QUARTERLY PERSPECTIVE
January 9, 2017

2016 Year-End Report

You know you're deep into a longstanding bull market when you see people checking their smart phones to see if the Dow Jones Industrial Average has finally breached the 20,000 mark. Who would have imagined record market highs at this point last year, when the indices ended 2015 in negative territory? Or when new year 2016 got off to such a rocky start, tumbling 7% in the first two weeks—making it one of the worst 10-day starts to a calendar year ever?

The markets eventually bottomed in mid-February and began a long, slow recovery, turning positive by the end of March, suffering a setback when the U.K. decided to leave the Eurozone and endured another hard bump in after-hours trading the night of the elections. In the end the Dow finished at 19,762.60 for the year, just short of 20,000 — but the bull market has continued for another year.

This was the second year in a row that the final quarter provided investors with solid gains. The Wilshire 5000—the broadest measure of U.S. stocks—was up 4.54% in the fourth quarter of 2016, ending the year up 13.37%. The comparable Russell 3000 Index gained 4.21% in the final quarter, to finish up 12.74% for the year.

Large cap stocks were up as well. The Wilshire U.S. Large Cap Index gained 4.14% in the fourth quarter, and finished the year up 12.49%. The Russell 1000 Large-Cap Index closed with a 3.83% fourth quarter performance, and finished the year up 12.05%, while the widely-quoted S&P 500 index of large company stocks was up 3.25% in the fourth quarter, finishing up 9.54% for calendar 2016.

The Wilshire U.S. Mid-Cap Index gained 5.31% in the final quarter, finishing the year with a gain of 17.22%. The Russell Midcap index gained 3.21% in the fourth quarter, and was up 13.80% in calendar 2016.

This was a year to remember for investors in small company stocks. As measured by the Wilshire U.S. Small-Cap Index, investors posted an 8.30% gain over the last three months of the year, for a total return of 22.41% over the entire 12 months. The comparable Russell 2000 Small-Cap Index finished the year up 21.31%, while the technology-heavy Nasdaq Composite Index rose 1.34% in the fourth quarter, to finish the year up 7.50%.

International investments contributed a slight decline to overall portfolio returns. The broad-based EAFE Index of companies in developed foreign economies lost 1.04% in the fourth quarter of the year, finishing the year down 1.88% in dollar terms. In aggregate, European stocks lost 3.39% for the year, while EAFE's Far East Index gained just 0.14%. Emerging markets stocks of less developed countries, as represented by the EAFE EM Index, gained 8.58% for the year.

Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT Index, lost 2.28% during the year's final quarter, but managed to finish up 7.24% for calendar 2016.

Last year, investors were wondering why they owned commodities in their portfolios, when their statements showed that the index delivered a whopping 32.86% loss. This year, they may be wondering why they weren't more committed to the asset class, as the S&P GSCI Index gained 11.37%, fueled in part by a 45.03% rise in the S&P crude oil index. Gold prices shot up 8.63% for the year and silver gained 15.84%.

In the bond markets, it's possible that the decades-long bull market—which basically means declining interest rates—has ended, and the fixed-income world is experiencing rate rises. But despite the nudge by the Federal Reserve Board, the moves have not exactly been dramatic. Over the past year, rates on 10-year Treasury bonds have risen from 2.25% to 2.44%, while 30-year government bond yields have risen from 3.00% to 3.07%. According to Barclay's Bank indices, U.S. liquid corporate bonds with a 1-5 year maturity have seen yields rise incrementally from 2.4% to 2.8% on average.

As always, there were many unpredictable anomalies in the investment world. In the international markets, anyone lucky enough to have speculated on the Brazilian Bovespa index—comparable to the U.S. S&P 500—would have reaped a gain of 68.9% this year, despite all the headline drama around the Zika virus and political uncertainties that were reported on during the Olympic games. Russian stocks were up 51% for the year, despite the recent sanctions from the U.S. government and the lingering international sanctions related to the invasion of the Crimean peninsula.

