



300 Preston Avenue, Suite 500  
Charlottesville, VA 22902-5096  
Phone: 800-293-9104  
Fax: 434-293-9002  
www.chaseinv.com



**Peter W. Tuz, CFA**  
President &  
Senior Security Analyst

## Outlook for 2017

December 30, 2016

The week between Christmas and New Year's is, to many, a time of reflection and prediction: reflection on what worked and didn't in the year that's ending and predicting what could happen next year.

First what worked - Stocks of almost all types in 2016, but not without a rocky start. Oil too.

The S&P 500 lost 11% from January 1 (2043.94) to February 11, 2016 (1810.15). The oft-heard technical indicators (the first five days of January, the entire month of January, etc.) boded ill for the full year. However, due in large part to continued talk of low interest rates by the Fed, markets stabilized and spent most of the year between 2000 and 2200. Then the November election occurred and, as anybody with a pulse knows, markets reacted well to the Trump victory and the message of lower taxes and regulation and greater economic growth that it conveyed.

Through December 28, 2016, the S&P 500 was up 12.5% and the Dow Jones Index 13.8%. The index numbers belie a big reversal of 2016 versus 2015. This is the tremendous outperformance of "value" stocks versus "growth" stocks. Through December 28<sup>th</sup>, the Russell 1000 Value index was up 17.7% versus a 7.8% gain for the Russell 1000 Growth index. Much of the difference has to do with the tremendous performance of financial and energy stocks in 2016. The groups make up higher weightings in the value index than in the growth index. The value vs. growth difference this year compares with a 9.5% difference with growth outperforming value last year.

What also worked to a great degree was oil with the price of a barrel of West Texas Intermediate up 45% from its December 2015 closing price of about \$37 per barrel. In addition, the SPDR<sup>®</sup> Gold Trust is now up about 8.5% year-to-date. Earlier in 2016 it had been up 29% but has sold off since.

What didn't work – Bonds. Although yields have risen substantially since the 10-year interest rate reached its low in July, bonds are flat year-over-year with yields of 2.47% today versus 2.27% on December 31, 2015.

As always, what the stock market might do in the coming year draws forth all sorts of statistical insights.

One we read this week, courtesy of CFRA's Outlook 2017 publication details the difference between first year market performances of new Republican presidents versus their Democratic counterparts. CFRA states that "Since WWII, the S&P 500 dropped an average of 2.7% during the first year of a new Republican president's term in office. In addition, the newsletter adds "the S&P 500 declined in price in four of five of those times." Under the six new Democratic presidents over the same time frame, market's rose 13.7% and gained in price 83% of the time."

Like all statistics, these should be taken with a grain of salt – 11 observations do not provide enough data to draw accurate conclusions. Secondly, the bump up in the market since Election Day probably influences the action of next year's market.

More concerning, earnings estimates have yet to catch up with the market's appreciation. As of December 22<sup>nd</sup>, analysts were expecting the S&P 500 to post aggregate 2016 earnings of \$120.57 per share. This puts the market at 18.7x 2016 earnings (December 27<sup>th</sup>). Next year's consensus estimate calls for growth of about 9% to \$131.39 in earnings. This puts the market at 17.1x earnings. Last year at this time, the S&P 500 sold for 16.3x the \$125.86 consensus estimate at that time. Today's valuation is not unreasonable given the depressed earnings that energy stocks continue to have this year, the boost that earnings of financial stocks could get due to rising interest rates and the overall boosts companies may get from lower tax rates and a stronger economy. It does not take into account the headwind the strong dollar is causing many large U.S. domiciled multinational companies.

More so than in recent years, there is more to worry about as we enter 2017.

Probably high on everybody's list is the new Trump administration's economic and tax policies.

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Markets are anticipating pro-growth policies coming forward as 2017 unfolds. Lower tax rates on individuals and corporations are undoubtedly good news, as is the likelihood of more business friendly regulation. The prospects of higher budget deficits, higher interest rates, higher inflation, tariffs on imported goods and business unfriendly jawboning on various corporate actions isn't. The really scary stuff involves unpredictable foreign policy issues.

Most people hadn't heard of the Spratley Islands 2-3 years ago. Yet they are becoming a hot-button issue between China and the rest of the world as China builds up and militarizes them. Taiwan may become a contentious U.S.-China issue going forward as well. China's president, Xi Jinping, comes up for re-election next year. The Wall Street Journal said he's been looking at ways of keeping power beyond his normal term and is using Vladimir Putin as an example.

