WealthHealth
Personal Wealth Management

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Market Review

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, U.S. stocks overall performed well and again took the lead, with larger-cap U.S. stocks gaining 11.96%. Developed international stocks returned just 1% in U.S.-dollar terms. European stocks in particular continued to face headwinds, falling 0.4% on the year. In both cases, the strength of the U.S. dollar weighed on returns.

With the knowledge that financial markets are volatile and the returns of various assets classes are cyclical, we intentionally construct globally diversified investment portfolios that are designed to be resilient across a variety of economic and financial market scenarios. By definition therefore, over any relatively short period of time, certain components of a balanced portfolio will do well while other components will inevitably lag.

Index Returns — *Through 12/31/2016*

			Annualized Returns		
Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	3.82%	11.96%	11.96%	8.87%	14.66%
Russell 2000	8.83%	21.31%	21.31%	6.74%	14.46%
MSCI EAFE	-0.71%	1.00%	1.00%	-1.60%	6.53%
MSCI All Country World Index	1.26%	8.40%	8.40%	3.25%	9.62%
MSCI Emerging Markets Index	-4.16%	11.19%	11.19%	-2.55%	1.28%
Barclay Capital US Aggregate Bond	-2.98%	2.65%	2.65%	3.03%	2.23%
Barclay Capital Municipals	-3.62%	0.25%	0.25%	4.14%	3.28%
Bloomberg Commodity Index	2.66%	11.77%	11.77%	-11.26%	-8.95%
HFRI Fund of Funds Composite Index	1.05%	0.71%	0.71%	1.26%	3.46%

As mentioned above, large-cap stocks gained 11.96%, marking the eighth straight year the large-cap S&P 500 Index had a positive return. This ties the streak from 1982–1989 and only the period from 1991–1999 saw a longer streak, at nine years. If the start of 2017 is any indication, this year may tie the record.

Emerging-market stocks were also strong performers, gaining 11.19% for the year. Developed international stocks were the big laggards. They returned just 1% in U.S.-dollar terms. European stocks did worse, falling 0.4% in dollar terms, although they gained 7.2% in local-currency 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.

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For 2016, the bond market didn't fare as well as a rising rate environment weighed on returns later in the year. Though core bonds got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, rates then reversed course, rising to 2.5% by year-end. In the fourth quarter, the Barclays US Aggregate Bond Index fell 2.98%—its worst quarterly performance in 35 years— due to rising interest rates. For the year, core bonds gained 2.5%. But while 2016 wound up being a poor year for Treasury's and core bonds, it was a good year for riskier fixed-income sectors such as high-yield bonds and floating-rate loans, which gained 17.5% and 10.2%, respectively. We are focused on this type of credit risk in lieu of interest rate risk within our fixed income allocations as we think this trend is likely to continue throughout the year and beyond.

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. Looking ahead we see a shift from deflation to inflation and from low interest rates to higher rates, and to a new administration more focused on fiscal rather than monetary stimulus. The combination of the Fed's plans for three additional interest rate hikes and promises from the incoming presidential administration and Republican-controlled Congress to significantly increase spending will likely translate into higher debt servicing costs for both consumers and the government (i.e., taxpayers). This resulting headwind to core bonds has us maintaining our expectations for actively managed flexible and unconstrained bond funds to produce at least solid mid-single-digit gains, helped by the improving growth outlook (which should be good for the funds' corporate credit exposure) and their lower duration (interest rate sensitivity) as mentioned above.

Managing downside risk is an integral part of our investment process, but it is especially challenging in this environment of low, though rising, interest rates. With core bonds offering very little portfolio protection, we continue to look to liquid alternative investments to hold their own in sharp risk-off environments. We are optimistic regarding the potential for our portfolios to continue to benefit from the trends that got underway in 2016, including rising interest rates. Should they play out, we believe this cyclical shift should see our equities and fixed income positioning as well as our investments in lower-risk alternative strategies poised to deliver solid returns.

Our analysis leads us to stay the course, maintaining a focus on our investment discipline, as opposed to trying to forecast economic or political outcomes, which we believe are inherently unpredictable.

Expert predictions of the future are usually no better than guesses. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

Even if one could know in advance the outcome of many of the important individual variables (such as election results, central bank policy decisions, and currency movements), one would still be likely to make many inaccurate market forecasts. For example, how many experts would have predicted gold would drop and stock markets would rally in the days and weeks after an unexpected Donald Trump election victory?

We don't bother guessing what financial markets will do. If we had to make a forecast for next year, or any year, it would be this: Expect the unexpected. Prepare to be surprised. Stock markets will be volatile; they will go up and down—probably a lot.

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