The Intelligent Investor: Looking Ahead—2017

Quick Thoughts:

Portfolio Strategies for 2017

Stocks: We remain guarded in 2017 as valuations for stocks hover around the upper end of historical averages. International and Emerging Markets are cheaper than United States companies and probably for good reason as the ramifications of Brexit and the transition of the Chinese economy remain big unknowns. President Trump's protectionist policies also appear to be a headwind for multinational corporations that are domiciled overseas. Our overall conclusion is the US Market is probably a little richly valued and we are glad we aren't index investors. We are focusing on managers whose process is quality over quantity and we think being selective and active is the key to this type of market. Our team continues to focus on risk adjusted returns, understanding that many investments currently carry more downside risk than upside appreciation, so we are being selective. We see additional volatility in 2017, but still see opportunity in a growing economy and think the year is currently setting up to be positive. Earnings will be key and a major focus for us. We will also focus on the new President's policies as we learn what will be policy and what was just campaign rhetoric. This (and his itchy twitter finger) have the potential to drastically change outlook, therefore we believe a dynamic and tactical approach to the markets is a must right now.

Bonds: Interest rates rose very quickly in the months of November and December, but have leveled off in January. The 10 Year Treasury is bouncing around the 2.5% mark, up from closer to 1.5% before President Trump's election. We continue to believe bonds are critical to a well-diversified portfolio, but look at them as purely insurance to clients right now. Bonds have a negative correlation to stocks, so when stocks go down, bonds go up. With interest rates still so low we are holding these investments to protect against quick and steep declines in the markets (see January of last year and Brexit in June). This money also gives the opportunity to invest into a sell off by selling an appreciating asset when stocks are falling. These investments won't be what we call "home runs," but they are as necessary as ever.

Political, Economic Uncertainty Signal a World in Transition

• Investors enter 2017 facing a world in transition. The result of the U.S. Presidential election — and the earlier Brexit vote in the U.K. — in part reflect potential populist sentiment that appears to be challenging the decades-long march of globalization.

• The uncertainty brought on by this political shift, paired with muted economic growth across much of the world, leaves many economies vulnerable to shocks. What's more, recognizing that aggressive central bank stimulus may have reached its limits, investors must consider the potential consequences of years of such policies.

• That said, the global economy continues along its low-growth path, but there are a number of bright spots. In the U.S., despite the political uncertainty, a strengthening consumer is driving stronger growth. A large fiscal stimulus under the new administration could well provide another boost to the U.S. economy. Valuations in many areas of the U.S. market appear stretched, but with a pickup in earnings, the market may not remain so expensive.

• Europe remains highly challenged, with uncertainty about the future of the European Union, low growth and high unemployment. Yet many companies are rising above regional woes and valuations appear relatively compelling.

• China's economy continues to grow, supported by aggressive stimulus and a healthier property market. And in many emerging markets the rebound that began in 2016 appears to have momentum, supported by higher commodities prices and China's turnaround.

With Election Behind Us, U.S. Consumer Leads Recovery Onward

• Uncertainty over the direction of the Trump administration may linger for months. But questions about the future of trade policy may be partially offset by prospects for lower corporate taxes and other business-friendly policies.

• With the election behind us, the U.S. expansion, well into its seventh year, continues to show age is just a number. With no obvious signs of excesses in the economy, look for continued growth in 2017, driven by a strengthening consumer. The U.S. remains a tale of two economies — with consumer health partly offset by relatively weak, albeit recovering, industrial activity — so expect modest growth.

• After years of gains, most U.S. stocks appear fully valued. As of September 30, 2016, the cyclically adjusted price to-earnings ratio for the MSCI USA Index was 24.1, above the index's long-term average. That said, the prospect of tax cuts and infrastructure spending by the Trump administration could provide a tailwind for corporate earnings. However, with equities priced for a solid year, selective investing is essential.

• With proven growth at a premium, look for innovative companies that are transforming the business landscape. For example, online retailer Amazon is changing the way consumers shop and internet search giant Google is among the pioneers of driverless cars. In addition, select companies in oil exploration and servicing, like Chevron and Schlumberger, may offer long-term value potential.

After Wave of Setbacks, Europe Is Still Playing Catch-Up

• Deflationary pressures, weak economic growth and mounting political risks are weighing on the outlook for the European economy. Negative interest rates are slamming the banking sector and corporate earnings, although improving, remain stuck in low gear.

• Meanwhile, political uncertainty is growing throughout the region as the U.K.'s June 23 vote to leave the European Union and Trump's rise to the U.S. presidency may bolster support for nationalist, anti-immigration movements. EU stability is rapidly becoming the biggest new threat to Europe's uneasy recovery from the 2008–09 financial crisis.

• The rate of economic growth in the euro zone is likely to be lower on average than it has been in the past. Previous expectations for annualized growth of 2% to 2.5% are now giving way to more pessimistic forecasts of 1% to 1.5%. That kind of anemic growth leaves Europe vulnerable to outside shocks, such as further slowing of China's economy or a potential recession in the United States.

• Select European companies are overcoming regional challenges. The currency depreciation brought on by the U.K.'s Brexit vote has been a tailwind for exporters, including select luxury retailers. For example, a devalued pound is making Burberry coats and scarves less expensive for overseas buyers. Health care companies with innovative therapies have also fared well. Swiss-based Novartis has seen increasing sales of its heart drug, Entresto.

India Rising: Developing Nation Buys Into Consumption Society

• India embarked on a journey about 25 years ago, opening its doors to globalization and world markets. Since then, the country has become one of the most important components of the global economy. India's growth has overtaken that of fellow Asian giant China. One of the key components of the country's economic growth is brisk consumer spending, which propelled growth in India's economy to 7.3% for the 12 months ended September 30.

