



## Observations and Outlook

January 5, 2017

### Selected Index Returns 4th Quarter/ 2016

Dow Jones Industrials 8.6%/ 16.5%    S&P 500 3.8%/11.96%    MSCI Europe -.4%/- .4%  
Small Cap (Russell 2000) 8.83%/21.31%    Emerging Mkts -4.2%/11.2%    High Yld Bonds 1.37%/15.3%  
US Aggregate Bond -2.98%/2.65%    US Treasury 20+Yr -12.16%/1.4%    DJ/UBS Commodity 2.7%/11.8%

A brief perusal of the above numbers clearly shows 2016 was a “Risk-On” kind of year with small cap stocks and junk bonds putting up substantial returns. The U.S. markets in general were the place to be outpacing emerging markets and European shares as well. What isn’t quite as clear is the fact that investors who were geographically diversified and sought to own lower risk/higher quality bonds are feeling a strong dose of ‘return envy’. An investor with a 50% S&P 500 and 50% Aggregate bond portfolio saw ‘only’ a 7.5% return for the year. What is also not seen is that the ‘risk on’ investor spent the first half of 2016 with negative returns with the post-election period accounting for approximately 80% of the year’s total gains. To summarize 2016 in one word: **volatile**. While the volatility ended the year on the plus side, it should give investors a moment to reflect on what they are willing to endure to see outsized gains.

### Forecast 2017: Large Swells and Wind Gusts to the North and South

Often after a rapid decline in stock prices, conditions become “oversold”. In the near term, oversold conditions often lead to a bounce or snapback in prices. The opposite is also seen when prices advance too far too fast. The rapid rise in equity prices has put the market into an “overbought” condition and, given the rise in stock prices based on expectations of tax relief and government spending to boost the economy, hope once again springs forth that today’s extreme valuations will be justified with a rapid rise in corporate earnings in 2017. In the meantime, prices have already risen and like bond prices in 2016 are likely to fluctuate greatly.

Actually, prices in both stocks and bonds have already begun to make large swings down and up. The year ended up, so the tendency is to assume rapid ‘up’ moves are natural, and of course welcome. Early 2016 bonds and gold did extremely well as stock prices fell. The roles were reversed in the second half with bonds and gold declining through the second half, while stocks edged up and the lurched up in the last two months. So, in fact, we have already begun a period of greater market volatility. It’s likely to see prices swing between Hope and Anxiety as we await the actual changes and impacts of the change in monetary policy (tightening from the Fed) and fiscal policy (lower taxes, increased deficit spending).

What outside issues might impact global markets?

## China Overnight Interbank Lending Rate Soars to 105%

Money markets are the source of short term funding for the financial system. Recently the HIBOR, Hong Kong Interbank Overnight Rate, has soared to unprecedented levels, yet very little has been talked about in the US financial press. This is the rate to borrow yuan overnight, for banks in Hong Kong- known as the offshore yuan rate. This was likely due to the PBOC intervening to make is cost prohibitive to short China's currency. In the U.S., though, we seem to be preoccupied with the number 20,000 to observe severe stress in the world's second largest economy.



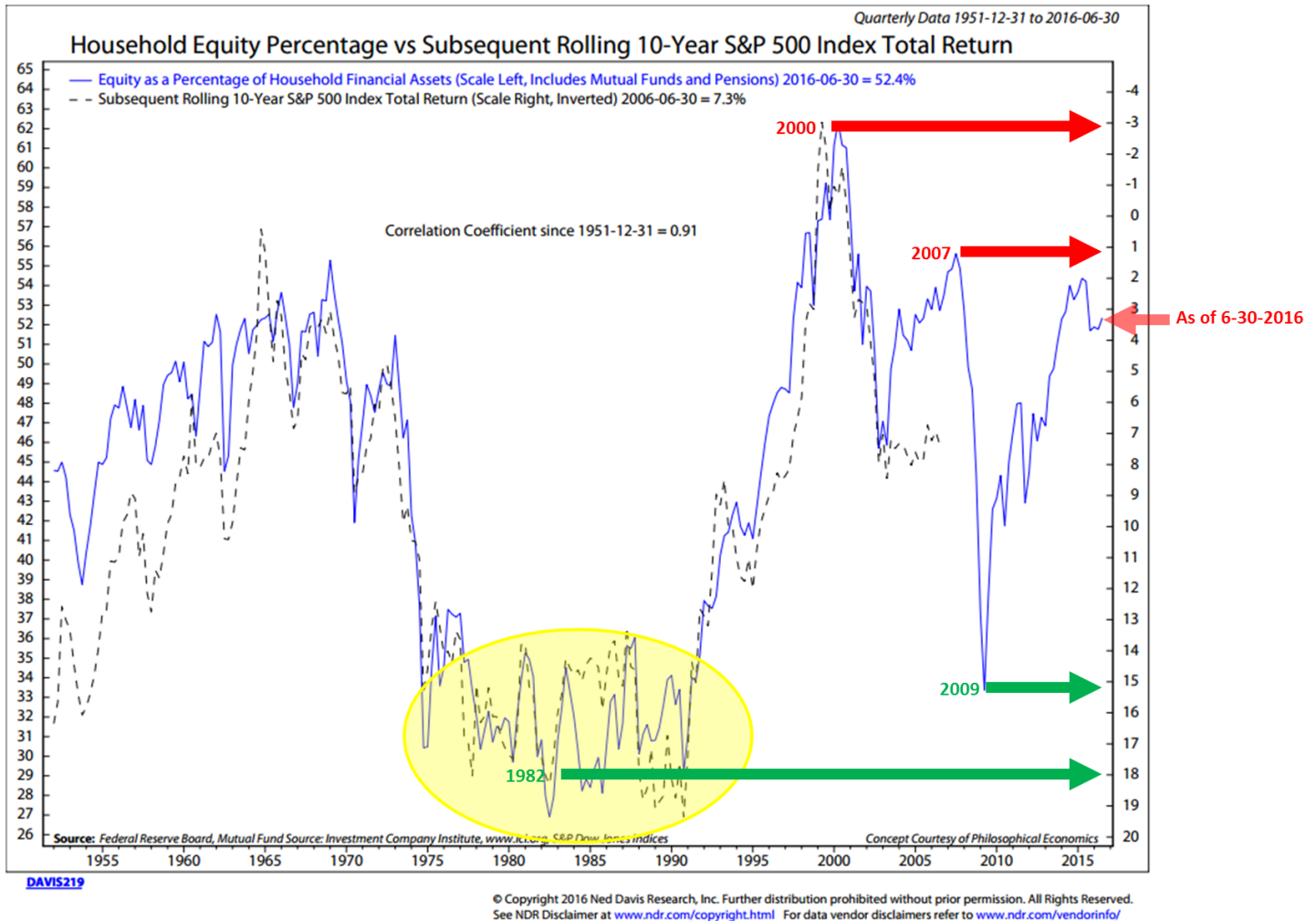
The last time an extreme liquidity crunch was seen was one year ago, and global equity markets became very 'nervous'. This also coincides with the annual reset of how much money China's citizens can send out of the country. The Chinese are allowed to take the equivalent of \$50,000 per person per year out of the country. There has been a significant weakening of the Chinese yuan vs the US dollar in an attempt to keep the yuan's strength versus other currencies low. Foreign exchange takes some effort to get one's head around, but in a world of paper money, it's an important factor in trade, profits and interest rates.

