Noland's Notes

A Publication of LBWM

Noland's Notes 2016 Re-cap / 2017 Outlook

For those of you who are new clients or those who are reading this note for the first time, I should explain. Each year, we write you a note. In it, I try to analyze the prior year in my own words so that you have an idea of what environment your accounts with the firm were active in. We also try to give you an idea of how we view the investment landscape as we enter the New Year. In our brief discussions throughout the year, time does not permit us to extol all of our thoughts and analysis with you. Our hope is that in the 20 minutes or so it takes you to read it, this note helps you gain a better feel for how Left Brain Wealth Management views the investment climate and how we think about Investment Markets, in general. ***Welcome aboard or welcome back and I welcome your feedback!!!***

Left Brain WEALTH MANAGEMENT

Before I forget, feel free to send our note to your inner circle of family, relatives or friends should you think it appropriate. Though we write this note for you, should you think of introducing us to your circle this will be a good way for them to get a "feel" for our work. Let's get started:

Here are the official returns from 2016:

Index	Return
Dow Jones Ind. Average (U.S. Stocks)	+ 16.50%
S&P 500® (US. Stocks)	+12.00%
Russell 2000 (Small Companies)	+21.3%
MSCI EAFE® (Intl. Stocks)	+1.5%
MSCI Emerging Markets	+11.6%
NAREIT (Real Estate)	+8.6%
Aggregate U.S. Bond Index	+2.65%
Gold	+8.69%

(Source: J.P. Morgan Asset Management)

(For those of you wishing for the abridged version of this note, feel free to jump straight to the summary which starts on page 5. For everyone else, we have lots to discuss it has been a whole year. So, let's jump right in!!!)

All Trumped Up!!

Any discussion of the current investment or economic outlook would be incomplete without mentioning the election of our new President and what that might mean. Normally, politics have very little sway in our view of the investment landscape. We are paying more attention to this outcome, though, because of what the vote signals. We could see a big change in sentiment and go from a country playing defense to one playing offense.

Was I shocked when he won? **"Yes!"** Was I disappointed? **"Nope!"**

Putting aside the stunning victory, if we were to stop and only think about the economic ideas that his administration is putting forward:

- Lower Taxes
- Less regulation
- Infrastructure spending
- Increased Employment

It looks to me like Trump is dusting off the old Reagan playbook. You all remember how the markets performed under Reagan, yes? Let me spare you the suspense and give you the Cliffs Notes. We had one of the most powerful Bull markets in history under Reagan!! If he can actually get some of these proposals implemented, they have the chance to be very powerful economic drivers.

Remember, his chances are pretty good being that both chambers of Congress are controlled by the Republicans. Obviously, the markets think so as there was a big rally to end the year after the election results came in. I have been giving some thought to the secondary effects of some of these ideas. And, I can't help thinking that maybe, just maybe, we finally get some inflation. You will recall in recent years that I've written about being surprised by the lack of inflation. I think the probabilities are very high that this will be the start of an inflationary period. First off, oil prices are on the move. Oil bottomed at $26 per barrel last February. As of this writing, prices have been bouncing around the low 50's but with the recent OPEC agreement to cut production, it looks like we've seen the lows in oil. Once oil prices start moving up, they will move the inflation gauges.

The other thing that may be a much bigger driver of inflationary forces has to do with what I think will happen in the boardroom. For years we've experienced sluggish economic growth. There are many theories as to why, but some of it has to do with how CEO's have behaved. Corporate chiefs have been flush with cash and improved balance sheets since the financial recovery took hold. But instead of engaging in expansion opportunities they've been very content with simply using the company cash to buyback shares and pay dividends to shareholders. Who could blame them with so much economic uncertainty, market volatility along with incredible policy and regulatory uncertainty?

Now, the markets have stabilized, the economic climate is rapidly improving. And, now there's a new administration that will be using carrots and sticks to get growth jump started! I think there is a high probability that company chiefs will start to feel the force and will engage in more expansion activities like: building or expanding plants, factories and buildings, creating new lines of business, and looking for opportunities to grow. If that is the case then those activities, too, are inflationary. So we are on inflation watch. It's not likely we'll get the 1980's type of super inflation but I think it starts to show up starting now. ***We will be adjusting portfolios accordingly.***

Not only should inflation start to rise but this should be the long awaited start to higher interest rates. We've been waiting for 8 long years for rates to start to move. (Actually, rates have been on a 30 year downtrend with some starts and fits.) I know all of those savers with bank accounts have been waiting for rates to rise! **You have most likely witnessed the lifetime lows in interest rates!!!** Since the election, interest rates have moved up meaningfully. From 11/9/16 to year end 2016, interest rates on the 10 year treasury bond went from 1.8% to 2.45%! Maybe you're thinking that's not a big move. If so, think again. For the first time, in a very long while, holders of "safe" bonds actually experienced losses. From 11/9/16 (the day after the Election) to 12/31/16 anyone holding a 10 year treasury bond would have seen prices fall by 11%!!!

