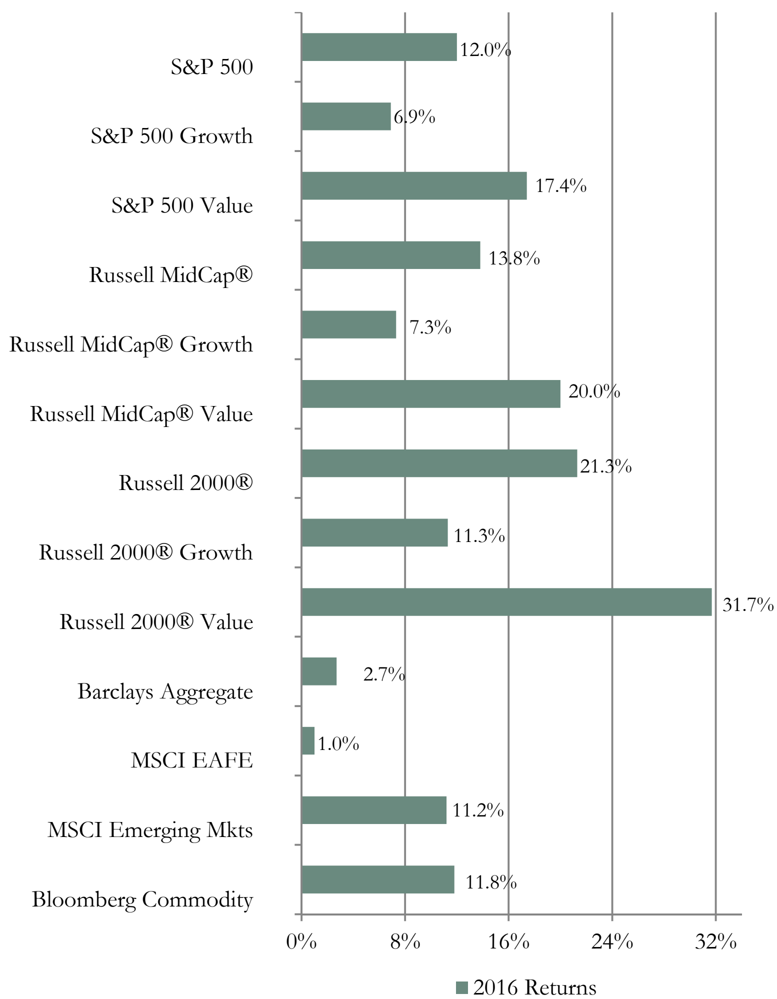
Market Summary – Year-End 2016

2016 was a positive year for major financial market indices. Returns for many indices, especially small-capitalization (cap) and emerging markets (EM) stock indices, turned out to be much higher than strategists had predicted at the beginning of the year. Several equity indices set numerous new record highs throughout the year. However, the path to the positive calendar year returns was not a smooth upward trend. The year was characterized by three distinct bouts of short-term volatility. These periods of volatility were related to: 1) the concerns about slow global growth and falling oil prices at the start of the year, 2) the initial negative reaction to the vote in the United Kingdom (U.K.) to leave the European Union (Brexit) and the swift recovery, and 3) the rise in optimism after the Republican sweep of the White House and Congress in the November elections coupled with the expectation for the first interest rate hike by the Federal Reserve Open Market Committee (FOMC) for the year. There were other important characteristics about financial market returns for 2016. First, the best performing asset classes in 2016 were some of the weakest performers in 2015, particularly commodities, emerging market stocks, and small-cap stocks. Second, various asset classes and equity sectors that were the best performing in the first half of the year tended to be the weakest performing in the second half as there was a distinct shift in the tone of financial markets in the second half.

Market Indices – 2016



Global equities and other risk assets began the year with a severe sell-off. The price of West Texas Intermediate crude oil (WTI) continued its slide from 2015 and fell to about $26 per barrel after sanctions against Iran were lifted worsening the global supply glut. For January the S&P 500 index, the Russell 2000®, and the MSCI EAFE indices were down 5%, 9%, and 7% respectively. The factors weighing on investor sentiment were familiar issues including a sell-off in Chinese equities, falling oil prices, weak global manufacturing data, and lower global growth expectations. Market participants became increasingly worried about the impact of those factors on corporate earnings and credit quality. In this negative sentiment environment defensive assets had the best returns. In equity markets, stocks in less economically sensitive sectors such as consumer staples and utilities had the best returns while more cyclical sectors such as energy, materials, and financials had the lowest returns. Precious metals had strong gains on flight to safety trading. Other safe haven assets also gained. U.S., European, and Japanese sovereign bond yields moved lower and prices moved higher during January given the "risk-off" sentiment. In a noteworthy move, the Bank of Japan lowered interest rates into negative territory in an attempt to spur economic activity. The market trends in January continued into the first half of February. Gold reached a 12-month high. The S&P 500 and WTI hit lows on February 11.

