First Affirmative
Financial Network, LLC

Investing for a Sustainable Future

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Economy Rebounds… But What'sup for 2017?

By Mel Miller, CFA® | Chief Economist

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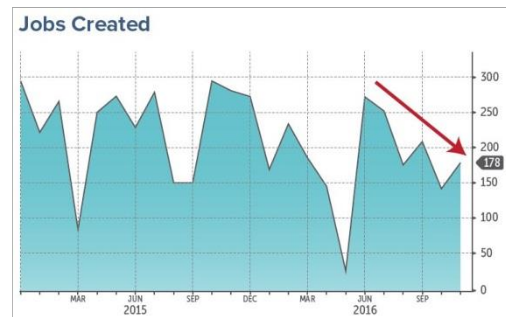
The first half of 2016 saw the economy "expand" only 1.1% — barely sufficient to describe it as an expansion. A tremendous third quarter followed, as the economy grew 3.2%, the largest quarterly expansion since 2014. The history of Q4 2016 is yet to be recorded, but here's what we know.

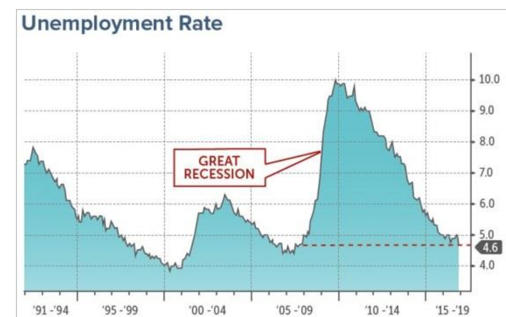
Let's start with jobs. The unemployment rate declined in 2016 from 5% to 4.6% in November. However, the monthly creation of new jobs has trended down since June. While still adding new jobs, the pace of creation is slowing.

While the unemployment rate is important, we must also consider the labor participation rate. The labor participation rate had started to recover starting in June of this year only to be followed by a decline in the fourth quarter. A declining labor participation rate means that individuals are either leaving the labor market because of retirement or because of frustration finding employment, or a combination of the two. Either way, the lower labor participation rate was a key determinate behind the decline in the unemployment rate during the quarter to a level not seen since the start of the Great Recession.

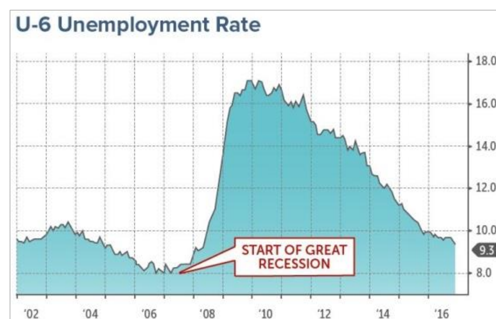


Demographic studies point to further declines in the labor participation rate because of the aging labor force. Currently the number of individuals over 65 is approximately 21% and is projected to grow to 28% by 2020.

The trend should continue to 2040, according to the U.S. Census Bureau, until a high of 37% is reached. The aging population will have a major impact on the labor force for decades to come.



A better measure of the health of the labor market is the U-6 unemployment rate which stands at 9.3% down from a high of 17.1% at the height of the economic downturn.



U-6 is considered the "true employment" rate. It includes total unemployed plus all persons working part-time out of necessity and those potential workers who have left the job market out of frustration as a percentage of the total potential labor force. While down from 17.1% it is still higher than the 7.9% rate recorded at the end of 2006.

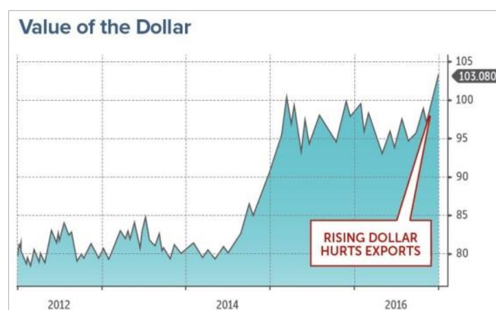
Year-over-year, U.S. average hourly earnings showed no improvement over the second quarter level. But consumer confidence as measured by the Conference Board has trended higher since May and now points to an upturn in future consumer spending, which is generally good for the economy as a whole.

2017 Forecast

Let's review my 2016 prognostications for accuracy. I had originally forecast GDP growth of 1.8% to 2.2%. Following a tepid first half of the year, I lowered my forecast to 1.3% to 1.7% in my second quarter Economic Commentary.

