January 13, 2017

Dear Friends and Clients,

Brokerage firms have a long track record of stifling the predictive wanderlust of their rank and file. Instead they attempt to speak with one voice through a strategist or economist that knows the compliance ropes and keeps them out of harm's way. Nonetheless, this time of year seems to stimulate the client's interest in what's happening next. While we could attempt to make the case that December 31st is just another day on the calendar, it's really not. Financial books close, semesters end, cars grow another year older and taxes face a cutoff. Year-end is a natural time to ponder the future.

A Collection of Surprises for 2017

Our mentor Byron Wein publishes a list of surprises every year and we admire his approach. He doesn't get too caught up in his own opinions and is happy to be more provocative than definitive, we hope to follow in his footsteps. The surprises on the following list qualify by having a 50/50 shot of materializing. If our list makes you think, we have accomplished our goal.

1) The Donald goes to Washington. Draining the swamp, dismantling the Affordable Care Act and deregulating the over-regulated will be a monumental task. Add to it the termination of treaties, trade agreements, extreme positions on immigration and the new administration will more than have its hands full. Marginal Republican senators and representatives will play traditional politics to advance their pet projects, selling their votes to the highest bidders and stifling administration initiatives. We do not expect a wall between the U.S. and Mexico. We consider beating the market out of a 10% price correction a victory….Trump should learn to accept small victories too. Ted Williams went to the hall of fame hitting .400.
2) Realized tax cuts for individuals and corporations will have a positive effect. Combine them with the continual promise of deregulation, plus infrastructure improvements and 2017 GDP will grow at an impressive 3.00%, stimulating the S&P 500 to top 2500. Dow 20,000 will be a cinch.
3) The Donald stays in New York. It's already apparent that Air Force One will be flying a triangle between New York, Mar-a-Lago and the White House. Actually we were entertained to see Ivanka and husband Jared buying a house in D.C. this week. She would have been the perfect White House tenant for her dad. Regardless of where he decides to establish residency, The Donald will drive the press corps and paparazzi nuts with his jet setting and reporter-eliminating Twitter account…..point Trump.
4) Fortune 500 companies will repatriate between $250 – 500 billion of the $1 trillion held overseas. The new administration is considering a one-time 10% tax package that will inspire them to settle up and bring the dollars home. This will be a win-win-win deal. Tax coffers will swell, corporations will get a tax break and shareholders will benefit….Donald will declare victory and CEOs will laugh all the way to the bank….point Trump and Corporate America.
5) Intimidation tactics will fail The Donald as multinational corporations use job repatriation head fakes and rope-a-dope tactics to deceive the billionaire. In the end, the wage differential is just too great and made abroad/sold in the states tariffs will prove ineffective….point Corporate America.
6) Leadership of the Democratic Party will become rudderless. Bernie Sanders and Elizabeth Warren will argue themselves right out of relevance. Michelle Obama to save the day? How about Hillary being elected mayor of New York City?

7) The Donald meets the smog monster…..Kim Jong-un might even choose Inauguration Day for a mid-Pacific missile launch. These two were made for each other and it should be a long term head banger. Expect Trump's advisors to be double-clutching and restraining to the best of their abilities. Their first encounter will be in January but there will be more. In the long run we like Trump. Expect the North Korean issues to cause the Donald to realize that China's currency is overvalued, not undervalued…a 180 that he is becoming a past master at. Expect punitive Chinese tariffs to be eliminated in exchange for stifling the despot's son with a bad haircut.
8) Inflation will rise to about 2.50%. Expect 10-year Treasury yields to increase from 2.35% to 3.50%, the yield curve will remain positive but pretty flat on the long end.
9) The Cubs will fail to repeat as World Series Champions, the Warriors will beat the Cavaliers in a seven game NBA playoff and Tiger Woods will win some high profile golf tournaments, but no majors.
10) The State of Nebraska disallows the sale of liquor in White Clay, ending a source of national embarrassment.

