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Fourth Quarter 2016

Market Developments & Investment Trends

Prepared by Lake Partners, Inc.

January 2017

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Market Developments & Investment Trends – 4th Quarter, 2016

Overview

Although the S&P 500 Index gained 3.8% in the fourth quarter (see Graph 1 on the next page), virtually all of its performance was attributable to the five weeks following the election. Prior to that, US equities faced steady downward pressure throughout much of October, reflecting investors' uncertainties about 1) the presidential election, 2) an increasing likelihood of an interest rate increase by the Federal Reserve (which also led to a shift upwards in the Treasury yield curve and a rise in the dollar), and 3) a decline in oil prices. Consequently, the S&P 500 declined -3.7% from September 30th through November 4th.

The election of Donald Trump as president led to a reversal in market sentiment, touching off a strong rally in stocks. From November 4th through December 13th, the S&P 500 gained 9.3%, spurred by investors' expectations that policy under the President-elect would be business-friendly by shifting towards greater fiscal stimulus, tax reform, and deregulation. Furthermore, signs of improvement in the labor market led to a stronger consensus that growth in the economy would be sustained, adding greater support for the rally in equities.

In sharp contrast to the rally in equities, the US bond market came under considerable pressure on heightened expectations that such policy shifts and economic trends would be reflationary, leading to higher interest rates and bond yields (see Graph 2 on page 4). The yield on the 10-year US Treasury rose from 1.59% at the beginning of the quarter to 2.60% by mid-December, before settling at 2.44% at quarter-end, which translated into a negative return of -6.8% for the period. This contributed to the -3.0% loss for the Bloomberg Barclays US Aggregate Bond Index during the quarter, but declines in other duration- and rate-sensitive sectors also contributed, including investment grade corporate credit, TIPS, and mortgage-backed securities. The only bright spot was high yield, especially junk, which rallied in sympathy with equities. Rates and yields also trended higher in international fixed income and credit markets. The other significant effect of the prospect of reflationary policy and higher rates in the US was to push the dollar higher.

The US equity market rally ran out of steam and reversed course as the quarter ended. From December 13th through the end of the year, the S&P 500 lost -1.4%. This reversal was due in part to the Federal Reserve's decision on December 14th to raise interest rates, as well as its indication that it anticipated raising rates at a faster pace during 2017. Furthermore, market sentiment diminished somewhat as investors began to take a more realistic view of what the incoming Trump administration might actually be able to accomplish.

It is important to note that the performance of the S&P 500 Index masked significant divergences among industry groups. Most notably, financials led with a gain of 21.1% for the quarter. In contrast, real estate, healthcare, and consumer staples were down -4.4%, -4.0%, and -2.0%, respectively. There were also wide differences by capitalization and style, with small caps besting large caps, and value topping growth. For example, the Russell 2000 Value Index rose 14.1% for the quarter, while the Russell 1000 Growth Index was up only 1.0%.

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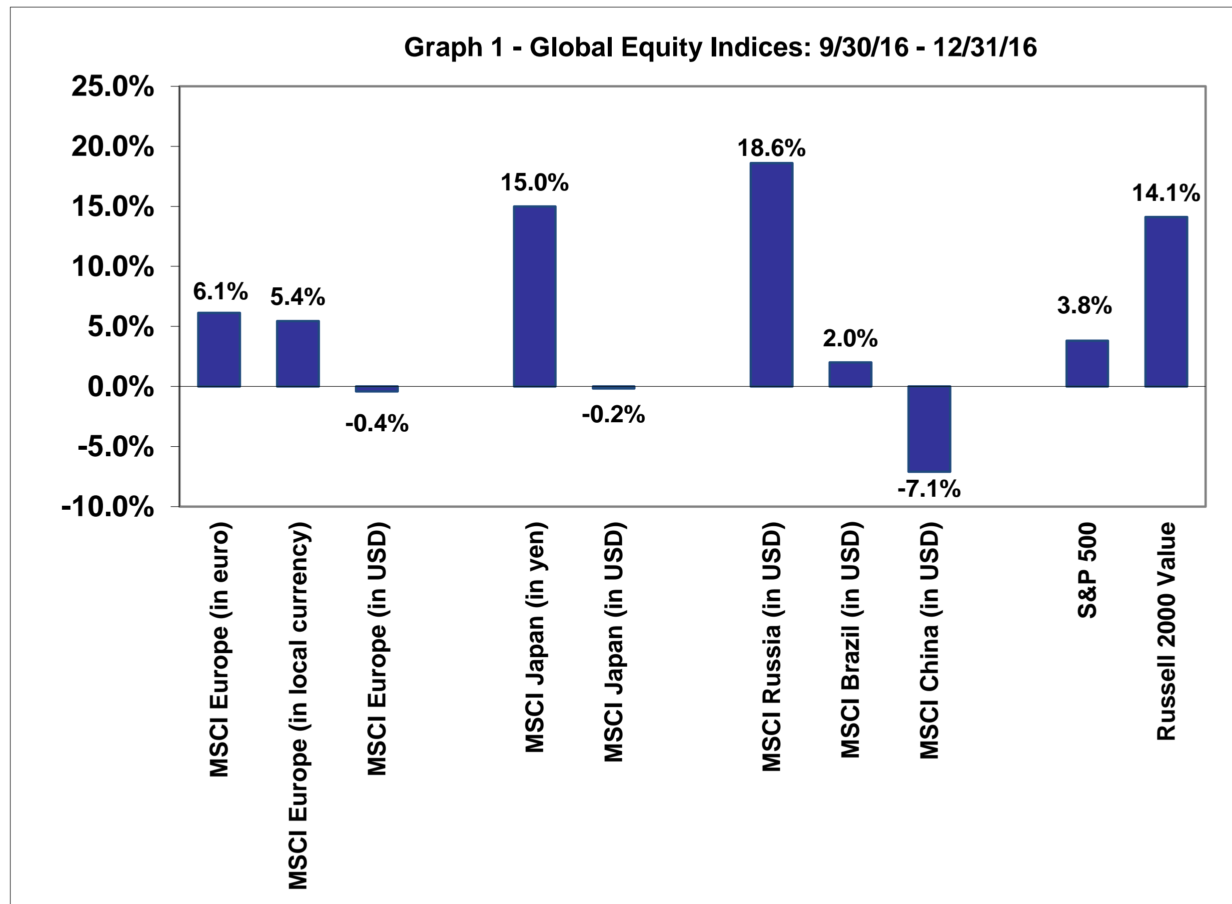
Overview (continued)

Non-US equity markets also responded to events in the US, but with mixed results. Note that because the US dollar strengthened significantly on the Fed's shift in policy and the rise in interest rates, currency translation resulted in wide swings in the performance of equity indices. This was most dramatic for Japanese equities, where the MSCI Index gained 15.0% in yen, but was down -0.2% in dollars. Similarly, MSCI Europe was up 5.4% in local currency terms, but down -0.4% in dollars. Emerging markets were mixed: Russia stood out with a gain of 18.6% as oil prices rose, while China fell -7.1% on concerns about economic growth, capital flows, and financial conditions (emerging market figures based on MSCI indices in US dollar terms).



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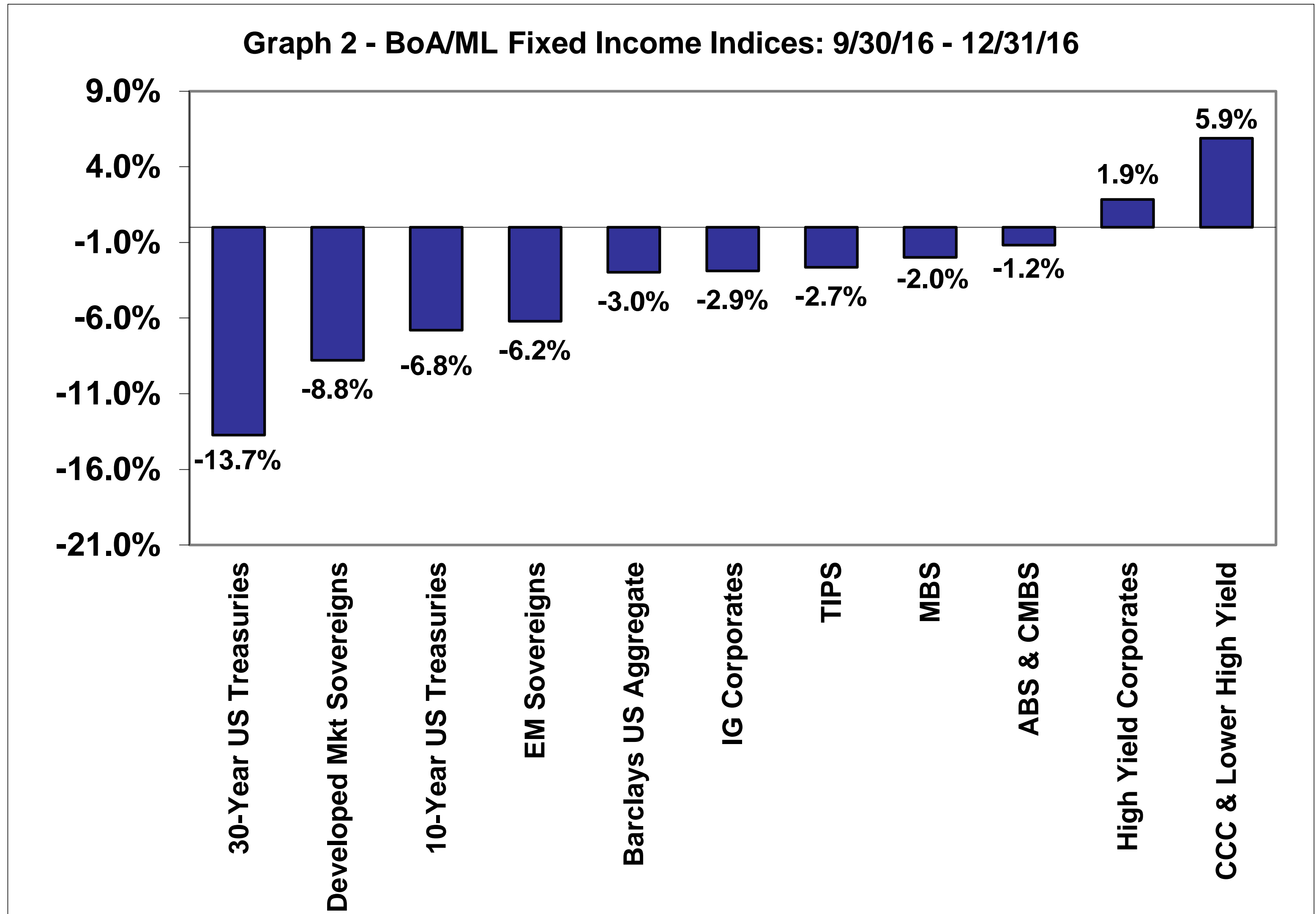

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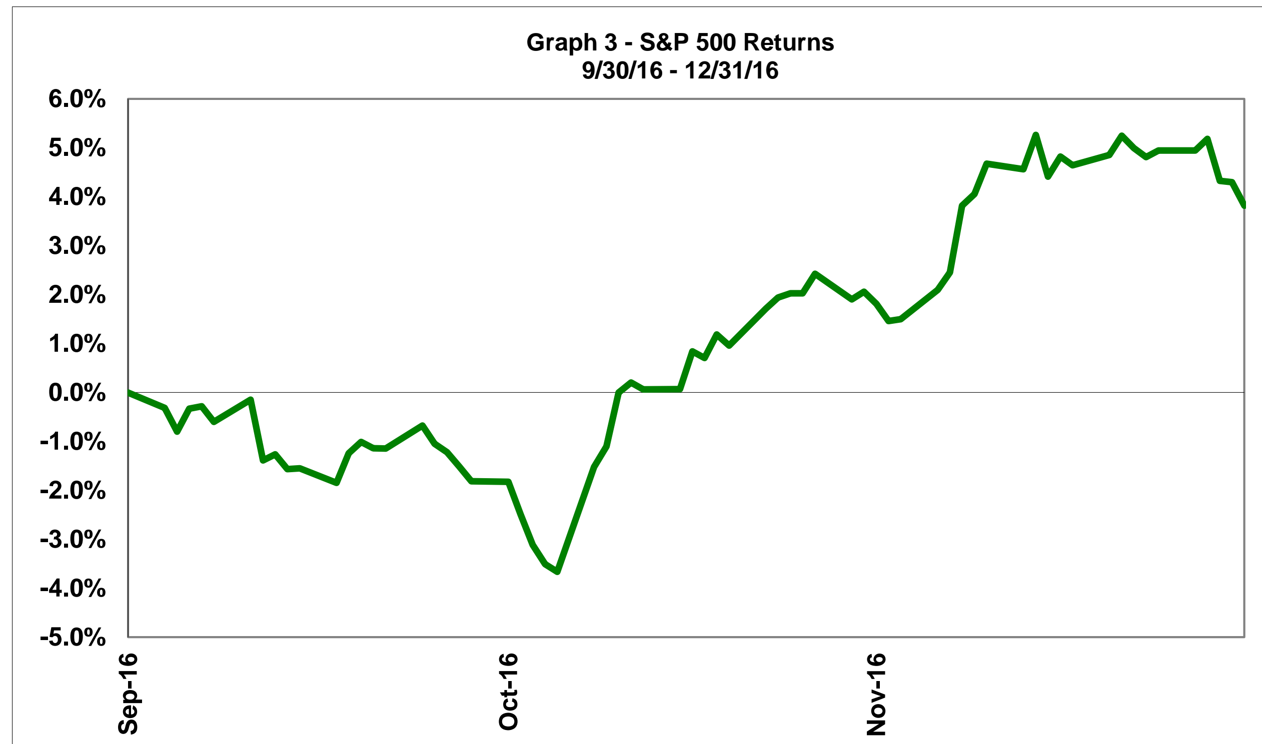
US Equities

US equities experienced two distinct phases during the fourth quarter, as shown in Graph 3 below. The first five weeks of the quarter were marked by gradual declines across equity markets as investor uncertainty was heightened by the presidential election, potential interest rate hikes, and falling oil prices. However, the election of Donald Trump led to a sharp rally in equity markets as investors focused on the stimulative policies proposed by the president-elect, such as tax reform and infrastructure spending. As a result, the S&P 500 recovered from a -3.7% drawdown from the beginning of the quarter to November 4th with a rebound of 9.3% from the trough to December 13th. Subsequently, the market rally subsided after the Federal Reserve increased interest rates on December 14th and signaled further hikes in 2017. Overall, the S&P 500 ended the quarter with a 3.8% gain.



