

Katonah Capital Group, LLC

B A L A N C E I N A C H A N G I N G W O R L D

Jason@KatonahCapitalGroup.com

80 Business Park Drive, Suite 304 • Armonk, NY 10504

p (914) 219-5880 • *f* (914) 273-6806

FOURTH QUARTER 2016 INVESTMENT ADVISORY REPORT

CLIMBING A “WALL OF NO WORRY”¹

The end of 2016 witnessed a coordinated global economic advance that provided a positive tailwind for many financial assets. This was in stark contrast to the beginning of the year which was one of the worst in history. Reporting on February 15th, Business Insiders wrote “The market had its shakiest start to a year ever, the S&P 500 is down 9% year-to-date, and global stocks fell into a bear market.”² Fears of a looming US recession due in part to plunging oil prices, stresses in the global banking system, negative interest rates overseas, tensions in the Middle East and massive capital outflows from China all combined to form a perfect storm.

Soothing words from Janet Yellen in her testimony to Congress, along with the Chinese allowing their currency to more freely depreciate, helped staunch the gloom and stabilize the markets. By the second half of the year, economic momentum picked up globally, along with rising inflation expectations and rising interest rates. The momentum caught fire with the election of Donald Trump to the White House, and with an unexpected OPEC agreement to curtail production. This set stocks up for strong year end performance, but also caused one of the worst bond routs in history. By the end of November, Bloomberg headlines reported “Global Bonds Suffer Worst Monthly Meltdown as \$1.7 Trillion Lost”.³

For equities, it was risk on as small cap stocks paced the rally with an 8.83% gain.⁴ However, performance was dispersed widely as for example, the health care and consumer staples sectors actually posted losses. On the flip side, the bond markets pain was the financial sectors gain as a more positively sloped yield curve and the promise of less regulatory burden drove the group to a 21% advance.⁵ Foreign stocks were generally flat to down for the quarter.

¹ All credit for this title must belongs to the erudite and entertaining blogger, Polemic Paine: <http://polemics-pains.blogspot.com/>

² <http://www.businessinsider.com/wall-street-2016-stock-market-outlook-2016-2>

³ <https://www.bloomberg.com/news/articles/2016-12-01/global-bonds-suffer-worst-ever-meltdown-as-bull-market-shows-age>

⁴ <https://www4.troweprice.com/gis/fai/us/en/insights/articles/2016/q4/quarterly-market-review.html>

⁵ Ibid. #4

www.KatonahCapitalGroup.com

Investment Advisor services offered through
Income & Asset Advisory, Inc., an SEC
Registered Investment Advisor,

Registered Representative offering securities
through American Portfolios Financial
Services, Inc., member: FINRA and SIPC;
d/b/a Katonah Capital Group, LLC.

American Portfolios, Income & Asset
Advisory Inc., and Katonah Capital Group, LLC
are unaffiliated entities.

Katonah Capital Group, LLC

Among the observations of the market environment discussed in our last quarter's report, two bear revisiting. First, we commented on the deep sense of pessimism surrounding the markets. We noted that investor heavyweights such as George Soros, David Tepper, Carl Ichan, Ray Dalio, Jeffrey Gundlach and Bill Gross were all very publicly bearish. This level of widely disseminated one-sided sentiment usually ensures that the opposite will occur, as the market "climbs a wall of worry"! And, in fact, CNBC recently reported that "Billionaire George Soros lost nearly \$1 billion after the stock market surged following Donald Trump's unexpected Nov. 8 election victory..."⁶ At this point, the pessimism still exists, but has been significantly tempered as people embrace the new presidents rhetoric and, hence the title of this report, "Climbing a Wall of No Worry".

The second event we were closely monitoring was the ascent of the US Dollar (USD). In the past, this has reflected a global restriction of liquidity and has led to severe market dislocations. However, at present, the USD has stabilized and actually weakened a bit. This is breathing life into broad sectors of the market, from US multinationals to Emerging Markets (EM).

We explored other phenomena that could affect the markets but we are now in a state of "certain uncertainty". As of this writing, it's hard to recall another period in recent history when outcomes – be they good or bad – are as opaque as they are now. And, as Barron's recently noted, "...unlike the uncertainty that comes from being able to see everything that could go wrong and little that could go right...this time the uncertainty could go either way."⁷

Thus, we continue to monitor the underlying technical strength of the markets (the intermediate term trend of the stock market currently remains healthy) and the macro fundamentals. Typically, this report focuses on key macroeconomic issues that are impacting markets. However, this time, we've chosen to highlight some socio-economic issues affecting the country at the moment. It is important to note that these are phenomena that have been unfolding for **decades** although their ramifications are only recently being manifest.

