Investment Perspective

The U.S. stock markets advanced strongly in 2016 despite a January correction that included the worst first five trading days to start a year. Historic experience suggested this was a precursor to below-average annual returns. But the markets beat those odds with returns of 12% and 16.5% for the S&P 500 and the Dow Industrials, respectively. Politically, conventional wisdom was upended twice in 2016. The British decision to leave the European Union (Brexit) and Trump's presidential election were unexpected and surprised most pollsters. These stunning outcomes demonstrate the difficultly in predicting the future and reinforces the challenge of determining the market's expectations. Despite those shocks, the stock market followed historical precedent after the first federal funds rate hike. Although stocks fell during the first 60 days following the December 15, 2015 rate increase, the S&P 500 is now 11% higher, which is consistent with the history of above-average returns 12 months after the first hike. Early cycle tightening is not the same as late cycle tightening. At this stage, higher interest rates signal stronger economic growth, which bodes well for earnings and equities.

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Today, the economic outlook is more robust and consistent with the view that some monetary tightening is appropriate. The fundamentals supporting a favorable outlook for equites – e.g. moderate growth, mild inflation and low interest rates – now include rising consumer and investor confidence. The "wall of worry" was successfully climbed last year, but today's challenge is to remain on guard for complacency and over-exuberance. Unexpected developments may produce moderate corrections against the backdrop of an uptrend in equity prices. A summary of last year's index returns through December 31, 2016 is as follows:

Dow Jones Industrials	+16.5%	Russell 2500	+17.6%
MSCI EAFE	+1.0%	S&P 500	+12.0%
NASDAQ Composite	+8.9%	Wilshire 5000	+13.0%

GLOBAL ECONOMY

World economic growth (ex. U.S.) is expected to increase 3.7% in 2017 – an improvement from the 3.3% pace last year. The global economy is gradually improving as a result of reflationary actions taken by the world's central banks. In addition, commodity prices have rebounded sharply from the lows of last winter, helping emerging economies. Growth expectations for France, Germany, Japan and the U.K. remain low compared to China and the U.S., but the tone is improving. The pace and impact of Brexit remains uncertain. The European Central Bank (ECB) continues to battle low growth with negative interest rates and quantitative easing, but investors are gaining confidence that the ECB may slow its massive easing programs. Policy normalization would be viewed favorably after nine years of massive stimulus. China is growing 6.6% with downside risk as it navigates a transition from infrastructure stimulus to domestic consumption. China is pushing reforms to reduce debt and contain the risks of an overheated housing market. Geopolitical tensions and protectionist attitudes are risks to the forecast. The U.S. dollar has been strengthening and any significant "flight" into the dollar could disrupt the terms of trade.

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The U.S. economy is expected to grow 2.1% this year following below-average growth of 1.6% in 2016. The major growth driver remains consumer spending with potential support from business investment spending. Recent indicators suggest that the economy has improved and anticipated business-friendly policies have provided hope for improving business investment. The manufacturing Purchasing Managers Index (PMI) increased to a two-year high of 56 in January, from 48.2 last January (readings above 50 indicate expansion). Particularly encouraging was the 17% rise in the new orders indicator. The non-manufacturing PMI remained at 57.2, indicating continued strong growth. Consumer confidence has also surged on expectations of improved business conditions and higher incomes. The Conference Board consumer confidence index rose to 113.7 in December, the highest since August 2001. Additionally, auto sales remained strong at 18 million annualized and slightly above the record 2015 pace. Employment growth averaged 180,000 new jobs per month in 2016 versus 230,000 in 2015 as the economy moved closer to full employment. The unemployment rate at year end was 4.7%, down from 5.0% the prior year. Private sector average hourly earnings increased 2.9% y/y. Existing home sales reached 5.5 million, up 5.0% compared to last year's pace, and the S&P/Case-Shiller Home Price Index advanced 5.3% y/y. Inventories of homes available for sale have tightened to a 3.6-months' supply – down 8% from last year. Single-family housing starts were up 4.9% y/y. Several leading indicators point to moderate growth across the economy with continued improvement.

