off for most market participants. The S&P 500 finished the year up 12%.

Going into 2017, we are less optimistic about equities than in 2016, but still far from bearish. As expected, second quarter of 2016 seems to have marked the trough for the S&P's earnings. We expect earnings growth in 2017 to be between 5-10%. We see a positive driver for American corporations coming from the new administration's policies which includes tax reform, reduced regulation, and other business friendly practices. These factors should help drive earnings growth going forward. However, stronger growth policies in the US will also drive the US Dollar higher. We believe this will hamper some of the effects of the new proposed business friendly practices for the larger capitalized multinationals. We also believe these policies will take years to implement and play out. It seems markets have priced in perfection for the new administration; however, we know there will be bumps in the road, which we will view as buying opportunities.

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Equity Market - One question we have been asked quite often is, “will higher rates affect US equities?” In our view, as long as higher rates are driven by increased growth, we do not believe an increase in rates will have a major impact on US equities. Bonds become more competitive with equites on a yield only basis, but when the market is experiencing earnings growth, it must be added into the equation. Total return for equities are driven by price and dividend. As equity prices increase, the yield portion of the returns are lowered, but if it is accompanied by a growth cycle in earnings, we believe prices will continue to move higher and equities will remain in favor.

We continue to believe the higher yielding sectors of the market remain overvalued as we wrote in our last letter.

“Sector allocation and a bottom up approach are going to be very important going forward. With rates being near zero we have seen money pour into higher yielding stocks. We positioned ourselves to take advantage of this a couple of years ago, but we are now to a point where we believe this trade is crowded and the stocks in those sectors have become overvalued.”

This pushed us into a reducing our weighting in consumer staples in the 4th quarter. The move paid off as staples and utilities underperformed the broader market by a wide margin. Going into 2017, our strategy remains the same as the latter half of 2016. We still believe the higher yielding, more defensive sectors are overvalued. We continue to like information technology, health care, consumer cyclical and certain sub groups in financials.

Fixed Income- From November 8, 2016, through the end of the year, interest rates gave up all of their gains for the year. Despite what the pundits are saying about the destruction of bond portfolios and the end of the 30-year bond bull market, most portfolios still finished in positive territory, especially the longer dated portfolios.

The consensus going into 2017 is interest rates are going to continue to move higher, being pushed by growth-stimulative policies from the new administration. We are usually on the other side of what experts are saying when it comes to interest rate predictions. We expected lower rates for the last 5-years when everyone else was calling for the opposite, and it seems we will be taking the other side once again. We think rates will remain low in 2017 and expect the 10-year to stay in a range of 1.8-2.70%. This is not to say rates won’t increase. As we have said before we expect the shorter end of the curve to move higher, but the longer end, which is driven not by monetary policy but by actual growth and longer term inflation expectations, to remained subdued.

We also need to remember why we invest in fixed income. It is not the growth engine of our portfolios, but it is what brings stability and predictability to them. If we are in a buy and hold strategy, interest rate movements are irrelevant as we are investing for a stream of cash flows and we know that principal will be repaid upon maturity as long as the bond is credit worthy. Pundits that speak to fixed income being riskier than the stock market are making a generalized blanket statement that we feel is just not accurate.

Conclusion – Overall, the market had quite an eventful 2016, making a huge comeback toward the end of the year after a a host of political and economic events that few could have predicted. In the end of the 2nd quarter, Brexit shocked markets around the world, positioning Europe for a dramatic economic restructuring and the potential renegotiation of trade deals. The effects of this were short lived as the market regained confidence and recovered relatively quickly. Soon after the markets shifted their focus to the U.S. election, where Donald Trump’s upset victory incited a market reaction few expected. The volatility expected to ensue with a Trump win instead paved the way for the recently dubbed “Trump Rally” as investors continue to watch many indices reaching record highs. In conclusion, 2016 was an eventful year for the market that ended on an extremely positive note.