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DECEMBER 31, 2016 INVESTMENT MARKET COMMENTARY

US stocks and bonds went their separate ways in the fourth quarter. Equities rallied strongly and ended the year with double digit gains, while fixed income returns were negative for the quarter and modestly positive for the year. In fact, November was the worst month for bond returns in 30 years as interest rates surged. **2016 kicked off with the worst January for US stocks in history, panic selling in high yield corporate debt, and the lowest oil prices in 13 years.** Much of this early year reaction was due to expectations for higher interest rates, and concern that corporate profits would disappoint. From mid-February and through the summer, virtually all asset classes rallied despite weakening earnings (4 consecutive quarters), political uncertainty (BREXIT vote, approaching US election, Italian constitutional referendum), and continued global economic malaise. Finally, due to the surprise result of the presidential election, the last seven weeks of the year witnessed rallies in stocks, multi-year highs in US interest rates, and a sharp advance in the US dollar**. In retrospect, the past year was unpredictable from start to finish, with no shortage of drama from an investment perspective.**

Stocks

While financial markets are still digesting the election results, domestic stocks have been the big winner since November, as investors now anticipate a breakout in economic growth due to 1) favorable prospects for across the board tax reform, both personal and corporate, 2) meaningful regulatory relief for a host of industries, and 3) higher government spending on infrastructure and defense. According to some estimates, the benefit to corporate earnings from lower tax rates alone could be as much as 20%, making a relatively expensive stock market seems more reasonably priced. **As 2017 dawns, investors, policy makers, and many Americans are starting to focus more on what could go right with the global economy as opposed to concentrating on the persistent problems of recent years. Financial assets are discounting better days ahead, and consumer confidence currently sits at a 15-year high.**

Indeed, some clear positives are already evident, beyond the obvious measures of higher interest rates and market momentum. **Since 2008, equity returns have been primarily dependent on one factor – low interest rates. The stocks of excellent and mediocre businesses alike often moved together, regardless of their fundamental underpinnings. Now, for the first time since before the 'great recession', individual stocks are being driven more by their own merits as opposed to broader financial influences.** We are heartened by this development, and confident that our time-honored philosophy of emphasizing quality companies that offer compelling long-term value will provide strong returns through full market cycles.

Bonds

The unexpected result of the presidential election accomplished what the Federal Reserve could not for eight years – raise interest rates. Having dropped below 1.4% in the summer, the 10-year US treasury yield soared after the election and closed the year at 2.4%. While, in our view, a 'normalization' of interest rate levels is critical to a healthy economic and financial market environment, the ferocity of this move threw a cat in amongst the pigeons and created near-term pain for bond investors. Municipal securities were particularly impacted due to the likelihood that individual tax rates will be reduced, thus somewhat mitigating the 'value' of tax-free income. **Interest rates have been unsustainably low for an extended period, and our expectation has been for yields to rise to**

levels that offered a reasonable premium to inflation. As such, focusing on short and intermediate term maturities cushioned the downdraft in bond prices. Importantly, fixed-income investors should benefit going forward as bonds mature and funds are reinvested in a higher rate environment.

The bond market is clearly signaling that economic conditions are expected to improve as spreads between corporate and Treasury yields have narrowed. Historically, this gauge has been an accurate indicator of corporate financial strength. This is particularly important at a time when many believe that the long bull market in bonds is over, and that rates will continue to trend higher in coming years. It was not long ago that sovereign bond yields were negative in many countries throughout Europe and in Japan, as well as being at unprecedented low levels here in America. This picture has changed dramatically, as deflationary fears have given way to expectations of rising inflation.

Our Take on 2017

Most everyone believes that big policy changes are coming. Since the election, animal spirits have been unleashed in the financial markets as investors see tax and regulatory reform, together with increased government spending as sure things. Yet, while these changes may be positive, they come with many unanswered questions, most notably with respect to timing, degree, and eventual effect. Certain actions, including regulation roll-backs and some tax reform, can be done fairly quickly. Others, most notably infrastructure and defense spending, will take years to implement. Will the corporate tax rate be 15% as the president-elect desires or 25% as many in Congress are suggesting? Health care and financial service laws may be replaced, but with what? Interest rates appear to be headed higher, but to what extent? **Investors have been making decisions of late based on promises (from politicians no less) and expectations that may or may not materialize. In short, it seems a bit premature to determine the impact that the proposed policy changes will have on economic activity and investments. As such, it is entirely possible that some of the late 2016 glow may be tempered as the new-year progresses.**

More specifically, we believe that two of the most critical factors to watch are the rate of profit growth and the level of interest rates. With the stock market at record levels, valuations have moved steadily higher for years despite the fact that profit expansion has not kept pace. Clearly, company earnings must accelerate quickly and meaningfully in order to justify current price levels. While many investors are now giddy, there are important headwinds that could impede economic and corporate profit improvement, and restrain stock prices. None are new, but each is stubborn. They include the impact of a higher dollar, government debt that will soon reach $20 trillion, and equity price/earnings ratios that are well above average. In addition, a sharp rise in interest rates would be an additional impediment, as stock valuations typically contract and financing costs rise as rates increase. **The bottom line is that 2017 investment returns will depend on what reforms are passed, when they are implemented, the degree to which they spur economic growth, and how successful is the transition to a higher interest rate environment.**

An objective viewpoint and historical precedent would suggest that increased volatility, and possibly a stock market retreat, will occur in the not too distant future. The current bull market is very long in the tooth, as stocks have not endured a 'bear market' in 8 years. Moreover, the first year of a new presidential term is generally not the best from an economic and/or investment standpoint, in part due to the implementation of new policies and programs that often create uncertainty and unrest. **While never enjoyable, interim market downturns are an inevitable part of the investing process and are actually healthy from a longer term perspective.** For decades, quality stocks and bonds have provided capital growth, a secure source of income, and a risk/reward balance that is financially satisfying and emotionally suitable for most investors. We see no reason why this should change in the future.

We wish you a very happy and healthy 2017!