The first chart is from a presentation given by Jeff Gundlach, the founder of DoubleLine Capital.⁸ It starkly shows how, for the past 3-4 decades, wealth has been accruing to the top 1% of the wealthy and away from everyone else. Currently, the top 1% owns almost as much wealth as the entire rest of the 99%. According to Gundlach, this chart and the one below are all you need to understand the Trump presidential victory. (Gundlach, it should be noted, was one of the very few who publicly predicted a Trump victory).

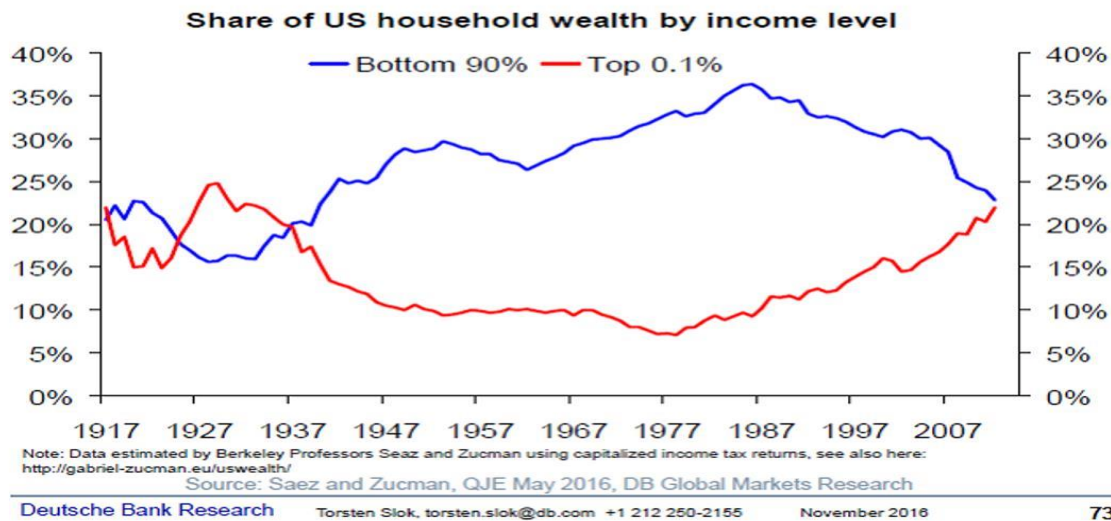
⁶ <http://www.cnbc.com/2017/01/12/billionaire-george-soros-reportedly-lost-nearly-1-billion-during-trump-rally.html>

⁷ The Trader – "Market Breaks 20,000 and Asks, What's Next"; Barron's; January 30, 2017; pg. M3

⁸ <http://www.businessinsider.com/jeff-gundlach-webcast-december-13-2016-2016-12/#heres-how-the-budget-has-changed-5>

Katonah Capital Group, LLC

US wealth inequality: Top 0.1% hold the same amount of wealth as the bottom 90%



The next chart is a bit less intuitive, although no less powerful in its implications! It shows that in 1940, roughly 80% of all children, regardless of class, had about a 95% chance of earning more than their parents. (Note that at the very upper percentiles of the ultra-wealthy, it does become exceedingly hard to out-earn your parents). This gradually deteriorates over the next 40 years, so that by 1980, the probabilities of out-earning your parents drop significantly.⁹

The data for the two charts below were compiled through a collaboration of a group of economists out of Harvard, Stamford and UC Berkeley called The Equality of Opportunity Project. Obviously, the work only extends down to 30-year-olds in the labor force. They write “A defining feature of the “American Dream” is upward income mobility: the ideal that children have a higher standard of living than their parents. Our work shows that children's prospects of earning more than their parents have fallen from 90% to 50% over the past half century.”¹⁰ The group then offers another graph, portraying the data in different and perhaps clearer format:¹¹

