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CAPITAL MANAGEMENT LLC

QUARTERLY COMMENTS
4th Quarter 2016

4th Quarter 2016: The Bonfire of Consensus

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What a year we had in 2016! As a group, experts and prognosticators across the political and investing realms have never been so spectacularly wrong about so many things. Here is just a short list of some of the more confounding events of last year:

- U.S. stocks delivered flattish returns in 2015, and began 2016 with their worst start to a calendar year in history. The S&P 500 crumpled by 11% between New Year's and mid-February, leading many strategists to warn of further declines. Stocks turned on a dime and began their recovery in March. After marking time leading up to the election, the market ramped into year-end to finish 2016 solidly in positive territory.

- Oil and commodity prices plumbed new lows in early 2016, feeding investor fears of deflation and widespread credit defaults in energy sector bonds. But after dipping below $30/barrel in January 2016, oil prices stabilized and closed the year north of $50/barrel. High yield bonds – a category heavy in the debt of energy and commodity-related companies – returned more than 15% and were the best-performing asset class in the market last year.

- In June, UK voters astonished political pundits everywhere by voting to leave the European Union. Global stocks sold off hard for all of 48 hours as investors fretted about the short- and long-term implications of "Brexit." Stocks regained all of those losses and more, staging new all-time highs within two weeks.

- The U.S. Presidential election results were the very embodiment of a surprise. None of the major polling services predicted a win by Trump, and almost all media commentators refused to seriously entertain the possibility that Mrs. Clinton might lose her bid to become the first female U.S. President. To the extent that investment strategists opined on the election at all, they prophesied that a (very) unlikely Trump victory would kick off a significant fall in stock prices and a decline in Treasury yields. Of course, exactly the opposite occurred. Trump won, stocks gained, and Treasury yields rose.

- Interest rates flummoxed basically everyone in 2016. The 10-year US Treasury yield started the year at 2.3%, before sluggish economic data and lower inflation statistics drove yields down to a multi-generational low of 1.39% in July. Then rates reversed course as the economy appeared to improve and inflation began to perk up. Yields ramped to close the year out at 2.5%. For the full year, the net change in 10-year yields was a modest increase of .2%, but their path along the way was as circuitous as markets have ever seen.

> "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."
>
> \- John Maynard Keynes
> *The General Theory of Employment, Interest, and Money*

Last year showed us lots of examples of events straying from consensus expectations. But should this be considered "surprising" at all? Probably not. Note that those who make their living predicting markets or election results generally rely heavily upon their reputations to further their careers. When making their forecasts, they are naturally aware of their peers' projections. The farther their forecasts vary from those in their cohort, the bigger the risk that they will look spectacularly wrong compared to everyone else. Obviously, for someone in the business of making predictions, being dead wrong can be disastrous to one's professional reputation. Therefore, experts in a variety of fields tend to exhibit "herding" behavior, in the sense that their predictions and observations tend to be relatively similar to one another. As an investor, being aware of this tendency can help one avoid the perils of consensus thinking.

Barron's 2017 Analyst Forecasts

As of 12/16/2016 >> S&P 500: 2,258 | S&P 500 Op EPS: $108.95 | 10 Year Trsy Yield: 2.60%

Analyst	Firm	Year-End 2017 S&P 500	Implied % Chg from 12/16/16	GDP Growth 2017	S&P EPS 2017	Implied S&P 500 Op EPS % Chg in 2017	10 Year Trsy Yield
Stephen Auth	Federated Investors	2,350	4.1%	3.00%	$130.00	19.3%	3.00%
Jonathan Glionna	Barclays Capital	2,400	6.3%	2.20%	$127.00	16.6%	2.40%
Jeffrey Knight	Columbia Mgmt	2,450	8.5%	3.00%	$135.00	23.9%	2.90%
Heidi Richardson	Blackrock	2,400	6.3%	2.40%	$127.00	16.6%	2.75%
David Kostin	Goldman Sachs	2,300	1.9%	2.20%	$116.00	6.5%	2.75%
Dubravko Lakos-Bujas	JP Morgan	2,400	6.3%	2.10%	$128.00	17.5%	2.55%
Tobias Levkovich	Citi Research	2,325	3.0%	1.80%	$129.00	18.4%	2.60%
Adam Parker	Morgan Stanley	2,300	1.9%	2.00%	$128.70	18.1%	2.50%
John Praveen	Prudential Intl.	2,575	14.0%	3.00%	$122.20	12.2%	2.75%
Savita Subramanian	BofA Merrill Lynch	2,300	1.9%	2.00%	$129.00	18.4%	2.65%
Average		2,380	5.4%	2.37%	$127.19	16.7%	2.69%
Median		2,375	5.2%	2.20%	$128.35	17.8%	2.70%

Source: Barron's Magazine; December 19th, 2016 issue

The Barron's poll of Wall Street strategists' forecasts for 2017 provides a good snapshot of consensus expectations for the year ahead. Note that only one out of ten is willing to vary much from the herd in their prediction for the S&P 500 index. The rest of the strategists are clustered in a comfortable herd that expects modest, single-digit upside for the broader market this year. The strategists' expectations are similarly herded in reference to GDP growth, S&P 500 earnings, and the yield on 10-year Treasuries.

