Investing in a Trump Economy

2017 Annual Outlook

In a year full of stunning macro surprises, which included Britain's vote to leave the European Union and the election of Donald J. Trump, markets were remarkably buoyant after an ugly start. Heading into 2017, optimism is high as the global economy appears to be finding its footing and forthcoming policies from the Trump administration are expected to be pro-growth. In particular, we believe economic growth may be boosted by tax cuts and relaxed regulation. Cuts to both corporate and individual tax rates are likely to encourage firms to repatriate cash, and the unwinding of many regulations recently enacted by the Obama administration on the beleaguered financial, energy, and healthcare sectors are likely to renew their growth. A large infrastructure spending program is also anticipated, but is likely to meet some resistance in Congress. Vocal opponents within the Congressional Republican caucus, who are concerned that entitlement spending programs and increasing interest expense are already pushing the federal deficit to troubling levels, may be reluctant to support any plans for additional expenditure. What is reasonable, in our view, is to expect improving trends and likely tax policy changes in the U.S. to generate better economic growth in 2017 than during the past twelve months. The consensus now largely reflects this view.

We are mindful of several risks to our viewpoint. While these aforementioned growth initiatives are likely to drive optimism, trade policy remains a wild card which could hamper global growth if protectionist policies such as tariffs are enacted on a widespread basis. Economic growth failing to meet rising expectations and sentiment turning somewhat more cautious could also challenge markets. More concerning is the possibility that growth-boosting policies may spark inflationary pressures, accelerate increases in interest rates, and bring forward expectations for future Fed rate hikes to create headwinds to growth. A more hawkish Fed might also push the U.S. dollar higher, which could tighten global financial conditions in a manner similar to 2015. Lastly, we are concerned that financial markets may have become too optimistic too fast. The 12-month forward PE ratio for the S&P 500 has surpassed long term averages, and, factoring in an aging economic expansion, the third longest domestic equity bull market on record and a rising interest rate environment, any disappointment may quickly reverse this euphoria. For now, we view these scenarios as tail risks that could disrupt our base case expectations of another solid year for global equities.

In short, a very exciting macro backdrop is likely to result in a somewhat boring market outcome in the first half of the year. Overall, our outlook remains one of tempered optimism, with the bull market likely to remain intact but facing headwinds from stretched valuations, diminishing central bank support, and frothy investor sentiment. This environment is likely to limit upside for global equities to single-digit gains. Leadership from cyclical groups, and particularly financials, remains intact, and we will be watching for renewed strength from defensive sectors such as utilities, telecom, and consumer staples for evidence that rising interest rates are increasing the odds of a significant equity market correction.

On the fixed income side, even in the wake of moderately higher rates, we still believe bonds serve a valuable role in a portfolio. With a strong economic backdrop, we recommend shorter-than-benchmark duration and still favor credit-sensitive bonds.

Lastly, to mitigate unforeseen volatility, we believe it is prudent to retain an allocation to alternative investments that have low correlations to traditional investments, and we prefer managers with flexible investment styles with the discretion and ability to move nimbly within their mandates in the face of the changing economic environment that we foresee.

Global Economy

Early in 2016, economic data showed declines in the manufacturing sector and growing global recession risks. By mid-year, signs of improvement began to develop and evidence of stabilization strengthened throughout the second half of the year. In circumstances similar to those we found at the end of 2015, markets are digesting a Fed rate hike in December. In contrast, however, economic data is trending higher rather than deteriorating. This is

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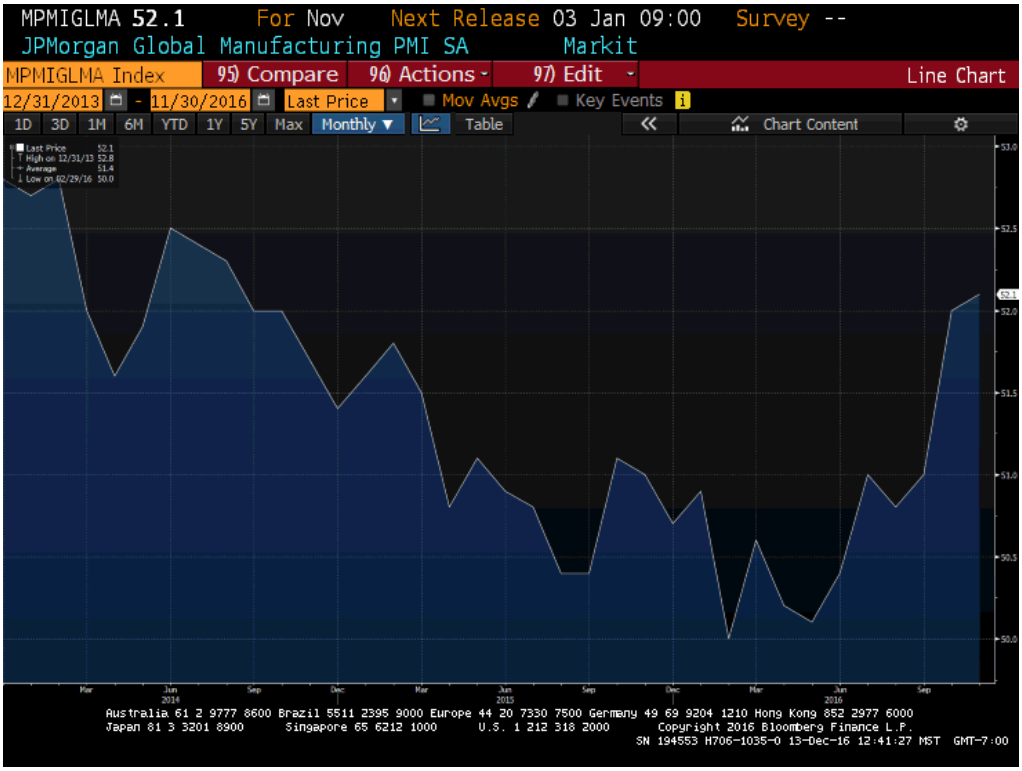
particularly evident in the global manufacturing sector, which began the year deteriorating at a troubling rate but is on an uptrend to end the year higher, as evidenced by the J.P. Morgan Global Manufacturing PMI in the chart below. This index gives an overview of the global manufacturing sector as it is based on monthly surveys of over 10,000 purchasing executives from 32 of the world's leading economies, which together account for an estimated 89 percent of global manufacturing output.

