

**“All economic movements, by their very nature, are motivated by crowd psychology.”**

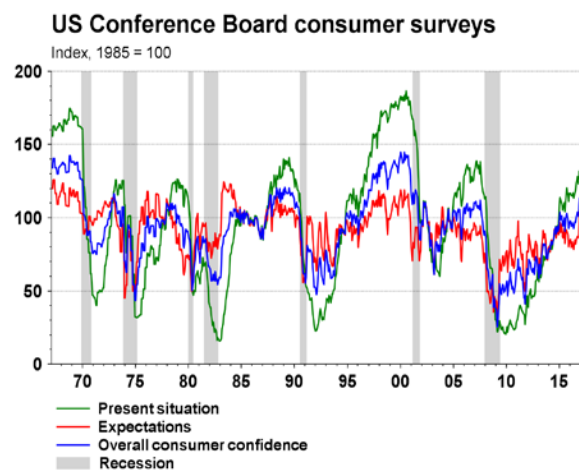
– Bernard Baruch

### The U.S. Economy – Building Confidence

As it stood on December 31, the U.S. economy appeared to be moving pointedly in the right direction. The Fed raised interest rates in December and signaled the likelihood for several more increases in the coming year. Analysts expected forward looking corporate earnings growth to be in the mid-teens. The employment picture continued to improve with headline unemployment down to 5% and December non-farm payrolls up well over 200,000. Interestingly, we are talking about December 31, 2015, which was followed by a 10% decline in the S&P 500 Index to begin 2016. The market ultimately recovered this loss and more, finishing the year with a respectable gain.

The market may react differently in the coming year, but the economic environment of December 2016 looks remarkably similar to that of December 2015. Again, the Fed raised interest rates one time in 2016 and signaled several more increases in 2017. Analysts expect corporate earnings growth of around 12.5% and employment remains strong with continued job creation (178,000 added in November) pushing unemployment below 5%. This is not to say that we expect another large market decline to begin the year, but rather to emphasize the difficulty in predicting short-term market movements. Oftentimes, these short-term market movements are the result of emotional overreactions by market participants. At HORAN Capital Advisors, our goal is to recognize and capitalize on these overreactions by focusing on available data to identify undervalued investments that clients will be able to own for the long-term.

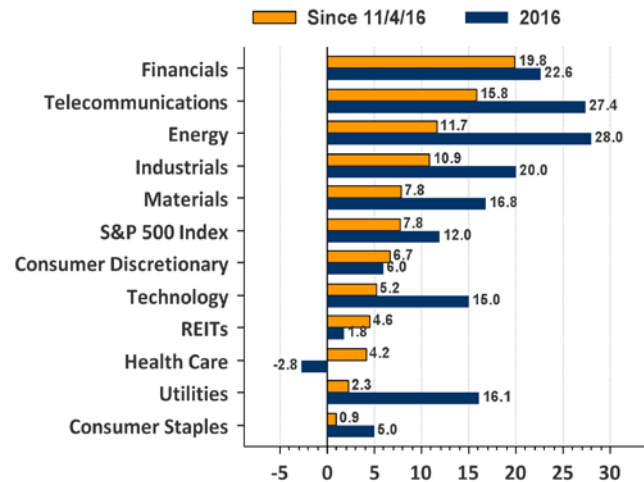
Given our data-centric approach and the remarkable similarities to the end of 2015, we find ourselves with a largely unchanged view of the U.S. economy. As we said then, “we see positive economic activity related to the consumer and services segments of the economy,” and with consumers accounting for 70% of economic activity in the U.S., we remain optimistic in our outlook. As seen in the chart to the right, US Conference Board consumer surveys are nearing levels of optimism not seen since July of 2007. As consumer confidence increases, consumer spending tends to follow, and continued consumer strength should be sufficient to keep the U.S. economy on at least a slow growth trajectory. We monitor increased signals of productivity for any evidence the U.S. can return to stronger year-over-year growth of 3%-5%.



## The U.S. Equity Market

The U.S. equity markets had a strong year in 2016 with the S&P 500 rising 12.0% (nearly 25% off of the February low). In the early part of the year, defensive sectors such as utilities and consumer staples led the market. These sectors were appealing to cautious investors because they tend to offer higher dividend yields and more price stability in market pullbacks. Since the election, however, there has been a large rotation into more economically sensitive sectors like financials and industrials. This shift by investors to more cyclical sectors of the economy indicates increased market confidence in the near-term. While the actual economic numbers have not changed substantially in the past year, the always forward-looking market is indicating a stronger likelihood of improvement in the year ahead.

