Commentary – January 1, 2017

In early December 2016 I received a call from a client concerned about her account's recent performance. While the stock market had been on a strong upward trend since the election of Donald Trump as President, her portfolio's value was essentially flat. As she had a sizable allocation to equities, she wondered why the balance was not higher. The answer was fairly simple, although it may not have been reassuring to her. A review of her portfolio indicated a 50% weighting of bonds and preferred stocks, and while stock prices had rose, the value of her fixed income vehicles had fallen.

Fixed income instruments were very rewarding for a good part of 2016. Bonds and preferred stocks do well in an environment of sluggish economic development, so prices rose in January as a sinking Chinese stock market heighted worries about the possibility of a prolonged period of slow growth and the potential for a recession in the U.S. This sentiment sparked a wave of stock selling worldwide, and the Dow Jones Industrial Average fell 6.2% during the first five days of 2016, its worst start ever. It bottomed on February 11th at 15,660.18, having fallen 10% from the end of 2015. Crude oil prices also hit their 2016 trough that day, settling at $26.21 a barrel, the lowest level since 2003. (Wall St. Journal December 30th, 2016)

Fears about the U.S. economy gradually abated and a rebound in corporate earnings, accelerating U.S. economic expansion and stabilizing oil prices helped stoke investor enthusiasm for stocks. The election of Donald Trump on November 8th supercharged the rally as investors bet the new administration would usher in business friendly policies such as tax reform, reduced regulatory obstacles and increased government spending on infrastructure. The DJIA finished above 19,000 on November 22nd for the first time ever and has gained 7.8% since Election Day, setting several closing highs in the process. (New York Times December 30th 2016) For 2016, the DJIA enjoyed a point percentage change of 13.4%, while the S&P 500 and NASDAQ increased 9.5% and 7.5%, respectively. (Barrons December 30th 2016)

A strong growth narrative means higher inflation and a faster pace of interest rate increases, which is not propitious for bonds. Inflation chips away at a bond's fixed returns over time. Moreover, higher fiscal spending generally requires greater issuance of Treasury bonds for funding, increasing supply and further pressuring prices downward. Expectations for a stronger economy and higher rates have helped send long term U.S. government bonds to a second consecutive year of price declines. The price of the Vanguard Total Bond Market Index fund, a suitable gauge of overall bond performance as it measures the returns of a myriad of taxable bonds, was little changed for the year, although it dropped 5.6% from its high posted on July 8th (think of investors seeking a safe haven in a post-Brexit panic) to its low set on December 14th. (Yahoo Finance January 1st 2017) This loss overlay the postelection stock market move, so that an investor with an equitable distribution of stocks and bonds may have seen a minimal adjustment in the value of his portfolio during this interim.

Some analysts believe the long cycle of low yields and high bond prices is coming to an end. They base their forecasts on Trump's fiscal stimulus and its expected boost to the economy. Others are hesitant to make this assertion. If Trump's policies fail to deliver, growth prospects will wane, and investors will return to bonds. Rising bond yields themselves slow momentum, as Treasury bond yields are a benchmark to fixing borrowing costs for U.S. businesses and consumers. U.S. mortgage rates, for example, have risen the past few months, which may down the road curb refinancing activities and harm the housing market.

Those considering a lower bond weighting should remember why they purchased bonds in the first place. They should recall how they felt in 2008 and early 2009, when stock prices were plummeting, falling from 14,198 to 6547 on the DJIA in only 17 months. (Yahoo Finance January 1st 2017) Bonds will be a source of stability during the next inevitable stock market retreat. For income-oriented investors, the interest generated from a bond is more reliable that a dividend produced from a stock. If rates do continue to increase, investors can take advantage by reducing duration and buying bank loans and floating rate securities, which have coupons that adjust higher as rates rise. Finally, who can say for sure that this recent trend will endure? For years, strategists have been predicting a sustained increase, with little to show for their forecasts. Foreign central banks have scaled back but not completely finished their quantitative easing programs. Our Federal Reserve raised the Fed Funds rate at its last meeting but did not signal a more aggressive series of hikes just yet, and the capital markets in general could turn more risk averse if Trump's plans for a stronger economy run into political hurdles.

Setting an appropriate asset allocation and committing to stay with it through good times and bad is a tenet of prudent investing. A fully diversified portfolio of asset classes with low correlations to each other diminishes risk but will often expose the investor to a category not performing well, perhaps even poorly. We have no way of knowing which stock or bond vehicle will appreciate and which will not, but diversifying these investments will help the investor avoid a substantial decline in the value of his account balance. The objective should not be to pick winning stocks or sectors, but to maintain a portfolio that, in the aggregate, will deliver a solid return over a long period of time.

As always, I invite and encourage readers to contact me with questions and concerns and am available to meet at your convenience.