2016 REVIEW

2016 was a year with a lot of volatility, as concerns about geo-political risks, global economic growth, central bank activity and a contentious U.S. election weighed on investors' minds. The U.S. economy continued on a path of moderate, but somewhat uneven growth. The economy grew at a slower pace in the first half, accelerated in the third quarter and ended the year with a lot of momentum. Equity markets started the year on a negative note as worries about the Chinese economy led to a sell-off and decline in oil prices. After bottoming in mid-February, markets recovered throughout the spring and early summer. The lead-in to the U.S. election caused some market weakness, but a strong rally followed the election results in November. Despite the ups and downs, the S&P 500 Index finished the year on a high note, gaining 11.8% for the year. The index was led by strong performance in the energy, financials and telecommunications sectors. While defensive sectors outperformed early in the year, the post-election rally saw more risk taking by investors and the outperformance of cyclical and non-defensive stocks.

A POSITIVE OUTLOOK FOR 2017

We have a positive outlook for the U.S. economy and the performance of the financial markets and see no reason to change our thinking. Our base-case expectation is for the continuation of the moderate economic growth driven by the continued health of the consumer. But for the first time in several years, we believe there is the possibility that growth will accelerate above the recent 2.0% trend. Above-trend growth would be driven by increased consumer and business activity as a result of successful implementation of regulatory relief and tax reform. We expect equity markets to generate positive returns in the base-case environment even if we get no tax or regulatory reform. However, we are cautiously optimistic about the potential for this new administration and Congress to work together on legislation that could elevate U.S. economic growth and provide even more support for corporate revenue and profit growth. The Federal Reserve is expected to continue the process of normalizing the fed funds rate, but we believe that in 2017 fiscal policy will be much more important to economic growth than monetary policy.

Consequences of the U.S Election: A Divided Nation

The U.S. election provided a lot of unease and, given the close results, political posturing on both sides of the aisle is likely to remain. We have largely become a fifty-fifty split nation which ensures that a significant portion of the country may not be happy with the path taken over the next four years. With every change in administration there is uncertainty about how a new President will govern. This time is no different. Even with a Republican Congress, the process of passing legislation can be slow and hard to predict. Congress has outlined an aggressive legislative agenda for this year including tax reform (both individual and at the corporate level), healthcare reform, as well as the normal battles over the budget and debt ceiling. We expect that we will see continued volatility in the markets as the new administration takes office and Congress works through the legislative process.

The Consumer as the Economic Driver

Once again the consumer will be the main driver of any economic expansion. Consumer debt levels remain manageable and with higher wages and still relatively low energy costs, disposable income is rising. The consumer is benefiting from the strong labor market—while the pace of job gains slowed a bit in 2016, the economy added an average of180,000 jobs a month last year for a total of over 2.1M new jobs. The unemployment rate has remained below 5.0% for the last 8 months, ending the year at 4.7%. In addition, the underemployment rate fell from 9.9% at the beginning of the year to 9.2%. This rate takes into account part-time workers that would like to be full-time, as well as other workers that feel they are employed below their skill level. After rising 2.5% in 2016, wages should continue to rise in 2017 as the labor market tightens further. Despite the difficult nature of the election, consumer confidence has surged in the post-election period. December's Conference Board survey of consumer confidence reached the highest level since the summer of 2001. Taken together, all of these factors should allow consumers to maintain current levels of spending as well as to raise the prospect of accelerated spending if some of the expected reforms are implemented.

Business Confidence will Boost Spending

Throughout most of the economic recovery, business spending has been uneven and somewhat weaker than expected. There are many reasons for this but tax policy, regulation and concerns about slowing global demand are often cited as major factors. Much like the consumer outlook, confidence at U.S. businesses has surged since the Presidential election as the prospect for tax and regulatory reform has improved. In December the NFIB (National Federation of Independent Business) Small Business Optimism Index surged to its highest level since 2004. This increase was primarily driven by the view that business conditions will improve, leading to increased sales expectations, making it a good time for business to expand. We are also seeing early signs of big business' willingness to invest and expand based on the potential for faster economic growth. Corporate profits have been relatively flat over the last two years, but they are expected to increase this year in a base-case scenario and could accelerate even further into 2018 if we get tax and or regulatory relief.

