2017 Market Outlook

The surprising election of president-elect Donald Trump resulted in sharp reactions globally in the stock, bond and currency markets. After initially falling the night of the election, U.S. stocks gained steadily throughout November and December, led by Financial and Industrial issues. The S&P 500 posted a 1.7% loss for the fourth quarter pre-election, but gained 4.6% after the election. Mr. Trump's victory raised expectations of a more pro-business political climate over the next four years, with a more restrained regulatory environment and lower corporate taxes contributing to higher corporate profits.

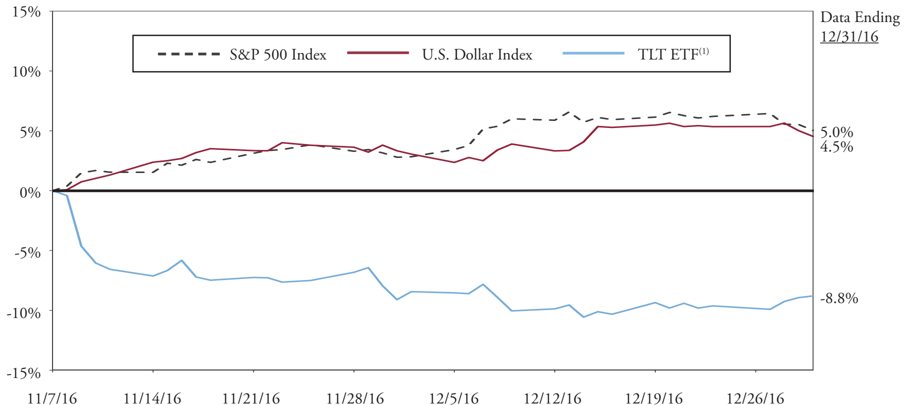
The U.S. dollar also posted strong gains post-election, helped in part by declines in other currencies, most notably the Mexican peso. Rising short-term interest rates also contributed to the dollar's strength, as the Federal Reserve raised their target for the Fed Funds rate to a range of 0.50% to 0.75% on December 14. The Fed also announced that they expect to raise rates another three times during 2017.

Bonds were the loser post-election, as prices on long-term Treasury bonds tumbled. The yield on 30-year Treasury bonds rose to 3.1% by the end of the quarter, their highest level since quarter ending 6/30/15. Interest-rate increases by the Fed contributed to the negative sentiment on bonds, but even more significantly, inflation expectations have risen. President-elect Trump's budget plans might result in increased federal budget deficits, at least in the short term, and rising energy prices are also contributing to higher inflation expectations.

Consumer confidence, as measured by the Conference Board, rose in December to its highest reading since 2001. A similar confidence survey by the University of Michigan showed the highest confidence reading in the past 13 years. Rising optimism may provide a boost to the U.S. economy over the next few quarters, even before new government economic policies are initiated.

The recent post-election stock market rally was the strongest the U.S. has experienced over the past 100+ years. As to what followed other strong gains, the record is somewhat mixed. The average gain in the next calendar year after a post-election rally of 5% or more has been 11%. However, this average includes a gain of 30.0% (in 1925) as well as a loss of 8.7% (in 1901).

