Round Table
Wealth Management

Quarterly Review – Fourth Quarter 2016

The year 2016 will be remembered as an example of the need to always consider the unexpected – from BREXIT to the Trump victory to the ensuing market rally that wasn't supposed to happen. We began the year with the S&P 500 declining approximately 10.5% through February 11. Several leading strategists suggested that given the poor start to the year, the probability of a positive year was very low. So much for conventional wisdom!

It turned out investors were rewarded for holding risk assets. The S&P 500 was up nearly 12.0%, while large cap value and dividend paying indices were up 17.3% and 20.7%, respectively. High yield bonds, floating rate loans and master limited partnerships (the latter left for dead in 2015), were up 17.1%, 10.1% and 18.3%, respectively. Anecdotally, equity indices generated a substantial amount of return during the post-election period. For example, the Russell 2000 generated 65% of its 21.3% annual return between November 8 and December 31. Lower risk fixed income investments represented by the Bloomberg Barclays U.S. Aggregate Index lost 3.0% in the final quarter and gained just 2.6% for the year.

Investors are always happy to generate annual returns surpassing expectations, and as advisors, we are happy too! But we need to remember the words of Bernard Baruch: "Nobody ever went broke taking a profit." Our advisory role is to constantly re-assess the risks and rewards of our clients' ongoing investments. We are cautiously optimistic as we enter 2017. We remain vigilant as to future corporate earnings and suspect of the market's ability for loftier valuations.

Annualized Benchmark Returns through December 2016*

	1 Quarter	1 Year	2 Years	3 Years	5 Years	10 Years
S&P 500	3.8%	12.0%	6.5%	8.9%	14.7%	6.9%
Russell 2000	8.8%	21.3%	7.7%	6.7%	14.5%	7.1%
MSCI World Ex. US Index	-0.3%	3.3%	0.3%	-1.1%	6.6%	1.4%
MSCI Emerging Markets	-4.1%	11.6%	-2.4%	-2.2%	1.6%	2.2%
Bloomberg Barclays U.S. Aggregate	-3.0%	2.6%	1.6%	3.0%	2.2%	4.3%
Bloomberg Barclays Municipal Bond	-3.6%	0.2%	1.8%	4.1%	3.3%	4.2%
Bloomberg Barclays U.S. Corporate High Yield	1.8%	17.1%	5.8%	4.7%	7.4%	7.5%
FTSE Nareit All REITs	-2.9%	9.3%	5.7%	12.4%	12.0%	4.7%
Alerian MLP	2.0%	18.3%	-10.7%	-5.8%	2.2%	8.0%

*Source: Bloomberg *Quarter return is not annualized.*

The Big Picture (for additional information click HERE)

Donald Trump. You may love him or hate him, but as investors we must plan and anticipate action in the face of changing policies. It is way too early to project what will or will not happen under the Trump administration. That said, based on the President-Elect's cabinet selections, we have an indication of his policy directions. In the near term, tax policy reform is likely to reduce corporate rates and increase the bottom-line earnings of corporations. Several equity market outcomes are possible under that scenario, including higher corporate dividend payouts, share buybacks and mergers/acquisitions—all supportive of equity valuations. We will communicate as policy develops, but with perhaps less frequency than the pace of the President's "tweets."

U.S. real Gross Domestic Product growth was 3.5% in the third quarter of 2016, a standout performance given the generally decelerating rate of growth for the last two years. The positive economic news, combined with strong employment statistics, aided the Federal Reserve's decision to raise its target rate by 25 basis points in December. That decision was largely a foregone conclusion due to Chair Yellen's public comments and Fed interest rate futures markets.

Investor focus has now pivoted to projecting how many interest rate increases will occur in 2017 (generally the market is forecasting 2-3 increases). Based on the Philadelphia Federal Reserve's Survey of Professional Forecasters, the expected 2017 U.S. real GDP rate is 2.2% and unemployment is projected to remain relatively steady at 4.7%. Should these projections materialize, we believe the Fed will take a more hawkish stance toward raising rates as inflation could become more of a concern. As an aside, we are conducting pre-emptive inflation research and developing actionable investments should that scenario play-out.

Europe will continue to be a region of interest, and uncertainty remains high. Prime Minister May of the U.K. is expected at some point to invoke Article 50 of the Lisbon Treaty that formally begins the BREXIT process. In addition, both Germany and France are having presidential elections this year, with France's Hollande deciding not to run for re-election. European equity valuations remain favorable relative to historical standards, but risks remain high. European region economic growth is forecast to be 1.4% in 2017, not too different from the 1.5% growth expected for 2016.

Emerging markets were a surprise this past year, though most of the return was driven by favorable currency movements. The rebound in oil markets supported petro-dominated economies such as Russia, which saw the Ruble gain on the U.S. Dollar by about 15% during 2016. Emerging and developing economies are projected to expand by 3.6% in 2017. Risks remain elevated especially in China, which continues to have large public and private debt issues to sort out.

