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MAIN STREET ADVISORS, LLC

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Market Commentary – Fourth Quarter 2016

As we look back at 2016 and ahead to 2017 and beyond, we'll leave most of the political discourse and analysis to others and focus our comments on the financial markets. We need to focus upon an objective analysis of investment opportunities and risks; the application of our analytical insights to the construction and management of diversified portfolios; and the disciplined execution of our investment process over the long term. So, whether one is personally happy or horrified—or somewhere in between—with the outcome of the recent U.S. presidential election, our focus as investment analysts, portfolio managers, and fiduciaries is unchanged.

December Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	**Dec**	**4Q**	**YTD**
Vanguard 500 Index	2.0%	3.8%	11.8%
iShares Russell 1000	1.9%	3.9%	12.0%
iShares Russell 1000 Growth	1.3%	1.1%	7.0%
iShares Russell 1000 Value	2.6%	6.8%	17.3%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	1.2%	3.2%	13.7%
iShares Russell Mid-Cap Growth	0.3%	0.4%	7.2%
iShares Russell Mid-Cap Value	1.8%	5.5%	19.8%
Small-Cap Benchmarks			
iShares Russell 2000	2.9%	9.0%	21.6%
iShares Russell 2000 Growth	1.4%	3.7%	11.7%
iShares Russell 2000 Value	4.2%	14.2%	32.0%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	2.5%	-1.5%	2.7%
MSCI World ex USA Index	3.3%	-0.3%	3.3%
Vanguard FTSE Europe ETF	4.9%	-1.2%	-0.4%
Vanguard FTSE Emerging Markets ETF	-0.7%	-4.5%	12.2%
Vanguard REIT Index	4.7%	-3.0%	8.3%
Vanguard Total Bond Mkt Index	0.2%	-3.2%	2.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	2.0%	1.9%	17.5%
Vanguard Intermediate-Term Tax-Exempt	1.0%	-3.3%	0.1%
S&P/LSTA Leveraged Loan Index	1.2%	2.3%	10.2%
Citigroup World Govt. Bond Index	-0.7%	-8.5%	1.6%

2016 Market Review

Global stocks performed well both in absolute terms and relative to core bonds this year, with U.S. stocks again taking the lead. Large-cap stocks (Vanguard 500 Index) gained 11.8% and small-cap stocks (iShares Russell 2000 ETF) surged 21.6%. (This marked the eighth straight year the large-cap S&P 500 Index had a positive return. While streaks of this length have occurred twice before, the market has never had a nine-year winning streak.) Emerging-market stocks (Vanguard FTSE Emerging Markets ETF) were also strong performers, gaining 12.2% for the year. Developed international stocks (Vanguard FTSE Developed Markets ETF) were the big laggards. They returned just 2.7% in U.S.-dollar terms. European stocks (Vanguard FTSE Europe ETF) did worse, falling 0.4% in dollar terms, although they gained 7.2% in local-currency terms (Deutsche X-trackers MSCI Europe Hedged Equity ETF). 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.

Though core bond prices got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, yields then reversed course, rising to 2.5% by year-end.

In the fourth quarter, the core bond index (Vanguard Total Bond Market Index) fell 3.2%—its worst quarterly performance in *35 years*—due to rising interest rates. This is why fourth quarter client returns likely disappointed despite the 5+% rise in stocks after the presidential election. For the year, core bonds produced a 2.5% gain, slightly above our longer-term (five-year) expected return outlook for them. Investment-grade municipal bond returns (Vanguard Intermediate-Term Tax-Exempt) were negative on the year. While 2016 wound up being a poor year for Treasurys and core bonds, it was a good year for riskier fixed-income sectors. Fixed-income sectors with more credit risk (and less interest rate risk), such as high-yield bonds (BofA Merrill Lynch U.S. High Yield Cash Pay Index) and floating-rate loans (S&P/LSTA Leveraged Loan Index), performed very strongly, gaining 17.5% and 10.2%, respectively.