STOCKS, BONDS AND THE DOLLAR SINCE THE ELECTION



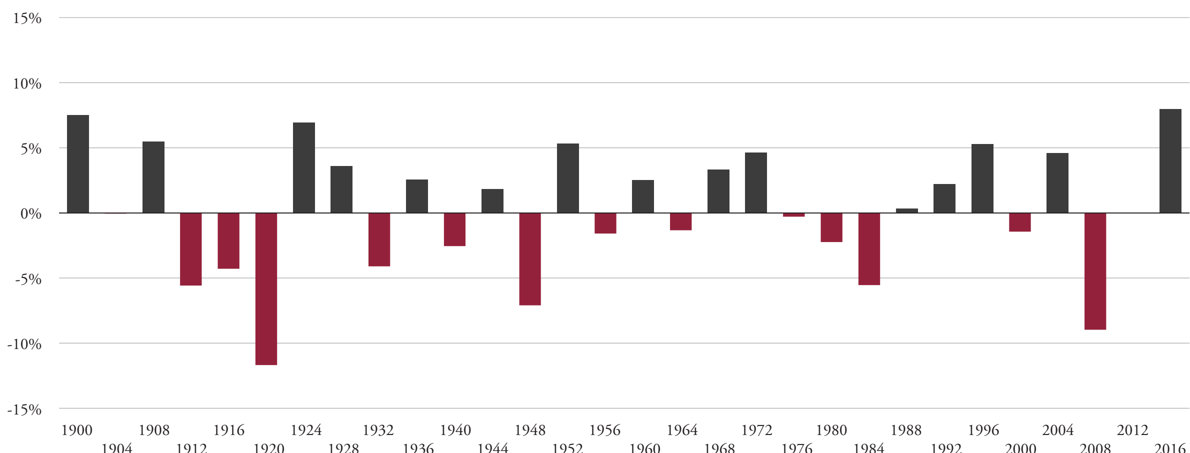
Data from 11/7/16–12/31/16

(1) The TLT ETF is an iShares 20+ Year Treasury Bond ETF.

Source: Bloomberg

POST-ELECTION STOCK MARKET RALLIES

Dow Jones Industrial Price Change From Election Day Through Year-End



Source: Wall Street Journal

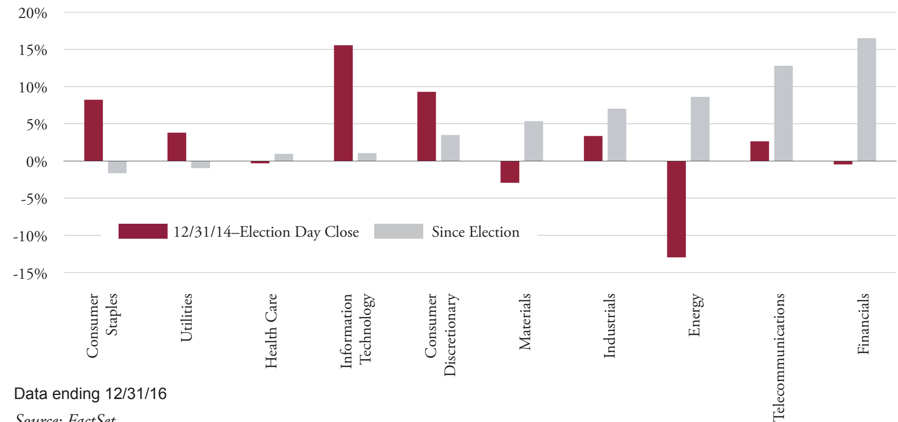
Market leadership within the stock market shifted dramatically following the election. While the Energy, Financial and Materials sectors were poor performers for 2015 and 2016 leading up to the election, they were among the strongest sectors over the remainder of 2016. Conversely, the Consumer Staples and Utilities sectors were among the strongest performing sectors through November 7, but then were significant underperformers through year-end. Rising expectations for economic growth contributed to the gains in more cyclically sensitive sectors, such as Energy, at the expense of traditionally defensive sectors such as Utilities.

If economic growth does accelerate, companies with exposure to capital spending should benefit. Historically corporations have invested cash in excess of their actual operating cash flow in capital spending projects, which over time contributes to rising productivity and stronger economic growth. However, since the Financial Crisis of 2008 many companies have underinvested in capital spending projects, preferring to use cash to buy back stock or pay out dividends. A return to a more traditional pattern of capital investment would be very beneficial to overall economic growth, and especially beneficial to companies involved in the capital spending sector, such as Technology and Industrial companies.

The S&P 500 P/E ratio rose to 21.0X by quarter-end, marking its highest level since quarter ending 9/30/09. The inverse of this measure, the E/P ratio or earnings yield, can be compared with the yield on bonds to provide a picture of the relative valuation of stocks vs. bonds. As the earnings yield on stocks has declined, the yield on bonds has increased, with the result that the spread between these two yields has contracted to its lowest point since the Financial Crisis. Even so, this measure is still unusually high relative to longer term history, suggesting that investors are still underpricing stocks, overpricing bonds, or perhaps a little of both.

