Predictably Unpredictable

The contrast could not have been more stark; in the third quarter we noted how uneventful that period was, there were no large market implicating crises, no booms nor busts. Markets moved higher on the thesis that no news was good news. Fast forward to the fourth quarter of 2016 and the situation is remarkably different. The Republican sweep of the House of Representatives, the Senate, and Donald Trump's ascension to the Office of the President, provided the singular talking point for the closing eight weeks of the year. There are many questions around the next four years, from the economy to taxes, foreign investment, Obamacare, and foreign policy. The markets have weighed in on the election of Trump to the Presidency, offering mixed results, the returns are early but instructive.

The U.S. Federal Reserve (Federal Reserve) chose to raise their overnight lending rate target band by 25 basis points in mid-December. The Federal Reserve has long been seeking the opportunity to normalize rates after taking them down to near-zero in 2008, and they have begun the resetting process. A secondary concern to the Federal Reserve, and indeed bond holders, is that the infrastructure "commitments" of the President-Elect total roughly nine-hundred billion dollars per year for a decade. Adding on that level of stimulus to the eighteen trillion dollar U.S. economy suggests that inflation could be on the horizon. Fixed income markets have softened on the back of the Federal Reserve taking short-term rates higher combined with the specter of inflation. A five-year U.S. Treasury bond offered an all-in yield of 1.18% to start the quarter, at the end of the year those bonds fell in value to offer a much higher 1.98%. Ten-year U.S. Treasuries experienced a similar move, rising from 1.46% to 2.34%. Despite the lack of action, and the lack of projected action, from the Bank of Canada, Canadian bondholders shared a similar fate to their American counterparts. The five-year Canadian Treasury bond rose from 0.62% all-in yield to 1.11%, while the ten-year Treasury moved from 0.99% to 1.72%. Fixed income markets loathe both uncertainty and even the suggestion of inflation.

Uncertainty was not limited to bond investors. Investors in the S&P500 Index saw a modest loss in the pre-election period, down 1.3% from September 30th to November 8th. Seeing some money taken off the table before a significant event is not uncommon, and predictably the intra-quarter lows were seen on November 3rd and 4th, with neither candidate showing a controlling lead in the polls. On election night as the red tide swept across television screens the futures markets began to sell off significantly, dropping more than seven percent. And then a most curious thing happened. As Americans awoke, their markets had regained most of that lost territory, by the closing bell U.S. markets closed up. The U.S. markets were up over 1%, and the U.S. dollar had risen 2.5 cents against its Canadian counterpart. The S&P 500 Index added 4.6% post-election, more than erasing the pre-election loss. The news might have centred on the U.S. election, but not everything that was newsworthy seems to have been reported upon.

The Canadian market was also higher on the 'Trump effect', adding 3.6% after the U.S. election to finish up 4.5% in the quarter and 21% for the year. The S&P/TSX Composite Index was the top performing developed market for the year. The Index was boosted by a significant run in the price of a barrel of oil, which began the year at US$37 per barrel before slumping to a February low of US$26 and finishing the year topping US$50. Gold traded substantially higher for most of the year, starting the year at US$1076 per ounce before settling back in at US$1160 to close the year. Stronger commodity pricing provided a boost to bank balance sheets, as the Canadian banks are the largest financiers and debt-holders for Canadian producers. The 'big five' Canadian banks saw fit to collectively raise their dividends a total of ten times, an important metric for financial health as well as a bonus to shareholders.

Although the Canadian dollar weakened by approximately 3% against major currencies other 'risk' markets delivered excellent returns in 2016. High yield bonds as measured by the iBoxx USD Liquid Index returned 12.2% after adjustment to Canadian dollars. Emerging markets have not been top of mind for investors in recent years but 2016 produced a respectable return of just under 8%, potentially paving the way to better things to come. The U.K. markets, while not traditionally considered a 'risk' market, delivered 9.8% returns after the Brexit vote, adding 14.4% for the year. While the U.S. election, rising interest rates, euro country solvency, Russian interference and Britain's defection may have been the headline grabbing news for the year, buried in the back pages was the quiet celebration of an excellent year for the holders of balanced portfolios.

Although 2016 was not a "straight line" for returns, and it never is, it was one where equities added value to portfolios. Recall late 2015 when investment sentiment was stacked against Canadian equities and firmly in favour of U.S. equities. Instead Canada rebounded from a loss of 11% to increase 21% (dividend stocks up 24%), the S&P 500 delivered a 9.5% return (6.5% in C$), and only the MSCI EAFE was essentially flat (-2.0% in C$). Managing investments requires an unemotional focus on value, holding quality companies, with a consistent overlay of risk management. We focus on investing in companies, not countries, and as the market was climbing the wall of worry surrounding the headline grabbing news, we were unfazed.

The simplest advice might be this then, the best approach to unbalanced times remains a balanced one. Bonds have sold off, perhaps making them relatively cheap for new investment. Perhaps in 2017, Europe will be the Canada of 2016, so work should be done to look for global companies that are unloved. The proliferation of opinion masquerading as news, and bias dressed up as analysis, has sent the value of independent, unbiased advice to a generational high. The world is imperfect, and markets may become cheap or dear, in which case the prudent investor will buy or sell their portfolio back to their targets. Market moves need not be feared, they represent a chance to rebalance and de-risk portfolios.