Exhibit 1: J.P. Morgan Global Manufacturing PMI



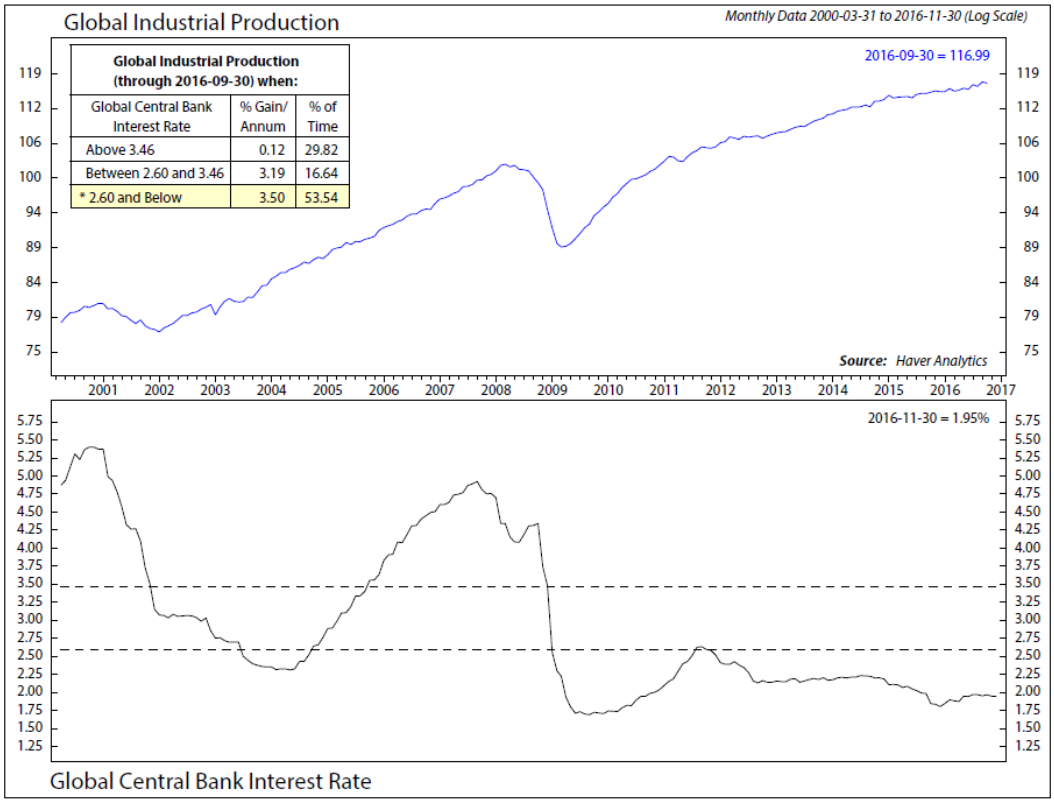
Source: Bloomberg; J.P. Morgan

With the backdrop of improving global economic data and the best consumer sentiment readings in the U.S. in several years, the odds of global growth matching or exceeding the IMF's forecast of 3.4% for 2017 appear strong, ending a two year period characterized by a string of downgrades to growth forecasts.

Central Bank Support Peaking

An unprecedented period of global monetary accommodation has had a debatable impact on economic growth, but very few would dispute its very positive impact on asset prices. A risk going forward, however, is that the world has reached a peak in central bank accommodation. The U.S. Federal Reserve has now ended its quantitative easing program and raised rates twice, albeit at an extraordinarily gradual pace. The European Central Bank has also recently announced it will begin an extended tapering of its asset purchases, and there is a growing belief among some traders that the Bank of Japan will be next, following an extremely sharp depreciation in the Yen. European and Japanese monetary authorities both appear resigned to wind down their negative interest rate experiments – a policy which has produced marginal economic benefits, at best. In the near-term, however, despite some very gradual moves toward normalization, global central bank interest rates remain extremely low by historical standards and are not an immediate concern.

Exhibit 2: The GDP-weighted Global Central Bank Rate vs Global Industrial Production



Global Industrial Production (through 2016-09-30) when:		
Global Central Bank Interest Rate	% Gain/ Annum	% of Time
Above 3.46	0.12	29.82
Between 2.60 and 3.46	3.19	16.64
* 2.60 and Below	3.50	53.54

Source: Ned Davis Research

The Impact of Trumponomics

The 2016 election cycle was remarkable in many ways. From a market perspective, it was particularly fascinating to see stocks react with volatility whenever it appeared Donald J. Trump was gaining in the polls. On election night, this fear briefly manifested itself in a sharp global selloff as it became apparent Mr. Trump would prevail. By early the next day, however, market fears were replaced by almost unbridled enthusiasm for potential policy changes that might positively impact the economic and earnings outlook for 2017 and beyond. The S&P 500 index has rallied over 6% since Election Day (through December 13th), with small-caps and cyclical stocks experiencing even bigger gains.

Growth Boosters: For now, the particular details and timing of expected policy proposals are not known with any certainty, particularly since Mr. Trump campaigned on few policy specifics. This makes precise estimates of policy growth impacts impossible, but those policies most likely to be prioritized and enacted in 2017 are cuts to the corporate and individual tax rate, which would encourage firms to bring overseas cash back to the U.S., and the unwinding of many regulations recently enacted by the Obama administration on the financial, energy, and healthcare sectors. Significantly reducing regulations will undoubtedly be a priority for the new administration and will likely be a driver for growth, but optimistic forecasts may be underestimating the complications associated with changing existing laws. These include legal challenges to most revisions, which are almost certain to follow, therefore ensuring that some degree of regulatory uncertainty will likely remain beyond 2017.

Infrastructure Spending: Somewhat more unknown is the potential for a large infrastructure spending program, an idea championed by Mr. Trump but likely to meet some resistance from vocal deficit spending opponents within the Congressional Republican caucus. The federal deficit is already expected to rise back to troubling levels in the coming years due to entitlement spending programs and increasing interest expense, with only so much discretionary spending that can realistically be cut. The possibility that tax cuts, increased defense spending and a

surge in infrastructure spending could create troublingly high fiscal red ink may not be a risk some deficit hawks are willing to take. More likely, we may see a somewhat modest offering of tax incentives to encourage private infrastructure investment, which could have a similarly modest impact on the growth outlook.

Risk of Protectionism: Trade policy remains a wild card which could act as a drag on global growth if significant tariffs are enacted on a widespread basis. Investors appear to be largely discounting this risk, viewing the sharp campaign rhetoric of Mr. Trump as largely a negotiating tactic that will give way to a more pragmatic approach. If the United States unilaterally withdraws from a variety of existing trade frameworks, in favor of pursuing a series of bilateral trade agreements, most experts expect China to play a more important leadership role.

Reagan Redux? Despite frequent comparisons between Trump policy prescriptions and those initiated by President Reagan, we would be somewhat cautious with making parallels to the impact of policy changes. When President Reagan was elected in 1980, the top marginal tax rate was 70% versus 39.6% currently, inflation was soaring and set to plunge, the unemployment rate was very elevated, and stock valuations were near historical lows on many metrics. Today, Mr. Trump will inherit a debt-to-GDP ratio of 105% (vs. 31% in 1981), an economy that is at or near full employment, an equity market that appears rich based on many traditional valuation metrics, and a Federal Reserve set to embark on an interest rate tightening cycle. Demographics were also a tailwind throughout the 1980s as baby boomers entered their prime working years, and women became a steadily growing percentage of the labor force - two trends which have now reversed. While a generally optimistic view of Mr. Trump's pro-growth policies is justifiable, Reagan-era-like growth on a sustained basis is likely not a high probability outcome. What is reasonable, in our view, is to expect the U.S. economy in 2017 to generate better growth than during the past twelve months due to already improving trends and likely tax policy changes.

Higher Growth Could Shorten Economic Cycle

Even if all the details of the forthcoming policy proposals were disclosed, it is important to remember that these policy changes would not happen in a vacuum. In particular, the potential for growth-boosting policies to spark inflationary pressures, increase interest rates and bring forward expectations for future Fed rate hikes could provide some headwind to growth earlier than expected. In this regard, every U.S. recession in the past 60 years has been preceded by substantial Fed tightening or accelerating inflation. The following table summarizes the changes in 3-month Treasury bill yields and the consumer price index leading up to the past nine recessions. While prior economic cycles suggest the economy currently has some runway, a significant move higher in inflation or a faster than expected pace of Fed tightening, would heighten cyclical risks.