Honorable Mention….

1) Medical and social marijuana use will continue to gain acceptance in 2017, but the Feds will continue to maintain a hard line.
2) The State of Nebraska takes long term constructive action to reduce the liquor being supplied to the Pine Ridge Reservation in South Dakota. We would have liked being able to write about disallowing liquor sales in White Clay, Nebraska but the liquor permits were renewed prior to the date of this letter. This situation is a national disgrace and needs to be rectified.
3) Huskers sign a top recruiting class in football. Before we could print this wish/surprise, the 'skers went 0 for 4 at the Army-Navy high school game….bad news. Top that off with the dismissal of Mark Banker as Defensive Co-ordinator, XXXXX as secondary coach and YYYY as director of football operations. Plenty of drama from Memorial Stadium.

The Itsy Bitsy Spider Climbed up the Water Spout…..Down Came the Rain and Washed the Spider Out…

Out came the sun and dried up all the rain….and the itsy bitsy spider climbed up the spout again. Itsy bitsy, yo-yo, zig-zag, call it what you like, markets do not move in a straight line for very long. Years ago, pundits older than me (which there are fewer of all the time) observed a stock market phenomena they called "climbing the wall of worry." Equities, it had been observed, would periodically have the ability to triumph over road blocks and pitfalls without the help of good news. Often in an environment where all the news is bad. The negatives it was said, provided the market something to lean against. Investors may not like the market from time to time, but their portfolios generate cash and that cash needs to be invested. Historically the stock market goes up in price about 65% of the time. Knowing that, this cash gets systematically spent on stocks and the bears start to become bulls as the road blocks resolve themselves.

Eventually, the pitfalls disappear and without any near term threats…..the wall of worry tends to collapse. Pretty soon, the majority of investors become bullish and all the pews are full….don't look now, no one left to buy. Even if the sellers don't take control, there is little reason to hold. The longs start to liquidate and a correction is at hand. The following conclusions seem backward but eventually they become self-fulfilling, a bearish sentiment produces it's own buyers while a bullish crowd is one step away from a collection of sellers. The Itsy Bitsy Spider you say? Yep, there are certainly some familiarities.

So how do we avoid this teeter-totter market action? The simple answer is you can't. Consider it the price of earning at equity rates instead of passbook savings rates. Markets grow on enthusiasm, become overpriced, sell off, and then recover. Think of the spiral on a football, the backspin on a free throw or the English on a cue ball…all counter directional actions necessary to complete a given task. You can lateral a football without spiral, but not very far. It generally goes backward instead of forward. Absent the itsy bitsy spin-cycle, the market tends to fail at one of its most important tasks….moving securities from weak hands to strong hands.

Goodbye 2016….

Few of us can sit back, watch the tape trade, react to the price action and differentiate our motivations. Which drives us harder? Greed or fear? I can admit to being a victim of both and I see both in clients all the time. For some reason people take pride in being fearful and dislike admitting to greed. Face it, we all have emotions and they are hard to quantify. None of us dream about selling the market 10% short of its highs and then buying it 15% off its lows…..we want the whole enchilada, buy at the bottom and sell at the top. When we see a price graph, our mind's eye focuses on the peaks and valleys….the highs and lows if you will. The rearview mirror always holds lost opportunities, historically we see all of them with 20/20 vision. Check out a few watershed events that occured in 2016:

January - Iran severs diplomatic relations with Saudi Arabia after they execute Shiite cleric Nimr al-Nimr.
June – The British vote Brexit and polls are stunned.
August - North Korea conducted its fifth nuclear test detonating an explosive yield of 10 kilotons.
October - The U.S. intelligence community agrees that Russian operatives hacked DNC email systems in an attempt to influence the election.
November - Trump wins the U.S. Presidency. The futures predict a down 800 point opening for the Dow.
December - Matteo Renzi resigns as Italian Prime Minister after voters reject his plan to revamp the country's political system.