Then conditions abruptly shifted and the negative sentiment eased ushering in a "risk-on" mood. Three key elements seemed to fuel the positive sentiment that drove "riskier" asset prices higher. One element was that oil prices were rising. Oil rallied back over $30 per barrel on talk of Saudi Arabia and Russia agreeing to production caps and on a weaker U.S. dollar. Another positive element was that worries about the U.S. or Europe falling into a recession receded as market participants focused on encouraging reports such as job openings, vehicle sales, and home sales in the U.S. improving and better Purchasing Manager Index (PMI) reports in the euro area, the U.K., and China. In the euro area unemployment declined to the lowest level since September 2011. A third key element was that the European Central Bank (ECB) and the FOMC showed that central banks were willing to continue to provide support to financial markets. The ECB surprised market participants with a series of actions aimed at encouraging banks to lend to spur economic activity and inflation. These actions included cutting a key lending rate, the refinancing rate, to 0% and lowering the deposit rate to -0.4%. The ECB also expanded the size of its monthly bond purchase program and included non-bank corporate bonds. The "risk-on" sentiment sparked a global rally in risk assets that continued into May and erased the previous year-to-date negative returns for large and mid-cap U.S. equity, EM equity, and commodities indices. During this period, cyclical stock sectors such as materials and industrials had the best returns and utilities, consumer, and technology sectors had the weakest returns. Healthcare was another weak equity sector during this period due to downward pressure particularly on biotechnology stocks where drug pricing was a concern and was the focus of congressional hearings. Bond yields moved higher with the U.S. Treasury bond yield returning to almost 2.0%

Financial markets were dealt a major surprise in late June, on the 24th to be exact, when the result of the Brexit vote was announced. The U.K. voted 51.9% to 48.1% in favor of leaving the European Union (EU). The outcome shocked market participants around the world since just the day before polls were indicating voters favored remaining in the EU. The reaction was a sharp sell-off in global equities and the British pound along with a steep rise in prices for safe haven assets like gold, global government bonds, the dollar, and the yen. For example, for the two-day period following the vote, the S&P 500 index fell over 5% and the STOXX Europe 600 fell over 10%. Yields on U.S. and Japanese 10-year government bonds fell to record levels (and prices rose), and gold rose to near a two-year high. The global equity sell-off was short-lived, just the Friday and Monday after the vote. Then markets swiftly reversed and many assets recovered much of the declines of the prior two days as central banks said they were prepared to take any necessary actions to ensure financial market liquidity and stimulate economic activity. The U.K., European, and Japanese stock markets declined the most and did not recover as much before the end of June as the U.S. and EM markets. The price of oil fell after the Brexit vote on worries about slower global demand but later retraced much of that decline reaching almost $50 per barrel. Also of note during June was the continued march lower for government bond yields around the world. Even before the Brexit vote, 10-year German and 30-year Swiss government bonds traded in negative territory for the first time.

After the initial reactions late in June and the first days of July, market participants mostly shrugged off concerns about Brexit. The FOMC, the ECB, and the Bank of England each held interest rates steady at their July meeting. Therefore, investors focused on corporate earnings and economic data with many reports coming in better than analysts expected. U.S., European, and EM stocks advanced. Growth stocks outperformed value stocks since technology and healthcare stocks were better performers and defensive and energy stocks were the weakest performing. Materials stocks were another top performing sector as precious and industrial metals prices rose on strong demand. U.S. Treasury bond yields moved modestly higher and prices lower in reaction to the strong economic data which increased expectations for an interest rate hike by the FOMC but retreated again after the FOMC decided not to raise interest rates. Energy stock prices declined sharply on worries about high inventories.

In the fall, financial markets cooled. In October there was a sell-off in global bonds that pushed yields up in the U.S., Germany, Japan, and the U.K. Better economic data and expectations of less accommodative monetary policies sparked the sell-off. Global equity markets returned to a "risk-off" sentiment that resulted in generally lower equity prices. In the U.S. equity markets the financials sector was one sector that did advance due to higher interest rates. Healthcare had very weak returns as the sector continued to be pressured by product pricing issues. EM equities bucked the broader equity trend and advanced due to continued improvement in country fundamentals and capital in-flows.

