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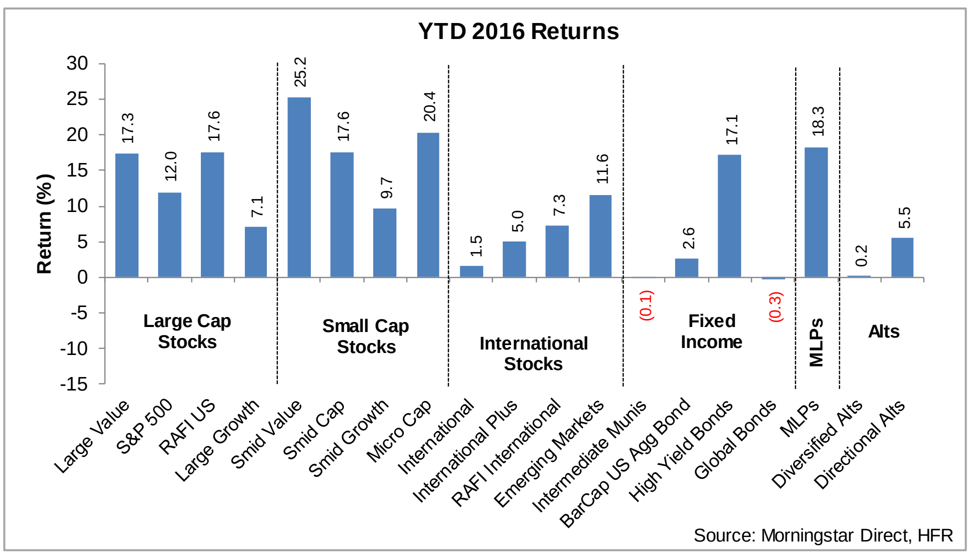
2016 Investment Review & Outlook

To Our Clients and Friends,

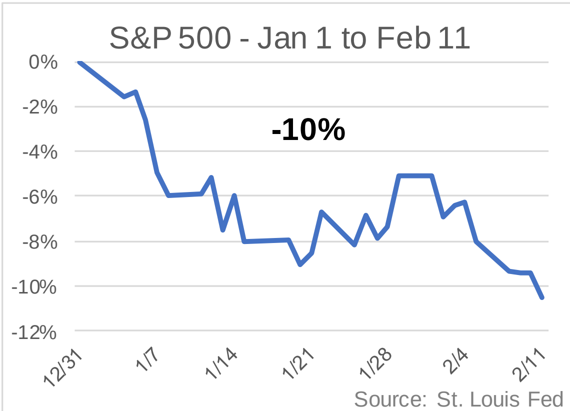
2016 will go down as quite a memorable year in the history of financial markets: one marked by unexpected outcomes and even more unexpected *responses* to those outcomes. Whether it was political newcomer Donald Trump winning the U.S. Presidential election, or the United Kingdom voting to end its 40-year membership in the European Union, this year was full of surprises. The market's resilience in the face of these disruptive events was particularly remarkable; despite doomsday forecasts, stock markets ultimately clawed higher in both cases. Today we face a seemingly new market regime, with the Dow Jones Industrial Average closing in on 20,000, new market leadership from financials and other economically sensitive stocks, and interest rates meaningfully on the rise.

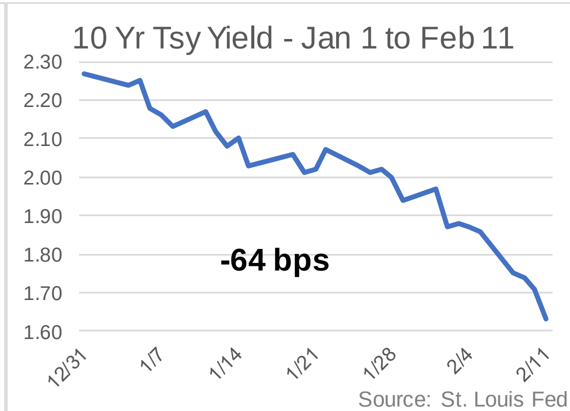


By year's end, the scorecard read as follows: U.S. large cap stocks gained 12%, U.S. small caps were up 18%, developed international stocks were higher by 1.5%, and emerging markets gained 12%. Non-U.S. stocks were significantly impacted by dollar strength during the year; on a local currency basis, developed international markets were up 6%. Within fixed income, intermediate municipal bonds were slightly negative, high-grade taxable bonds gained 2.6%, and non-investment grade fixed income generated strong double digit results on the year. Alternatives finished the year higher but lagged the strong gains observed in the equity markets. These final tallies hardly tell the full story, however, in what was an extremely eventful year for the financial markets and the global economy.

