Introduction

Happy New Year! By the time 2016 drew to a close, investors had shaken off a considerable amount of financial and political uncertainty to end the year on a surprisingly optimistic note. Stocks overcame the worst start to any year as fears of faltering economic growth, plunging oil prices, and Chinese currency devaluation spooked investors out of risk assets. A few months later, the unexpected vote by the UK to leave the European Union briefly did the same. Finally, investors appeared to cheer the outcome of the US presidential election as they focused on the growth potential of likely pro-business policies, tax reform and less regulation, sending the stock market to new heights in the final months of the year. In the bond market it was a year of extremes. Bonds rose sharply in the first half of 2016, benefitting from a flight-to-quality out of risk assets, then dropped in the final quarter as the potential for higher growth and inflationary policies became a threat, ending the year not all that far from where they began. Meanwhile, commodity prices rebounded after two years of declines, fueled by a dramatic turnaround in oil prices after a very shaky start to the year.

Stock markets in the US, as measured by the S&P 500 Index, rose 12.0%. Given the steep rise in oil prices, it should come as no surprise that energy stocks outperformed all other sectors this year, up 27.4%, while uncertainty surrounding healthcare policy and drug pricing weighed heavily on that sector, which dropped 2.7%, the only sector with a decline for the year. The more volatile Russell 2000 Index of small-cap stocks appreciated 21.3%. The MSCI-EAFE index of stocks in developed international markets, up only 1.5%, lagged both US stocks and emerging markets stocks, which were up 11.6% despite fears that a strong US dollar and weak global growth would make it difficult for emerging countries with dollar-denominated debt but local currency income to meet obligations. However, these economies were beneficiaries of income from exporting raw materials that gained in the commodity rally. Investors were not ready to flee the safety of high-quality bonds, especially after the rocky start to the year which caused Federal Reserve Chair Janet Yellen to indicate a slower path of rate increases were likely. In fact, the Fed ended up with only one rate increase, in December. The Barclays US Aggregate bond index managed a 2.6% gain for the year, even after a drop of 3% just in the fourth quarter alone. The Bloomberg Commodity Index broke its losing streak with an impressive 11.4% gain, primarily due to stabilization in the oil market after a miserable prior year. US crude ended the year at $54/barrel, an increase of 45% for the year but, more impressively, a rebound of more than 100% from the mid-February 2016 low.

2017 brings a new US president with an unconventional governing style who has never held elected office. Positive expectations are for fiscal stimulus through tax reform and infrastructure spending as well as a reduced regulatory burden for companies. These could lead to GDP growth and increased consumer confidence as well as inflationary pressures. On the other hand, several Fed rate hikes and/or protectionist trade and immigration policies, along with the potential for global instability, could serve as a headwind to growth and spook investors already concerned about rich asset prices. At the same time, the global impact of Brexit still is in the future and, while China has been quiet, its leadership's focus on growth over structural reform remains a risk to future global economic growth.

4th Quarter Review

Performance Summary

Total Returns & Values for Selected Assets as of 12/31/16

	4Q 2016	YTD Return	Price / Value
Dow Jones Industrial Average	8.7%	16.5%	19,763
S&P 500 Index	3.8	12.0	2,239
Russell 2000 Index	8.8	21.3	1,357
MSCI EAFE Index	-0.7	1.5	6,476
MSCI EM (Emerging Markets)	-4.1	11.6	1,831
Barclay's Capital US Aggregate	-3.0	2.6	103
Barclay's Capital Municipal Bond	-3.6	0.2	107
Gold – Continuous Contract	-12.6	8.6	$1,152
Light Crude Oil – Continuous Contract	11.4	45.0	$54

Source: Factset

Economy

Economic growth in the last full quarter of the Obama administration ended on a high note, perhaps buoyed by post-election enthusiasm. After posting an upwardly-revised 3.5% growth rate in the third quarter, GDP likely increased at a respectable mid-2% annual pace in the fourth. As the markets digested the growth potential of President-elect Trump's policies, equities rallied sharply in the final weeks of the year, while consumer confidence surged to the highest level in nearly twelve years. Based on recent data, prospects for business and capital spending, a disappointment in the otherwise solid, consumer-led recovery, also seem brighter in the coming year.

