The November elections, and Donald Trump's subsequent staff selection, appear to have dominated market trends during the fourth quarter. In October, stock price movements indicated a market preference for Hillary Clinton's candidacy; the broad shock of Trump's victory caused an immediate sell-off. However, the market quickly reversed in celebration of Trump's presumably-expansionary tax and fiscal policies. Excluding the Healthcare and Consumer Staples sectors, stocks saw steady gains through the end of the year. Interest rates increased significantly, especially for longer-durations.

ANALYZING THE TRUMP BUMP

While we have seen some recent positive surprises in economic data, recent gains in consumer and business confidence appear to be mainly driven by optimistic policy expectations. Donald Trump's proposed headline cuts to corporate income taxes are widely expected to be supportive of profit growth, but will need to be funded by a broadening of the tax base, and will be moderated as he negotiates a budget with Congress. Further, because these cuts are intended as reform rather than stimulus, it is unlikely that they would be retroactive, and they are thus unlikely to directly benefit earnings in 2017. The possibility of fiscal policy revival via infrastructure spending has lifted Industrials sector stocks, though this is another area in which Trump will need to compromise given the GOP establishment's zeal for reducing the deficit.

While elections often result in a sense of regulatory clarity that supports corporate decision-making and spending, Trump's cabinet selection has extended uncertainty. His stated intention to overhaul various government departments is backed by his selection of cabinet members with almost exclusively private-sector experience, and with records of opposition to many of the regulations they will be responsible for overseeing. Specifically, the expected trend towards deregulation has fueled recent gains in the Energy and Financials sectors.

DOMESTIC HEADWINDS

The outlook for financial markets in 2017, including the first quarter, is significantly cloudier than usual, as we navigate investor reactions to potentially far-reaching shifts in policy. As we analyze the wide range of possibilities, we note that Donald Trump's selection of Reince Priebus as Chief of Staff increases the likelihood that the next federal budget will resemble the anti-regulation and privatization-focused budget proposed by House of Representatives Speaker Paul Ryan. The top priority of Ryan's plan is the repeal of the Affordable Care Act, along with an aggressive reduction in the deficit.

We expect dollar strength to continue in response to both interest rate increases and the threat of protectionist trade policies. While providing a marginal benefit to U.S. consumers, U.S. dollar appreciation creates a significant headwind for exports. Though the House's proposed tax plan seeks to bolster exports with a complex border-adjustable corporate income tax, the primary effect of this is likely to be an additional increase in the value of the U.S. dollar. With emerging markets already struggling under the weight of China's decelerating growth, this trend could put significant pressure on foreign entities that have borrowed in U.S. dollars.

In addition to significant policy uncertainty, the U.S. economy faces a number of strengthening economic headwinds. Rising interest rates and banks tightening lending standards presage lower borrowing by corporations and by "smarter" and more rate-sensitive consumers. The Conference Board's Leading Economic Indicators remain low and below coincident indicators, and both are below lagging indicators. This trend historically suggests a decelerating economy, consistent with the age of the current recovery and the pressure that accelerating unit labor costs are exerting on profit margins.

Economic surprises, which were overwhelmingly positive in second half of 2016, have contributed to significantly elevated expectations. We believe that current levels of consumer and business confidence are inconsistent with the high level of policy uncertainty, leaving significant room for downside in 2017. Meanwhile, the Wall Street consensus estimate for S&P 500 returns in 2017 is a mere +5.5%, the lowest prediction since 2005. The bond market has incorporated a more negative view of the policy implications of the Trump presidency, with interest rates on Treasuries moving between 0.35%-0.60% higher since the election.

FOURTH QUARTER 2016 RETURNS

During the fourth quarter, we continued to maintain a maximum equity exposure for clients where we have the ability to allocate between stocks and bonds, capitalizing on the significant outperformance of equity markets. Meanwhile, we moved toward a risk-neutral positioning on our equity model in anticipation of a close election, seeking to moderate volatility in anticipation of aggressive post-election market movements.

Small-Cap stocks outpaced Mid-Cap and larger stocks for the quarter, as well as for the year. The Russell 2000 Index total return was +8.82% for the quarter and +21.28% for the year, while the S&P 1500 and S&P 500 returned +4.31% and +3.82% for the quarter, and +13.02% and +11.95% for the year, respectively. The rising dollar created a more challenging environment for non-U.S. stocks, with the MSCI All-Country World Index excluding the U.S. down –1.25% for U.S. investors for the quarter, though still up +4.50% for the year. Meanwhile, MSCI's Emerging Markets Index declined –4.31% for the quarter while remaining up +11.27% over 2016. The price of a barrel of West Texas Intermediate Oil finished the Fourth Quarter up +11.36% at $54, building on gains in the first half to end the year up +45%. Bond returns, as measured by the Barclays Government/Credit Intermediate Bond Index, were down –2.07% for the quarter but +2.08% for the past twelve months. Municipal bonds underperformed corporates, dropping –3.62% for the quarter to a +0.25% annual return on concerns that the attractiveness of their tax-exempt status will be compromised by the new administration.

Looking at the U.S. market on a sector by sector basis shows widely divergent returns dominated by the election results and corresponding policy expectations, from a –4% decline in Health Care stocks to a +21% gain for Financials.

VALUATION

As of December 31, 2016, the expected earnings yield on the S&P 500 was 5.3%, while the yield on the 10 year Treasury Inflation-Protected Securities, or TIPS, was 0.5%, indicating an approximately 4.8% greater expected return for large capitalization U.S. stocks than for bonds. However, we believe that current valuations for U.S. stocks are looking less attractive after the market's strong Fourth Quarter performance, given tightening economic conditions and a high level of uncertainty.

The current earnings estimate consensus for the S&P 500 in 2017 is $131, but forecasts are typically revised downward during the year. Currently, the S&P 500 index is at 18.8 times expected earnings for the next twelve months, above the 25 year average of 15.9 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 28.3 times earnings, 0.4 standard deviations above the 25 year average of 26.0, and 1.7 standard deviations above the average since 1881.

POSITIONING

Given the economic headwinds addressed above, we continue to anticipate softening economic growth in the near future. This risk is paired with that of acute market volatility during the first innings of Donald Trump's presidency. As a result, while stocks continue to have higher return potential than bonds, we believe that the downside risk for equities has increased significantly. In concert with this outlook, and with a goal of protecting client assets, we are adjusting our equity exposure back from maximum to neutral for clients where we have the ability to allocate between stocks and bonds. Meanwhile, we will continue to maintain a risk-neutral positioning of our equity strategies.

We anticipate that our portfolio companies, which we select based on their strong balance sheets, strategic leadership in their products and markets, and strong environmental, social, and governance policies, will have the financial flexibility and leadership wisdom to navigate choppy and volatile economic conditions. We also continue our active corporate engagement and policy work to address important structural issues such as corporate responses to climate change, the gender pay gap, and the need to pay a living wage. This work is made ever more important by an incoming administration which does not appear to share these priorities. Please refer to our First Half 2017 Advocacy Update for details on our ongoing efforts in these areas.