An Interesting Year!

The year 2016 ended about the exact opposite of how it began after Trump's surprise victory and even more surprising market reaction. Leading up to the November vote the stock market pulled back with every gain Trump made in the polls. On election night stock futures started out up about 1% anticipating a Clinton victory. By the time it was clear that Trump was going to win stock futures had fallen all the way to -5% when trading was halted. The next day the stock market only opened down about 1% and climbed throughout the day ending in positive territory. And the market hasn't looked back since.

The year started with one of the worst declines in January ever, after a lackluster 2015 and by early February was already down over 10% on the year and down nearly 15% from the previous high. The energy market was in freefall with crude falling to as low as $28 a barrel and investors feared an economic crisis in China. Gloom was pervasive and more selling seemed certain. Within about a month, however, the losses were recouped. **We had been pretty cautious up to this point in our allocation but we felt the market was sending a message that it was time to get more engaged in the stock market.**

These sharp reversals have been a consistent pattern since the stock market stalled in late 2014 suggesting that the average investor had not reengaged in the stock market. After the financial crisis most people concentrated on reducing debt instead of investing. As a result the marketplace has not seen panic selling during any correction. **More importantly the relative strength of the S&P 500 masked a lot of damage below the surface. Large parts of the market like small- and mid-capitalization (cap) stocks, large-cap value stocks, and international stocks all suffered big declines. A strong argument could be made that we experienced a stealth bear market. As a result we found a lot of attractive opportunities and many high-quality stocks trading near 52-week lows even after the rebound in the spring and summer.**

Since the stock market reflects the collective wisdom of what is to come, we also thought the market's strength was signaling better economic and earnings performance and that is indeed what has occurred. The beleaguered middle class is finally seeing improvement - average hourly earnings for private-sector workers jumped 2.8% year over year in October, the largest annual rise since June 2009. Consumer confidence climbed in December to the highest level since August 2001 as Americans were more upbeat about the outlook than at any time in the last 13 years. Manufacturing data globally has been improving. Corporate profits rebounded in the third quarter on the back of a powerful GDP reading of 3.2%, the strongest growth in two years. Real fundamental improvement has taken place which is rightly fueling the stock market rally.

Clearly Trump's victory improved market sentiment and added fuel to the improving landscape. Investors are focusing on Trump's market pleasing positions of lower taxes, less regulation and increased infrastructure spending. Of course there are multiple sides to Trump and plenty of risks to monitor. A reworking of trade agreements to improve U.S.'s competitive position would be welcome; insular, protectionist policies would not. In addition, it may be that an aging population and sluggish productivity make it very hard to push economic growth up to the 3-4% hoped for by the new administration.

Another risk is valuation. While we'd ignore the sometimes hysterical pleas that stocks are wildly overvalued, it's hard to argue they are a bargain. **However, although small-cap, mid-cap and large-cap value stocks have done well lately, they still are reasonable priced. International stocks have yet to catch fire and look like the best opportunity, especially given low valuations.** The two things that need to happen for investors to warm up to international stocks are better earnings and a healthier banking system. Fortunately market signals are improving overseas. Like the U.S., measures of market sentiment globally are on the rise. Interest rates and inflation expectations are advancing supporting an OECD forecast that the euro-zone economies could grow at a respectable 1.6% next year. The weaker euro is a boon supporting profit margins of European companies. Most importantly, the value of the Euro Stoxx banks index has risen 30% since the start of October perhaps signaling higher inflation and growth.

Overall it seems the path of least resistance remains to the upside, hence our low cash position. However, the current honeymoon period for Trump cannot last indefinitely and we expect some sort of pullback to test investor's resolve. Perhaps 2017 is the mirror of 2016 with a strong beginning and a weak ending.

James Tillar, CFA and Steve Wenstrup

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