# The Type 2 Investor

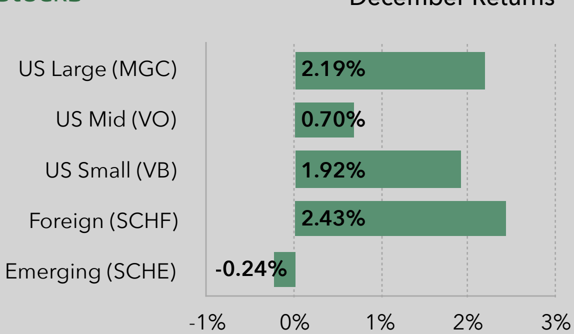
January 9, 2017

## December 2016

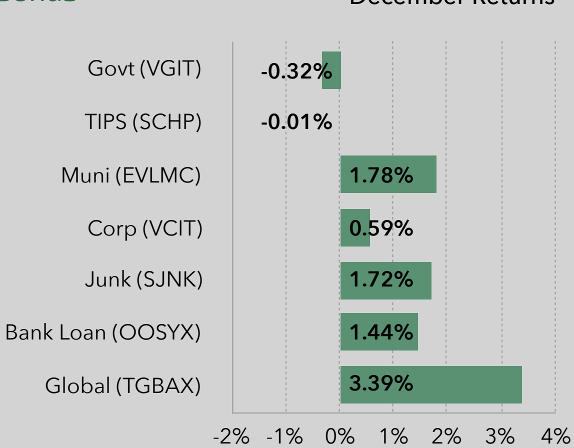
### Economic Data

- As expected, the Fed raised rates a quarter point at the December meeting to a range of 0.50% to 0.75%
- Year-over-year inflation (CPI) continued its upward trend to 1.7% in November from 1.6% the previous month; the core rate remained at 2.1%
- Retail sales growth was softer than expected at only 0.1% in November, compared to a downwardly revised 0.6% the previous month
- 156,000 jobs were added in December, but the unemployment rate edged up a tenth to 4.7%. Wage inflation hit a cycle high of 2.9% year-over-year

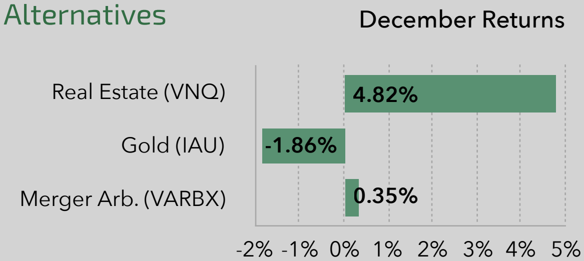
### Stocks




### Bonds




### Alternatives




*Performance data provided by Morningstar.*

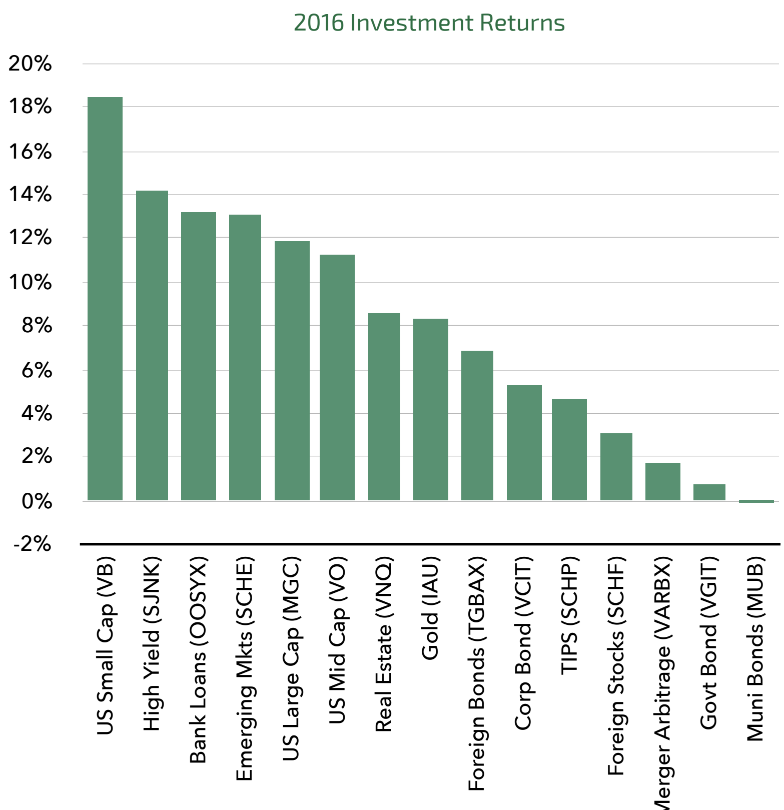
*The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.*