The results of the U.S. elections in November surprised market participants and led to a sharp drop in global financial markets during the night of the election. However, the negative reaction was short lived in the U.S. with the major equity indices closing higher the day after the election and continuing to rally through year-end (the Trump Bump). Several major equity indices reached new all-time highs. Importantly, the tone of global financial markets changed after Donald Trump won the election and the Republicans gained control of both houses of Congress. Sentiment shifted as market participants increasingly focused on the potential for stronger economic growth and higher inflation in the U.S. bolstered by the increased fiscal spending, lower taxes, and less regulation favored by President-elect Trump. The U.S. dollar reached a 14-year high on post-election expectations for stronger economic growth and inflation, but also on expectations that the FOMC would tighten monetary policy beginning with a rate hike in December which did occur when the FOMC raised the federal funds rate by 0.25%. Small-cap stocks had the largest gains since in general they were seen as benefiting the most from Trump administration policies because they tend to have more domestically focused businesses and higher tax rates. Financials stocks, especially banks, were also top performers on expectations for higher interest rates due to forecasts for strong economic activity and a strengthening dollar. Higher interest rates tend to boost bank margins. Expectations for increasing demand for commodities from higher infrastructure spending in the U.S. in a Trump administration drove industrial metals prices higher. The implications of Trump favored policies are not positive for all asset types. The prospects of tighter foreign trade policies pressured equity markets and currency values of many U.S. trade partners after the election, especially in Latin America. The prospect of higher government spending pushed bond yields higher and prices lower. The 10-year U.S. Treasury bond yield rose to over 2.5% for the first time since 2014. Higher bond yields hurt interest sensitive stocks, such as real estate related stocks. Safe haven assets gold and silver had steep declines as the U.S. dollar strengthened on expectations of improving economic conditions. Another important development late in the year was the agreement by the Organization of Petroleum Exporting Countries (OPEC) and 11 other countries, including Russia, to limit oil production. In reaction to the agreement, WTI rose to reach the highest price in 17 months and ended the year at $53.72 per barrel.

In summary, returns were positive for the year for the major asset class indices shown above despite several periods of sharp declines and swift recoveries. Improving economic conditions drove equity prices higher in much of the world, but late in the year led to higher interest rates with bonds giving back much of the gains from earlier in the year. In the U.S. equity market most sectors posted a positive return for the year. The main exception was healthcare which was pressured throughout the year by product pricing issues and uncertainty about the impact of possible changes to the Affordable Care Act with Republicans in control of the White House and Congress. In the U.S and foreign equity markets, cyclical sectors generally outperformed defensive sectors. The defensive and high dividend income stocks that were the performance leaders in the first half of 2016 became laggards in the second half as investors' focus shifted to stocks that will benefit from pro-growth policies and rising interest rates. In the U.S., small-cap stocks outperformed by a wide margin since they were seen as benefiting the most from the improving U.S. economy and pro-growth, pro-business policies favored by President-elect Trump. Bond market returns were modest. The 10-year U.S. Treasury yield began the year at 2.27% then dropped to an all-time low of 1.36% in reaction to the uncertainty surrounding Brexit but rose throughout the second half of the year on FOMC rate hike and pro-growth policy expectations to end the year at 2.45%. Commodity markets rebounded sharply on strong demand from Chinese stimulus measures, the OPEC production limit agreement, and improving global economic activity. Most commodity prices fell early in the year but soon recovered. WTI began the year at just over $37 per barrel, declined to under $30 and then rallied to end the year at $53.75 resulting in a 45% gain for the year. Gold ended the year with an 8% gain. The price of gold rallied early in the year due to concerns about slow global growth but retreated later in the year as the pro-growth sentiment grew.

Economic data in the U.S. is showing improvement. Also, expectations are high that business-friendly economic policies such as tax cuts and infrastructure spending proposed by President-elect Trump will lead to higher economic growth in the U.S. However, the details and timing of any policy changes are uncertain. Outside the U.S, there are signs that economic growth is picking up in Europe and stimulus measures are still in place. However, Brexit negotiations and several key elections in 2017 elevates the uncertainty in Europe. Due to the high level of uncertainty in various regions coupled with valuations at near or above historical averages, it is likely financial markets will experience bouts of volatility as more details emerge about any fiscal or monetary policy changes. Therefore, an adequately diversified portfolio including growth and risk reduction focused investments continues to be a prudent strategy.

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