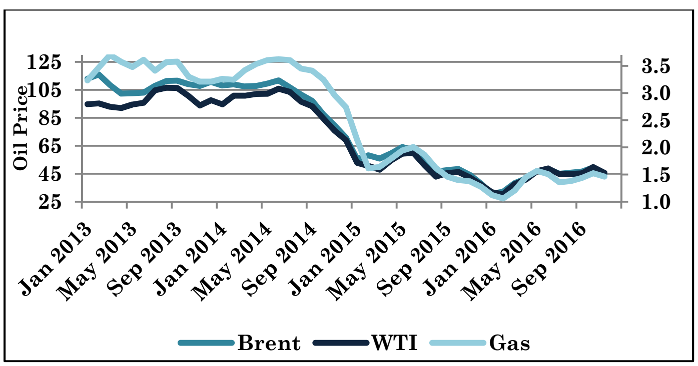
First Quarter 2017 Comments

The U.S. Economy

The fourth quarter was a fitting end to a year of surprises in just about every regard. We entered 2016 expecting “lower for longer”, an analysts’ moniker for an extended period of low interest rates, low inflation and low GDP growth. The Fed had just raised the Fed Funds rate for the first time in eight years and falling oil prices were causing concerns in both the equity and credit markets.

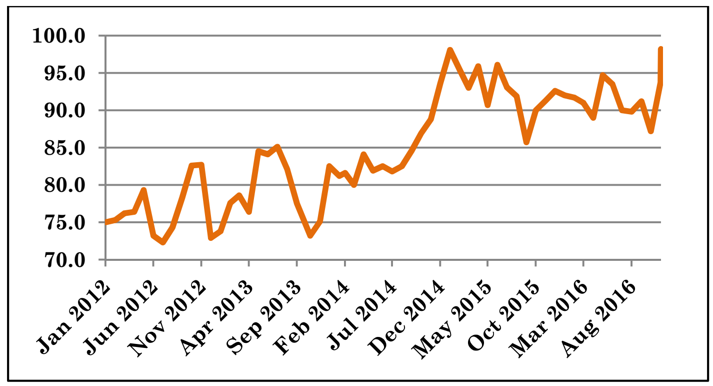
The first quarter of 2016 got off to a rough start with equities dropping 10% and oil bottoming at $27 per barrel.

Oil and Gas Spot Prices



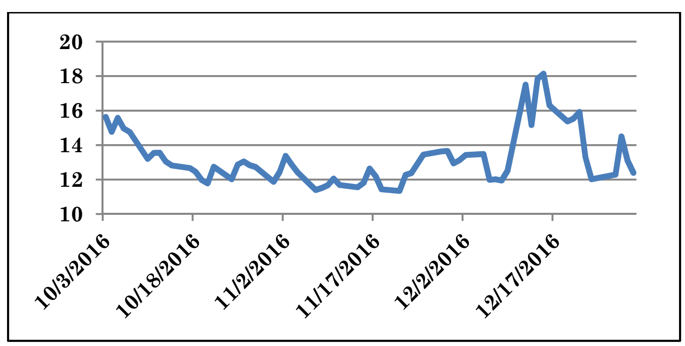
The second quarter brought better economic data which boosted consumer confidence and spending. The reduction in the unemployment rate raised sentiment, and Americans legitimately began feeling better about the economy. A record number of consumers reported favorable expectations on economic growth, significantly higher than in 1981 when Ronald Reagan took office.

Consumer Sentiment



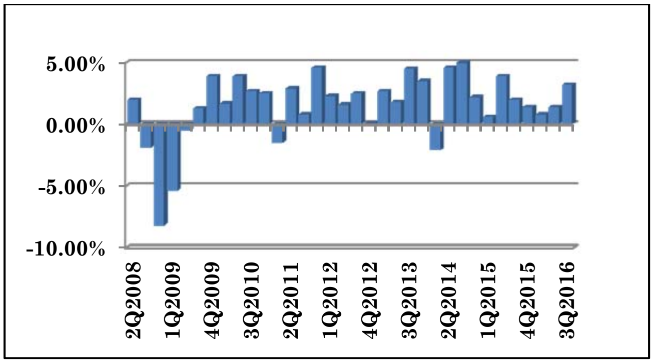
In late June, however, the UK shocked the world by voting to leave the European Union. Global markets reeled for a week and settled down after pundits detailed the delay in the withdrawal and the many scenarios that might evolve. Given the developments in Europe and the pending US election, one would have expected a volatile third quarter.