Alternative strategies turned in mixed performance. Lower-risk, diversified arbitrage strategies had solid absolute returns, ranging from the low- to middle single digits. Managed futures, where we utilize Grant Park Managed Futures, returned a respectable 4.3%. Our gold bullion holding returned 8% after giving up much of its large gains earlier in the year. We expect to hold gold and precious metals a while longer but will gradually exit most alternative strategies.

We also witnessed a number of sharp reversals in market trends and consensus views during the course of the year. To name a few: Value and cyclical stocks beat growth names (for the first time in several years), while "bond-proxy" stock sectors (utilities, consumer staples, and REITs) underperformed. In the commodity markets, crude oil prices rebounded sharply, doubling from their February lows and reversing a dramatic two-year slide; our energy ETF purchase in August returned high single digits by year-end. That pattern was true for commodity prices in general, with the Bloomberg Commodity Index gaining 20% from its January low (up 11% for the year). The reversal in interest rates, as noted earlier, was also significant. Just as with the U.S. presidential election and the Brexit vote results, very few "experts" predicted these reversals. The consensus was surprised and wrong at the inflection points, as it usually is.

Related to this, we often make the point that markets are prone to both momentum (continuation of a trend) in the shorter term and cyclical behavior (reversion to the mean) in the longer term. We don't think anyone can consistently time markets—buying in just before an upswing, riding the momentum, and then selling at the top. To the contrary, there is a mound of evidence (academic and industry studies, as well as our own observations and experience) that suggests most investors destroy value over time due to perversely bad timing of buys and sells. They are repeatedly whipsawed by shorter-term price volatility—driven into and out of asset classes and funds by emotional reactions, performance-chasing, risk-aversion, and the lack of a fundamentally sound, long-term investment discipline to guide their decisions. If 2016 is a harbinger of what's to come, that lack of investment discipline may cause permanent financial harm.

Performance Reversals in 2016		
Since:	**Previous Two-Year Return**	**Return Since**
Emerging Markets Low in January		
Emerging-Market Stocks	-25.5%	28.2%
Oil (WTI)	-68.7%	82.4%
U.S. Market Low in February		
U.S. Small-Cap Stocks vs. U.S. Large-Cap Stocks	-18.0%	19.5%
U.S. Value Stocks vs. U.S. Growth Stocks	-7.7%	10.8%
U.S. Value Stocks vs. U.S. Momentum Stocks	-11.2%	14.1%
10-Year U.S. Treasury Yield Low in July		
U.S. Core Bonds	9.1%	-3.3%
U.S. Treasurys (7–10 Year Index)	14.8%	-7.0%
U.S. Presidential Election in November		
Consumer Staples Stocks vs. S&P 500	6.3%	-6.2%
Utilities Stocks vs. S&P 500	4.3%	-5.2%
Energy Stocks vs. S&P 500	-25.5%	4.0%
Financial Stocks vs. S&P 500	-3.4%	11.8%

Source: Morningstar. Returns through 12/31/16. Two-year returns are cumulative.

Portfolio Performance

Our portfolios benefited from many of 2016's trend reversals.

Bonds: In most of our balanced portfolios, a little under one half of our fixed-income exposure is in non-high quality core bond funds, meaning foreign government (Templeton Global Bond), short-term high yield (Osterweis Strategic Income), and actively managed unconstrained/flexible multisector funds (Loomis Sayles Bond). These positions added significant value compared to core bonds, with gains in the 6% to 11% range versus 2.5% for the bond index.

Emerging-market stocks: Our more risk-tolerant and growth-oriented portfolios have some exposure to emerging-market stocks via T. Rowe Price New Asia. When emerging-market stocks rebounded in 2016, however, our holding did not benefit as it heavily weighted in China.

Our core foreign stock funds hold small positions in emerging markets but these positions were too small to add much value. We do not expect to have much exposure to emerging markets for now despite their cheap valuations versus the United States equity markets. Further, the Trump administration may impose protectionist trade policies and tariffs to build job growth domestically, and there could be negative effects from further U.S. dollar appreciation and emerging-market currency depreciation.