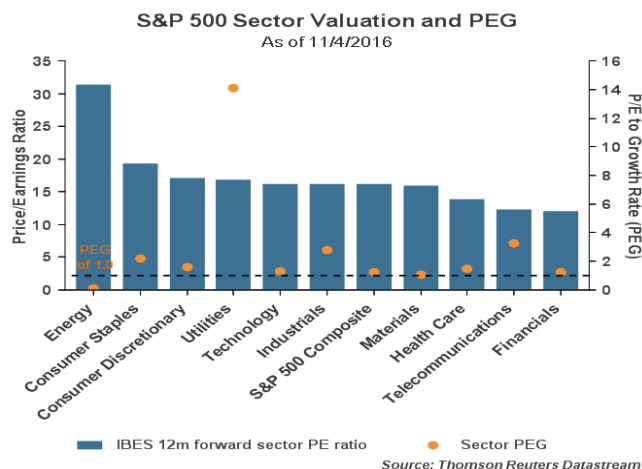
S&P 500 Index Sector Performance



As of 12/30/2016

Source: Thomson Reuters Datastream

The most cited cause of the recent market rotation is the increased optimism based on the policy proposals of President-Elect Donald Trump. While we acknowledge policies reducing regulations and encouraging the repatriation of corporate profits held overseas may act as major tailwinds for U.S. corporations, we would argue the election outcome was merely the catalyst for an almost inevitable rotation into more economically sensitive stock sectors. The chart below (re-created from our summer 2016 investor letter) shows the Price to Earnings ratio and the Price to Earnings relative to growth ratio (PEG ratio) for each of the sectors as of 11/4/2016 (prior to the election results.)



Source: Thomson Reuters Datastream

The clear anomaly in the chart is the utilities sector that traded at a seemingly unjustifiable valuation given its consensus growth estimates. On the other end of the spectrum was the financials sector which was clearly the cheapest sector based on Price to Earnings ratios and among the cheapest based on the PEG ratio. Though it is nearly impossible to predict the timing of a market rotation, outsized valuations like the ones seen signal a potential reversion to the mean that can present opportunities for patient investors.

## The Rise of the “Populist Movement”

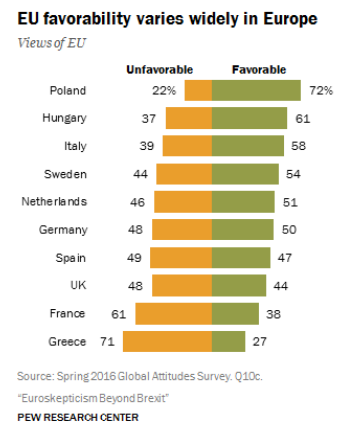
From the BREXIT vote in June to the Italian Referendum in December, the so-called “Populist Movement” has dominated politics throughout the western world in 2016. While universally defining the Populist Movement is difficult given the different concerns/demands of different countries, Gavin Hewitt of BBC News provides a unifying theme by explaining that, “the restlessness among voters on

both sides of the Atlantic is rooted in the powerlessness of those in power. Politicians seem unable to respond to demands of the voters.” While we take no stance on the merits of such movements, it is undeniable that recent elections have dramatically altered the state of western politics.

One of the most important consequences is the rise of protectionist policy proposals throughout Europe and the United States. Should we witness the implementation of these policies, it would be an enormous shift from the globalization trend of the past several decades. This shift could harm the sales of many large companies considering that nearly 45% of S&P 500 constituent revenue comes from international sales.