### Stupid Good Year

If someone would have told you on December 31, 2015 that in the year ahead the US stock market would have its worst start ever, year-over-year earnings for the S&P 500 would decline during every quarterly reporting period, the UK would shock the world by voting to leave the EU, and Donald Trump would be elected president, how would you feel about the prospects for your investments? Not very good, I assume.

And yet it ended up being a stupid good year for almost all investments across the board. US small cap stocks were the best performing asset class, up 18.44%, with most of those gains coming in the wake of the election. Smaller companies garner a larger percentage of their revenues from within the US, and the potential for lower taxes and a protectionist agenda, combined with trade wars raged on the Twitter battlefield seemed to bode well for them.

Municipal bonds were the only major asset category that clocked in a loss, albeit a very small one at only -0.16%. It's worth noting, however, that munis were the best performing of an otherwise rotten bunch in 2015.

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## The Folly of Forecasting

Humans are bad at predicting the future, and there is plenty of data to support this. It's largely attributable to our overconfidence, which is a heuristic-driven bias we are all at the mercy of. Luckily, not many people will remember the predictions you made in the past. If they do, you can always make up excuses as to why your predictions turned out wrong.

Phillip Fetlock, a psychologist at the University of Pennsylvania, has identified the five most common excuses forecasters use when their predictions don't pan out. And I'm going to use all of them as we review some of the predictions I made during 2016:

1. **The "if only" defense: i**f only OPEC didn't come to an agreement to cut production, thus driving oil prices higher, my prediction for a continuing rise in high yield bonds defaults would've materialized.
2. **The "ceteris paribus" defense:** something outside of the model of analysis occurred, so it's not my fault. Like when I predicted TIPS would do well because of expectations for rising inflation, all else equal. Inflation did rise, but all else wasn't equal as interest rates have spiked following the election. To be fair, TIPS did outperform other government bonds and clocked in a respectable 4.64% return. They just weren't the best bond category to be in.
3. **The 'I was almost right' defense: l**ike when I wrote on April 5 that oil "would stay in the $30-$50/bbl range for the next year or so." It hit a high of $54 on December 28. I mean, that's pretty close, right?
4. **The "it just hasn't happened yet" defense:** like when we went underweight on stocks in September because we thought the market was finally going to start pricing in fundamentals, and then further underweight the day before the election because we thought Trump would win and that would rattle markets. It'll happen! Eventually! You'll see!
5. **The "single prediction" defense:** just because I was wrong about these things doesn't mean I will be wrong about everything else!

And to build on that last excuse – and so you don't think reading this newsletter is a waste of time – here is a short list of some of the things I got right in 2016:

- January 8: called Tesla (TSLA) a good company, but a bad stock. Tesla underperformed the S&P 500 by 16.43% over the remainder of the year.
- April 5: with regards to the number of rate hikes to expect from the Fed this year at a time when they had been broadcasting as many as four I said, "don't be surprised if that number falls to one or none or 'to hell with it, let's cut them again!' It ended up being one.
- April 5: warned the migration crisis could swing the vote towards Britain's departure from the EU.
- June 6: "Inflation is likely to heat up over the next eight months." Inflation has already increased from 1.0% in June to 1.7% in November, and we still have three months to go on this.
- November 7: "Don't be surprised if Donald Trump is the president-elect at the end of tomorrow night." Along with this I predicted civil unrest (Portland, Oakland, LA, Chicago, Miami, etc.), a sharp selloff (although it only lasted a few hours, it was significant), and that Treasuries would not be a safe haven (yields on the 10-year treasury shot up 0.57% through the end of the year, driving prices lower). I also predicted gold would do well (wrong), and emerging markets and international stocks would get hit (they did).