Even prior to the surprising election results, the economy consistently managed to create jobs despite worries that the labor market was near "full employment". Companies hired nearly 500,000 additional workers in the quarter for the sixth consecutive year of payroll growth above 2 million. We are simultaneously seeing a low level of layoffs. This combination has resulted in an unemployment rate traditionally representative of full employment, which often sets the stage for wage pressures. The December payroll number could foreshadow the coming trend, surging to 2.9% from 2.5% despite only a slight uptick in the unemployment rate to 4.7%. While one month of data does not make a trend, this unemployment rate is clearly reflective of a labor market with little excess capacity.

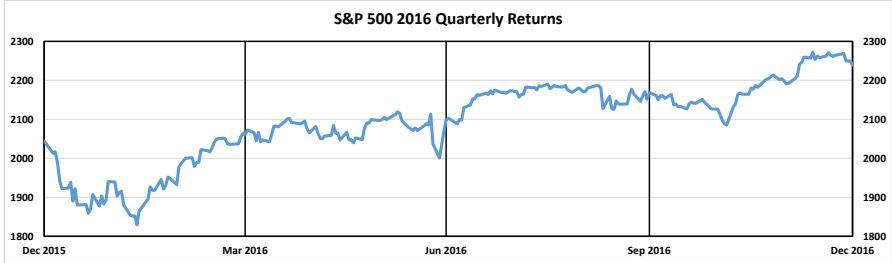
Further fueling worries about wage inflation was the surprisingly resilient showing of the domestic manufacturing sector, primarily due to strong auto sales, despite many export-oriented manufacturers facing the headwind of a strengthening dollar, which reduces their competitiveness. The Fed's December rate hike likely will further the dollar's advance, yet manufacturing activity steadily improved over the past four months through December, as new orders rose while inventories continued to fall sharply. Factory managers responded with the strongest pace of hiring in over a year.

At this point, a resurrection of animal spirits and a modest pop in wages seems healthy given the disappointing nature of this post-financial crisis recovery. After all, deflationary worries prevailed as recently as this summer following the surprising Brexit vote, and wage growth was non-existent for much of the past eight years. However, regardless of the slow pace of improvement, the recovery is long in the tooth at eight years; resources, particularly within the labor markets, are stretched close to capacity. Historically this is the point in the cycle when the Fed responds with higher rates, hoping to tap the brakes on growth before rising inflation expectations become a self-fulfilling occurrence. The December Fed minutes erased any doubt that the prospects of an infrastructure build-out and lower marginal tax rates would be factors in future monetary policy deliberations. It will be a tough balancing act, since even a small increase in the unemployment rate runs the risk of generating a domestic recession. Clearly that result is not what the Fed wants at this point.

We are in a wait-and-see mode about some of the proposed Trump political agenda and believe entrenched secular forces such as aging demographics and counter-cyclical trends such as dollar strength should keep the inflationary potential of the agenda in check. However, we believe a proactive Fed is the biggest risk to the outlook, in addition to any fallout from trade wars that are difficult to prognosticate at this point. Consistent with the recent rise in short-term interest rates engineered by the Fed, long maturity yields likewise surged of late. A significant increase from here may impact credit dominated sectors of the economy such as housing. Mortgage rates are nearly a full 1% higher than the recent low, which adds nearly 10% to the typical monthly payment. Regardless, we think recent employment and wage gains will offset modestly higher rates and that a confident consumer will continue to spend until fiscal measures take the baton later in the year. We believe the Fed will respond in a measured manner, favoring its growth mandate over inflation to ensure the damage from the credit crisis is fully repaired. As a result, we see the economy operating at a healthy mid-2% rate of growth in the coming year.

