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## ***The Intelligent Investor—2016 Market Recap***

### **Quick Thoughts:**

Below is a recap of the 2016 markets. I wanted to provide some context to 2016, and a review and recap the markets. I spent several hours last night reflecting and reviewing the outlook I wrote for 2016 almost a year ago. I wrote it for our internal team as a tactical guideline, but what 2016 has reminded me is how humbling the markets are, and while value can be found in a tactical approach, it must be paired with a strategic goals-based, customized allocation and comprehensive financial plan. 2016, also reminded many the value of sticking to that plan, both in times of panic (January and then again in June) and times of euphoria (Trump Rally). To provide clarity to an uncertain world I am also preparing an outlook for 2017 you will see in the coming weeks.

### **Year in Review**

If the old adage is true that markets climb a wall of worry, then 2016 may go down in history as the poster child for drama-fueled gains.

Throughout the year, the prevailing headlines reflected turmoil in all corners of the globe. From China's slowing economy, to an existential crisis in the European Union, to a bitter and fractious U.S. presidential election, there was virtually nowhere to hide from economic and political upheaval.

And the results?

Global equities have gained nearly 7% (DJ Global Stock Index WSJ) from January to December 30, powered by worldwide central bank stimulus measures, signs of improving economic growth in the U.S., and a strong rally following Donald Trump's election to the U.S. presidency.

Global bonds have returned about 1%, supported by massive government bond-buying programs in Europe and Japan, as well as generally declining interest rates (with the pronounced exception of November and December, when rates moved significantly higher).

Several key market indexes hit record highs in December, including the Dow Jones Industrial Average, the S&P 500 and the Nasdaq Composite, as investors cheered plans by President-elect Trump to cut taxes, reduce regulations and boost infrastructure spending.

Emerging markets enjoyed the biggest gains, rising 9% as commodities prices bounced back after years of grinding lower. Oil prices established a bottom in February and have since staged several rallies, improving the fortunes of oil-producing nations including Brazil, Russia and much of the Middle East.

## **Humble Beginnings**

The end of the year is a far cry from the start. Stocks ushered in 2016 with one of the worst declines in history. An alarming deceleration of China's economy, falling oil prices, and worries about a potential U.S. recession sent global stocks into a tailspin.

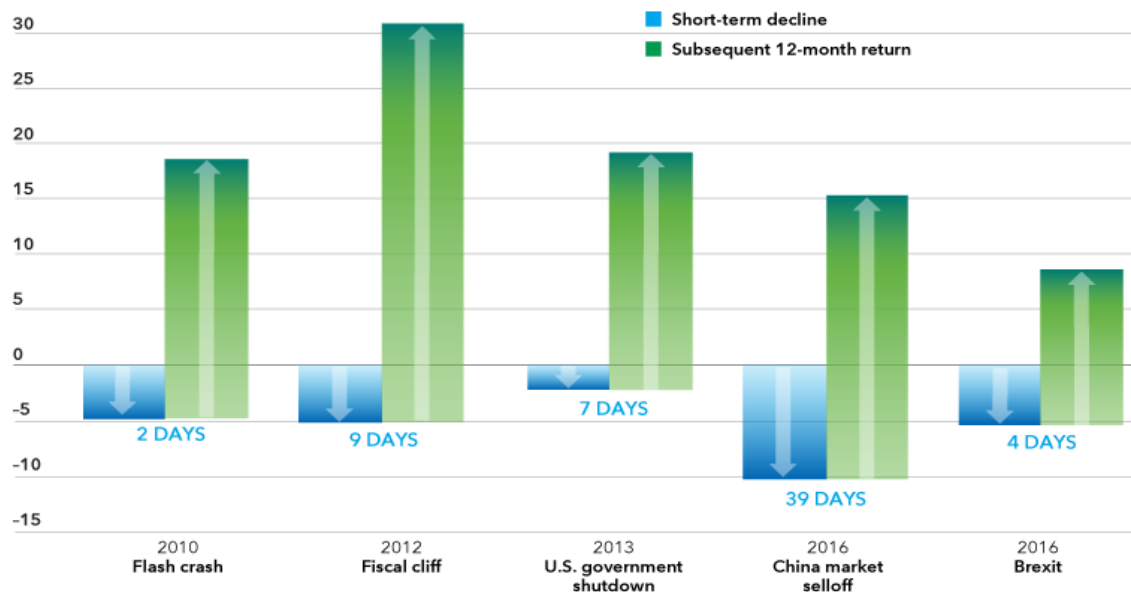
The MSCI World Index declined 12% from January to mid-February. Adding to the turmoil, China's currency tumbled to a five-year low against the U.S. dollar, exacerbating worries that China's economy might be headed for a hard landing. Oil prices fell in tandem as investors feared that China's deteriorating outlook would hurt demand for commodities.