PRO-GROWTH AGENDA

Policy changes by the Trump administration could boost U.S. economic growth by a full percentage point in 2018

Policy changes by the Trump administration could boost U.S. economic growth by a full percentage point in 2018. The administration's pro-growth agenda will involve three key elements: deregulation, infrastructure spending and tax reform. Corporate tax reform will increase cash flow for capital investment, research & development and mergers & acquisitions. In addition, a reduction in U.S. corporate taxes will level the playing field with other international companies and stem the tide of U.S. businesses looking to reincorporate in other countries. Individual income tax cuts may help bolster consumption as a primary engine of growth. Initially, deregulation will most likely impact healthcare with the proposal to "repeal and replace" Obamacare and allowing Medicare to negotiate drug prices. The banking sector also may benefit as the Dodd-Frank legislation is moderated. In general, the Trump administration comprises many executives who may help streamline government bureaucracy. Business fixed investment, the weak link in the current expansion, will benefit from reform that reduces the after-tax costs of capital spending. In addition, government stimulus for infrastructure and rising defense spending may add 0.4% to GDP annually and generate private sector jobs. Surveys of corporate executives are beginning to reflect the anticipated tax policy changes. For example, Trump's victory is evident in the 8% rise of the Small Business Optimism Index from November to 105.8 in December, the highest since the end of 2004. Related, the net percentage of firms expecting the economy to improve soared from 12% during November to 50% last month, the highest since March 2002. We anticipate that a lower corporate tax structure, expensing of new capital investment and a more relaxed regulatory environment will boost confidence and encourage businesses to hire and invest. As a result, business investment spending may grow almost twice the rate of GDP over the next few years. The potential offset is that rising protectionism from renegotiating trade agreements may reduce world trade.

CORPORATE PROFITS

This will be the first meaningful increase in earnings in three years. The improvement comes from reacceleration in revenue growth which has been tepid

We expect S&P 500 operating earnings to increase 8% in 2017 to $129 per share, the first meaningful earnings increase in three years. The improvement comes from a reacceleration in revenue growth which has been tepid. Sales growth for the S&P 500 turned negative for a few quarters in late 2015/early 2016 due to the impact of falling energy prices, the strong dollar and general economic sluggishness. We are now lapping that period with 4% sales growth in the fourth quarter of 2016, which should improve during 2017. This would be the best pace of revenue growth since early 2012. The combination of margin improvement and share repurchases should leverage this year's 5% sales increase into 8% earnings growth. In addition, the potential for a reduction in the corporate tax rate will give earnings growth a boost. Hindsight shows that we just experienced a shallow profits recession with a stabilized market environment. For example, the S&P 500 traded at the same price in December 2014 that it did in November 2016. It is another reminder of the powerful and efficient discounting that takes place in the investment world – the market is always looking ahead despite challenging short-term obstacles. Companies with a domestic focus may benefit in the period ahead due to greater exposure to lower U.S. tax rates and policies aimed at "Making America Great Again."

INFLATION & INTEREST RATES

All the domestic inflation measures indicate inflation is rising moderately at an acceptable level

The Federal Reserve is likely to raise interest rates twice this year after a single hike in both 2015 and 2016. The Fed is tightening because inflation is nearing its 2% target and employment levels are healthy. In addition, the central bank needs to normalize interest rate policy to replenish the Fed's monetary policy tools. Overall inflation is 2.1% and core inflation (excluding food and energy) is 2.2%. The Fed's preferred inflation gauge, the core personal consumption expenditures (i.e. core PCE) price index, is up 1.7%. All the domestic inflation measures indicate inflation is rising moderately at an acceptable level. Currently, the fear of U.S. deflation has subsided. Specifically, the 10-year breakeven inflation rate is 2.08% – up from last year's lows of 1.23%. This market-based indicator measures the difference between the yield on inflation-protected and nominal Treasuries and implies the inflation rate expected by bond investors. Globally, the risks appear skewed to the threat of deflation. Future rate increases here should be gradual and slower than historical precedent. The peak in the federal funds rate might reach 2% to 3% versus prior peaks of 4% to 6%. In general, continued low interest rates overseas and the strong dollar are likely to restrain U.S. rates from rising too rapidly.

INVESTMENT OUTLOOK

Business fundamentals are improving after a brief slowdown in economic activity. Furthermore, business confidence and investor sentiment have improved dramatically and the stock market is hitting new highs. The election highlighted a pro-growth agenda, cleared uncertainty and unleashed a positive investment bias. The outlook for equities continues to be positive. The stock market appears attractive at 17.5x this year's estimated S&P operating earnings of $129 considering the long-term outlook for earnings, inflation and interest rates. The deflationary cross-currents that confounded the Fed have eased, which is allowing the tightening process to resume. The early to middle stages of a Fed tightening process is usually positive for equities. In fact, when the 10-year Treasury yield is below 5%, rising rates have historically been associated with rising stock prices.

