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# A LOOK BACK AT 2016

## HITS AND MISSES

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### KEY TAKEAWAYS

Our stock market forecast, as described in our *Outlook 2016* publication, was largely on target for the year, while we appropriately maintained our year-end stock market forecast during the February market lows.\*

Political elections, both in the U.S. and the U.K. made for some of the biggest surprises of the year, and brought some unexpected market impact.

Other hits included our decision to largely stay on the sidelines with regard to international equity markets, while favoring large caps and growth were among our misses.

\*As noted in our *Outlook 2016*, we expected mid-single-digit returns for the S&P 500 in 2016, consistent with historical mid-to-late economic cycle performance. We expected those gains to be derived from mid- to high-single-digit earnings growth over the second half of 2016, supported by steady U.S. economic growth and stability in oil prices and the U.S. dollar. We believed a slight increase in price-to-earnings ratios (PE) above 16.6 would be possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe.

**This week we take a look back at some of our hits and misses of 2016.** We certainly had some of both in what was a difficult year to forecast the equity markets.

First, the year got off to one of the worst starts ever with a 10.5% stock market correction during the first five weeks of the year as oil prices collapsed. Then we got unexpected election outcomes. In the U.K., the Brexit vote and the stock market's post-vote resilience were both largely unexpected. Similarly, few predicted Trump's victory (which apparently surprised even the president-elect himself). That surprise was followed by another—one of the strongest post-election stock market rallies in history.

Against that unpredictable backdrop for stocks, we got some things right and some things wrong. Here is a look back at the hits and misses of 2016.

### WHAT WE GOT RIGHT

**Stock market forecast.** One could argue this forecast belongs in the "hit and miss" category but we give ourselves the benefit of the doubt on this one. We called for mid-single-digit returns for the S&P 500 this year, writing in *Outlook 2016: Embrace the Routine*:

"Stocks, we believe, will not collapse, as many think, or soar, as many hope, but may offer near historical routine returns."

Through December 16, 2016, the S&P 500 is up 10.7% year to date (12.8% including dividends). Sure, that's a little above our forecast but it is right in line with long-term average historical returns, and is above our forecast for (and actual) bond market returns (and we would certainly rather miss on the low side if we're going to miss). And after five straight weeks of gains, it would not be a surprise if we got a little dip over the next two weeks.

Later in the year, as the major averages hit a series of new highs and valuation concerns became widespread, we noted that stock valuations were reasonable given the stage of the business cycle and low interest rates and inflation. This is still our view which has, up to this point, been right.

**Response to early 2016 volatility.** We did not anticipate the sharp downturn early in 2016. However, we made the right decision to maintain our year-end forecast at that time while many Wall Street strategists cut their year-end forecasts. We also

stood by our call for continued economic growth, i.e., no recession, and to generally maintain portfolio risk levels near benchmarks. Further, the catalysts we cited in our February 16, 2016, [Weekly Market Commentary, “Data-Driven Perspective on a Rough Start to 2016”](#) all played out, including: higher oil prices, improving credit markets, evidence of a more pragmatic Federal Reserve, and stable Chinese capital flows and currencies.

**Technical and sentiment.** Our use of technical indicators and sentiment measures to help guide our asset allocation decisions proved helpful in 2016. At the February 2016 lows, the number of bulls in the American Association of Individual Investors (AAII) was near financial crisis lows in March 2009, suggesting the worst might have been over (and it was). Market breadth indicators helped us stay positive toward equities during the early summer ahead of the Brexit vote. Historical seasonal patterns supported sticking with stocks after Trump’s victory, as large market declines after elections have been extremely rare, with recessions providing (2000 and 2008) the only exceptions going back to the 1952 election.

**International developed.** We came into 2016 expecting an opportunity to emerge in international developed equities, as represented by the MSCI EAFE Index, but that opportunity never came. Still, we were better off on the sidelines in tactical portfolios where we remained for virtually the entire year. Simply put, quantitative easing (QE) in Europe was not enough to overcome geopolitical challenges and sluggish economic growth. Developed international markets have returned just 0.5% year to date, well behind the S&P 500.

## WHAT WE MISSED

**Election outcomes.** The two big election outcomes—the Brexit vote in the U.K. and the U.S. presidential election—were among the two biggest things we got wrong; though we certainly were not alone. In both cases, stocks reacted better than we

expected (though based on futures markets the S&P 500 did correct about 6% overnight during Election night). We had expected a pullback to potentially provide an opportunity to get more positive on U.S. equities, but that pullback never really came. The one that did—the post-Brexit vote decline—was essentially over in two days and totaled only 4% based on closing prices.

