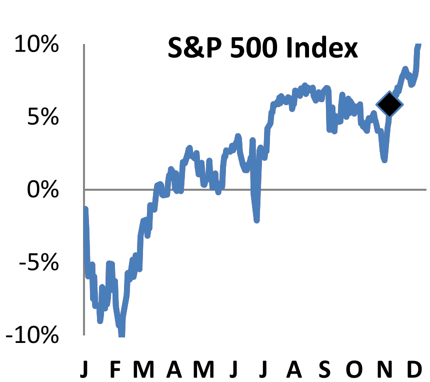
NOTTINGHAM ADVISORS
ASSET MANAGEMENT

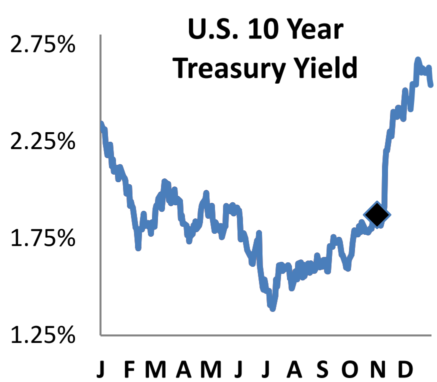
2017: THE NEXT CHAPTER

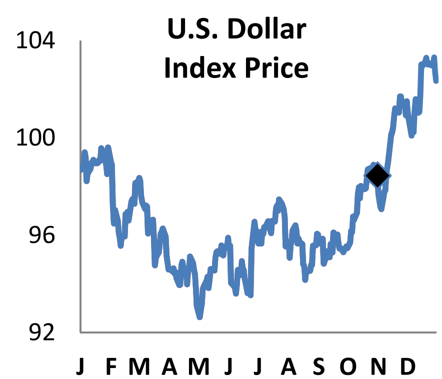
"Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."
-John Maynard Keynes,

2016 was a remarkable year that will be remembered for many things. As we suggested in our last letter, could the Cubs possibly win the World Series? YES! Could the Federal Reserve actually agree to raise interest rates in December? YES! And, most far-fetched of all, could Donald Trump actually win the contest for the Presidency of the United States? Um, yes.

And so, we had the year 2016 pre-November 8th, and the year 2016 (and beyond), post-election day. And what very different worlds they were, and are likely to be going forward. As we roll into 2017, very little of the "new order" is known, much less certain. President-elect Trump has seemingly surrounded himself with well-known, successful business-types, a la Reagan, but as for his actual agenda, much remains to be seen. As terrified as markets were of a Trump presidency pre-election day, there's a positive giddiness in the stock market these days.







S&P 500 Return		US Long Term Fixed Income		US Dollar Index Return	
Jan. - Oct.	5.85%	Jan. - Oct.	10.73%	Jan. - Oct.	-0.90%
Nov. – Dec.	5.74%	Nov. – Dec.	-8.62%	Nov. – Dec.	4.09%
2016	11.93%	2016	1.18%	2016	3.16%

A Brief Review of 2016

Last year was frustrating for investors on a lot of levels, but for valuation-sensitive asset allocators such as ourselves, it was positively maddening. After a swift decline to open the year, equities rallied strongly into the summer and early fall, before pulling back some in the face of a likely Clinton election win. By November 8th, as the charts above show, U.S. equities hadn't done much while international developed markets did even less. And bonds rallied! The U.S. 10-year Treasury note yield reached an all-time low of 1.35% in mid-July, while international sovereign yields from the likes of Germany, Japan and Switzerland dipped into negative territory (-0.19%, -0.30%, -0.70% respectively).

After being swiftly and severely penalized for implementing risk measures in February, Nottingham managed to eke out reasonable returns in a very difficult environment. Much to our chagrin, we didn't own enough of the truly risky (emerging markets) or the truly expensive (U.S. small cap) to beat our benchmarks. Nor did we (much to some of our client's chagrin) own the Dow Jones Index. Then again, I'm not exactly sure who does own the Dow Jones Index! It ended 2016 up 16.4%, largely thanks to a few select stocks in this arcane price weighted index methodology.

Looking at 2016 through the lens of “pre-election” vs. “post-election”, we find unique winners in each, with only energy remaining constant. Utilities, for example, were one of the best sectors through mid-year, up 23%. They proceeded to lose -7% over the balance of the year and were one of the worst sectors post-election. Financials were up only about 1% through early October, before catching a huge election-related bid in November to close up 23%! Such was the sea-change in investor psychology that has occurred since the election.

S&P 500 Sector Returns			
Jan. - Nov. (Pre-Election)		**Nov. - Dec. (Post-Election)**	
Winners		**Winners**	
Energy	13.84%	Financials	16.59%
Utilities	13.30%	Telecommunications	12.74%
Info Tech	10.83%	Energy	8.69%
Losers		**Losers**	
Con. Disc	0.79%	Healthcare	0.93%
Real Estate	-1.30%	Utilities	-0.74%
Healthcare	-5.25%	Con. Staples	-1.69%

As for bonds, the tale of two trades was even more pronounced. Through the first half of 2016, culminating in the shock Brexit vote, bond yields were on a swift trajectory lower. Global political and economic uncertainty was rising, economic growth was uninspiring and investors globally were favoring safety over speculation. And then the Brits decided they no longer wanted to be part of the European Union. Certainly this seemingly rash and short-sighted decision would result in economic chaos and trigger the imminent collapse of the EU. Investors immediately panicked and began selling international stocks, with the FTSE, DAX and CAC stock markets collapsing -6%, -10% and -11% in short order.