What's going to happen in 2017? Short-term market traders seem to be expecting a robust economic stimulus combined with lower taxes and deregulatory policies that would boost the short-term profits of American corporations. But it is helpful to remember that we are entering the ninth year of economic expansion, making this the fourth longest since 1900. In addition, growth has not exactly been robust; the U.S. GDP has averaged just 2.1% yearly increases since the Great Recession, making this the most sluggish of all post-World War II expansions.

Slow but steady has not been a terrible formula for workers or stock investors. The unemployment rate has slowly ticked down from a post-recession peak of 10% to less than 5% currently. U.S. stock indices are posting record highs with double-digit gains, and that Dow 20,000 level, while essentially meaningless, is still catching a lot of attention.

It's clear that the new President-elect wants to accelerate America's economic growth, but the policy prescription has not always been clear. Will we rip up longstanding trade agreements, cut back on immigration quotas and deport millions of workers who crossed the border without a visa? Will there be a wall built between the U.S. and Mexico? Will the government pay for huge infrastructure projects, at the same time reducing taxes and thus raising the national debt? Will Congress raise the debt ceiling without protest if that happens? Will the Fed raise rates more aggressively in the coming year, or cooperate with the President-elect in his efforts to drive the economy into a faster lane?

At the same time, there are many unknowns around the globe. China's economic growth has stalled for the second consecutive year, and you will soon be reading about a banking crisis in Italy that could force the country to leave the Eurozone—potentially a much bigger blow to European economic unity than Brexit or a still-possible Greek exit. Russian hackers may have ushered in an era of unfettered global intrusions into our Internet infrastructure, and there will surely be a continuation of ISIS-sponsored terrorism in Europe and elsewhere.

Every year of this longstanding bull market, we have to look over our shoulders and wonder when and how it will end. With so much uncertainty at this time last year, nobody could have predicted double-digit returns on U.S. stocks at year-end. This year could bring more of the same, or it could fulfill the dire predictions many have made during the election cycle, including both Democrats and Republicans who believe the country is in worse shape than the numbers would indicate.

What we know is the markets will always find a way to surprise us, and that trying to time the market and get out in anticipation of a downturn is a loser's game. At the county fair, when we get on the roller coaster, we don't bail out and jump over the side at some scary point on the track; we hang on for the ride. The history of the markets has been a general upward trend that benefits long-term investors, and looking out over the long-term, that—and the occasional dips and/or bumps along the way—is probably the likely path we will continue to travel.

2016 Returns

As you can see from the chart below, with the exception of foreign stocks in developed countries, 2016 posted healthy returns. The figures below are total returns; not just the price movement of the index, but the return generated via reinvested dividends or interest as well.

Index	Tracks	2016 Return	3 Year Annualized	5 Year Annualized	10 Year Annualized	Since Inception	Standard Deviation (10 Year)
Russell 3000 Index	Broad US stock market	12.74%	8.43%	14.67%	7.07%	11.72%	15.82%
S&P 500 Index	US large cap stocks	9.54%	6.60%	12.23%	4.67%	5.59%	15.29%
Russell 2000 Index	US small cap stocks	21.31%	6.74%	14.46%	7.07%	11.65%	20.14%
MSCI EAFE Index	Foreign stocks	(1.88%)	(4.20%)	3.58%	(2.06%)	6.19%	18.59%
Dow Jones US Select REIT Index	Real estate stocks	6.68%	13.73%	11.77%	4.63%	9.34%	26.55%
S&P GSCI	Commodities	11.37	(20.60%)	(13.13%)	(8.10%)	6.98%	23.63%
Barclays US Aggregate Bond Index	Investment grade taxable bonds	2.65%	3.03%	2.23%	4.34%	7.55%	3.31%
3-month T bill	Ultrashort govt debt (proxy for cash)	0.34%	0.14%	0.11%	0.71%	4.04%	0.41%
Consumer Price Index (through Nov)	Inflation	1.70%	1.15%	1.30%	1.84%	3.53%	1.12%