2016 Year End Review

Surprise!

Investors will remember 2016 as a year when, more than usual, various geo-political events helped shape overall portfolio returns. In broadest terms, Canadian portfolios holding a diversified basket of **global stocks ended the year on a high note** with average high single-digit returns, and with domestic and US equities as notable bright spots. On the other hand, many bond prices fell markedly in the fourth quarter, delivering a below-average, though slightly positive, fixed income return for the year.

Canadian equities shone in 2016, owing largely to a comeback in the resources sector. After hitting a 12-year low last January, the price of crude oil ended December at its highest point since July 2015, for a one-year gain of over 40%. A driving force late in the year was a new OPEC agreement, whereby member countries committed to output reductions, giving a further boost to resource stock prices. The Canadian equity market was also boosted by its large financials sector, whose companies benefitted from the continued combination of robust real estate markets and historically low interest rates.

US equities were strong as well; in particular, **small-company stocks outperformed large-caps by a wide margin and "value" outperformed "growth", much to the benefit of investors with DFA holdings**. The US rally accelerated after November's election as the incoming Republican administration promised pro-business policies in 2017. Amidst a climate of improving economic data (especially unemployment numbers), the Federal Reserve (the Fed) raised its benchmark interest rate in December for only the second time since 2006 and, as a result, the US dollar (USD) moved higher against other currencies.

As a group, **international equity returns were soft** in 2016 and were dampened further by the translation to Canadian dollars (CAD). June's Brexit vote sent the pound sterling to its 30-year low. Elsewhere in the eurozone, tepid economic conditions prevailed despite ongoing accommodative policies. Japan's Nikkei was flat in local terms, even with its improving economy and depreciating yen. Emerging markets returns were individually quite varied but, as a whole, up over 8% CAD.

For fixed-income portfolios, **the Fed's move to raise its bellwether rate by ¼% resulted in an increase in yields** across US and Canadian maturities, translating into a drop in prices (inverse relationship). Nevertheless, a basket of shorter-term, high-quality bonds registered a return of between 1% and 2% for the year.

Following are the returns for major indices for the period ended December 31st, 2016:

	4th quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.1	0.5	0.6	0.8	1.2
Canadian Bonds (FTSE Short Term Bond)	-0.5	1.0	2.2	2.1	3.6
Canadian Stocks (S&P/TSX Comp.)	4.5	21.1	7.1	8.3	4.7
U.S. Stocks (S&P 500)	6.3	8.6	17.7	21.2	8.5
Non-North American Dev. Stocks (EAFE)	1.6	-2.0	6.3	12.6	2.2
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-1.0	7.9	5.3	7.1	3.3

*Last quarter, 1 year, and 3 year returns are FTSE Emerging. Other periods are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook for 2017

Many Questions

It may seem hard to imagine the year ahead holding bigger surprises than 2016, but it certainly begins with investors having many more questions than answers. **November's US election result and the earlier UK Brexit vote revealed a clear discontent with the status quo** in two of the world's most influential countries, but the real-life implications of both are yet to unfold. Will there be more to come in France, Germany or Italy, all of whom have elections this year? How will markets react to the apparent seismic shifts in US/China and US/Russia relations? To what extent are trade agreements with the US, including NAFTA, at risk? Many questions; few answers.

To start in the US, the November election was monumental not only because a brash Washington outsider and billionaire businessman won the White House, but also because his Republican counterparts will control Congress for at least two years. Everyone expects some gap between campaign promises and actual future policy decisions, but Mr. Trump's bent is clearly towards lower personal and corporate taxation, corporate tax reform, deregulation and aggressive infrastructure and defense spending. In the short term, **stock markets have soared on the promise of a pro-business agenda**, leaving the prospect of much higher deficits yet to be reconciled with his base.

In addition to fiscal restraint, another apparent disconnect between Trump's views and traditional Republican doctrine is his stated protectionist trade policy. Consider for example that 75% of exports from China and developing Asia into the US are produced by US multinationals and joint ventures, not Chinese-owned companies. Penalizing them through a harsher tariff policy seems tantamount to cutting off one's nose to spite one's face and potentially a challenging campaign promise.

Across the Atlantic, the road ahead for a post-Brexit Britain is also unclear, but no one doubts Theresa May faces an extremely difficult year. She has indicated she will invoke Article 50 (the legal beginning of Britain's exit from the EU) by the end of March. Once it's triggered, there is a short two-year timeframe to negotiate their exit, including a six-month ratification period. It is a daunting schedule. As The Globe and Mail recently noted, this deal along with their need to rewrite new immigration, trade and border control policies, will be the biggest set of negotiations Britain has undertaken since WWII. By comparison, Canada has spent the past seven years negotiating a "friendly" trade deal with the EU, and we are still waiting for ratification. Compounding matters for May is a very small majority in parliament, a populace torn by their decision and dozens of elections coming up in other EU jurisdictions. **Expect more drama in Europe in 2017**.

Since markets anticipate events (often long before they unfold), we've seen a rally in stocks and the USD, the British pound has plummeted and bond yields have started to rise. And though political events have triggered these initial moves, it is likely investors will now look for evidence of the promised benefits. In 1992, Bill Clinton was famously reminded, "it's the economy, stupid". Political leaders everywhere should expect to be judged by the same metric in the months ahead.