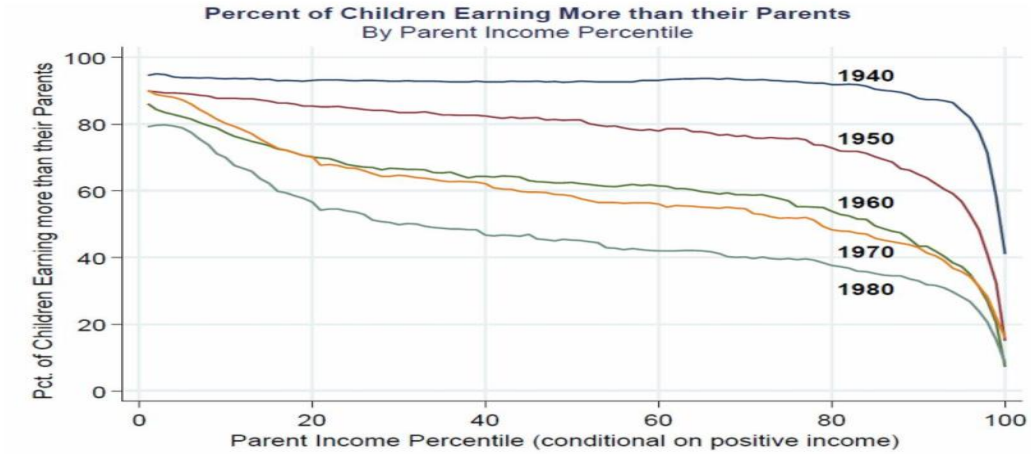
⁹ <http://www.businessinsider.com/jeff-gundlach-webcast-2017-outlook-just-markets-2017-1/#turning-to-us-economic-challenges-that-trump-needs-to-tackle-8>

¹⁰ <http://www.equality-of-opportunity.org/>

¹¹ Ibid; # 10



Children Earning More than Their Parents

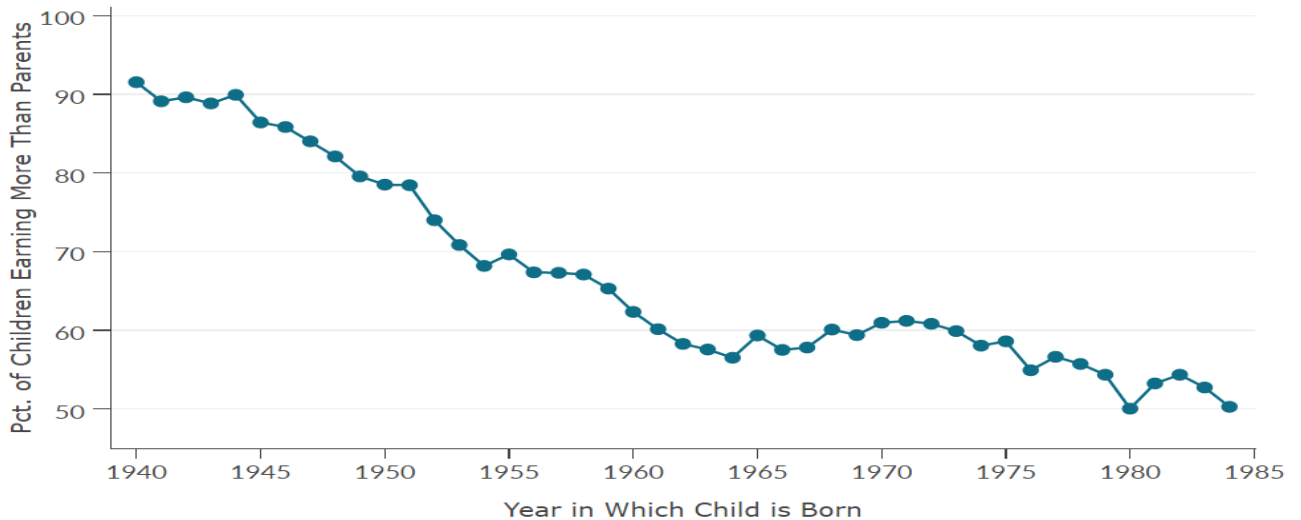


Note: by decade of birth
 Source: <http://www.equality-of-opportunity.org/> The Equality of Opportunity Project (out of Stanford and Harvard)