**Value.** After getting growth over value right in 2015, we stuck with that positioning too long in 2016. A sizable portion of the value outperformance this year (the Russell 3000 Value Index has returned 16.3% year to date) has come from financials in the post-election rally. As the year progressed we did turn more positive on both financials and energy, the two biggest value sectors, and recommend a balanced style approach in 2017.

**Small caps.** Our preference for large caps over small during the year was mostly business cycle driven, which was totally outweighed by policy considerations. The unexpected Republican sweep opened up a strong avenue toward comprehensive tax reform. In addition, small cap companies pay higher tax rates than their large cap global counterparts, so they have more to gain from the lower corporate tax rates that are likely forthcoming. Smaller companies are also more insulated from potential protectionist trade policy, so Trump’s victory likely drove some rotation from large into small caps (despite tax repatriation of overseas cash, a likely to be proposed piece of tax reform more beneficial to larger cap companies). Though certainly a missed opportunity, the double-digit returns in U.S. large caps still provided attractive absolute returns, despite trailing small caps, as measured by the Russell 2000, by about 9% year to date.

## HIT AND MISS

**Earnings.** We were overly optimistic in our S&P 500 earnings growth forecast for 2016, which was in line with consensus according to Thomson Reuters at mid- to high-single-digits,

underestimating the depth of the energy downturn and strength of the U.S. dollar. However, we accurately forecasted the second half earnings rebound which, assuming the historical pattern of upside holds, will reach a mid- to high-single-digit range in the fourth quarter of 2016 (and was close in the third quarter with a more than 4% year-over-year increase). More on earnings in our *Outlook 2017* due out later this week.

In emerging markets (EM), over the full year our optimism was largely warranted, with the MSCI Emerging Markets Index returning 10.5% year to date. We maintained previously established, modest exposure to EM in several portfolios during the year, which helped performance, although allocations added during the year have not added value yet due to the post-election sell-off on trade war fears.

**Return of active management and diversification.** Active management continued to struggle for most of the year, although the second half is shaping up better than the first. Among the factors helping active managers include: 1) higher dispersion among individual stocks and sectors, 2) rising interest rates, 3) individual company fundamentals are increasingly driving stock prices, and 4) better performance of value stocks, as many managers have a valuation discipline.

Diversification has added a little bit of value this year, after detracting most of the past five years. Diversifying into small and midcap stocks was helpful, while EM equities had only a marginal negative impact, though lagging developed international markets (based on the MSCI EAFE Index) detracted from performance when used as a diversifier.

## SECTOR LEVEL REPORT CARD

With 11 S&P equity sectors, there will always be hits and misses. Here are the ones that were most impactful:

**Technology.** We were right to favor technology (+14.9% year to date) due to attractive valuations,

some favorable product trends, and encouraging earnings prospects. Although the sector has outperformed in 2016, we believe recent weakness related to global trade and access to labor may be overdone.

**Industrials.** We were right to recommend industrials this year, as the sector has returned +19.5% year to date. We cited improved economic growth and, later in the year, prospects for infrastructure spending which we anticipated regardless of the U.S. election outcome. A boost in defense spending under President-elect Trump would also provide support.

**Consumer.** Our caution toward both consumer sectors was well placed as both consumer sectors have underperformed year to date, especially consumer staples (+6.0%). Consumer discretionary (+7.8%) caution was largely due to its better historical performance during the early part of business cycles. Our preference for cyclical sectors as economic growth improved was the primary reason for our negative consumer staples view.

**Healthcare.** Our positive view on healthcare (-1.7%) in 2016 has missed the mark. We underestimated the impact the drug pricing controversy would have on the biotech and pharmaceutical industries. Recent indications that reducing drug prices may be a priority for the president-elect, on top of the uncertainty surrounding the future of the Affordable Care Act, have led to recent underperformance and our tempered optimism for the sector in recent weeks.

## CONCLUSION

As we turn the page to 2017 we look forward to potentially another solid year of stock market performance for investors and, hopefully, more hits than misses in our soon-to-be-released *Outlook 2017*. ■

**The *Weekly Market Commentary* will not be published on December 26, 2016. Look for our next publication on January 3, 2017. We wish you all a joyous holiday season!**

#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

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Active Management may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

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#### INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.

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