VIX



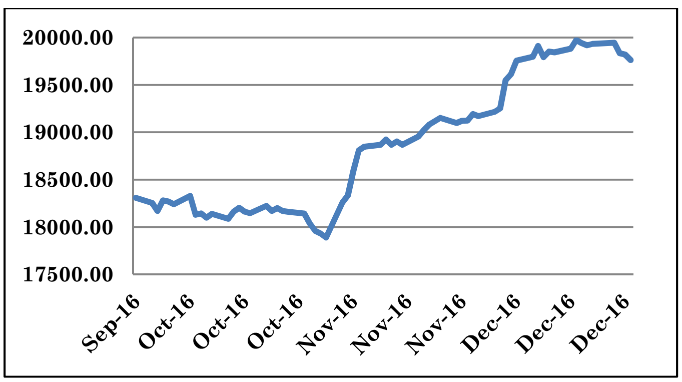
To the contrary, the VIX never broke 20 and many warned of complacency. Investors focused on wage growth, rising oil prices and improving GDP growth, keeping the markets in a narrow trading range.

U.S. GDP Growth Rate



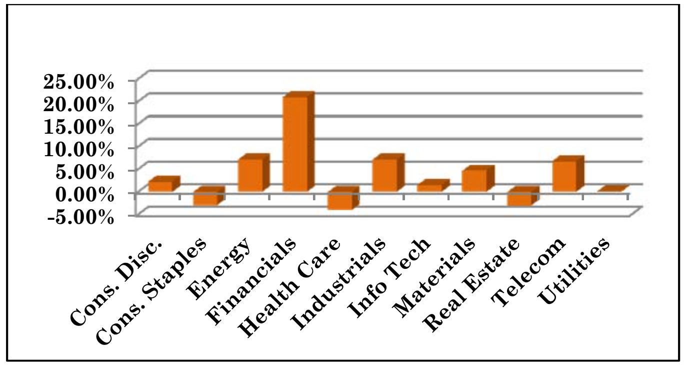
The 4th quarter started with 80% predicting a Hillary Clinton win and many predicting a Democratic House and Senate sweep. Prognosticators warned of increased regulation from Elizabeth Warren's camp and social programs to placate the Bernie Sanders supporters. Election Day proved just how wrong predictions and polls could be.

DJIA Fourth Quarter 2016



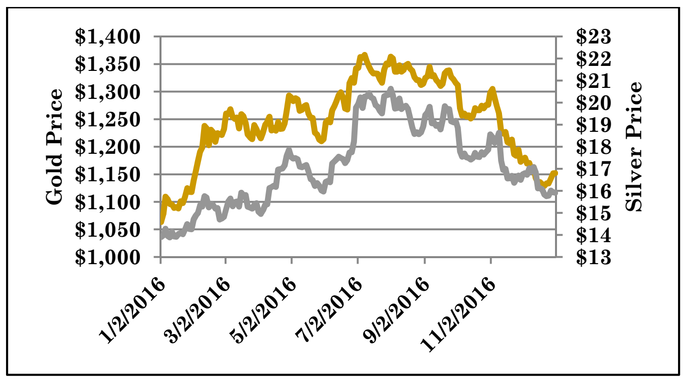
The initial reaction of markets to the electoral surprise was one of shock. Futures plunged 900 points in aftermarket trading. By the time markets opened on Wednesday, the Trump Rally had begun. Financials, Energy and Industrials were the main benefactors as the prospects for less regulation and increased infrastructure spending became more likely. Not all sectors enjoyed the upswing. Consumer Staples, Health Care and Real Estate registered negative returns for the final quarter. Consumer Discretionary and Info Tech squeaked out modest gains.

Fourth Quarter 2016 Sector Performance



By the end of the quarter, the Dow was teasing 20,000 and, despite the increasing uncertainty, the VIX was hovering around 12 while gold plunged $200 per ounce to $1150.