Now I wish I had not lowered my forecast in July since the economy expanded 1.9% on an annualized basis for the first three quarters of 2016. Once the data is all collected and analyzed, the final GDP expansion for 2016 is likely to exceed the high end of my adjusted forecast of 1.7%.

The economic and market impacts of the Trump election victory have truly been a surprise — nearly as great a surprise as the election itself! The stock market gain of approximately 5.3% between when the polls closed on November 8th and the calendar year-end appears to be based on the belief that Trump's version of stimulus spending will drive the economy in 2017. However, it's difficult to see how the president-elect's economic policies will be able to deliver his promised 3% to 5% GDP growth next year.



I'm looking for GDP growth of 1.75% to 2.0% in 2017, very similar to 2016. If this forecast is correct, it's likely that the FOMC will only raise the Fed Funds rate one time during calendar year 2017.

I am surprised that so many economists are projecting more rapid growth in 2017, given the rising value of the U.S. dollar. Over 50% of S&P 500 profits derive from foreign sales and the rising dollar is hurting exports.

The strong dollar coupled with the trade rhetoric of president-elect Trump does not bode well for exports. The possibility of a trade war, and all the negative ramifications, cannot be

overlooked.

Inflation is likely to trend higher in 2017 as the economy enters the eighth year of recovery from the Great Recession. Upward inflation pressure emanates from improving wages and the recent OPEC agreement designed to drive the cost of oil back up to $60 a barrel from a low of approximately $29 in early 2016.

I would not be surprised if headline inflation exceeds core inflation in 2017 for the first time since August 2014. “Headline inflation” is the raw inflation figure as reported through the Consumer Price Index (CPI), while the measure of “core inflation” excludes certain items that are generally quite volatile.

I wish our president-elect well, for the sake of the economy. However, I believe there is a 20% probability of a recession in 2017.

I truly hope my forecast of 1.75% to 2.0% GDP growth is exceeded and a recession is avoided.

Strong Finish for Stocks

By Kevin O’Keefe, CIMA®, AIF® | Chief Investment Officer

For U.S. stocks, 2016 was a tale of four markets. The first six weeks belonged to the bears (S&P 500 down 10.5%). The next six months was won by the bulls (S&P 500 up 19.7%) despite the short sell-off in late June after the Brexit surprise. The next three months went to the bears (S&P 500 down 4.8%). And then the bulls took charge for the last seven weeks of the year (S&P 500 up 7.4%).

Although much of the attention lately has been on the surprising year-end surge, the bounce from the mid-February low, when pessimism was at its greatest, contributed the most to last year’s double-digit percentage gains.

A Year of Surprises, Inflection Points

Small company stocks in the U.S. outperformed large and value stocks clobbered growth stocks across the market-cap spectrum. The impressive performance of value stocks last year may continue for a while as investors requiring portfolio income look for alternatives to bonds. Internationally, the MSCI EAFE Index (non-US Developed markets) barely managed to finish in the black on a total-return basis. Emerging Markets performed much better.

Central Banks have been the primary stimulus for stock price gains in recent years, and that stimulus has effectively disappeared. If stocks are going to add to their gains going forward, they will need to do it on earnings.

Bonds performed very well in the first half of the year, but retreated in the second half. Although bonds will still be an essential asset class for managing volatility, it appears that the 35-year-long bull market in bonds is over. Returns from bonds going forward will likely be anemic by comparison.

Active management has been on the defensive in recent years, as evidenced by the amount of column inches devoted to the subject and the tremendous asset flows out of actively managed mutual funds and into index funds. Over the last five years, index funds have received inflows averaging more than $200 billion per year. Last year, active funds saw net withdrawals of more than $200 billion.

This trend has helped perpetuate the outperformance of index funds. To the extent that a portfolio's positions have differed from that of the index, it has likely underperformed. If market-cap weighted index funds continue to benefit at the expense of actively managed funds, valuations of large positions in passive portfolios will eventually become unsustainably high. Investors who remember the dot-com bubble should keep this in mind when considering indexing versus active management.

Looking Ahead

As this publication goes to press, the overarching question among investors is: How will a Trump administration affect investment returns?

The short answer is, of course, that no one knows; but here are a few reasonable expectations.

Just like last year, 2017 is likely to be politically unpredictable, so investors should expect volatility. There will likely be periods in which markets will trade on news headlines, tweets, and speculation.