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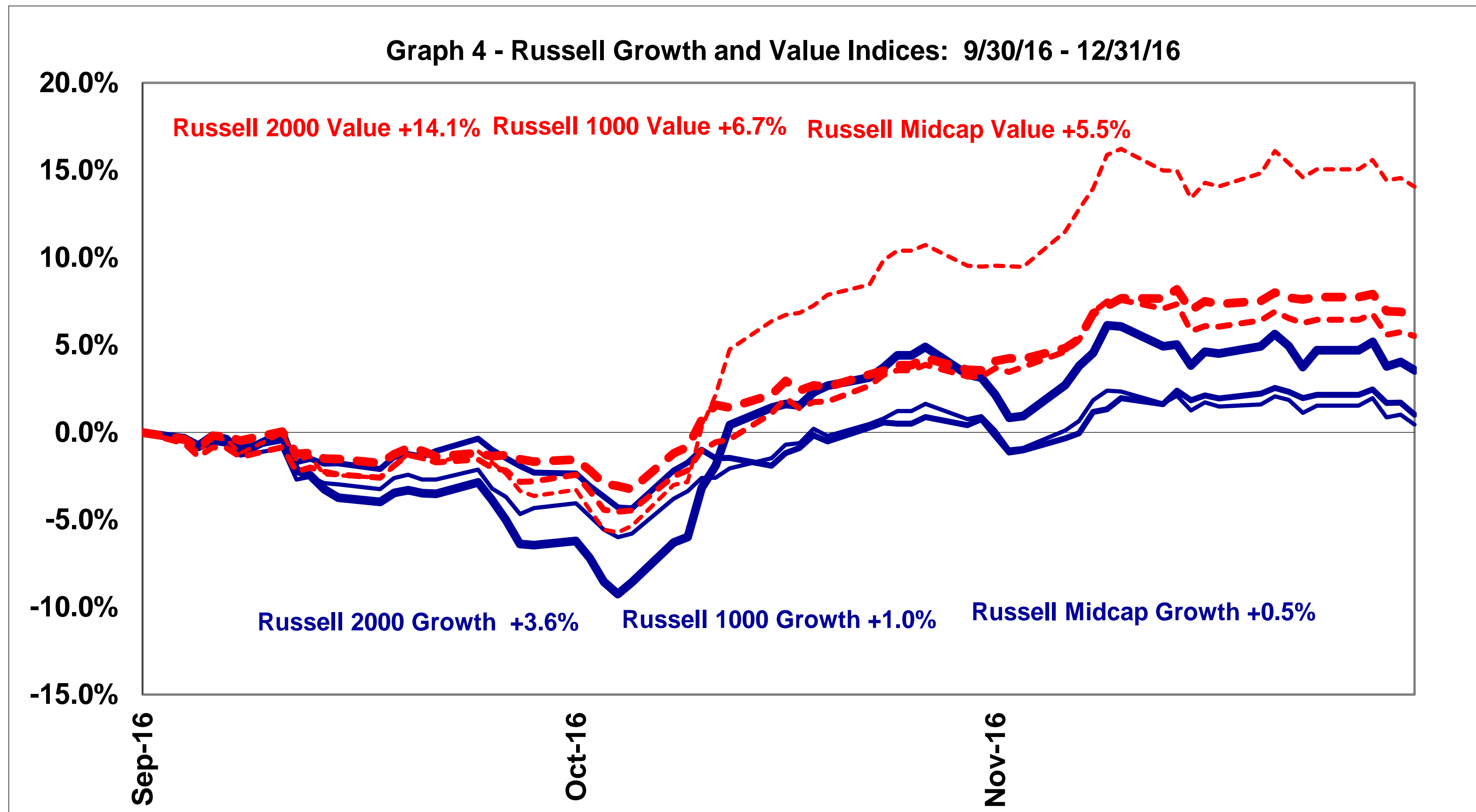
US Equities (continued)

There were significant divergences within the US equity markets during the quarter. As shown in Graph 4, value stocks significantly outperformed growth stocks across all market capitalizations, marking a reversal from the outperformance of growth in the prior quarter. Large-cap value outperformed large-cap growth by 570 basis points, mid-cap value outperformed mid-cap growth by 500 basis points, and small-cap value outperformed small-cap growth by 1050 basis points.



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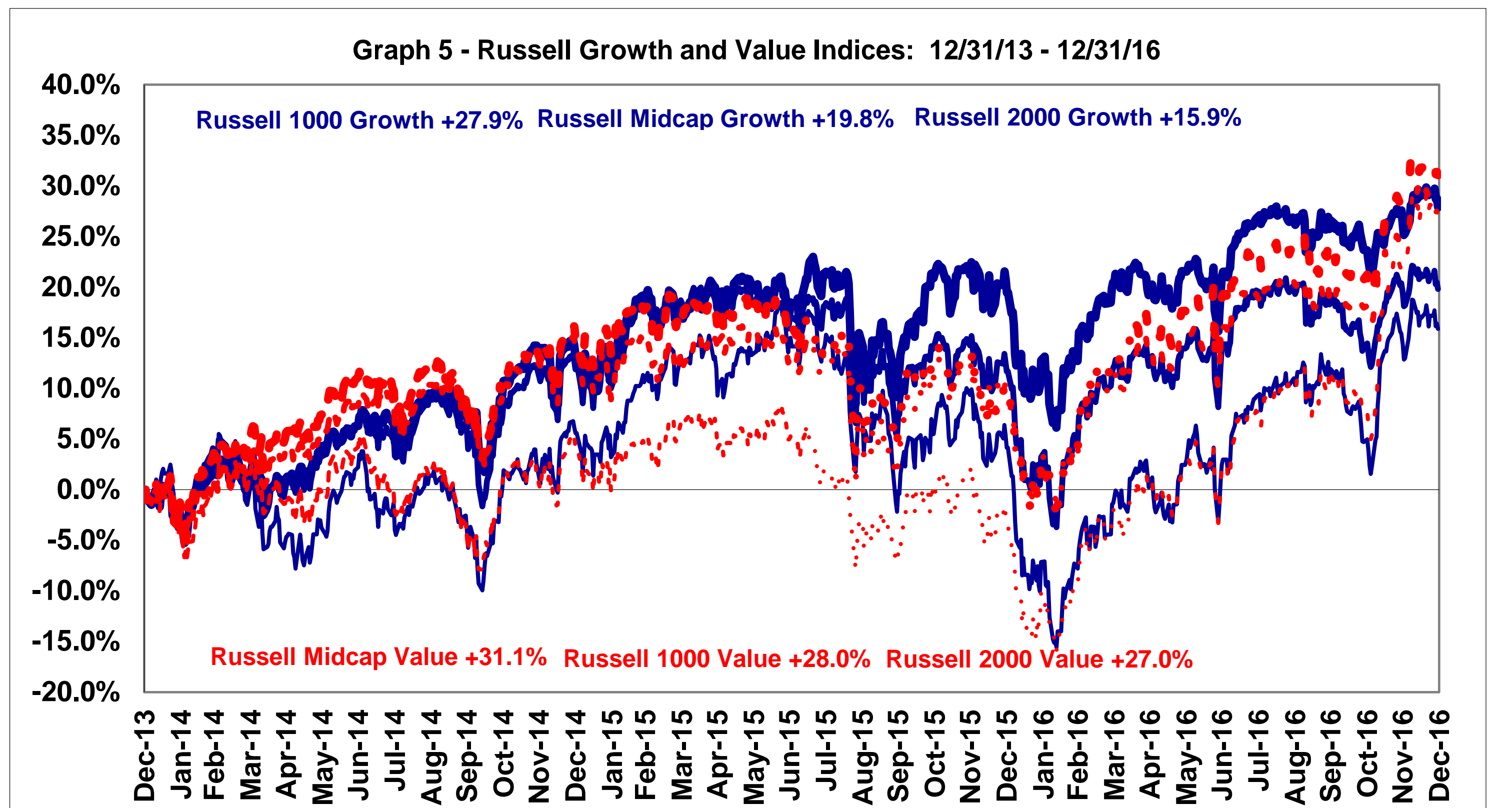
US Equities (continued)

Since the end of 2013, growth stocks generally had outperformed value stocks, as shown in Graph 5. However, this trend reversed in the fourth quarter as value significantly outperformed growth across market capitalizations. Notably, the previous outperformance of growth versus value was attributable to the dominance of a relatively small number of growth stocks (the so-called "FANGs" – Facebook, Amazon, Netflix, and Google). However, this trend reversed in the fourth quarter of 2016, partly due to the outperformance of value-oriented sectors such as financials.



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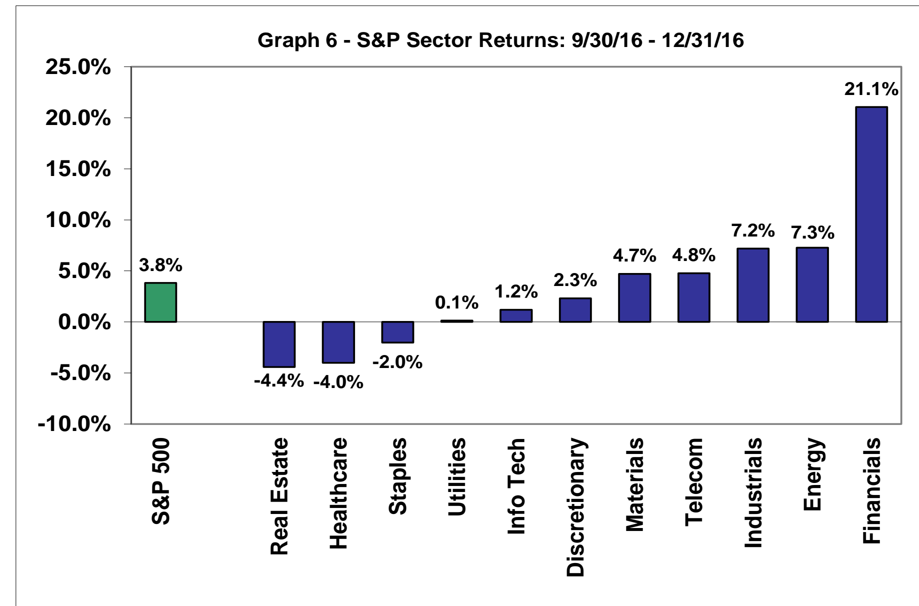
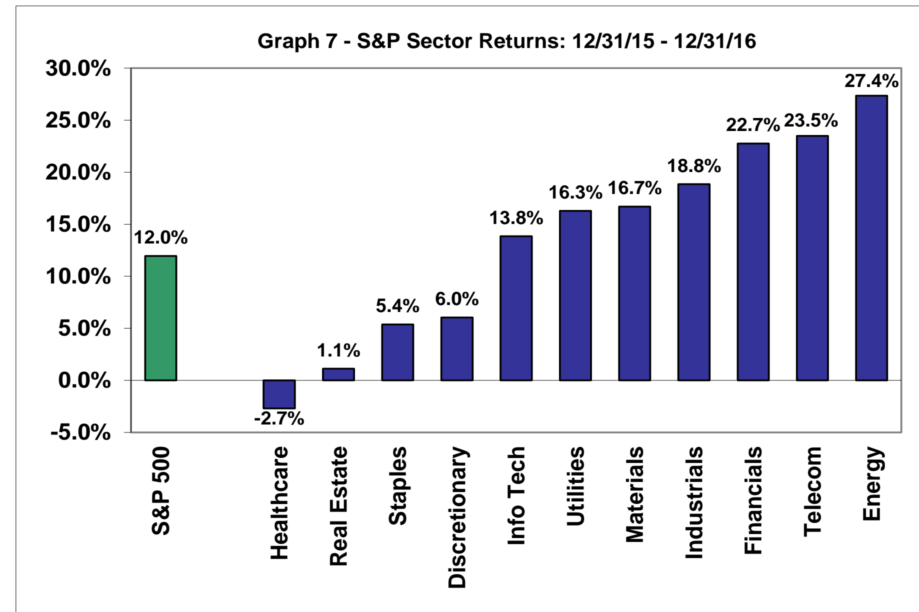
US Equities (continued)

There were also wide divergences among S&P 500 sectors during the fourth quarter, as shown in Graph 6. Financial stocks significantly outperformed the broad index as expectations for higher interest rates, and thus wider interest margins for banks, lifted the beleaguered sector by 21.1%. Energy stocks also outperformed during the quarter, particularly after the price of crude oil rebounded in late November. In contrast, real estate and healthcare stocks underperformed, declining -4.4% and -4.0%, respectively, reflecting concerns about 1) how rising interest rates might impact REITs, and 2) uncertainty over the future pricing power of healthcare companies under a new regulatory regime. The dispersion among sectors seen in the quarter is further evidence of the widening divergences that started at the end of 2015, as shown in Graph 7.





