

Client Quarterly

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Great Expectations Trigger a “Pip” of a Rally

The serialization of Charles Dickens' *Great Expectations* captivated readers from December of 1860 to August 1861. The novel chronicles the personal growth and development of an orphan nicknamed Pip. It features some of Dickens' most memorable scenes and vivid imagery and explores such grand themes as wealth and poverty, love and rejection, and the eternal struggle between good and evil.

The opening months of the Trump era also offered their share of strong images, plot twists, and conflict swirling around big issues. Whether the more apt comparison is a classic novel or a seamy TV soap opera may depend on one's political and entertainment preferences. But the stock market is all about *expectations*, and those appear to have been pretty great so far.

On Election Day, the Dow Jones Industrial Average closed just above the 18,000 level. January 25th saw the Dow's first close above 20,000, and on March 2nd it blew through 21,000. “Market melt-up” became the phrase of the day, offering little real explanatory value.

All manner of pundits are busily handicapping the prospects for replacing or repairing Obamacare, reforming the tax code, and rationalizing regulation. These and other initiatives will prompt partisan battles and staunch resistance from an array of contending interests.

Meanwhile, the “real” economic data appear to indicate gathering strength with broadly positive implications for corporate profits. The Institute for Supply Management's (ISM) non-manufacturing index hit a 16-month high of 57.6 in February, and the business activity component of the index jumped to a six-year high.

The folks at Capital Economics note that a weighted *average* of the ISM manufacturing and non-manufacturing indices is consistent with an economic growth rate higher than we've seen for several years. Commensurately, the employment index has risen to “a level that, historically, has been consistent with monthly gains of slightly above 200,000 in just services payrolls.”

Confirming that rosier outlook, the Federal Reserve is signaling another uptick in its target interest rate. Whatever aspirations and expectations Mr. Trump may have for the nation, economic and market

momentum appear to be giving us a little head start.

As Benjamin Graham noted long ago, “In the short run, the market is a voting machine, but in the long run, it's a weighing machine.” When the market goes on a tear, up or down, investors do well to focus on long-term goals rather than trying to guess the durability of that market trend or the timing of the next turning point. And when the market hands you a surprise gift, there's nothing wrong with taking a little risk off the table, perhaps to redeploy into stocks when the inevitable correction comes around. ■

Politics and Trade; Checking the Numbers

In late 2010, we noted President Obama's executive order instructing the government to use “every available resource to support a doubling of U.S. exports over the next five years.” That order did not specify any strategy or policy, but it did place the president at the head of a parade already in progress. U.S. companies

had just logged export growth of 18% for the *prior* 12 months.

The *ensuing* five years saw exports grow just 22% *cumulatively*. Imports rose a bit more slowly, leaving our trade deficit little changed. Now another U.S. president is decrying that deficit and looking to shake up the terms and tax policy surrounding trade.

With long-run economic issues, it usually helps to cast the numbers as a share of gross domestic product (GDP). The table to the left offers that picture at five-year intervals. From World War II into the early 1970s, the U.S. ran trade *surpluses* as the rest of the world retooled. *Since* 1975, imports have consistently exceeded exports even as *nomi-*

Surveying U.S. Trade Across Six Decades

Year	U.S. GDP in billions of \$	Exports % of GDP	Imports % of GDP	Bal./Def. % of GDP
1961	563.3	4.69 %	3.94 %	0.75 %
1966	815.1	4.78	4.42	0.36
1971	1,167.8	5.11	5.22	-0.11
1976	1,877.6	7.60	7.92	-0.32
1981	3,211.0	9.17	9.67	-0.50
1986	4,590.1	6.75	9.77	-3.02
1991	6,174.1	9.37	9.87	-0.50
1996	8,100.2	10.51	11.80	-1.29
2001	10,621.8	9.47	12.87	-3.40
2006	13,855.9	10.52	16.02	-5.50
2011	15,517.9	13.71	17.24	-3.53
2016	18,567.0	11.90	14.60	-2.70

Sources: Bureau of Economic Analysis; U.S. Census

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Tables Turn for High Yields and Energy

What a difference a year can make! The Investment Performance Review carried in our Spring 2016 issue reported *negative* one-year results for every fund category except long-term municipal bond funds. A glance at this issue's Performance Review shows a striking reversal.

A year ago we took that opportunity to focus on high yield (lower rated) bonds which had posted the weakest one-year results (–5.6%) among the bond fund categories. Tepid economic numbers had clouded the general outlook for high yields compared to higher grade corporate and government bonds.

More specifically, the dramatic, two-year slide in oil prices had resulted in a fairly broad downgrading of debt issued by some of the more aggressive, leveraged players in energy exploration and development. In fact, over that same trailing 12 months, the average total return for Specialty Natural Resources stock funds had produced a particularly punishing decline (–22.0%).

