MARKET Insights

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February 2017

Expect the Unexpected

Investing in the New Abnormal

The past year certainly was full of surprises – both negative and positive – for investors. In 2016 there was a surge of populist movements globally, most evident in the successful vote by the United Kingdom to leave the European Union ("Brexit") and in the upset election of Donald Trump as President of the United States. At the start of 2016 the US stock market fell sharply, as the S&P 500 declined over -10% from Jan 1st to Feb 11th. Meanwhile interest rates reached rock-bottom lows, as the yield on the benchmark US Treasury ten-year note settled to a record low of 1.37% on July 5th. Both market moves were stark signs of concerns over global growth and declining corporate profits.

What A Finale... Major Market Results in 2016

	Jan-Jun	Jul-Dec	Full Year
US Large Cap Stocks S&P 500 Index	+3.8%	+7.8%	+12.0%
US Small Cap Stocks Russell 2000 Index	+2.2%	+18.7%	+21.3%
US Treasury Bonds 10-year Treasury note	+14.8%	-11.8%	+1.2%
US High Yield Bonds Merrill Lynch HY Index	+9.3%	+7.5%	+17.5%
Market Volatility Average CBOE VIX Index	18.0	13.7	15.8

However, what a difference six months makes. All the bad news so apparent last summer gave way to a winter of abundance. Smaller and lower-quality companies out-performed blue chips in 2016, with Russell 2000 stocks up +21.3% and the Merrill Lynch High Yield bond index up +17.5%. The US economy as a whole is as strong as it has ever been, as measured by official unemployment at 4.7% and GDP per capita at a record high of $51,678. The US stock market is at record highs, with the Dow Jones Industrial Average breaching the 20,000 mark. Even the stock market's "fear gauge," the VIX (CBOE volatility index) is currently near 12, a level close to historical lows and well below its long-term average of 20.

Portfolio Themes & Positioning

After a positive start to earnings season, equities have retreated in recent days on concerns over the Trump administration's immigration and trade policy announcements. Concern about the administration's ability to enact pro-growth measures while restricting trade and borders threatens to stall the rally that has propelled the market since early November. With a backdrop of improving domestic growth, we expect a modest but upward trending increase in inflation due to higher hydrocarbon prices than in 2016, and higher food prices from tariffs on Mexico and other major food sources. Tighter labor markets due to low unemployment, restricted immigration and higher urban housing costs will also place upward pressure on wage costs.

Three major themes driving our positioning of client portfolios this year:

1. MAINTAIN A PRO-GROWTH INVESTMENT STANCE, FAVORING STOCKS OVER BONDS

We are currently overweight US large cap stocks, favoring key cyclical sectors such as financials, industrials, and technology. We are less reliant on stocks that previously served as bond or income proxies, such as utilities, REITs, telecom, some consumer staples. Total return matters more than a tempting dividend yield.

INVESTOR CONSIDERATIONS:

Consider US large cap stocks in key sectors such as financials, industrials and technology.

We expect monetary policy, especially in the US, to take a back seat to fiscal policy. The Federal Reserve has already revived its original playbook of managing inflation and employment via the overnight Federal Funds rate. Further rate increases will occur slowly, and the Fed will remain "data dependent". The US Congress now faces expectations of significant stimulus from major infrastructure spending, tax cuts and a streamlining of regulations. This should serve to elongate the bull market before reaching a cyclical peak. Be wary of bumps in the road, however.