Look for this to be the start to a very long period of increasing rates. Some of it is due to a stronger economy and the other part is simply economics along with supply and demand. You see, if Trump is planning to spend $1 trillion on infrastructure then the United States Treasury will need to issue lots of bonds to finance those expenditures. The more bonds that are sold usually means lower prices i.e. higher rates.

Sizing up the Investment Climate

I am often asked what I think of the markets. I think it is important for you to understand how we size up the investment landscape at any given time. Here is the lens that we view the investment climate through. The lens never changes, but quite often, the view does. Here goes:

1.) Interest Rates- As noted above, interest rates are low. As I write, the 10 year treasury rates are 2.4% and money markets are still below 1%. The 5 year CD rates are about 1.6%. So rates are still very low. Low rates lead to a favorable investment environment. This year, though, rates are set to rise. The Federal Reserve is forecast to raise short term interest rates 3 times this year. However, that will still leave us in a low rate environment. So, we'll check the favorable box on this one.

2.) Inflation- Inflation is also currently low but set to rise. One of the reasons that Central Bankers in some parts of the world have resorted to negative interest rates is to fight this low inflation environment. The good news is that inflation is starting to rise only moderately and from a low base. If the pace of the rise quickens this could be trouble. But, for now, we'll list the inflation environment as fairly favorable.

3.) Earnings- If there was only one metric that we could use to determine what investment climate we are in this might well be it. Valuations would be a close second, though. The latest earnings estimates for the S&P 500® is $133 for 2017. Earnings growth was non-existent last year. Mostly dragged down by the energy and commodity sectors. With energy prices up that should lead to earnings increases this year. Last year's index gains were mostly driven by higher valuations. But, not because of earnings growth!! That won't happen again this year. We'll need companies to stand and deliver. The good news is that expectations are that S&P earnings will rise this year. We'll check the mildly positive box on this one, too.

4.) Valuations- Valuations are also OK. Not extraordinarily cheap, nor extraordinarily expensive either. The 25 year average P/E (Price to Earnings) ratio of the S&P 500® is 15.9. As I write, the S&P 500® P/E ratio is 16.9. So, today's market is a tad more expensive, but remember we are in a much lower interest rate environment so valuations should be a little richer. The real driver of investors into stocks, though,

is that compared to other places to invest (bonds, cash and Real Estate), stocks look much more attractive in comparison. We'll rate valuations as being mildly favorable.

Putting it all together, the market itself may not be extraordinarily cheap but, nor is it overly expensive. The good news is that we are still finding very good companies to buy at attractive prices. With the tailwind of fiscal stimulus and increasing growth expectations from an expanding economy and full employment, we are looking for a strong year of returns.

Get Ready for Higher Rates

I mentioned earlier in the note that we may have witnessed lifetime lows on interest rates ending in 2016. We've been on rate watch since the 2011 edition of Noland's Notes. I'd like to spend some time on this topic as few things are as important in our financial lives as interest rates. Mortgage rates, CD, bank accounts and money market rates are set by them. Auto loans, credit cards and, of course, bonds are affected by interest rates. The highs for interest rates happened in in the early 80's when 10 year treasury rates touched 15%!! Since then it's been almost straight down for interest rates. I doubt if rates will go straight back up but they should start heading in that direction. Normally, when we enter a rising rate cycle, interest rates rise about 3% from the bottom.

Here's the playbook for higher interest rates;

We've already discussed the ravages of higher interest rates on lower yielding securities and "safe" bonds. But, there are other income securities that do relatively well in a rising rate environment. Convertible Bonds, Floating Rate and High Yield Bonds are three that have done very well in past rising rates environments. *(We have been owning more of these High Yield Corporate bonds for that very reason since rates went to zero. It took several years, but they are finally showing their mettle.).* Part of the reason they do well is because of the higher interest rates they pay. The average coupon is over 6% right now. The other reason they do well is normally interest rates move up because economic conditions are improving. When economic conditions improve, companies' ability to repay their debts improve as sales and earnings increase. That can lead to credit upgrades which can lead to higher bond prices which can result in capital gains in addition to the interest payment!

The Bull Continues

The present Bull Market is entering its 8th year. You may be wondering if the markets can keep posting positive returns. Well, the short answer is "yes". There's an old saying on Wall Street *(isn't there always some pithy Wall Street saying?)* That is, bull markets don't die of old age.

That simply refers to the fact that bull markets usually turn down because of some economic or fundamental reason having nothing to do with the length of the expansion itself. For the record, this is not the longest expansion in history. That honor belongs to the bull market that started in 1987 and ended in 2000. It lasted a whopping 4500 days!!

What If??