Equities

US equity investors reacted favorably to the presidential election results, focusing on the fiscal stimulus campaign promises of lower taxes and less regulation while shrugging off protectionist rhetoric. Investor, consumer and business confidence were all buoyed higher. Prior to the election, year-to-date returns for US equities were modest at 6.7%, recovering from the significant pullback we experienced in early 2016. The post-election return boost of 5% for the S&P 500 left the index return at 12% for the year and 3.8% for the quarter.



Source: Bloomberg

Across the S&P 500 sectors, financial stocks were strong, up 21% for the quarter and 22% for the year, due to higher rates and an expectation for a friendlier regulatory environment. The rebound in oil prices from the February low continued in the quarter and drove the energy sector to the top of the list with a 27% return for the year and 7.3% for the quarter.

Stocks of companies in developed international markets did not fare as well as those in the US, with the MSCI EAFE index up only 1.5% for the year. Commodity-rich Canada topped out the non-US developed markets, returning 24.6% for the year as oil prices strengthened. Despite Brexit worries, the UK market did quite well, ending the year up 19.2% in local currency terms. Emerging market stocks fared much better, rising 11.6%, after the Fed seemed to signal a slower pace of rate hikes, which have a negative impact on emerging markets due to debts priced in US dollars. The rebound in commodity prices also helped stocks of emerging economies.

The strong year-end lift to stocks pushed prices ahead of profit growth. Thus the price/earnings multiple expanded to 20.6x by year-end due to investor enthusiasm. This should be compared with the long-term average valuation of 14.8x. While the current level is above the average, it is still well below the 30+ P/E multiple experienced at the end of the 1990s tech bubble.

We expect 2017 to be a year full of volatility for equity markets as lofty investor expectations ebb and flow. The crosscurrents of positive fiscal stimulus, rising rates, US dollar strength and protectionist trade policy will create standing waves and eddies. As much is still unknown about actual policy implementation, investors are likely to react strongly in both directions as the debate continues. With this volatility, the current above-average valuation levels for US equities add to the risk. Increases in interest rates also are likely to be a drag on P/E multiples expanding further. However, investor optimism and associated fund flows out of bond funds and into US equities could provide an offsetting lift to valuation.

Economic and Market Drivers

Tailwinds	***Headwinds***
Fiscal Stimulus Package	Rising Interest Rates
Improving Real Personal Income	Expanding Global Political Uncertainty
Low Inflation	Higher US Equity Valuations
Consumer & Business Optimisim	Strong US Dollar
Household Formation Increasing	Protectionist Trade Policies
	Aging Demographics in Developed Markets
	China Over-Investment

Given the relative strength of the US economy and currency, we favor companies that have a higher US dollar revenue mix. US small cap stocks were strong performers during 2016 due to greater domestic exposure; we expect this trend to continue into 2017 and advocate allocations where appropriate.

Developed international equity markets remain less compelling than those in the US due to a weaker growth profile, but we continue to monitor the expanding valuation gap for opportunities to increase allocations. While they offer a more favorable demographic and long-term growth profile, emerging economies are not helped by a stronger US dollar and protectionist trade policies. We will wait to see how the trade policies develop before we increase allocations to emerging markets.

Fixed Income

Despite dropping 2.98% for the quarter, the Barclays US Aggregate bond index managed to generate a positive 2.65% for the year. While most scenarios of a Trump win pointed to a flight-to-quality into bonds and therefore lower yields, rates proceeded to ascend. Renewed inflation concerns and uncertainty regarding Trump's campaign promises pushed rates higher into year end.

U.S. 10 Year Treasury Yield

Source: Factset

What had previously been a central bank-driven market morphed into one focused more on domestic fiscal policy and political headlines. It would appear that the bond market rally that has been in place for decades may now be dissipating and

a more discerning environment may be emerging where not all fixed income will benefit. With fiscal policy replacing central bank influence, we will be shifting our term structure strategy to more of a laddered approach and will look to purchase all maturities (where we find value) rather than overweighting just the short- and long-ends. The one bias that remains is our duration stance, which is below that of the benchmark.

