CRIBSTONE
CAPITAL MANAGEMENT

Fourth Quarter Newsletter

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New Year's celebrations are over, yet it's hard not to continue our reflection on how much took place in the course of just the last twelve months. Although the term has been in use since the ancient Sumerians, a calendar year is still an arbitrary measurement of a period of time. Yet it's the way we define the events that shape the course of our lives. In that regard, we think of 2016 as the year that no one could have predicted—not even the pollsters.

What about that correction?

Recall that 2016 began as one of the worst ever in the history of the stock market, with the first two weeks of January alone down about 6%. Things were looking so bleak at that point that the market continued to slump into a classic 10% correction by mid-February. Oil prices collapsed further to about $26 (from a high of over $100 in 2014), and the Chinese economy—the world's second largest—seemed more and more likely to be headed toward a hard landing, driven by a falling currency and capital outflows. Surely this was going to threaten the fragile US economic recovery and keep a lid on stock market performance?

Not so—the correction was short lived and the market rallied back. Stock market valuations by most measures closed the year at or near all-time highs. That was in spite of the fact that US economic growth remained elusive and earnings for US companies continued to falter for three of the four quarters in the year. Even the uncertainty resulting from the surprise outcomes of both the UK vote to leave the European Union and Donald Trump's Presidential victory failed to derail the US stock market.

Where we go from here

So far, stocks have caught a tailwind as 2017 gets underway. Several key economic indicators, as well as corporate earnings, have also turned upward, providing some support to equities. Wage growth is picking up, consumer confidence remains high and the industrial and manufacturing sides of the economy are finally moving in the right direction

Corporate earnings comparisons turned positive—albeit modestly—in the third quarter of 2016 for the first time in six quarters. The other boost to stocks has been driven by the expectation that many of Trump's campaign promises aimed at juicing US economic growth will be passed into legislation and will lead to a higher growth path for the country. These include regulatory rollbacks, lower corporate taxes and a whopping one trillion-dollar infrastructure spending bill.

Interest rates were on the rise even before the election, as it became apparent that the Federal Reserve had the data they needed to justify a rate hike (they hiked the fed funds rate 0.25% in December and promised three more in 2017). From a low of around 1.4%% in July, 10 year US Treasury rates inched up to 1.79% right before the election. Now they hover around 2.5%. Bond prices have been hit, as have other interest rate sensitive securities like real estate investment trusts, utilities and high dividend paying stocks like consumer staples.

As you know from reading our prior newsletters and our meetings, we had taken a more defensive stance toward equities. Additionally, we added to areas that we felt would provide not only protection, but a better return if stocks underperformed amidst disappointing corporate earnings. As it turned out over the last eight to nine months, exposure to both fixed income and commodities like gold, and the underweight to equities, have detracted from performance. We believe, however, that markets have likely priced in much of the potential positive outcomes that ensue through a return to what has been affectionately referred to in the media as 'animal spirits.'

While we never want to miss an opportunity, we also want to ensure that we always remain focused on your 'big picture', which very much indeed includes understanding the impacts of risks events like 2008 and 2009. Cribstone apologizes if our returns did not meet expectations in 2016 and we were overly focused on risk management. Hindsight is 20/20, yet based on our current assessment of market valuations, we still believe that the reasons for a cautious stance remain for the near-term.

Volatility Likely to Increase

As always, we are focused on achieving your investment return targets, but doing so with discipline. We also believe that incorporating defensive strategies continue to make sense given the historically high valuations that exist for both US equities and fixed income.

Not only that, but there is tremendous uncertainty underpinning the global financial markets which could spell an increasingly volatile environment for stock prices in 2017. Higher interest rates raises borrowing costs and makes the yield on stocks less compelling by comparison to bonds. In addition, a higher dollar will make US producers less competitive than their international peers and will negatively impact the dollar value of earnings repatriated from abroad. Finally, while the overwhelming consensus view is that Trump's platform will be beneficial to US economic growth and corporate earnings, at this point in time we do not know when or to what extent the new administration's policies will be adopted.

International Markets Could Steal Headlines

Our uncertainty at home surprisingly enough might be surpassed by what occurs in other parts of the globe. Both France and Germany will be voting for their leaders in coming months, and in both cases populist and nationalist candidates are gaining in popularity. Again, any major shifts in economic, social or trade policies only add to the uncertainties that already exist in the financial markets—namely the pace of economic growth. While we find many international and particularly emerging markets equities to be attractive on a valuation basis alone, these and foreign currency risks may add to market jitters.

Tax Time Coming Up

Repealing or reforming Obamacare may be what the new Administration says is their number one priority. However, tax laws are also likely to be high on the list of changes coming our way. In addition to arguing for lower corporate tax rates, the Administration has called for simplifying the income tax code from seven to three brackets: 12%, 25% and 33%. The plan also calls for revising the way deductions and exemptions are taken.

Obviously, nobody can foresee exactly what will transpire politically over the coming months. Nor will any of this impact how we file for 2016. Our message to you is that we are here to help coordinate all of your financial affairs, including tax planning, and we are happy to work closely with you and/or your tax preparer in doing so. We look forward to meeting with you soon. In the meantime, please don’t hesitate to contact us with any questions or concerns.

With warm regards,

Scott Upham, Managing Partner   Odette S. Galli, Partner   John D. Duffy, Partner

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