Fixed Market Commentary

December 31, 2016

Trumped

As unexpected as Donald Trump's victory in November was, the reaction of financial markets was equally stunning. In the run up to the election, the conventional wisdom was that a Trump victory, though highly unlikely, would cause a massive stock market selloff. As the election results began to filter in, and it appeared that the impossible might actually happen, stock index futures started to decline. By the following morning, however, bargain hunters jumped in with both feet, stocks rallied, and the market hasn't looked back since. Since the election, nearly $70 billion has poured into US equities, far outpacing any other asset class. Even more surprising has been the bond market reaction. On Election Day, the 10-year Treasury note yield was 1.85%. Yields fell as the election results came in, but then spiked higher when markets opened on 11/9. The 10-year Treasury reached a high yield of 2.60% on 12/15, the highest since Sep 2014. The 10-year closed 2016 at a 2.45% yield.

In short, the election results were great for stocks and bad for bonds. The S&P 500 was up 3.8% in Q4 and finished 2016 with a 12.0% return. On Jan 6 2017, the S&P 500 reached a new all-time high of 2277. On the other hand, the Barclays Aggregate Bond index was down 3.0% in Q4 as interest rates spiked higher. The magnitude of the bond market selloff was historic. On a percentage basis, the 3-month change in the 10-year Treasury yield was the second largest in the past 20 years. Despite the massive Q4 selloff, the Aggregate Index returned 2.65% in 2016.

The aftermath of the election left analysts scratching their heads to explain these dramatic moves. In many respects, Donald Trump is a wildcard. It's difficult to say with much certainty what policies he will support and what legislation he will successfully get through the GOP-controlled Congress. The perception seems to be that Trump will push for a large fiscal package to stimulate the economy. It's anybody's guess as to what form that will take. Many believe that tax cuts will be involved. In addition, many expect regulatory relief. Market indicators are pointing to expectations of higher inflation in the days ahead.

Almost lost in the all the election hoopla is the fact that the Federal Reserve raised the federal funds rate in December 2016 for the first time in a year. The move was widely expected, especially given post-election stock market strength. The question now becomes how aggressive the Fed will be in 2017. The fed funds futures market is currently pricing in one rate hike in June, and a second hike in December 2017. But that is sure to change over the coming months!

While the Commerce Department announced that Q3 GDP was revised upward to a robust 3.5% annualized growth rate, the story for the economy basically remains the same. The Blue Chip forecast consensus for Q4 GDP is 2.2%, which would bring the full year 2016 growth rate to … you guessed it … 2%; roughly the same rate of growth we've experienced throughout the recovery from the Great Recession.

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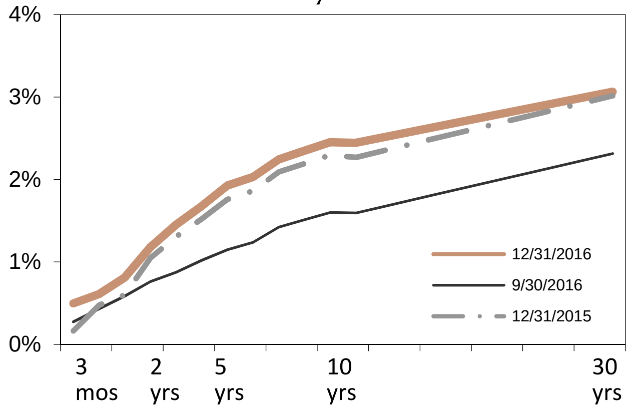
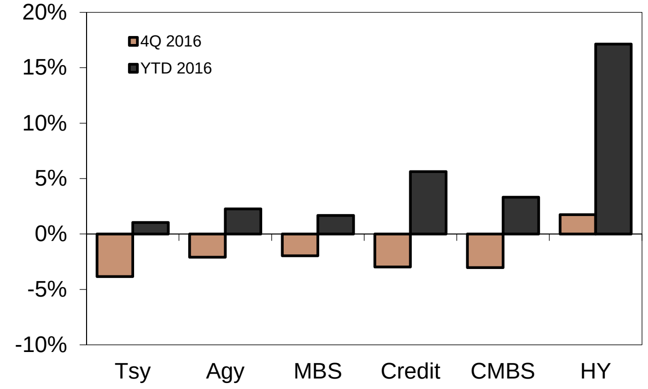
US Treasury Yield Curves