"China was a big concern in January," says Capital Group portfolio manager Jody Jonsson. "The macroeconomic picture was ominous and the markets were reflecting it. At that time, I don't think anyone would have predicted the kind of broad market rally we've seen in the latter part of this year." "Of course," Jonsson continues, "that's why we don't invest in markets. We invest in companies."

By mid-February, investors were calmed by three well-timed events: Chinese officials unveiled a new series of stimulus measures and currency controls; U.S. economic data showed significant signs of improvement; and the U.S. Federal Reserve indicated that it would postpone a planned interest rate hike. Markets rebounded strongly from there.

## Short-Term Declines vs. Subsequent 12-Month Returns

35% S&P 500 total return



Sources: Capital Group and RIMES. Decline represents the total loss from the start of the event to the correction trough. Subsequent 12-month return represents the total return from the event trough through the following 12 months. China market selloff and Brexit subsequent returns through December 16, 2016.

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## Much Ado About Brexit

Indeed, after each market crisis in 2016, stocks bounced back – oftentimes in a big way. After the China scare, stocks staged a powerful rally from mid-February until mid-summer, when the word “Brexit” suddenly gained global significance.

On June 23, voters in the United Kingdom shocked the world by approving a ballot measure to withdraw from the European Union, becoming the first established member in history to abandon the 28-nation bloc. The unexpected decision raised questions about EU stability amid the growing influence of nationalist movements across the continent. Alarm bells also sounded for an imminent recession in Great Britain.

## Keep Calm and Carry On

Markets fell sharply in the days after the Brexit vote; however, most of the losses were recovered in short order as the U.K. and European economies appeared to suffer few immediate consequences. At the time, Capital Group investment professionals urged calm and asserted that, over the long term, the U.K. would be OK.

“The U.K. may be in uncharted territory and indeed faces a difficult economic adjustment ahead,” explained Capital Group political economist Talha Khan, “but its

institutions, rule of law and attractiveness as a place to invest will likely persist in its eventual future state.”

U.K. stocks gained 17% in local currency terms as of December 16, making it one of the best performing markets this year in Europe (though the rapidly declining pound hurt returns for dollar-based investors).

## **Political Upheaval, American Style**

The populist, anti-establishment and anti-immigration themes highlighted in the Brexit movement perhaps should have foreshadowed an upset on the other side of the Atlantic. Regardless, few pundits or polls predicted the events of November 8, when real estate baron Donald Trump defeated a heavily favored Hillary Clinton to become the 45th president of the United States.

Overseas markets initially sold off amid the uncertainty posed by Trump’s unexpected victory. Within hours, however, markets reversed course as investors began to assess the implications of President-Elect Trump’s campaign platform, as well as the fact that the Republican Party will control the White House and both houses of Congress. Since November 8, U.S. stocks have gained nearly 6%, hitting a succession of record highs along the way.

“While the outcome of the election was a surprise to many, I think the market has come to the realization that there is going to be a sea change in Washington,” says Capital Group portfolio manager Ted Samuels. “Investors are anticipating tax cuts, regulatory reductions and fiscal stimulus that could lead to stronger economic growth in the second half of 2017 and into 2018.”

## **More to Come?**

Brexit and the rise of Trump may just be the start of sweeping political change for Western democracies.

As Europe heads into an election super-cycle next year, December has already witnessed the downfall of two major euro-zone leaders. Italian Prime Minister Matteo Renzi announced his resignation on December 5 after voters rejected his constitutional referendum seeking to streamline the federal government. Meanwhile, French President Francois Hollande said he would not seek re-election in 2017, bowing to record-low approval ratings.

The Italian referendum, in particular, was seen as a potential market-moving event, perhaps even in the same league as Brexit. However, markets shrugged off Renzi’s defeat and powered ahead anyway. Italian leaders have since moved to form a new

government, and markets are not pricing in much risk that Italy will attempt to leave the EU anytime soon.

## **Déjà Vu All Over Again**

Financial markets ended 2016 the same way they ended 2015 — with an interest rate hike by the Federal Reserve. It was only the second time in nearly a decade that the Fed moved to raise short-term rates, reflecting the view that easy monetary policy remains necessary to help the U.S. economy recover from the 2008–2009 financial crisis.

On December 14, the Federal Open Market Committee decided to increase the federal funds target rate by 25 basis points to a range of 0.50%–0.75%. The move was well telegraphed and, therefore, priced into the U.S. bond market well ahead of the announcement.

What's the rate outlook for 2017?

“U.S. interest rates remain very low, relative to history, and it's important to keep that in perspective,” explains David Hoag, a fixed income portfolio manager with Capital Group. “However, it does appear that the Fed is more willing to tap on the brakes now that both economic growth and inflation are moving higher. As we consider the outlook for monetary policy in 2017, a slow and gradual move toward higher rates is likely.”

*Sincerely,*

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