2. SHORTEN DURATION IN BOND PORTFOLIOS, ALLOCATE AWAY FROM GOVERNMENT DEBT

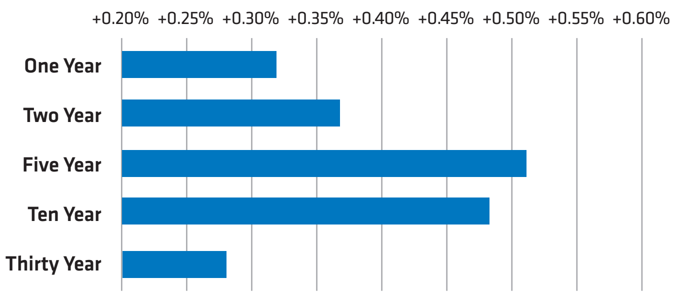
Investment grade bonds have already sold off on expectations of higher growth and inflation in the US, and we expect further interest rate increases across the range of bond maturities. Thus far, the greatest increase in interest rates has been in the "belly" of the fixed income curve – at maturities of 5 to 10 years. Rates for longer maturity bonds haven't risen proportionately. A key risk for fixed income investors is if fiscal policy or growth turns out to be stronger than the market currently expects. That would likely cause the fixed income curve to steepen further, with rates on long term maturities rising significantly from current levels. We are avoiding this kind interest rate risk by shortening bond portfolios, both for taxable and municipal holdings. For municipal bonds, we are monitoring expected Federal tax changes that will determine the appropriate after-tax value of these bonds.

US Treasury Notes and Bonds
Increase in Yields - Jan 27 2016 - Jan 27, 2017

Maturity	Change	Current Yield
One Year	+0.32%	0.78%
Two Year	+0.37%	1.22%
Five Year	+0.51%	1.94%
Ten Year	+0.48%	2.48%
Thirty Year	+0.28%	3.06%

Source: FactSet market data

Interest Rate Increases, by Maturity



Source: FactSet market data

In other Fixed Income sectors, we remain cautious about US high-yield bonds. The current extra yield of these bonds over US Treasuries is approximately 4%. This is less attractive than a year ago, when high yield bonds offered almost 9% more than comparable US Treasuries. We recommend a moderate allocation to inflation-linked government bonds that stand to benefit from increases in official inflation. We also are including small allocations to debt of emerging market companies that are denominated in the US dollar.

INVESTOR CONSIDERATIONS:

Consider shortening bond portfolios, both for taxable and municipal holdings. Consider moderate allocation to inflation-linked government bonds and small allocations to debt of emerging market companies denominated in the US dollar. Consider funds that hold senior floating-rate loans as potential inflation-hedge.

Current yields on corporate bonds in emerging markets are more than those of similar American companies. We prefer to invest with managers or funds that hold emerging market corporate debt instead of government bonds. Private companies tend to have better balance sheets and offer more transparent financial reporting than governments in almost all emerging market nations. We also are including floating-rate debt as a bond substitute with potential inflation-hedging qualities, primarily via funds that hold senior floating-rate loans.

3. DIVERSIFY GLOBAL EQUITIES SELECTIVELY, AVOIDING "ANTI-GLOBALIZATION" RISK

We are underweight non-US equities, primarily in international developed markets while we are neutral regarding emerging market equities. A rotation of global investment capital toward emerging markets may be already underway. Seven of the top ten performing country markets in 2016 were emerging markets nations, with the large markets of Brazil and Russia up +67% and +58%, respectively. European equities appear cheaper than their American counterparts on historical price-to-book and price-to-earning measures. However, European interest rates do not yet reflect expectations for the kind of earnings growth that would make these stocks attractive at this time. We would await clear sign of a growth catalyst – such as fiscal stimulus in Britain or France – that would unlock the apparent value of European equities.

Top Performing Country Stock Markets In 2016

Place	Country	Return (in USD)	Emerging or Developed
1	**Brazil**	**+67%**	**Emerging**
2	**Russia**	**+58%**	**Emerging**
3	**Hungary**	**+35%**	**Emerging**
4	**Thailand**	**+27%**	**Emerging**
5	Canada	+26%	Developed
6	**S Africa**	**+21%**	**Emerging**
7	**Indonesia**	**+18%**	**Emerging**
8	Norway	+18%	Developed
9	**Taiwan**	**+17%**	**Emerging**
10	USA	+12%	Developed

Source: MSCI Indexes

Major global institutions such as the United Nations, World Trade Organization, International Monetary Fund and NATO, may be disregarded in favor of direct bi-lateral alliances and episodic trade deals or treaties. The current US President is openly hostile to global trade deals and dismissive of military alliances such as NATO and those with East Asian partners. The UK is already exiting the EU and anti-EU parties are gaining political clout in France and Italy, the Eurozone's second and third largest economies. China's leadership has described the nation as a champion of globalization but is expanding its naval footprint in the South China Sea, which threatens fisheries and the free movement of goods in East Asia.

