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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Clearly the big event of the last quarter was the Presidential election. Not only were many people surprised (and some shocked) at the outcome, but the market's reaction clearly showed the hazards and futility of predicting short-term market reactions. Before the election, virtually all the pundits and commentators were suggesting that a Trump victory would be an immediate disaster for stocks. The stock market did finish lower – for one day. Instead, the disaster occurred in US Treasury and municipal bonds, which were hardly even on the predictors' radar. The lesson from this story is that you should take anything you hear or read regarding financial predictions with a grain of salt.

The Economy

Economic growth picked up in the 3rd quarter, registering 3.5%, bringing the last 12 months up to 1.65%. Before we get too excited, the real-time Fed estimate for the 4th quarter is back to 2.5%. Annual corporate profit growth has become slightly positive, which is an improvement from the negative trend of the prior 5 quarters. A sharp rise in 30-year mortgage rates to 4.3% has not yet affected home prices, which were up 4.9% vs. last year, led by the south and western parts of the country.

Trump and The Markets

Having gotten the effect of the Trump victory completely wrong, when faced with reality, the purveyors of the conventional wisdom scrambled to explain the markets' reaction. The revised explanation is that Trump's emphasis on economic growth, tax cuts, infrastructure spending, and reduced regulation are all good for the stock market. Several sectors of the stock market reacted favorably and quickly, most notably the banks, which presumably will benefit from higher interest rates and less regulation. Industrial companies, including the Dow Jones Industrial Average, as well as smaller companies have also been bid higher, perhaps due to the promise to reduce corporate tax rates, and greater fairness in international trade. Plans to foster repatriation of overseas profits also may have helped, since some say they will be used to provide funds for corporate stock buybacks. On the other hand, drug and biotech companies have lagged as the health care subsidies of the Obamacare program are jeopardized.

It may be, though, that the market's reaction is less related to policy specifics. It may simply be a relief rally based on the expectation that things will change after years of slow growth and increasing government micro-management. That sense could also have contributed to the highest consumer confidence reading in 15 years. However, longer term, there may be some validity in the pre-election warnings.

- The Federal Reserve, which has been supporting the economy for years, may now be comfortable taking a more hands-off approach. Their expectation of three interest rate increases in 2017 suggests a firming of their desire to unwind the money-printing policies of the past. They may not be able to accomplish this, but clearly the philosophy has changed. Interest rate increases are not good for holders of stocks or bonds.
- Renegotiating trade deals may be helpful in the long run, but messy in the near term and increase inflation. Protectionism and trade wars can reduce global economic activity. Consider for a moment that the Smoot-Hawley tariff of 1930 is widely thought to have contributed to the severity of the Great Depression.
- Increasing military and infrastructure spending can lead to further increases in government debt from a level that is arguably already too high. Other countries, like China, have played a large part in financing our deficits by purchasing Treasury bonds. If global economic tensions increase due to a reset of established trading patterns, who will finance the debt? With fewer buyers, interest rates would likely increase. Paying the interest on the debt could become even more difficult, and result in accelerating deficits.

The philosophies and policies of the new administration will clearly be different from the last. How that difference will play out is impossible to know. Right now the view of the future is murky, but such a substantial change will create opportunities as well as dangers. My own guess (remember the salt) is that the time of a flat economy and markets may be past. Economic and financial volatility are more likely as the effects of new approaches are digested. Even if the market's initial reaction is correct, and the policies of the new administration are positive, it will take time to implement, and even longer for the effects to be felt. As the prior administration found, there are few magic "shovel-ready" projects immediately available.

Dow 20,000?

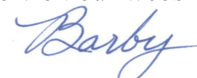
Over the last several days and weeks, the nightly news and other media have featured stories about the Dow Jones Industrial Average closing in on the 20,000 mark, fueled by the Trump election rally. To the extent that 20,000 is important, it is because people look at it as an "anchor", which is a reference point that may or may not have any actual relevance to them. In reality, it is only a new high in an abstract index that imperfectly represents one market segment. But because it is a new high, it does have meaning. It is said that the most bullish thing stocks can do is go up, and a new high is undoubtedly up. On the other hand, markets tend to get stuck at round numbers, perhaps due to the anchoring effect. ("If the market gets to 20,000, I'll sell"). Spencer Jakab wrote for the Wall Street Journal that this stickiness is most true when the market is overvalued. The table shows when the Dow went through a round number in an overvalued condition (as measured by Robert Shiller's Cyclically Adjusted Price / Earnings Ratio or CAPE), it retreated sooner or later, and took years before going back up through the same level for the last time with a lower CAPE. The table also shows the tremendous volatility that occurred in between those times.

Level	First Time		Last Time			Volatility Between First and Last			
	Date	CAPE	Date	CAPE	Years	Highest	% Gain	Lowest	% Drop
10,000	4/1/1999	42.71	7/1/2010	19.66	11	14,279	43%	6,440	-36%
1,000	1/1/1966	24.06	11/1/1982	8.35	16	1,042	4%	570	-43%
200	12/1/1927	18.65	1/1/1950	11.66	23	386	93%	41	-80%
100	1/12/1906	20.13	5/27/1942	8.51	26	380	280%	41	-59%

Right now the CAPE is 28.1, higher than all but one of the initial break points, and higher than all of the final break points. This does not bode well for any expectation that a current break of 20,000 will be the last. If history repeats, this may occur between 11 and 26 years from now, which is how long it may take to continue moving up, leaving 20,000 in the rear-view mirror, with some large gains and losses in the interim.

"The Dow" was first published in 1896, before the days of calculators. It was a simple arithmetic average of the price of 30 companies' stock. It still maintains its structure, representing large, "blue-chip" companies. No small companies. No foreign companies. No bonds. No commodities. It does not represent the whole stock market, let alone a balanced investment portfolio. Over the years, the Dow has overstated actual market performance, because losers are removed from the average and replaced (remember AIG?). It also overstates what an investor might accomplish. It does not have the expenses, residual cash position, or withdrawals that a real investor has. This makes the Dow largely irrelevant for most people and can distort their investment focus. Emulating the Dow leads to a non-diversified portfolio, made up of one asset class: large-cap value stocks. Advisors do not recommend that most investors should "put all their eggs in one basket". The TV news quotes and stories can lead a person to become anxious for fear of missing out, consciously or unconsciously wanting to mimic a risky and unsuitable investment style, and be tempted to change strategy just to capture what may be illusory, volatility-created gains.

If you would like help looking into your financial future, evaluating your risks, managing your investments, or planning to manage your income effectively, please call or e-mail. We invite you to visit our website.



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