The prospect for significant policy changes in the United States has played a part in driving the recent rally in stocks. Value stocks have outperformed, with financial and energy stocks leading the way, while previously strong names in the technology and health care sectors have lagged. The surge in bank stocks reflects optimism about deregulation and further interest rate increases.

There is also anticipation of greater fiscal spending in the U.S. Stocks that would benefit from faster growth and higher inflation have done well in recent months, as have lower quality infrastructure and defense names. Global economic growth will likely be in the 3% to 4% range. Emerging markets may exceed this growth rate, while most developed countries may fall short. The U.S. is expected to be among the better-performing developed countries.

The Fed will likely raise interest rates in 2017 more than once. However, key Central Banks in other countries are not expected to follow that lead. This divergence may help pave the way for international equities to outperform their U.S. counterparts. The strong dollar may also help improve the relative attractiveness of international equities.

If Trump's campaign rhetoric translates into actual policies of lower tax rates, less regulation, and more protectionism, the effects on the economy and global trade are highly unpredictable. We have already seen that protectionist tweets can impact specific companies and industries on a short-term basis. Global supply chains are potentially vulnerable to such populist rhetoric; we will have to wait and see whether voter anti-establishment leanings of 2016 carry over to the 2017 elections in France, Germany, and the Netherlands.

Remember that stocks are ownership shares of actual businesses, and the profitability of each business has more influence on the price of its stock over the long-term than the political winds that may be

blowing at any given point in time. Markets may fluctuate wildly, but over time it's fundamentals that matter most to the price of any given stock.

Is the Bull Market in Bonds Over for Good?

By the Team at SNW Asset Management (www.snwam.com)

The past year can be characterized as having been "good, not great" for the bond market. Yields fell sharply in the first six months, but quickly reversed in November as the prospects for stronger economic growth caused interest rates to rise. A small increase in yields for most maturities was offset by income generation and gains from credit spread tightening, resulting in modestly positive full year returns.

Looking ahead, we acknowledge some market forecasters are predicting that interest rates are likely to continue their march higher as the U.S. finally breaks out of the sluggish growth and inflation environment that we've become accustomed to since the great recession. But a deeper look at economic and policy trends suggests that significant nuances must be considered when thinking about bond investing in 2017 and beyond.

Uncertainty Reigns Supreme

Tax reform appears to be at the top of the agenda for the new Trump administration, but we haven't seen the framework in which such reforms will be structured, nor do we know over what time period they will be implemented.

The same uncertainty applies to fiscal stimulus through infrastructure spending. While it's fair to assume that lower tax rates and increased spending would be a positive contributor to economic growth, at least in the short term, other policies, such as trade protectionism and limits on immigration, would likely detract from economic growth.

Inflation is likely to remain constrained moving forward. Not only is the Federal Reserve on a tightening path (which has the largest effect on short-term bonds with limited price sensitivity to a change in rates), but the U.S. Dollar has risen sharply in recent weeks. In addition, while higher commodity prices will boost inflation early in the year, these base effect gains will lapse as we move through 2017.

Much of the rest of the developed world is going through a prolonged growth downturn, likely causing foreign yields to stay low for the foreseeable future. The relationship between U.S. and Japanese and U.S. and German bond yields should provide support for our markets as foreign investors take advantage of the relative value opportunity that yields on U.S. bonds provide.

There is no shortage of potential risk and volatility in the global financial marketplace. Overleverage across developed market economies, a continuation of capital outflows in China and currency driven dislocations in emerging economies need to be watched closely. If these trends create volatility, high quality U.S. bonds should do quite well.

Could rates move higher during certain periods of 2017? Sure. Will the bond market enter a sustained bear market where yields correct sharply to the upside? Unlikely. And even if rates do move higher over the course of the year, bond investors can still make a positive return with relatively low levels of volatility because of the income bonds provide.

Green Bonds

Growth momentum in the green bond market increased last year. Almost $90 billion of green bonds were issued in 2016, roughly double the amount issued the previous year. These issuances were dominated by the Chinese which accounted for 37% of the total — not surprising given China's aggressive commitment to low carbon energy production.

The municipal sector saw clear increases in total issuance in 2016 compared to 2015 while the sovereign sector saw its first sovereign green bond issuance in December by Poland.