Smaller-cap stocks: Having benefited from a multiyear period of small-cap underperformance, because our holdings here were quite light, we subsequently missed out on small caps' strong rebound during the remainder of the year.

Active U.S. equity managers: Our active larger-cap U.S. equity managers, in aggregate, outperformed the market index. One big exception was the stellar Harbor

Capital Appreciation fund, which returned basically zero after humming the previous three years. The turnaround in value and our active managers' strong performance—in absolute terms and versus the market index—support the argument we made last year that the underperformance of value stocks and value-based strategies relative to growth and momentum stocks and related strategies had likely been a cyclical headwind to our active managers in aggregate. It also gives us optimism that this cycle may be turning in our favor, with further active management outperformance to come. There are no guarantees, of course.

Developed international stocks: Given our modest tactical overweight to Europe, we were hurt by the continuing trend of U.S. stocks outperforming other regions. This marked the fourth straight calendar year and the sixth in the past seven that the S&P 500 has beaten the global ex-U.S. index. Going back to 2008, this is one of the longest stretches of U.S. outperformance on record. U.S. stocks also meaningfully outperformed European stocks in 2016.

Liquid alternative strategies: Our lower-risk alternative strategies (such as arbitrage and managed futures) met their performance objectives and our expectations in 2016 but were no match for the double-digit return of U.S. stocks. In addition to our portfolios' tactical underweighting to U.S. stocks versus foreign stocks, they are also underweight to U.S. stocks relative to alternative strategies. In other words, part of the funding for our liquid (mutual fund) alternative strategies positions comes from stocks. This has hurt us for the past four years.

Meanwhile, despite some short periods of very strong performance when equity markets dropped sharply early in the year and again right after Brexit, managed futures had only a decent year. We certainly aren't happy about their performance. Unfortunately, our view of the long-term strategic benefits from investing in managed futures strategies as part of a diversified portfolio has not changed. But we will soon either experience a sharp benefit during a downturn or remove these funds from our portfolios. As with any investment—particularly one as confusing and "alternative" as managed futures—a deep understanding of the fundamental investment rationale as well as realistic risk and return expectations are critical to maintaining the confidence and emotional fortitude necessary to stick with them during rough stretches. We are running out of that confidence, however.

Gold bullion, silver, and junior gold mining stocks all had stellar years in 2016 until the fourth quarter. They still ended the year up 8%, 17% and 75% respectively. We will continue holding these for now.

Looking Ahead to 2017

As we consider investment opportunities and risks in the context of how our portfolios are currently positioned, we'll focus on two key questions we've been hearing from clients:

1) Why do we still own foreign stocks?

Since the end of 2009, the large-cap S&P 500 has returned a cumulative 131%. In contrast, developed international stocks have gained 32% and emerging-market stocks a measly 1.3% (in dollar terms). Because our portfolios' long-term, strategic equity allocation is diversified globally,

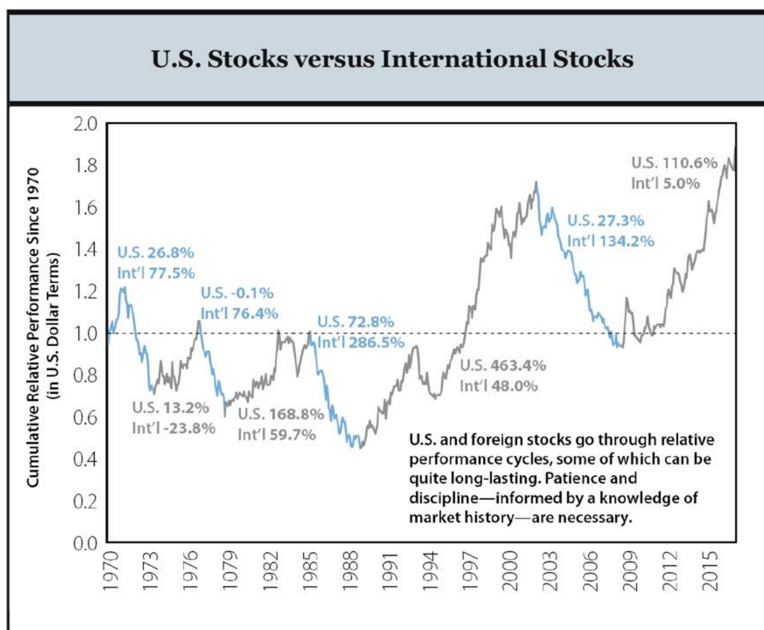
they have obviously lagged compared to a purely U.S. stock portfolio.