1-10-17 Just Markets 11

The Fading American Dream

Percent of Children Earning More than their Parents, by Year of Birth



www.KatonahCapitalGroup.com

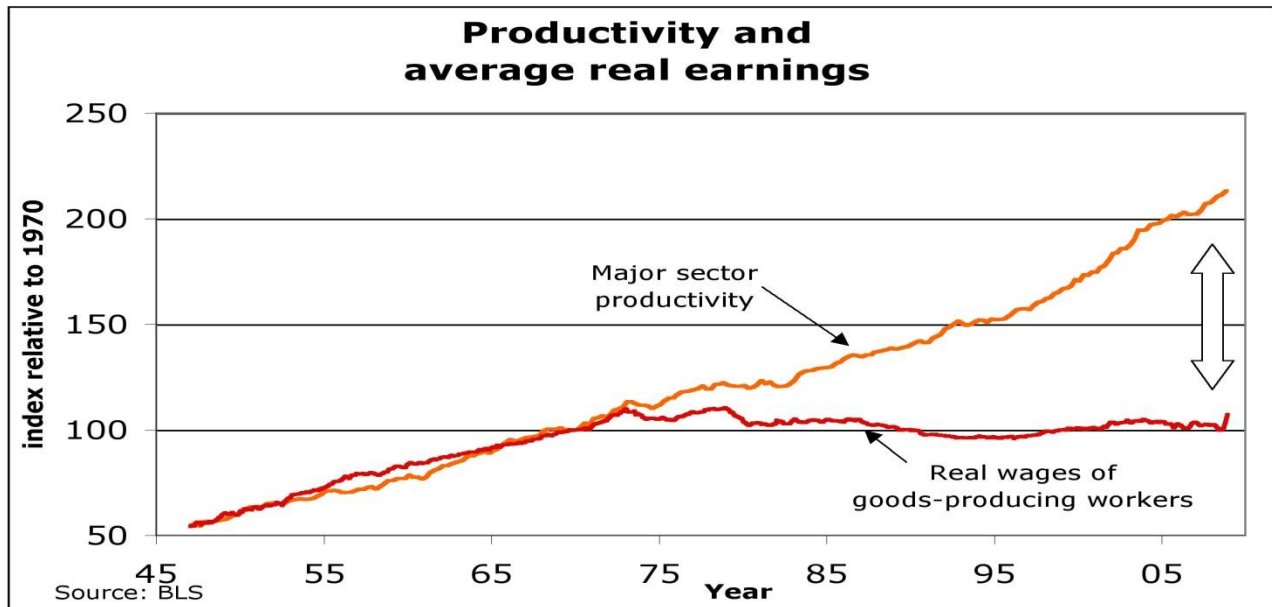
Investment Advisor services offered through
 Income & Asset Advisory, Inc., an SEC
 Registered Investment Advisor,

Registered Representative offering securities
 through American Portfolios Financial
 Services, Inc., member: FINRA and SIPC;
 d/b/a Katonah Capital Group, LLC.

American Portfolios, Income & Asset
 Advisory Inc., and Katonah Capital Group, LLC
 are unaffiliated entities.

Katonah Capital Group, LLC

The next chart depicts the plight of the manufacturing and goods producing wage earners in the US – the former bastion of the American middle class.¹² It portrays the stagnant trend in wage growth, along with the inexorable rise in productivity – i.e. globalization and technology have eroded good paying manufacturing jobs in the US. Obviously, these trends represent serious headwinds that have been eroding our socioeconomic well-being for decades.



The chart following this shows how at least some portion of the wealth gap affecting “the rest of the population” is being addressed.¹³ It clearly presents the relentless attempt to re-distribute some of the wealth. However, it’s far from clear that this is a sustainable (let alone workable) long-term solution to anything, and arguably, the policy entails its own host of “unintended consequences”.

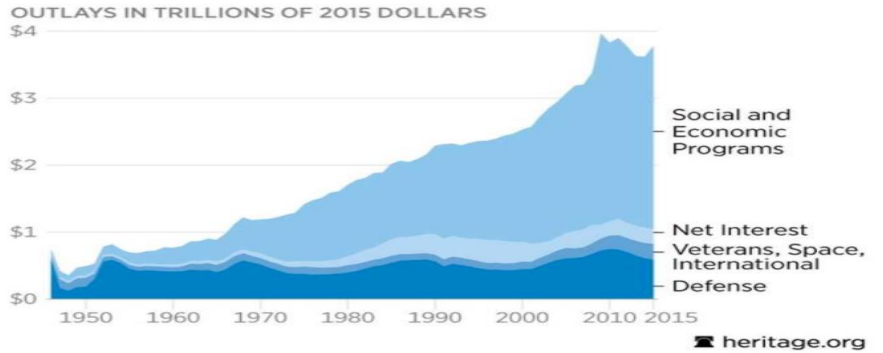
¹² https://commons.wikimedia.org/wiki/File:US_productivity_and_real_wages.jpg