The past two decades have witnessed an unprecedented migration of people – both across borders and from rural to urban markets within borders. This migration trend is ceasing due to government crackdowns on immigration in Europe and the US, as well as a slowing rate of urbanization in developing economies with swollen megacities. In addition, high housing costs in most cities deter citizens from moving within their countries from rural and ex-urban areas to the cities.

INVESTOR CONSIDERATIONS:

Consider adding an element of "anti-globalization" in the form of domestically-oriented companies, including US small and mid-caps, for beneficial diversification in equity allocations.

Risks to Outlook

"It's tough to make predictions, especially about the future," as Yogi Berra aptly stated.

Domestic risks to our positioning include continued fiscal intransigence by Congress and new populist policies. If the current administration and Congress prioritize tax cuts over additional spending on new private sector jobs, there will be less additional growth via such stimulus. The implementation of populist policies – closed borders, restricted trade and finance, drug price controls – would result in new burdens on established business models in manufacturing, retail, healthcare and banking.

External geopolitical risks include a Chinese banking crisis that would result in an immediate sell-off of risky assets, such as in emerging and commodities markets. A Chinese devaluation of the yuan to improve their terms of trade would help bank balance sheets, but also worsen the US-China trade deficit. US military entanglement in the Middle East could drive a sharp rally in oil and Treasury bond prices. Although a long shot, if a major nation such as Italy leaves the Euro currency system, this would spark a major banking crisis, leading to potential rallies in the US dollar, gold and Treasuries, and a sell-off of almost all other assets. Any of these scenarios could create rebalancing and reinvestment opportunities as long as the domestic growth outlook in the US remains healthy.

Asset Class Recommendations

Asset Class	Sector or Geography	Recommended Positioning
Equities	US Large Cap	Overweight, specifically in financials, industrials, technology, materials
Equities	US Large Cap	Underweight utilities, telecom and other "low volatility" bond proxies.
Equities	International Developed	Underweight until clear signs of profit growth and/or fiscal stimulus.
Equities	Emerging Markets	Neutral, but potential to add as EM earnings growth improves.
Fixed Income	Government Debt	Shorten duration, avoiding long maturities (10+ years).
Fixed Income	Municipal bonds	Remain short duration, await resolution of expected Federal tax changes.
Fixed Income	Bank Loans	Substitute traditional bonds via floating-rate, senior secured loans.
Fixed Income	High-Yield	Reduce position sizing on strength. Current relative yields are not compelling.
Fixed Income	Inflation-Indexed	Moderate allocation to profit from increases in official inflation indexes.
Fixed Income	Emerging Market Debt	Corporate US-dollar issuers based on attractive relative yields.
Alternatives	REITs	Underweight due to interest rate sensitivity.
Alternatives	Commodities	Negative on oil and base metals, potential Chinese demand fades in 2H 2017.
Alternatives	Absolute Return	Small, satellite allocations to arbitrage and buy-write options strategies.

What does it mean for investors?

Investors should expect the unexpected in 2017. Opportunities at this time include cyclical assets such as US financials, technology and industrials, plus emerging market assets and floating-rate or inflation-linked debt. We are wary of interest rate sensitive sectors and strategies, such as utilities, telecom, REITs and "low volatility" portfolios.

Key risks to wealth include rising interest rates as well as a steepening of the US Treasury yield curve (even higher long-term interest rates). Lackluster fiscal stimulus or major geopolitical shocks remain important short-term risks, but we are confident that long-term investors can use such volatility to reinvest at more attractive prices, especially if US growth remains resilient.

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Source for charts: FactSet 12/31/16

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