# Asset Strategy Consultants

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Fourth Quarter 2016 and a summary of historical performance for the major asset style passive indices for the period ending December 31, 2016. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Asset Strategy Consultants

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing over $7.5 billion under advisement. Headquartered in Baltimore, ASC has offices throughout the East Coast.

Celebrating 25 Years 1991-2016

## Fourth Quarter 2016

# Market Review

## MACROECONOMIC ENVIRONMENT

**Donald Trump is inheriting one of the strongest economies that has been handed to a new President in recent history (based on 3Q GDP). Since the 1970s, only George H.W. Bush and Jimmy Carter assumed the office with higher GDP growth rates.**

Further, investors have been cheered by Trump's anticipated business-friendly ambitions on taxes, trade and regulations and have driven U.S. stocks to record highs. The S&P 500 Index gained 3.8% for the fourth quarter of 2016 and 12% for the year. Small stocks, as measured by the Russell 2000, roared 8.8% for the quarter and surged 21.3% for the year. The bond market did not fare as well, especially post-election. The prospect of increased fiscal spending sparked concerns over higher inflation and tighter monetary policy, leading to a sharp sell-off in U.S. Treasuries. The 10-year Treasury yield climbed 85 bps, the largest quarterly increase since 1994. The year was a volatile one for bonds; the 10-year Treasury yield started the year at 2.27%, hit an all-time low of 1.37% in July (post-Brexit) and ended the year sharply higher at 2.45%.

The average price for an existing single family home was $282,341 in November, the highest ever. New and existing home sales also posted strong gains, perhaps fueled by buyers rushing to lock in mortgage rates.

The U.S. economic picture continued to improve during the final quarters of 2016. Third quarter GDP was revised up to 3.5% (1.7% year-over-year), the sharpest quarterly increase in two years. Unemployment reached a nine-year low of 4.6% in November and jobless claims remained relatively muted. Initial jobless claims fell to less than 300,000 in early 2015 and remained below this key level for more than 90 weeks, the longest streak since 1970. The Atlanta Fed's wage growth tracker index showed that wages advanced 3.9% in October, the fastest since November of 2008. Home prices hit a record high in October; the S&P CoreLogic Case-Shiller U.S. National Home Price Index rose 5.6% in October for the trailing 12-month period. The average price for an existing single family home was $282,341 in November, the highest ever. New and existing home sales also posted strong gains, perhaps fueled by buyers rushing to lock in mortgage rates. Consumer confidence, as measured by the Conference Board Consumer Confidence Index, hit its highest level in 15 years in December. Auto sales are on pace to beat last year's record of 17.5 million light vehicles. Even the manufacturing sector showed signs of improvement with the ISM Composite Index of factory sector activity showing consistent gains through the quarter.

Inflation, while still benign, is rising. For the trailing 12-month period, the CPI rose 1.7% in November, the most since 2014. Core CPI (excluding food and energy) was slightly higher at 2.1%. The Fed's preferred metric, the Personal Consumption Expenditures Index, rose 1.4% over the same time period but remains short of the 2% target. Oil prices surged to their highest level in 17 months to close the year at $54 per barrel. The U.S. dollar soared, hitting a multi-year high versus the euro and the yen and appreciating roughly 7% versus a basket of currencies for the quarter.

Interest rates began to creep up early in the fourth quarter as investors gained confidence that the Fed would make a move in response to encouraging U.S. economic data.

The Fed, in a widely anticipated move, raised the Fed Funds rate 25 bps to a range of 0.50% – 0.75% in December. This turned out to be the Fed's only move for the year although at the end of 2015 it had projected four hikes in 2016. As communicated in its "dot plot," the Fed expects three additional hikes in 2017, though the markets expect fewer. Interest rates began to creep up early in the fourth quarter as investors gained confidence that the Fed would make a move in response to encouraging U.S. economic data. Trump's win propelled rates sharply higher fueled by expectations for escalating inflation in tandem with more debt. The 10-year U.S. Treasury closed the year at 2.45% but hit an intra-quarter high of 2.60%, the highest since September 2014.

