



**Artemis**  
FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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Fourth Quarter of 2016

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### *Executive Summary*

- **Q4 2016: It was a decent quarter for global equities, which rose 2.2% on a market-weighted basis. The U.S. market carried the day increasing by 4.1% overall, offsetting a modest decline of -0.7% in developed international markets, and a sharp retreat of -4.2% in emerging markets.**
- **Bond returns turned sharply negative in the U.S. with high yield the only exception.** Bond yields increased as investors rotated toward equities following the election, and the Federal Reserve raised short-term interest rates in December.
- **2016 Summary: Global economic acceleration in 2016 provided a favorable backdrop for financial assets.** The uptick in global economic activity during the year was marked by a resurgence of growth in China, improved global industrial activity, reduced deflationary pressures, and continued economic expansion in the U.S. **As a result, the global equity markets advanced by 8.4% in the aggregate.**
- It was an interesting year in bond markets as well. In the first half of the year, we saw Treasury yields steadily declining to all-time lows in the immediate aftermath of Brexit. After the U.S. election, Treasuries took a sharp turn upward, ending the year modestly higher than at the start. In contrast, high yield had a stellar year, rebounding from a sharp selloff at the end of 2015.
- **2017 Outlook: We expect the global economic expansion, which got underway in 2016, to persist in 2017.** Growth will be supported by a shift to an expansionary fiscal policy in the U.S. (if it occurs) while monetary policy will still be accommodative. **Such favorable monetary and fiscal policies substantially reduce the probability of a recession any time soon** and mean that U.S. reflation is likely to be the year's dominant theme.
- **Artemis Strategy: 2016 was one of the best on record for Artemis portfolios relative to their benchmarks.** Our portfolios benefited strongly from their structural tilt to smaller companies versus larger companies and toward value-oriented versus growth-oriented companies. We also increased our currency hedging in our international allocation and tilted our position away from Europe to Asia and to Japan, in particular; both of these moves proved highly beneficial.

#### 4<sup>th</sup> Quarter in Review

It was a decent quarter for global equities, which rose 2.2% on a market-weighted basis. The U.S. market carried the day increasing by 4.1% overall, offsetting a modest decline of -0.7% in developed international markets, and a sharp retreat of -4.2% in emerging markets. (See Figure 1.)

Donald Trump's election victory and his plans to cut taxes, boost infrastructure spending, and reduce regulations were seen as positive for domestic growth and encouraged investors to bid up U.S. equity prices. In addition, investors were buoyed by news that U.S. GDP grew 3.5% year-on-year in the third quarter, a pronounced pick-up in activity from the first half of 2016.

**Figure 1. 2016 Asset Class Returns in USD (%)**

Asset Class	2016		Index
	Q4	Total Year	
<b>Equities</b>			
All Markets - Global*	1.3	8.4	MSCI ACWI IMI
U.S. Large Companies	3.8	12.0	S&P 500
U.S. Small Companies	8.8	21.3	Russell 2000
Int'l Developed Markets	(0.7)	1.0	MSCI EAFE
Emerging Markets	(4.2)	11.2	MSCI EM
<b>Fixed Income</b>			
All Segments - U.S.*	(3.0)	2.6	Barclay's U.S. Aggregate
U.S. Treasuries	(5.5)	1.0	Merrill Lynch U.S. Treasuries, 7-10 Years
U.S. Municipal Bonds	(2.6)	(0.3)	Merrill Lynch Municipal Bonds, 3-7 Years
U.S. Corporate	(2.5)	5.7	Merrill Lynch U.S. Corporate Bond
U.S. High Yield	1.9	17.5	Merrill Lynch U.S. High Yield Bond
Int'l Bonds	(11.4)	2.1	Merrill Lynch World Gov't Bond, Ex-U.S.
EM Bonds	(4.2)	10.2	J.P. Morgan USD Emerging Market Bonds
<b>Real Assets</b>			
U.S. Tips	(2.4)	4.7	Barclays Capital U.S. TIPS
Commodities	2.7	11.8	iPath Bloomberg Commodity
U.S. Real Estate Income	(3.2)	4.9	Fidelity Series Real Estate Income Composite
Int'l Real Estate	(6.9)	1.4	iShares Int'l Developed Real Estate

\*Used to create Artemis portfolio benchmarks



Emerging markets retraced some of their gains from earlier quarters, owing to uncertainty over U.S trade and foreign policy following the election, and the prospect of higher interest rates in the U.S. These developments particularly affected China and Mexico, given their large trade deficits with the U.S.