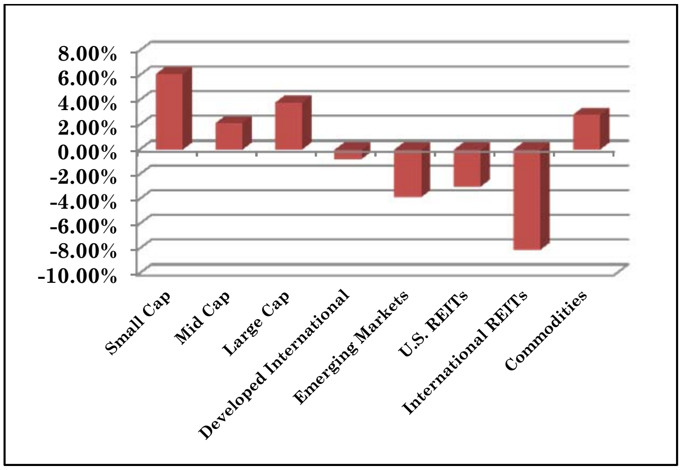
Gold and Silver Spot Prices



Outlook/Strategies

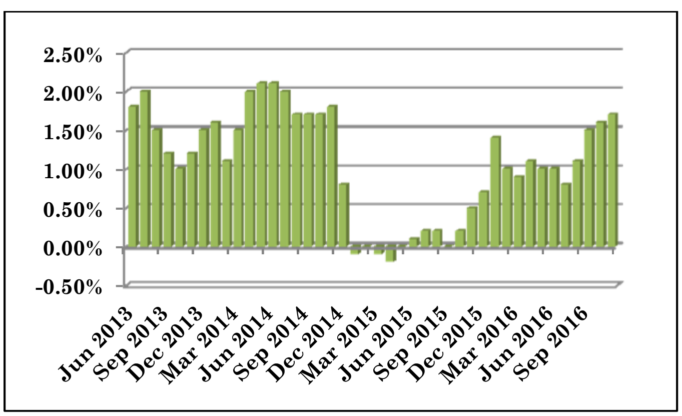
Trying to predict the longer term effects of the election with any certainty is folly, since we do not know yet the level of support President Trump will receive from his own party, much less the opposition the Democrats will mount. That said, there are a few short-term generalities that can be offered. The protectionist policies advocated by the President-Elect will benefit small and mid-cap companies, because they do most of their business in the US. Conversely, the potential tariffs would hurt International and Emerging Market stocks. Infrastructure spending benefits commodities and the large cap companies that would build the proposed projects.

Fourth Quarter 2016 Asset Class Performance



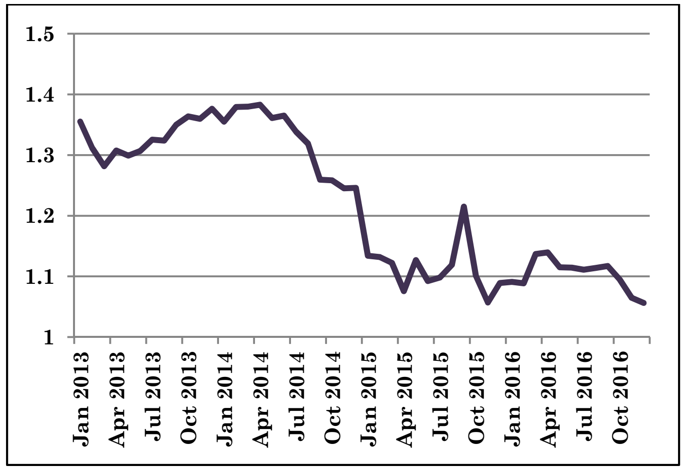
For the most part, these observations are already baked into the market, as witnessed by fourth quarter performance. Longer term, we would expect better GDP growth, albeit with growing deficits. This in turn would most likely lead to greater inflation. With unemployment down to 4.7% and wages starting to improve, pressure on prices is bound to return.

12 Month Change in CPI



Fed tightening and ECB easing should cause the dollar to strengthen, stemming in part from higher interest rates and economic stimulation. Repatriation of cash strategies such as tax amnesties will cause corporations to sell foreign currencies to buy dollars, further bolstering the dollar.

Euro vs U.S. Dollar



Most of the amnesty strategies being offered feature some degree of taxation. In 2004, a 5.25% rate was sufficient incentive to bring home about half of the $600 billion outside our borders. After the initial tax burden of repatriation is paid, companies would have billions for share repurchases, research and development, mergers and acquisitions, and increased dividends. All of these could potentially stimulate the market.

