Making Sense of Finance

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Fourth Quarter 2016 Review

STOCK MARKET

The three major stock indices continued to advance in the last quarter of 2016. In contrast to prevailing views heading into this divisive presidential election, most of the increase in stock prices came after the unexpected Trump victory. S & P 500 futures dropped a quick 5% in a knee-jerk reaction after the election results came out but then made a dramatic turnaround when the stock market opened in New York. The Dow Jones Industrial Average beat the other two major indices in the quarter by a wide margin, with a gain of almost 8% versus gains of 3.25% for the S & P 500 and 1.34% for the Nasdaq Composite in that same time period. For all of 2016 all three indices performed well; again the DJIA leading the way with a return of over 13% and coming very close to the much talked about "20,000" mark. Valuations are still the focus of attention, as the trailing price/earnings multiple of the S & P 500 stands at 25, slightly higher than a year ago, and the dividend yield continues to hover around 2%, slightly lower than this time last year.

Bank stocks were the best performing industry group in the fourth quarter. The expectation is that since interest rates are on the rise and the Federal Reserve increased the Fed fund target rate last month, that bank earnings should improve based on increases in their net interest income. Industrial stocks also did better than the overall market last quarter, all of this gain coming post-election, as investors anticipate a more business friendly environment for these companies as well as additional tax dollars invested in infrastructure in the coming years. Healthcare stocks lagged in the fourth quarter as they did all year although they did show signs of life after the election. Now that we have somewhat adjusted to how the Affordable Care Act has made changes to the industry, again investors are thrown into uncertain times as the repeal of the Act is now front and center in Congress. The consequences of such a repeal of course no one knows but there are many investment dollars at stake (as well as health consequences for many Americans).

The U.S. market was the place to be as an equity investor in the fourth quarter, having performed better than its developed market foreign counterparts, especially in U.S. dollar terms. Although the Italian market did have double digit percentage gains in the fourth quarter, it was still a loser for 2016. The United Kingdom's

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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FTSE 100 index reached an all-time high but when translated into U.S. dollar terms, it too had a loss for the year, as the British pound's depreciation was too large to overcome for the U.S. investor in the UK market. The Canadian stock market and currency combined for a significant gain for investors in U.S. dollar terms benefitting from the rebound in oil prices (spot oil price increased 17% in the fourth quarter and 44% for the year). Some emerging market stock indices performed very well in 2016, also somewhat helped by the rise in oil prices. Russia RTS index increased 52% and Argentina's main stock market index increased over 40%. The Chinese market didn't fare as well with a double digit percentage loss.

BOND MARKET

The U.S. Treasury market also had a dramatic reaction to the election, however in this case bonds significantly declined in price (yields increased). Treasury yields already were on the rise earlier in the fourth quarter, but the increase accelerated post-election. The 10 Year Treasury yield had begun the last quarter of 2016 yielding 1.42%, steadily rose to a 1.88% on Election Day, the following day jumped to 2.07% and concluded the year at 2.45%. Wary of tax cuts combining with increased federal spending to fuel the deficit and inflation, bond investors responded quickly. So far in 2017, bond prices have retraced some of the ground they lost in the fourth quarter when the Barclays Aggregate Bond Index, (a measure of a blend of investment grade domestic bonds) lost over 3%.

Not only did the election seem to spark a sell-off in the bond market, but more fuel to the fire was added when the Federal Reserve decided at their December meeting to raise the Fed Fund target rate. This increase had been anticipated for quite some time. Nonetheless, over the course of last quarter the one month Treasury bill yield more than doubled from a paltry .20% to .44%. The increase in the Fed Fund rate has ramifications for business lending, and although the rates are still extremely low, corporations may have seen the bottom for rates on loans to fund their stock buybacks (already decreased amounts of stock buybacks in 2016 from previous year). The Federal Reserve has indicated there will be more rate increases in 2017.

Municipal bonds also struggled last quarter. November was the worst month for municipal bonds since the financial crisis in 2008. Declines in municipal bonds were attributed to the general increase in interest rates and also the slightly less attractiveness of a tax-exempt bond if lower tax rates come to fruition. In general, the longer the maturity of any bond, the worse it performed last quarter.

OUTLOOK

Repeat after me! "I CAN NOT PREDICT THE SHORT-TERM DIRECTION OF THE MARKET!" Do not get tricked into thinking you can just because you end up being correct once or twice. The market, after all, can only do one of three things; go up, down, or stay flat. Brexit and the recent U.S. Presidential Election are just the most recent events to prove most "experts" wrong, resulting in rising U.S. equity markets despite negative commentary from pundits. George Soros, the hedge fund wizard and philanthropist (net worth approx. $25 billion) allegedly lost close to $1 billion betting wrong on a Trump win. Our goal at Karagosian Financial is not to speculate on short-term movements, but rather long-term prospects of companies that will be around for the long haul. This is markedly different than the exhilarating trades made by hedge funds, but usually with much better long-term results. Even state-run pension funds are finally learning that hedge funds that are exciting, but charge 10x traditional investment management fees and have below-average returns don't make sense and are reducing their exposure there.

We continue to think that equities (stocks) are a bit pricier than we'd like, but not completely out of whack. Signs of continued strengthening in the U.S. economy could make valuations justifiable or even cheap, in hindsight. Our value-based strategy, which has been a bit out of favor the past two years, also seems to have started coming into its own again, which could continue into 2017. The optimistic scenario that we painted in past newsletters of having a slow and controlled increase in interest rates seems to be occurring, as well. Although fixed income investments will likely face headwinds for many years, they can still prove to be safe investments with some modest positive returns, in our opinion.

The "Trump Rally" seems to have stalled with investors' likely waiting for the man to take office. His disruptive management style is sure to lead to greater market volatility, but strong and intelligent execution of sound policies could lead to continued economic expansion. Only after his term ends can we fully judge his effectiveness, in our view.