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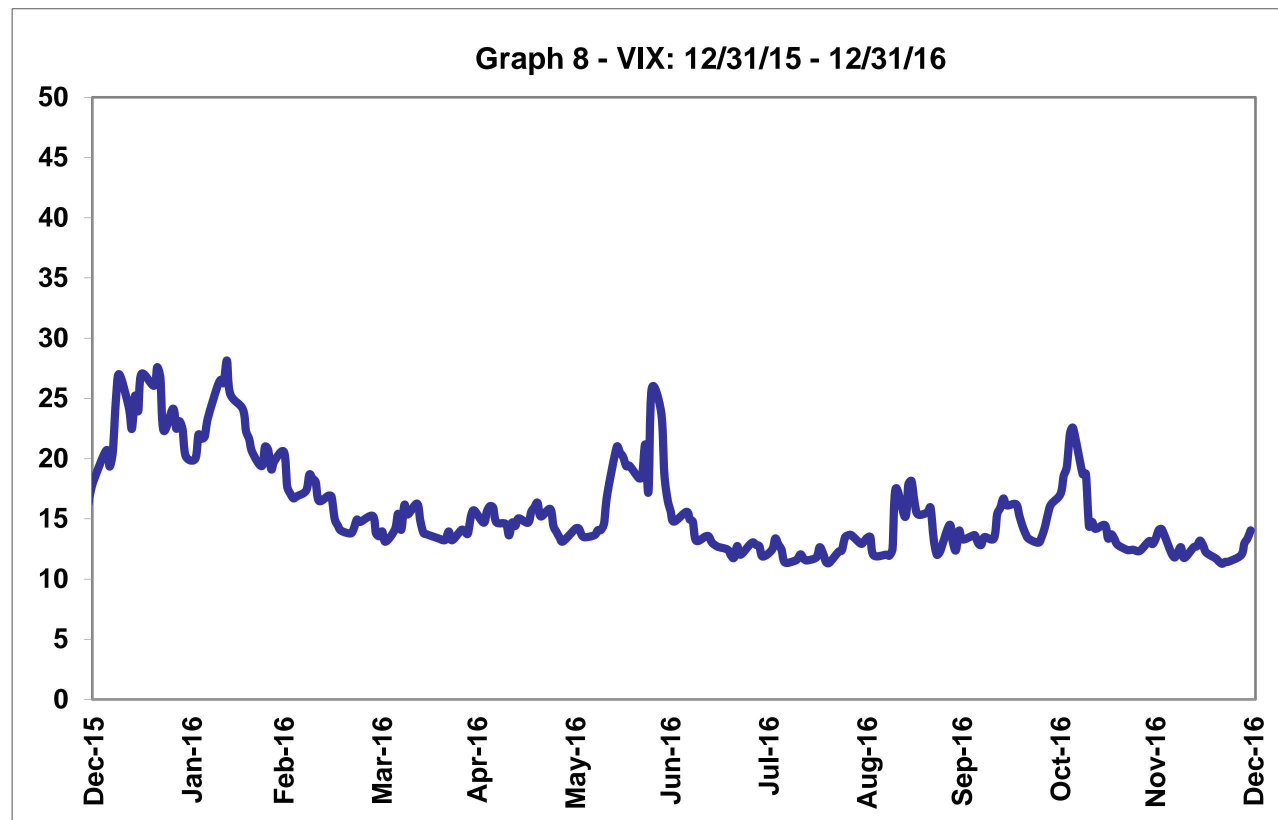
US Equities (continued)

Volatility rose sharply in the days prior to the presidential election, but then quickly returned to low levels as equities rebounded after the election. The CBOE Volatility Index (VIX, or the "fear index," which is a measure of expected volatility displayed in the equity options market) was suppressed for much of the remainder of the quarter. However, interest rate hike fears were stirred after the December FOMC meeting, driving the VIX higher in the final weeks of the quarter, as shown in Graph 8.



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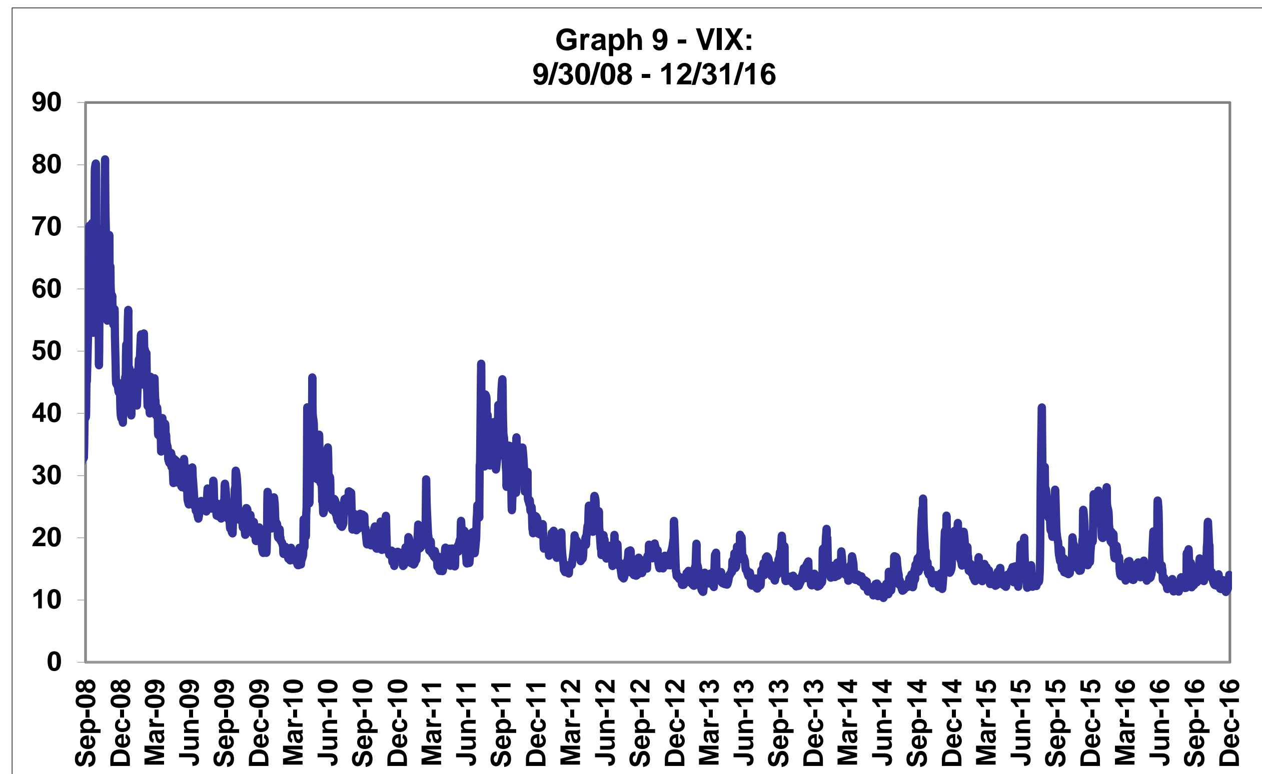
US Equities (continued)

To put this in broader perspective, although the VIX spiked briefly during the quarter, the Index remains below its longer-term average of about 20. In addition, the minor spike in VIX seen prior to the presidential election was still well below the historic levels of the Global Financial Crisis of 2008 and the spike in August 2015, which was roughly in line with the levels seen during the US budget/debt ceiling crisis in 2010 and the European sovereign debt crisis of 2011, as shown in Graph 9.

Indeed, VIX has been bumping along historic lows for much of the past three years. The last stretch of exceedingly low volatility occurred from late 2003 through early 2006. However, our view is that the recent spikes in volatility foreshadow more to come, as 1) China is grappling with its financial excesses while attempting to orchestrate a gradual economic restructuring, 2) geopolitical tensions and the rise of populism around the world could fuel bouts of political uncertainty, and 3) the Federal Reserve is moving towards normalizing interest rates. This does not mean that we expect to see a return to the peaks of 2008, just that the long stretch of very low volatility is likely behind us as markets adjust to a new phase of the market cycle.



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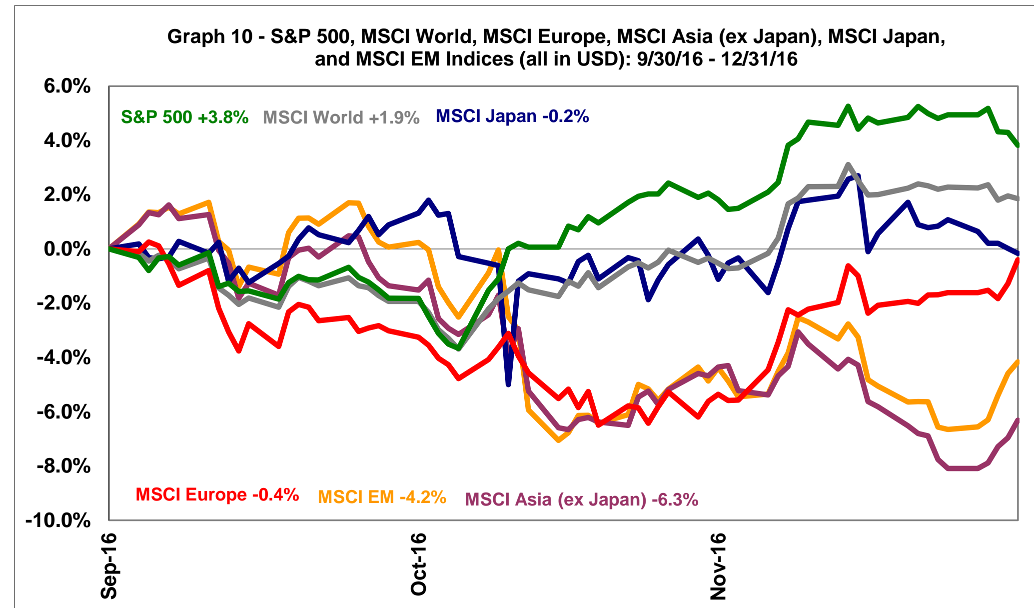
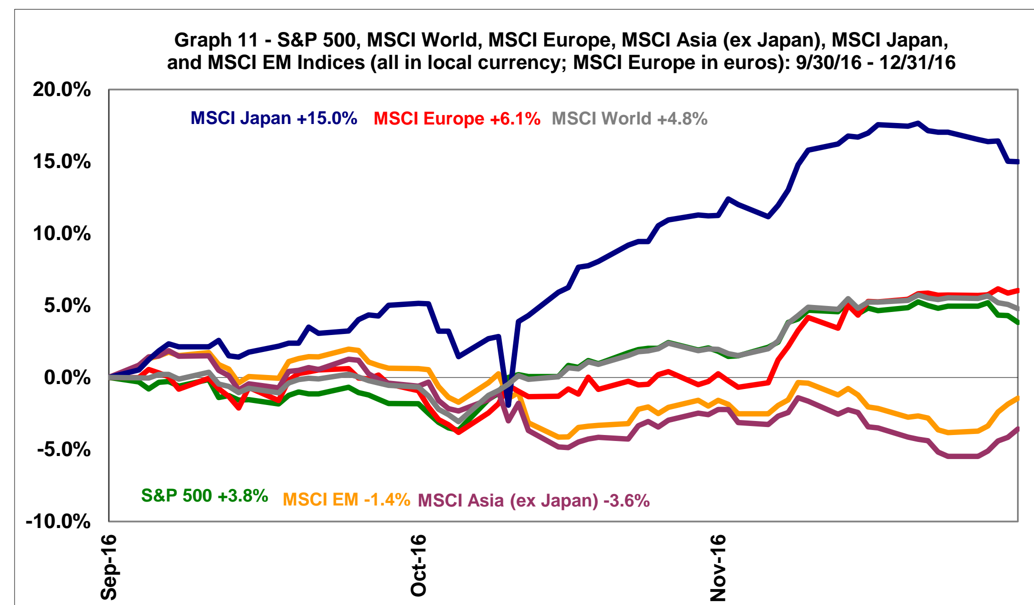
Non-US Equities

In US dollar terms, the major international equity markets once again tended to follow the pattern of the S&P 500 during the fourth quarter, although with a heightened degree of dispersion and volatility, as shown in Graph 10. In US dollar terms, each of the major international indices depicted underperformed the S&P 500 in the fourth quarter. However, in local currency terms, international equity markets generally performed much better. Notably, MSCI Japan jumped 15.0% in yen and MSCI Europe gained 6.1% in euros. In contrast, MSCI Emerging Markets and MSCI Asia (ex Japan) declined, as shown in Graph 11.

With the exception of Japan, which saw a strong rally in local currency terms during the quarter, Asian markets significantly underperformed global indices in the fourth quarter. The primary detractors were China and India, where concerns about capital flight and rising credit in China along with a lull in economic and regulatory momentum in India led to a pull back in equities in those countries.