Overseas, the European Central Bank announced that it would extend its asset purchase program beyond March, 2017 when it was set to expire, but purchases will be lower (€60 billion per month down from €80 billion per month). Italians voted "no" to reforms and a rescue fund was created for troubled banks in response to acute challenges at Monte dei Paschi di Siena. Deutsche Bank settled with the U.S. Department of Justice for its role in selling mortgages during the crisis, agreeing to a $7.2 billion payment (roughly half of what was originally suggested). The unemployment rate in the euro zone declined to 9.8% in October, the lowest since July, 2009; it has been falling since reaching a record high of 12.1% in April, 2013. The range in unemployment rates is highly divergent among euro zone countries, with Spain's at 19% and Germany's at a 35-year low of 4%. Consumer prices in the euro zone increased 0.6% year-over-year in November, the highest since April 2014, but well below the 2% target. GDP is expected to have picked up in the final months of the year from the 0.3% (1.6% year-over-year) pace registered in the third quarter to 0.4% – 0.5%.

In Asia, the Japanese economy advanced 0.3% (1.0% year-over-year) in the third quarter, below the preliminary estimate of 0.5%. The economy continues to struggle in spite of aggressive stimulus measures. The Bank of Japan made no changes to its monetary policy but upgraded the outlook for 2017 given the yen's weakness versus the U.S. dollar, which should provide a boost to exports. The dollar reached a 14-year high versus the yen.

Despite worries at the start of 2016, China ended the year with growth expected to be in line with its target of 6.5%. Its stock market stabilized and is up 19% since its low in late January, 2016. Its currency has depreciated, but in an orderly fashion. However, challenges remain in the form of a high debt load and an overheated property sector. ■

## EQUITY MARKET RESULTS

Equities posted strong returns in the fourth quarter, cheered by relatively good economic data, a rebound in corporate earnings, and speculation that Trump's presidency will bring lower taxes, lighter regulation and increased spending. The S&P 500 climbed to an all-time high of 2,239 on December 30 and closed up 3.8% for the quarter. However, there were stark differences in sector returns. Financials (+21.1%) were beneficiaries of

Trumponomics, riding expectations for a more lenient regulatory environment and higher interest rates while Health Care (-4.0%) was one of the worst performing sectors. While smaller cap bio tech stocks performed well, uncertainty over the future of Obamacare hurt hospitals. The newly established REIT sector (-4.4%) was punished by rising interest rates. Small capitalization stocks outperformed large by a wide margin; the Russell 2000 rose 8.8% in the quarter and is up 21.3% for the year while the Russell 1000 gained 3.8% and 12.1% for the same periods. Value gained favor after prolonged underperformance. While this trend was in place before the election, Trump's win boosted Financials and Energy stocks, which make up a significant portion of the value indices. The largest difference between growth and value was in small caps. The Russell 2000 Value outperformed its Growth counterpart by 10.5% (+14.1% versus +3.6%) in the quarter and by double that amount, 20.4%, over the year (+31.7% versus +11.3%). Foreign developed and emerging market indices trailed the S&P 500. The MSCI ACWI ex-US fell 1.3%, modestly below the MSCI EAFE's -0.7% result. Dollar strength was broad-based and thus detracted from returns for U.S. investors. In developed markets, Italy (+11%) was the top performer in the fourth quarter, although it remains at the bottom of the pack for the year (-11%). The MSCI Emerging Markets Index dropped 4.2% for the quarter. Among emerging markets, Russia posted the best return (+19%) while Turkey (-14%) sank. Turkey's economy shrank 1.8% in the third quarter, its first year-over-year decline since 2009. Mexico, hurt by Trumponomic concerns, was down 8%. ■

## FIXED INCOME MARKET RESULTS

Interest rates in the U.S. rose sharply in the fourth quarter, driven both by encouraging economic data and worries that the pro-growth agenda put forth by President-elect Donald Trump will have an inflationary effect. The 10-year U.S. Treasury yield rose 85 bps and returned -6.8% for the quarter in the sharpest quarterly selloff in more than two decades. TIPS outperformed nominal Treasuries, bolstered by rising expectations for inflation. The Bloomberg Barclays TIPS Index returned -2.4% for the quarter but ended the year up 4.7%. The 10-year inflation breakeven rate was 1.95% as of December 30th.