With regard to overseas markets, president-elect Trump's positions on trade and immigration clearly contributed to market weakness after the election. The possibility of trade tariffs being imposed on Mexico and China,

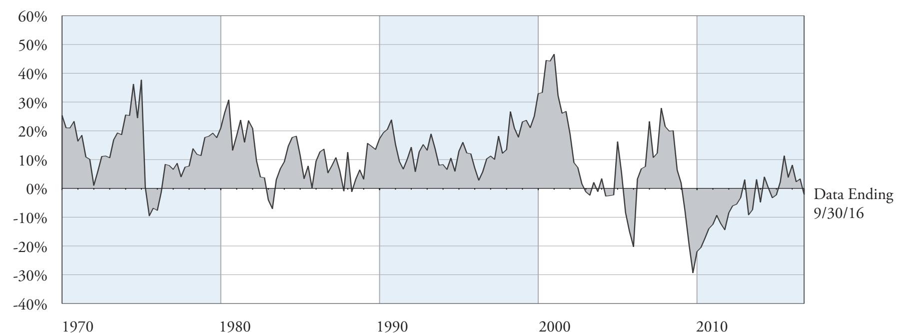
S&P SECTOR PERFORMANCE BEFORE AND AFTER THE 2016 ELECTION



Data ending 12/31/16

Source: FactSet

THE FINANCING GAP[1] AS A SHARE OF CORPORATE CASH FLOWS

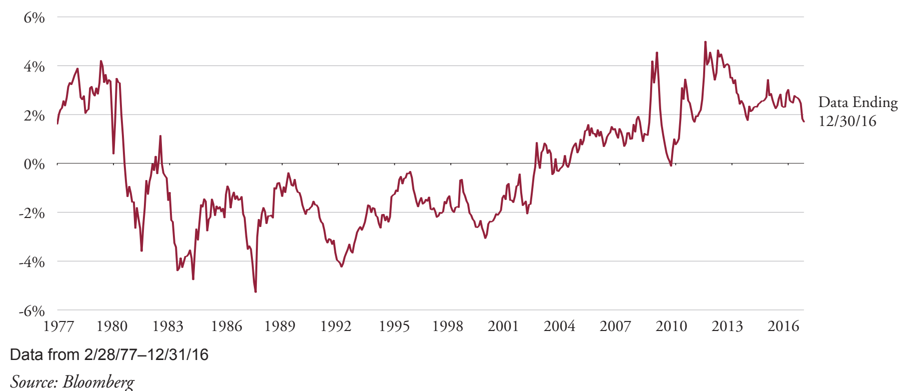


Data from 12/31/69–9/30/16

[1]Financing gap is the difference between corporate cash flows and capital spending.

Source: Federal Reserve

S&P 500 EARNINGS YIELD MINUS 30-YEAR TREASURY YIELD



Data from 2/28/77–12/31/16

Source: Bloomberg

as well as the negative impact of an appreciating U.S. dollar on U.S. investors holding foreign securities, led to declines in overseas markets in last year's fourth quarter.

However, there are potential positive effects of a stronger dollar on overseas investors as well, as a stronger dollar will help the profits of foreign exporters to the U.S. Early signs of a better economic environment in the U.S. will also help many foreign companies, as the still dominant U.S. economy tends to lift other global markets.