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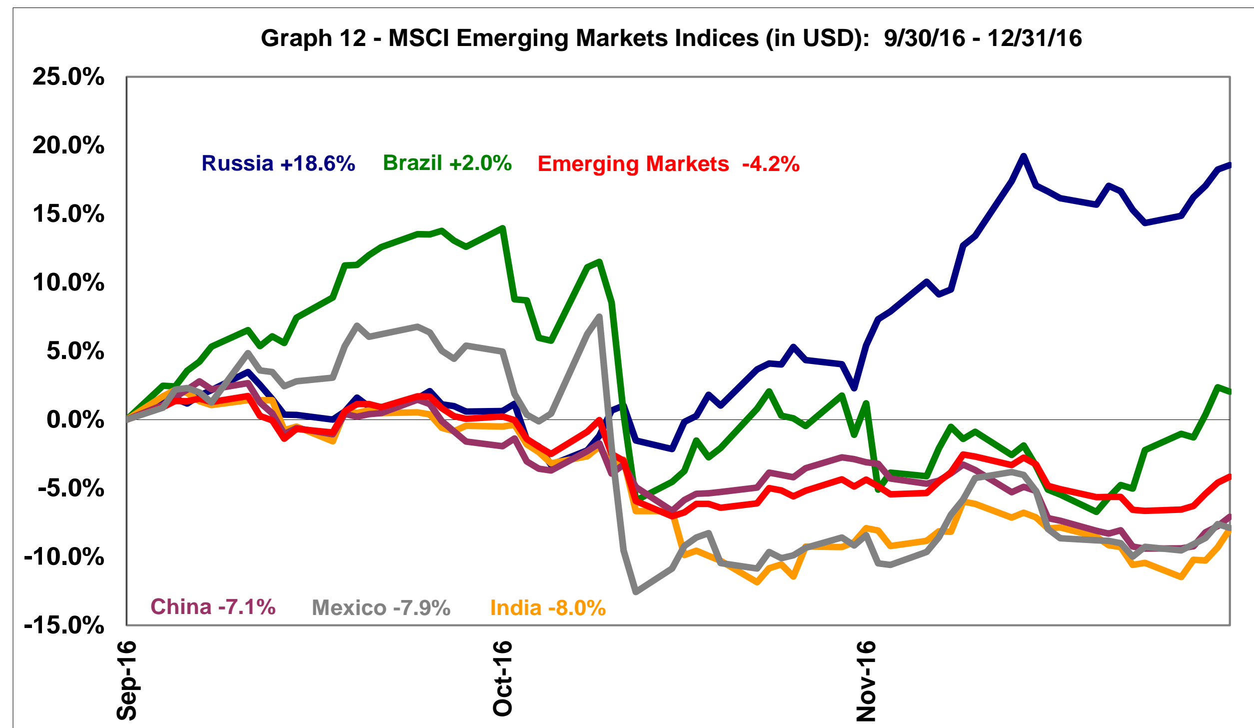
Non-US Equities (continued)

Emerging market equities continued to experience a large degree of dispersion among individual countries during the fourth quarter, as shown in Graph 12. The MSCI Emerging Markets Index was relatively range bound throughout the quarter and experienced relatively low volatility, finishing with a loss of -4.2% (in US dollar terms). However, the broad emerging markets index masked much of the dispersion among individual countries. For example, MSCI China and MSCI India were especially volatile, falling -7.1% and -8.0% respectively in US dollar terms in the quarter. In contrast, MSCI Russia and MSCI Brazil were also volatile during the quarter, but ended higher (up 18.6% and 2.0%, respectively). Specifically, while China and India both suffered from a loss of investor confidence due to weakening economic momentum and currency flows, Russia, and to a lesser extent Brazil, benefited from strengthening commodity prices and improving political situations.



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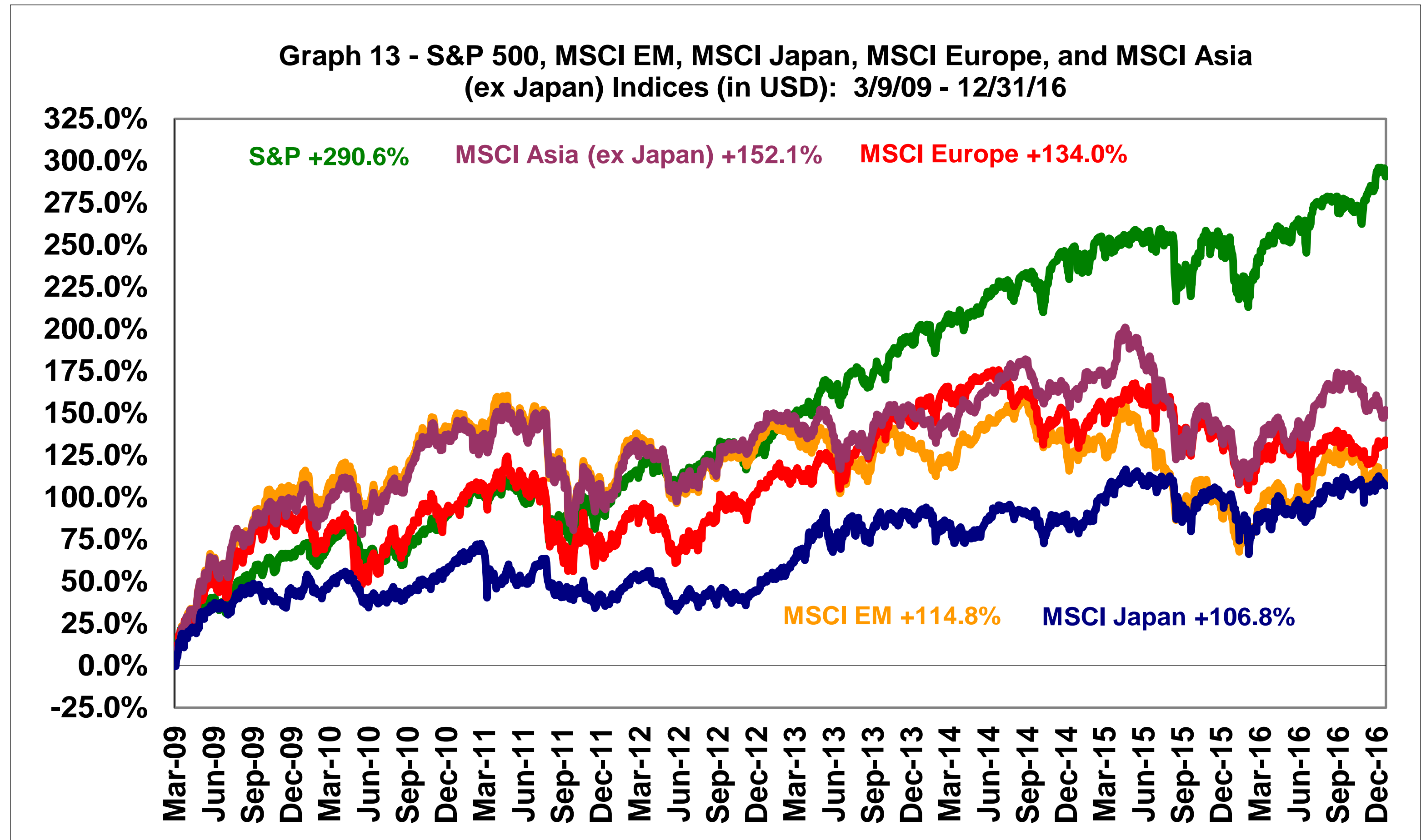
Global Equities

Putting the global equity markets in broader perspective, the major indices have increased significantly since their post-Global Financial Crisis lows of early March 2009. However, it has been quite a roller-coaster ride along the way, as shown in Graph 13.



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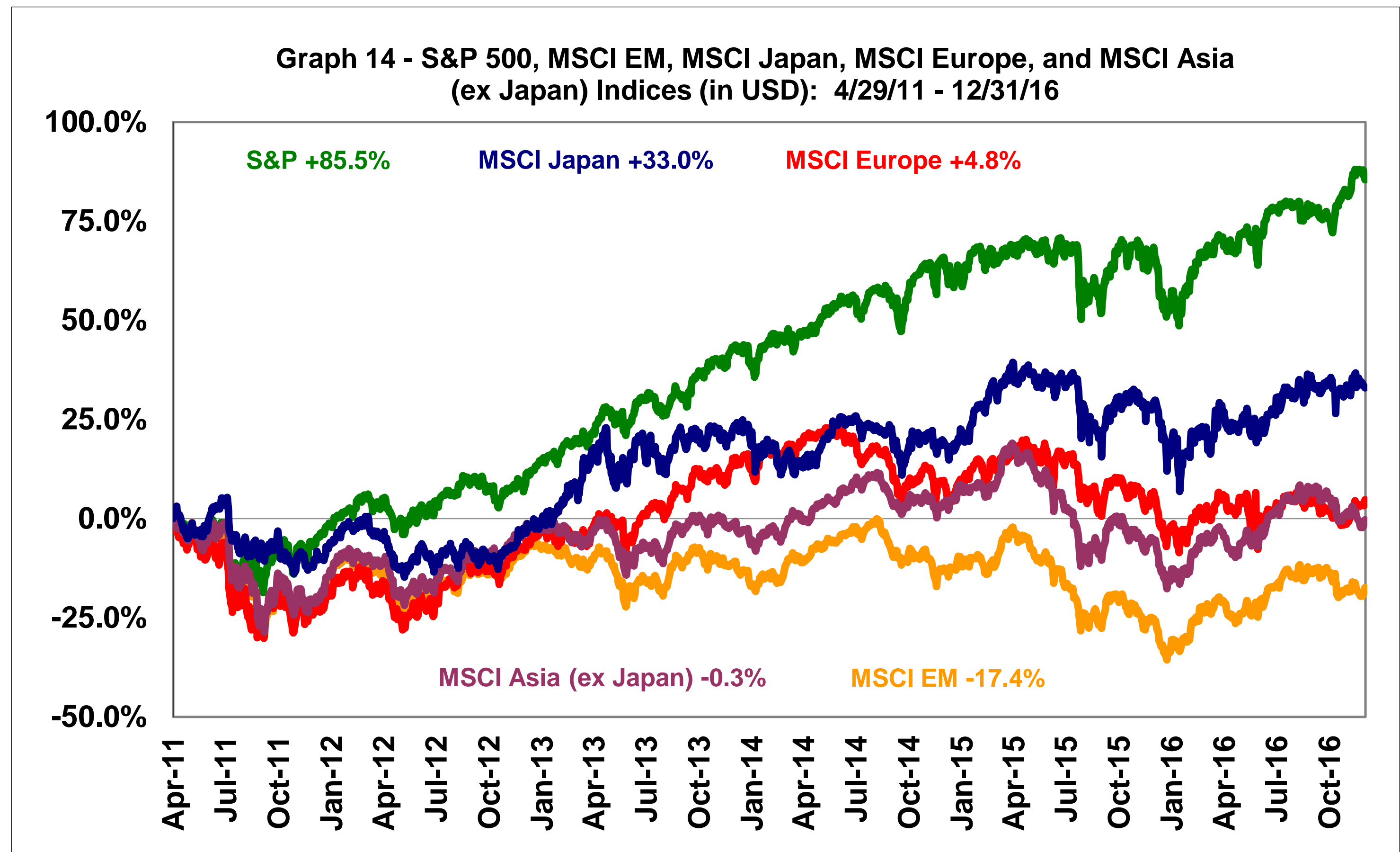
Global Equities (continued)

Since the prior peaks of April 2011, the dispersion among major equity markets has been particularly wide. The market that has exceeded its prior peak of April 2011 the most has been the S&P 500, having increased 85.5% from that point, as shown in Graph 14. MSCI Japan is now 33.0% above its April 2011 peak (in US dollar terms), partly as a result of the "Abenomics" rally of 2013 as the market has moved sideways from mid-2013 through the fourth quarter of 2016 (again, in dollar terms). In contrast, MSCI Europe is up 4.8% from April 2011 in US dollar terms, and MSCI Asia (ex Japan) is down -0.3% from the 2011 peak in US dollars. MSCI Emerging Markets has done far worse, having declined -17.4% from its April 2011 peak in US dollar terms.



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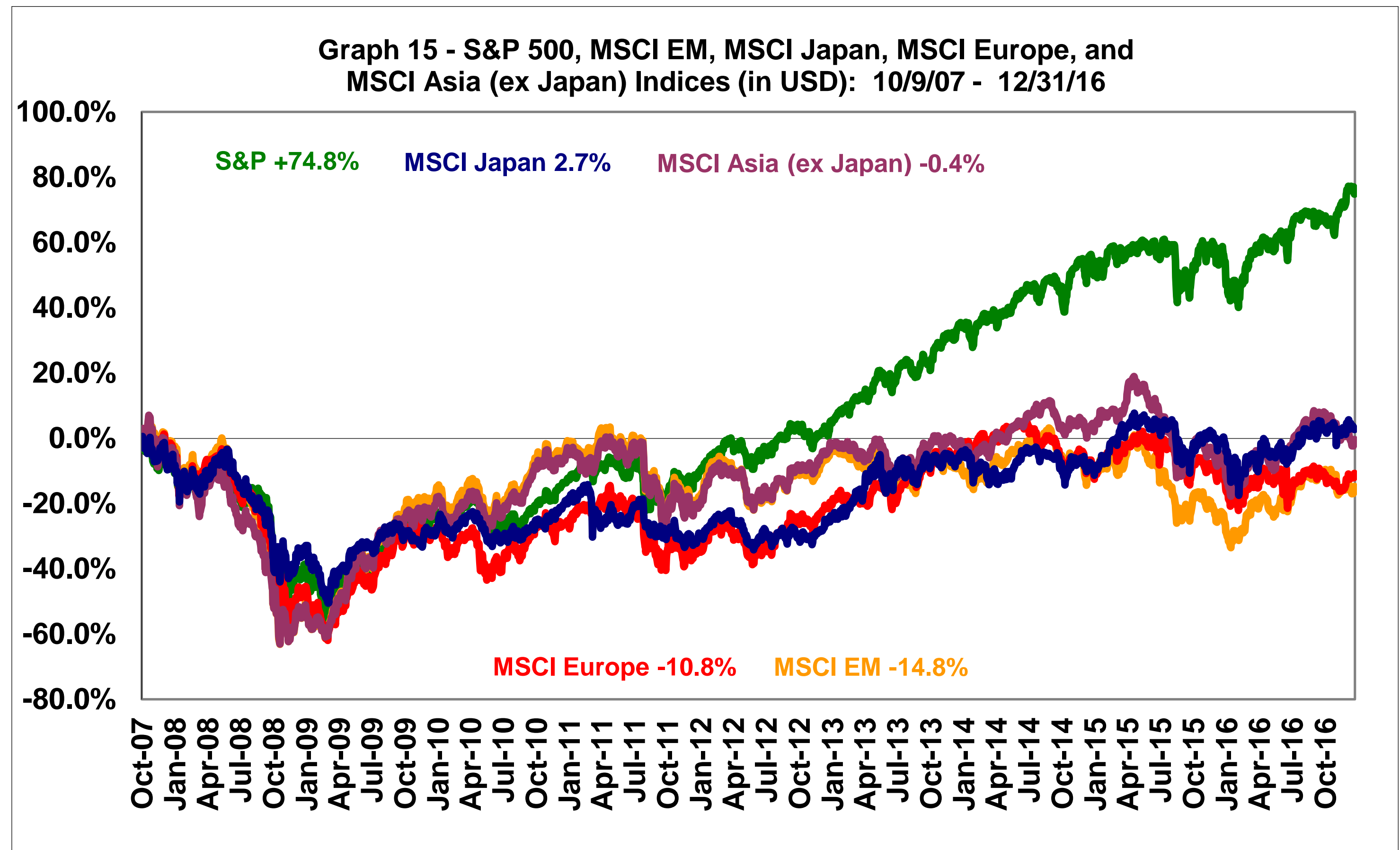
Global Equities (continued)

As shown in Graph 15, several global equity indices remained below their prior peaks of October 2007 (in US dollar terms), partly reflecting the increased volatility in global equity markets that started in the third quarter of 2015. The most significant exception is the S&P 500, which was up 74.8% over this period. Notably, by the end of 2016 MSCI Japan was the only major non-US index with a positive return for the period in US dollar terms. The graph underscores the protracted nature of the recovery in equity markets since the 2008 Global Financial Crisis.