Exhibit 3: Inflation and Short-term Interest Rates Leading into Prior Recessions

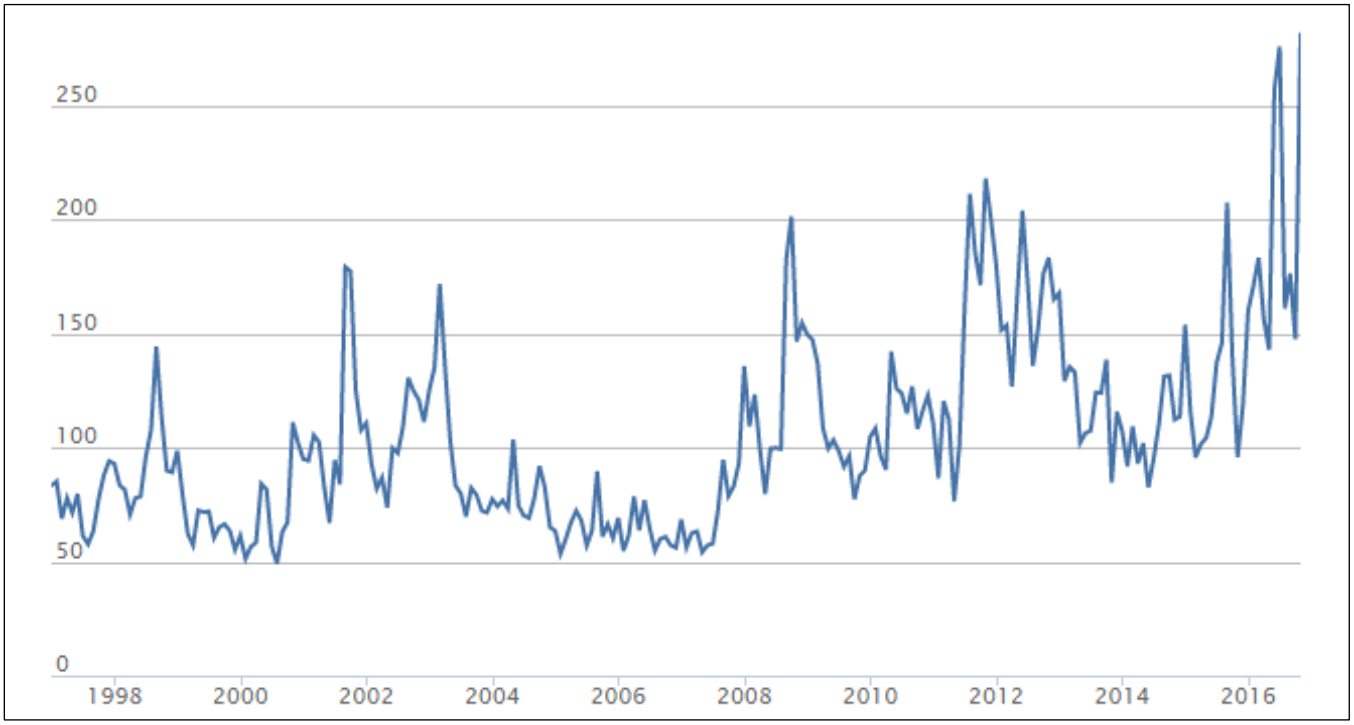
Recession Date	Consumer Price Index (y-o-y % change)	3-month T-Bill (Cycle High vs Low Difference)
August 1957	3.6%	2.4%
April 1960	1.9%	3.6%
December 1969	5.9%	4.3%
November 1973	8.3%	5.5%
January 1980	13.9%	7.7%
July 1981	10.8%	7.9%
July 1990	4.8%	3.2%
March 2001	3.0%	2.2%
December 2007	4.1%	4.2%
Minimum	1.9%	2.2%
Median	4.8%	4.2%

Source: Federal Reserve Bank of St. Louis; TSIM

Policy Uncertainty – A Potential Headwind

A risk in the first half of the year is a very high level of global policy uncertainty. Beyond the incertitude over what exactly will be enacted in the U.S., the details of Britain's exit from the European Union remain unknown, and a number of important European elections will continue to generate headlines in 2017. Although more emerging market debt today is denominated in local currencies, a strong U.S. dollar has often presented a significant challenge to policymakers as many emerging market countries still owe interest on U.S.-dollar-denominated bonds. Populist frustration may also fuel further anti-globalization, nationalist or nativist sentiment. Heading into year-end, global policy uncertainty actually exceeds prior crisis periods as quantified by the academics who developed the website *policyuncertainty.com*. This methodology involves measuring policy uncertainty based on newspaper coverage of economic policy-related uncertainty, the number of federal tax code provisions set to expire and disagreement among economic forecasters. Past episodes of heightened policy uncertainty have often been accompanied by equity market volatility and credit market stress, which thus far have not characterized the current episode. One more factor to note is the possibility that the implementation of new policies may be delayed, which could introduce more uncertainty, and ensuing volatility, in the near term.

Exhibit4: Global Economic Policy Uncertainty - Monthly Global Economic Policy Uncertainty Index (1/1/97-11/1/16)



Source: policyuncertainty.com (12/13/2016)

Equity Markets

Volatility marked the beginning of 2016, after the Federal Reserve raised rates in December 2015 for the first time in nearly a decade. Already weakening momentum in the manufacturing sector continued to deteriorate throughout the first half of the year, while ongoing fears of a hard landing in China and renewed financial crisis in Europe weighed heavily on investor sentiment. Despite the inauspicious start to the year, and a number of jarring macro events which ranged from the Brexit vote to the U.S. elections, domestic stocks look set to end the year with double-digit gains amid widespread optimism that coming policy changes will jumpstart economic growth. However, as shown in Exhibit 5, developed foreign equities have once again posted disappointing returns. Year-to-date emerging market returns have nearly matched the U.S. market in dollar terms, despite a bout of weakness in the fourth quarter.

Exhibit 5: Equity Market Performance (as of 12/13/2016)

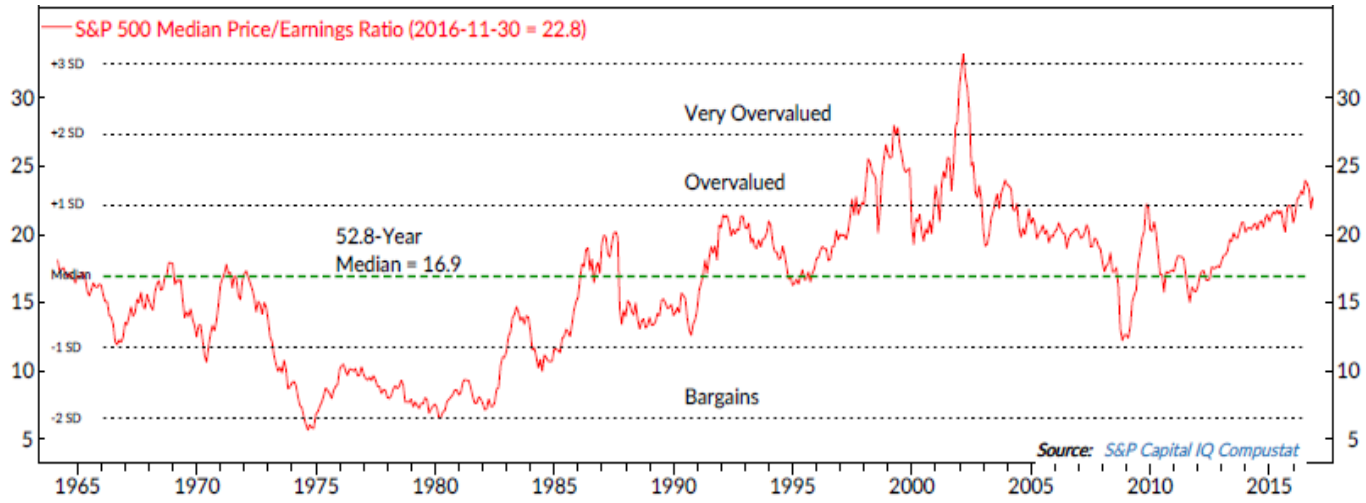
	Q4 2016 %	YTD 2016 %
Developed Foreign Equities - MSCI EAFE Index	-0.9%	1.3%
Emerging Market Equities - MSCI Emerging Market Index	-3.3%	12.5%
Global Equities - MSCI All World Index	2.4%	8.6%
U.S. Equities - Russell 2000 (Small Cap)	10.0%	22.6%
U.S. Equities - S&P 500 Index	4.6%	12.8%

Source: Morningstar; as of 12/13/2016

Valuations High But Still Justifiable

Valuation metrics are imprecise tools, but viewed over the long term, they can be useful in assessing the market's overall risk/reward proposition. In the current environment, one of our favorite valuation metrics is the median price-to-earnings of the S&P 500. Using median valuation helps minimize the impact of large one-time losses or unsustainable gains, such as the recently extremely depressed energy sector earnings, on the analysis. As shown below, the current median P/E of the S&P 500 is more than one standard deviation above the historical norm and has only been exceeded twice - during the height of the 1990s tech bubble and prior to Great Recession.