The trained eye will notice there is something missing here…price action. We want you to push the rewind button and put yourself back at those dates again. As your own money manager, would you have been long or short the market leading up to or as a result of these events? Were you fearfully anxious, ambivalent, or perhaps excited in greedy anticipation? Would you have changed course on election night? Make some notes and continue reading.

Here's what Happened….

This exercise probably won't make us any money, but let's see how a sophomore portfolio manager would have done. As you probably know, P&A was fully invested throughout 2016. Some of these events were front of mind for us at the time and some of them were way off our radar screen. Some moved the markets, some didn't and some you just couldn't tell.
With some editorial remarks, here's what happened:

Nimr al-Nimr:	I didn't know this guy from Duran Duran and it still don't know how significant this event was. Dow falls from 17,425 to 15,660, down 10.13% in 39 days….ouch. Could have been this event and it could have been the January affect
Brexit:	They fooled me; I would have voted "remain." Dow falls from 18,011 to 17140, down 4.83% in four days.
North Korea:	This guy's annoying and wants to be relevant. Dow falls from 18,454 to 18,034, down 2.27% in 14 days
Hacking:	Yet to go away, the Dow fell from 18,240 to 17,888, down 1.92% in 27 days, not much….market noise.
Trumping:	I was fooled, Dow rallies from 17,888 to 19,974, up 11.16% in 46 days, a watershed event.
Renzi:	I actually tracked this and thought the guy would get re-elected. Dow rallies from 19,549 to 19,974 in 13 days, up 2.17%

With the exception of the kid with the bad haircut and the Russian hacking (two serial repeaters that may never end), these were all scheduled events. Did you exit the market when Nimr al-Nimr was executed? Did you exit when the Russian hacking first crept into the news? If so, did you get back in before the election? Missing the Trump rally would have cost you 11.16%. In between these watershed events the market churned higher and delivered a 16.50% return measured by the Dow, or 13.70% as measured by the more diversified P&A Blend Index.

If you bought good stocks and let the market climb the wall of worry your stocks probably generated a 10%+ return. Truth be known, 2016 was a portfolio manager's nightmare, a rising tide did not lift all ships. Value stocks outperformed growth stocks, the major indexes started to regress to a common mean with the Dow outperforming the S&P 500…Small Caps outperformed them all! As a portfolio manager, any time spent un-invested would have been problematic. Even the most conservative of strategies was rewarded by not bolting from the fold. Money market fund rates continued to hover around zero and failure to take some risk was punished severely. As always, I am glad we take the long-term view.

The World According to Pitt and Dan…

We have been in rally mode since 2009…that's a long time by anyone's measure. A 10% Dow correction at these levels is a -2,000 point move and 15% is -3,000. Don't know when, but something like that is probable. The market impresses us as being fairly priced but not terribly overpriced. Using the 10-year Treasury as a barometer, interest rates have skyrocketed from 1.95% to 2.37% over the last 12 months. If you buy a new house you can expect to finance it with a 3.92% 30-year mortgage or a 3.20% 15-year. Overnight money market fund rates range from 0.35%–0.50%. Automobile loans can be financed at commercial banks in the 2.625%–3.00% range. The consumer price index rose 1.70% in 2016. Corrections usually occur when no one is looking for one….certainly not the case today. Donald Trump promises lower tax rates and less regulation….the markets believe him.

We continue to Really Like equities but find ourselves keeping one eye on the door. Do us a favor….have some fun. If you are planning a trip, take it or at least fund it. If a lake home is on your bucket list, start shopping. How about a nice RV? Maybe a cruise is in the offing or perhaps a new car. We are at all-time highs so philanthropy has never been cheaper….contributing to a donor-advised fund might just scratch the itch. Who knows, maybe this is our mojo, whenever we recommend spending money the market seems to trade higher.

As Always,

Pitt

James S. Pittenger, Jr,
Chairman/CEO
CFP®

Dan

Dan Anderson
President
CFP®