In contrast, bond returns turned sharply negative in the U.S., with high yield the only exception. Bond yields increased as investors rotated toward equities following the election, and the Federal Reserve raised short-term interest rates in December. Even Treasury inflation-protected bond returns were negative despite the increase in inflationary expectations. They did, however, outperform non-inflation-protected Treasuries.

### ***Year in Review***

Overall, global economic acceleration in 2016 provided a favorable backdrop for financial assets. The uptick in global economic activity during the year was marked by a resurgence of growth in China, improved global industrial activity, reduced deflationary pressures, and continued economic expansion in the U.S. As a result, the global equity markets advanced by 8.4% in the aggregate (see Figure 1, previous page).

Nevertheless, the year got off to a very rough start, in part due to China's clumsy moves to manage its stock market, but also because investors did not believe the global economy was sufficiently strong to justify the Federal Reserve increasing interest rates (which it had done for the first time in years in December 2015.) By the third week in January, oil was trading at what proved to be a low for the year at \$27.10 a barrel, and Japan caused global shockwaves by embracing negative interest rates.

Despite the early pessimism, global economic data started to stabilize and markets picked up steam until the surprising Brexit vote on June 23, which caused the market to drop sharply, but only temporarily. By this time, the underlying trends of the global economy and inflation were already accelerating and a turnaround began to take hold as investors recognized these developments. The year ended with the election of pro-growth Donald Trump accelerating the momentum that had already taken hold in the market; investors are optimistic about President Trump's plans for reducing taxes and increasing government spending.

European and Japanese equity markets were equally volatile. The financially-heavy European index was weighed down by ongoing concerns about banks, and Japan was held back by its lackluster performance. Returns in U.S. dollar terms were held back by a strengthening dollar, especially in the second half of the year.



In contrast, emerging markets had a very good year overall, on the back of rising oil prices and resurgence of growth in China. Moreover, the Shiller version of the P/E (stock price to earnings ratio) for the MSCI emerging markets index fell below 10x in January for the first time since the index's inception, prompting longer-term investors to reconsider their positions.

It was an interesting year in bond markets as well. In the first half of the year, we saw Treasury yields steadily declining to all-time lows in the immediate aftermath of Brexit. Then yields started to climb as investors began to recognize the improving global cyclical outlook. After the U.S. election, Treasuries took a sharp turn upward, ending the year modestly higher than at the start. In contrast, high yield had a stellar year, rebounding from a sharp selloff at the end of 2015.

### ***2017 Economic Outlook***

We expect the global economic expansion which got underway in 2016 to persist in 2017, even if Donald Trump is unable to implement many of his pro-growth policies. In 2016, China's economic stabilization, fueled by accommodative fiscal and monetary policy, was a key factor in ending the steep global trade recession, and could continue to support global growth in the coming year.

Growth will also be supported by a shift to fiscal policy in the U.S. (if it occurs), while monetary policy will still be accommodative. Moreover, the European Central Bank (ECB), the Bank of England (BoE) and the Bank of Japan (BoJ) are all expected to continue with their asset purchase programs this year, although the latter two may raise nominal policy rates later in 2017.

Such favorable monetary and fiscal policies substantially reduce the probability of a recession any time soon and mean that U.S. reflation is likely to be the year's dominant theme. Interest rates should continue to rise in 2017 on the back of more robust growth, greater inflation pressure, and larger government budget deficits. With the Federal Reserve set to hike interest rates while other central banks continue to keep theirs low, the U.S. dollar is likely to continue to strengthen.