Exhibit 6: S&P 500 Median Price/Earnings



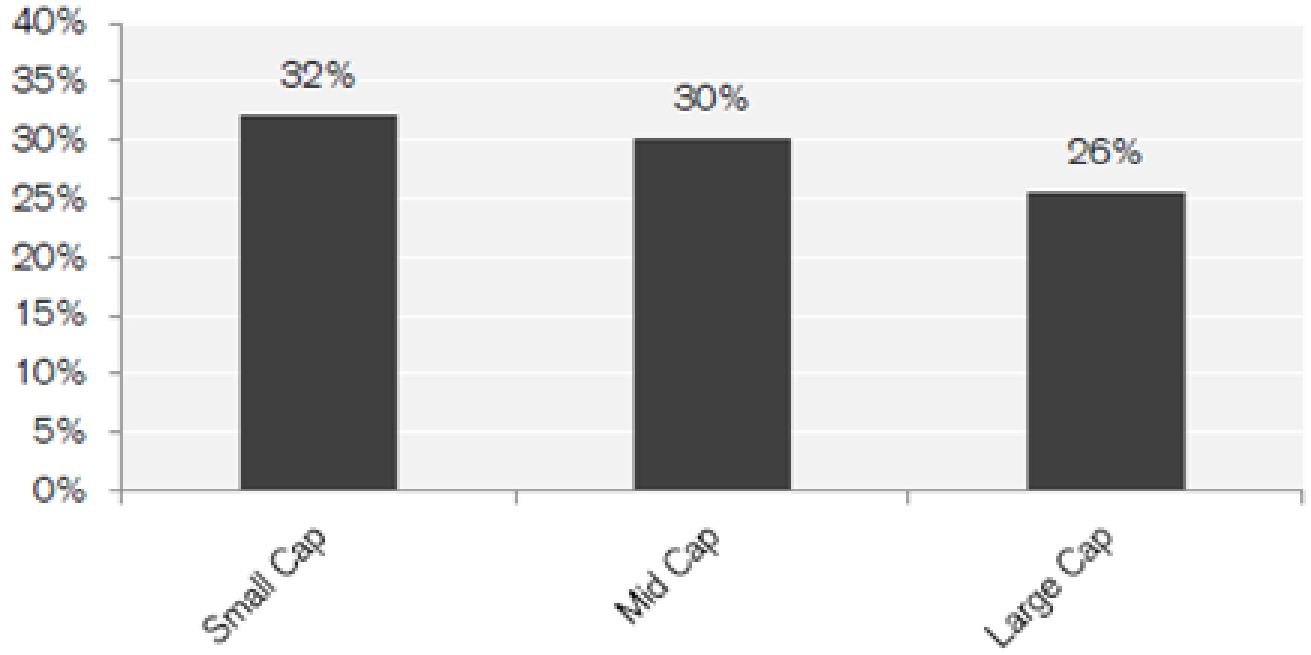
Source: Ned Davis Research

Extraordinarily low interest rates have helped to mitigate some of our valuation concerns in recent years and, looking forward, the prospect for a large reduction in corporate tax rates is likely to boost future bottom-line earnings. Estimates vary widely, but we believe the combination of a significant tax cut and a cyclical improvement in earnings due to improving global growth, offset by some margin compression from rising wages and interest rates, make a 15% gain in median earnings from current levels a reasonable estimate for the next twelve months. This would result in median earnings of approximately $111 and a median P/E of 20.5 based on the current S&P 500 price (as of 12/13). While high by historical standards, the S&P 500 would need to rise above 2,450 to be one standard deviation overvalued on this metric if our expectations for earnings prove roughly accurate. This represents about 8% upside from current levels, at which point we would likely become very concerned about bear market risks if credit conditions begin to tighten or inflationary pressures build.

Corporate Tax Cut Supports Case for Small-Caps

The potential for a significant reduction in the corporate tax rate has played a major role in increasing optimism over the outlook for corporate earnings. It is unclear what rate will ultimately be enacted between Mr. Trump's proposal of a 15% rate and prior congressional Republican discussions of a 25% rate. In terms of impact on bottom line earnings, it is important to note that large-cap companies have been paying a far lower effective rate than the federal statutory tax rate of 35% due to deductions and the percentage of sales booked overseas at lower rates. The difference in effective tax rates by market capitalization is illustrated in the chart below. Therefore, with many deductions likely to be eliminated as part of tax reform, smaller firms stand to benefit the most from a reduction in the corporate tax rate. This is likely the primary reason that small cap stocks have done so well in the wake of the election.

Exhibit 7: Current Effective Tax Rates by Market Capitalization
(R2000, RMid, S&P 500, Wgt Median, Ex Neg Pre Tax Income, Ex REITs)