Jumping to the latest numbers,

Asset Correlations *May Be* Falling

For decades, diversification has been a guiding principle of risk-sensitive portfolio design. That principle is based on the historical patterns of different asset categories responding differently to economic conditions, geopolitical developments, and market sentiment. However, for much of the past decade, financial markets have been more tightly correlated in

high yield funds swamped other fixed-income categories this past year with an equity-like 16.3% total return. The average gain for Specialty Natural Resources funds was a standout 27.9%.

This isn't just a casual coincidence. High yields have a notable history of providing a slightly more comfortable, contrarian entry point in difficult markets. Yet they can be vulnerable to industry-specific or even company-specific developments. Meanwhile, natural resource plays have been a rather more reliable source of volatility than long-term growth. But both sectors have their moments and might be enjoyed in watchful moderation. ■

a kind of risk-on-risk-off two-step.

That dance may be breaking up as global stocks, bonds, currencies, and commodities have followed rather different paths in recent months. Based on 34 indicators tracking relative performance of different asset classes and regions, a recent Morgan Stanley analysis showed those correlations falling to their lowest levels since 2006.

One notable aspect of the financial crisis and its aftermath was the convergent behavior across asset classes, first as a flight from risk and then as a push back into risk assets as investors tried to counter the rock-bottom “riskless” yields suppressed by the world's central bankers.

The Federal Reserve's quantitative-easing ran from November 2008 until October 2014, during which U.S., global, and emerging-market stocks, as well as high-yield bonds, saw annualized gains of 15% or more. Oil, industrial metals, emerging-market debt, and high-grade corporates all gained over 8% annually. From the fall of 2014 until the recent election, performance was generally more mixed and muted.

Now, with economic growth and interest rates perhaps on the rise, reactions may vary more widely across a mix of assets. Mainstream equity markets rallied strongly in the wake of the election, while bond markets have been nervous. Commodities have held their own, reflecting a higher inflation bias accompanying those growth expectations.

Some observers suggest that “active” investment managers could have an edge over “passive” strategies in such an environment, but variables abound. The accompanying Investment Performance Review covers a wide range of investment assets and tends to show that “risk-on” has been pretty rewarding over the past year, but a mixed bag longer term. That still argues for broad diversification, whether one's preferred management style is active, passive, or something in between. Markets cycle, and so do relative asset correlations. ■

Investment Performance Review	TOTAL RETURN *			
	(dividends and capital gains reinvested)			
	--- Annualized through Mar. 3, 2017 ---			
Selected Mutual Fund Categories *	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Blend)	20.6 %	9.0 %	12.5 %	6.9 %
Mid-Cap Stocks (Blend)	22.4	7.0	12.2	7.1
Small-Cap Stocks (Blend) †	27.3	6.6	12.1	7.1
Foreign Stocks (Large Blend) †	11.8	0.3	4.6	1.3
Diversified Emerging Markets †	19.8	1.0	0.1	2.5
Specialty Natural Resources †	27.9	– 3.9	– 1.4	1.6
Specialty Real Estate †	10.1	9.6	10.0	4.2
Cons. Allocation (30-50% Equity)	10.3	3.4	5.2	4.4
Long-Term Bond	3.0	5.5	4.7	6.5
World Bond †	3.6	0.3	1.1	3.7
High Yield Taxable Bond †	16.3	3.4	5.6	6.0
Long-Term Municipal Bond	– 0.1	3.5	3.0	3.6
* Source: Morningstar. Past performance is NOT indicative of future results.				
† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.				

Paying Up for Distracted Driving

If you're reading this on your smartphone, we trust you aren't driving. Auto accidents have been on the rise in recent years, and insurance companies increasingly cite distracted driving as a key factor.

Several major auto insurers reported poorer underwriting results for the fourth quarter of 2016, with crash-related costs outpacing premium increases. And we're not just talking about fender-benders. The National Highway Traffic Safety Administration reported a 7.2% jump in *deadly* accidents in 2015, and the nonprofit National Safety Council has estimated another 6% increase in 2016. At least one insurer, Cincinnati Financial Corporation, reported to its investors last fall that it was seeing many accidents with "no skid marks."

State Farm, the nation's largest auto insurer by market share, conducted a 2015 survey in which 36% of respondents admitted to texting and 29% to accessing the internet while driving. Perhaps most alarming are the responses from drivers in the 18-29 age group, 64% of whom acknowledged texting and 54% accessing the web while driving.

Despite campaigns to stress the danger, those percentages were up significantly from a similar survey conducted in 2009. Among those respondents, smartphone ownership rose from 52% to 88% between 2011 and 2015.

There are other factors helping to reverse what had been a notable decline in crash-related payouts by insurers. For example, lower gas prices and the sustained economic recovery have spurred a resurgence in annual miles driven by Americans. But to varying degrees, insurance markets are where we socialize (i.e., spread) the cost of risky behavior. Average annual auto premiums rose to an estimated \$926 in 2016, having troughed at about \$790 in 2009. Another meaningful bump is expected for 2017.

