



DECEMBER 2016

Have We Only Just Begun?

Stampeding global markets post-election make us question whether the bull still has life. This month, we present a rationale for why it may still have room to run, analyze its underpinnings, and suggest how investors can use market dips as entry points to reposition portfolios and take advantage of what may be a new trend in equity strength.

Stock markets have been on a mini tear since November 9, when Donald Trump surprisingly won the majority of electoral votes. It has been a rally few anticipated, and indeed, the assumption before the election was that a Trump victory would lead to a 5-10% decline in equities. Instead, the opposite has happened. The question now is whether we have only just begun.

That question is certainly related to the overall possible market shift from bonds to stocks, the “great rotation,” about which we and many others have been musing. That rotation, should it continue, will certainly provide the fuel for further

equity market strength. But there are other aspects to the recent stock market strength, with the Dow surging toward 20,000 and above. This has clearly been a relief reaction to the election, and already many are speculating that it has gone too far, too fast. Perhaps that’s so, but there are good reasons to consider that we are at the beginning of a new trend.

Yes, it may have only just begun

Skepticism has been the dominant reaction to equities over the past years. Even as US indices have continued to rise year after year, along with global equities for the most part, investors and analysts have routinely expressed caution and



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Figure 1:

Strong Post-Election Month in 2016

(Total returns 1 month after election day, 1980–2016)

Election Years	S&P 500	Russell 2000	Nasdaq	MSCI EAFE
2016	5.21%	16.14%	4.45%	1.55%
2012	-0.68%	-0.34%	-0.40%	3.02%
2008	-15.62%	-19.35%	-18.64%	-14.85%
2004	5.51%	9.84%	9.21%	6.58%
2000	-6.04%	-8.75%	-19.40%	-3.61%
1996	4.47%	5.78%	5.80%	3.01%
1992	2.75%	7.30%	8.56%	0.10%
1988	0.84%	-1.05%	-0.96%	6.25%
1984	-4.11%	-5.63%	-4.58%	-1.69%
1980	2.44%	2.43%	3.57%	-4.52%
Monthly Average (1980–2016)	0.91%	0.86%	N/A	0.68%

Source: Bloomberg

Figure 2:

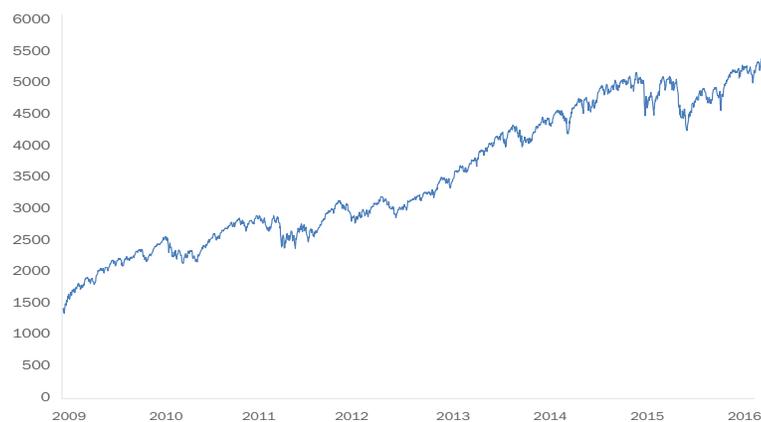
Strong and Weak Sector Performance (Sep – YTD 2016)

	% Returns	
	2016 YTD	Since Election Day
S&P 500 Financials	20.67%	17.03%
S&P 500 Industrials	16.98%	7.85%
S&P 500 Healthcare	-4.03%	1.30%
S&P 500 Info Technology	13.51%	2.42%

Source: Standard & Poors. YTD as of 12/14/16. Since Election Day return period is 11/8/16 to 12/14/16.