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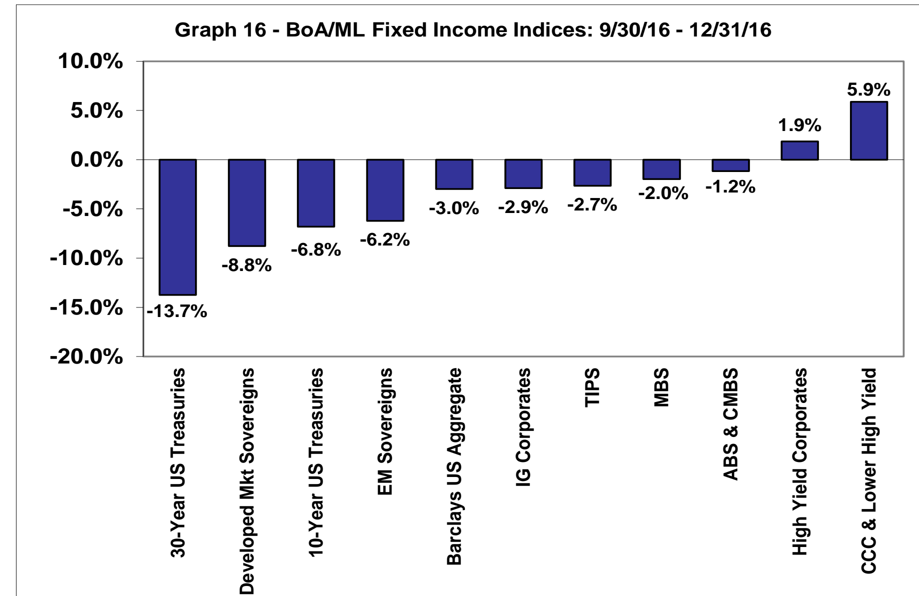
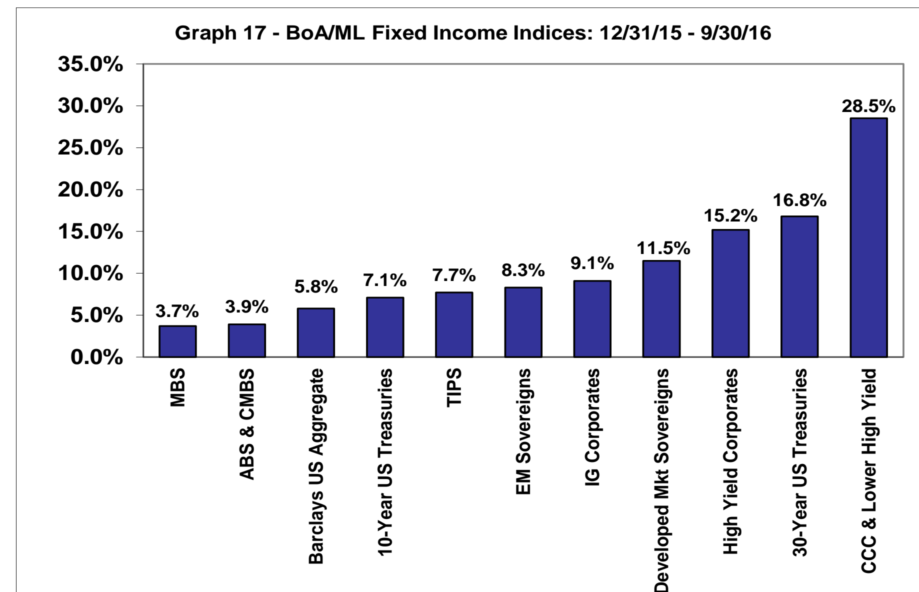
Global Fixed Income

Fixed income markets generally saw negative returns during the fourth quarter, as shown in Graph 16 on the right. This marked a reversal from the strong rally seen in the first three quarters of the year, as shown in Graph 17, which primarily reflected the overall decline in global interest rates and the ongoing rebound in credit-related fixed income, particularly in commodity-related sectors.

Long-term US Treasuries lagged in the fourth quarter, as the yields on such bonds rose sharply following the US presidential election and in the days preceding the December FOMC meeting. In particular, inflation expectations have increased as a result of Trump's fiscal stimulus and tax reform plans, as well as the Federal Reserve's more hawkish tone. As a result, the 30-year US Treasury declined -13.7% in the fourth quarter and the 10-year US Treasury declined -6.8%. International sovereign bonds in both developed and emerging economies also declined as rising rates in the US and the strengthening US dollar caused investors to view such bonds less favorably.

In contrast, credit-related sectors outperformed in the fourth quarter. The BAML CCC & Lower High Yield Index, which includes many of the riskiest corporate credits in the US, rallied 5.9% in the period, bolstered by the continued rebound in commodity prices, which has alleviated widespread concern that commodity-related sectors would see an increase in defaults. Similarly, the BAML High Yield Corporates Index gained 1.9% in the quarter. However, investment grade credit followed US Treasuries lower with a decline of -2.9%. Structured credit had a relatively muted loss during the quarter, as the MBS, ABS, and CMBS categories all saw small declines but outperformed other fixed income indices.





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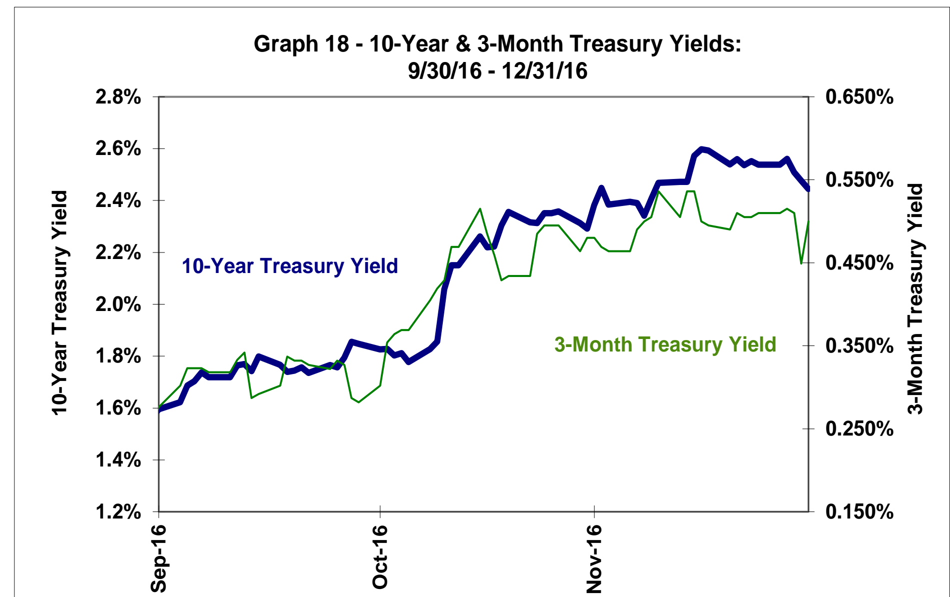
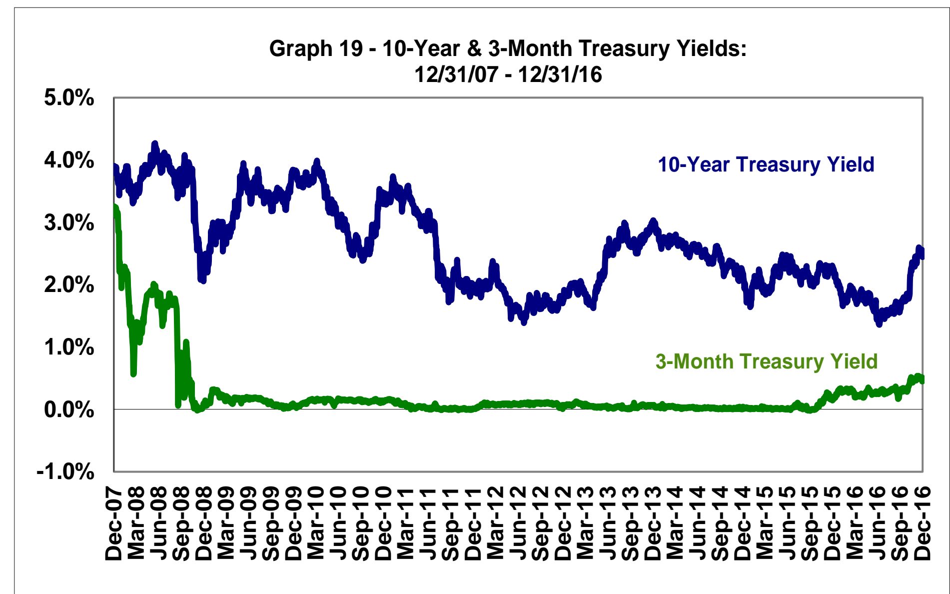
US Government Fixed Income

In the US government market, short-term interest rates moved higher throughout most of the fourth quarter as expectations for a December rate hike increased, as shown in Graph 18. However, 3-month Treasury yields remained relatively range bound following the December FOMC meeting as investors awaited further signaling on when the next rate hike might occur. Similarly, the yield on the 10-year Treasury trended higher throughout the fourth quarter, before falling slightly in the final days of the quarter. The yield started the quarter at 1.60% and rose to 2.45% at the end of December.

The yields on 10-year Treasuries declined significantly between the fourth quarter of 2013 and the third quarter of 2016, albeit with increasing volatility over the past twelve months, as shown in Graph 21. Despite the increase in yields during the fourth quarter, they remain significantly lower than the levels of 2008 and 2009.





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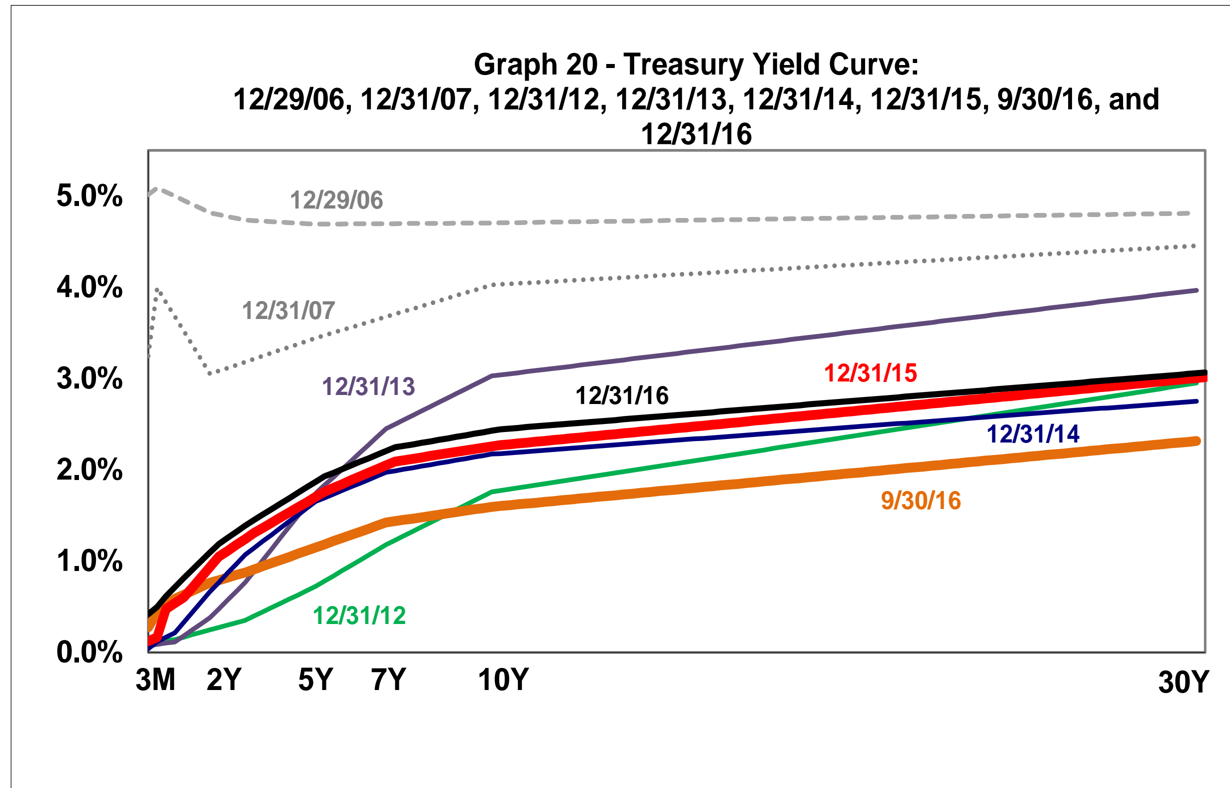
US Government Fixed Income (continued)

There was a nearly uniform increase across the yield curve during the fourth quarter, as shown in Graph 20. This reflects increased inflation expectations since the election of Donald Trump and the rising likelihood of interest rate hikes both before and after the December FOMC meeting. It also is noteworthy that the shorter end of the curve and the middle of the curve steepened relative to the rest of the curve during the quarter, as 3-month, 1-year, 2-year, and 5-year interest rates increased relatively more than longer dated yields during the fourth quarter. Note also that the "belly" of the curve has become more pronounced relative to the end of 2012, when the economic outlook was much more uncertain. Per our usual exercise in historical context, we have included the curves from the end of 2006 and 2007, which were much higher and even inverted, reflecting economic conditions that were more ebullient and monetary policy that was much less accommodative.