The municipal bond sector faced headwinds in the fourth quarter with robust supply, concerns over Trump's desire for lower taxes, and rising interest rates contributing to outflows from the sector.

The Bloomberg Barclays U.S. Aggregate returned -3.0% for the quarter but was up 2.6% for the year. The Corporate sector returned -2.8% and +6.1% for the same periods. Issuance by U.S. corporations hit another record high in 2016 at roughly $1.3 trillion. Long maturity bonds performed the best, in relative terms, with long corporates outperforming like-duration Treasuries by 436 bps. Mortgages underperformed Treasuries as durations extended with the increase in interest rates. The Bloomberg Barclays High Yield Index gained 1.8% in the quarter and more than 17% for the year.

The municipal bond sector faced headwinds in the fourth quarter with robust supply, concerns over Trump's desire for lower taxes, and rising interest rates contributing to outflows from the sector. Supply in 2016 was $445 billion, breaking its record from 2010 ($443 billion). The Bloomberg Barclays Municipal Bond Index fell 3.6% for the quarter and was essentially flat (+0.2%) for the year.

Overseas, yields were also higher though dollar strength was the primary driver of sharply negative returns for unhedged indices. The Bloomberg Barclays Global Aggregate ex-US Index fell 10.3% for the quarter (-1.9% on a hedged basis). The U.S. dollar benefited from higher interest rates as well as prospects for growth. The yen lost more than 13% versus the dollar over the course of the quarter and the euro depreciated by more than 6%. Emerging markets debt underperformed developed markets. The JP Morgan

EMBI Global Diversified Index dropped 4.0% for the quarter and the local currency GBI-EM Global Diversified lost 6.1%. ■

## OTHER ASSET RESULTS

Commodities benefitted from OPEC (Organization of the Petroleum Exporting Countries) announced cuts as well as the prospect of increased infrastructure spending. In November, OPEC agreed to production cuts to reduce output by 1.2 million barrels per day or roughly 1% of global output. Several non-OPEC nations also agreed to cut output by around half a million barrels per day. Oil closed the year at $54 per barrel, the highest level since July, 2015. The S&P GSCI Commodity Index rose 5.8% for the quarter and 11.4% for the year. MLPs were up modestly during the quarter (Alerian MLP Index +2.0%) with stronger results for the year (+18.3%). ■

## CLOSING THOUGHTS

We enter 2017 with U.S. stock markets at new highs, rising interest rates and historically low volatility. The U.S. economy continues to gain traction and there are glimmers of hope that a bottom has been reached overseas. However, a whole host of geopolitical challenges continue to cause angst. Further, the election of Donald Trump has resulted in widespread speculation as to the impact his policies will have on markets, but much uncertainty remains with respect to the scope, implementation and timing of these policies. With this in mind, we caution investors to maintain a long-term perspective. As such, prudent asset allocation with appropriate levels of diversification and a long-term perspective remain Asset Strategy Consultants recommended course. ■

