CARLTON | HOFFERKAMP & JENKS
WEALTH MANAGEMENT

For further information,
direct inquiries to John Sinitiere at
john@chjwealthmanagement.com.

WEB ADDRESS
www.chjwealthmanagement.com

PHONE
(281) 298-2700
(877) 824-4299

MAILING ADDRESS
10200 Grogan's Mill Road, Suite 340
The Woodlands, TX 77380

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1st QUARTER OUTLOOK

Expect the Unexpected

Before we climb on the roller coaster ride that is likely to be calendar year 2017, let's take a look back at the fun ride that we just disembarked that was 2016. It seemed like such a long time ago now, but you may recall that 2016 did not get off to a very good start. On the contrary, the first month and a half of the year just ended was historically bad for stocks. By the first part of February the S&P 500 was sporting a massive 10% decline, and sentiment had grown extremely bearish. Doomsday calls by assured pundits filled the financial media 24 hour news cycle and it appeared that we were on the road to a disastrous 2016 for the stock market. We had talked about a stealth bear market that had been occurring throughout the previous year and what had been stealthy, now seemed to be becoming quite apparent.

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Of course, just when everyone believed the sky was falling, stocks found support, valuations appeared reasonable, oil prices found some footing (alleviating some of the deflation fears that had permeated the narrative), and the Federal Reserve backed off their bold rate hike predictions for 2016. It was becoming clear that the Fed was back to being data dependent and the data was not going to justify several rate hikes for the coming year.

As you, of course, know by now stocks roared back to reach new highs by the spring and things were coasting along swimmingly until it was time for a vote in the UK. Yes, you remember the Brexit vote. There was no chance that the UK would vote to leave the European Union, but of course this was 2016 and we would begin to learn to expect the unexpected. Indeed, the Brexit vote passed to the market's surprise, and stocks tumbled mightily for two trading sessions. It appeared that investors had been caught off sides by the vote and were scrambling to lessen risk exposure.

Of course, as if on cue, opportunistic bulls swooped in to buy and stocks once again rallied to all-time highs by the end of the first half of the year. At the midway point of the year, stocks had already suffered two dramatic declines but had recovered to post slight gains as we were entering the second half of the year.

The Election

After the tumultuous first half of 2016, the third quarter was somewhat non eventful.

Stocks coasted to post modest gains, but it had the feeling of the calm before the storm. Yes, the election was coming and markets had never experienced a political race like the one that was unfolding. It appeared that Hillary Clinton was eventually going to emerge victorious and that is how "experts" were positioning investment portfolios. But of course, as with the Brexit vote, we were once again to learn to expect the unexpected in 2016. Donald J Trump was elected President on the night of November 8th and the futures markets went crazy in late night trading. Dow Jones Industrial Average futures were down more than 800 points and S&P 500 futures were down the 5% limit. But a funny thing happened before stocks opened the morning of November 9th. All the overnight losses in the futures were erased, and by the opening bell the market averages were actually lifting into positive territory.

As you know, stocks surged for the next few weeks and the market averages rocketed to new all-time highs. The rally seemed to simply run out of gas by mid- December, and the markets drifted into year end, but the post- election rally had already made an impression on market participants. We were going to be entering the new year at all-time highs and with a renewed enthusiasm and confidence.

Climb Aboard and Buckle Up

As we enter 2017, a rotation from what was working previously to what should work under the new administration has been underway. If economic growth is to be fiscally stimulated, then investors may continue to move from the slow growth investment theme of 2016 to sectors that would be accommodated by the new political environment. 2016 was a difficult year for growth stocks as investors shunned growth for value and dividends. But now, improved growth prospects may also stimulate inflation thus creating an environment for higher interest rates.

Recent winners since the election include Financials, Industrials and Materials, sectors which had woefully underperformed for some time. Staples, Utilities and Health Care, sectors whose stocks often sport reliable dividends could become less attractive in a rising rate environment. Staples and Utilities especially become vulnerable as their growth rates are modest and in the case of staples, a rising dollar can cause particular damage (cost of their goods sold overseas rises).

As is often the case, though, things get overdone quickly, and the rotation into these newly favored sectors has been dramatic. Prices have become stretched in these sectors and the coming earnings season just may bring a tinge of reality to the new narrative. Sure, a case can be made for industrials and financials in a Trump political environment (infrastructure build and less regulations for instance), but share prices have been inflated and the spending has yet to even be approved much less begun. It is likely that this earnings season will bring with it a dose of reality.

The Federal Reserve

As mentioned, the Fed entered 2016 full of vim and vigor. The intentions were to raise interest rates at least 3 or 4 times in 2016 and possibly even more. Of course, as the year unfolded and growth was less than vigorous, the Fed, data dependent as always, retreated back to their dovish stance- one that they seem most comfortable with. As we know, they did not raise rates again until just this past December. Once again they are indicating that with the possibility of fiscal stimulus, more rate hikes in 2017 could and should be in store. Fiscal stimulus (spending) would hopefully produce a stronger growth environment. In addition, corporate tax reform and a roll back in regulations could also be stimulants to the economy. If all of this is passed and enacted upon, then a stronger growth picture would likely create a stronger inflation picture. If this is the case then maybe the Fed can actually do a series of rate hikes this year. Of course, they will remain data dependent and we will just have to wait and see what actually does come to fruition from the political agenda that is being proposed.