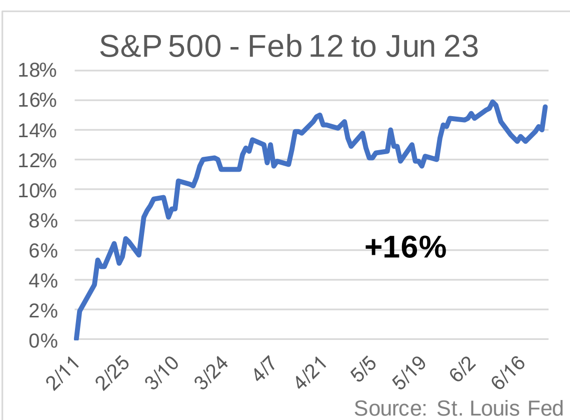
To provide a more robust review of 2016, we thought it would be helpful to take a step back and recall the course of events from this year as they unfolded. We finish with a summary of our outlook for 2017 and address any potential shifts in portfolio construction.

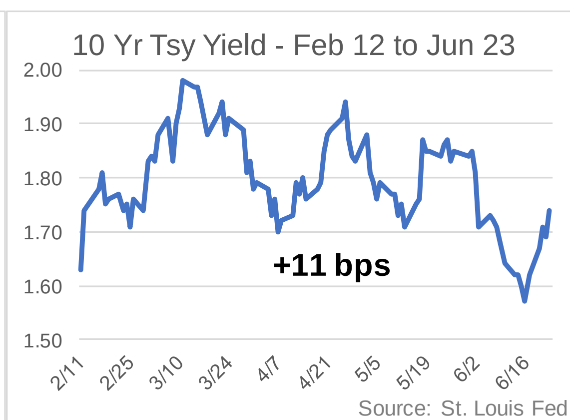
January 1st to February 11th: Investors entered 2016 hopeful that the challenges of 2015 would dissipate – recall that in the prior year, credit conditions had deteriorated, energy prices had failed to stabilize, and most stocks lost money outside of the so-called "FANGs" (Facebook, Amazon, Netflix, Google). No immediate reversal was in store, however, as stocks started out with double-digit losses in the first two weeks of the year. As noted by the Wall Street Journal and others, it was the worst start to the year in recorded history for stock markets. Virtually every asset class except the "safest" of bonds declined as investors scrambled to avoid a possible bear market (despite a wide range of indicators, as we noted at the time, that suggested no such development was likely). In turn, the 10-year Treasury yield declined more than 0.60% despite the Federal Reserve hiking short-term interest rate mere weeks earlier. By February 11th, the S&P 500 was down 10% year-to-date, junk bonds traded 9% over Treasuries, and oil traded at $29 a barrel. After not experiencing a market decline of 10% or more for four years, investors had been treated to two in the span of six months (with the other occurring in August 2015).





February 12th to June 23rd: Suddenly, and without a clear catalyst, financial markets dramatically changed course. Between February 12th and the end of the first quarter, stock markets surged by more than 16% to experience their largest intra-quarter recovery in more than 80 years. Virtually all asset classes performed well, particularly riskier segments of the stock and fixed income markets. Curiously, interest rates did not revert while this risk-on rally took hold. Treasuries and high grade bonds chopped sideways, leaving interest rates little changed in the quarter. This paved the way for more interest-sensitive equities such as telecoms and utilities to continue their momentum with 20% year-to-date gains. Meanwhile, the market's largest sectors, including financials, technology, and healthcare, sat in negative territory. Through June 23rd, stocks were up 4.5% on the year, oil had nearly doubled to $49, and interest rates stood at 1.74% - still more than 0.50% below year end levels.