Investor appetite for green bonds continues to be high with most of the new issues being oversubscribed. Expectations of continued growth in 2017 are moderate, with the total issuance of labelled green bonds expected to be in the $120 billion range.

We believe the bright spot for 2017 will be the municipal bond market. Many states and municipalities have been vocal since the Presidential election in their continued commitments to address climate change, create more affordable housing, increase healthcare access, and ensure an inclusive and equitable community for their residents. These states and municipalities will be looking to the public markets for financing for many of these projects.

Good News: American Are Getting Serious About Retirement

We've all seen the alarming news flashes suggesting that most Americans aren't saving enough to live a financially secure retirement.

It's time to look at the bright side. On average, workers in 2015 put 6.8% of their salaries into 401(k) and profit-sharing plans, according to a recent survey of more than 600 plans by the Plan Sponsor Council of America. That's up from 6.2% in 2010.

An increase in retirement savings of 0.6 percentage points may not seem like a lot, but a 10% increase in the amount of money being invested into financial assets over the last five years is significant — billions of dollars.

If this trend continues, more plan participants could begin meeting the savings recommendations of retirement experts by setting aside at least 10% of compensation regularly over the course of their career.

Nearly six out of ten retirement plans surveyed allow for automatic enrollment, meaning that employees only need

to take action if they do not want to participate. This "opt out" feature has probably helped increase the retirement savings rate more than anything else.

More Americans contributing more money into their retirement accounts could also help offset the potentially negative effect of what some are calling the "liquidating demographic bulge." In other words, there is a risk that millions of retiring baby boomers who are spending down their retirement savings over the next several decades could put downward pressure on stock prices. A good demographic balance of net buyers and net sellers should help reduce this risk.

Portfolio Rebalancing: Does It Really Help?

One of the core tenets of the First Affirmative Investment Philosophy is belief in the value of periodic rebalancing — periodically adjusting portfolio allocations such that they are brought back into alignment with each client's Investment Policy Statement (IPS).

Periodic rebalancing is widely considered a best practice for reaching one's long-term financial goals. However, Michael Edesess, Chief Investment Strategist at Compendium Finance, argues that rebalancing is no better or worse than a buy-and-hold approach. He asserts that the academic reports showing a financial advantage for rebalancing are the result of improper and selective analysis of the data.

Proper analysis shows that there a number of possible outcomes from rebalancing, ranging from much worse to much better than buy-and-hold. Our experience at First Affirmative is consistent with this observation. Our timing could not have been better in 2016 as we were net buyers of stock mutual funds on February 11, 2016, which was the market low for the year, but this has not always been the case. In a long bull market, without any significant corrections, rebalancing does not beat buy-and-hold.

Stock Superiority Comparison

	1970-79	1980-89	1990-99	2000-09	2010-16
U.S. large-cap stocks	3rd	2nd	1st	3rd	2nd
U.S. small-cap stocks	1st	3rd	2nd	1st	1st
Developed foreign markets	2nd	1st	3rd	2nd	3rd

(Data courtesy of Jonathan Clements, ThinkingBeyond.com)

This table compares the decade-specific average annual returns of three major asset classes of stocks. In the 1970s, small-cap stocks were the best performers. In the 1980s, the winner's trophy went to non-U.S. stocks. In the 1990s, large-cap stocks won the derby. Small-cap stocks have led the way since 2000.

Investors tend to pour money into recent winners and shun recent losers. Rebalancing takes some profits away from the best performers and allocates the proceeds to recent underperformers, with the expectation that returns tend to revert to the mean.

So why rebalance? Periodic rebalancing helps clients achieve their goals; but the way in which it helps may not be self-evident. We believe that periodic rebalancing helps support optimal investor behavior. There is a saying: "If you don't rebalance your portfolio, the market will do it for you." This refers to the fact that if stocks become significantly overweight in your portfolio, when a nasty bear market arrives, you are likely to experience a bigger loss than you otherwise would if your portfolio allocations were more closely aligned with your IPS.

You may be better off or worse off by rebalancing, as compared to the buy-and-hold approach, but the experience of a greater decline will be more painful, which increases the likelihood that you will abandon your financial plan. We believe in rebalancing because it improves the likelihood of our clients achieving their long-term goals.

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SNW Asset Management *is an independent investment advisor and certified B Corp focusing exclusively on managing low-cost, tax-efficient fixed income portfolios based in Seattle, Washington. SNW is a fixed income separate account manager for certain clients of First Affirmative Financial Network.*

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