



## **Commentary: December 2016**

### **UNEXPECTED. NOT SURPRISING**

With all matters investment related, we seek to avoid surprise when the unexpected happens. This objective promotes a healthy skepticism of the consensus view and supports a calm demeanor in the presence of market instability. Even more, measured thinking encourages a heavy emphasis on risk measurement and control, a central tenet of our approach to investment management. Though the approach is not fail proof—we are human, after all—the intention at least ensures we maintain a proper perspective in all our work.

#### **Reverent Indifference Tested**

Certainly, the latest U.S. Presidential election makes for a fine example...a test of our measured indifference to low-likelihood outcomes. Some, arguably, were not surprised by President Elect Donald Trump's ascent to the White House. In our view, it was clear his ultimate win was not on the probable side of possible among the average market participant's estimations. This hypothesis is supported by market trends both before and immediately after the November 8 decision.

Heading into the election, markets seemed to favor a win by Ms. Clinton insofar as we can in retrospect recall greater stability being associated with the rising prospects of her success. Conversely, market reaction to hints of Mr. Trump's increasing strength seemed met with capital market resistance.

And that made sense, in a way, as Ms. Clinton was almost certainly the better understood candidate, having been broadly visible on the national political stage for the better part of three decades. Mr. Trump has been a notable presence on the national and international corporate stages for at least as long but, except for recent years, never really in a political context.

It is cliché but apropos to note that markets do appreciate greater certainty. Thus, there was not much of a surprise when U.S. equity markets plunged in aftermarket trading as it became clearer that the nation would not in the near term see another Clinton in the White House. The fear didn't last, however, and the morning after saw relative calm in the equity markets. Indeed, there was more than a bit of eagerness to position fixed income portfolios for a potentially more favorable macroeconomic outcome stemming from the Trump win.

If there were one wonder in the whole thing, it was the substantially divergent performance trends of the domestic equity and fixed income markets. From the eve of the presidential election through the month's close, the broader U.S. fixed income market, as represented by the Bloomberg Barclays U.S. Aggregate

Bond Index (Bloomberg Aggregate) slumped 2.4% on a total-return basis. Heading in the opposite direction, the U.S. equity market, as reflected by the Russell 3000 Index, jumped 4.2%.

We should be careful to make too much of the action, though. If we zoom out from this more recent equity market snapshot, the bounce fits into the relatively more volatile, but still uptrending market we have seen since the rout at the beginning of the year. And the downtrend in the bond market actually started a good bit earlier. After flat-lining for much of the summer, the Bloomberg Aggregate saw a near-term peak in its total-return index level (just a bit below the long-term peak hit this past summer) on September 29. Since then the index is off 3% on a total return basis (including the reinvestment of income).

Readers may feel pressured to “do something” as a result of what might seem to be a radically different market trajectory from here on out. On the contrary, in our view, there is a logic to the trends and the upshot is that clients need not worry as much as they might be.

### **Net/Net Positive Take**

This story has one primary plot, namely, the outlook for domestic macroeconomic growth, and two supporting themes, the first being monetary policy and the second being fiscal policy. Central banks generally are charged with setting monetary policy. The objective of monetary policy generally is to foster a stable macroeconomic environment. Central banks seek to do so primarily by targeting levels of interest rates in the broader economy. Lower rates can be seen as “accommodating” growth (basically by making monies desired for growth-inducing investments cheaper in the form of lower interest rates on debt). Higher rates can be seen as “restricting” growth (lifting the hurdle for potential investments to be attractive by making debt-funding more expensive). Fiscal policy is set by politicians and generally involves the sorts of spending mostly pursued solely by government, with infrastructure being among the most relevant to this particular story.

### **Monetary Policy May Back Off...**

On the monetary policy front, bond markets are finding greater assurance that interest rates in general are on the rise as the domestic macroeconomic picture improves. Given stronger domestic growth, more stable and still improving labor markets and a more benign inflation backdrop (actually on the rise, but to a level more comfortable than concern-inducing levels nearer to zero), it has become more likely that the Federal Reserve will become less accommodative, perhaps as soon as its next meeting in December.

Importantly, the Fed is very likely to retain by most measures a still very accommodative stance, though only a bit less so. Long story short, while the Fed might be applauded for using its whole playbook to foster growth, macroeconomic growth remains light by historical standards. Some thus are inclined to view the shift in Fed policy to be a nod for fiscal policy to take over some of the burden. The thinking is that by creating jobs to mend bridges and roads, for example, fiscal policy might just provide the jump-start needed to kick the economy into a higher gear.