Our main takeaway from this table is that we should not be surprised to be surprised in 2017, at least relative to the experts' projections. For example, the average and median expectations for the S&P 500 indicate a gain of approximately 5% for the full year.

The strategists could be right in expecting low returns for the S&P 500 this year, but history is not on their side. Since 1901, there have been only 12 calendar years in which the S&P 500's return has ranged

S&P 500 Price Only Annual Returns

>	<=	# of Years
-48%	-42%	1
-42%	-36%	2
-36%	-30%	2
-30%	-24%	2
-24%	-18%	3
-18%	-12%	9
-12%	-6%	10
-6%	0%	10
0%	6%	12
6%	12%	12
12%	18%	18
18%	24%	12
24%	30%	12
30%	36%	5
36%	42%	4
42%	48%	2
	TOTAL YEARS	116

between 0% and +6%. There have been 10 years in which the S&P 500 fell between 0% and -6%. Putting those two figures together, the yearly S&P return has been between -6% and +6% 22 times since 1901, or roughly 19% of the time. The other 81% of years have seen bigger price moves for stocks, with a bias to big "up" moves. Stocks have risen more than 12% in 53% of years, while they have fallen more than 12% in only 16% of years.

From our perspective, the odds favor a decent-sized move for stocks in 2017, with the trillion dollar question being one of direction.

Factors that we think are supportive of a continued bull market in stocks this year include the following:

- Love him or hate him, President-elect Trump will be coming to office with a pro-growth agenda. If he is able to execute his proposals to cut corporate taxes and increase infrastructure spending, corporate profitability and the growth rate of the economy are set to improve.

- Even before the presidential election, there were positive signs emerging in the economy. Manufacturing has rebounded, we are at near full employment, wage growth is improving, and the housing market continues to recover.

- Inflation is firming. While there is definitely "too much of a good thing" when it comes to inflation, it is much preferable to deflation. Falling or stagnant prices send negative signals to markets, and they tend to slow down consumer and corporate spending decisions. Why buy something now if the price will be the same – or lower – tomorrow? Continued reflation of prices for goods and services will most likely be received favorably by investors.

- After hovering for years at extremely low levels, interest rates appear to (finally) be normalizing. Moderately higher rates are a positive for most financial services companies, and they also help savers and investors.

"Thank God! A panel of experts!"

- Investor sentiment has improved meaningfully over the past twelve months. We think this is important. Nasty memories of the financial crisis do not fade easily, and most investors have been cautious or even outright skeptical of stocks for several years now. As long as investors do not become too exuberant, rising bullish sentiment is likely to be a tailwind for stock prices this year.

There are also some headwinds to consider for 2017:

- Stocks are not cheap. The S&P 500 trades at more than 21 times trailing earnings. On this basis, stocks are more expensive on average than they have been in 90% of all prior periods. Looking ahead, the S&P trades at 17 times analysts' estimates for the next 12 months, which is above the historical forward multiple of 15 times. Stocks are also relatively expensive on a price-to-book and price-to-sales basis.

- If history is any guide at all, President Trump will experience some speed bumps as he seeks to institute his preferred policies. Even though he has a Republican congress to help him, many of those Republicans are not in his corner. Therefore, he is likely to run into difficulty selling big tax cuts and higher fiscal spending, to say nothing of repealing and replacing the Affordable Care Act. To the extent that these changes take longer or end up being diluted, investors could be disappointed.

- Although we think a moderate increase in interest rates is a net positive for the economy and investors, there could be some negative side effects. Ultra-low rates over the past several years spurred some investors to allocate more capital to stocks. But if bond yields rise enough, they begin to offer more competition to equities.

All in all, we approach this year with cautious optimism on the economy and the markets. We think it likely that economic growth will improve to some degree over the course of 2017. Stocks are not cheap, but bull markets generally support higher valuations. Corporate earnings have been generally disappointing for several years now, but potentially lower taxes and a resurgence in Energy and Financial sector profitability could finally help S&P 500 earnings meet or beat analyst expectations. Finally, roughly half the country is less-than-enthused with the prospects for the Trump presidency. This is not unlike the sentiment that greeted President Obama after the 2008 election. To the extent that Trump proves to be more competent and less disruptive than many people expect (again, just like Obama did after his own inauguration), he could represent an "upside surprise" for investors.

Happy New Year!

Norm Conley

Looking Ahead to 2017

- Valuation is still elevated. Not a catalyst but worth noting.
- Investor sentiment was sour most of 2016, but that is not the case anymore.
- People are expecting big, quick results from Trump. History argues against that outcome. Washington has a tendency to slow everything down.
- Many people, especially Republicans, expect the market to perform well under Trump. Previous instances are not promising.
- Regardless, year 1 of presidential election cycle returns is the worst. Why? Because year 1 is characterized by changes in legislation that are never uniformly popular. Year 3 is the best. Why? Because by that time, Presidents have generally accomplished most of their agenda, at least the parts they are able to push through Congress. Less change = better returns for stocks.
- Have low expectations for 2017. But stay invested and opportunistic. Longer term, Trump policies could be good for economy and markets. Cash returns are still miniscule. Bonds are ok – better than most think, especially as a diversification tool in a portfolio. Plus, as we saw last year, sometimes it pays to expect the unexpected!
- Big correction is probably not in the cards, but would be a buying opportunity if it occurred.

Disclosures

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