• When it comes to being an economic powerhouse, India may just be getting started. The country still lags much of the world in owning items such as refrigerators and air conditioners. But modernization is progressing at a relatively rapid rate. Under Prime Minister Narendra Modi, highways, airports and railways are being improved, which could provide opportunities for companies and boost the economy.

• Over the next decade, about 150 million people will enter India's workforce. That's about the size of the entire U.S. working population. A swelling labor force makes it likely India will continue to be a massive market for consumer companies around the world. For example, Korean personal electronics and appliance maker Samsung and Japan's Sony Corp. have operations in India.

In Emerging Markets, a Tech-Tonic Shift Is Taking Place

• Emerging markets are bouncing back after a tough stretch the past few years. Currencies have strengthened, commodity prices have stabilized and global interest rates remain low. Conditions appear to be "less bad" in Brazil, where a new government is pursuing fiscal reforms, and in Russia, where economic growth appears set to resume amid stronger oil prices and prudent central bank policies. However, some believe the election of Donald Trump in the U.S. may impact global trade.

• Times have changed in emerging markets. Materials and energy companies used to be key components of developing markets, but the focus has shifted to technology and consumer companies that are benefiting from rapid adoption of mobile phones, increasing internet use and rising wealth. Growing populations will continue to shape consumption habits. Consider that most of the world's 2 billion millennials (those born from 1980 to 2000) are living in emerging markets.

• EM valuations look attractive compared with developed markets, and earnings in aggregate are forecast to grow. Our research suggests a focus on companies that stand to benefit from increasing internet penetration rates and rising wealth in developing countries, such as Asian technology firms, Indian banks or U.S. technology companies operating in emerging markets

Dividend Income Is Hard to Find! Consider Searching Overseas

• Dividends have historically played a significant role in driving total returns for equity investors. In fact, since 2001, dividends have accounted for more than half of average annual total returns in developed international markets.

• Given the expectation for low to moderate global growth in 2017 and beyond, dividends may take on even greater importance than they have since the start of the 21st century.

• To be sure, strong demand for dividend income has driven valuations for many traditional dividend payers in the U.S., such as utilities and consumer staples, high above long-term averages.

• For investors willing to look beyond U.S. borders, however, there are a significant number of companies in both developed and emerging markets with dividend yields greater than 3%. Keep in mind, many of today's higher dividend payers are in more economically sensitive areas than traditional dividend payers. Given the risks, selectivity is key.

• There is a broad range of companies paying substantial dividends in developed and developing markets around the world. Among these are European financials such as Barclays and Prudential, telecoms such as China Mobil and Verizon, tech companies including Taiwan Semiconductor and IBM, and oil and gas firms like Royal Dutch Shell in the U.K., Enbridge in Canada and Chevron in the U.S

Sure, Rates Have Been Low for a Long Time. Expect More of the Same

• Rates drifted higher after the U.S. presidential election, as Trump's emphasis on infrastructure spending and tax cuts could lead to a higher budget deficit and higher inflation. Despite the rise, rates remain relatively low by historical standards and appear poised to remain so for some time.

• Even if the Fed does continue to slowly hike rates, it could have a relatively modest impact on long-term yields if other factors, like global demand for Treasuries, persist in holding them down. Central bankers may also prefer to allow the economy and inflation to "run hot" for a while rather than tighten policy more aggressively.

• Although this 8-year period of low rates might seem long, history has shown that low-rate periods can carry on for much longer.

• Interest rates look poised to remain relatively low for an extended period. Central bankers around the world may err on the side of keeping policy accommodative, rather than risk recession. If rates do rise only slowly, downside risk to bond prices driven by rates will be limited. Despite monetary policymakers indicating that they are comfortable with inflation rising modestly above their usual target, the market expects inflation to remain low. As a result, Treasury Inflation-Protected Securities (TIPS) may represent good potential value.

Believe It or Not, U.S. Rates Are Actually Relatively High

• Global investors searching for yield in a world of negative rates can look to the U.S. and U.K. for somewhat better alternatives. However, as hedging costs have risen in the latter part of 2016, the potential pickup in additional yield has begun to decline.

• In addition to searching for yield abroad, investors can also find opportunities in higher yielding sectors, if comfortable with a higher risk profile. Emerging markets debt could offer such an opportunity. Certain U.S. dollar denominated bonds and local currency bonds appear attractive. Being selective is key.

• For some time, investors have faced extremely low yields, and in 2016 they broadly plunged even lower. That may tempt some to accept higher risk profiles to boost income. However, prudent bond and sector selection is still necessary to seek capital preservation. Through U.S. credit exposure or emerging markets bonds, fund managers can rely on deep research to provide a yield boost, while aiming for relative safety.

Munis Remain Hard to Ignore for Income Seekers

• In 2017, returns for munis are unlikely to reach the heights of recent years. For income-seeking investors, however, munis remain unmissable. While bonds from Puerto Rico and Chicago have been in the headlines for the wrong reasons, it's worth remembering that most bonds in the $3.7 trillion market are unaffected by state and local government finances.

• Revenue bonds — such as those linked to hospitals, schools or toll roads — account for more than two-thirds of the investable universe. For this type of municipal bond, the credit fundamentals of the corporate or nongovernmental issuer are what matter. So it's deep bond by-bond research that helps investors uncover the best opportunities.

• In a low-yield world, the after-tax income potential of munis remains compelling. Investors comfortable with more volatility should consider high-yield munis; they've tended to be less correlated to stocks than taxable bonds — making them a great source of diversification, as well as income.

Sincerely,

David B. Miller

Luther A. Lockwood II
Managing Principal
Luther.lockwood@mbl-advisors.com

David B. Miller
Managing Director
David.miller@mbl-advisors.com