We know the underperformance of foreign stocks is trying some clients' patience. It tries our own, at times, as well. However, we continue to believe, and our paid analysis supports, maintaining stable strategic allocations to foreign stocks as well as an additional, modest, tactical overweight to European markets, *particularly* after this prolonged period of underperformance.

In terms of the strategic rationale, here are the key supporting points:

- Equity markets and asset classes go through cycles, meaning it is unwise to extrapolate recent/past performance trends far into the future.
- People are generally overconfident in their ability to predict changes in trends and cycles and are therefore poor at timing their buying and selling.
- Because markets move in cycles, by definition you will always own some assets that are lagging while others are outperforming. Prudent investors diversify because they know they can't consistently predict which asset classes will outperform when.
- Most importantly, by owning a globally diversified equity portfolio, we gain access to a much broader investment opportunity set—more than twice as large as that available through investing in U.S. stocks alone. Many of the most attractive companies and equity market returns are located outside the United States.

Our paid analysts are continually digesting new data, information, and news relevant to our asset class analysis. While there were certainly plenty of headlines over the past year, our fundamental tactical views on European stocks and emerging-market stocks have not materially changed. Our

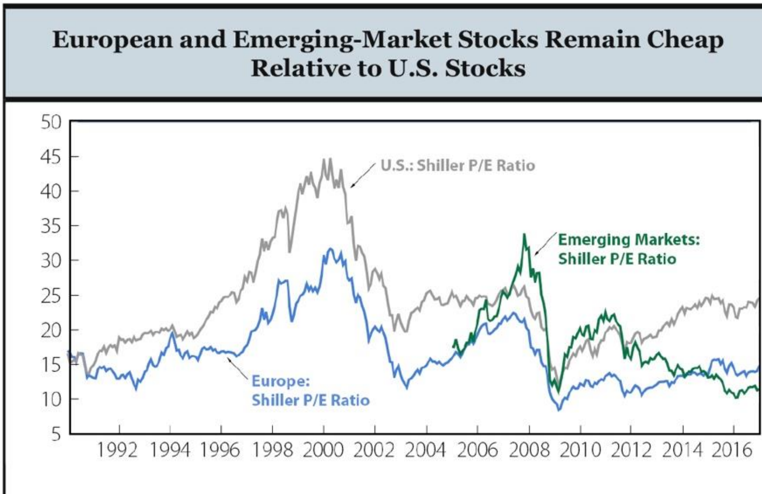


Source: Morningstar Direct. Data as of 12/31/16. International stocks are represented by the MSCI World ex USA Index from 1970 to 1988 and the MSCI ACWI ex USA Index from 1988 onward.

analysis implies that from current price levels, both markets are likely to generate much higher returns than U.S. stocks over the next five years (our tactical time horizon). In our base case scenario, we estimate low double-digit potential returns from European and emerging-market stocks, driven largely by improving earnings growth from still very depressed levels. This compares to low-single-digit expected returns for the S&P 500 in our base case.