Europe remains a wildcard. The UK is not the only country with a groundswell of populism. Just as certain sections of the US felt left behind in the economic recovery, portions of the European continent feel the same. A deeper crack in the EU would surely lead to a slower recovery in countries already vulnerable such as Italy and Spain.

China is always hard to call because their economic data is suspect and they are secretive about their shortcomings. Most observers feel their conversion from an export-based economy to a consumer-based economy is behind schedule and leaning heavily on government spending. Many fear a housing bubble could set off further devaluation of the yuan, which would worsen global deflationary pressures.

Given that stocks are expensive (forward price-to-earnings of 18.9 vs. a 10-year median of 15.2) and global forecasts are so uncertain, risk management is paramount. To that end, we would recommend investors continue to widely diversify their portfolios with an overweighting of US stocks and Commodities, and an underweighting of International and Emerging Markets stocks. Within the domestic holdings, we would lean toward small and mid-cap companies that derive most of their revenues from US sales. To offset the risk of P/E compression, we would focus on high quality stocks selling at lower multiples and that have a strong history of increasing dividends to combat inflation.

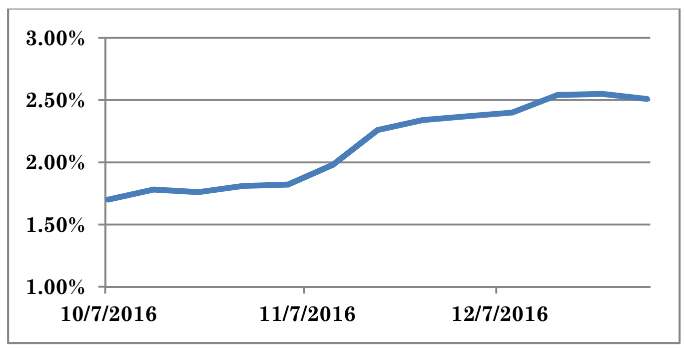
Fixed Income Markets

For the past decade, interest rates have been on a steady decline. The reasons were many: weak global demand, falling commodity prices, and a prolonged and dramatic quantitative easing policy by central banks around the world. Rising globalization and access to labor around the world drove down manufacturing costs, and geopolitical tensions drove investors to seek the security of the U.S. bond market. Unemployment rates continued to hold its own, but wage growth was stagnant, inflationary pressures were below target levels and interest rates continued to fall for the first half of 2016.

Moving into the third and fourth quarter of 2016, the bond market began reevaluating inflation risk and Fed policy, as commodity prices saw a slight uptick and U.S. labor markets showed slight signs of improvement.

The surprising outcome of the Presidential election and a new administration brought promise of policy changes ranging from a reduction in individual and corporate tax rates, increase in infrastructure spending, a reduction in regulation, and a revamp of trade policies. The bond market interpreted that as a potential boost to economic growth and inflationary pressures. Bond yields rose, with the 10-year Treasury note moving from 1.60% at the beginning of the 4th quarter 2016 to 2.47% at the end of the year, some of which was attributable to expectations of a Fed rate hike. As the market anticipated, the Federal Reserve increased the Fed Funds rate and announced that three more rate hikes in 2017 were expected.