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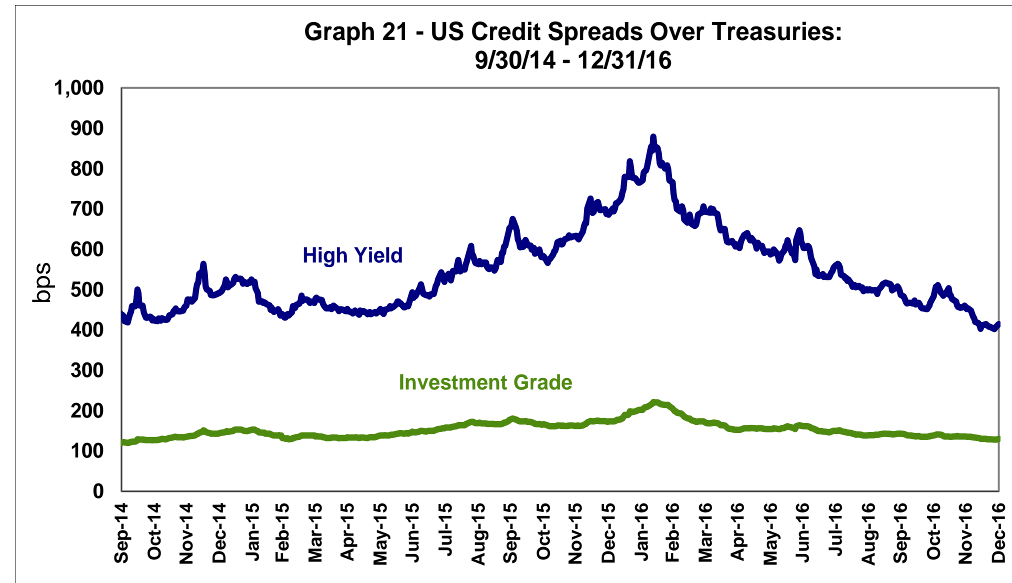
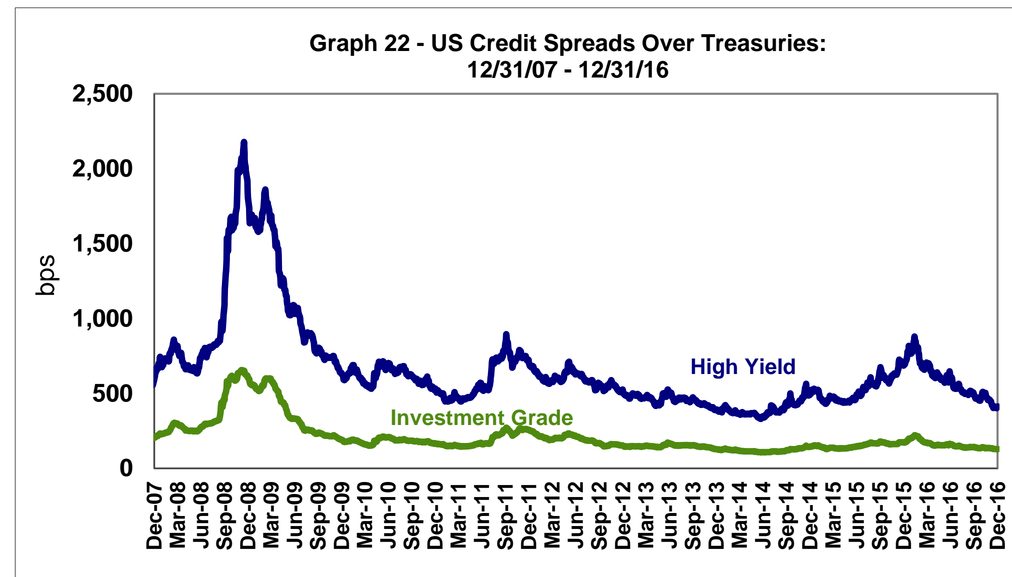
US Corporate Credit

In the US corporate credit sector, high yield spreads continued to narrow throughout the fourth quarter, as shown in Graph 21. Investment grade spreads followed a similar pattern, but were relatively more stable as spreads remained quite narrow. Credit spreads trended wider during the second half of 2015 primarily due to the impact of the selloff in the energy sector, which faced persistently low oil prices that have impaired profitability in the sector and raised the specter of eventual defaults and bankruptcies. The rebound in commodity prices since the lows of mid-February 2016 helped alleviate these concerns to some extent, contributing to the recent positive performance of high yield corporate credit year to date. In addition, the ongoing search for yield in reaction to the low interest rate environment continues to push credit spreads narrower.

Furthermore, as shown in Graph 22, credit spreads have narrowed towards post-crisis lows. Notably, although the spread widening seen in 2015 was similar in magnitude to the credit selloff in 2011, neither of those were as severe as the historic spread levels that occurred in 2008.





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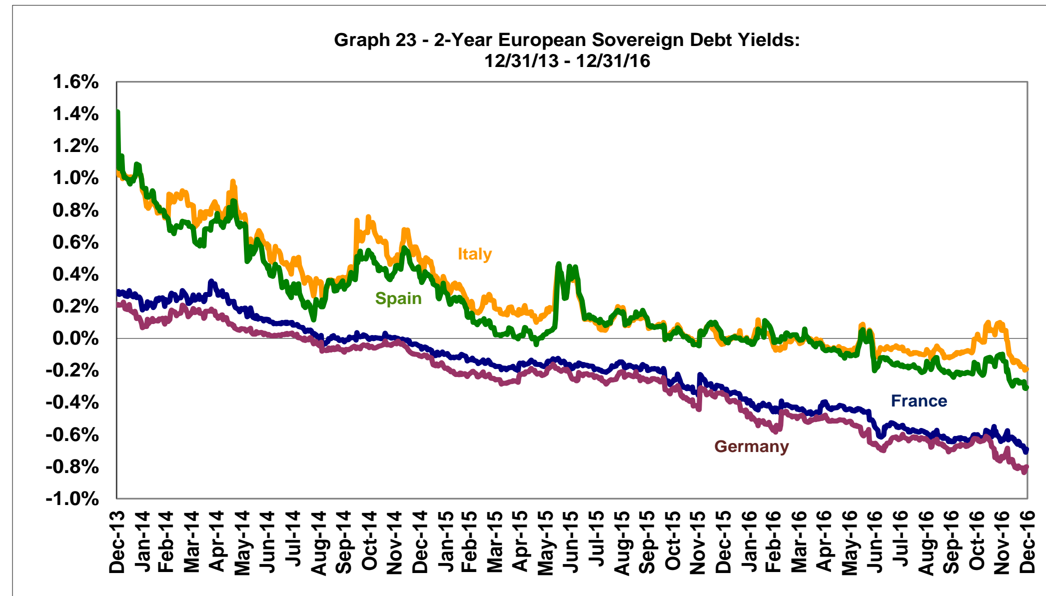
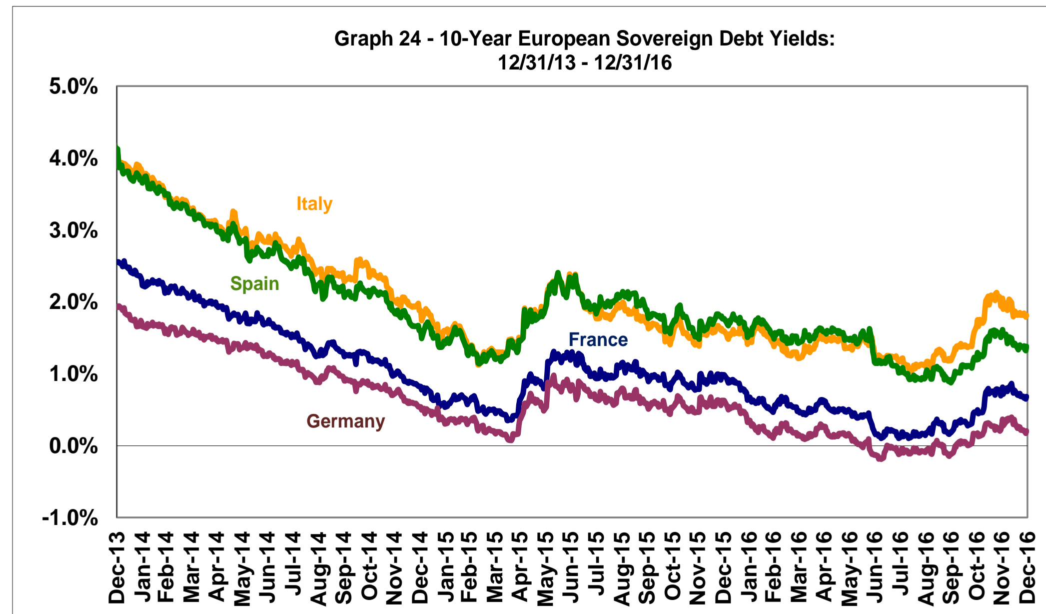
European Sovereign Credit

One notable ongoing trend in global fixed income markets has been the steady decline of yields on European sovereign debt. As shown in Graph 23, the 2-year yields in Germany and France have been negative since late 2014, while Italian and Spanish 2-year yields also moved into negative territory in early 2016. This downward trend was interrupted in the latter part of the second quarter of 2015, when the crisis in Greece intensified yet again, but sovereign yields resumed their downward path in the third and fourth quarters of 2015 as the Greek crisis dissipated, as shown in Graphs 23 and 24.

As shown in Graph 24, 10-year European sovereign yields remained positive despite the downward trend, until the German 10-year fell into negative territory in late June and stayed below 0% throughout the third quarter of 2016. However, European 10-year yields rebounded significantly in the fourth quarter as rising populism across Europe, particularly in Italy which culminated in Prime Minister Renzi's resignation, has led to growing concern over the sustainability of the euro zone's key economic agreements.





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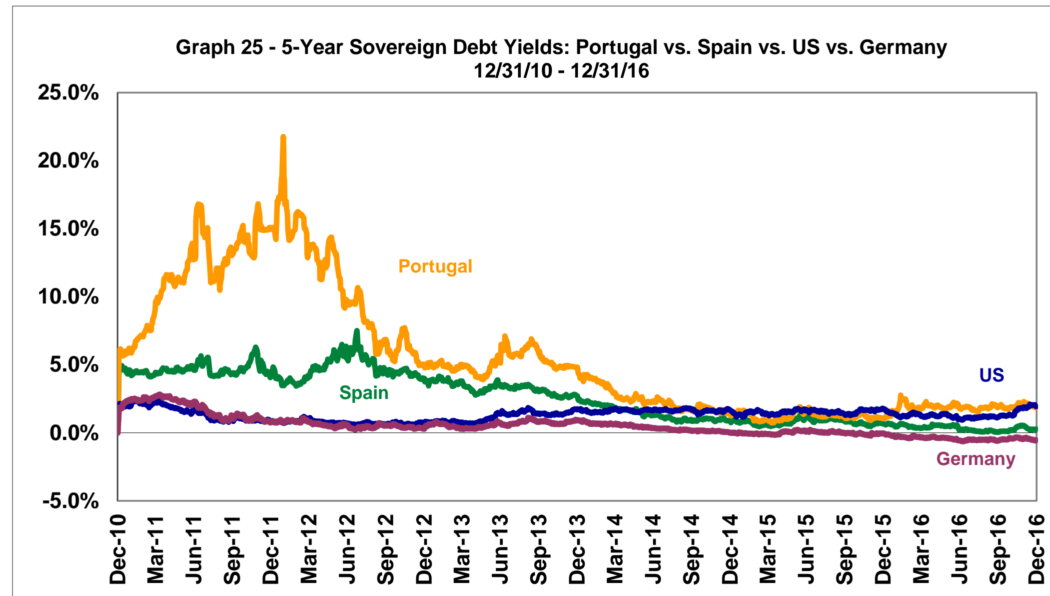
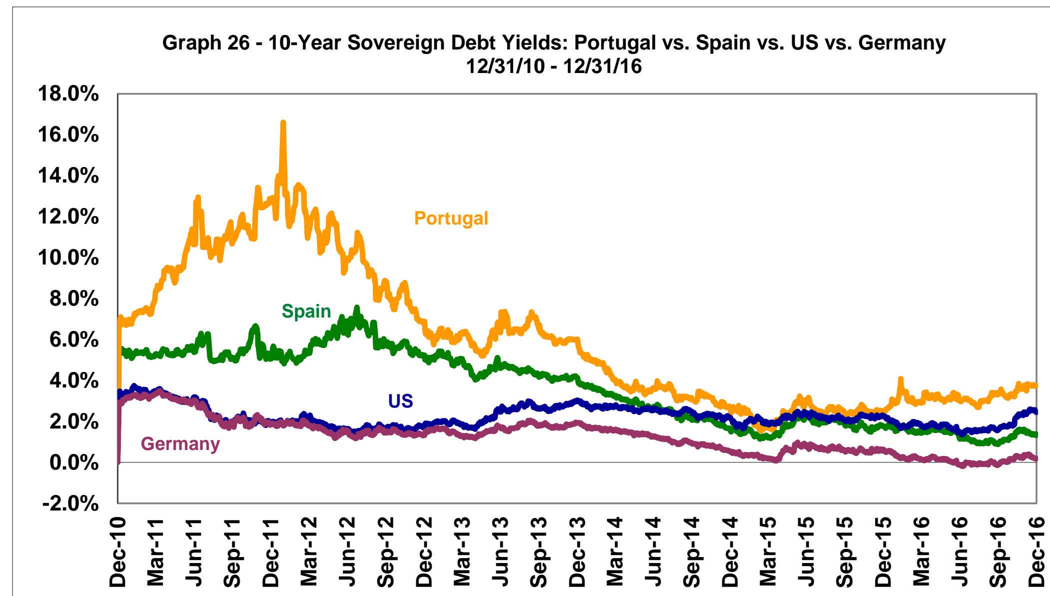
European Sovereign Credit (continued)

