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the Lonely Bull

January 2017 — *a market **perspective** by Riverplace Capital* — Number 74

FOURTH QUARTER

FUNDAMENTALS MEAN SOMETHING!

Through all the twists and turns of last year, the fundamentals told a consistent story. The economy was all right, in fact it was growing at a modest rate that kept things from overheating, but at the same time absorbed around 200,000 new workers every month; not bad. The disaster in the oil patch did not spread, but gave an economic boost to many. Corporate earnings recovered from the blow from cheaper oil prices and the stock market ground higher.

One investment factor was a decided shift in investor sector preference during the past year. The high growth and momentum stocks went into corrections while value oriented ones came to the forefront. Investors that did not make the shift lost out. This shift persisted through all of the turbulence in our public life brought partially about by the election process.

Even though U.S. GDP growth got off to a meager start for the first two quarters, it accelerated into the second half of the year. The election did not seem to affect the general economy at all. In fact, once the election results were known, the market really took off with the belief that policies of the new administration would accelerate things even more. Pundits named this the Trump rally.

The corollary to higher equity prices was lower bond prices and higher interest rates (remember bond prices go down as interest rates rise). This was a bond rout, starting with 10 year Treasuries trading around 1.5% and rising to 2.5%. This is a big percentage move and will result in losses for many longer-term bond funds and portfolios. We have been warning this was coming and it is far from over. Bonds are now in a bear market. Except for counter-trend rallies, bond prices should go lower and yields rise for years.

Another phenomenon of investment significance this year is that commodities, including oil, bottomed and began an irregular rally back to higher prices. Over supply across many commodities a few years ago caused prices to plunge. This started a liquidation cycle that finally appears to be over. Supply and demand appear to be in better balance. Future price gains will depend upon world-wide growth that pushes greater demand. Whether that happens or not depends upon your outlook for the adoption of reflation policies of the Trump administration and their success. We shall see!

> *"The stock market is filled with individuals who know the price of everything, but the value of nothing." **- Phillip Fisher***

TALK WITH US

Investing, by its nature, is an uncertain process. There is no way to accurately predict the future. Prognostications in the financial industry are notoriously wrong. We all have to have some sort of base case in order to develop a strategy, but good investors realize adjustments, if not U-turns, might be necessary.

This is not to say that good investing reacts to every unexpected blip, but when blips indicate that a completely different base case should be considered, it's time to make changes. **Knowing when and how is part of *the art of investing*.** The science of investment can be taught, the art is instinctive honed by experience.

The Chinese philosophy of the Tao speaks well to uncertainty. It says you cannot possibly know all the complexities within a possible set of outcomes. Even if one knows a result, one usually cannot predict the eventual outcome. A good case example is the recent election of Donald Trump as President of the United States. Not only was this a surprise to many, the reaction in the stock market also surprised. The eventual outcome is yet to be known.

Uncertainty is not to be feared, but embraced. It creates great values from time to time and challenges all investors to periodically re-evaluate their assumptions. Quality, bought at a reasonable price, is one of the processes that helps mitigate the inevitable ups and down in the market place. Quality, at good value, endures the whims of popularity and fashion.

Another technique for dealing with uncertainty is to use diversification; spreading one's risk. This is a well-established technique. Another is to incorporate into an investment approach non-correlating assets (those that do not have price changes in line with other assets). These can be bonds with stocks or some private investments. The mix depends upon the client's needs and tolerance. Remember, totally hedging out volatility will also reduce if not eliminate returns.

The art is in picking the right mix for the conditions as well as the individual components. There is not a static model that works for all times or cases. Working with an experienced firm helps make the correct choices, ***Talk with Us.***

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FORECAST

ECONOMY

Many investors and most economists believe that the prescription for higher economic growth put forward by the new administration will be successful. It very well could be, but there are risks. Higher growth will bring about greater inflation and higher interest rates. Faster growth often borrows from the future unless there is a lot of slack in the economy. Since there is not, growth will create higher prices and other distortions that will bring about a recession. The economy is like "mother nature;" you can fool or distort her for a while, but she will always win and sooner or later, readjust.

In the meantime, investors are betting on greater growth and higher earnings. We are going along, but cautiously. We are always more comfortable as contrarians when there is too much of a consensus. However, we need evidence to take such a position and so far the evidence suggests that the economy will continue to grow. We are just not sure that a sustained **higher** growth rate is assured. So, caution during this euphoria is warranted. ◆

EQUITIES

Maybe so, maybe not; this is an especially good mindset to have for the coming year. If last year taught us anything, it ought to have shown that unpredictability is a fact of life. One could not have forecast all the twists and turns for investors during 2016. Even if one guessed correctly now and then, the market reaction might still surprise. We doubt that 2017 will be any easier.

The Trump rally borrowed some return from the future. We need a lot to go right before higher valuations are likely. Not only does much of the economic policy package of the new administration need to be passed and implemented, companies need to show that they are benefiting and earning profits at a higher rate; a lot of ifs. **Also, money flows into the market have not increased.** At the end of the year, they still indicate caution; interesting. How do we invest for this? See the next section. ◆

FIXED INCOME

It's a fixed income bear market. We warned this was coming. Bull and bear markets in this important allocation sector can last for a decade or more (interest rates rising for a long time). In the meantime, short to medium term, quality instruments can provide positive returns. We are getting close to this being possible and we are beginning to search for such investments. ◆

INVESTMENT STRATEGY

EQUITIES

Quality at a reasonable price is our approach to investing through this potentially volatile period. This produces a robust portfolio that stands up to the whims and turbulence of interesting times. Back to the beginning statement of this letter, **fundamentals mean everything over time.** Solid value with good prospects always gets you through scary times.

We really do not know what will happen in 2017, we just are preparing for a variety of conditions; and we may see quite a few of them. Money flows are still negative. This cannot persist and stocks continue to rise.

For all balanced accounts, we will be adding back bonds which we were unwilling to buy until interest rates increased. This will happen over time as we find quality issues priced fairly. These bonds will help cushion downturns and provide liquidity for opportunistic buys. ◆

FIXED INCOME

We have been using a dividend strategy to provide income for clients that need it. In the coming year we will also begin adding bonds to these portfolios. This will provide an additional source of cash flow and reduce volatility. The dividend approach worked very well when rates were very low, but with higher rates, we can now use bonds again. ◆

WEALTH MANAGEMENT

The allocations for the asset allocation models performed well in 2016. It appears that they should again perform well in the New Year. Therefore, we plan to make no immediate changes. As always, we constantly monitor this to ensure good performance with low risk. ◆

MAJOR INDICES

as of 12/31/2016

Large Cap Stocks (S&P 500)	9.5%
Dow Jones Industrial Average	13.4%
Mid Cap Stocks (S&P 400)	18.7%
NASDAQ Composite	7.5%
Small Cap Stocks (Russell 2000)	18.5%
MSCI EAFE	-1.88%
Barclay Aggregated Credit Index	5.86%
Inflation	2.0%

Equity indices are twelve-month returns excluding dividends.

NOTICES

Check out our updated web site. It offers a lot more information for you including a blog with weekly insights. We look forward to your feedback.
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