The picture is more mixed internationally. While growth is accelerating modestly in Europe, individual countries such as the Netherlands, France, and Germany will have national elections in 2017 amongst rising populist sentiment and continue to face the usual array of unresolved structural problems. The weaker euro should help, but there appears to be little appetite for fiscal stimulus.



The emerging markets picture is also mixed. While oil prices have stabilized and Latin America is set to grow again, many emerging markets economies are still at the early stages of reducing their debt burdens, which will keep growth in check.

### ***2017 Investment Outlook***

Assuming Trump doesn't take us into a destructive trade war, China doesn't implode from credit excess, and Trump gets at least some of his pro-growth policies through Congress, stocks should outpace bonds in 2017 and do reasonably well. Most of what Trump wants to do (excluding trade protection and immigration restrictions) is pro-growth, and U.S. economic momentum going into 2017 is already solid. Moreover, Janet Yellen, the chairwoman of the Federal Reserve, is signaling that the U.S. economy is almost at "maximum employment" and that the 2% inflation target is now in reach. As such, absent any negative shock to the U.S. economy in 2017, the Fed is likely to follow through with its desire to increase short-term rates again soon.

It is true that the current bull market is nearing its eighth year, second in length only to the almost 10-year rally that preceded the technology bubble (1990-2000). Strong returns have left valuations in their 10<sup>th</sup> decile, indicating that they have been cheaper at least 90% of the time historically. Subsequent returns from high valuations have been muted in the past. Nevertheless, as I have written before, valuation is not a good predictor of returns over short time horizons and therefore is unlikely to be an obstacle to reasonable equity returns in 2017.

Even still, and especially after the market run up in 2016, 2017 equity returns are likely to be more muted, unless policy drives the market to new highs. Europe and Japan are also likely to benefit from U.S. growth acceleration, and their weaker currencies will also be a tailwind for their equities in local currency terms.

It's a tough call on emerging markets equities. Emerging market growth will be supported by the return of growth in Latin America, as Brazil and Argentina exit recessions. But Chinese growth is likely to slow, as policymakers have already pulled back on the massive fiscal and credit easing that engineered a boost to growth in 2016. Moreover, emerging markets have the most to lose if global trade slows due to a rise in protectionism.

As for bonds, faster U.S. growth, rising interest rates, and rising inflation each point to poor prospects for developed market government bonds. Credit, while unlikely to trace its stellar performance in 2016, should hold up relatively better again as improved economic growth and higher oil prices mean credit fundamentals should stop deteriorating.



In summary, it may be a reasonable year for global equity investors in 2017, but the risks are elevated. I continue to worry about China and worry about the coming elections in Europe where populist sentiment is riding high. I am also quite concerned about Trump’s anti-globalization sentiment. As I wrote last quarter, the vast majority of job losses in the last 20 years have been due to automation and technological change, not trade liberalization. A trade war will only reduce growth with very little long-term benefits.