¹³ <http://www.businessinsider.com/jeff-gundlach-webcast-december-13-2016-2016-12/#lets-face-it-a-lot-of-these-jobs-have-been-lost-to-robots-and-that-is-not-going-away-4>

U.S. Budget Demands Have Changed



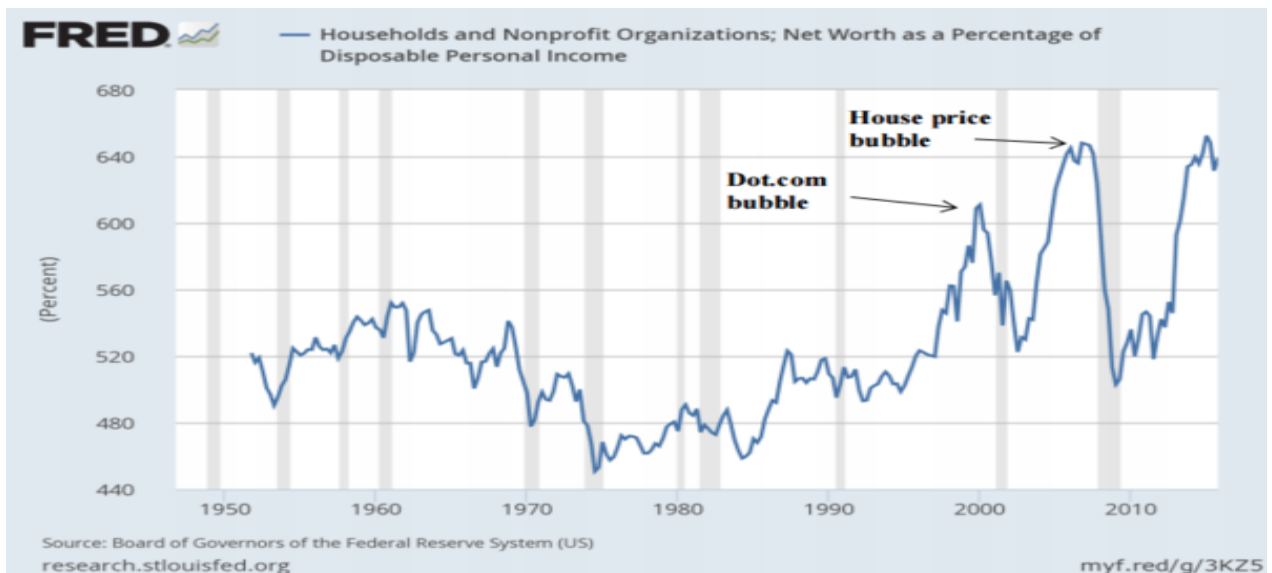
How the Budget Has Changed



Source: Bianco Research as of December 31, 2015

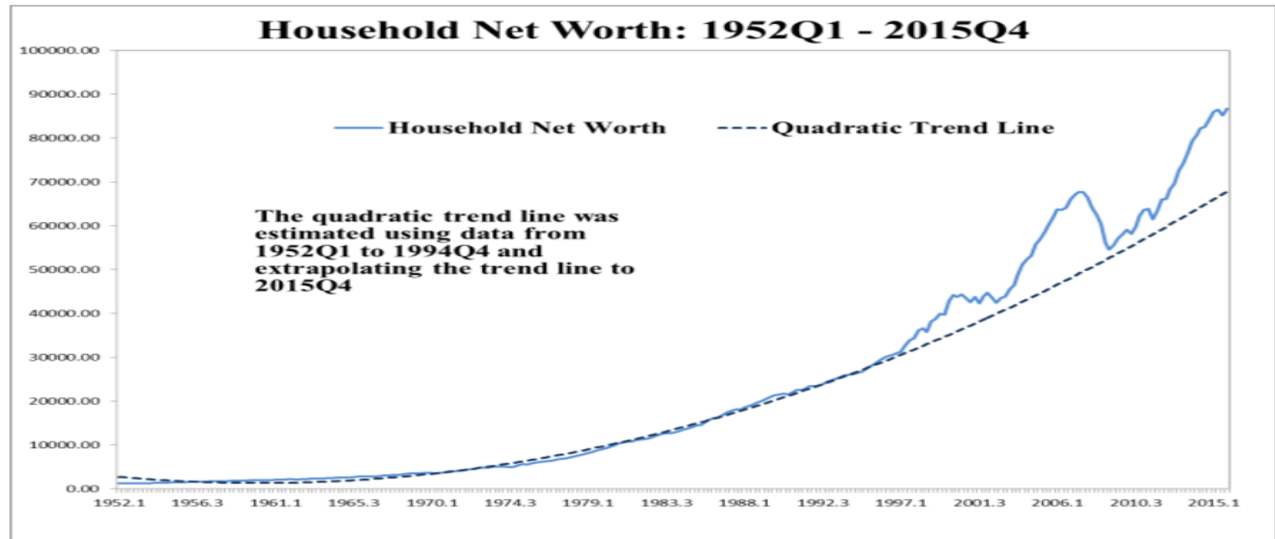
12-13-16 DBLTX Webcast 14

All of this paints a scenario of wealth concentrating increasingly towards a smaller and smaller class of uber-wealthy individuals, no middle class wage growth, both of which combine to impede upward mobility, while engendering a growing segment of the population that is dependent on Government transfer payments. Amongst this backdrop, we leave you with the following two graphs depicting total wealth in this country – regardless of where it may or may not be concentrated. They are from Lance Robert’s weekly blog, and are two versions of the same message.¹⁴



¹⁴ <https://realinvestmentadvice.com/this-or-that-10-21-16/>

Katonah Capital Group, LLC



These last two charts are, of course, a gross depiction of the “creation” of wealth since 2008. It is predictive of nothing, in terms of predicting a market top, and there’s certainly the possibility of continued prosperity and growth in average net worth. It’s possible that the policies of the new administration will be the antidote to the problems highlighted above that have been brewing for the past decades. Or not. At this point, it’s too early to be able to separate the rhetoric from ultimate policy. We remain invested in risk assets with an overweight currently in EM and cyclical, economically sensitive stocks such as basic materials and infrastructure. There are early wiffs of a secular trend change in inflation which, if sustainable, will largely inform our strategies and will result in a further underweight in fixed income and an increased shift towards materials, commodities, and senior secured bank loans. Nevertheless, there is no escaping the reality