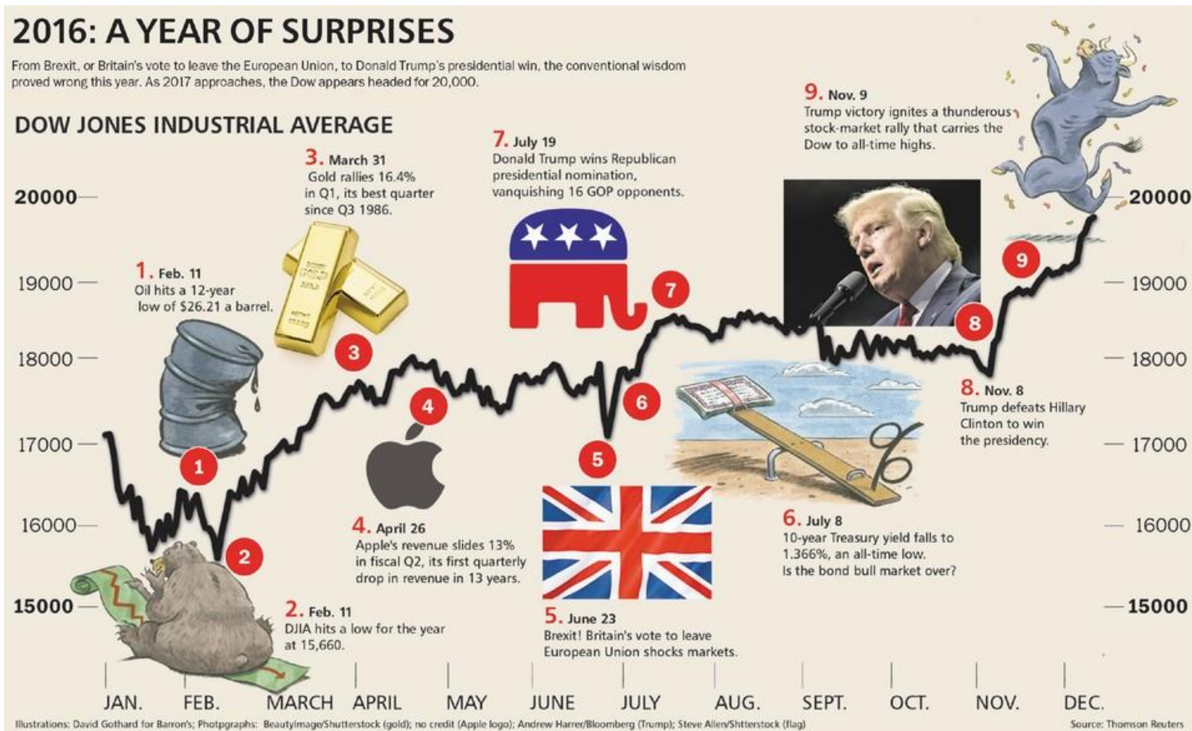
The Year of Surprises

"Forecasts create the mirage that the future is knowable." ***–Peter Bernstein***



2016 was a year in which political surprises dominated global headlines. From Brexit to Donald Trump, populism gained momentum around the world shocking insiders, giving hope to outsiders, and leaving market pundits to figure out what this all means for the future. Here's a look back at a few of the major events that dominated market headlines:

- **The FED** raised rates for the first time since 2006 in December of '15, helping to cause market weakness to start the year. They then raised rates again in December of '16 and hinted that they might raise 3 times in 2017.
- **OIL** hit a 12 year low, but the low on February 11th coincided with a market bottom. Production continued to be cut throughout the year, culminating in September when OPEC finally joined in, sending oil back above $50. (See 1 Above)
- **The BREXIT** referendum won out and markets around the world declined sharply, however, they quickly rebounded as people realized that there was a lot more that needed to happen in order for them to actually leave. (See 5 Above)

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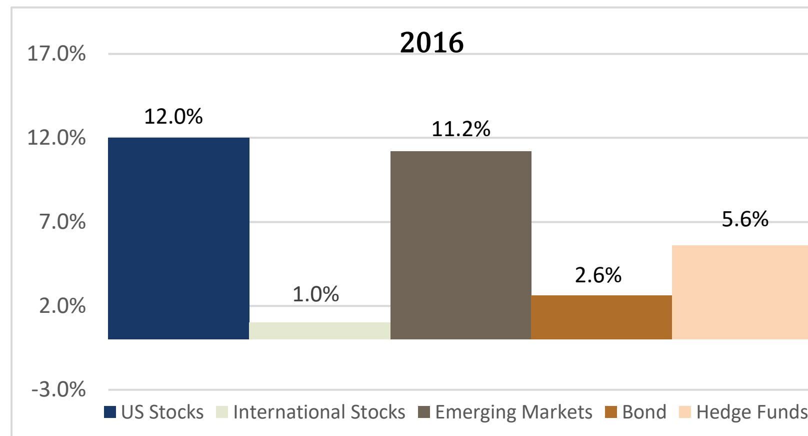
- **The SUMMER MALAISE** consisted of 43 straight days without a market move greater than 1% either way.
- **TRUMP** won the US presidential election and markets sank overnight, but they quickly reversed and roared into the year-end. Bonds on the other hand saw their largest 2 week loss in 26 years. (See 8 Above)