Experts had predicted that a proliferation of vehicles with high-tech,

Social Security's "Full Retirement Age" Just Started Inching Higher

Americans reaching age 62 this year are leading a transition for future retirees. Starting in 2017, Social Security's full retirement age (FRA) inches up from 66 to 67 in two-month increments over the next six years. Benefits can still be initiated at age 62, but the percentage of one's FRA benefit available at 62 will slide lower. When the FRA reaches 67, those triggering benefits at 62 will receive 70% of their projected FRA benefit compared to 75% available to 62-year-olds in recent years.

At the other end of the continuum, 70 remains the age at which one maximizes the "bonus" for waiting. Those whose FRA is still 66 can look to a monthly check 32% larger than their FRA benefit when they start benefits at 70. But with an FRA of 67, the bonus for waiting to 70 is 24% of an individual's FRA benefit.

This adjustment was set in legislation way back in 1983, and it represents an incremental factor for retirement planning. Other aspects of Social Security may well have greater implications. For example, what does one gain by continuing to work for a couple more years or

picking up a job in retirement?

Social Security benefits are based on your 35 highest-paid years with those earnings adjusted to reflect the rise in average wages over time. Assuming a relatively full working career, another year or two may have little or no effect on the benefits one eventually receives. But if one's work history has had significant interruptions or periods of very modest earnings, a few extra years could help materially.

Marital status also can make a big difference. The spouse with a spottier or lower-wage work history may be destined to draw the spousal benefit in any event, which would not be enhanced by working a little longer. How much of one's Social Security benefits will be taxable in those first few years, and at what marginal rate, is another key factor in deciding when to start benefits.

Every situation is a little different. Advisors often see an advantage to delaying Social Security benefits for those who can afford to do so and expect to spend at least a couple of decades in retirement. You and your advisor can weigh the variables that make *your* situation unique. ■

IRS Warns (Again) on Tax Scams

In the midst of another tax season, the Internal Revenue Service has updated its annual "Dirty Dozen" List of Tax Scams for 2017. The list highlights schemes taxpayers could encounter *any* time, but which tend to peak around this time of year.

The overarching message is to be very protective with your per-

sonal information and circumspect about anyone trying to solicit that information from you. The list runs the gamut from telephone and email scams to identity theft to bogus tax shelter "investments" and even dishonest tax preparers.

Column space prevents us from taking a deeper dive into all these items in the *Quarterly*, but the IRS website provides extensive, cautionary details. To learn more, we suggest the following internet destination as a starting point.

<https://www.irs.gov/uac/newsroom/dirty-dozen>

Have a happy tax season, and please be careful out there. ■

anti-collision gear and other safety features would *lower* premiums. That may have to wait until those technologies can more fully *replace* us as drivers. Meanwhile, thank you for pulling over to give this a read. We do want you to be around for our *next* issue as well. ■

Youth Doesn't *Have* to be Wasted on the Young

It's comforting to believe that wisdom comes with age, perhaps because so much else goes away. But if you're still young and in a hurry to gain *financial* wisdom, the folks at Credit.com have posted a list of "50 Things Millennials Can Do Now So They Can Retire at 65."

Of course, "50 things" may sound more like a second job than light reading, but building a secure retirement does require a little work and attention. Happily, most of the

items on the list are neither new nor complicated, and they reinforce a few core concepts covered often in these pages, including:

- Spend less than you earn (the key to almost all the rest).
- Save and invest early and often (ideally, systematically).
- Take advantage of opportunities to save on a *tax-advantaged* basis.
- Set goals and keep an eye on your progress toward them.
- Consider the potential value of experienced, professional assistance.

A 2016 "Retirement Income Strategies and Expectations" survey by Franklin Templeton Investments found 70% of millennials "stressed and anxious" about retirement savings. That may belie the image of a laid-back, technologically savvy, socially hip generation, but if you're feeling that stress, you can check out those 50 things at <http://blog.Credit.com>. ■

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Politics and Trade...*

nal GDP grew tenfold.

Imports and exports have grown markedly as a share of national output. And recent trade deficits have been modest in the context of the past two decades. Nevertheless, *both* parties' presidential contenders disavowed the Trans-Pacific Partnership trade deal and reprised a 25-year-old debate over NAFTA.

Trade patterns tend to broadly reflect absolute and *relative* shifts in economic conditions here and abroad. Consumers account for 70% of *our* economy, so it's not surprising that an

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uptick in imports versus exports often corresponds to periods of relative U.S. economic *strength*. Conversely, on a relative basis the nation's *smallest* trade deficit of the past 20 years was generated during a recession-racked 2009.

Politicians of different stripes often seize on "deficits" as emergencies that call for desperate measures. The resulting policy tweaks are usually modest, and the world keeps turning, including world trade. For now, financial markets are *guessing* that will be the case once again. ■