Although the vote to leave occurred months ago, the full impact of Brexit on either the United Kingdom's economy or Europe's is now unfolding. Nor have we seen the end of the European banking crisis. One of Italy's oldest banks is teetering on the brink of insolvency as this year ends. As the 2007-09 banking crisis here demonstrates, banking crises are rarely confined to one institution and have a way of spreading into non-bank companies as well. Several European elections next year could clarify whether the Eurozone will stabilize or see more countries choose to go it alone as England has done.

Although not the power it used to be, Russia and its leader Vladimir Putin remain unpredictable.

OPEC and other oil producing countries have agreed to cut production – a move that starts in a few days. Whether it sticks and boosts oil prices or collapses and sends oil prices back to the \$40's will be interesting to watch. The Mid-East generally remains a tinder box and, as always, some conflagration could occur there that could drastically raise oil prices.

There is a lot to be hopeful about here as well.

Lower tax rates could put more money in both U.S. consumer and corporate pockets. On the corporate side, so could a significant repatriation measure for foreign profits. A long-awaited massive U.S. infrastructure measure could boost employment and, ultimately, productivity. The regulatory pendulum may swing back towards moderation from years of overregulation.

Although we generally let our investment process guide us into which stocks and sectors to own, it is worth thinking about what might be the big drivers of the major sectors going forward.

**Consumer Staples:** Things generally go better for Coke, and Pepsi, and Procter & Gamble, etc. in softening economies and less well in expanding ones. Big U.S. consumer staple companies are hurt by a strong dollar. The best stocks will probably be those of companies undergoing restructuring

**Consumer Discretionary:** The pocketbooks of the American consumer could be fatter by year-end but the "Amazon" effect is continuing and retailers will have mixed results in adapting to it.

**Energy:** The group has rallied on higher prices for oil and natural gas but the key question is does the recent OPEC/Oil producer agreement work and keep prices rising?

**Financial Services:** Rising rates are clearly a positive for the U.S. banking and insurance sector to a point but flatter yield curves and underwater bond portfolios offset this. The group has moved the most since election day and financial results will have to improve significantly to justify the stock prices.

**Health Care:** This group seems to be the ultimate political football now, and has few friends either on Wall Street or in Washington. The winners are, as always, those with amazing new disease treatments.

**Industrials:** As with consumer staples, a strong dollar hurts large U.S. exporters, but they are more helped than hurt by a stronger economy.

**Materials:** Like industrials, helped by a strong economy, especially China's.

**Real Estate:** The newest S&P sector is affected by U.S. economic growth and interest rates. As with utilities, rising rates generally have a negative correlation with real estate stock prices.

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**Technology:** It is hard to make a generalization about such a strong sector but it is safe to say the “cloud” continues to grow, security issues do not go away and the trend towards the “internet of everything” continues to grow. The winners and losers tend to be very company and product specific.

**Telecom:** The big ones like Verizon & AT&T have been moving into content; T-Mobile and Sprint have been causing havoc with pricing. We expect more of the same in 2017.

**Utilities:** So go rates, so go utilities in the opposite direction.

Over the long-term, it has always been better to be an owner of stocks than any other asset class (per Ibbotson SBBI) and we’ll guess this remains true in 2017 as well. That’s not to say bonds, real estate and cash aren’t important assets to consider as well. As always, we’re happy to discuss your portfolio, asset allocation and other investing concerns at your pleasure.

Warm regards for a happy and healthy 2017,

*Peter W. Tuz, CFA*

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President

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The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividends.

The Russell 1000<sup>®</sup> Value Index is an index of approximately 1,000 of the largest companies in the U.S. equity markets, the Russell 1000 is a subset of the Russell 3000 Index. The Russell 1000 (maintained by the Russell Investment Group) comprises over 90% of the total market capitalization of all listed U.S. stocks, and is considered a bellwether index for large cap investing.

The Russell 1000<sup>®</sup> Growth Index contains those securities in the Russell 1000<sup>®</sup> Index with a greater-than-average growth orientation. Companies in this index tend to exhibit higher price-to-book and price-to-earnings ratios, lower dividend yields and higher forecasted growth rates.

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Index performance is not indicative of fund’s performance.

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