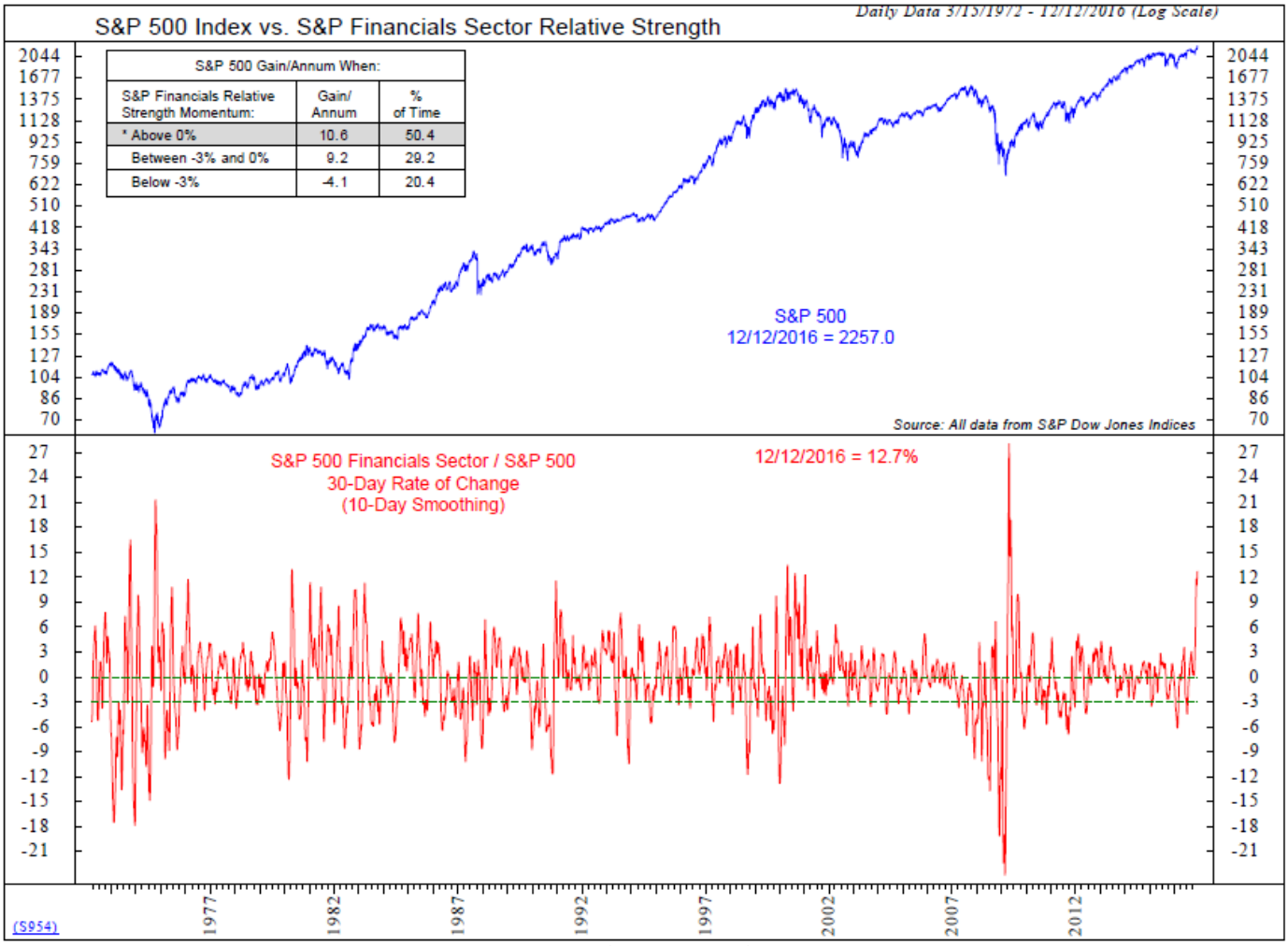


Source: Credit Suisse

Relative Strength of Financials Support Bullish Case

As of mid-December, sector leadership is encouraging and has been spearheaded by financial stocks, which have shown the most strength relative to the overall market since the election. On average, periods of strong relative performance for the financial sector have been associated with above average subsequent returns for the overall market. In this regard, the market is possibly signaling a period of improved bank lending driven by regulatory changes and generally easier lending standards for small businesses and consumers. We will be watching for signs of more defensive groups such as utilities and consumer staples reasserting leadership as an indication that the risk of a significant correction is building.

Exhibit 8: Financial Sector Relative Strength vs. S&P 500

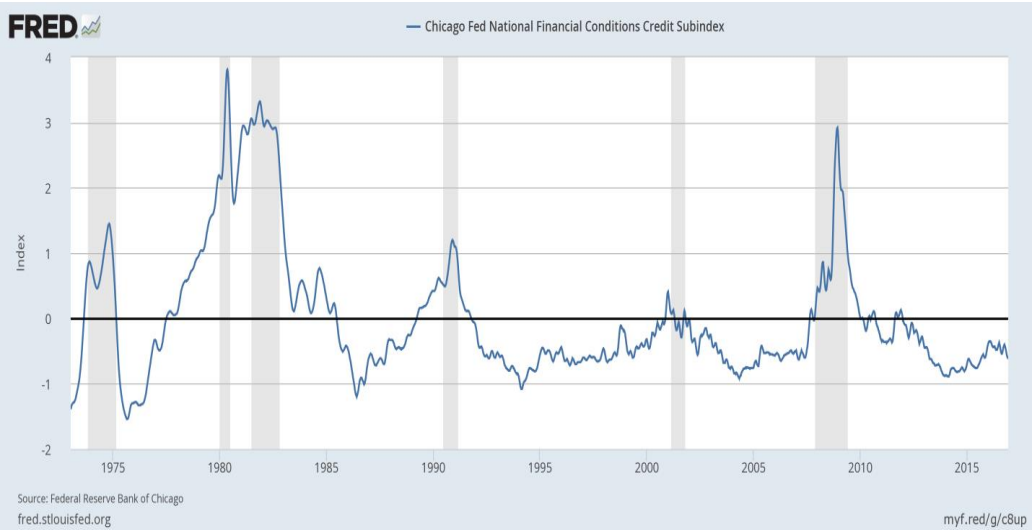


Source: Ned Davis Research

Credit Conditions Remain Healthy

One risk that bears watching is whether a strengthening U.S. dollar and rising interest rates lead to tighter financial conditions that could hinder the economic recovery. So far, there is yet little evidence of this occurring. One measure of financial conditions is the Chicago Fed National Financial Conditions Credit Subindex, as depicted in Exhibit 9. A rise in this index suggests tighter credit conditions. A decline suggests looser credit conditions. In our opinion, a sharp, multi-month rise that approaches a reading of zero would be a sign that risks are rising.

Exhibit 9: National Financial Conditions Credit Subindex



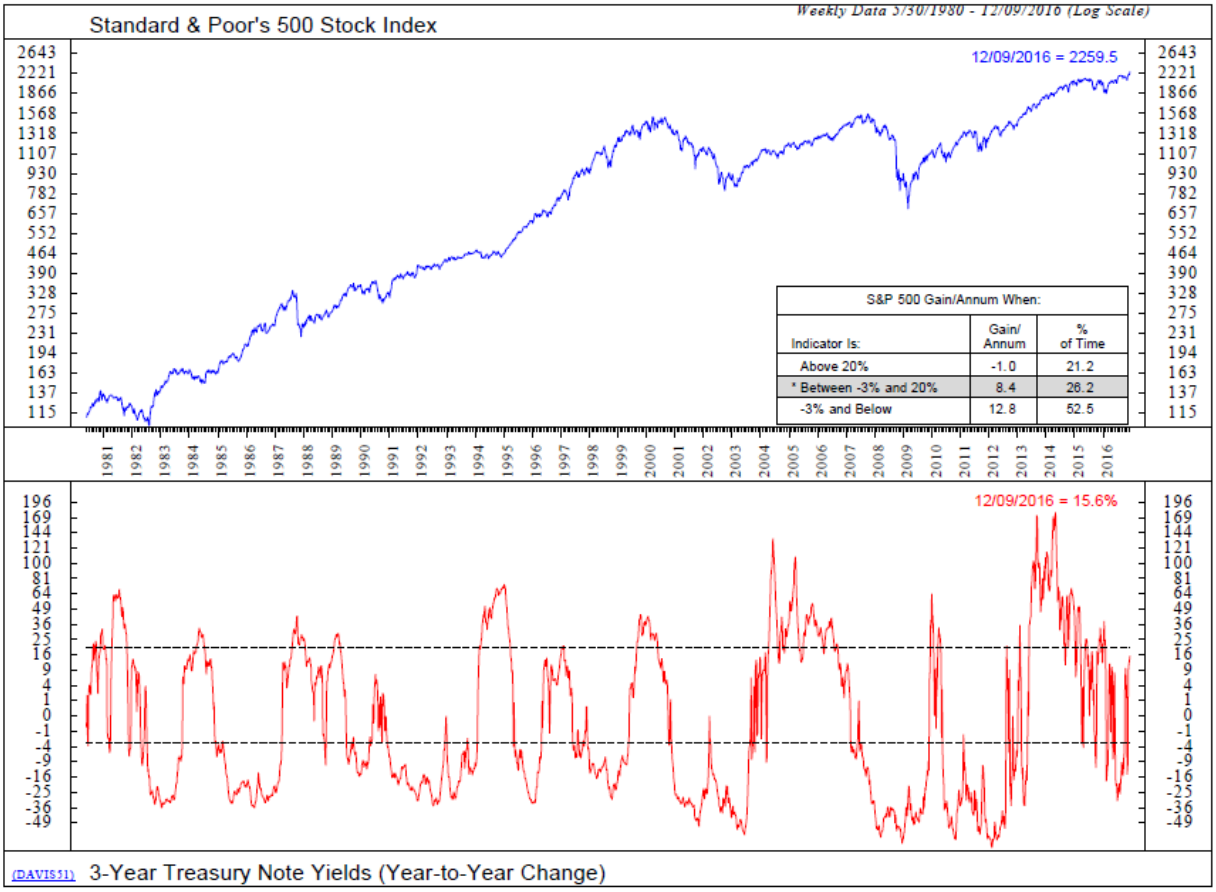
Source: Federal Reserve Bank of St. Louis