While our analysis indicates we are being reasonably compensated for taking on equity risk in Europe and emerging markets, we don't believe that is the case with U.S. stocks. U.S. stocks appear overvalued, with a lot of optimism baked

into current prices. This accelerated post-election. That makes the U.S. market particularly vulnerable to a negative surprise (e.g., a government policy disappointment). We expect the market price-to-earnings multiple to decline in our base case, consistent with U.S. market history, dragging down expected returns. History and investment logic also tell us that *high starting-point valuations are a strong predictor of low future returns* when looking out over a five-to-10-plus-year horizon. It is this longer-term horizon upon which we base our tactical decisions. Putting it all together, on a relative and absolute basis, we are even to moderately overweight to non-U.S. stocks and underweight to U.S. stocks.



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Of course, there are risks to our European and emerging-market equity positions, just as there are risks accompanying any investment position. But current valuations suggest these risks are pretty well— though certainly not *fully*—discounted. In other words, you can't pick up a newspaper (does anyone actually "pick up a newspaper" anymore besides me?) without seeing a discussion of the political uncertainties from the rise of nationalism in Europe and the related economic/breakup risks facing the eurozone, or the negative ramifications for emerging markets of China's huge public debt build-up (to name a few big ones). These have contributed to the poor stock market performance in recent years. Markets are discounting a lot of risks and a lot of bad news. Because of that, the news must only get somewhat "less bad" for market sentiment and stock prices to improve. That typically happens when the market least expects it.

Consistent with this, we believe the key earnings growth and valuation assumptions that underlie our base case five-year scenarios for these markets are reasonably conservative. Yet we still derive attractive potential returns over our tactical time horizon. That's not to say these markets still don't face potential *shorter-term* cyclical downside risk, or even that a more bearish five-year scenario than our base case will not actually play out. We consider more bearish scenarios and outcomes in our analysis, which is why we don't have larger tactical positions to these markets. However, we believe the overall risk/reward, the combination of the *likelihood* of certain scenarios playing out and the *magnitude* of the gains or losses across those scenarios, continues to support a modest tactical overweight. Unless or until our analysis suggests we should make an allocation change, we will remain patient, maintaining confidence we will be rewarded, as has been the case historically for long-term value-driven strategies.

As Warren Buffett wonderfully and concisely put it, "A simple rule dictates my buying: Be fearful when others are greedy,

and be greedy when others are fearful." Much easier said than done.

2) What if we are facing a macroeconomic "regime shift"—a cyclical change from monetary to fiscal policy, from deflation to inflation, from falling interest rates to rising rates?

In the weeks since Donald Trump's election, we've observed an increasing number of investment strategists refer to a so-called regime shift. (We may nominate *regime shift* as our investment buzzword of the year for 2017.) The gist is that the U.S. economy is poised to undergo a number of significant transitions:

- from the dominance of monetary policy since the 2008 financial crisis to an increased emphasis on fiscal policy stimulus,
- from a disinflationary/deflationary trend to a reflationary/inflationary trend, and
- from a 35-year trend of declining interest rates to rising rates.

This is certainly one plausible scenario. But there is tremendous uncertainty in terms of what policies the Trump administration and Congress will *actually* implement, the *timing* of those policies, the *magnitude* of the *economic* impact, and finally, how (and when) *financial markets* will react to and discount those potential impacts—not to mention how the financial markets' reaction can in turn impact the policies themselves. It is a series of continuous, interactive feedback loops, which is what makes predicting the results so difficult. In her press conference following the Federal Open Market Committee meeting on December 20, Federal Reserve chair Janet Yellen summed it all up as "a cloud of uncertainty."

In any case, the consensus narrative at the moment seems to be the Trump administration and Republican-controlled Congress will implement fiscal stimulus via both increased infrastructure spending and reduced corporate and individual tax rates. Potential deregulation across many industries is further stoking market optimism that dormant "animal spirits" (and corporate profits) will soon be revived.

On the monetary policy front, as the markets expected, the Fed raised the federal funds rate 25 basis points in December (to roughly 0.625%). The Fed also signaled it expects to raise rates three more times in 2017 and another three times in 2018. The Fed has been *woefully inaccurate* in prior years' forecasts of rate hikes. A year ago it thought it would raise rates four times in 2016 but did so only once. Over the past several years we have continued to hold and recommend bonds in general. If the Fed is finally at least in the ballpark for 2017, this would clearly represent a shift from the highly accommodative and unprecedented policies in place since 2008. We remain dubious about three more increases this year, as global bond markets and investors may not cooperate.