# PRELIMINARY RETURNS FOR VARIOUS PERIODS: 4Q16

| | Mo. Ending 12/31/16 | Mo. Ending 11/30/16 | Mo. Ending 10/31/16 | Last Quarter | Last 2 Quarters | Last 3 Quarters | Last Year | Last 3 Years | Last 5 Years | Last 10 Years | Last 15 Years |
|---|---|---|---|---|---|---|---|---|---|---|---|
| MSCI:ACWI | 2.16 | 0.76 | (1.70) | **1.19** | 6.55 | 7.61 | **7.86** | 3.13 | 9.36 | 3.56 | 5.92 |
| Russell:3000 Index | 1.95 | 4.48 | (2.16) | **4.21** | 8.79 | 11.65 | **12.74** | 8.43 | 14.67 | 7.07 | 7.11 |
| Russell:3000 Growth Index | 1.25 | 2.67 | (2.64) | **1.20** | 6.18 | 7.03 | **7.39** | 8.27 | 14.44 | 8.28 | 6.50 |
| Russell:3000 Value Index | 2.63 | 6.28 | (1.68) | **7.24** | 11.40 | 16.49 | **18.40** | 8.55 | 14.81 | 5.76 | 7.54 |
| **MegaCap** | | | | | | | | | | | |
| Russell:Top 50 | 2.93 | 2.29 | (1.74) | **3.45** | 6.95 | 9.34 | **10.43** | 8.77 | 13.96 | 6.26 | 5.33 |
| Russell:Top 200 | 2.18 | 3.36 | (1.45) | **4.08** | 8.07 | 10.52 | **11.33** | 8.87 | 14.67 | 6.79 | 6.10 |
| Russell:Top 200 Growth | 1.55 | 1.42 | (1.74) | **1.21** | 5.84 | 6.09 | **6.95** | 9.53 | 14.94 | 8.61 | 6.05 |
| Russell:Top 200 Value | 2.83 | 5.46 | (1.14) | **7.21** | 10.47 | 15.45 | **16.20** | 8.22 | 14.40 | 4.97 | 6.19 |
| **LargeCap** | | | | | | | | | | | |
| S&P:500 | 1.98 | 3.70 | (1.82) | **3.82** | 7.82 | 10.47 | **11.96** | 8.87 | 14.66 | 6.95 | 6.69 |
| Russell:1000 Index | 1.88 | 3.94 | (1.95) | **3.83** | 8.01 | 10.75 | **12.05** | 8.59 | 14.69 | 7.08 | 7.00 |
| Russell:1000 Growth | 1.24 | 2.18 | (2.35) | **1.01** | 5.64 | 6.29 | **7.08** | 8.55 | 14.50 | 8.33 | 6.42 |
| Russell:1000 Value | 2.50 | 5.71 | (1.55) | **6.68** | 10.39 | 15.45 | **17.34** | 8.59 | 14.80 | 5.72 | 7.41 |
| **MidCap** | | | | | | | | | | | |
| S&P:400 Mid Cap | 2.19 | 8.01 | (2.68) | **7.42** | 11.87 | 16.33 | **20.74** | 9.04 | 15.33 | 9.16 | 9.73 |
| Russell:Midcap Index | 1.14 | 5.39 | (3.17) | **3.21** | 7.87 | 11.30 | **13.80** | 7.92 | 14.72 | 7.86 | 9.51 |
| Russell:Midcap Growth | 0.35 | 4.35 | (4.06) | **0.46** | 5.07 | 6.71 | **7.33** | 6.23 | 13.51 | 7.83 | 7.96 |
| Russell:Midcap Value | 1.78 | 6.26 | (2.42) | **5.52** | 10.22 | 15.47 | **20.00** | 9.45 | 15.70 | 7.59 | 10.28 |
| **SmallCap** | | | | | | | | | | | |
| S&P:600 Small Cap | 3.37 | 12.55 | (4.48) | **11.13** | 19.14 | 23.28 | **26.56** | 9.47 | 16.62 | 9.03 | 10.17 |
| Russell:2000 Index | 2.80 | 11.15 | (4.75) | **8.83** | 18.68 | 23.18 | **21.31** | 6.74 | 14.46 | 7.07 | 8.49 |
| Russell:2000 Growth | 1.36 | 8.95 | (6.21) | **3.57** | 13.12 | 16.79 | **11.32** | 5.05 | 13.74 | 7.76 | 7.48 |
| Russell:2000 Value | 4.13 | 13.27 | (3.29) | **14.07** | 24.19 | 29.54 | **31.74** | 8.31 | 15.07 | 6.26 | 9.22 |