Rising rates a potential threat to equities

From our perspective, there are two primary risks that could disrupt the consensus bullish outlook for equities in 2017. The first potentially challenging scenario would entail economic growth failing to meet rising expectations and sentiment turning somewhat more cautious as fears build that the impact of slowing population growth, aging demographics, and already high debt levels prove stronger secular headwinds than currently recognized. This scenario, at least in the first half of 2017, is probably not a major risk for equities. Even if growth were to disappoint in the first quarter, the prospect that policy changes will ultimately lead to resurgent growth later in 2017 and into 2018 will likely remain intact. At the same time, a resumption of sluggish growth trends early in 2017 would likely lead to a more cautious Fed policy and enhance the political case for aggressive fiscal stimulus. Barring a very significant near-term deterioration in economic conditions, which we view as unlikely, growth early in 2017 somewhat below consensus may not be much of a negative catalyst for equities.

A bigger near-term risk for asset markets, in our view, would be continued rising inflation leading to higher bond yields and rising commodity prices leading to a pulling forward of expectations for future Fed rate hikes. We view this as a bigger risk in 2017 than at any time since the financial crisis. A more hawkish Fed could also push the U.S. dollar higher, which could result in tighter global financial conditions, similar to 2015. Sharply rising interest rates, in addition to potentially creating a headwind for the housing market, have also tended to weigh on equities, as shown in Exhibit 10.

Exhibit 10: Changes in 3-year Treasury Note Yields vs. S&P 500



Source: Ned Davis Research

Rate Hikes (Eventually) Bite

As Exhibit 11 summarizes the historical returns for the S&P 500 around the start of Fed tightening cycles. During the past seven fast tightening cycles, stocks have tended to struggle in the first year and then do a little better in the second year as the end of the tightening cycle comes into view. By contrast, the five slow tightening cycles have been associated with strong first year returns and a weak second year. This suggests even a slow pace of rate hikes eventually takes a toll on economic growth and risk appetites. Of course, the current cycle has been unprecedentedly slow, taking a full 12 months between 25 basis point hikes. This analysis may become highly relevant, however, if the Fed in fact does hike more than twice in 2017, as consensus estimates have been set for just two despite the Fed's own guidance of three.

Exhibit 11: S&P 500 Returns During Fed Tightening Cycles

	Slow Tightening Cycles	*Fast Tightening Cycles*
Gain Before First Hike	16.60%	16.30%
Gain During 1st Year	10.80%	-2.70%
Gain During 2nd Year	-1.80%	4.30%

Source: Ned Davis Research

Inflation Bears Watching
There is also still an ongoing debate among economists about how much slack remains in the labor market and to what degree the very low labor force participation rate reflects declining secular trends, such as baby boomers retiring, having reached a peak in women entering the labor force, and/or a persistent mismatch between available jobs and the skills of available workers. Large fiscal stimulus via tax cuts and increased government spending when the economy may be nearing full employment is a policy recipe that is not without potential risks, chief among which is the potential for strong upside surprises in inflation data. To be sure, a moderate degree of wage inflation which outpaces price increases for goods and services and diminishes measures of inequality may be welcomed by the Fed for a period of time. However, many measures of wage inflation sit near cycle highs and are already approaching historical norms, including the Atlanta Fed's three-month moving average of median wage growth. The historical tendency for rising inflation and interest rates to weigh on asset valuations is a risk for 2017 and beyond.

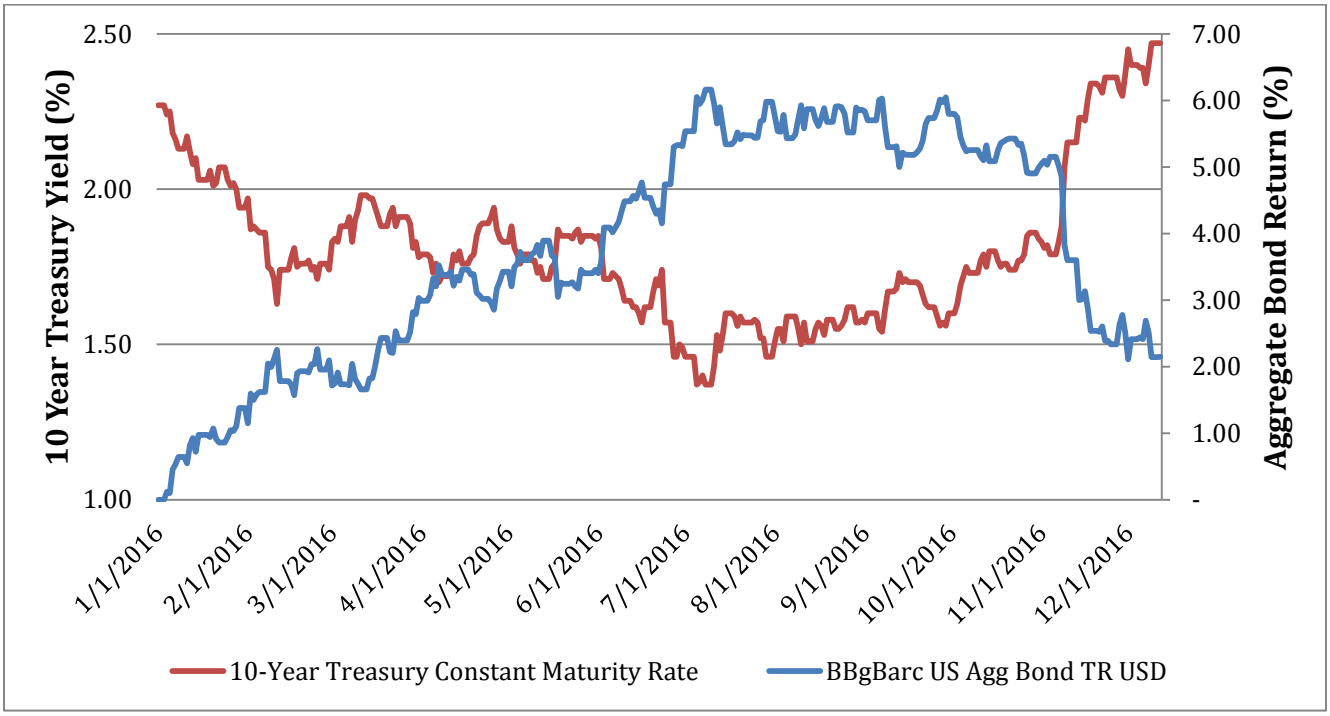
Exhibit 12: Atlanta Fed's Wage Tracker

Source: Federal Reserve Bank of Atlanta (12/13/2016)

Fixed Income Markets

Fixed income markets began the first half of 2016 with strong gains. The yield on the 10-year Treasury, a widely used benchmark, started the year at 2.27%, then declined after the equity selloff and following the Brexit vote, as investors seeking safety drove up prices on bonds. Midyear, this yield briefly hit an all-time low around 1.4% in early July. From that bottom, yields gradually rose in the period leading up to the presidential election, almost reaching 1.9%. Following the election investors, anticipating Trump's policies would be inflationary, quickly drove the yield above 2.6%. Exhibit 13 illustrates the 10-year Treasury Yield in red and the YTD return of the Bloomberg Barclays U.S. Aggregate Bond index in blue. Yields, which move inversely to bonds, rose more than 1% in less than six months. The broad market bond index reached a YTD return of just over 6% in early July but has since given up much of these gains and stands around 2% nearing year end.