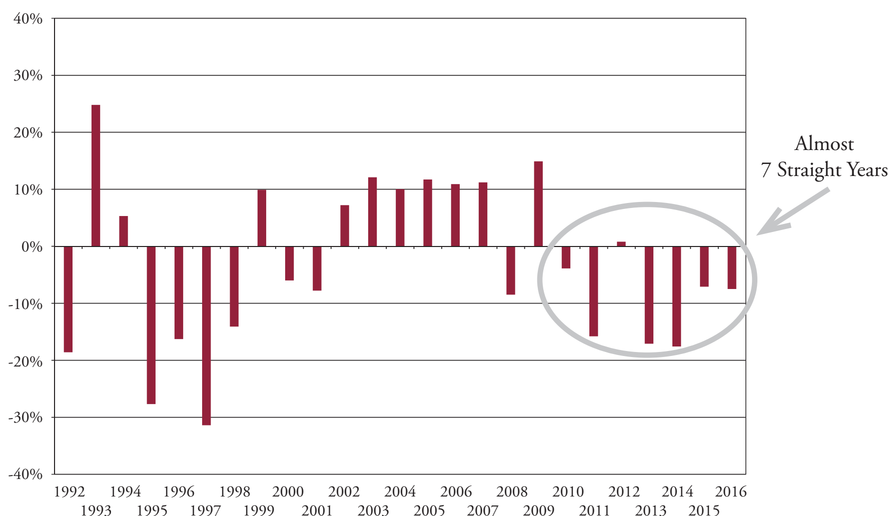
Foreign stock markets have lagged U.S. stocks for most of the past seven years, marking one of their longest stretches of underperformance since the 1990s. Clearly foreign markets are not the "hot money" play for investors today, but that is a good reason why investors should maintain a position in international markets, in order to benefit when the performance cycle turns. International markets are too big for the U.S. investor to ignore and continue to offer both diversification effects and potential return enhancement. In addition, underperformance in recent years has resulted in overseas markets selling at meaningful discounts to U.S. stocks, adding to the opportunities internationally.

The new political environment we are about to experience in 2017 is likely to be very different from the past, and a certain amount of uncertainty and volatility is to be expected. However, we are also encouraged by recently rising economic optimism in the U.S. and reasonable market valuations in the U.S. and overseas markets. We remain confident in our ability to identify and invest in high-quality, reasonably priced growth stocks and believe that stocks continue to offer good long-term return potential.

We believe that our portfolio is well positioned to take advantage of an improving economic landscape in the coming year.

MSCI ACWI EX US INDEX MINUS S&P 500

Annual Returns[1]



[1] Past performance is not indicative of future results. Performance for periods of less that a year is not annualized. All returns are shown in U.S. dollars.

Source: FactSet

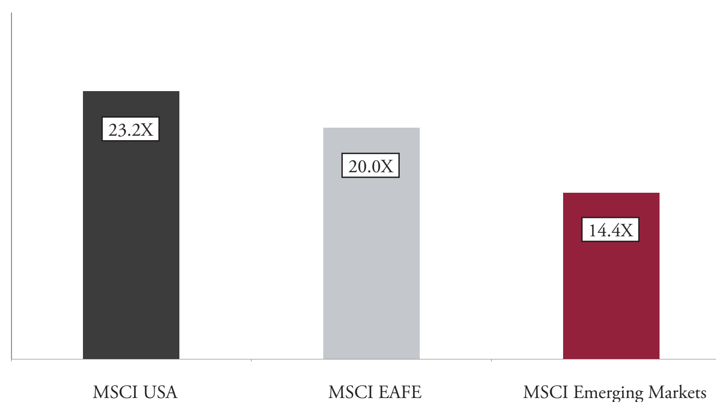
INTERNATIONAL MARKETS TOO BIG TO IGNORE

1. Of the 15 largest banks in the world, 10 are outside the U.S.
2. Metals and Mining (12 of top 15)
3. Airlines (11 of top 15)
4. Automobiles (12 of top 15)
5. Diversified Telecommunication Services (10 of top 15)
6. Pharmaceuticals (9 of top 15)

Source: MSCI ACWI, ranked by index weight as of 6/30/16

MARKET VALUATIONS AROUND THE WORLD

Trailing 1-Year Price-to-Earnings Ratio



Data as of 12/31/16

Source: MSCI

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S&P 500 Index— The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. It is calculated by Standard & Poor's Corporation, and reflects reinvestment of all dividends and capital gains.

MSCI ACWI Index—The MSCI All Country World Index is designed to measure the performance of the large and mid-cap segments of global equities. The index consists of approximately 2,500 securities from 23 developed market and 23 emerging market countries.

MSCI USA Index—The MSCI USA Index is designed to measure the performance of the large and mid-cap segments of the U.S. market. The index consists of approximately 630 securities and covers 85% of the float adjusted market capitalization in the U.S.

MSCI EAFE—The MSCI EAFE Index is designed to measure international equity performance for U.S. investors. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding U.S. and Canada. The index consists of approximately 925 securities from 21 countries.

MSCI Emerging Markets— The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the emerging markets. The index consists of approximately 800 securities from 23 countries.