

Market Observations

December 2016



WINDS OF CHANGE

Winds of change are blowing through governments, economies and markets. A challenge is to determine whether the impact of change is temporary or permanent. A review of some recent economic and market trends can provide perspective for assessing change in the period ahead.

Recent Trends

The unexpected U.S. election outcomes were reflected in some abrupt changes in market trends. **Chart I** compares returns before and after the election in market sectors that experienced notable trend changes. Expectations for President-elect Trump's policies brought favorable trend reversals for total U.S. stocks (higher rate of economic growth), U.S. large cap value stocks (lower personal income tax rates), and U.S. small cap stocks (lower business tax rates and less regulation). At the same time, unfavorable trend reversals occurred for foreign emerging market stocks (stronger dollar) and U.S. high-yield bonds (higher inflation). Interestingly, the price of gold declined both before and after the election as the commodity appeared caught in a downtrend seemingly unaffected by the election outcome.

The recent pattern of U.S. real economic growth highlighted in **Chart II** may have more to do with improving stock prices than election outcomes. Growth weakened materially in the fourth quarter of 2015 and the first quarter of 2016. Stock indexes struggled to reach new highs throughout this period. Economic growth reaccelerated in each of the last two quarters and stock prices have responded favorably. **Chart II** also shows the 69-year +3.2% average quarterly growth rate versus the +2.0% average quarterly growth rate of the past seven years. Growth rates exceeded the long-term average in only 6 of the past 28 quarters. The growth rate last quarter reached the long-term average for the first time in two years. Sustaining the long-term average in the period ahead could go a long way to making American job growth, income levels, profits and stock prices relatively great.

Two major trends of the past seven years are shown in **Chart III**, rising stock prices and declining bond yields. Even with the most recent "Trump bump" in stock prices, the Dow Jones Industrial Average shown here is back only to the seven-year trend line. Bond yields have turned notably above the seven-year downward trend line, pushing bond prices lower at the same time. While higher bond yields is the current consensus view for the period ahead, a similar rising rate pattern in 2013 ultimately was reversed.

Investment Implications

Winds of change are blowing through markets but without certainty as to length of time or magnitude of impact. The implications of such change are to be understood, and addressed in portfolios through appropriate diversification.

Chart I

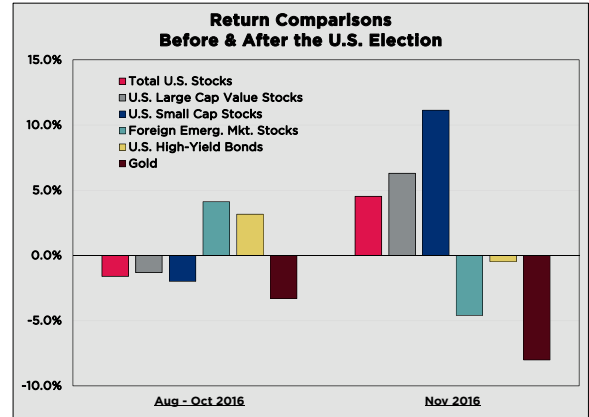


Chart II

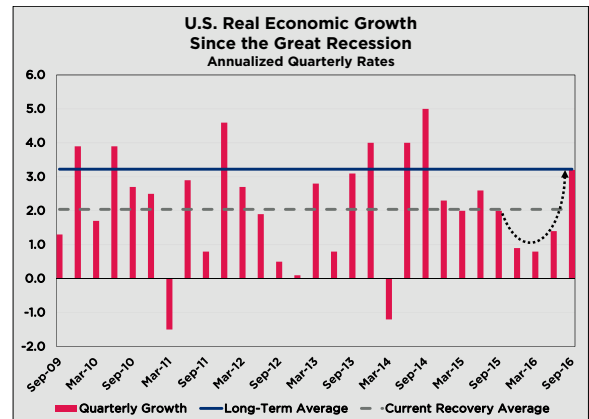


Chart III

