KEATSCONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

December 31, 2016

REVIEW OF THE FOURTH QUARTER

The old Chinese proverb goes … May you live in interesting times. A Western addition is "but not too interesting!"

2016 will go down in the record books as a year where a whole lot of interesting events occurred. And looking back, much of it was not forecast to happen.

The two biggest financial and economic events of 2016 were Brexit and Donald Trump.

Neither of these events had the negative impact on the stock markets that the pundits expected. When the UK voted to leave the European Union in late June, there was a significant drop in stock markets for one day. Then the market seemed to shrug it off and climb back up again.

Before the US election, most polls expected Clinton to win. And the only thing that market strategists seemed to agree on was that if Trump was elected we were going to see a lot of volatility. Well, the polls were wrong and so far, the volatility has not shown up in the stock market.

But those were just the two big events. We started the year with a serious downdraft in the US stock market. People thought the second crash was here. From the middle of January until early February the S&P 500 stock index fell over 10%. In hindsight, it is good we didn't react too quickly because it was not the end of the bull market as the S&P 500 index was 12% higher on December 31, 2016, than it was on December 31, 2015. [1]

The other big story in financial markets in 2016 was interest rates. Early in the year, Japanese 10-year government bonds reached yields below zero. Never before had the 10-year bond of a large nation dipped into negative territory. Shorter term bonds had fallen below zero but never the 10-year benchmark bonds. Germany would soon follow suit. German bonds are considered one of the safest sovereign country bonds in the EU so they act as a proxy for the best credit quality among the EU. For a while, both Japanese and German 10-year government bonds were trading with negative yields! [2]

On July 6th 2016, the US 10-year Treasury bond hit a low of 1.323%[2]. This is the first time the 10-year US Treasury bond has reached that low.

The US 10-year Treasury bond then climbed out of its low on economic data that the US economy appeared to be on a better track than many other nations. It had already climbed up to 1.7% range when the US presidential election took place in early November. After Trump was elected there was a dramatic move upwards in the yields on bonds, notably the 10-year US Treasury bond. It jumped half a percent almost overnight and then continued to climb to about 2.5% in a matter of weeks. It has hovered around the 2.5% level since then. [3]

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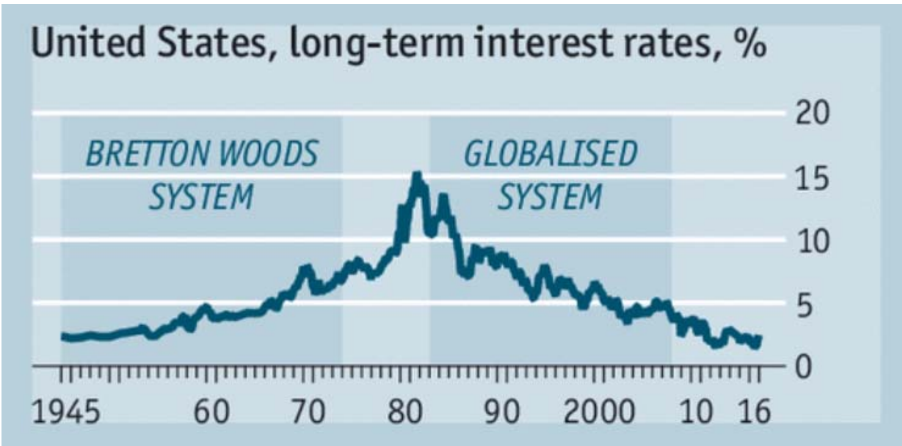
2016 may go down in history as the year that bond yields reached their lows of the past 35 years. Many of you remember the early 1980s when interest rates were at double digits. The trend has been down ever since. Although there were some spikes, when looking at any graph of interest rates, you will note a significant downward trend over the past 35 years since the peak in 1982.



Source: The Economist January 7, 2017

All of these changes might indicate we are in the midst of a major economic change. As described in an Economist article from January 7, 2017, the chart above shows that the world financial system has been in two fundamental eras since World War II. The first era is known as the Bretton Woods era named after a hotel in New Hampshire where the world economic powers congregated after the war to develop economic standards and put in place a world economic system. This era saw high growth rates as a result of rebuilding after the war. Fixed exchange rates, capital controls and the gold standard were needed to keep the system functioning. The stock markets did well throughout the 1950s but then started to drift in the 1960s as crises developed around the world and the system was not flexible enough to deal with everything. Finally, the system collapsed under oil embargos and rampant inflation in the 1970s.

The US Federal Reserve was forced to push rates up to choke off the economic growth that was causing inflation. This led us into the second era in the early 1980s where global trade, floating currencies, deregulation, and flow of technology led to more innovation. Stock markets again reacted well throughout the first two decades as bond yields came down and global trade increased.

That era appears to have ended, marked by the low interest rates around the world and the dissatisfaction of people in the developed world with their governments and the global system. There has been a dramatic pullback from globalization back to national interests as marked by the populist revolutions that passed Brexit and elected Donald Trump.

The markets so far have noted the differences in the past era but seem to shrug off the potential downsides of the current trends of pullback from a globalized world.

The previous two eras were met with a large amount of financial experimentation when they started to falter. At the end of the Bretton Woods era, the US Federal Reserve moved interest rates up to levels that were beyond any they had thought they would have to.

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And the era of globalization from the 1980s to present has seen several serious market dislocations, most notably the global financial crisis that started in 2007 and lasted through early 2009. This era also saw its share of unprecedented financial action as central banks pulled interest rates down to very low levels and discussions of negative interest rates consumed headlines.

One thing that is different now from the past is that central banks have very little room to reduce interest rates to stimulate growth. Over most of the past 60 years, when there were periods of economic malaise, interest rates were higher so central banks had room to maneuver where they could reduce interest rates to provide liquidity into the economy.

Another big risk to the system is that populations are aging around the world most notably in the developed economies. This will tamper down growth prospects for these countries.

With bond yields low, and growth prospects in developed countries lower than they were in the past, we are looking at a world where lower growth is the most likely outcome. We can continue to search for return in the factors that have brought return in the past, but our forecasts for stock returns are lower than they were ten years ago.

We do expect that we will see a significant downturn in the stock market in the next few years. We don't believe we should reduce allocation to stocks because the timing of any downturn is unforeseeable, but we do think you expect to see a downturn sometime in the next few years. Since 1927, the US stock market has never had seven positive years in a row. And now that 2016 is behind us, the bull market is eight years old! [4]

We will be reaching out to you to set annual review meetings where we review your investment policy and portfolio. We look forward to speaking with you again soon.

[1] Wall Street Journal: Performance Charting – January, 2017, [2] Wall Street Journal: Interest Rates Charting – January, 2017
[3] Wall Street Journal: Interest Rates Charting – December, 2016, [4] JPMorgan Guide to the Markets – January, 2017

Sincerely yours,
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