We still favor corporate bonds, as new supply is forecast to drop in 2017 after 5 years of record sales. Decreased mergers and acquisitions as well as a reduction in share buybacks should halt any growth in issuance, in addition to the potential for the repatriation of overseas earnings and a reduction/elimination of interest expense deductions. Macro conditions should be conducive to corporate health with expected GDP growth above 2% and other stimulative policies on the horizon. While negative-yielding global debt has receded from peak levels, the $8.7 trillion or so that still remains should continue to support foreign demand of US corporates, albeit to a lesser degree. The strong inflows into investment grade funds that took place in 2016 likely will not continue into 2017. All these factors combined could make for a difficult year ahead and contribute to muted returns.

Municipal Bonds

Weakness within the municipal bond market in the third quarter morphed into a full meltdown following the US presidential election, resulting in a fourth quarter decline for the Barclays Municipal bond index of 3.6%. This erased nearly all the previous gains for the year, as the market eked out only a 0.25% return for 2016.

The combination of tighter monetary policy and potentially aggressive fiscal policy was too much for bonds to bear, driving massive outflows from municipal bond mutual funds. Mutual funds are the dominate buyer of long-maturity municipals, so forced selling to meet withdrawals from these entities could pressure the market for some time.

Concurrent with ebbing demand, the new supply of tax-free bonds remained strong in 2016 with the expectation for additional heavy volume continuing in 2017, primarily to fund Trump's promised infrastructure build-out. We expect robust borrowing in the tax-free market to fund these projects, although it will not happen immediately.

We remained committed to a defensive posture so we were well-positioned for this rise in yields. This also may prove to be an excellent buying opportunity, and we have started buying longer maturities with yields residing near two-year highs.

In addition to the negative impact of Fed policy, a Trump presidency generates extreme uncertainty in the municipal bond area as reductions in marginal tax rates for individuals reduce the after-tax benefit of tax-free bonds, while lower corporate rates diminish demand for crossover buyers like insurance companies.

In addition, Trump appears committed to reducing certain taxes, one of which is the 3.8% surcharge on investment income which does not apply to municipal interest; thus, on the margin, its elimination is negative for tax-free bonds. More importantly, however, is the survival of the municipal tax benefit itself. While we think the tax-favored status will endure, given its beneficial impact on borrowing costs for local government, one cannot dismiss the possibility of radical change. Therefore, we will look to buy bonds whose absolute yields look fair in an environment of modestly-rising inflation expectations with competitive relative yields versus taxable bonds.

The policy implications of the coming administration.

Both during the campaign and after the election, President-elect Trump has been quite vocal about the policy changes he plans to make. It is important for investors and business people to try to understand what they are and whether they are likely to come to pass. They fall into five broad categories: tax, regulation, trade, fiscal and health care. Nothing has been released in any detail, so a lot of speculation is necessary.

Trump has spoken out about the need to change US tax policy, both business and personal. As a sidebar to business tax, he has talked about the need to work with businesses to repatriate earnings held overseas by US companies to avoid taxation. This last part has an extremely high probability of being enacted quite early in the new administration since there is support for it on both sides of the aisle. Corporate tax reform also is likely to come about as well, with a loose agreement that something must be done. There will be wrangling about levels and what deductions should be eliminated, such as the interest deduction, but within eighteen months we expect there will be a bill through Congress. Individual tax reform is a far different matter, and Trump will find a significant number of Republicans resisting any reduction of government revenue that is not balanced from another increase or from a reduction in spending. If enacted at all, we believe it will be late in his term. However, one point that may be addressed earlier is the problem of "carried interest". Carried interest is a share of the profits of an investment paid to the investment manager, specifically in alternative investments, in excess of the amount that the manager contributes to the partnership. It currently is taxed at a preferential tax rate, but many people feel it should be taxed at ordinary income tax rates.