Despite everything that happened, the S&P 500 still managed to finish the year up 12% on a total return basis. In spite of the uncertainty, the resiliency of this bull market shows that underneath it all, market fundamentals still look strong. These market conditions show that there is still room for the bull run to continue in 2017, but as we have all come to learn, the unpredictable nature of our new President leaves us wondering what surprises he will have in store for us next.



The Difficulty of Forecasting (and Polling)

As famed economist John Kenneth Galbraith once said, “The only function of economic forecasting is to make astrology look respectable.” Every year around this time, pundits and strategists start to formulate their opinion as to where the market is going. While it is necessary to create such an opinion in order to allocate assets, we must all, as investors, realize that it is an opinion and not a fact. These opinions are derived from great research and thought, but they are not always right, and in some cases, as seen this past year, they can be drastically wrong: reference Brexit and Trump. This is why it’s important to stay diversified and be prepared to react to whatever outcome occurs.

We have always been fans and followers of Howard Marks at Oaktree Capital. Not only has his firm produced great results over the years, he is a sought after speaker and writer. His quarterly memos have now become required reading for investment professionals around the world. In his latest memo, he touched on the subject of forecasting and the fallacy of it all.

At the end of the letter he summarized his “opinions of opinions” and per usual he is spot on. We echo his sentiments and want to share each one of those with you:

1. There are no facts about the future, just opinions. Anyone who asserts with conviction what he thinks will happen in the macro future is overstating his foresight, whether out of ignorance, hubris or dishonesty.
2. Developments in economies, interest rates, currencies and markets aren't the result of scientific processes. The involvement in them of people – with their emotions, foibles and biases – renders them highly unpredictable. As physicist Richard Feynman put it, "Imagine how much harder physics would be if electrons had feelings!"
3. It's one thing to have opinions on these subjects, but something very different to be confident they're right (and act on them).
4. Taking bold action based on forecasts of things that are uncertain isn't just misguided; it's dangerous. As Mark Twain said, "it ain't what you don't know that gets you in trouble. It's what you know for certain that just ain't true."
5. Everyone at Oaktree has opinions on the macro. And when we see extremes in markets and, especially, capital market behavior, we're apt to take strong action. But we're highly aware of what we don't know, and when conditions are moderate or indistinct, we don't bet heavily."

At the end of his memo, Howard Marks referenced an Observer Article from Nov. 16th called "Want to Really Make America Great Again?" It's final paragraph says it all:

> *"If you wish to improve," Epictetus (first-century Greek philosopher) once said, "be content to appear clueless or stupid in extraneous matters." One of the most powerful things we can do as a human being in our hyperconnected, 24/7 media world is say: "I don't know." Or more provocatively, "I don't care." Not about everything, of course – just most things. Because most things don't matter, and most news stories aren't worth tracking.*

It's important to focus on what Warren Buffett calls "knowable" and things that you can control.

What's *Knowable* Heading into 2017

So what do we know about the market going into 2017 that will help shape our portfolio allocations (credit Barry Ritholtz & The Big Picture for some of these)?

- The Upside or Downside of the market will most likely not be determined by who's in office – Presidents get entirely too much blame or praise for the performance of the stock market. **The biggest political risk factor is not policies or politics – it's the potential of a watershed event (or a TWEET).**
- **Missing rallies can be devastating to long term performance**. Last year it was "As goes January, so goes the year." If you had sold after the 10% drop, you would've missed a subsequent 25% gain.