Inflation had been gradually moving higher in 2016 prior to the election. Trump's policy agenda suggests further inflationary pressure is likely. From the perspective offered by a simple Economics 101 supply/demand framework, fiscal stimulus should shift the aggregate demand curve outward—leading to higher economic growth and rising price pressures. To the extent Trump also carries through on his protectionist trade rhetoric,

that would shift the aggregate supply curve inward, at least in the near term. This would also be inflationary but negative for growth. Although an all-out trade war can't be ruled out, it would clearly not be in the country's or U.S. corporations' interest. (With Trump it seems pretty much anything and everything is on the negotiating table.) It seems likely the demand-expanding effects would outweigh the supply-contracting effects with the net effect being positive for U.S. growth. But again, the timing is uncertain.

More importantly, economics in the real world is never as clean and simple as it is in the textbooks. There are numerous other variables that impact growth and inflation. The direction of interest rates and the U.S. dollar are two big ones. In theory, these policies, if implemented, should drive both U.S. interest rates and the dollar higher. We've *already* seen the bond and currency markets respond in that way. The dollar hit a 14-year high in December and the 10-year Treasury yield hit a two-year high. It is not obvious how much further they will move from here—or even in which direction they'll move.

Further complicating things, financial markets are global markets. Policy decisions and outcomes in other countries impact the United States, and vice versa. Treasury yields can only rise so far if other government bond yields with similar risk aren't also rising. The consensus does not expect the European Central Bank or the Bank of Japan to tighten monetary policy any time soon, and with those countries' rates at rock-bottom levels, that should constrain U.S. rates. On the economic growth side, despite the expected fiscal stimulus, long-term, structural drivers of lower expected growth remain, such as an aging population, high overall debt levels, depressed investment spending, and low productivity growth.

While the initial rise in interest rates and the dollar would reflect optimism about stronger U.S. economic growth, at some point higher rates and a stronger dollar become headwinds to such growth and are disinflationary. Higher rates and Treasury yields mean higher variable and fixed mortgage rates, which would hurt the housing market and ancillary industries. Higher rates for consumer and business loans depress demand and spending. Higher rates and expanding government budget deficits from fiscal stimulus also pose risks given the already-high levels of government debt—by raising the nation's debt servicing costs. A stronger dollar hurts exports and the competitiveness and profits of U.S. companies that do business overseas, hurting S&P 500 earnings growth, as we saw in 2015. Ned Davis Research estimates that a sharp appreciation in the dollar could cut in half stimulus. Rising wages, driven by further tightening of the labor market, which is the positive growth impact of fiscal already at or near the Fed's definition of "full employment," could further cut into profit margins and earnings growth. These are all meaningful uncertainties.

Portfolio Positioning and Outlook

Assuming an economic regime shift takes hold next year, what are some likely implications for our portfolios?

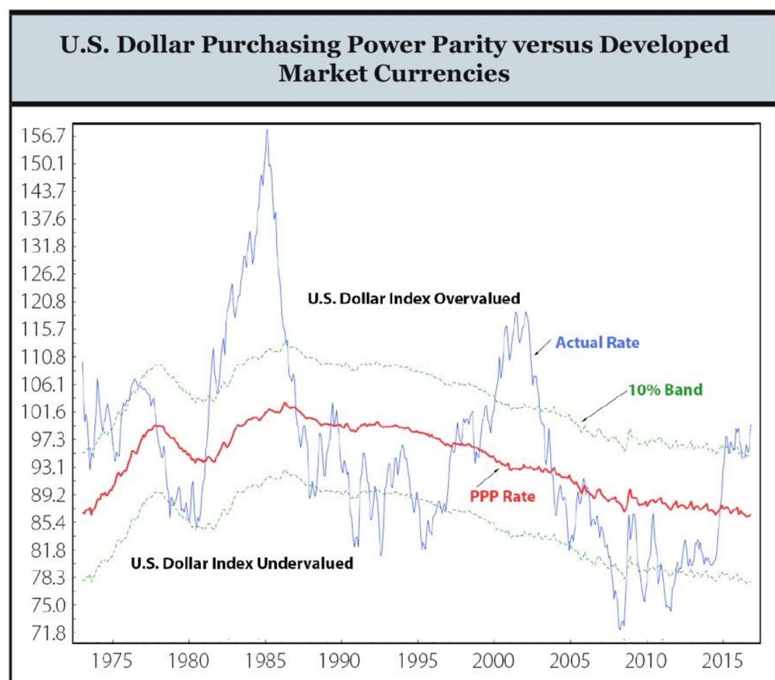
Fixed-Income: The most straightforward impact from a reflationary regime shift would be a continuation of the poor performance core/high-quality bonds have delivered starting in July. As an example, we estimate that a 100-basis-point (1%)

