TOO MUCH TOO SOON?

The S&P 500 Index did not disappoint investors in the fourth quarter of 2016, logging a total return of 3.86%, bringing the full-year total return to 11.96%. The presidential election on November 8th served as a fulcrum point for intra-quarter market leadership and investor sentiment. There existed a sharp dichotomy in sector returns and leadership during the pre-and post-election timeframes. As seen in the table below, the market traded down in the pre-election period (9/30/16 to 11/8/16*), posting a -1.10% return with only two of the eleven S&P sectors managing to post positive returns: Financials (+3.69%) and Utilities (+0.36%). During the post-election period (11/8/16 to 12/30/16*), the S&P 500 Index generated a +4.98% total return that was highlighted by broad-based participation and leadership. Nine of eleven S&P sectors logged positive returns with five sectors outperforming the market. The strongest sectors included Financials (+16.80%), Telecom (+12.91%), Energy (+8.98), Industrials (+7.48%) and Materials (+5.86%). Notably, healthcare stocks struggled during the entire quarter. Prior to the election, the negative political rhetoric targeted at the industry, as well as some earnings disappointments, pressured their stocks. Post-election, money flowed into more economically and interest-rate sensitive issues as expectations for a faster growth environment were incorporated into forecasts.

S&P 500 Index 4th Quarter Returns

Sector	Pre-Election: 9/30/16 – 11/8/16*	Post-Election: 11/8/16 – 12/30/16*
Consumer Discretionary	-1.48%	3.84%
Consumer Staples	-0.86	-1.17
Energy	-1.57	8.98
Financials	3.69	16.80
Health Care	-5.18	1.24
Industrials	-0.25	7.48
Information Technology	-0.03	1.23
Materials	-1.09	5.86
Real Estate	-6.29	2.01
Telecommunications Services	-7.20	12.90
Utilities	0.36	-0.22
Total S&P 500 Index	**-1.10**	**4.98**

Source: Telemet America, Inc. *Closing prices used

The positive market response is not without historical precedent as other first-term presidents experienced similar, if not stronger market responses. For instance, since 1928 the following presidents experienced equally strong post-election to year-end returns: Hoover (+8.2%), Eisenhower (+8.0%), Kennedy (+5.4%), Reagan (+5.2%), Carter (+4.2%) and Clinton (+3.8%). Given the contentious nature of this year's election, the markets may have been more than happy for the contest to end, regardless of the outcome.

The move could also be explained by the market's belief that the pro-growth, business-friendly platform of the incoming administration has the potential to reinvigorate the economy and earnings growth. These policies include corporate and individual tax reform, repatriation of U.S. based business's capital held overseas, broad-based deregulation and infrastructure spending.

Wall Street strategists, in turn, were quick to incorporate these policy initiatives into their 2017 and 2018 earnings outlooks. As a result, S&P 500 earnings are forecast to rise by low double-digit rates over the next two years. Strategists are typically an optimistic bunch having forecast similar rates of earnings growth at the beginning of 2015 and 2016. Unfortunately, the last two year's earnings growth projections were buffeted by a strong dollar, a collapsing oil price and generally flat yield curve causing growth expectations to fall flat. Thus, the optimism surrounding 2017 and 2018 projections should be taken with a grain of salt.

Of all the new policy proposals, corporate tax reform seems the least controversial and would be the most direct and recurring benefit for profitability. Early proposals call for the tax rate to decline from 35% currently to a range between 15% - 20%. It is estimated that every 5% point cut in the U.S. corporate tax rate adds approximately $5.00 to S&P 500 earnings. So at this juncture, it is obvious that the majority, if not all, of the expected earnings growth for 2017 and 2018 is built upon these policies being implemented in short order. While we adhere to the philosophy that earnings growth drives stock prices, what comes out of Washington D.C. during 2017 may be one of the greatest drivers of corporate profitability growth over the next couple years!

During the Fed's year-end press conference, Chairwoman Yellen expressed confidence in economic growth and stated that the case for further increases in the Fed Funds rate during 2017 had strengthened.

The Federal Reserve has been very accommodative since 2009 adding support to the market. The Fed increased interest rates 0.25% on December 14, 2016 for only the second time since 2008. The first was in December 2015. During the Fed's year-end press conference, Chairwoman Yellen expressed confidence in economic growth and stated that the case for further increases in the Fed Funds rate during 2017 had strengthened. Some have argued that the prolonged period of easy money served as a crutch for both the economy and markets. So, there does exist some risk that higher rates will negatively impact some durable goods industries, such as autos and housing, as lending rates rise making payments more expensive.

We look hopefully upon the incoming administration's policy initiatives which could help unleash the animal spirits to speed up economic growth and innovation. Importantly, the implementation of these policies is tightly interwoven in the optimistic projections driving the expected acceleration in earnings growth over the next couple years. Risks to the current rosy outlook are many. A stronger-than-expected dollar could crimp profits of multinational companies.
Higher-than-expected inflation could drive interest rates to levels that could negatively impact demand of durable goods. There are geopolitical risks with a resurgent China and belligerent North Korea, along with others. There is also potential for the country's newfound nationalistic pride to disrupt global trade. Washington may matter more than most would like to believe, but as we have witnessed, the market has already begun to price in positive outcomes. At this juncture, markets will more than likely move sideways to down until policy initiatives are passed and implemented. Let's not forget that during the month of January, a large portion of all publically traded U.S.-based companies will be reporting last quarter's earnings. We shall see if management commentary concurs with the market's enthusiasm. Stay tuned.