Over the last three years, multiple expansion has provided most of the S&P 500's price return and it is time for earnings growth to resume as a primary driver of return. For example, the S&P 500 was up 21% over the last three years (2014-2016) while earnings per share improved 1.7% to $119. It appears that a healthy increase in earnings is achievable this year with rising revenue growth. Also, the negative impact of declining energy earnings has passed and the earnings recovery will be supported by a 46% increase in the oil price and OPEC's agreement to cut production. Importantly, all 11 S&P economic sectors should be growing this year which has not been the case recently. Higher interest rates will benefit the earnings of financial companies which comprise 20% of the S&P 500. On the flip side, a strong U.S. dollar continues to pose a risk to revenues and earnings from overseas operations.

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Supply and demand fundamentals for equities are favorable as M&A and stock repurchases shrink the equity base while new supply from initial-public-offerings (IPO) remains limited. After setting a $2 trillion record in 2015, U.S. mergers and acquisitions activity slipped 15% to $1.7 trillion in 2016. We expect a better year for takeovers in response to improving business confidence, favorable tax policy and "low-and-rising" interest rates. Gently rising rates motivates prospective buyers to invest while access to capital is inexpensive. IPOs had the lowest level of activity since 2009. In fact, the last two years were two of the lightest non-recessionary years for IPOs in the last 15 years. A reduced flow of new equity supply is positive for existing shareholders and a healthy dynamic for a rising market without a frenzy of IPOs and excessive exuberance.

We expect a better year for takeovers in response to improving business confidence, favorable tax policy and "low-and-rising" interest rates

Technically, the stock market has improved significantly, but may be overbought short-term. Price momentum, breadth and other confirmatory signals are positive. The NYSE advance/decline ratio is making new highs confirming the secular uptrend. The Investor's Intelligence poll near 60 is close to record highs but this level of "bullishness" can often be a contrarian signal. The four-week moving average of the S&P put/call ratio is historically low which indicates less fear and more complacency. In addition, the VIX option volatility index is near the lowest level in years at 11.50 – the index rarely reaches 10. The "wall of worry" is lower than usual, so we should embrace the optimism but be skeptical of rampant bullishness. The market often trades on the old cliché "buy the dream, sell the reality." Some caution is warranted.

A few key risks include: unexpected inflation, a Chinese hard landing, weakness in the periphery of the euro-zone, cyber-attacks and military conflicts. Additionally, protectionism presents a significant wildcard for the economic outlook. The Trump administration aims to move production and jobs back to America through a variety of means, including tough bargaining. Trump has proposed tariffs and other barriers to imports, which may inhibit the flow of trade and sour relations with key trading partners. A sharply stronger dollar or tough talk could hurt S&P 500 earnings and business sentiment.

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We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. The resumption of above-average earnings growth with some multiple expansion should support appreciation consistent with historic trends. We believe the odds favor higher equity prices, although we may experience some unexpected turbulence. The potential buying power for equities is substantial as stocks are under-owned by institutional and retail investors. In addition, the cash percentage of global fund managers is 5.8% – the highest level since

2001. The pace of equity fund inflows remains below historical trends which highlights the opportunity for better flows in the future.

Does the January trend matter? The old stock market adage is "so goes the first day, week and month, so goes the year." This January the first five days were up 1.5%. Based on 41 years of data, this leads to a positive annual return 85% of the time with an average gain of 14%. But that adage was not true in 2016 – the S&P 500 increased 12% for the year despite declining in January. In fact, the year started with the worst first five days in history!

Protectionism presents a significant wildcard for the economic outlook

In closing, 2017 is the Chinese "Year of the Fire Rooster." The rooster is aggressive, confident, creative, loyal, nimble, and protective. Tradition suggests that it is good to deal with financial events during Rooster years. Among the 12 Chinese zodiac signs, Rooster years produce the fifth best stock market returns. Finally, December's rise of 8% in the Small Business Optimism Index was the third largest on record. The four prior gains over 5% produced an average stock market increase of 14% in 12 months. We look forward to producing above-average returns in 2017.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2015	Yearend 2016	Difference/ Change
Fed Funds Rate (%)	.50	.75	+25 bps
10 Yr. Treasury Yield (%)	2.30	2.48	+18 bps
Inflation (CPI y/y % ch.)	0.70	2.10	+140 bps
Gold ($/oz.)	$1,060	$1,151	+9%
Oil ($/barrel)	$37	$54	+46%
Euro per Dollar	.92	.95	+3%