increase in the 10-year Treasury yield next year from current levels would mean roughly a 1.5% loss for the core bond index for the year. In contrast, we'd expect our 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 their corporate credit exposure—and their lower duration (less interest rate sensitivity) compared to the benchmark. Floating-rate loan funds may again meaningfully outperform core bonds; while we have studied this sector several times now we have not added it to our bond holdings.

Equities: The outlook for equities as a whole and U.S. versus foreign stocks is much less clear. It's easy to assume that improved economic growth would coincidewith a rising stock market, but that's not necessarily the case. Over the shorter-term and in any given year, stock market returns have multiple drivers. Not only is there a lot of uncertainty about the timing and magnitude of policy changes, *the U.S. stock market has already discounted a lot of potentially good economic news*. In that sense, it may have "pulled forward" some 2017 returns into 2016. There is also the risk that too rapid a rise in interest rates (e.g., in response to heightened inflationary concerns) would hit valuation multiples. But should the existing U.S. reflationary trend continue in 2017, we think our active stock pickers will continue to benefit versus the market index, consistent with what we saw play out so strongly in the second half of 2016.

While the storyline that foreign stock markets will continue to underperform next year seems clear cut, there are other plausible scenarios. For example, if the new administration's trade policies are more bark than bite, there's a good chance of an emerging markets rebound. More broadly, to the extent that reflation extends beyond just the United States, that will undoubtedly benefit foreign stock markets, where, unlike in the United States, growth expectations and market valuations are low.

The U.S. dollar remains a wild card in terms of its short-term direction and therefore its short-term impact on foreign equity returns to dollar-based investors. When viewed from a longer-term valuation perspective, it looks overvalued relative to both developed and emerging-market currencies. Still, there are sound reasons to expect continued depreciation of the euro, yen, and many emerging-market currencies (including the Chinese yuan)



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against the dollar. Yet just as the dollar's post-election rise coincided with a selloff in emerging-market assets, we'd expect the reverse to be true as well.

Alternative strategies: Our lower-risk investments would generally benefit from a reflationary backdrop as rising short-term interest rates would help boost returns. We do plan to finally exit from managed futures and merger arbitrage, with the proceeds split between stock and bond holdings. Our gold positions continue to act as insurance against major market disruptions, and have not materially hurt our performance since 2013 (when it obviously did).

Concluding Comments

Expert predictions of the future are usually no better than guesses. Sometimes they are right, often they are wrong. And the experts who are right one year are often wrong the next. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which themselves are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

Even if one had a crystal ball and could know in advance the outcome of many of the important individual variables (e.g., election results, central bank policy decisions, 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 won't bother guessing what the markets will do next year. An important part of our portfolio risk management process *does* analyze the impact of various short-term (12-month) stress-test scenarios. But those are neither forecasts nor predictions. If we had to make a forecast for the financial markets next year, or for 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*.

We at Main Street Advisors wish you and yours a happy, healthy, peaceful, and prosperous New Year.

—Main Street Advisors, LLC (1/17/2017)