COMMENTARY

PRIVATE CAPITAL MANAGEMENT
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Fourth Quarter 2016

"Know what you own, and know why you own it." - Peter Lynch

In our humble opinion, 2016 was one of the most interesting years for investors since the Financial Crisis in 2008. Furthermore, we believe the year delivered several important reminders for investors that we will explore in this quarter's commentary.

After shaking off its worst-ever start to the year, the Dow Jones Industrial Average (DJIA) delivered its best results since 2013, gaining 16.5%. It is remarkable to see the DJIA closing in on 20,000. This is triple the 6,547 low that the index hit during the financial crisis. The S&P 500 large cap stock index was up 12%. After underperforming the large-cap stocks in both 2014 and 2015, small-cap stocks outperformed in 2016. International stocks continued to underperform domestic stocks again this year. This is a topic we will explore in more detail below. After outperforming stocks for the first six months of the year, bond performance lagged during the second half as interest rates started to rise. In the end, bond returns lagged stock returns for the full year.

Forecasters' Folly

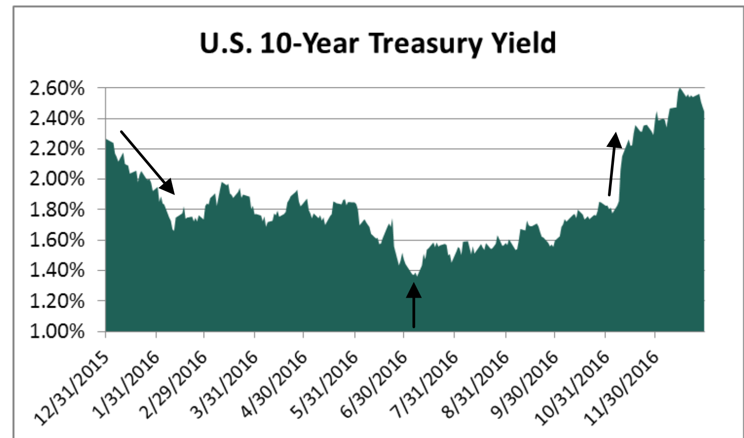
Each year we like to provide a summary of some of the top market strategists' forecasts for the upcoming year. The table below from *Barron's* shows that 2017 S&P 500 market forecasts range widely from a modest increase of 3% to a healthy gain of 15%. The average of these estimates calls for a 6% price gain in 2017. U.S. GDP growth estimates are fairly closely centered between 2% and 3%, which is about the same as their 2016 estimate of 2.5% growth. The strategists' estimates for the 10-Year U.S. Treasury rate vary from 2.4% to 3%. The 2017 average earnings estimate is $127. Given that the S&P 500 closed the year at 2238, the market is trading at roughly 17.6 times the average of these earnings estimates. For comparison, the 25-year average price to estimated earnings ratio is 15.8. Investor optimism is high right now.

2017 U.S. Estimates	S&P 500	% Gain	EPS	U.S. GDP	10Yr Rate
John Praveen, Prudential Int'l	2575	15%	$122.2	3.00%	2.75%
Jeffrey Knight, Columbia Threadneedle	2450	9%	$135	3.00%	2.90%
Heidi Richardson, BlackRock	2400	7%	$127	2.40%	2.5-3%
Jonathan Glionna, Barclays Capital	2400	7%	$127	2.20%	2.40%
Dubravko Lakos-Bujas, JP Morgan	2400	7%	$128	2.10%	2.55%
Steve Auth, Federated Investors	2350	5%	$130	3.00%	3.00%
Tobias Levkovich, Citi Research	2325	4%	$129	1.80%	2.60%
David Kostin, Goldman Sachs	2300	3%	$116	2.20%	2.75%
Savita Subramanian, Bank of America	2300	3%	$129	2.00%	2.65%
Adam Parker, Morgan Stanley	2300	3%	$128.7	2.00%	2.50%
Average:	**2380**	**6%**	**$127**	**2.37%**	**2.68%**

Index, EPS, GDP and Interest Rate data provided by Barron's as of 12/17/2016

Make Bonds Great Again

In many ways, 2016 served as an excellent reminder of how a diversified portfolio should work. We believe that diversification is achieved by owning investments in asset classes that don't always move in the same direction at the same time. For example, from January 1st through February 10th, the S&P 500 was down about 10%, but bond prices were going up (as interest rates declined). This is the inherent link between bond prices and interest rates: they move in opposite directions. As shown in the chart below, the U.S. 10-Year Treasury Yield started 2016 at 2.27%, fell to 1.36% by July, and then ascended to 2.45% by year end. While many investors feel like rates have been rising dramatically, the increase over the full year was only 0.18%.



Data provided by the Wall Street Journal as of 1/8/2017.

For the first half of 2016, the Barclays Aggregate Bond Index was outperforming the S&P 500 stock index. Following the U.S. elections, stocks prices have been rising on optimism that a unified government under a Republican majority with a Trump presidency would jump-start sluggish economic growth and enhance U.S. corporate earnings via corporate tax reform, personal tax reform, deregulation, and infrastructure spending. At the same time, interest rates have also been rising (and bond prices declining) on higher inflation expectations and the belief that the Federal Reserve may need to accelerate its rate-tightening timetable.