Exhibit 13: 10-Year Treasury Yield vs Bloomberg-Barclays U.S. Aggregate Bond Return

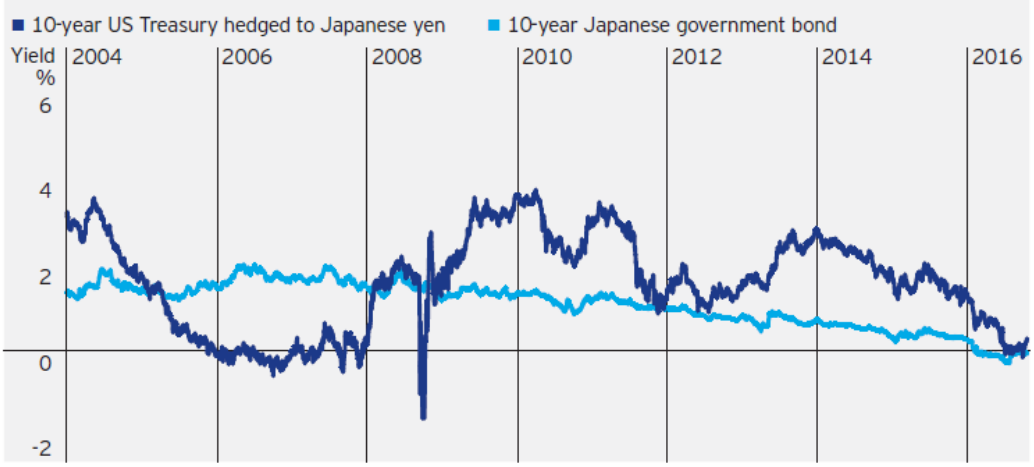


Sources: Federal Reserve Bank of St. Louis and Morningstar

The second half of the year's bond market volatility was driven more by inflation speculation, rather than central bank actions, which had driven financial markets in the first half and in previous years. Beyond the inflationary pressure of the potential infrastructure spending that both candidates supported on the campaign trail, president-elect Donald Trump has supported deregulation and tax cuts which could be expected to spur more growth, and thus even more inflation, as well as more bond issuance.

Looking abroad, both the Bank of Japan (BOJ) and European Central Bank (ECB) have started to reduce their expansionary monetary policies, which may lead their bond yields to rise as they decelerate their bond purchases. The BOJ has started to shift away from its negative interest rate policy, which has hurt banks, and started to target a 10-year yield of zero. While the ECB extended their bond buying program, it did start to reduce its monthly bond purchases. As global bond yields rise, the relative attractiveness of U.S. bonds fades. In addition, central banks in emerging markets have been selling Treasurys to support their currencies. Lastly, the yield advantage for foreign buyers who had been buying U.S. Treasurys and hedging the currency risk in a search for yield has diminished, as it is becoming increasing expensive to hedge this currency risk, as seen in Exhibit 14 . All these factors are supportive of higher domestic yields.

Exhibit 14: Yields on Hedged U.S. Treasurys vs Japanese Government Bonds

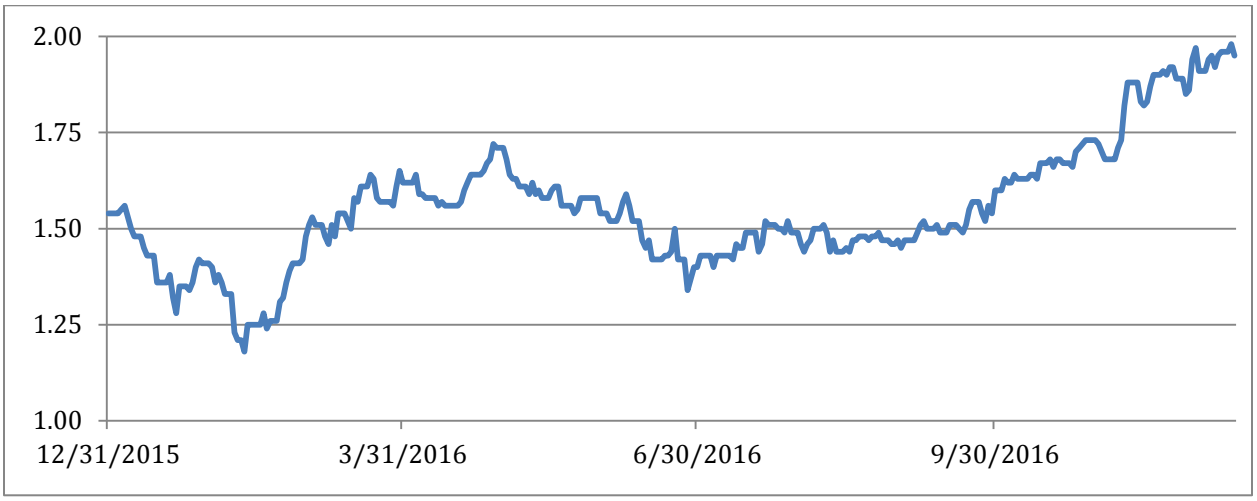


Sources: Bloomberg L.P., Invesco, data from Jan. 1, 2004 to Oct. 20, 2016.

After maintaining the status quo in September, the Federal Open Market Committee (FOMC) voted in December to increase the Federal Funds rate by 0.25% to a target range of 0.50% to 0.75%. Going into the December meeting, futures markets had fully anticipated this outcome with the probability of a rate hike nearly 100%. Investors shifted their attention away from what the Fed might do in December and paid more attention to the Fed's future guidance regarding what it may do in 2017 and beyond. In September, the FOMC indicated it expected two rate increases in 2017, but revised this figure in December's meeting and now expects an increase of 0.75%, or three hikes of 0.25%, in 2017. The upward revision was attributed to a tightening labor market and firming inflation.

Since mid-year, the break even rate for Treasury Inflation Protected Securities (TIPS) has been moving up and is now close to 2%. This suggests bond investors are pricing in an inflation rate of 2%, which represents an increase of over 0.50% since June. Many money managers anticipated this rise in inflation expectations and were substituting TIPS for Treasurys earlier in the year. It was a good trade relative to Treasurys. However, on an absolute basis, TIPS were down the second half of 2016 due to their longer duration as Treasury yields moved up along with inflation expectations.

Exhibit 15: 10-Year Breakeven Inflation Rate



Source: Federal Reserve Bank of St. Louis

Despite interim volatility, this is the second year in a row in which the 10-year Treasury yield ended the year close to where it began. However, looking to the future, inflationary pressures noted previously could continue to push yields even higher. We have increased our expectations and believe the benchmark yield could end 2017 between 2.75% and 3.25%. As central banks reduce their monetary stimulus, we anticipate increased bond volatility. Inflation in excess of expectations, which could force the Fed to act more aggressively, could also widen our expected yield range.

We favor investment-grade credit relative to Treasury bonds, as higher yields may buffer against a rising rate environment. We believe that the U.S. economy will continue to grow at its slow and steady pace, which should provide for stable credit ratings and keep default rates in investment grade bonds at lower levels.