Figure 3:

US Equities (NASDAQ) since March 2009



Source: Yahoo Finance. Chart reflects adjusted close prices for Nasdaq composite from 3/1/2009 to 12/13/2016.

advised wariness. The reasons have ranged from “stocks are overvalued” to “markets are being juiced by easy money from the Federal Reserve (Fed)” to “economic fundamentals don’t justify these levels.”

Yet, none of that has mattered. There have been repeated periods of volatility, mostly caused by anxiety in the bond markets, as the Fed ended its policy of quantitative easing and then last year began to signal that interest rates would gradually rise. There also was a global reset in equities and international bonds when energy and commodity prices collapsed in 2015. Nonetheless, stocks in general have been resilient and have trended up.

Then we have a surprising post-election rally. And not just any rally, but one of the best post-US presidential election performances in nearly 40 years (Figure 1). Even more important for the future has been the surge in small-cap stocks, as represented by the Russell 2000. Small-caps often do better when investors believe more economic expansion lies ahead. Investors now anticipate a stimulative kick-off to the Trump administration in the form of tax cuts and infrastructure spending. His administration may also have a bias toward purely domestic US companies, which tend to be mid and small cap rather than the more globally exposed large-cap multinationals.

This rally has been selective, which is another reason to expect it to continue. Rather than all boats rising, particular sectors have done spectacularly (Figure 2) well. Financials and industrials tied to expectations of infrastructure spending have surged, while technology shares that led the market in 2015 and healthcare stocks have both lagged considerably. Earlier this year, dividend-paying stocks, such as utilities and certain staples, did well, and now have lagged. A market surging based on rotation among sectors often represents a more stable foundation for future gains than one in which all stocks are rising. The latter can be a sign of frothy markets where investors are just rushing into equities willy-nilly, rather than making choices based on expectations of strength in future fundamentals.

Then there is the Fed. At its December meeting, the Fed raised the short-term rate to 50 basis points, and signaled its intent for three more increases in 2017. Granted, that needs to be taken as intent rather than a fact: After all, last year the Fed suggested that four rate increases

were likely in 2016, and that did not happen. Even though very easy money will no longer be an energy source for equity markets, stocks are rising just the same. Using the Fed as a reason for equity market skepticism will be a harder argument to make.

Finally, there is the long-rehearsed argument that equities have been on an upward trend since March 2009, and that after seven-and-a-half years, the “bull market is getting tired.” Analysts dredge up charts to show how long the “average” bull market lasts, and indeed seven plus years is a long time.

Periodization, however, is very much in the eye of the beholder. You can, should you so desire, pick any starting point you choose to make just about any argument you choose. So, it is true that if the “bull market” began in March of 2009 (Figure 3), it may be getting old. But did it really begin then?

You could equally say that the last major, secular bull market ended in March of 2000 (Figure 4), when the Nasdaq reached its then stratospheric high in the 5000s, and did not again reach such levels until a few months ago. In fact, in inflation-adjusted terms, the Nasdaq index remains today more than 20% below its March 2000 high, whereas the S&P 500 in inflation-adjusted terms is only 2% higher over that same sixteen-year span (Figure 5).

This perspective makes equities over the past decade and a half look much more like the storied bear markets of 1962-1979 than like the bull market in equities from the early 1980s through early 2000. During the 1962-1979 bear period, there were multiple times when stocks soared 50% and then crashed 50% (Figure 6). You could have called the months when the market soared a “bull market,” but it was against the backdrop of long years of relative stasis.

Bonds have been in a thirty-year bull market since the early 1980s.¹ Equities have arguably been stagnant in the 2000s. From that perspective, the rally of the past month since the election is small compared to the potential for future expansion, especially if there is a modest rise in inflation, continued resetting in bond yields and prices, and an uptick in economic growth in the United States spurred by government stimulus.

