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2016 Year-End Review and Forecast

The Year in Review

2016 was characterized by a dramatic selloff in equity markets early on followed by a steady recovery for the remainder of the year.

The chart below shows the performance of various types of markets over the course of 2016. There are a number of curves on these charts but the sense is clear. Here is a key to what each curve represents:

SPY: US Stocks (S&P500 index)
DJP: Commodities (Dow Jones – AIG Commodity index)
EEM: Emerging Market Stocks (MSCI Emerging Market index)
EFA: Non-US Developed Market Stocks (MSCI EAFE index)
TLT: Long-dated (20 year+) US treasury bonds

By mid-February stock markets and commodities were down almost 10%, with a corresponding increase in long-dated treasury bonds that often happens due to the generally negative correlation between stocks and bonds. It was in fact the decrease in the price of oil, and more broadly in commodities prices, that affected the stock market at the beginning of the year.

In my year-end review last year I noted that commodity prices and stock prices had become highly correlated and indeed it is clear that this continued in 2016. As commodity prices recovered off of a very low bottom in mid-February, equity markets recovered as well.

I also wrote in the year-end review that I expected commodity prices to recover maybe 30% in 2016 and that the selloff at the beginning of the year was probably a buying opportunity in commodity and equity markets. I expected this recovery to start towards the middle of 2016. It turned out I was correct about the recovery but not the magnitude or timing, as the price of oil went from $30 to $50 by June and then remained in the range of $40 to just over $50 for the rest of the year.

I also said last year that I expected value stocks to outperform growth stocks and that we should focus on dividend-paying investments. This brings us to the rather interesting chart below. This chart shows the broad US stock market (S&P 500) in black, US value stocks in brown, and US growth stocks in blue.

Clearly value stocks won the day in 2016 with steady outperformance, but also with dramatic outperformance after the US elections. The Trump victory was perceived as favoring large US manufacturing and industrial companies and between Election Day and the end of the year the Dow Jones index (which is mostly composed of these types of companies) was up about 8% while the S&P 500 was up 4% and the NASDAQ (mostly technology and other growth companies) was up about 1%.

The election of Donald Trump as US president was certainly one of the drivers of investment performance in 2016. I recall watching stock markets collapse during election night as the surprise of a Trump victory took hold. At one point the Dow Jones futures were down 800 points - but then there was a dramatic turnaround as the perception took hold that a Republican victory, especially one with such a pro-business candidate as president, would likely be good for US companies. By the end of trading on the day after the election the Dow was up over 200 points, and the rally continued over the next month.

The other event that had a dramatic influence on investment markets in 2016 was the Brexit vote. Again, there was an expectation that a vote would go one way (UK staying in the EU) and a surprise when it went the other way. You can see from the charts above what happened at the end of June as this vote took place. First there was a selloff of about 5% in stock markets around the world but then there was a recovery over the next few days,

including the British market. So equity markets ultimately weren't that affected by the Brexit vote, but currency markets were a different story.

The chart below shows various currencies vs. the US Dollar over the course of 2016. Notice how at the end of June, when the Brexit vote occurred, the US Dollar dramatically strengthened vs. the British Pound (in black). The Pound sold off about 15% vs. the US Dollar on the vote, and another 5% to the end of the year. This means that investors who track their returns in US Dollars would have realized a 15% loss on any British Pound denominated investments just as a result of the currency selloff.

There are three other interesting things to note in the currency chart above:

First of all, have a look at the US Dollar/Mexican Peso exchange rate (in orange) after the Trump election victory in November. The Peso weakened by about 15% overnight and again the new exchange level has been maintained. With all the talk (and tweets) from the Trump camp regarding building a Mexican wall, imposing import duties, and punishing US firms that outsource to Mexico, it is no surprise that this has occurred.

The second thing to note is less dramatic; it is the recovery in the Canadian Dollar. This is the bottom line in the chart and shows that the Canadian Dollar strengthened vs. the US Dollar by about 10% to May and 5% over the course of the year as commodity prices increased. The same pattern can be seen in other commodity-based currencies, like the Australian Dollar for example.

The third thing of interest is the gradual weakening of the Chinese Yuan. This is the blue line and the Yuan weakened by about 5% vs. the US Dollar in 2016. This is notable because the Yuan is a managed currency. The Chinese government sets a band for their currency vs. the USD and maintains the exchange rate within the band through currency market manipulation. The fact that despite this currency management the Yuan weakened by 5% suggests that if the currency wasn't managed it might have weakened by much more. It wasn't so long ago that the world was talking about how China was going to take over and the strength of the Yuan, and now it seems this situation has changed considerably and we hear more about how the Chinese economy is slowing, bad debts rising, the currency weakening, and investment money flowing out of the country.

Looking Ahead

2016 ended up being a decent year for US stock market investors, but in a diversified portfolio there may have been a drag from non-US investments or bonds, which sold off towards the end of the year as interest rates finally started to rise in the USA. It turned out to be a good year especially for value investors and those holding dividend-paying investments rather than fixed income.

Let's turn now to the future. What I see is a continuing improvement in economic fundamentals in the USA and possibly even in Europe. The US recovery is now about eight years old but it has been a very slow recovery so we shouldn't get too nervous about its length. The unemployment rate in the USA continues to be low and recently we have finally seen wages start to increase. This has been the missing piece in the recovery and it usually denotes the inflection point from "recovery" to "growth".

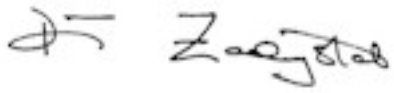
With wages increasing and commodity prices stable or maybe gradually increasing as well, this means we should see some inflation. Indeed the Federal Reserve has finally started raising interest rates in the USA as economic prospects have solidified. This suggests that fixed income investments may have a tough time going forward. Indeed there may even come a time when there is a dramatic selloff in such investments, although I think it more likely that we will just see years of steady fixed income underperformance.

Given the recent outperformance of value stocks over growth stocks in the USA, if we are now at the end of the "recovery" and beginning of the "growth" phase of the economic cycle, I wouldn't be surprised to see growth stocks outperform over the next year or two. For conservative investors, I would continue to advocate a focus on dividend-paying investments rather than fixed income.

I'll also go out on a limb and say that possibly we might see the European markets outperform US markets in 2017. Although there is uncertainty over how Brexit will play out, in mainland Europe things seem to be stabilizing. Recently we have even seen some healthy inflation. Given the recent US equity outperformance and the strength of the US Dollar, perhaps European companies, especially those exporting to the USA, might see their prospects and share prices positively affected over the next year.

I am still nervous about emerging markets although so far most of the economic forecasts I have heard have projected a soft landing in China rather than economic disaster. President Trump's intent to impose US import duties to try and encourage global firms to manufacture in the USA rather than in lower cost countries and the recent exit of the USA from the Trans-pacific Partnership agreement, might have a nasty effect on the USA's closest trading partners.

Best wishes in the New Year,



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