Anticipated Changes in Regulations

While we all recognize the need for some regulation, for many business owners the cost of regulation has become somewhat prohibitive. The incoming administration is expected to focus on reducing some of the regulatory burden which we hope will spur more business investment. As an example, there are more than $50B in energy infrastructure projects outstanding that have been held up by regulatory agencies. Removing those barriers would provide economic stimulus and jobs, improve our energy infrastructure while not requiring any government funds. We also would expect to see some focus on bank and financial sector regulation that may ease costs for mid-sized and smaller banks in particular. The prospect for some type of corporate tax reform has improved but it will still take time to work out the details and get a bill passed. The repatriation of foreign-held cash could be used to invest in business expansion. It is also likely that some portion of the associated tax will be utilized for infrastructure spending. Any reduction in the overall tax rate or the tax on foreign-sourced profits could provide additional stimulus to the economy and move growth above its recent trend.

Monetary Policy to Take a Backseat to Fiscal Policy

The Federal Reserve's Open Market Committee (FOMC) increased the target range for the Federal Funds rate by 0.25% in December of 2016. Despite expectations for multiple rate hikes during the year, this was the only action taken in 2016. As we have noted in the past, FOMC action has become increasingly hard to predict given the committee's consideration of global factors outside of its primary mandate of price stability and full-employment in the U.S. The committee has indicated that it expects to raise rates several times in 2017, but the market is taking a bit more of a conservative outlook based on history. With the economy close to full-employment, the key to the pace of rate hikes going forward will likely depend on inflation. Consumer price inflation remains relatively stable and at the current 1.7% annual pace, remains below the Fed's target of 2.0%. Any significant increase in inflation might lead to a faster pace of rate hikes. It is important to note at this point, that the fed funds rate is still near historically low levels. Rate increases from today's levels should still be considered part of a normalizing process rather than a tightening of monetary policy.

Despite the near inactivity from the Federal Reserve during 2016, we did see interest rates move higher, especially in the second half of the year. Interest rates on U.S. Treasuries reached a low early in the summer following the Brexit vote, but since that time have moved steadily higher. This was largely in response to the stronger economic growth in the second half of the year and optimism about a potential acceleration of growth into 2017. The 10-year U.S. Treasury bond ended the year yielding 2.4%, more than 1.0% higher than the July low. The 30-year Treasury bond ended the year yielding 3.1%. Higher longer-term interest rates could eventually slow the purchase of houses, but even with the recent increase, mortgage rates remain near historically low levels and are supportive of a healthy housing market. For clients with a fixed income allocation, these higher rates will allow us to revisit the idea of investing in individual bonds, with the goal of providing portfolios with price stability while earning incremental income. We still expect to keep maturities relatively short, as we have for the last several years. The path for interest rates is likely higher from here, but we do not expect to see rates return to the levels seen prior to the recession given the conservative Federal Reserve and moderate economic growth.

Continued Global Growth despite On-Going Uncertainty

The outlook for the global economy remains similar to prior years. We expect to see moderate global growth driven by China, modest gains in Europe, stability in Japan and some potential for growth from emerging markets. However, geo-political risk remains high throughout the world. In March 2017, the U.K. is expected to invoke Article 50, which will officially begin the process of exiting the European Union. France will be holding elections in June 2017 and German elections take place in October 2017. Given the somewhat surprising results of elections over the last year, we should probably be prepared for more surprises in 2017. Away from the politics, we may see uncertainty surrounding OPEC and its recent production cuts, concerns about changes to global trade policy and the prospect for action from global central banks.

IMPACT ON YOUR INVESTMENTS

Any of the discussed events has the potential to impact investor confidence and to add to market volatility in the short-run. However, on balance, we believe that the U.S. and global economies are on solid footing and will continue to grow at a moderate pace and perhaps even accelerate. We will continue to invest in companies that we believe can increase revenues and grow profits in the current environment. We are hopeful that we will see some reforms that can push growth higher and lead to an even better profit environment. We remain focused on the long-term fundamentals and do not anticipate making any major changes to your portfolios unless we see a shift in the outlook.