CORBETT ROAD

MACRO MUSINGS

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2016 Market Year in Review

Summary

- A review of MACROCAST™ from last year underscores the importance of maintaining discipline among typical volatile markets.
- Our annual review of major asset classes reinforces the idea that 2016 was a year of "Risk On."

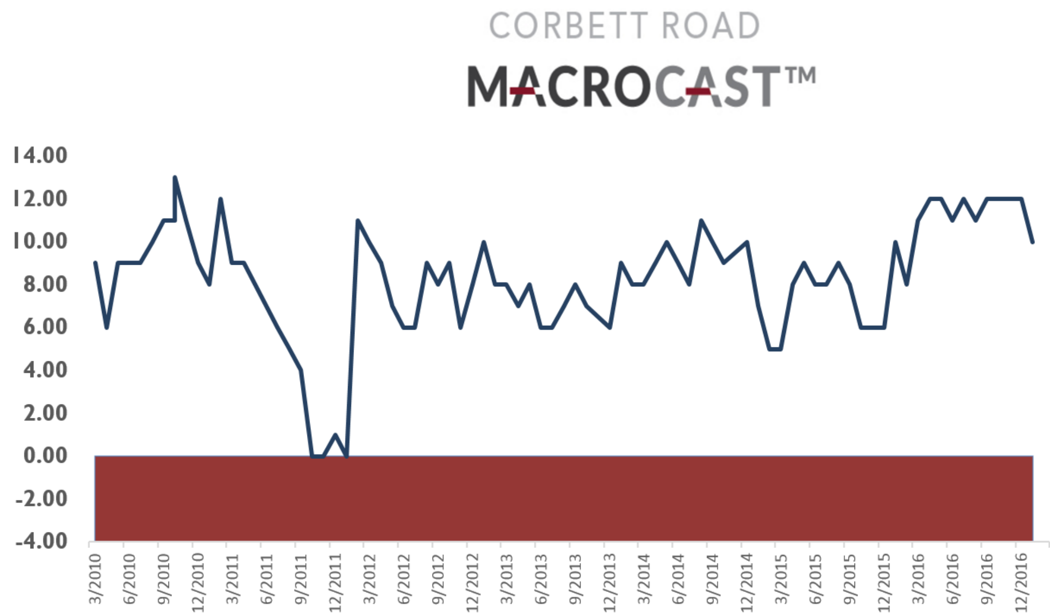
The Message from MACROCAST™

MACROCAST™ was consistently positive throughout 2016. If we go back to the beginning of last year, the market sold off immediately, correcting 14% from January 1 until the middle of February. During this period, our MACROCAST™ score did the opposite, increasing from +6 at the end of December to +10 in January and +8 in February. Despite the volatility and panic, our process suggested that risky assets were still in favor, that the economy was not entering recession, and that the market was likely to rebound.

Stocks went on to rally almost 24% from the bottom through the end of the year.

MACROCAST™ is designed to measure recessionary pressure within the market, rather than typical market declines. History illustrates that it is normal for double digit declines in the market occur nearly every year. This volatility is the price of admission to invest in securities that have higher expected returns. We use our model to assess the chance of major, protracted bear markets. Examples of such markets are the declines of 1973-74, 2000-2002, and the financial crisis of 2008. By potentially avoiding major losses in these type of markets, we can preserve capital and reduce the stress and anxiety of our clients.

MACROCAST™ is Corbett Road's in-house model that measures the attractiveness of risky assets by looking at the **VITALS** of the market—**V**aluation, **I**nflation, **T**echnical Analysis, **A**ggregate Economy, **L**iquidity, and **S**entiment. Through assessment of these factors we can get a better sense of overall market conditions and the probability of a major market decline.



Digging deeper into current conditions, the strength in MACROCAST™ is coming from the 'Aggregate Economy' category. Leading economic indicators are universally positive. The biggest detractors are in the 'Valuation' category, which has been the biggest source of concern for some time now. A current reading of +10, MACROCAST suggests any decline in the near term is not likely the beginning of a major bear market.

ASSET CLASS REVIEW: THE RETURN OF RISK

A look at returns for 2016 suggests a theme of "Risk On," where the poorest performing, most volatile asset classes of 2015 rebounded.