Looking ahead to 2017, here are some new predictions. Just don't put too much faith in them. As Yogi Berra once said "It's tough to make predictions, especially about the future.":

- Sears (SHLD) will finally shutter all its doors and sell off its properties.
- It will be a tough year for automakers as higher interest rates and trouble in the sub-prime auto loan market begins to have an impact.
- The strong dollar is going to hurt profits for large, exporting companies.
- The jump in interest rates should pull the share-buyback rug out from under the market, as companies will no longer be able to finance the purchase of their own stock at ridiculously low rates.
- Inflation gets close to 3% in the next few months
- Marine Le Pen wins. I think the most important single event of the year will be the French election. With Francois Hollande's approval rating at 4%, a record low for any French President, there is no chance of a socialist winning. Marine Le Pen, a sort of French Donald Trump, looks likely to make it past the first stage of France's two-round election process. That will likely put her in a head-to-head competition against fellow conservative Francois Fillon, which polls suggest she will lose. Given the recent accuracy of polls, however, I wouldn't count on it. If this happens, kiss the EU goodbye.

## Binge Box

### Westworld

HBO's Westworld should already be on your radar, but if you haven't watched it yet hopefully I can convince you. And if not me, perhaps George RR Martin can, as he thought it would beat out Game of Thrones at the Golden Globes (sadly, neither won last night). The series is based on a 1973 film of the same title written by Michael Crichton, and is set in a western-themed amusement park in the future with android hosts there to satisfy your every desire.

*"Now the first time I played it white hat. The family was here, we went fishing, did the gold hunt in the mountains."*
*"And last time?"*
*"Came alone. Went straight evil. It was the best three weeks of my life."*

| Tactical Asset Allocation | | | | | |
|---|---|---|---|---|---|
| Asset Class | Heavy Under-weight | Under-weight | Neutral | Over-weight | Heavy Over-weight |
| **Cash** | | | | ● | |
| **Fixed Income** | | ● | | | |
| Core Domestic | | ● | | | |
| TIPS | | | | | ● |
| US High Yield | ● | | | | |
| Bank Loans | | | | ● | |
| Foreign Bonds | | | ● | | |
| **Equities** | | ● | | | |
| Large Cap | | ● | | | |
| Mid Cap | | ● | | | |
| Small Cap | | ● | | | |
| Developed Intl. | | ● | | | |
| Emerging | | ● | | | |
| **Alternatives** | | | | ● | |
| Real Estate | | ● | | | |
| Commodities | | | | | ● |
| Hedging | | | | | ● |

- Finally, what 2017 list of predictions would be complete without the always unreliable prediction for the year-end price of the S&P 500? Let's see, the current forecasts (they like to change them throughout the year) from top strategists are currently within a tight 2300 - 2500 range, according to a survey by Bloomberg. That's a forecasted price return of between 2.7% and 11.7%, plus about 2% in dividends. Each of them will surely be wrong, it's just a matter of by how much. Since they are all forecasting a positive return, I'll go contrarian. I expect trailing P/E ratios to contract from 25 to… let's say 20 (still above the long-term average of about 16). And I think earnings will increase by about 18%, which is significantly less than the 33% increase analysts are expecting. That gives us a price target of about 2,200 which is below where the market ended the year (2,239). And I am almost 100% confident I will be wrong. But hey, I might be close.

## Party Like it's 19,999!

The Dow Jones Industrial average, that antiquated, price-weighted index that won't die, came ever so close to hitting the 20,000 mark but fell less than a point short on Friday. It's a meaningless milestone, but hopefully all those "Dow 20,000" hats don't end up in a dumpster.

## Trump and Taxes

Let's say the Republican-controlled congress pushes through President Trump's tax plan, thus moving the top corporate income tax rate from 35% down to 15%. On the surface it would appear that this will essentially give corporate earnings an immediate 30% boost, but it's not that simple. Most corporations don't pay 35%. For S&P 500 companies, the effective rate over the past five years has been closer to 29% due to loopholes and business deductions the tax plan aims to mostly eliminate. That gets us to about an 18% increase in profits.

But there is a lot that can happen on a corporate income statement before you reach the bottom line. Buybacks, for example, have been funded by corporate debt issuance, but with higher interest rates who's to say they won't now be funded by tax savings? There is also no guarantee that whatever tax plan is passed will look exactly like this. Pushing through such a dramatic decrease in the corporate tax rate might be difficult, because even though Republicans love tax cuts, they also hate deficits.

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## About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies, as well as fiduciary investment management for select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.



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