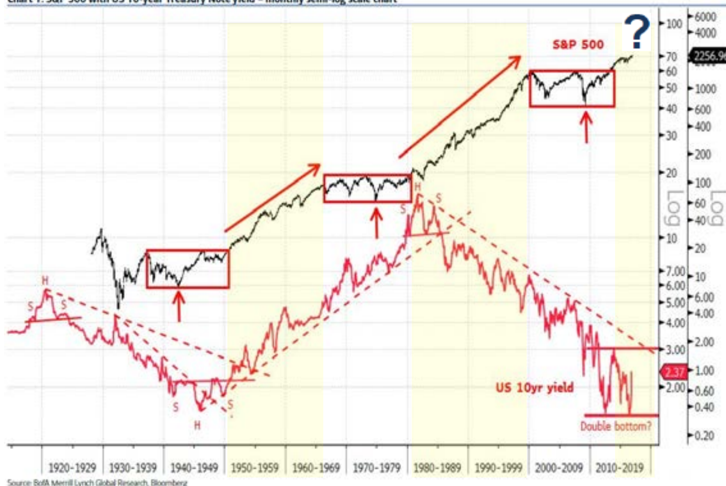
For the first time in many years, we believe several forces are now in place that could lead to rising interest rates. First, it is becoming widely believed that with a tight labor market and less slack resources in the economy, the much anticipated fiscal policies being negotiated in Washington could lead to higher levels of inflation. Inflation levels are an input into bond yields because bond holders generally prefer a real return (above inflation) on their investment. If inflation begins to stay above the Federal Reserve's 2% target, the Fed could feel pressured to keep raising interest rates in an attempt to keep inflation under control. Additionally, if the government

reduces taxes and increases spending on infrastructure, the budget deficit could widen leading to the issuance of more government bonds to fund it, and increase downward pressure on bond prices.

We believe the stock market is trading higher on optimism about potential public policy reform, which means that the chance for disappointment has been growing. Should public policy miss the recently heightened expectations of investors, the stock markets could pull back at any time. Just because rates may rise does not mean bonds don't still serve the same diversification purpose in a portfolio that they did in January and February of 2016. And, in the long run higher rates will be better for bond holders because they will earn a higher yield.

New Secular Bull Market?

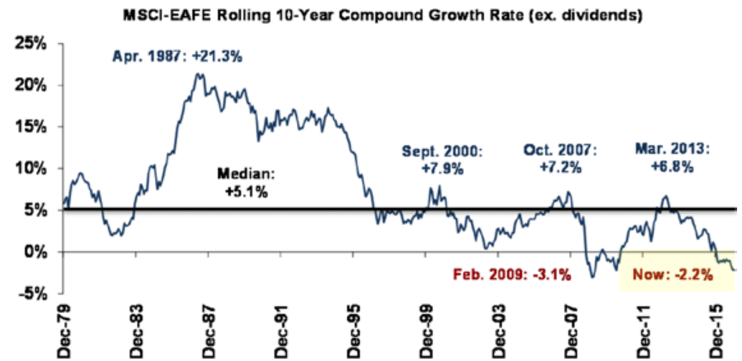
Over long periods of time, the stock market has generally trended higher, rewarding long-term investors. But, it is rarely a smooth ride. Additionally, there have been extended periods of time when the stock market was volatile but did not rise to new highs. Most recently, this was the case from about 2000-2016. But, as you can see in the chart below from Bank of America Merrill Lynch, following these sideways periods (red boxes), there have been some significant secular bull markets (yellow highlights).



Bank of America believes we are in the very early stages of the next secular bull market, which could be similar to the one in the 1950s when stocks and U.S. interest rates were both rising.[1] The US 10-year yield bottomed near 1.5% in late 1945 and the S&P 500 remained firmly within its secular bull market until yields moved to 5-6% in the mid-1960s.[1] The S&P 500 rallied 460% over this period.[1] It's worth noting that stock market corrections and recessions both occurred during past secular bull markets. But, secular bull market recessions did not derail the secular bull trend with new S&P 500 highs following the recessions.[1]

International Reversion to the Mean?

Since 1969, the MSCI-EAFE index of developed international companies has posted a compound annual return of 9.3% and delivered positive total returns in 70% of those years.[2] But, since 2007, this same index underperformed the S&P 500 seven of nine years, posting a sub-3% cumulative total return.[2] As you can see in the next chart from CFRA, the MSCI-EAFE's rolling 10-year compound growth rate is -2.2% and rivals the all-time low of -3.1% reached during the depths of the financial crisis in 2009. S&P/CFRA Chief Investment Strategist, Sam Stovall, reminds us that while it's understandable that investors are considering unloading this international component from their portfolio, Murphy's Law applies to investing as well. "The year you give up on a previously dependable investment strategy is the year in which it will start working again."[2] He goes on to point out that "there is no guarantee this performance could not erode even further, but the age old mantra of "reversion to the mean" implies that this index's performance is likely nearing a bottom and, as a result, is reason for investors to at least maintain their foreign exposure, if not consider adding to it."[2]



Source: CFRA, MSCI. Past performance is no guarantee of future results. Data: 12/31/69-12/16/16.

Best Wishes for the New Year

Wishing you good times, good cheer and a memorable new year!

By the numbers…

Index	Close	4th Quarter	Year-to-Date
S&P 500	2238	+3.8%	+12.0%
Dow Jones Industrial Average	19,762	+8.7%	+16.5%
Russell 2000	3372	+8.8%	+21.3%
MSCI EAFE	1684	-0.7%	+1.0%
MSCI Emerging Markets	862	-4.2%	+11.2%
Barclay's US Aggregate Bond	-	-3.0%	+2.7%
Bloomberg Commodity	87	+2.7%	+11.8%

Data provided by Morningstar as of 12/31/2016

1 Suttmeier, Stephen, CFA, CMT, and Jue Xiong, CFA. *2017 Equity Tehcnical Year Ahead Low & rising interest rates confirms 1950s-style US equity secular bull*. Rep. no. 15 December 2016. N.p.: Bank of America Merrill Lynch, 2016.

2 Stovall, Sam. *REVERSION TO THE MEAN*. Rep. New York: CFRA, 2016. Print. U.S. Equity Research Sector Watch.

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