Market Commentary

Fourth Quarter 2016

Fredric P. Lutcher, CFA
Managing Partner

Thomas J. D'Auria, CFA
Managing Partner

The fourth quarter was a volatile one for US equity markets, with the US presidential election coming near the halfway point in the quarter. From Election Day onwards, equity and fixed income moved in opposite directions. The benchmark S&P 500 Index had a total return of 3.8% during the fourth quarter which brought the calendar year total return to 11.96%. From the February lows, the S&P 500 rebounded almost 25% through year-end. The 10-year note yielded 2.45% on December 31, 2016, well above the 1.60% yield at the end of September, although not significantly higher than the 2.27% at the end of 2015. November saw the largest one-month increase in Treasury note yields since December 2009. Returns for most fixed income holdings were negative during the quarter, with only high-yield credit posting a positive return as the spike in yields caused principal losses across most credits.

Economic and Market Outlook

With the US elections now behind us, investors can once again focus on investment fundamentals and valuations. While political pollsters and "experts" had egg on their face after getting the Presidential election quite wrong, many stock market prognosticators also took it on the chin. Most had predicted that a Trump victory would be very negative for stock prices. In fact, in the weeks before the election, US equities traded in lockstep with the rising or sagging chances of Trump and Clinton. When Trump was doing better in the polls, the stock markets declined. Conversely, when he was doing worse, markets rose. This led the talking heads to determine that markets would do better if Clinton were elected. Yet stocks rallied sharply since the election and bonds sold off. Many are asking why? Tandem believes Trump will reduce corporate tax rates, increase government spending on infrastructure, and reduce regulatory pressures. All of these should lead to higher corporate profits. Since the election, the sharp movements in both equities and fixed income show that markets are assuming economic growth, inflation and interest rates will be higher than previously expected, while the unemployment rate will likely be lower. Recent economic releases show the consumer is in good shape, and the overall economy is improving. This will lead to a resumption of earnings growth in 2017 and beyond. We also point out the US economy has added private sector jobs for 80 straight months which has resulted in the lowest official unemployment rate in over nine years. We have long disdained the official unemployment rate as misleading, but we do agree that employment is trending better. Wage growth and consumer confidence have been rising with the latter statistic at its highest level in a decade. It is these more enduring statistics that give us confidence in the equity markets going forward, rather than the more nebulous ideas of what the incoming administration might do. We continue to repeat our fundamental belief in choosing the proper asset allocation for your individual situation and staying true to it in good times and in bad. Emotional decisions based on fear or greed lead to missed opportunities, trading losses, higher taxes, and lower overall returns.

As evidence of this we note that individual investors were once again chasing performance during the quarter, particularly following the election. In the two weeks after the election, domestic equity funds had inflows of $30 billion, after steady outflows since the start of the year. Conversely, bond funds saw outflows of $11.4 billion over the same period after ten months of continued inflows. This performance chasing is why individual investors tend to underperform indices as well as professional investment managers on a regular basis.

29 Emmons Drive, Suite A-5
Princeton, NJ 08540
Tel 609-452-2100
Fax 609-916-1280

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628
Fax 928-458-7100

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An agreement by OPEC to reduce oil production was reached in late November which boosted energy prices. WTI oil reached $53.72 a barrel up from $48.06 on September 30. While we have long expected oil prices to stabilize around $50, there is little reason to expect significantly higher oil prices from here due to the huge amounts of shale production that becomes very profitable in the high $50s range. If there are no geopolitical flashpoints in the coming months, oil should remain in the $40 to $60 range which benefits consumers yet allows oil producers to earn a decent profit.

In mid-December, the Federal Reserve increased the Federal Funds rate by 25 basis points to a new target range of 0.50%-0.75%. This was one of the most telegraphed rate hikes in history and equity markets were well prepared for the increase. The Fed now believes they will increase rates by a total of 75 basis points in 2017, and a similar 75 basis points in 2018 which would bring the Fed Funds rate to approximately 2% by late 2018. Fixed income markets sold off following the announcement which is a bit puzzling since even if the Fed follows through on its plan, interest rates in 12-18 months will still be well below where economists had predicted as recently as three months ago.

Portfolio Positioning

With the election behind us, the largest uncertainty to markets has been removed. It is not a stretch to predict the incoming administration will be far more business friendly than the prior one. The two main areas to watch are regulatory and tax policy. Removing regulatory burdens in many sectors will allow economic growth to rebound to well above the 2% level we had been told was the “new normal”.

We also believe the markets seem to be transitioning from an interest rate-driven to an earnings-driven secular bull market. After two years with no earnings growth, corporations are seeing a resumption of bottom-line growth along with expectations of reduced corporate taxes which could drive earnings growth for the next few years. The higher economic growth rates and interest rates in the US versus most other developed markets have led to a persistently increasing US Dollar during the past 24 months. This has made earnings growth for US multi-nationals more challenging and has favored companies that get a greater percentage of their overall revenues from domestic markets. This has led us to companies that are slightly smaller in overall size.

Conclusion

As we look into 2017, we can be certain of a few things. Change is coming. It is coming to financial markets, to regulatory agencies, and it is coming to individuals via likely tax changes. The very strong equity returns since Election Day may have borrowed a bit from 2017’s returns and we would not be surprised to see a short-term pullback from record levels. With more clarity on interest rates, a better environment for corporate America, and consumer-friendly legislation for taxes and healthcare expected, we believe the bull market can continue for a few more years at least, although short-term declines along the way are probable.

In closing, we wish you and your loved ones a safe, happy and healthy 2017. We continue to encourage feedback from our clients. Please call or email us if you have any comments or questions about your investment portfolio.

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29 Emmons Drive, Suite A-5
Princeton, NJ 08540
Tel 609-452-2100
Fax 609-916-1280

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Prescott, AZ 86303
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