European sovereign debt yields remain well below their crisis-era levels. They also have converged with, or traded through, yields on US Treasuries, as shown in Graph 25 and Graph 26. In fact, the yield on Spanish 5-year issues has been less than that on 5-year Treasuries since mid-April of 2014. In addition, the yield on Spanish 10-year issues fell further below 10-year Treasuries in the third quarter.





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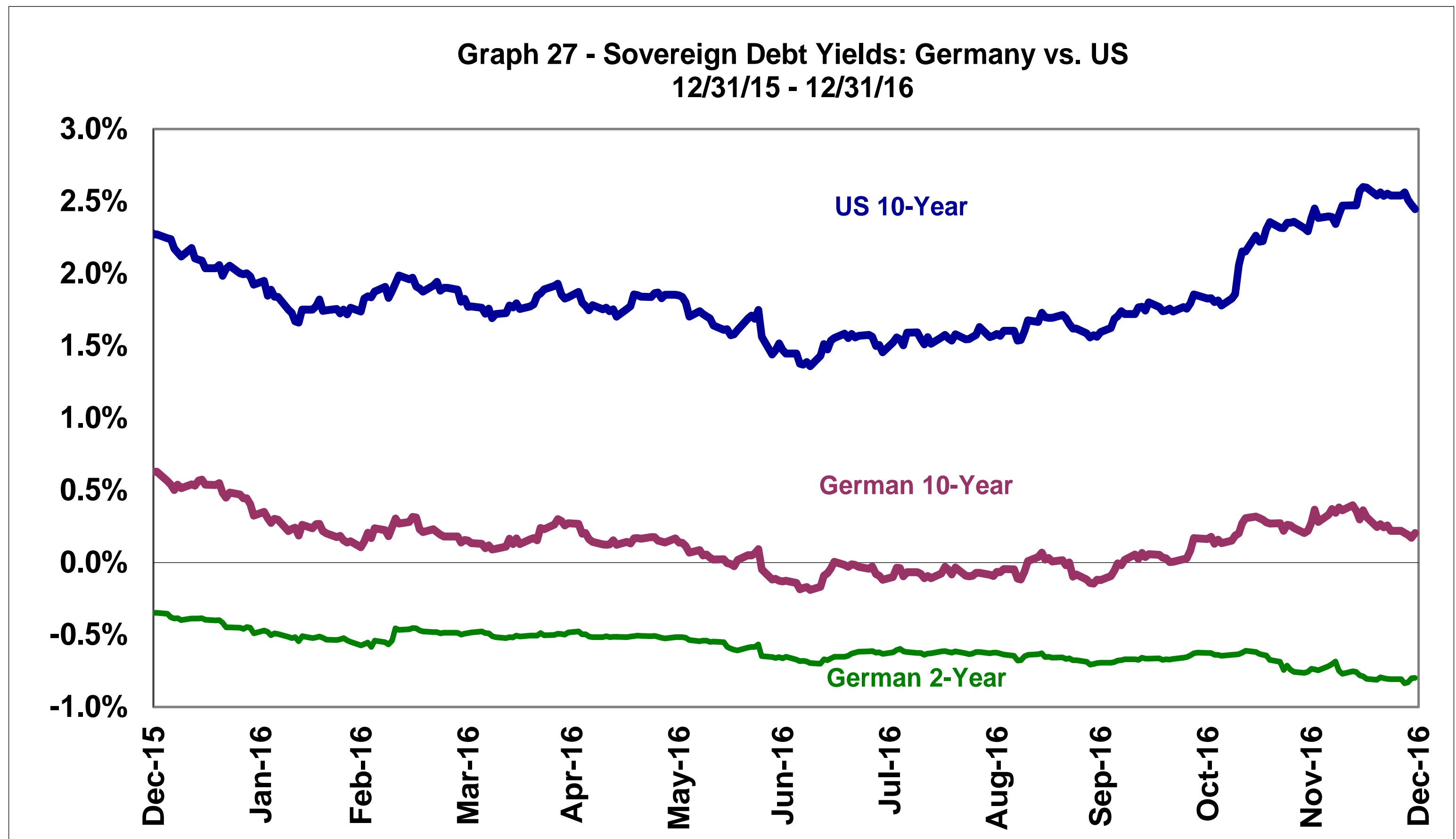
European Sovereign Credit (continued)

The stark contrast between German and US sovereign bond yields is highlighted in Graph 27. Although yields in both Germany and the US have followed similar trends throughout 2016, the yield on 10-year German bunds fell to 0.20% and 2-year German yields fell to -0.80% versus the US 10-year Treasury yield of 2.45% at the end of December. Such has been the effect of different growth and inflation expectations, as well as the divergence of monetary policies.



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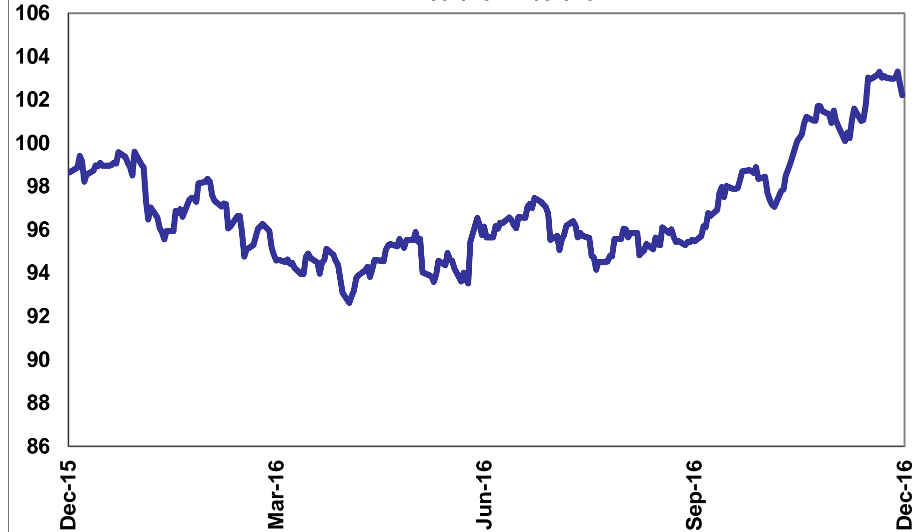
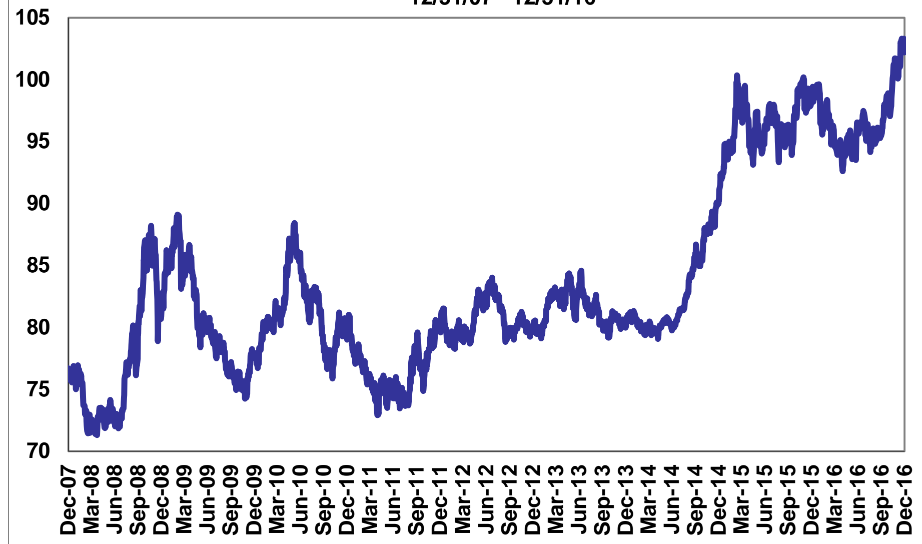
Currencies

After falling during the first quarter of 2016, the US Dollar Index (USDX) bottomed near the end of April, and has moved higher despite bouts of volatility since then, as shown in Graph 28. Volatility in the US dollar has risen as some investors expect the US dollar to rally as a result of the new interest rate hike cycle, while others believe the Federal Reserve will take a prolonged pause given lackluster inflation data and international economic risks.

Nevertheless, the US dollar remains near the strongest levels it has seen in the post-crisis era, as shown in Graph 29. At the previous peaks in late 2008 and mid-2010, the surge in the dollar was temporary and reflected its haven status during crises. The dollar's strong appreciation from mid-2014 through the end of the fourth quarter of 2016, however, has been the result of the relative strength of the US economy and the divergence of central bank policies, further boosted by rising expectations for inflation related to Donald Trump's proposed fiscal policies.





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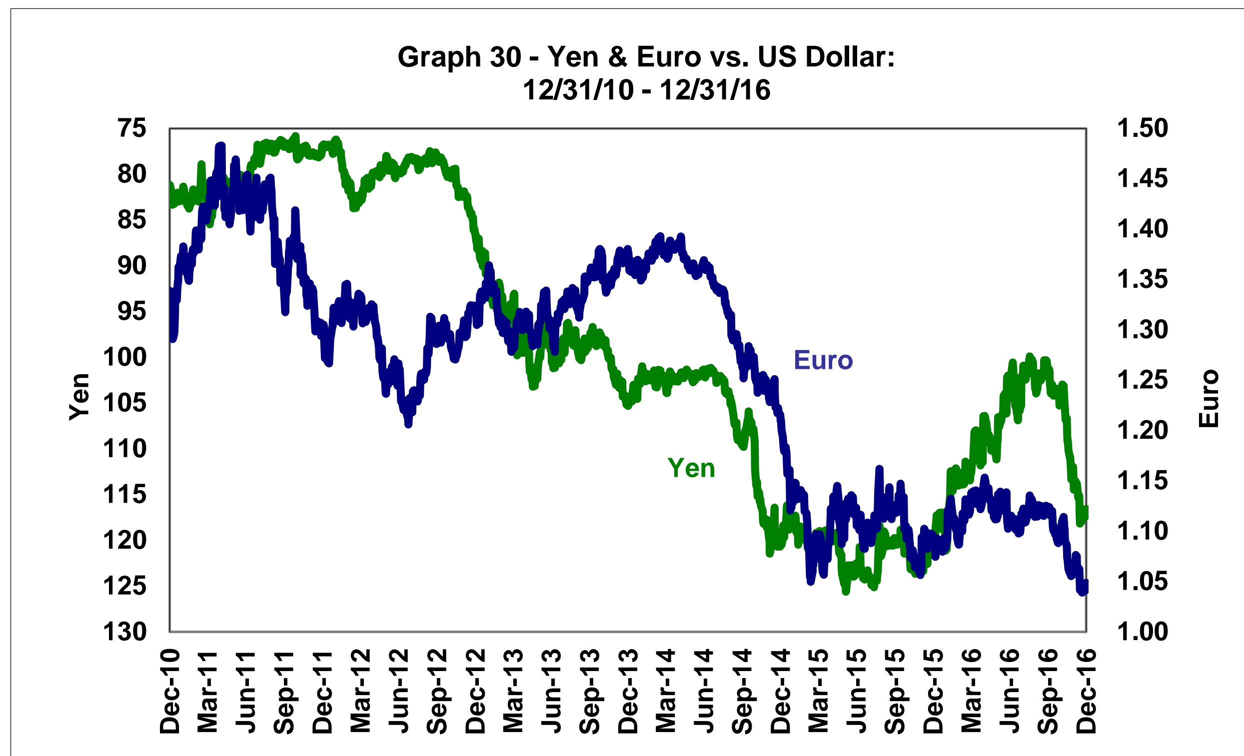
Currencies (continued)

The yen and euro both weakened significantly versus the US dollar during the fourth quarter, as shown in Graph 30. The euro has been particularly volatile throughout 2016, which remained the case throughout the fourth quarter as investors grappled with the implications of Brexit, rising populism across the continent, uncertainty about ECB quantitative easing, and the fragility of major European banks. The euro began the quarter at 1.124 against the US dollar, which was also its peak for the quarter, and fell to 1.052 by the end of the quarter, registering a quarterly decline of -6.4% versus the dollar.

