

Quarterly Market Commentary

Perspective on the economy and trends in the marketplace.

As the New Year begins, investors cannot look ahead before acknowledging some of the memorable events which took place over the course of 2016. Early in 2016, U.S. stocks and oil prices experienced a correction but were eventually able to bounce back and finish the year with positive returns. Uncertainty faded throughout the year due to global events coming to a close, like Brexit and the U.S. presidential election. Investor confidence was also supported with positive economic data, such as a low unemployment rate which ended the year at 4.7%, a healthy consumer and a turnaround in corporate earnings. With encouraging economic data and positive stock market returns, the Fed decided to raise rates at the end of 2016, causing bonds to sell off but still finish the year with gains. Looking forward, we believe 2017 could be a tale of two stories. The first story includes a modestly improving U.S. economy and flat global growth while the second story introduces the potential for a new growth cycle based on governmental impact on reduced taxes, regulation and healthcare. We are prepared for either scenario and intend to capitalize on opportunities as they emerge.

■ U.S. Equities

After subpar stock market returns in 2015, the S&P 500 posted a return of 11.9% for the year. An early stock market correction created a buying opportunity for investors and initiated a “risk-on” environment which was further supported by the Fed holding off on raising interest rates to stimulate the economy. In acknowledging these trends, we maintained a higher equity allocation throughout the year. Although most sectors posted positive returns in 2016, we saw a rotation away from income producing sectors like utilities, into cyclical sectors like financials, energy and industrials on news that Donald Trump would be the new President-elect. Smaller size stocks benefited disproportionately from positive headlines in 2016 as the Russell Mid-Cap Index finished the year up 13.8% and the Russell 2000 Index (small cap stocks) finished the year up 21.3%.

A strengthening U.S. labor market and a rebound in profits leads us to believe this bull market still has legs but may come with some volatility. Given a change in policy resulting from a Trump presidency, there may be increased dispersion between sector and product returns. We intend to maintain our disciplined approach to investing in 2017 but be nimble and tactical where appropriate.

■ International Equities

International equities were a major concern this year caused mainly by tremendous political volatility, rising populism, and a problematic banking system. We witnessed an unprecedented breakup between the United Kingdom and the European Union, which caused a sell-off in global equities. Markets proved their resiliency by re-entering positive territory after two days of losses, with the MSCI EAFE Index ending the



year up 1.00%. Diverging monetary policy, the upcoming elections in the Netherlands, Germany, and France, as well as the United Kingdom Brexit represent significant challenges. These factors limit the upside of owning international equities in the coming year.

Emerging markets experienced a good year overall as oil prices bottomed out and continue to improve after OPEC and non-OPEC countries reached their first agreement to cut oil production. However, the asset class has historically been susceptible to speculation and political instability. Presidential-elect Trump's preferential treatment of certain countries over others adds another layer of uncertainty to emerging market economies. A stronger dollar as a result of tightening monetary policy may also be detrimental to commodity producing countries. We believe the space presents attractive opportunities for long term growth, as fundamentals have improved and valuations are cheap relative to developed markets, however, short term concerns may continue to be a source of volatility.

■ Fixed Income

2016 was an extremely volatile year for fixed income, marked by all-time lows in interest rates followed by the potential beginning of a rising rate environment. The U.S. 10 year ended at 2.45% after bottoming at 1.36%. The U.S. 10 year spiked over 0.4% within two weeks after Donald Trump's victory in expectation of his expansionary fiscal policies. Aggressive fiscal stimulus could potentially increase inflation and as a result, negatively impact bond prices. More bonds will also have to be issued to fund the projects proposed by President-elect Trump. As supply increases, the price for bonds will decrease.

The long anticipated December rate hike of 0.25% also helped to push the U.S. 10 year Treasury yield higher. We think 2017 could present more volatility in fixed income as opposing forces interact with one another. On one hand, a tightening Fed signaled the potential for three rate hikes in 2017. On the other hand, aging demographics, excessive debt, and a modestly expanding economy will suppress interest rates. Additionally, as the divergence in monetary policies widen between the Fed and other central banks, the demand for U.S. Treasuries amongst foreign investors will increase due to their relatively higher yields. This makes the U.S. bonds more expensive and will ultimately cause the yields to fall. Since it will be hard to predict each force's magnitude of impact on the fixed-income market, this leads us to believe the asset class will continue to experience volatility in 2017.

■ Alternatives

Risk-reducing alternatives provided valuable downside protection during a volatile year that featured events that were expected to disrupt markets, but took a backseat to traditional return producers during the post-election rally that characterized much of the 4th quarter. The Deutsche Bank Hedge Fund Index finished the quarter up 0.18%, and down -1.33% for the year. Commodities were volatile during a year dominated by



political headlines, but ended the year in positive territory. After experiencing price swings to start the year due to unresolved supply and demand imbalances, oil prices rebounded on news of OPEC's agreement to cut its daily production of oil to a target level of 32.5 million barrels a day. Moving forward, hedged-equity, long/short, and market neutral alternatives will continue to play a key role in downside protection, reducing volatility within a portfolio by maintaining low correlation to equity and fixed income markets.

■ Real Estate

Housing continued to be a positive contributor to the economy in 2016. New home sales jumped 5.2% in November, and are up 16.5% from a year ago, and homebuilder confidence hit its highest level since 2005 in December. Accelerating wage growth and employment gains are making home ownership more accessible for a population that is at historically low levels of homeownership. Though the data has been solid, we remain cautious as higher mortgage rates have the potential to hurt home sales and demand for new construction in 2017.

■ Conclusion

Despite multiple global events unfolding in 2016 and an unpredictable Federal Reserve, equities enjoyed strong performance while bonds did not fare as well. We also saw the rise globally in ideologies such as populism and protectionism in 2016, which we feel could continue to show up in 2017. We plan to monitor all of these factors expected to impact financial markets such as the U.S. profit recovery, policy changes, global elections, and geopolitics. We maintain our overweight to U.S. equities and underweight to fixed income and international equities based on these factors as we look to make optimal decisions in our portfolios in 2017. 

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