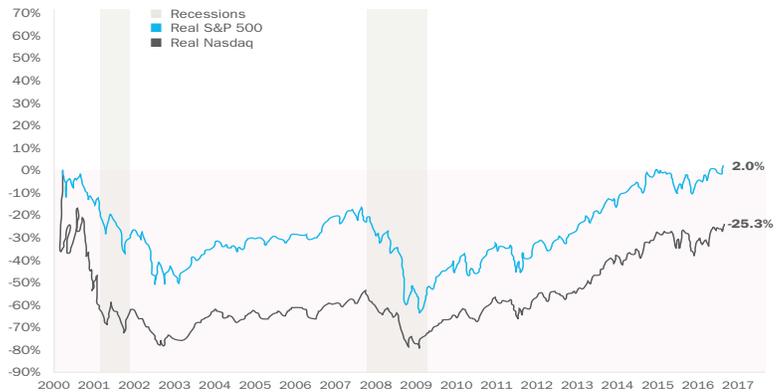
¹ Source: [Forbes, November 2016](#).

Figure 4:
US Equities (NASDAQ) since March 2000



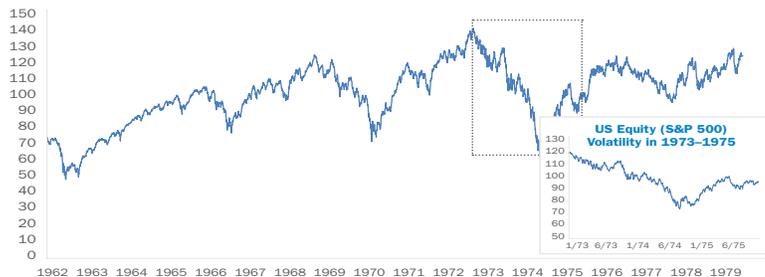
Source: Yahoo Finance.
Chart reflects adjusted close prices for Nasdaq composite from 3/1/2000 to 12/13/2016.

Figure 5:
Three "Real" Indexes: Percent Change from Their 2000 Peaks



Source: Advisor Perspectives, December 2016.
Inflation-adjusted price based on the Consumer Price Index.

Figure 6:
US Equities (S&P 500) 1962-1979



Source: Yahoo Finance.
Chart reflects adjusted close prices for S&P 500 from 1/1/1962 to 12/31/1979.

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And if it has only just begun?

Straight lines are, as most of us know all too well, rare in investing. That is why sharp and sudden reallocations rarely work, unless you are very, very lucky. But rather than rebalancing back to what may already have been a bond-heavy allocation, it may be wise to allow equity portions of a portfolio to roam a bit. If, like many investors, you have been bond-heavy, cash-heavy, and equity-light, then it may be a good time to shift. Too many have been either sitting on the proverbial sidelines or seeking excessive safety in bonds to the point where they are not invested appropriately given their goals and needs. You don't have to become an equity bull overnight to assess whether being so heavily weighted in bonds in a potential period of long-term equity strength will suffice.

And of course, there will be stock market dips and gyrations. If we are in the midst of both a rotation and a period of relative equity market strength, then

those gyrations should be used as modest entry points. Finally, with signs of a rise in both inflation expectations and interest rates, sticking to the same bond allocations without adjusting could lead to underperformance.

We will see if the new regime in Washington follows through with expectations, and it may be that some sectors that have surged will fall back if it appears that there is less here than meets the eye in domestic infrastructure or deregulation. That could well dampen some of the modest euphoria, but it will not change the secular shift likely occurring that is resetting prices, yields, and sentiment of both bonds and equities globally. So, have we only just begun? The answer is a guarded yes, but proceed cautiously, stick to a disciplined allocation strategy, and don't jump on any bandwagons. ■

December Takeaway:

The election result has been eclipsed by one of the best post-election performances in about 40 years. As investors anticipate the new Administration's tax cuts, infrastructure spending, and a more favorable business environment, they are voting with their feet. Small-cap stocks have fared particularly well, responding to investor optimism that economic expansion lies ahead. Rising interest rates and inflation are resetting bond prices and yields, making the case for investors to back away from bond-heavy portfolios and adopt a disciplined equity allocation strategy.

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