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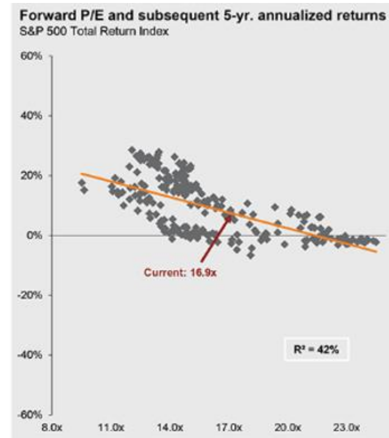
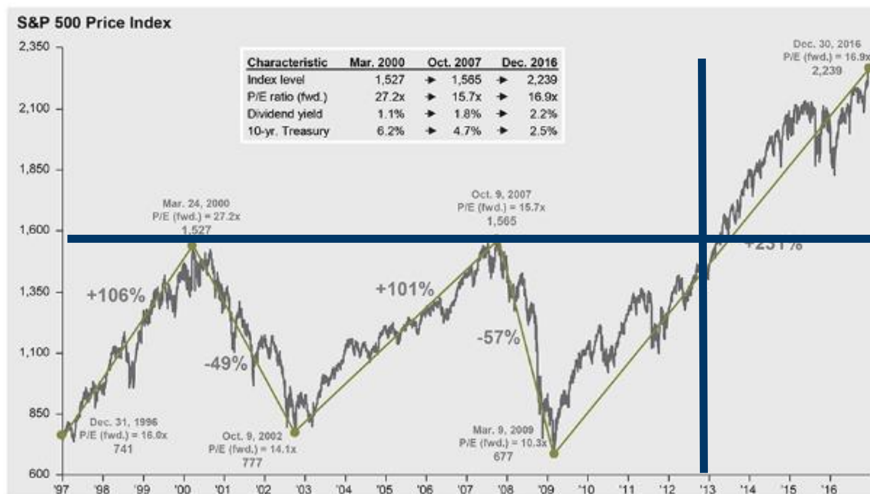


- **Valuations are high, no doubt about it, but since 1990 the S&P 500 has traded above it's historical average (as measured by the CAPE ratio) for 307 of 324 months – that's 95% of the time.** If you'd abandoned stocks during those times, you would've missed 1,000% gain. Future returns might be lower, but that doesn't mean they will be negative.
- Bonds might be slated for a bear market, but what does that actually mean relative to a stock bear market? **Consider 1941-1982 when rates rose from 2% to 15%. The worst year for bonds was -5.01% in 1969**. The second worst year was -3.0% in 1980.
- Is the bull market really that long? It depends where you start. Everyone measures it from 2009, but a bull market doesn't have to start at the previous bottom; it's typically **measured from the break-out of the prior bear market trading range, which recently is April 2013. If that's the case, there is a lot of room to run.**



Characteristic	Mar. 2000		Oct. 2007		Dec. 2016
Index level	1,527	→	1,565	→	2,239
P/E ratio (fwd.)	27.2x	→	15.7x	→	16.9x
Dividend yield	1.1%	→	1.8%	→	2.2%
10-yr. Treasury	6.2%	→	4.7%	→	2.5%

Big picture, what does that all mean? In our view it means that the market could continue moving higher, and even if there is a drop, it's difficult to predict why and when. You play defense by being diversified. Yes, bonds do still have a place in portfolios, and looking beyond traditional asset classes that can provide positive performance and income no matter the market environment is essential.

Canal's Portfolio Positioning

Optimism, high cash levels, pro-growth policies and continued low interest rates have continued to the push the market higher as we have come into the New Year. That said, we are cognizant that we are late in the party. While volatility will most likely pick, as long as what we know about the market hasn't changed, we must remain positive and stay the course. That said, the opportunity set for returns must continually broaden past what has been the only game in town for some time: US Stocks. With signs pointing to historically lower but positive returns, we must focus our portfolios to capture diverse sources of return. As we begin 2017, our positioning is as follows:

- **US Stocks**: Remain overweight with higher premium on sector and stock selection as correlations have come down and potential Trump policies could create clear winners and losers. Specifically we are focusing on:
  - High Quality companies with strong balance sheets and the ability to generate cash and grow earnings no matter the market environment.
  - Financials – Because of deregulation, lower tax rates and rising interest rates.
  - Energy – Deregulation and domestically focused policy initiatives.
  - Industrials – Increased spending on defense and infrastructure.
  - Small Caps – Strong dollar and lower tax rates
- **International Stocks:** Continually adding to our allocation, focusing on:
  - European blue chip companies – One of the few places around the world where you can get high quality, high yielding companies at attractive prices.
  - Emerging Markets – Economic growth and earnings have started to rebound but stock prices have lagged.
- **Fixed Income:** Underweight in our allocation with an aim toward:
  - Limiting duration – Less sensitivity to interest rate movements
- **Non-Traditional:** Overweighting our allocation with a focus on:
  - Finding alternative sources of income: Real Estate, Direct Lending, etc..
  - Private & Public Infrastrucutre
  - Strategies that can take advantage of global policy divergence and volatility.

DISCLOSURE: Past performance is no guarantee of future results. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than original value. These investments may not be suitable for all investors, and there is no guarantee that any investment objective will be obtained. All indices are unmanaged and investors cannot invest directly in an index. Unlike investments, indices do not incur management fees, charges or expenses.

Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. The purchase of bonds is subject to availability and market conditions. There is an inverse relationship between the price of bonds and the yield: when price goes up, yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. Some bonds have call features that may affect income. Treasury bonds are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, they offer a fixed rate of return and fixed principal value. U.S. Treasury bonds do not eliminate market risk.
The precious metals, rare coin and rare currency markets are speculative, unregulated and volatile and prices for these items may rise or fall over time. The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.