

MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

4th Quarter, December 31, 2016			
	12/31/2016	% Change 4th Quarter	% Change Year to date
Dow Jones Industrials	19,762.60	8.66 % *	16.50 % *
S & P 500	2,238.83	3.82 % *	11.96 % *
Russell 2000	1,357.13	8.83 % *	21.31 % *
BC Aggregate BD Index		-2.98 %	2.65 %
10 YR Treasury Yield	2.446 %		
30 YR Treasury Yield	3.063 %		

* Includes reinvested dividends

Observing Trends

As we listen to the market prognosticators speculate on the direction of the market in 2017, we are reminded of a quote by Edgar Fiedler, an American economist born in 1929.

“The herd instinct among forecasters makes sheep look like independent thinkers.”

Forecasters tend to look in the rearview mirror and make predictions based on prior trends. The longer the trends have been in place, the more confident they are in their forecasts.

As security analysts, we are predisposed to evaluate specific securities and observe trends. In particular, we look for changes in long term patterns which might affect security valuations. 2016 was a sea change in the markets on many levels. A few observations follow.

Market Correlation

Market Correlation is decreasing and dispersion is increasing. In an oversimplification, individual stock selection along with investment style made a significant return difference in 2016. The table below reveals subsector returns for major indices.

	<u>4th Quarter 2016</u>	<u>Year 2016</u>
S&P 500 <u>Growth</u>	0.48 %	6.89 %
S&P 500 <u>Value</u>	7.35 %	17.40 %
Russell Mid Cap Value	5.52 %	20.00 %
Wilshire 5000	4.54 %	13.37 %
EAFE (Europe, Australia, Far East)	- 0.68 %	1.50 %
Euro Stoxx 50	3.18 %	0.70 %

As noted in the table, market capitalization, investing styles and global placement made a significant difference in the quarterly and yearly performance. This outperformance of the value style of investing signaled a change in trends. While avoiding any forecast, we will note that trends tend to stay in place for long periods of time. When long term trends change, market opportunities and risk increase.

Bond Market

Bond yields began to rise late in the 3rd quarter and continued that trend in the 4th quarter. The BC Aggregate Bond Index fell 2.98% (bond prices and their yield are inversely related) in the 4th quarter and for the year returned 2.65%. The trend since July 2016 has been rising yields and we will monitor closely as the new year unfolds. If the trend of rising yields continues, equity valuations will be affected. In the meantime, we favor short term Treasuries (Two Year and under) with the Two Year currently yielding 1.2%.

Risk

In addition to the possibility of higher interest rates and a change in inflation, there is appreciable policy and political risk in the new year. Monetary policy as a stimulus faded in 2016 and expectations for an expansive fiscal policy were baked into the fourth quarter rally. We will monitor the changes on the legislative, judicial and administrative fronts and adjust portfolios as necessary.

We are concerned about possible disruptions in overseas markets. Rising populism bubbled to the surface in 2016. The European Union will face a challenging 2017 with elections in the Netherlands, France and Germany. In 2016, forecasters underestimated the disgruntled attitude within the European Union. While the markets are adjusting for Brexit, they are unprepared for a change in the Netherlands, France or Germany. China remains a growth risk in 2017 with debt issues creating challenges. While disruptive events overseas will dislocate all markets in the short term, we expect that the strength and stability of the US economy and markets will continue to attract capital. The US markets remain the safe harbor trade.

The trends and risk discussed above should result in continued outperformance for the Value style of investing. Market disruptions and mispricing will continue, presenting Value investors with the opportunity to buy below intrinsic value and sell into periods of extreme over valuations. We are looking forward to observing, adjusting, monitoring and guiding your portfolio through the new year.