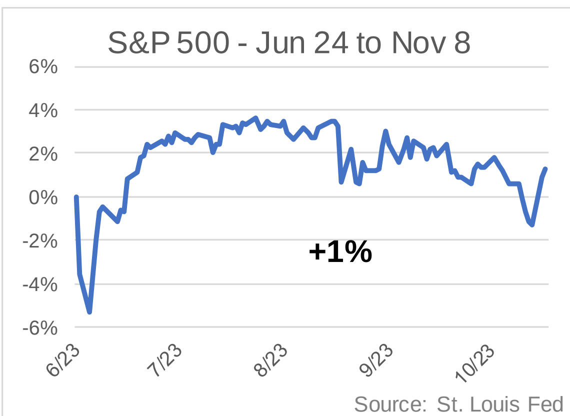


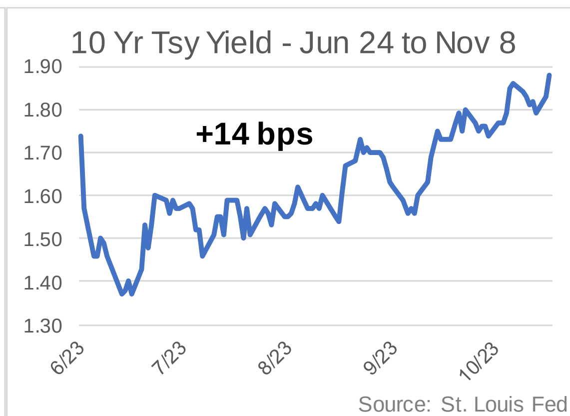


June 24th to November 8th: This great market run was interrupted on the night of June 23rd, when investors learned that citizens of the United Kingdom had unexpectedly voted to exit the European Union. With the implications of this so-called "Brexit" unknown, the British pound fell to multidecade lows and equity markets cratered. In a stunning turnaround, however, stocks reversed course in just two short days and regained their initial 5-6% losses in a matter of weeks. This was also true for stocks closest to Brexit's epicenter; since the vote, developed international stocks have surprisingly outperformed U.S. markets on a local currency basis.

Little noticed at the time – but what may also prove to be an historic event – was a bottoming of interest rates on July 7th (two weeks after Brexit). The yield on the 10-year Treasury reached an all-time low of 1.37% that day, before climbing 0.51% by election day on November 8th and ultimately more than a percent higher by year end. There are myriad reasons for this shift, but none were more important than an uptick in inflationary pressures in the U.S. (longer-term interest rates are directly impacted by inflation expectations). We spent time detailing this in our third quarter letter, as price levels were clearly on the rise due to tightening labor markets, improving economic data, and recovering commodity prices.

After the rapid rebound from the post-Brexit lows, markets lost momentum in the summer months and largely moved sideways. Entering election day, stock markets were up 6.7% for the year, bonds had given back some of their gains but were still up 4.9%, and oil prices had stabilized between $40 and $50 a barrel. Spreads on non-investment grade credit had also narrowed by nearly 4% in just seven short months.



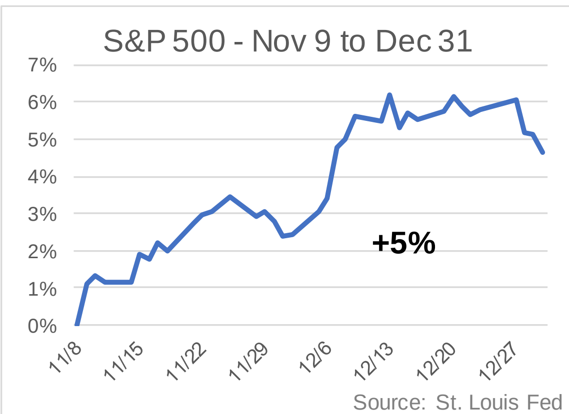


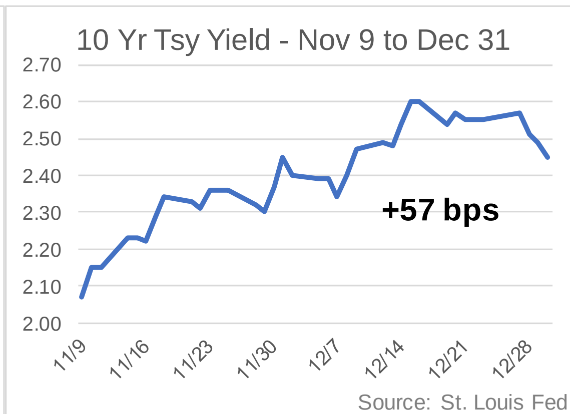
November 9th to December 31st: Change was certainly afoot heading into election day 2016, but nothing could ultimately compare to the surprise election of Donald Trump as 45th President of the United States. While many investors (ourselves included) anticipated significant negative volatility around a Trump victory - if nothing else because of the sheer unexpectedness of it – equities have consistently marched higher since the election. Despite many details of his policies and approach remaining unknown, investors have clearly embraced his attitudes on taxes, regulation, and economic policy.