China is at the same time trying to slowly deflate a massive real estate bubble, while not effecting other areas of the economy. Leverage, aka credit, is fuel for higher prices in all assets like real estate and equities, as well as some areas of the bond market (borrow short term, buy long term bonds and earn 'carry' profits). It is extremely difficult to remove leverage and not have prices decline, yet this is what China is trying to do, while also defending its currency. China is using its massive reserves of Treasuries to manage its currency depreciation vs the US dollar, and going through it at a rapid rate. IF the rate at which its spending its reserves continues, China, could see its reserves decline by 50% in as little as 2 years, which is very significant.

China being a closed, autocratic society means data can be obfuscated, changed, and outright fabricated with very little complaint. As such China is a ripe source of potential Black Swans in 2017. We are already seeing very strange, even for China, developments in its money markets.

## The Big Picture

Here it is.....



Take a moment and understand what this chart says.

Given the level of household exposure to equities, or put another way, the percentage of stocks in portfolios, has had a very strong predictive value upon the next 10 years' returns. As household become more heavily weight towards equities, the lower the next 10 years returns from equities. The dashed line ends in mid-2006 because there was return data for the following 10 years, through mid-2016.

Households' exposure to equities was very low at the 2009 market lows (people tend to sell after prices go down unfortunately), and indicated a forward 10-year annualized return approaching 15%. If the S&P 500 achieved this, it points to approximately 2800 by mid-2019, an increase of 23% from current levels over the next 2.5 years. The gap between the dashed and blue lines shows this is not an exact science.

I apologize in advance for the math here. 23% over 2.5 years is about 8.6% annualized. If the margin of error from our chart above gives us only 13% annualized from 2009, that points to about 2270, an increase of 0% over the next 2.5 years; and if our chart ends up at 11% 10yr annualized rate, we will be at 1987 in 2.5 years, a decline of almost 13%.

A range over the next 2.5 years of +23% or -13% is much lower than the return the market has given us over the past few years. The past 2 years has seen the S&P 500 swing from 2130 to 1850 to 2280 currently, while corporate earnings have been declining and recently grew back to a level seen in early 2015. While 2014 was a good year, the past two years have seen major price swings and rewarded investors with only 5.5% annually for the past two years. It's my opinion that this kind of earnings levelling off, slowing of annualized returns, compounded by very high current valuations are indicative of a late stage bull market. Past Price to Earnings ratios (see my blog post [Definition of Long Term Investor](#)), and the chart above also point to reduced returns from equities in the next few years.

### **What Can Be Done**

If one suspects returns will be lackluster, and prices volatile, should one endure it? The solution is at once simple and difficult at the same time given our cultural of equity ownership and the media's constant focus on one asset class: equities.

Diversifying amongst the other 6 asset classes is a start. Most advice revolves around 2, stocks and bonds. If one truly wants to buy low and sell high, one must identify the other areas that are "low", increase exposure there, and reduce exposure to "high" asset classes. Not only does this smooth out volatility but can increase long term returns. Given the outlook for more volatility in stock and bond prices; very low prices (historically and relative to other assets) in precious metals, agriculture and oil; there should be many opportunities to take advantage of short term swings to benefit and move some 'eggs' from the equity side into other, non- and lower-correlated asset classes that are currently much lower in price.

Easier said than done, yes. This is exactly why investors should seek out Investment Advisors willing to do this difficult work and that have a strategy to deal with changing markets. For more information on how I am doing this for my clients, please contact me.

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