I would like for you to harness your inner "12 year old" for just a second and do a little day-dreaming for just a bit. It seems like we've been on an economic rollercoaster over the last several years and that has shown up in the investment markets. Think of what happened last year. Though the markets ended up in positive territory for the year, the ride was anything but smooth or certain for that matter. We got off to the worse start in the history of the markets through mid February 2016, only to start a stunning rally through the summer. Then we ran smack into Brexit *(The U.K. decision to leave the EU)* and the end of the year gave us the stunning election surprise with the Trump win. The markets tossed and turned at each event. So, we've been through a lot. But just imagine what might happen this year if we can get some of these items to come to pass:

- Companies do repatriate billions of cash currently parked overseas
- Trump does get a tax cut through Congress
- Trump gets to spend billions/trillions on Infrastructure
- We get regulatory rollback
- Animal spirits start to percolate in the corporate boardroom and on Main street.
- Housing starts and household formation perk up and get back to normal
- Workers start to spend more of their increased income (from higher wages and improved job opportunities)

Summary- Our 2017 Playbook

With the backdrop of higher interest rates, reasonable valuations, lower taxes, and some level of fiscal stimulus, we would expect a decent year of investment returns. We may well get a pull-back at some point but I expect those to be relatively mild and to be used as a buying opportunity for those millions of investors who are still uninvested or at least under invested. I am still not hearing blatant optimism from anyone, anywhere. Investors seem to be more optimistic than they have been in a long time but there is still a healthy amount of skepticism and hesitancy. For these, and other reasons, we wouldn't be surprised at all to see the markets "hot up" instead of "melt down". There is some worry about the age of this present bull market which started in March 2009. But, bull markets don't simply stop because of the date on the calendar. There is usually some dumb policy mistake made in Washington that causes the Bull to stop bucking. So far, this is the second longest one on record having lasted over 3,200 days and accounting for a 220% rise in the S&P500 ®. If you think that is something, it pales in comparison to the longest and greatest bull market of all time. That honor would belong to the Bull that started running in 1987 (Yes, that 1987. The year that contained the greatest crash in history) and lasted to 2000 when the S&P 500® rose a whopping **582%!!!** The way I see it is that we have a ways to go to catch that one, yes?

As we enter 2017, look for Emerging Markets to do well. They started off well last year but closed the year with a whimper owing to the Trump victory. All of his talk about NAFTA, closing our borders, and renegotiating trade deals took their toll. That, coupled with a stronger dollar, sealed the fate of Emerging markets *(Brazil, Russia, India, China etc.)* as the year closed. But, Emerging markets have underperformed the U.S. markets going on 6 years now. The valuations are attractive and growth rates are faster in Emerging markets. I look for a strong run, starting now.

Also, the Healthcare and Biotech sectors have been two of the weakest areas in the markets since the infamous Hillary Clinton tweet in the summer of 2015. We look for those sectors to come back with a vengeance as the year progresses. Normally, the Healthcare sector is considered a defensive. That means that Healthcare normally holds up well in times of economic upheaval. We know healthcare expenses are **NOT** discretionary!! Prices aren't expensive as the healthcare sector of the S&P trades at a valuation level below that of the S&P 500® with a much better business outlook. Investors are waiting for clarity on whether Obamacare (the Affordable Care act) will be be repealed and replaced. But, by the time that gets sorted out, prices will have already firmed.

Having gold exposure still makes sense to us given all of the uncertainty in the world and with an unpredictable new Commander in Chief in the White House. But, we prefer the miners to the metal itself.

We do expect an increase in inflation this year which is why the Federal Reserve forecast 3 interest rate increases this year. With that as a backdrop, we need to be careful with the types of bonds "Fixed Income" that we buy. The most sensitive bonds to rising rates are very long term (over 10 years), low payment, safe "i.e. U.S. Govt" bonds. Those type of bonds don't do well when interest rates are on the rise. Last year, I remarked how attractive High Yield corporate bonds *(bonds rated below BBB carry repayment risk)* were and they posted very good returns. When improving economic environments are combined with rising interest rates, these types of bonds have historically performed very well and I expect them to do well again this year.

Finally, as we approach 20,000 on the Dow Jones Average, it seems that most strategists are forecasting very low returns this year. I don't think anyone would be surprised to see a pullback. I think what would completely surprise investors is a **"melt up"!**

Because of the expected rise in interest rates, we think this could be "the year of a start of a great rotation from bonds and into stocks". Earnings are expected to grow this year after being flat in 2016. Growing earnings combined with increased economic activity and improved sentiment as the countries grow starts to pick up create a favorable backdrop. For these reasons, we would not be surprised to see the markets "Hot Up" as investors chase stocks out of fear of being left behind the rally.

No matter what happens, I'll be here manning the ship on your behalf.

As always, I will be looking for opportunities to profit this year and in the years ahead!!

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