SFA
Santa Fe Advisors

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A Year of Surprises

The Perils of Conventional Wisdom

2016 began in a very inauspicious manner in global financial markets, with global stock and credit markets plummeting for the first six weeks of the year. The broad US stock market experienced its worst January in history, amid an oil price collapse, a decline in corporate earnings, and fears of an economic “hard landing” in China. High yield bond defaults rose and prices plummeted, particularly in the energy sector. Amid extremely negative investor sentiment, oil, stocks, and high yield bond prices all bottomed on 2/11/2016, and rallied sharply from that point. As the year drew to a close, US company earnings turned higher, global growth showed signs of a rebound, and US large cap stocks, high yield bonds, and oil had returned 12%, 17%, and 45.5% respectively.

Just as the overwhelmingly negative Q1 investor sentiment proved a poor predictor of results for the remainder of the year, there were several examples of conventional wisdom being wrong on the probability (and likely market reaction) to 2016 geopolitical events. Prominent among the year’s surprises was the rise of populist political movements in both Europe and the United States.

Pollsters and odds-makers badly misread the UK electorate, and were surprised at the result of the 6/23 “Brexit” referendum, in which voters chose to leave the European Union. Likewise, Wall Street strategists were almost uniformly wrong on the likely stock market reaction to the referendum result, predicting big declines in equity markets in the event of a vote to leave. To the contrary, US stocks rallied slightly, and UK stocks enjoyed large gains after the vote.

Pundits also misread the US Presidential election cycle, during which populist insurgencies propelled “non-traditional” candidates to strong challenges in both the Democratic and Republican party primaries. They also got the ultimate election outcome wrong: odds-makers consistently placed the odds of a Clinton victory at 80-85%. Finally, market observers also overwhelmingly predicted a negative stock market reaction in the event of a Trump win; instead, “risk” assets rallied sharply after the election, as markets priced in expectations of stronger economic growth and company earnings.

These outcomes, which were unanticipated by the vast majority of market “experts”, highlight the difficulty of predicting outcomes, the perils of consensus thinking, and the importance of a theme that we regularly stress: successful investment outcomes are best achieved by adopting a low cost investment strategy consistent with one’s risk tolerance, and then sticking with it. Attempts to try to predict short-term outcomes, and changing investment strategies based on prevailing sentiment, are generally losing propositions which lead to poor results.

The graph below shows the performance of US stocks (S&P 500 total return), UK stocks (FTSE 100 index total return) US high yield bonds (Barclays US HY total return index), and oil (WTI front contract) in 2016, with the three vertical lines denoting the 2/11 lows, the 6/23 Brexit vote, and the 11/8 US presidential election, respectively.

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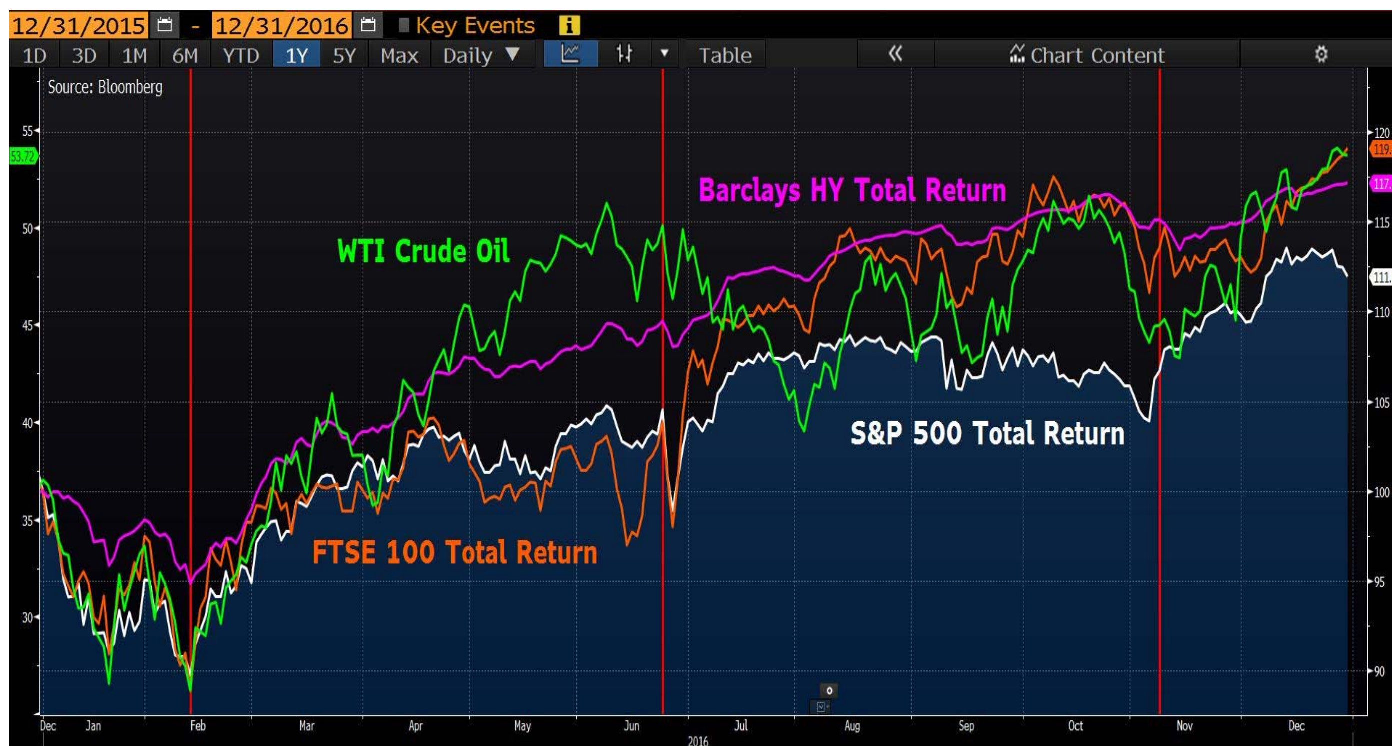