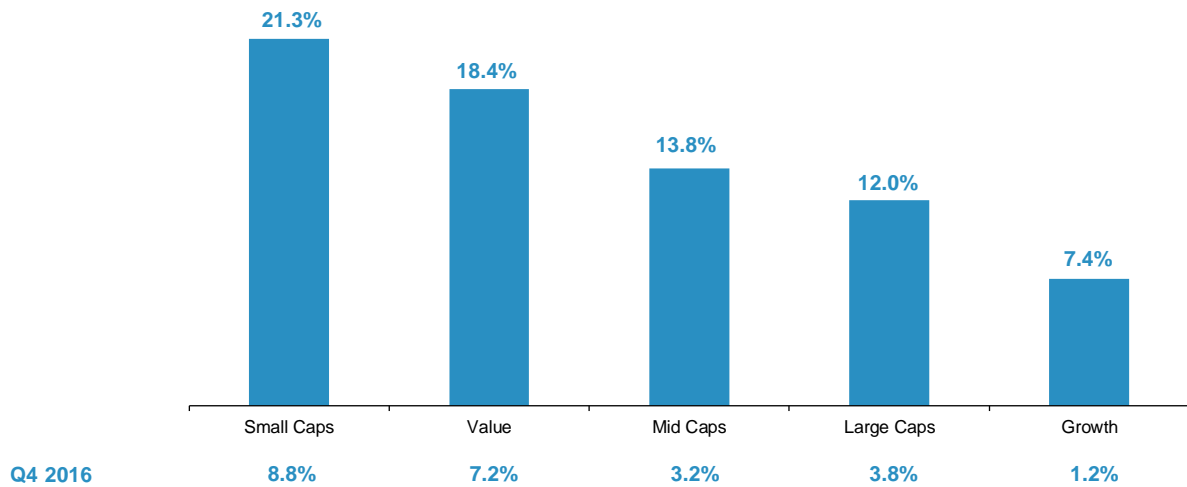
### Artemis Portfolio Strategy

#### *2016 Retrospective*

2016 was one of the best on record for Artemis portfolios relative to their benchmarks. Our portfolios benefited strongly from their structural tilt to smaller companies versus larger companies and toward value-oriented versus growth-oriented companies. (See Figure 2.) They also benefited from a general overweight position to the U.S. vs. other developed countries.

Figure 2. 2016 U.S. Equity Market Returns by Segment

#### 2016 Total Return



Source: Fidelity

At a more tactical level, we increased our currency hedging in our international allocation and tilted our position away from Europe to Asia and Japan in particular. Both of these moves proved highly beneficial as the dollar strengthened especially relative to the yen in



the latter half of the year, and Japan's equity market took off following the BoJ's decision to peg its 10-year government bond yield.

So what didn't go so well? I regret reducing our exposure to high-yield debt early in the year as the asset class recovered handsomely following its rout in 2015, which was largely tied to the change in oil prices. I also regret our severe underweight to emerging market debt, which also had an amazing year. Emerging markets have been challenging to say the least for the last five years, and I have been increasing exposure very slowly.

### *2017 Positioning*

It's tough to argue that 2017 is not going to be volatile. Anyone who has been watching the chaotic political transition process underway has had a good glimpse of what we are likely in for. There is also a tremendous amount of uncertainty regarding how far and how fast President Trump will be able to get his agenda through Congress. I find it hard to see how "small government" Republicans are going to sign up for the full package of proposed tax cuts and spending increases President Trump wants to enact.

But as long-term investors, it's important to see past the noise and look at the economic data. And the data look pretty good. As such, and not without risk, we are going to initiate very modest exposure to emerging market (EM) debt. EM debt, represented by the JPMorgan GBI-EM Global Diversified Index, is attractively priced. At the end of November, the index was trading at a yield of 6.8% compared to developed market debt, proxied by the Barclay's Capital Global Aggregate Bond index, which is offering only 1.6%. This 5.2% yield spread is well into the top decile of the historical range and well over the historical average of 3.9%.

We are also adding a little more inflation-protected vis-à-vis buying Treasury inflation-protected bonds (TIPS). One of the problems with Trump's desire to use fiscal policy to induce faster growth is that we are running out of workers, especially well-trained workers. As such, one can envision a scenario in which increased spending leads to strong inflationary pressures as the supply side simply can't keep up the demand induced by the additional spending. In such an environment, TIPS should do well.

Equally important is what we are not doing, which is chasing the Trump rally and betting he is going to be able to accelerate U.S. growth to 3.5%-4.0% annually on a sustained basis as he aspires to. This means we are not adjusting our equity exposure upward as we are already overweight equity, and volatility is going to be high.





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Most importantly, we are not adjusting downward any of our structural (read: longer-term, more permanent) tilts to smaller companies and to value-oriented ones. As I have explained in this report over the years, capturing the higher expected returns to these two tilts requires taking a long-term perspective.