Investment Commentary: 12/2016

AWM

A year that started as a bust looks like it will end with a bang. Most stock market indices have been in party mode since the election, with small-cap stocks leading the way. The Russell 2000 finished the month up 11.2%, while S&P 500 Index ended the month up 3.7%. Equity gains have reflected hopes that fiscal stimulus paired with large tax cuts will be swiftly implemented by a Republican-controlled Congress. As investors shifted funds to sectors they viewed as poised to benefit from stronger economic growth, cyclical stocks performed particularly well. The gains in industrials (up 8%) and materials (up 7%) came at the expense of more dividend-oriented and defensive sectors such as utilities (down 6%) and consumer staples (down 5%). Financials were the top performer (up 14%) as investors began to price in a faster pace of interest rate increases by the Federal Reserve and less regulation.

Bond investors did not share the euphoria. The Barclays Aggregate bond Index dropped 2.4% for the month. That was the indices worst monthly performance since July 2003. Bonds suffered losses as investors rushed to sell, pushing the yield on the 10-year Treasury to 2.37%, its highest level since June 2015. Against an improving domestic economic backdrop, the selling reflected anticipation of deficit-financed spending and related higher economic growth driving inflation and interest rates higher. Oil prices also rose, reaching nearly $50 per barrel, spurred on by OPEC's November 30 announcement of an agreement to cut production by 1.2 million barrels a day, starting in January.

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International stocks turned in a weak performance during November. The MSCI EAFE index fell 2.0%, while declines in emerging-market stocks were more pronounced. The 4.6% fall in the MSCI Emerging Market index resulted from investor concerns about global trade and the economic pressures of a rising U.S. dollar. To the extent the president-elect makes good on his promises of greater protectionism and a rollback of free-trade agreements, the implications are likely negative for regional economic performance. The valuation on emerging-market stocks are relatively attractive however negative sentiment and a rising dollar may keep them under pressure. As we approach the end of a volatile year, we believe investors should continue to expect, and position for, a high degree of uncertainty, particularly on the policy front.

Individual bonds vs. bond funds

Over the past few years one of the most frequent question I'm asked is 'should I own individual bonds instead of bond funds to protect against rising interest rates?' I believe this arises from a misperception that individual bonds can somehow protect you against interest rate risk if you simply hold them to maturity. The reality is when interest rates rise the market value of an individual bond drops and that risk cannot be avoided by holding it to maturity. A few years ago, famed investor Cliff Asness wrote a great article in the Financial Analysts Journal on his ten pet peeves about the investment industry. His top peeve was the fallacy that owning individual bonds is really any different than investing in a bond fund, here is an excerpt from the article he published:

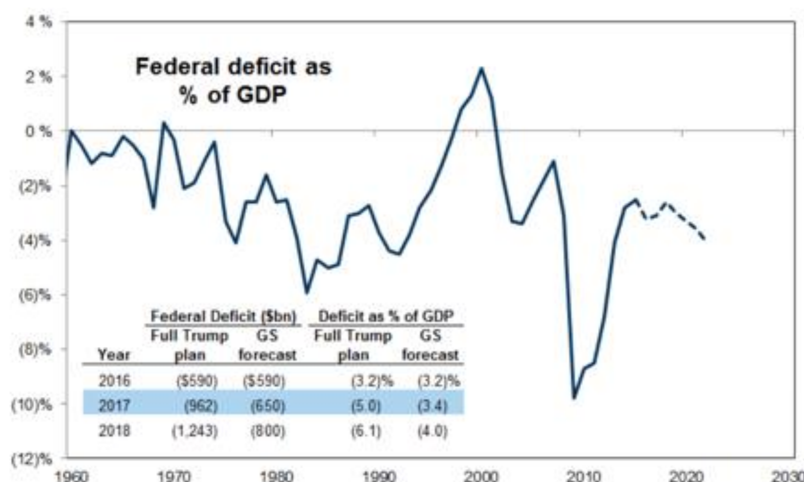
Bond funds are just portfolios of bonds market to market every day. How can they be worse than the sum of what they own? The option to hold a bond to maturity and "get your money back" (let's assume no default

risk, you know like we used to for US government bonds) is, apparently, greatly valued by many but is in reality valueless. The day interest rates go up, individual bonds fall in value just like the bond fund. By holding the bonds to maturity, you will indeed get your principal back, but in an environment with higher interest rates and inflation, those same nominal dollars will be worth less. The excitement about getting your nominal dollars back eludes me. But getting your dollars back at maturity isn't even the real issue. Individual bond prices are published in the same newspapers that publish bond fund prices, although many don't seem to know that. If you own the bond fund that fell in value, you can sell it right after the fall and still buy the portfolio of individual bonds some say you should have owned to begin with (which, again, also fell in value!). Then, if you really want, you can still hold these individual bonds to maturity and get your irrelevant nominal dollars back. It's just the same thing.

We agree with much of what he wrote and believe that bond funds can have several advantages over individual bonds, including the following: lower total costs due to a fund's ability to buy individual bonds, which can be illiquid, at much lower spreads than individual investors can buy them. Greater diversification from owning many bonds rather than just a handful, and easier reinvestment of interest payments which can reduce costs and mitigate the impact of rising interest rates. Lastly, the ability to target particular segments of the bond market such as floating rate debt, high-yield, etc., which would be extremely difficult to do with individual bonds. That being said, there are times when owning individual bonds make more sense. For example if you need the money on a specific date or want to have greater control over the timing of purchases and sales. The bottom-line is there are many misconceptions about the differences about individual bonds and bond funds, and most investors may be better served investing in funds for the reasons mentioned above.

What Could Disrupt the Bull Market?

As we write in early December the stock market continues to rally and break-out to new highs. As we look forward the path of least resistance appears to be higher, which has us wondering what could bring the rally to an end. Here are a few potential risks recently highlighted by Goldman Sachs that are worth watching as we move through December and into January.



Source: Congressional Budget Office, Goldman Sachs Global Investment Research

The Federal Deficit- estimates are that if the Trump plan is fully implemented it could cause the deficit to increase to as much as $1.2 trillion in 2018. These estimates may keep deficit-focused Republicans (and Democrats) from passing the proposed tax cuts, which may be a disappointment to investors.

Rising inflation that causes the Fed to raise rates more than expected- current inflation estimates are approaching the Fed's goal of 2%. With employment markets relatively

tight the possibility of a strong stimulus package and global trade restrictions may push inflation above the Fed's 2% target. Which could lead to faster rate hikes by the Federal Reserve than is currently expected by the markets.

Bond Yields Continue to Rise- since the election interest rates have risen sharply across the maturity spectrum. If interest rates continue to rise and borrowing costs increase for coporations there could be pressure on future earnings given the large level of debt on the books of corporations. Eventually, if rates continue their path higher bonds will become a better alternative to stocks which may cause some reallocation of money away from stocks.

Although, we don't necessarily expect these risks to play out in the near-term we do think it's important to keep an eye on what could cause the current rally to end.

--AWM Investment Team (12/16)