What We Got Right

2016 was an extremely good year for our client portfolios, with all risk models significantly outperforming respective benchmarks. Our portfolios benefitted from our decision to add high yield bond exposure early in January, as well as our decision to keep our average high quality bond maturity short, which insulated our clients from the negative impact of the late-year rise in interest rates. Portfolios also benefitted from our tilt toward US and Emerging Market stocks, which both significantly outperformed international Developed Market stocks. Finally, a modest overweight position in real estate debt and equity favorably impacted portfolio results.

What We Got Wrong

The biggest miss in our positioning was our significant overall underweight risk position in stocks, particularly in US stocks. Whereas we feel that our rationale for the underweight was sound (equities were clearly expensive by most historical metrics, and earnings growth was poor), the fact is that the strong year-end rally propelled equities to a good 2016 result. Consequently, had we been less conservative in our positioning, our client results would have been even better. However, we feel comfortable with our decision process at the time, and are very pleased that, despite our conservative positioning, our clients fared very well in 2016.

Our Outlook and Positioning as 2017 Begins

As we recently articulated in a client note, over the last few weeks the SFA team engaged in rigorous debate over the market implications of the US election result. The outcome will certainly lead to material changes on a number of policy fronts, with impact varying by asset class.

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Clearly, the new administration has a pro-growth agenda, and with a majority in both congressional houses, can be expected to implement much of it. As a result of a number of factors – lower taxes, business regulatory relief, improved energy sector earnings, higher infrastructure spending, and improved consumer and business confidence – we believe that the environment is favorable for better overall economic and earnings growth than had previously been forecast. Should growth accelerate, then we believe prospects are good for a continuation of the current bull market, particularly if increased investor confidence leads to a reversal in the exodus of money from stocks occurring since the 2008/2009 recession.

Against these positives, there are a number of risk factors to consider. Perhaps the most important is that, while conditions for risk taking have improved, most major asset classes remain, at best, fully valued. Should earnings growth not materialize as anticipated, markets would likely correct. The new administration's fiscal plans, while economically stimulative, are also likely to increase US budget deficits and national debt. This may lead to further interest rate rises, which would impact the return on bonds and real estate. In addition, should the dollar continue to strengthen, this could negatively impact the large percentage of US corporate profits generated abroad, as well as hurt export-driven emerging economies. Finally, should protectionist policies be implemented, global trade and growth could be negatively impacted.

After consideration of all of these factors, the SFA team decided to implement a modest risk addition to our portfolios, in the form of greater exposure to US stocks, funded by selling high grade bonds. This leaves our portfolios with a very modest overall risk underweight, which we feel positions us well in the new environment. Should we experience another leg up in the current historic bull market, our clients will participate. However, in recognition of the risks outlined above, we have retained a fair bit of dry powder, in order to capitalize if (and when) the next inevitable correction occurs.

Thank you for your trust and support, and please contact any SFA team member if you have any questions. We wish you and your loved ones a prosperous 2017!

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