Summary of Allocation Recommendations

Asset Class	Recommendation	Comment	Asset Class Summary Link
U.S. Large Cap	Overweight	Pro-growth government policy, tax reform, share buybacks/dividends	*U.S. Large Cap Review*
U.S. Small & Mid Cap	Overweight	Domestic focus, M&A activity	*U.S. Small Cap Review*
Non-U.S. Developed	Neutral	Attractive relative valuations but marginal economic growth and EU risks	*International Equity Review*
Emerging Markets	Underweight	Currency concerns due to rising U.S. Dollar	*International Equity Review*
Fixed Income	Neutral	Maintain safe haven assets for protection during periods of high market volatility, interest rate risk	*Fixed Income Market Review*
Tactical	Neutral	Continue to hold floating rate loan and MLP exposure	*Tactical Investments Review*
Alternative	Hedge Funds & Private Equity	For appropriate allocations	Contact your Wealth Advisor

The Outlook

During 2016, the S&P 500 was up 12.0%, and our January 2016 projection called for mid- to upper-single-digit total returns for the year. Our forecast held until post-election, after which the S&P 500 increased about 5.0%. Energy was a standout sector in 2016, and we supplemented client portfolios with an energy ETF to enhance exposure. We will continue to make similar sector enhancements when appropriate.

We revise our 1Q 2017 large cap recommended allocation to overweight because our outlook is more optimistic given the pro-growth intentions of President Trump. The combination of lower corporate taxes and easing regulations may provide a much-needed catalyst for earnings growth. We find this particularly important as trailing P/E equity valuations are at a 20% premium to the historical 5-year median. Forward-looking P/E valuation premiums are an elevated 13%. Factset estimates the S&P 500 will increase earnings 11.5% in 2017; the index is expected to generate growth of 0.2% in 2016. Estimates have historically trended down during the ensuing year, but we are hopeful the new administration's policies will support analysts' outlooks. The risk of lower valuations will continue to loom in 2017.

We modify our outlook on small and mid caps to overweight as we view the new administration and Republican agenda positively impacting the asset class. While policy uncertainty exists, we believe it is focused on timing and degree of actions, not necessarily the actions themselves. We view the new administration as a positive for small caps for several reasons including their domestic revenue focus, potential to be acquisition targets of larger peers, and potential to benefit from reduced regulatory burdens.

We are recommending a neutral to modest underweight allocation to developed market equities and an underweight to emerging markets. Our developed market outlook continues to be driven by Europe. We believe that there is more opportunity now than at the start of 2016; however, risks remain high in the region, particularly from the upcoming political elections. Developed Asia (primarily Japan) continues to muddle through.

Despite the very strong returns in emerging markets this year, we remain underweight the asset class. Most of the return was due to favorable currency movements relative to the U.S. Dollar. Post-election we witnessed the market's negative interpretation of the impact Trump's policies may have on EM economies. We suspect that should oil prices continue to improve, countries reliant on its export should prosper, including Russia, Brazil and Mexico. This is opposite of how these countries fared between late-2014 through mid-2016. China will continue to influence the asset class given its role in world trade and the Pacific region.

We are reducing our fixed income recommendation to neutral. The Federal Reserve has signaled its willingness to increase rates. High yield and investment grade bonds trade at relatively low yields, which offers less total return protection in a rising rate environment. High grade allocations will continue to play a role as "safe haven" assets should risk assets such as equities sell-off. We recommend lowering exposure to high yield bonds that are trading near historically low interest rate spreads to Treasuries. We continue to favor floating rate loans that offer compelling yields and the ability to reset coupons when interest rates increase.

We continue to recommend master limited partnerships (MLPs) for tactical exposure. MLP yields are favorable, and President-elect Trump's policies are widely expected to favor the energy industry. The financial sector continues to offer upside as the Federal Reserve begins in earnest a rate hiking cycle. Within this sector regional banks that provide traditional lending are in focus. Inflation does not appear to be an immediate concern, but we are working on actionable investment options should the need arise.

Tax and Financial Planning News

For some time, many of us have been saying, "WHEN interest rates rise, not IF…" So, with the FOMC's recent decisions to begin increasing its target Fed Funds rate, it is worthwhile to revisit what this could potentially mean to you. Besides the Fed Funds rate, the 3-Month LIBOR rate and the yield on the 10-Year U.S. Treasury Note are just some of the important determinants of rates that impact consumers, lenders, borrowers, homeowners, investors and savers alike. While you aren't likely to feel any dramatic effects of last month's Fed Funds rate hike right away, their most recent quarter-point hike can telegraph into an increase in the interest rates on your home equity line of credit, your credit card, your adjustable mortgage or the yield on your fixed income portfolio.

If you are a borrower, now would be a good time to review the specific terms and rates of any loans to determine whether you should make any changes. For example: Should your home equity line of credit be paid off sometime this year at the current rate leaving the full amount available only for unforeseen, [expensive] emergencies? Should you consider refinancing your adjustable mortgage into a fixed rate before mortgage rates rise? If you are considering the purchase of a home or one last opportunity to consider refinancing your current fixed rate mortgage, you may want to see if you can hasten the process and make 2017 the year to do so, while rates are still low.

A greater impact to both borrowers and investors will likely occur later this year as the Fed has indicated that three additional hikes may be in store for 2017 (all data dependent, of course). These additional hikes will begin to have an impact on many aspects of your finances. Over time, as the Fed raises rates further, mortgage rates are expected to rise in lock step. This is the time to begin looking at the potential impact in the years to come.

If you would like to discuss your specific situation further, please contact your Wealth Advisor.

Firm News

We've moved! Our new address for our New Jersey office is 241 North Avenue West, Suite 300, Westfield, New Jersey 07090. All phone and fax numbers, as well as email addresses, are unchanged.

Respectfully submitted,

Round Table Wealth Management