fourth quarter 2016

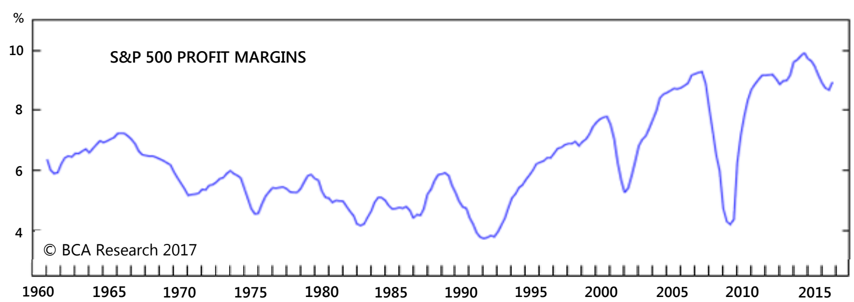
INVESTMENT *perspective*

During the fourth quarter of 2016, U.S. equity markets rallied materially in reaction to Donald Trump winning the presidency and to Republicans maintaining control of the House of Representatives and the Senate. The S&P 500 and Russell 2000 appreciated 3.8% and 8.8%, respectively during the quarter. Investors believe Trump's platform of corporate tax reform, broad regulatory relief, infrastructure spending, and protectionist trade policies is confirmation that support for the U.S. economy will shift from policy led by monetary actions to pro-growth fiscal policy. While we are not surprised that the equity markets rallied post-election, we believe the magnitude of the gains is a result of the significant repositioning in risk assets over a short period of time, and not necessarily investors assigning higher intrinsic values to individual securities.

In the first week following the election, U.S. stock ETFs took in $33 billion, which represented a third of the $100 billion received from the beginning of the year through the week after the election. According to TrimTabs Investment Research, U.S. Equity ETFs received $97.6 billion from November 8, 2016 through December 15, 2016. This compares to $61.5 billion in flows received for all of 2015. Much of the flows were directed to small cap indices, financial sector ETFs, and material sector ETFs. In connection with these flows, Treasury rates increased materially as investors pulled money from bond funds in order to increase their allocation to U.S. equities.

CHART 1

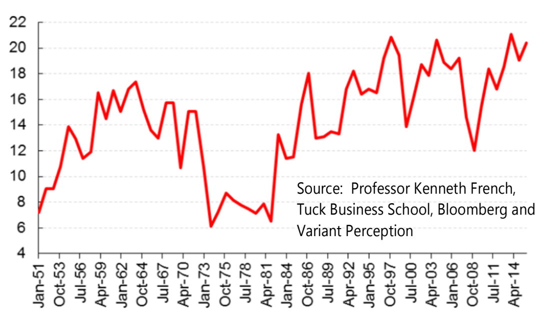
PROFIT MARGINS



As investors, we welcome pro-growth policies and believe that new pro-growth fiscal policies are necessary in order to achieve earnings expectations in 2017 and 2018. However, we must acknowledge that margins and valuations for equities are near all-time highs and that the business and credit cycles are quite mature **(Chart 1, Chart 2)**. In order to support current valuations and to expect further market gains, the credit environment must remain benign while companies increase capital expenditures in order to boost productivity and drive sustained earnings growth. We do not expect the transition from monetary stimulus to fiscal stimulus to be smooth, and we anticipate a material rise in market volatility over the short to medium term.

CHART 2

NYSE MEDIAN P/E RATIO



Over for conclusion.

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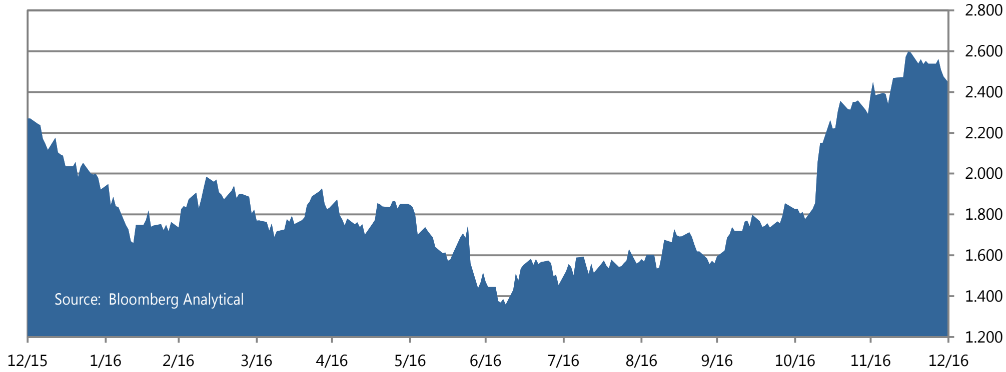
As the nature of the market continues to change there are still individual stocks that will perform well over the medium term. Our outlook remains balanced, stock-specific, and not reflective of opportunities in specific industries, regions of the world, or broader market indices.

For fixed income investors, the fourth quarter continued a move to higher interest rates that began in July. 10-year Treasury yields increased 85 basis points (1.60% to 2.45%) in the quarter and for the full year ended 18 basis points higher (2.27% to 2.45%). That slight increase in 10-year Treasury yields during 2016 does not show the extreme movements of rates during the year. Yields declined nearly 100 basis points during the first half of the year, only to selloff 115 basis points in the second half of the year **(Chart 3)**.

CHART 3
U.S. 10-Year Treasury Yield
12/31/2015 - 12/31/2016



Investment grade credit spreads exhibited similar volatility with risk premiums widening 50 basis points during the first six weeks of the year before improving economic data, a recovery in commodity prices, and significant foreign buying drove risk premiums down to levels last seen in 2014. For the full year, investment grade credit spreads ended 129 basis points over similar maturity Treasuries, which was 44 basis points lower than they began the year. This improvement led the corporate sector to be the best performing asset class within the investment grade universe.

The combination of weak Treasury market returns and the talk of tax law changes (lowering the corporate tax rates) from President-elect Donald Trump weighed heavily on the municipal bond market in the quarter. If a reduction of the corporate tax rate from 35% to 15-20% is passed significant institutional buyers like insurance companies and banks could become net sellers of municipal bonds in the years ahead. While this uncertainty was somewhat priced into the market since the election, the positive news is that any selloff makes yields even more attractive for high net worth individual investors where only minor changes in the top tax rates are expected.

As we look out the next couple of years, we welcome the possibility of a continued gradual rise in U.S. interest rates. We will continue to structure our portfolios to protect principal (shorter duration), to produce above market annual income, and to take advantage of dislocations within the investment grade universe.