The yen also weakened versus the dollar during the fourth quarter, reversing from its recent strengthening trend in the prior three quarters. The yen began the quarter at 101.33 and sharply fell to 117.00 by the end of December, marking a -15.5% decrease. The severe weakness in the yen reflected a combination of rising inflation that remains a key goal of the Bank of Japan, as well as the stark contrast in monetary policy between Japan and the US.



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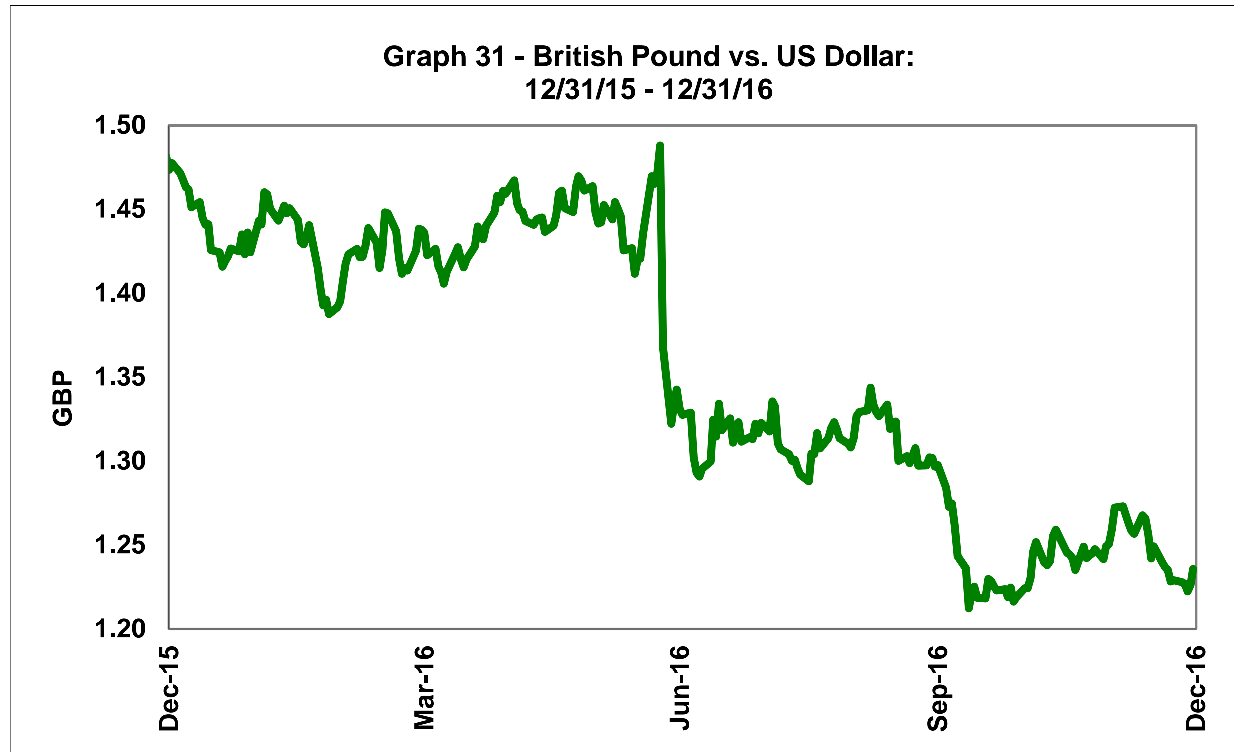
Currencies (continued)

The British pound experienced a sharp selloff following the outcome of the EU referendum in late June, as shown in Graph 31. The pound fell -15.5% versus the US dollar from its June peak to its post-Brexit low, hitting levels not seen in over three decades. As investors have started to wonder what the implications of the UK leaving the EU will mean for the British economy and for the rest of Europe, and how regional central bankers will react, the pound has remained volatile and range bound since the end of June. While the initial shock of the referendum outcome was more severe than the immediate implications of leaving the EU (such implications will not become clear until the UK actually begins the process of leaving the EU by invoking Article 50), the event is a harbinger of a new volatility environment for investments related to the UK and the broader European region.



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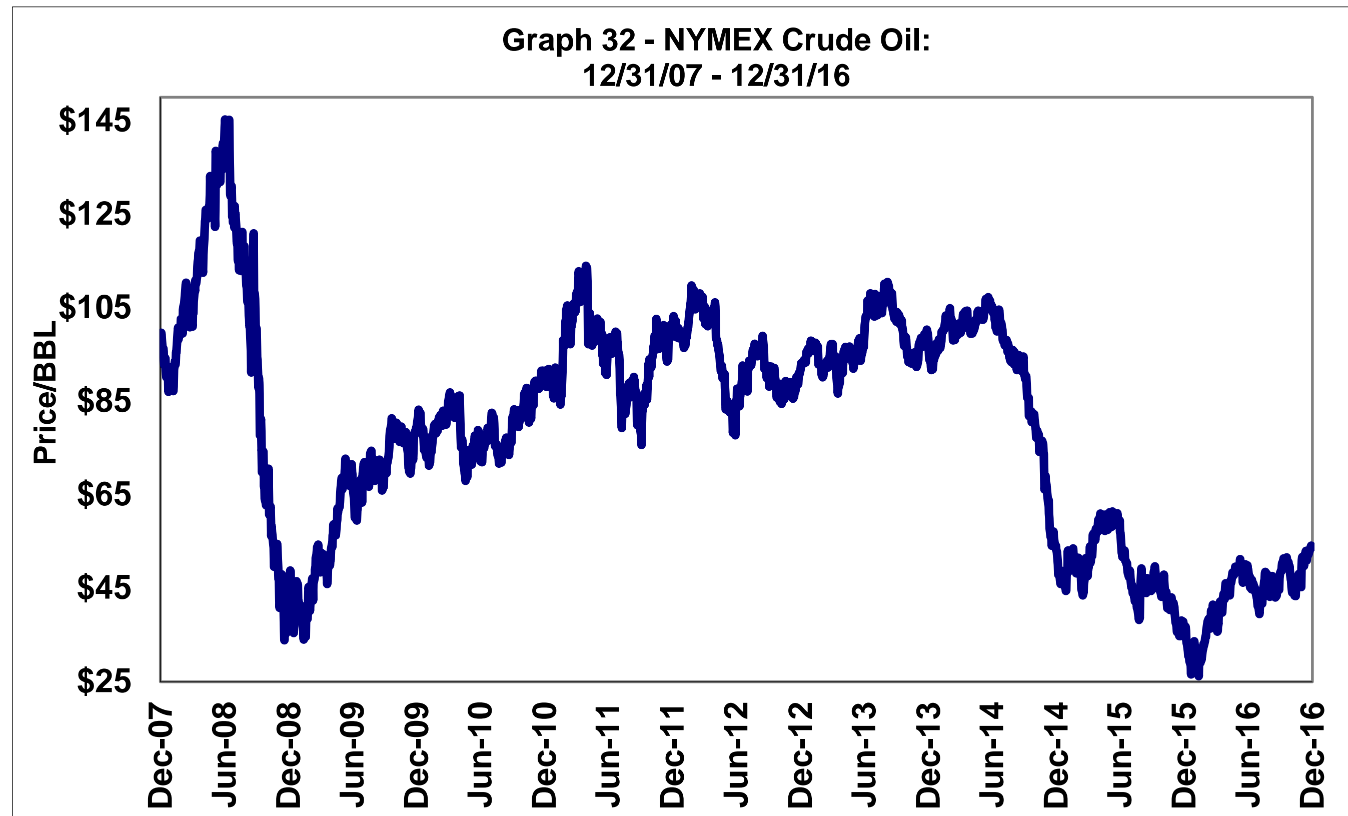
Commodities

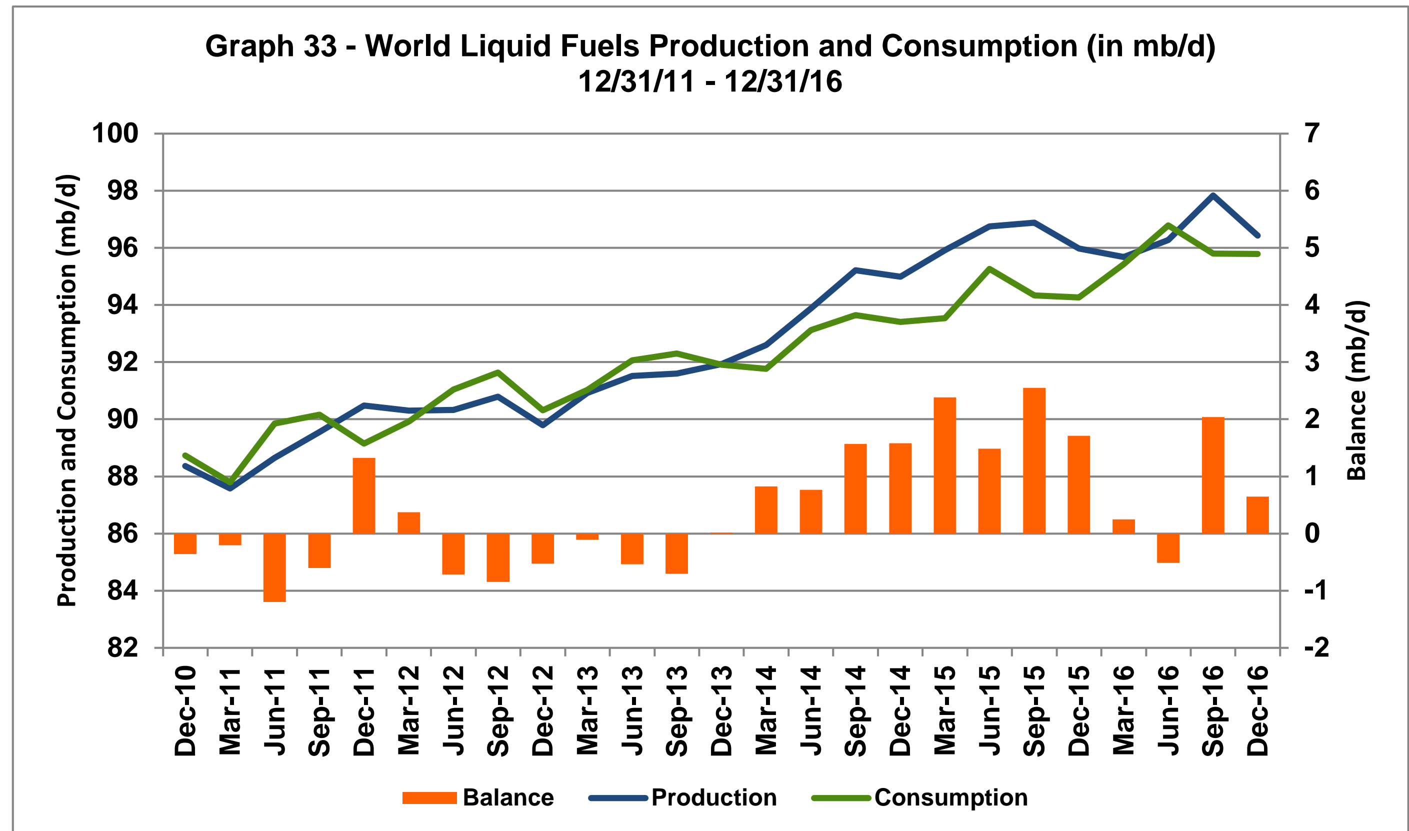
Aside from equities, fixed income, and currencies, one of the most closely-watched features of the investment landscape has been the move in oil prices. After crashing in the second half of 2014, crude oil prices showed signs of forming a bottom by the end of the first quarter of 2015, and then rebounded for much of the second quarter, but resumed the downward trend in the third quarter and fourth quarter of 2015, as shown in Graph 32. However, oil prices staged a rally from the middle of the first quarter through the middle of the second quarter of 2016, then stabilized in the third quarter and gyrated higher in the fourth quarter, in response to continued declines in rig counts, a slowdown in production, and most recently, an OPEC agreement to reduce output. Since the interim peak of $61.43 per barrel in June 2015, the price of West Texas Intermediate fell to as low as $26.21 on February 11th, 2016, before rebounding sharply to $53.72 by the end of December.



Market Developments & Investment Trends – 4th Quarter, 2016

Commodities (continued)

Much of the decline in oil prices has been due to global oversupply and the decision by Saudi Arabia not to cut production in late 2014, and to a lesser extent to weaker demand, especially from China's industrial sector. Furthermore, the reduced economic restrictions on Iran have enabled the country to begin producing more oil for export, resulting in a spike in production in the second half of 2016. The net result of these trends has been a significant supply/demand imbalance, as illustrated in Graph 33, resulting in significant oversupply and a large increase in inventories that took place over the last two and a half years.



Source: U.S. Energy Information Administration

Market Developments & Investment Trends – 4th Quarter, 2016

Commodities (continued)

The energy industry, especially in the US, responded by shutting marginal rigs, as shown in Graph 34, and delaying or cancelling exploration projects. In addition, global production began to flatten and decline after peaking in the first quarter of 2015, although production has since gradually rebounded, starting in the second quarter of 2016. As a result, the imbalance between production and consumption diminished significantly in the first half of 2016, although it increased again in recent months. While OPEC's production cuts raise the prospect of a greater balance between supply and demand, and thus firmer prices, such an outcome is far from imminent, particularly given the excessive production and buildup of inventories over the last two years.