Of course, "the economy" has been relevant all along as people suffered through the long, global funk triggered by Wall Street almost a decade ago. But now populist leaders are voicing the frustrations of those who have never recovered from it, and from which no amount of easy monetary policy, however creative and well-intentioned, has seemed to help. **Fortunately, most governments have now wrestled fiscal**

deficits down to manageable levels and can embark on fiscal initiatives to spur growth. Canada has taken the lead in this, but it remains to be seen whether the deficit hawks in the US Congress will go along with their new president's spending plans. Even if they dial them back, the global economy is showing surprising signs of life - not only in the US, but in Asia and Europe as well. So, along with the changing political landscape, this reality has shifted the economic and market risks going forward.

First, **US interest rates have already started to move up**. The Fed raised short-term rates a quarter point for the first time this cycle in December 2015, indicating they expected four further increases in 2016. Weaker-than-expected growth meant only one quarter-point increase happened, in December 2016. The Fed now contemplates three more increases in 2017: time will tell. Perhaps more interesting to investors are rates in the bond market. Central banks have a large influence over short-term interest rates, but it is largely bond buyers and sellers who dictate longer-term interest rates. The bellwether bond is the 10-year US Treasury and its yield hit a cyclical low of 1.3% last April. By election time it had climbed to 1.75%, and it has continued its ascent to about 2.5% - all in anticipation of "Trumped-up" stimulus.

These rates remain low by historical standards, but further increases could have economic and market repercussions not seen in many years. Higher borrowing costs affect both consumers and businesses negatively. At the same time, higher yields mean bonds become a more attractive alternative to stocks than they have been. And the impact of interest rates can spill over borders. For example, since the US election, Canadian mortgage rates have inched up in response to stronger expected growth south of the border, despite the fact that the Canadian economy is still relatively weak.

Second, **this recent rally in stocks has resulted in stretched valuations**. A year ago, we noted stocks were "slightly overvalued" relative to fundamentals, including corporate earnings, but this recent surge has moved them into "overvalued" territory. If the economy were to move forward quickly and corporate profits follow suit, valuations could be restored and thereby justify current prices. However, an economic setback or languishing corporate profits (not to mention a geopolitical threat) would leave the US market vulnerable. It is expensive because market participants believe the US economy will lead the world and expectations are high. Non-North American and emerging markets are the cheapest because of slower growth, more perceived political risk, weaker currencies and less robust share prices.

Third, **any major setbacks to globalization could dampen the global recovery** and threaten recent gains in stock prices. The prospect of Brexit already hinders a hitherto free-trading EU; additional populist measures would compromise it further. One potential outcome of this anti-trade sentiment may be that smaller country-to-country agreements could replace multi-country agreements going forward, similar to the direction in which Britain is headed. Some have noted that Canada might be a beneficiary of this trend if, for instance, it were able to position itself as a gateway between major trading partners, such as Europe and the US.

As we can in every year, it is easy to list other potential pitfalls for 2017: a major slowdown in China, excessive strength in the USD (impacting emerging markets, corporations and investors with US debt), another European debt crisis (Italy?) or a rancorous Brexit negotiation.

For Canada, risks have also shifted somewhat, with less concern about commodities and more worry about high housing prices and consumer debt levels. Higher Canadian interest rates would definitely hurt borrowers. On the other hand, improvement in manufacturing activity in Ontario and higher prospects for US demand are encouraging signs for the year ahead.

In summary, it appears that the risks are shifting away from deflationary forces towards inflationary ones: a most welcome sign that global economic healing is truly underway - a long process which has taken the better part of a decade to achieve.

Portfolio Strategy

At the beginning of each year, many strategists make twelve-month market predictions and then position portfolios accordingly. As you know, at Milestone, we consider this to be a fruitless exercise since history teaches it is next to impossible to consistently predict which market/asset classes will do what. For example, last January almost no one expected Canada to be one of the best equity markets in 2016 - but it was.

There is no question that, as 2017 begins, investors face many uncertainties - just like every other year! Successfully navigating these unknowns entails maintaining a well-diversified global portfolio with broad asset-class diversification. Perhaps a particular asset class will be a big winner and, with the benefit of hindsight, why that happened will be crystal clear. But it is not in advance and, rather than aggressively betting on what 'might' happen, investors are better served maintaining their longer-term discipline.

We will be rebalancing equity portfolios, where appropriate, to trim Canadian and US positions and add to international stocks or fixed-income assets, depending on policy guidelines. This is consistent with **the best long-term strategy of reducing asset classes that have outperformed and adding to ones that have underperformed recently**. Though counterintuitive, it ensures that assets are sold on strength and purchased on weakness.

In fixed income portfolios, **we continue to emphasize shorter-term, high-quality investments of five years or less**. Typically, we include global bond positions along with GICs for added diversification. If interest rates continue to rise in 2017, GICs may well do better than bonds. On the other hand, if the global economy weakens and bond yields fall again, bonds will probably provide the higher return.

Regardless of the surprises 2017 may bring, we will close with our familiar refrain: global diversification and disciplined rebalancing are the keys to long-term investment success.

Happy New Year!