Asset Class Returns

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
HG Bnd 10.3%	EM 56.3%	REIT 31.6%	EM 34.5%	REIT 35.1%	EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%
REIT 3.8%	Sm Cap 47.3%	EM 26.0%	Int'l Stk 14.0%	EM 32.6%	Int'l Stk 11.6%	Cash 1.4%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%
Cash 1.6%	Int'l Stk 39.2%	Int'l Stk 20.7%	REIT 12.2%	Int'l Stk 26.9%	AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%
HY Bnd -1.9%	REIT 37.1%	Sm Cap 18.3%	AA 8.9%	Sm Cap 18.4%	HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.1%	EM 11.6%
AA -3.8%	Lg Cap 28.7%	AA 14.1%	Lg Cap 4.9%	AA 16.7%	Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%
EM -6.0%	HY Bnd 28.2%	Lg Cap 10.9%	Sm Cap 4.6%	Lg Cap 15.8%	Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%
Int'l Stk -15.7%	AA 25.9%	HY Bnd 10.9%	Cash 3.2%	HY Bnd 11.8%	HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%
Sm Cap -20.5%	HG Bnd 4.1%	HG Bnd 4.3%	HY Bnd 2.7%	Cash 4.7%	Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%
Lg Cap -22.1%	Cash 1.0%	Cash 1.4%	HG Bnd 2.4%	HG Bnd 4.3%	REIT -15.7%	EM -53.2%	Cash 0.2%	Cash 0.2%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%

Abbr.	Asset Class – Index	Annual	Best	Worst
Lg Cap	Large Caps Stocks – S&P 500 Index	6.69%	32.4%	-37.0%
Sm Cap	Small Cap Stocks – Russell 2000 Index	8.49%	47.3%	-33.8%
Int'l Stk	International Developed Stocks – MSCI EAFE Index	5.75%	39.2%	-43.1%
EM	Emerging Market Stocks – MSCI Emerging Markets Index	9.85%	79.0%	-53.2%
REIT	REITs – FTSE NAREIT All Equity Index	10.79%	37.1%	-37.7%
HG Bnd	High Grade Bonds – Barclay's U.S. Aggregate Bond Index	4.58%	10.3%	-2.0%
HY Bnd	High Yield Bonds – BofAML US High Yield Master II Index	8.42%	57.5%	-26.4%
Cash	Cash – 3 Month Treasury Bill Rate	1.22%	4.7%	0.0%
AA	Asset Allocation Portfolio*	7.47%	25.9%	-22.4%

Past performance does not guarantee future returns. The historical performance shows changes in market trends across several asset classes over the past fifteen years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 12/31/16.

*Asset Allocation Portfolio is made up of 15% large cap stocks, 15% international stocks, 10% small cap stocks, 10% emerging market stocks, 10% REITs, 40% high-grade bonds, and annual rebalancing.

Source: Novel Investor

Please see important disclosures at the end of this article

Some additional insights:

1. ***"Risk On" was led by smaller companies.*** Small caps had performed poorly going back to the middle of 2014 until they collectively bottomed in February 2016. Small caps are considered riskier because they tend to fluctuate more than large caps, falling more on the way down and rising quicker on the way up.
2. ***International stocks have had a rough time the past three years.*** It has been a difficult few years for international stocks in developed countries. These are companies based mostly in Europe, Australia, and Japan. A lot of this underperformance can be attributed to how strong the dollar has been over this time, but even adjusting for currency change, international stocks are still only up 2.74% annually.
3. ***Large Cap Stocks, represented by the S&P 500, have now outperformed Novel's Asset Allocation strategy for eight consecutive years.*** Novel Investor outlines a basic asset allocation portfolio, which they include in the above table under AA. We first highlighted the recent weakness of the Asset Allocation portfolio last year. In 2016, the S&P once again outperformed the AA portfolio. Part of the reason for this is the asset allocation model consists of 40% bonds. Despite the large allocation to bonds, the asset allocation model often outperformed from 2000-2008. It will outperform again at some point, and we believe our tactical strategies are flexible enough to take advantage of any shifts back to international stocks, which was the primary driver of outperformance a decade ago.
4. ***High Yield bonds recovered thanks to the Energy Sector's recovery.*** High Yield bonds, also known as "Junk" bonds, had a lot of exposure to the energy sector. Many energy companies borrowed heavily in order to expand and take advantage of developments in fracking technology. When the price of oil began to collapse in the summer of 2014, the sector suffered a major decline, even though other parts of the high yield market did not see their default risk rise. When the price of oil bottomed early last year, so did the negative performance of this asset class.

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