Regulatory reform is complex and certainly in need of work. The Code of Federal Regulations (CFR), a compilation of all federal regulation, was 175,000 pages long in 2015. The World Bank ranks the US 51st out of 190 countries for ease of starting a new business, down from the 10th spot just 6 years ago. Regulations distort investment choices and can substantially reduce growth rates and productivity. Some regulations are very important, but it is unlikely that we need 175,000 pages of them. Look for attempts by the new administration to change environmental, energy and employment regulations right off the bat. There will be battles but expect some early successes, particularly in the area of employment and energy. One category where the party in power seems united is in easing financial regulation, with some sort of relief likely to come about in the first eighteen months. Trade policy is difficult because there have been mixed signals from the Trump camp. The biggest culprit, according to the trade hawks in the incoming administration, is China. Some have just branded China as an unfair trader and currency manipulator that should be punished, while others say that all the US wants is a level playing field. There are some important facts with which the administration should come to grips: the US trade deficit with China has been falling for the last few years, China is one of the largest trading partners with the US and adds many thousands of jobs to our economy, and any serious disruption of trade will hurt these jobs and be very inflationary. Trump should not be concerned so much with trade as with lowering the illegal prohibitions of doing business in China, ending intellectual theft, and effecting complete cessation of commercial cyber espionage. We think this will prove to be a time consuming, arduous task.

Another important talking point from the administration is a Border Adjustment Tax (BAT). This is a tax on products made for US companies by their non-US affiliates, or a foreign manufacturer, and imported into the US. Exported products would not be taxed. Although clever sounding, this tax will not achieve the desired goals of increased US employment, stopping the outflow of good jobs, and reducing the trade deficit. As an example, most successful export-based companies in the US employ small numbers of highly skilled workers and export complex technical goods or services. Conversely, many import-based companies, such as Walmart, hire large numbers of low-skilled employees. This is a classic mismatch where the US may lose more jobs and suffer inflation. Another example is from the energy business, an industry the administration is anxious to help. A BAT would adversely affect the energy sector because of its industrial organization. The domestic refining business is geared to refining heavy oil, while the US produces mostly light oil. The perfect arbitrage is for the US to export light oil, which it has in abundance, and to import heavy oil, which it can easily refine. Both importers and exporters benefit. A BAT would effectively end this profitable trade to the detriment of energy company earnings, energy employees and US citizens through higher inflation and perhaps energy shortages. It will take a lot of work to get this passed.

Changes to fiscal policy are perhaps the most important and best of the proposals. A clever use of fiscal policy can cure many ills, and there is some agreement that fiscal policy is a good alternative to monetary policy. Credit is cheap, so it would not cost much to finance this type of spending. Policies could be chosen carefully to ensure there is a positive return to government. Fiscal policy has the potential to boost growth by investing in ways that raise productivity. The government can invest in vocational training along with bricks and mortar. Fiscal policy also addresses the problem of income inequality. Monetary policy works through lowering interest rates and raising the price of financial assets, thereby increasing the well-being of financial asset holders but exacerbating income inequality. Fiscal policy, on the other hand, would generate higher paying jobs and increased productivity which raise wages, helping to relieve income inequality.

Health care is perhaps the most hyped of the policy changes being discussed. While there is consensus amongst Republicans about repealing ACA, there is a great divide between agreeing that it should be repealed and enacting legislation to both repeal it and provide an acceptable substitute. Although it is on the top of the agenda, this reform may be the most difficult to achieve, with many of the top ACA critics now saying some provisions should be kept. This may be the one policy change that takes much longer than anticipated.

Conclusion

In summary, we are optimistic that the US economy will continue to experience growth of slightly above 2% over the next year but recognize the high probability of 2017 being a volatile year due to a new presidential administration and, with it, policy changes that may impact markets in both directions. We expect the 10-year Treasury yield to end 2017 slightly above 3%, due to the Fed's message that they anticipate making several rate increases over the next 12 months. As long-term investors, we continue to favor stocks over bonds but are mindful of the fact that stocks are not cheap. We are more favorable to US stocks over international ones due to better economic growth prospects, a strong dollar and rising interest rates. As valuations become more compelling in international markets, we likely will move to overweight those areas, but we prefer to wait until US dollar strength abates. Our muted enthusiasm for bonds is primarily due to the lack of return potential as interest rates are poised to rise, which has a negative impact on bond prices.