that risk levels are highly elevated, and on many levels. Stocks are historically expensive, and interest rates are historically low as are rates of inflation. The post WW II order, as we’ve known it for the past decades, is being challenged and is coming apart. Other than that, the landscape is abundant and benign! At some point, the “wall of worry” that the market has been climbing probably does turn into a “wall of no worry” where the last buyer will have made their purchase. However, there’s no evidence that we’re there yet!

Thanks for reading,

Jason

www.KatonahCapitalGroup.com

Investment Advisor services offered through
Income & Asset Advisory, Inc., an SEC
Registered Investment Advisor,

Registered Representative offering securities
through American Portfolios Financial
Services, Inc., member: FINRA and SIPC;
d/b/a Katonah Capital Group, LLC.

American Portfolios, Income & Asset
Advisory Inc., and Katonah Capital Group, LLC
are unaffiliated entities.

Katonah Capital Group, LLC

<u>US STOCK INDEXES</u>	Q4 2016	Year-to-Date
Dow Jones Industrial Average	8.66%	16.50%
S&P 500 Index	3.82	11.96
Nasdaq Composite Index	1.34	7.50
S&P MidCap 400 Index	7.42	20.74
Russell 2000 Index	8.83	21.31
<u>INTERNATIONAL INDEXES</u>		
EAFE (Europe, Australasia, Far East)	-0.68%	1.51%
All Country World ex-U.S.A.	-1.20	5.01
Europe	-0.36	0.22
Japan	-0.14	2.73
All Country Asia ex-Japan	-6.25	5.76
EM (Emerging Markets)	-4.08	11.60
<u>US BOND INDEXES</u>		
Bloomberg Barclays U.S. Aggregate Bond Index	-2.98%	2.65%
J.P. Morgan Global High Yield Index	2.41	18.27
Bloomberg Barclays Municipal Bond Index	-3.62	0.25

www.KatonahCapitalGroup.com

Investment Advisor services offered through
Income & Asset Advisory, Inc., an SEC
Registered Investment Advisor,

Registered Representative offering securities
through American Portfolios Financial
Services, Inc., member: FINRA and SIPC;
d/b/a Katonah Capital Group, LLC.

American Portfolios, Income & Asset
Advisory Inc., and Katonah Capital Group, LLC
are unaffiliated entities.