| Russell:Microcap | 4.55 | 11.62 | (5.70) | **10.05** | 22.43 | 27.28 | **20.37** | 5.77 | 15.59 | 5.47 | 8.16 |
| **Non-US Equity** | | | | | | | | | | | |
| MSCI:ACWI ex US | 2.56 | (2.31) | (1.44) | **(1.25)** | 5.57 | 4.89 | **4.50** | (1.78) | 5.00 | 0.96 | 5.87 |
| MSCI:EAFE | 3.42 | (1.99) | (2.05) | **(0.71)** | 5.67 | 4.13 | **1.00** | (1.60) | 6.53 | 0.75 | 5.29 |
| MSCI:EAFE Growth | 2.21 | (3.41) | (4.30) | **(5.53)** | (0.84) | (0.99) | **(3.04)** | (1.20) | 6.67 | 1.64 | 5.06 |
| MSCI:EAFE Value | 4.58 | (0.62) | 0.23 | **4.17** | 12.50 | 9.37 | **5.02** | (2.14) | 6.28 | (0.22) | 5.41 |
| MSCI:EAFE Small Cap | 2.87 | (2.81) | (2.83) | **(2.86)** | 5.54 | 2.79 | **2.18** | 2.10 | 10.56 | 2.95 | 9.53 |
| MSCI:EM | 0.22 | (4.60) | 0.24 | **(4.16)** | 4.49 | 5.18 | **11.19** | (2.55) | 1.28 | 1.84 | 9.50 |
| **Fixed Income** | | | | | | | | | | | |
| Blmbg:Aggregate Idx | 0.14 | (2.37) | (0.76) | **(2.98)** | (2.53) | (0.37) | **2.65** | 3.03 | 2.23 | 4.34 | 4.58 |
| Blmbg:US TIPS Index | (0.10) | (1.92) | (0.40) | **(2.41)** | (1.47) | 0.22 | **4.68** | 2.26 | 0.89 | 4.36 | 5.30 |
| Blmbg:Long Gov/Cr | 0.73 | (5.83) | (2.84) | **(7.84)** | (6.70) | (0.59) | **6.67** | 7.16 | 4.07 | 6.85 | 7.03 |
| Blmbg:Long Credit A | 1.33 | (4.81) | (2.24) | **(5.71)** | (4.02) | 1.77 | **8.44** | 7.30 | 5.26 | 6.40 | 6.67 |
| Blmbg:High Yield CP | 1.84 | (0.47) | 0.39 | **1.75** | 7.40 | 13.34 | **17.13** | 4.65 | 7.36 | 7.46 | 8.36 |
| Blmbg:Mn 1-10(1-12) | 0.72 | (2.75) | (0.58) | **(2.62)** | (2.72) | (1.32) | **(0.10)** | 2.32 | 2.03 | 3.69 | 3.87 |
| Blmbg:Gl Agg ex US | (0.96) | (5.27) | (4.35) | **(10.26)** | (9.34) | (6.26) | **1.49** | (2.59) | (1.39) | 2.44 | 4.96 |
| Blmbg:Gl Agg x US H | 0.37 | (1.09) | (1.15) | **(1.86)** | (1.35) | 1.34 | **4.90** | 4.97 | 4.50 | 4.41 | 4.48 |
| JPM:EMBI Plus | 1.32 | (4.64) | (2.01) | **(5.32)** | (2.37) | 3.48 | **9.62** | 5.82 | 5.10 | 6.61 | 9.41 |
| **Other Assets** | | | | | | | | | | | |
| Blmbg:Commodity TR Idx | 1.80 | 1.33 | (0.49) | **2.66** | (1.31) | 11.30 | **11.77** | (11.26) | (8.95) | (5.57) | 1.16 |
| GS Commodity Index | 4.72 | 2.53 | (1.50) | **5.76** | 1.37 | 14.22 | **11.37** | (20.60) | (13.13) | (8.10) | (1.03) |
| S&P:Gold Spot Price Ix | (1.89) | (7.79) | (3.34) | **(12.56)** | (12.79) | (6.79) | **8.63** | (1.42) | (5.97) | 6.08 | 9.91 |
| FTSE:NAREIT Equity Index | 4.69 | (1.69) | (5.66) | **(2.89)** | (4.29) | 2.37 | **8.52** | 13.38 | 12.01 | 5.08 | 10.80 |
| Alerian:MLP Index | 4.39 | 2.30 | (4.45) | **2.04** | 3.14 | 23.45 | **18.31** | (5.80) | 2.25 | 8.05 | 10.93 |

**DISCLAIMER AND SOURCES**

The material contained in Asset Strategy Consultants quarterly Capital Markets Review is based upon information and data produced by Asset Strategy Consultants and Callan Associates.