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Fourth Quarter 2016 Commentary

Rotations, The Unimaginable, The Unpredictable and Surprises.

2016 was a difficult year for growth investors. By contrast, small cap stocks gained 18% after Election Day, an indication that appetite for risk might be returning. Large and mega-cap growth stocks spent the year correcting which was non-productive for holders of growth stocks. Investors had little appetite for risk assets during much of 2016. It started during the first two months of '16 when the NASDAQ corrected 19%. After that, investors rotated out of growth stocks into safe, conservative plays like telecoms, utilities, which in turn became expensive. Investors avoided Treasury bonds ahead of the rate increases the Fed promised. Also, the economy was bumping along at a subpar 2%. Some thought the market selloff in early 2016 foreshadowed a recession. Much to worry about…

The outperformance of big cap growth stocks during the seven-year bull market was seen as part of the problem, viewed as victims of their own success. Growth stocks rose dramatically during that time. Facebook was a 2012 IPO. From July 2013, through October 2015, the stock rose 240% to $110.65. Facebook rallied to $133.50 in October just before the Election. Investors sold the rally and Facebook was not alone in this. Facebook rose 9.9% for the year after, being up as much as 27.6%, closing at $115.05, 13.5% off its 2016 high. The stock ended the year in the midst of a 13-week correction.

On Election Day, with the Trump victory, the S&P 500 futures dropped 1000 points overnight. However, stocks rallied the next day and continued for a month. After the Election, the Dow led. Two Dow components, Goldman Sachs and J.P Morgan Chase, led the way. A laggard for years, Chase rose 32%. Goldman rocketed 32%. Historically, the Dow has been a lagging index, not one to lead robust market moves. Media coverage focused on Dow 20,000, which hasn't happened yet. However, the NASDAQ has made a series of all-time highs. NASDAQ strength should be good for client portfolios. Stocks held in portfolios make up 24.5% of the composite. The strong performance of the NASDAQ, along with the nascent leadership among financials, augurs well for growth stocks. Growth stocks lead when they can capitalize on something new. For the financials, it's reduced regulation along with lower taxes and prospects for increased lending. Financials also thrive during periods of robust economic growth which recent indicators suggest are beginning to materially improve. Jason Trennert remarked that the Obama years were good for markets but it was "a decade of indifference" toward equities and "hostility by Washington." It was a "joyless bull market" and equities were under-owned. The election loosed "animal spirits," a term coined by John Maynard Keynes. The idea is that companies' confidence fuels investment and spending which creates jobs. The NFIB small business optimism index shot up to 105.8 in December, the best reading since 2004. The 7.4 point increase was the biggest gain in decades. With that kind of positive news, it's likely that growth stocks will lead the next market uptrend.

For 2016, portfolios underperformed the major indexes. Post-election, investors sold growth stocks and rotated into out-of-favor financials, cyclicals, materials and small caps. The end-of-the-year corrections in portfolio stocks were contained, in a range of 12-15%. Despite these modest setbacks, Apple, Amazon, Tesla, Netflix, Priceline and Facebook remain in longer-term uptrends.

For 2017, with the expectation of an improving economy and a strong market, I am sanguine because similar conditions in the past have promoted robust gains in growth stocks. While painful, corrections and back and forth action are useful and set the stage for new uptrends. Last year, the market was very volatile and experienced several instances of cluster distribution which put the market under pressure repeatedly. When the market corrects, growth stocks can perform worse by as much as 2.5 times the market drops. Among the weakest groups in 2016 were biotechs. Biotechs' rallied right after the Election but started down anew over potential restrictions on pricing. Biogen hit bottom in July after declining continuously during the first half of the year. It rallied 20% in the week after the Election only to drop 17% through year end. On a more positive note, Biogen and other biotechs have become inexpensive and they continue to innovate, discovering life-changing treatments for a variety of serious medical conditions. The cloud is one of the most promising areas of growth for both businesses and stocks. Far and away the biggest player is Amazon which is changing the way people shop. Alibaba is another successful online retailer. Other cloud beneficiaries in client portfolios are Adobe and Seagate. The latter also pays a substantial dividend. The future also looks bright for Tesla which manufactures electric cars and batteries. Netflix recently put up very strong subscriber numbers and analysts have recently concluded that competitive threats are not as potentially damaging as previously thought. Throughout 2016, analysts worried that content acquisition costs would seriously damage Netflix's price appreciation potential. While many have questioned Apple's ability to innovate, recent quarterly results, the strength of the iPhone 7 and 7+, along with the forthcoming iPhone 8 promise a bright future for the smartphone company. When markets are strong and certain, quibbles fail to impact stocks. But when things are very uncertain, as they were in 2016, little concerns become big problems for stock prices.

One of the most important elements of individual stock performance is the current condition of the major market indexes. Stocks have trouble advancing consistently, especially highly valued growth stocks, when the market is challenged by global turmoil, economic uncertainty, and the surprising election results. From November 7, a day before the election, through year end, the NASDAQ was up in 23 of 38 sessions. During that time, the NASDAQ made a number of new highs. If the NASDAQ leads, that is promising for portfolio companies. As was the case with Netflix in October, if portfolio companies report strong earnings, then expect to see these companies lead again. The plan for 2017 is to continue to own innovative companies, to hold stocks of companies that are changing the way we do things like shop, or turnarounds like Freeport, which are likely to benefit from improved economic conditions.

John Preston
Sr. Vice President & Portfolio Manager