And then, for some reason, investors stopped selling and began buying. Animal spirits? Who knows, but European markets began rallying. Perhaps the end of the world wasn't at hand after all. Our guess is that populist fever (which resulted in both Brexit and the Trump election, and to a lesser degree the Italian "No" vote), will remain with us into 2017, and the outcome of this will be difficult to predict.

A similar scenario played out with the U.S. election, which according to the "experts" was a foregone conclusion as early as mid-October. It would be Hillary Clinton of course, running our country over the next 4 years, and with that, likely many of the same policies and initiatives as her predecessor Barack Obama. But to borrow from some sports parlance, that's why they play the game. So much for the experts.

As for us mere investors, or investment experts, we too were largely caught leaning the wrong way. Career risk? Business risk? Common sense? Who knows, but we didn't have the "Trump" trade on going into Election Day. Not many did (little consolation I know).

What we did have correct, to the benefit of our clients, is that the U.S. would outperform international (and so we were overweight U.S. vs. International), and that interest rates would rise (and so we stressed low-duration in all our portfolios). In any other year, getting that right would be enough. Not so in 2016. We still stress valuation as a fundamental driver of our investment decision making process and in 2016, it was valuation be damned, full speed ahead post-election. Borrowing from the future? Perhaps, more than likely. Speculative? You bet. Disappointing when you're not part of the crowd making outsized returns? Certainly. Prudent in the long run? Definitely.

What's in store for 2017

If I were honest and just said "who the heck knows?" my guess is that you might stop reading right here (assuming you made it this far!), and you would miss the happy ending which I always try and promise my regular readers. So let's speculate a little, as it seems everyone else already is.

The next two years promise a 1-party government, dominated by the Republicans, similar to the Democratic sweep in 2008. The Republicans will likely focus on the following: 1) tax reform, 2) repeal/dismantle Obamacare, 3) revise the rules of international trade and 4) infrastructure growth. And if we have to borrow a lot of money to accomplish these objectives, so be it. In theory, all of the above is good for business (and the stock market) and bad for bonds. In theory, since at one point or another I've made par on every hole on the golf course I play on, I might be considered a scratch golfer. In reality, I'm a 16 handicap!

Right now, there's an overwhelming bullishness in the stock market, even as the Dow approaches 20,000 and small caps trade at 28x earnings. As for the bond market, it seems every day brings a new sell-off. Will all this persist into 2017?

As is often the case, things that look or sound easy rarely ever are. Tax reform? Likely by 2018. Infrastructure? There aren't enough shovel-ready projects to make any economic difference over the next couple of years. Repeal Obamacare, and replace it with what? I haven't heard or read about any proposals along these lines. Trade barriers? THEY HAVE NEVER IGNITED ECONOMIC GROWTH OR PROSPERITY.

So, what is it that has investors clamoring for U.S. stocks (or sectors of the U.S. stock market)? Back in 1936, the great British economist John Maynard Keynes published the classic titled <u>The General Theory of Employment, Interest and Money</u>. In it, and as revealed in the opening quote to this letter, Keynes suggested that periodically things happened (i.e. markets rallied or sold off), for no other reason than that “animal spirits” took over, causing people to act in one way or another. Whether based on hope, aspiration, desperation, fear or boredom, animal spirits have proven to be very powerful forces over time. They help explain why overpriced, low-growth markets sometimes rally, while cheap oversold markets can sometimes stay that way for a long time.

If anyone but Keynes had coined the phrase, it probably wouldn't still be relevant. But the man knew what he was talking about and he still remains of the legendary investors of all time. <u>So, the good news is that our current expensive, low-growth market stands a very good chance of going higher in 2017!</u> Despite bond yields nearly doubling from their lows, bonds remain decidedly unattractive for investors with the option to invest elsewhere. Although we've gratefully stuck a fork in the TINA thesis (<u>T</u>here <u>I</u>s <u>N</u>o <u>A</u>lternative to equities), we're not quite sure what comes next. We'll continue to rely on diversification, knowing that although it hasn't paid off for a couple years now, the basic laws of investing haven't changed, and it remains the only free lunch available.

As we look ahead, we're filled with "hopes". We hope that President-elect Trump doesn't follow through on some of his more dubious campaign promises regarding walls, trade wars and personal vendettas. We hope that the President-elect and the Republican Congress can thoughtfully enact a fiscal stimulus program that boosts U.S. GDP growth above 3% per annum. We hope they can do this without materially worsening the US deficit. We hope this translates into corporate earnings growth, and that corporations invest capital in new research and capital equipment, rather than financial engineering. We hope that interest rates trend higher at a very measured pace. We hope for a safe and peaceful year in the U.S., devoid of terrorism and filled with less racial and economic tension. We're hoping for a lot of things. Let's all hope that "HOPE", the main philosophy of the previous regime, becomes less of an ideological strategy, replaced by thoughtful action by a government that needs to remind the American people it remembers how to govern. We all deserve it.

From all of us at Nottingham Advisors, thank you for entrusting us with your hard-earned wealth. Our promise to you in 2017 is that we will continue to manage it with the same care, discretion and prudence as we have since 1981. We wish you all a peace-filled new year.

With hope,

Lawrence Whistler, CFA
President/Chief Investment Officer
January 2017

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