Below-investment grade bonds, otherwise known as high yield bonds, saw a major sell off at the end of 2015 reflective of the higher concentration in oil and gas issues in this asset class. As oil prices rebounded, high yield indices have rebounded in 2016. As growth continues and oil prices stabilize, high yield default rates are expected to be subdued. However, the high yield sector has done well this year and spreads — the yield benefit over comparable Treasurys — have narrowed. While we maintain an allocation to high yield for the purpose of diversification, their relative attractiveness has decreased, so it may be prudent to reduce overall exposure to these bonds and choose opportunities selectively.

In the fourth quarter, as yields have risen, we have seen a sell-off in the taxable municipal bond market, which tends to be higher in duration, more retail-driven and more sensitive to supply and demand. Issuance is expected to decrease in 2017, which should constrain supply. However, the sell-off in the fourth quarter prompted a stream of outflows in the sector, which exacerbated weak returns. In October, the municipal bond market saw its first net outflows in 54 weeks. This sector, as measured by the Bloomberg Barclays Municipal Index, has already lost over 4% during the second half of 2016 and is on pace to finish roughly flat for the year. Fundamentals, however, remain positive. Increased tax collections associated with an improving economy is positive for municipal bonds. For taxable investors, municipals remain very attractive on a relative basis, with the caveat that any decrease to lower personal tax rates would also reduce the attractiveness of this sector. In addition, as we expect rates to continue to rise in 2017, the longer duration of municipal bonds could negatively impact returns.

Foreign bonds may diversify portfolios against rising U.S. interest rates and unexpected inflation; however, investors must be aware of currency risk. Foreign bonds may appreciate in value in local currencies, but may not appreciate in U.S. dollar terms. The U.S. dollar has increased in value relative to most of the world's currencies over the past year and is expected to continue to increase due to stronger GDP growth prospects and higher interest rates in the U.S.

We continue to recommend a shorter-than-benchmark duration, although still keeping some duration in portfolios to buffer equity volatility. Being overweight credit may benefit a portfolio as the additional yield can offset some of the principal losses from falling bond prices. We are comfortable with this credit overweight because improving growth prospects which push up yields would also likely cause default rates to remain in check. Diversification within fixed income is also important, such as not having too much exposure to one risk factor such as duration, credit or sector.

Risks to Our Outlook

Although our base case market and economic expectations have steadily improved from the weakness in the first half of 2016, the change in the political environment and the forthcoming US monetary tightening cycle has undoubtedly increased uncertainty. As the world settles into its new political and monetary policy narrative, the following risks are on the top of our minds.

Too Far, Too Fast
One area of concern is the speed in which markets have appreciated since late October, and there is a risk that financial markets may have become too optimistic, too fast. There appears to be much confidence in future growth and policy initiatives even though details are far from being formalized. Directionally, plans appear pro-business, but many of the proposed policies by President-elect Trump will take time to implement and even longer to stimulate growth. The 12-month forward PE ratio for the S&P 500 has surpassed long term averages and, factoring in an aging economic expansion, the third longest domestic equity bull market on record, and a rising interest rate environment, any result below these high expectations may quickly subdue investors' euphoria.

Policy Lag
Much of the increase in equity prices and interest rates at the end of 2016 is associated with the expectation of increased pro-business policies. Should policy proposals be delayed, either by prolonged debate on their details or by opposing litigation, the expected impact may not be felt until late 2017 or beyond . This, along with possible delays in the implementation of said policies, may delay any positive impact to earnings and may increase equity market volatility.

The Impact of Presidential Policy
President-elect Trump campaigned on promises of a trillion-dollar fiscal spending initiative, corporate and personal tax cuts, and an "America First" trade stance. Though our base case is constructive for corporate profits and domestic growth in a lower tax and regulation environment, the prospects of fiscal spending adding to the government deficit late in the business cycle could prove problematic. These risks include accelerating inflation and further appreciation of the U.S. dollar, which would hurt U.S. exporters. With 31% of S&P 500 revenue generated internationally, a strong dollar would then reduce the value recognized overseas when converted back into our currency. While these pro-growth initiatives could accelerate short-run growth, they do little to meaningfully address the slowdown in productivity, a key element for sustainable future growth. On the international front, President-elect Trump has publicly taken a hard stance against China, Mexico, and other developing market exporters. The prospect of heavy tariffs could reduce global trade and potentially provoke trade wars. Protectionist actions may also further strengthen the U.S. dollar.

Fed Tightening Cycle and Market Returns
When the Fed raised rates in December, it was not a surprise; however, the hawkish tone from the committee's economic projections, indicating a higher future rate than originally projected in September, surprised many. The committee now expects three rate hikes in 2017, followed by two or three in 2018 and three in 2019. Previous committee projections indicated two hikes in 2017 and a perceived willingness to let the economy run hot. While the Fed did increase its rate hike projections, they still suggest a gradual cycle. However, as we noted previously, slow cycles have not been friendly to domestic equities during the second year of a tightening period.

Investment Implications

Although already protracted, we expect the current bull market and economic expansion to continue. As prior concerns about the economy losing its momentum have given way to fears of its heating up too quickly, we see little probability of recession. This provides a scenario in which we see positive equity performance, but with measured gains below historical averages. With this in mind, we do not recommend drastic deviations from an individual's long-term stock/bond targets.

Last year's slow earnings growth environment supported a tilt more toward growth over value. With growth picking up, we now favor more value-oriented groups. Specifically, higher rates and a steepening yield curve should be a tailwind to financials. From a political standpoint, the shift from monetary policy to fiscal policy, in infrastructure in particular, should help the energy and industrial sectors. Within value, we would be wary of the more interest rate sensitive sectors such as utilities, staples and telecom. A more favorable business backdrop, coupled with a possible tax holiday for corporate cash stockpiled overseas, could result in a pick-up in business spending. Beyond the sectors already discussed, technology should be a beneficiary of this theme.

U.S. dollar strength in 2016 led to yet another year of U.S. equity outperformance compared to foreign equities. In fact, the last seven years saw the widest margin of U.S. outperformance since the period from 1995-2001. Higher relative interest rates, coupled with a strong domestic economy would provide tailwinds for the dollar to continue strengthening. However, we see attractive valuations in Japan, emerging markets, as well as parts of Europe. While we would be mindful of the impact of currency, we still recommend a globally diversified portfolio due to valuation and mean reversion opportunities.

On the fixed income side, we see rates drifting higher toward the 2.75% - 3.25% range on the 10-year Treasury. Even in the wake of moderately higher rates, we still believe bonds serve a valuable role in a portfolio. We would recommend shorter-than-benchmark duration for the fixed income portion. With a strong economic backdrop, we feel comfortable being overweight credit bonds. Given our modest equity outlook, we continue to see opportunities in high yield and floating-rate bonds, but are cautious at current spread levels.

From a portfolio implementation standpoint, to mitigate unforeseen volatility, we believe it is prudent to retain an allocation to alternative investments that have low correlations to traditional investments. Lastly, we prefer managers with flexible investment styles that provide the discretion and ability to move nimbly within their mandates in the face of this changing economic environment that we foresee.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

GLOSSARY

Bloomberg-Barclays U.S. Municipal Bond Index *is an unmanaged, market-value-weighted index of investment-grade municipal bonds with maturities of one year or more.*

Bloomberg – Barclays U.S. Aggregate Bond Index – *which used to be called the Lehman Aggregate Bond Index, is a broad base index, maintained by Barclays Capital, and is often used to represent investment grade bonds being traded in the U.S. Barclays Capital (BarCap) U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.*

MSCI EAFE Index *(Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.*

MSCI Emerging Markets Index *is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.*

The ***MSCI World Index*** *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.*

Russell 2000 Index *measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

The ***S&P 500*** *is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*