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Corporations

As mentioned, Corporate America could really be in for a treat should the Republicans be able to move forward on their agenda. Corporate tax relief, a possible tax holiday for overseas assets, and deregulation should be music to their ears. A more stable energy environment and individual tax reform would also help create continually increasing consumer confidence. We have already seen the confidence numbers rise since the election, and should the agenda be enacted one would think that confidence would continue to improve.

Yes, the environment for American companies should be good in 2017, but it's not without risks. One problem, as mentioned, could be the strength in the dollar. Companies that sell goods overseas will be hurt as their goods become more expensive for foreigners to buy. In addition, should trade wars ensue, that would be another huge risk for Corporate America.

We really don't know how this will all play out as the process we are watching unfold is certainly unprecedented (will tweets become policy?).

Stocks

Stocks seem healthy entering the New Year as the Dow Jones Industrial Average hovers near the 20,000 level and both the S&P and NASDAQ find themselves in record territory. Have stocks gotten a bit ahead of themselves? This coming earnings season will provide us with some of those answers.

We mentioned the rotation that has been going on since the election, and noted that some of the newly favored sectors seem a bit stretched in price and valuation. It is not likely that this coming round of earnings reports is going to support these aggressive price moves. Of course, the market looks ahead and even if these levels can't be justified right now, perhaps the new environment will produce the desired results in time, and prices can hold while fundamentals catch up.

We have seen many sector rotations over the life of this market advance since 2009. After pauses, these rotations have continued to take us higher and higher. It could be argued that what we haven't seen, in the past years, an influx of new investor capital, and the bulls might argue that this is exactly what might occur with this newly found confidence. Outflows of equity funds have been dramatic over the past eight years despite the fact that the market has continued to advance. It would be interesting to see how markets would be affected if the investing public got a bit more interested in the stock market. Many have never returned since 2009. Could this new environment bring them back?

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Bonds and Interest Rates

Bonds experienced a full round trip in 2016. The 10 year Treasury note began the year with a yield firmly above 2.25%, but slow growth, Brexit worries and continued weak corporate earnings helped cause bond prices to surge sending the 10 year yield well below 1.50% by midyear. But as we moved into the fourth quarter and the Presidential election, bond yields began to spike. Whether for a good reason, a surge in economic growth fiscally stimulated, or a not so good reason, the fear of inflation resulting from exploding budgets, the yield on the 10 year moved back near 2.50% by the end of the year.

As we enter 2017, the direction of interest rates might be a tell that guides stock investors. An economy that would grow at 3% or better would warrant higher interest rates, and for the right reasons. The Fed would be able to raise the Fed Funds rate a few times and move towards a normalization of rates.

Many have called for the end of the 35 year bull market in bonds for some time now (we admit we have been premature in our stance). Could 2017 actually be the year that a full-fledged bear market in bonds begins? Most investors have never seen their bond portfolios actually show a loss in value.

Of course, if the Republicans are unable for some reason to enact their growth agenda, all bets would be off, and bonds price could rally once more and the 10 year yield could fall right back below 2%. Indeed, the bond market will be very interesting to watch this year.

Conclusion

2016 was quite a roller coaster ride, and a year that most of us will not easily forget. As we enter 2017, stock prices are at or near all-time highs. Valuations, though not ridiculously stretched as we have seen at market tops in the past, are certainly not cheap. We will need the economy to grow at a nice clip to be able to see corporations actually able to justify their valuations. The political environment, though very noisy, might be able to produce fiscal policies that, along with continued easy monetary policies, could stimulate more economic growth than we have seen for years. A stronger growth environment should be good for stocks, as long as inflation doesn't get carried away (remember the Fed has been yearning for some inflation for years), but a stronger growth environment might not be good for bonds in general (high yield corporate debt could possibly benefit from strengthening credit quality).

Though many market pundits are weary of stock prices and are predicting gloom and doom, it is not clear that this bull market has yet moved even close to the euphoric stage that typically is found at market tops. Indeed, this multiyear advance in the market averages has been mostly despised and participation by individuals has been modest at best.

Markets are said to move in a cycle from despair to euphoria. We may have long ago moved past the despair stage of this current market cycle, but we would be hard pressed to find evidence that we have moved anywhere near the euphoria stage. Now, if we get economic growth and stock prices surge with the help of individual investors flooding into the markets from the safe havens, then we will have cause for concern. Until then, it appears that normal market corrections and price surges are likely what we will have in store for us in 2017. Perhaps, not much different than what we experienced in 2016. Buckle up, as we have seen, the roller coaster ride can be thrilling.

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As always, we appreciate that you entrust us to manage your money. We strive to keep you informed and to provide you with the best service in the industry. Please don't hesitate to contact us with any thoughts or questions. If you feel that we can help someone you love that has gone through a life changing event, is selling a business, or is planning to retire soon please let us know. We will take very good care of them. Good luck to all in 2017.