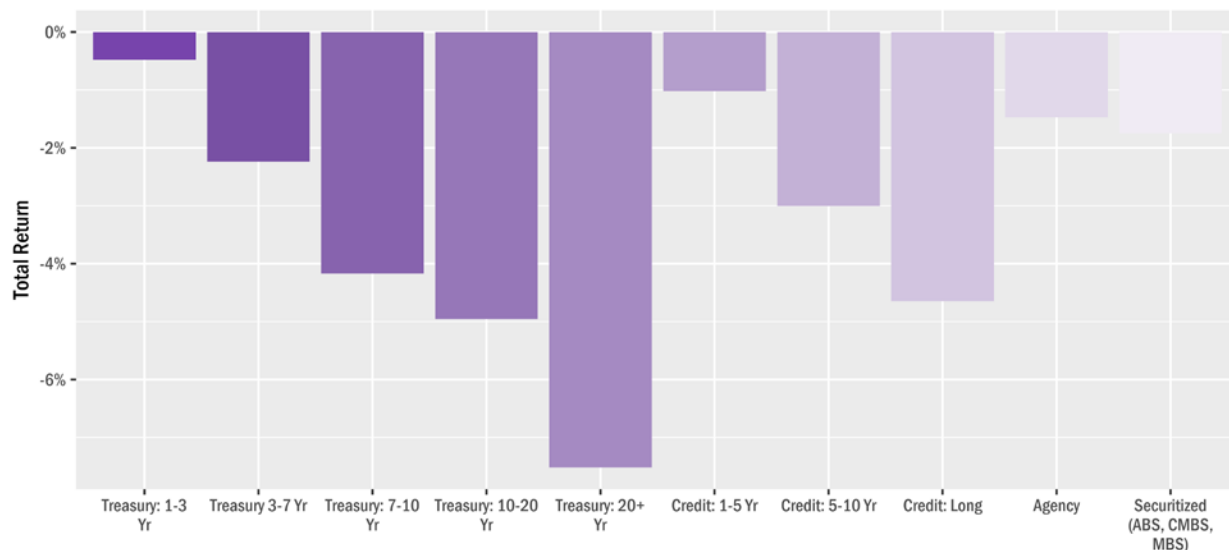
**...Perhaps Fiscal Policy Takes Over**

And that idea brings us to the second thread. Throughout the campaigns, both candidates suggested they would choose to increase spending on infrastructure. We will editorialize a bit and suggest that many figured any attempts by Ms. Clinton to increase spending, perhaps with an increase in the federal debt as a consequence, would be met with skepticism by a still heavily Republican Congress concerned about such matters. On the flip side, the surprise at Mr. Trump’s success seemed to suggest many had not deeply considered the applicability of his near-term fiscal and regulatory policy promises.

Given the win, however, Mr. Trump’s plans moved front and center. The result was a mix of delight and apprehension. The President Elect’s stated intentions for regulatory maneuvers—mostly of the “de-” sort within the corporate sphere—might be expected to improve the fortunes of certain sectors. Financials were the headline here as regulations borne of the Financial Crisis were seen as headed for overhaul and the sector’s equities surged: the S&P 500 Financials Sector Index has soared 12.4% since the election. Industrials, too, had a good go of it as investors seemed to perceive faster growth headed for a range of segments within the broader group of companies. On the flip side, concerns were raised that so much spending amidst tax cuts, more restrictive trade policy and already growing wage pressures could spark too much inflation. Inflation expectations rose as a result over the week following the election.

Potentially higher growth mixed with higher inflation and higher domestic government debt were of considerably negative consequence for longer-term bonds, which tend to be more sensitive to changes in interest rates. In Figure 1, we can see this in the relative performance of the various segments of the Bloomberg Aggregate. Also of note is the relatively better performance of corporate bonds (credit), a reflection of the expectations for an improved outlook for growth.

**Figure 1: Bloomberg Barclays U.S. Aggregate: Sub-Sector Total Return**



From 11.07.16 to 11.30.16. Past performance is not indicative of future results. One cannot directly invest in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

## Maintaining Perspective, Staying the Course

We highlight the push/pull of fixed income, versus equity (and within equity, given the divergent performance of domestic equity, versus international), as examples of the positive influence that diversification may have on overall portfolio performance and risk. Generally speaking, we should avoid too much emphasis on near- or even medium-term trends. The results of this election are no exception. Indeed, as we penned this commentary, investor concerns in regard to upcoming constitution-related votes in Italy were cited as at least one reason these election-related trends might not have staying power.

We have established these portfolios to target a range of expected return over long periods of time. To the extent that the divergent trends we experienced since the election are natural to the capital markets, we remain less concerned in regard to their implications. Indeed, we should remind readers that, while the extra volatility might understandably be uncomfortable, the broader fixed income market was outperforming U.S. equities just prior to the election and remains up 2.5% year to date.

We have suggested that capital markets could see greater instability as a result of the election and its aftermath. We nonetheless believe that there remains no compelling reason to interpret the enhanced volatility as demanding a material shift in our investment perspectives.

The medium-term general underperformance of international (non-U.S.) equity markets has not limited our enthusiasm for diversification as a means to reduce overall portfolio risk. And with domestic markets still on the richer end of the valuation spectrum, we appreciate the relative value many international markets present.

We further remain committed to the underlying portfolio tilts to smaller companies (the “size” factor) and to less expensive stocks (the “value” factor). In fact, both factors generally provided a substantial boost to portfolio performance relative to the broader equity indexes since the election, with smaller and less expensive equities outperforming their larger and dearer peers.

Within fixed income, though most exposures have seen a decline over the month of November, most remain strongly in the green for 2016. Also, as rates rise our portfolios are likely to benefit from the increased income that the fixed income allocation presents.

## A Race Complete. A Course Begun

Just as did the prior four and the forty before them, the next four years will present a mixed bag of applause and jeer, success and failure, elation and concern. We will seek to avoid shock at whatever may come of them. This style may at times seem a bit indifferent to the here and now, but indifference should not be construed as dismissive. Rather, our methodology incorporates a true respect for the unknowable nature of the factors that impact capital markets in the short and medium term. We first target that level of risk clients find most appropriate to their financial and emotional well-being and thereafter diversify portfolios among a range of equity and fixed income markets while keeping our eyes on the long-term horizon. We believe that approach best serves our clients and partners in planning for and ultimately meeting their long-term financial goals.

## **Important Information**

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market.

The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization.

The S&P 500 Financial Sector Index represents members of the S&P 500 Index operating within the Financial Services industry.

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