Sector Index Returns



On December 4, Italy held a referendum on a government reform package, which was soundly defeated. Italian Prime Minister Renzi has resigned and many are calling for early elections which could lead to a new anti-EU government. A Brexit-type referendum in Italy (nicknamed "Italeave") is a strong possibility. If Italeave passes, this would deal a fatal blow to the EU, shaking world markets.

We will tactically adjust portfolio durations to take advantage of anticipated interest rate moves. Our client portfolios are underweight government securities. US Treasuries currently offer little value, but they do provide liquidity and act as a hedge against "flight to quality" buying. We are overweight credit and slightly underweight mortgage-backed securities.

Equity Market Commentary

December 31, 2016

2016 was challenging for equity investors as the market sank 10% earlier in the year only to recover and produce positive gains by year-end. For the year, the large-cap dominated S&P 500 gained 12% while the average U.S. Stock Fund increased 10%. While it was a good year for domestic equities, foreign stocks continued to underperform their counterparts as the Morgan Stanley EAFE Index decreased 2%. Despite falling 3% during the 4th quarter, the Barclay's Aggregate Bond Index still managed a gain of 2.6% for the year. The Balanced Composite Index climbed 8%.

The end of year was dominated by the U.S. presidential election and its aftermath. Days before the election the market had pulled back some 4%. The unanticipated victory of Trump and the legislative sweep sparked a rally and reshuffling of market leadership as traditional growth stocks were sold off aggressively and value stocks soared (the likely beneficiaries of Trump economic policy). For the quarter, large cap growth funds decreased 1.2% while large cap value funds increased 7% (an unusually large gap in such a short period). The net of this is that we are experiencing sector repositioning under the new political landscape. Post-election, growth sectors like consumer staples and healthcare lost market share while value sectors such as financials and industrials gained market share. We expect this trend to continue and have repositioned your portfolio accordingly.

Many are scratching their heads wondering why the markets have responded so favorably to the Trump election. In our view, there are two primary reasons for this relief rally. First, voters and investors recognized that politicians had overcompensated after the housing collapse. An overly burdensome and hostile regulatory climate, massive deficit spending and massive entitlement expansion have combined to hamstring the economy. Simply stated, too much government has been crowding out private sector growth, the engine of our economy. The Trump election represents the opportunity to move on to the necessary second stage of recovery, structural reform. The likelihood is that we will finally see tax reform, entitlement reform, a regulatory rollback; in other words less government. Secondly, the Federal Reserve will lose its position at center stage. The default economic policy of most developed economies over the past eight years was to defer to the central bankers. While early on this was somewhat effective, during the past several years this policy lost its power. With interest rates at or below zero it was abundantly clear that artificially low interest rates were not the long-term solution. Unfortunately, central bankers didn't see it that way and voters forced the structural reform with the Brexit vote and the Trump election. In other words, it's time to try something new.

Looking ahead, global economic conditions are strengthening and we are encouraged by the improvement to corporate and consumer confidence that the election results seem to have provided. Corporate earnings, a major driver of stock price gains over time, have begun rising after a sharp decline during the 2014-2015 energy sector downturn. The FED is expected to raise rates multiple times in 2017 as the economic backdrop improves. We believe a normalization of interest rates will benefit investors over time – particularly retirees searching for higher yields. And lastly, the (dot.com) bust and the subprime mortgage meltdowns of yesteryear forced investors to shy away from equities and to embrace bonds and cash. With interest rates beginning to rise, we believe we are in the early stages of reversing this phenomenon, creating a powerful tailwind for the equity markets in 2017 and beyond.