10-year Treasury Note Yields



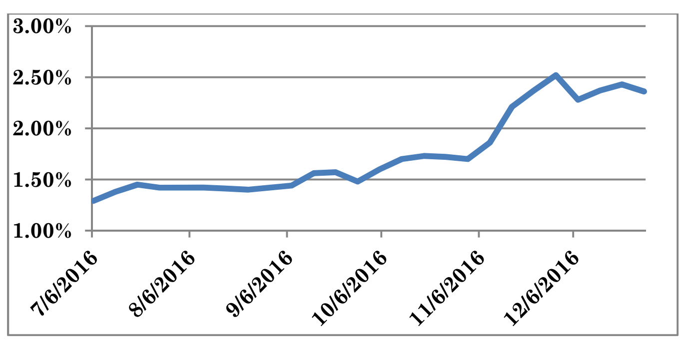
It has been quite some time since bond yields have consistently moved higher. Some investors are not accustomed to seeing market values decline and negative total returns in bond portfolios. Any time a drop in market value occurs quickly, overreaction can take place, causing investors to abandon their long term goals out to fear, which only intensifies the outcome. Although the past several months saw an unusually large increase in bond yields (yields rise, prices fall) it is important to keep the move in perspective. Short-term reactions to uncertainty occur and it remains too early to know how changes in policy will affect economic growth and interest rates. It comes down to how quickly legislation gets passed and the degree of impact on the economy. In spite of a Republican White House and Republican Congress, there remains a huge level of division. Should enacting new policies stumble, consumer spending and business investment may hold off, stunting growth and pressuring rates lower. If pro-growth policies are enacted sooner, rates would continue to rise. The strength of the economy and inflation levels will determine how quickly interest rates will rise going forward. Even in a rising rate environment, opportunities exist within the bond market and it is important to remember why bonds are an integral part of a diversified portfolio. Exposure to bonds provides a dependable income stream and reduces overall volatility in a portfolio as they typically react differently than equities. There are several factors that can affect the overall performance of a bond portfolio such as duration, quality, sectors, and holding periods. Proper management of these factors is key in protecting principal and mitigating downside risk. In spite of some short-term volatility that could lay ahead, our investment philosophy includes staying fully invested and altering asset allocation based on a change in needs or objectives, not market volatility.

Municipal Bonds

With the election of Donald Trump there are a lot of uncertainties surrounding 2017. Some of the proposed changes include the top marginal tax rate being cut from 39.6% to 33%, the removal of the 3.8% Obama care surtax on high income individuals, and a reduction in the capital gains rates. The potential changes in the tax structure would have an impact on the rate individuals pay on interest on taxable bonds. This, in turn, would have a substantial impact on municipal bonds and their appeal to higher income investors. Since the income generated from tax- free bonds is just that (tax-free), those bonds do not benefit from a tax-rate cut, while taxable bonds (i.e. corporate bonds) would. This means that tax-exempt bonds would be less attractive relative to taxable bonds, and the value of the tax exemption would be reduced. Municipal bond prices would move lower, yields would move higher, and total return would be under pressure. On the positive side, with a properly structured portfolio of individual bonds, an investor looking to protect principal would be in a position to hold the bonds until maturity. They continue to earn the income and receive the principal in full at the maturity date. Any capital loss would only be realized upon the sale of the bond prior to maturity.

In reaction to the rhetoric on tax rate changes, municipal bond yields did move higher. In addition, greater infrastructure spending equates to more debt being issued, and the increase in supply can drive yields higher as well.

10-year Municipal Bond Yields



However, the bond market has dealt with potential tax changes in the past. When marginal rates declined in 2001 and 2003, municipal bonds went through a period of underperformance, but ultimately rebounded, posting competitive returns to other bond sectors. While some volatility may remain in the short term, we are hesitant new tax reform will have a substantial negative effect on municipal bonds. We still like the sector for overall strong credit quality and income generation, but as interest rates move higher and we get more direction as to the changing economic environment, we will continue to monitor our maturity and duration target for our portfolios and adjust accordingly.

The other topic being tossed around is the repeal of municipal bonds' tax-exempt status. This has been a source of discussion many times in the past and each time, state and local officials have made it all too clear the negative impact that increased capital costs would have on their taxpayers. This is a proposal Trump has bantered about, but he realizes the importance of state and local governments to the nation's infrastructure, so it is highly unlikely to come to fruition.

The change in the marginal tax rates is expected to be adjusted; the degree of that change is the unknown.

Richard L. Ware, CFA & Beth D. Swartz

December 2016

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3. VIX
Chicago Board Options Exchange: Implied volatility of S&P index options.

4. U.S. GDP Growth Rates
U.S. Department of Commerce, Bureau of Economic Analysis:
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5. DJIA S&P Dow Jones, Dow Jones Industrial Average:
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6. Sector Performance
Morningstar: Sector performance of the 11 S&P 500 sectors on a quarterly basis.

7. Gold and Silver Spot Prices
Bullion Vault: Current price of the commodity that can be purchased/sold immediately.

8. Asset Class Performance
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9. 12 Month Change in CPI
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10. Euro vs U.S. Dollar
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11. 10 year Treasury Note Yields
Federal Reserve Economic Data: Yields for U.S. Treasuries.

12. 10 year Minicipal Bond Yields
SIMFA.

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