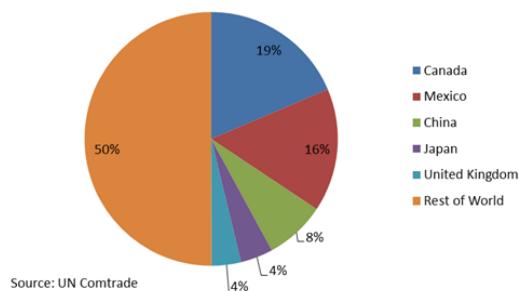
The “Populist Movement” also brings the future of the European Union (and euro zone) into question. The European Union is the political/economic union that allows for barrier free trade between member countries. The euro zone/euro area is the subset of European Union members that have adopted the euro as their official currency. As discussed in prior newsletters, British citizens elected to leave the EU in June. After Italy’s resounding December “no” vote to restructure parliament and the euro zone’s decision to freeze debt-relief measures for Greece, there is fear that BREXIT may simply be the tip of the iceberg. As the Pew Research Center chart to the right shows, France and Greece have an even more unfavorable view of the EU than the UK. Additionally, though Italy’s approval rating is significantly higher, its ongoing banking crisis may force it to reject EU rules and abandon the euro as its official currency. We do not view the dissolution of the European Union or euro zone as the most likely outcome, but it remains a possibility and one we continue to monitor closely.

### EU favorability varies widely in Europe



Domestically, President Elect Donald Trump (and Senator Bernie Sanders on the other side of the aisle) has attracted supporters with his anti-establishment rhetoric. With Republicans controlling both the legislative and executive branches of the national government, there is the potential for significant change in the coming years. From a purely economic perspective, many of these changes could be major tailwinds. Over a longer period, the simplification of regulations and the tax code could encourage increased domestic business investment. We would caution, however, that the effects of this increase in investment could take several years to fully develop. For a more immediate boost to the

### US Exports by Country (2015)



economy, we look to the repatriation of overseas corporate profits. Apple alone has approximately \$230 billion in cash parked overseas. This huge inflow of cash at a reduced tax rate (Republicans have proposed 10% to 15%) would provide U.S. corporations with financing for new business investment or added capital for share buybacks/dividend increases. The reduced tax rate for the repatriation of overseas corporate profits is an idea that has some bipartisan support and that could be implemented early in the Trump administration. Importantly, there are also several policy proposals that could be detrimental to the U.S.

economy. As previously mentioned, the protectionist policies (high tariffs, significant barriers to immigration, etc.) proposed by the administration could slow the U.S. economy. While protecting the

intellectual property of U.S. companies and American jobs is important, shortsighted and reactionary policies could result in a decrease in global trade and increase the cost of many imported goods to the end consumer. The chart on the previous page shows percentages of U.S. exports by country (2015 numbers). If Trump imposes tariffs on goods imported from countries like China and Mexico (22% and 13% of U.S. imports respectively), those countries would almost certainly retaliate with tariffs on U.S. exports to their countries (8% and 16% of U.S. exports respectively). This so called “trade war” would be detrimental to all involved countries and the global economy. Additionally, when coupled with large-scale spending on infrastructure, a slow-down in the economy could prove problematic for the ever-growing national debt. Similar to the dissolution of the EU, we do not view a trade-war that dramatically alters global trade as a likely outcome, but a potential outcome that we must acknowledge.

## **2016 Client Performance**

On both an absolute basis (overall market returns) and a relative basis (investment returns relative to a benchmark) 2016 was a strong year; however, outperformance did not come easy. Our discipline of buying lower valuation assets and selling expensive ones (thus buying low and selling high) led us to be well positioned for much of the year, and specifically, for the post-election market rotation. For client fixed income allocations, we avoided interest rate risk (duration) by using floating rate and short-term credit funds. For client equity allocations, investments in U.S. Midcap equities and specific individual stocks drove outperformance. Timely purchases of International Paper, Harman International Industries, Citizens Financial Group and BB&T were rewarding. The specific additions within the financial sector, underweight to consumer staple stocks and absence of utilities in the second-half of 2016, created an ideal positioning into the end of the year; financials being the top performing sector since the election and utilities and consumer staples being the worst performing sectors (see chart at top of page 2). As a firm focusing on growth at a reasonable price, we seek to buy undervalued securities that can offer long-term outperformance. Also, we diligently try to avoid overvalued segments of the market.

## **Conclusion**

As the introductory quote notes, crowd psychology is at the very base of most economic and market movements. Globally, crowd psychology is currently manifesting itself in the Populist Movement. The economic consequences of this remain to be seen, but the potential for large-scale change appears to be present. We look forward to working with you in the years ahead to assist in navigating this changing environment.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us at [www.horancapitaladvisors.com](http://www.horancapitaladvisors.com)

Warm regards,

*HORAN Capital Advisors*

\* HORAN Capital Advisors, LLC is an SEC Registered Investment Advisor.

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