Market movement following the election was markedly different in tone from earlier in the year. Interest rates that had been on the rise since early July accelerated sharply in the final weeks of the year. This caused further losses in high grade, intermediate bonds (recall that bond prices and yields are inversely related). Within the equity markets, new leadership took root as more economically sensitive stocks such as financials, industrials, and small caps dramatically outperformed. Nowhere was this more evident than in the Dow, where an amazing 25% of the index's gain since election day was singlehandedly driven by Goldman Sachs.

Somehow lost amid these headlines was the Federal Reserve's decision to hike short term interest rates for a second time in December. In a shift from previous communications, the committee signaled its intentions to hike three times next year instead of two, underscoring what is clearly a new phase in the Federal Reserve's unprecedented intervention that started nine years ago. Such a shift promises to have major implications for financial markets, ranging from economic growth to stock market volatility.

Ultimately the year finished in robust double-digit territory as we described in our opening paragraphs. That momentum has carried into the New Year with most financial assets higher thus far in 2017.





Outlook: Looking forward, much of the impact of a Trump presidency will ultimately depend on his ability to execute his agenda. President-elect Trump will shortly be inaugurated with his party in control of both houses of Congress and a clear mandate to cut corporate taxes, reduce regulation, and increase infrastructure spending. Surely some portion of these agenda items will occur; to what extent his fiscally conservative counterparts in Congress allow him to embark on a more ambitious (read: expensive) agenda, however, remains to be seen.

Still, several broader tailwinds appear to be kicking in as we near Trump's presidency. Economic data has clearly inflected, as the manufacturing and commodity recessions we experienced during 2014 and 2015 have dissipated. This is filtering through into corporate earnings, which have re-emerged from negative territory, and U.S. GDP that has risen to above 3.0% annualized. Labor markets also hover near full employment (although the quality of that employment remains up for debate), which is spurring wage gains and likely inflation.

All of this would seem to point to better economic growth, improved corporate fundamentals, and thus a more constructive environment for a stock market that has largely relied on unsustainable earnings drivers such as buy backs, mergers, and cost cutting in recent years. It also underlies a change in market leadership, from dividend payers and secular story stocks (FANG) to the more economically sensitive small caps, financials, and industrials sectors (collectively known as the

"Trump Trade"). Finally, the shift in inflation and growth would also suggest that the recent move higher in interest rates is well-founded.

In thinking about the investment implications of these developments, we start with the premise that our client portfolios are already well positioned for – and have benefited from – this shift in market environment. Within fixed income, we long ago shortened duration and added more credit centric exposures that proved quite additive to performance this year. Within equities, our balanced approach between large cap and small cap was rewarded by strength in the latter. Maintaining global portfolios had more of a mixed impact, as strong emerging markets returns were offset by lagging performance in developed international (Europe and Japan) stocks due to aforementioned currency effects. Moreover, having a diversified portfolio allowed our clients to participate in this year's market rally despite the dramatic rotations in market leadership that occurred through the year.

The latter observation is especially critical as we consider where markets go from here. We must balance the idea that stocks are poised for a strong run against several factors such as elevated valuations (in both stocks and the U.S. dollar), potential volatility caused by any unconventional actions by President Trump, as well as the possibility that Trump's agenda items do not materialize as expected. Ultimately, we believe a patient approach is needed as we sort fact from fiction in the months ahead. We will react as opportunities present themselves, but we must also not overcommit to a single view point. 2016 was a perfect reminder that even if you can predict the unexpected, the market's reaction to that outcome is far from assured. With that in mind, we remain committed to a balanced, disciplined investment approach to achieve your long-term financial goals.

As always, please call us or visit our offices should you have questions. If you would like to review your current asset allocation or risk profile, we encourage you to speak with us at your convenience.

Kindest regards,
Your Investment Team
1/17/2017