MONTHLY MARKET UPDATE FROM THE INVESTMENT COMMITTEE

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OUR CORE PURPOSE:
To bring clarity and confidence to our clients about all aspects of their financial lives, and to help them achieve and maintain a secure financial future.

Market Performance Overview

Exhibit 1: Global Asset Class Performance (%) as of November 30, 2016

Asset Class	Benchmark	1 Month	3 Months	YTD	1 Year	3 Years
U.S. Stocks	Russell 3000 Index	4.5	2.4	10.6	8.3	8.7
U.S. Large-Cap Stocks	S&P 500 Index	3.7	1.8	9.8	8.1	9.1
U.S. Small-Cap Stocks	Russell 2000 Index	11.2	7.1	18.0	12.1	6.5
International Stocks	MSCI ACWI ex. US Index	-2.3	-2.5	1.9	0.0	-2.3
Developed Market Stocks	MSCI EAFE Index	-2.0	-2.8	-2.3	-3.7	-2.2
Emergin Market Stocks	MSCI Emerging Markets Index	-4.6	-3.2	10.9	8.5	-3.1
U.S. Taxable Bonds	Barclays U.S. Aggregate Bond Index	-2.4	-3.2	2.5	2.2	2.8
U.S. Municipal Bonds	Barclays U.S. Municipal Index	-3.7	-5.2	-0.9	-0.2	3.6

3-Year return figure is annualized. Source: Morningstar

Global Events and Market Reaction Surprise Investors

Yet again, investors in aggregate (ourselves included) were surprised by global events and the financial markets in November. The catalyst this time was no doubt the election of Donald Trump to be the next president of the United States of America. Trump's electoral victory came as a relative shock to most market observers as polling results and the popular opinion in the press was that Hillary Clinton would win the election, perhaps by a significant margin.

Especially notable is how this marks the second major political event in the last six months where the consensus expectation (and polling) was off the mark—the other instance being the outcome of the United Kingdom's referendum to leave the European Union, the so-called "Brexit" vote which took place in late June. As was the case with Trump's unexpected election, the punditry and popular opinion had come to firmly expect the opposite result, which, in the case of the Brexit, was that the UK would vote to remain in the European Union. Also notable is how in both of these instances the consensus' expectation for what these outcomes would mean for the financial markets turned out to be incorrect too.

In the months and weeks leading up to the U.S. presidential election, the consensus among political and market analysts was that a Trump victory would be bad for the markets (by markets here, we are primarily referring to global stock markets). And, for the majority of the campaign season, this appeared to be the case since whenever events occurred that made it appear that Trump's chances of winning had increased, stocks generally declined, and vice versa. This trend played itself out right up through election night when stock markets around the globe declined significantly in overnight trading as it became increasingly apparent that Trump would in fact win. At one point during the night, U.S. stock futures on the Dow Jones Industrial Average were down nearly 900 points, implying that the U.S. stock market would open trading the following day down nearly 5%.

Then, as was the case in the aftermath of the Brexit vote, the trend reversed course and markets by and large shook off the surprising outcome and began to rally. As Exhibit 1 at the top displays, U.S. stocks, as measured by the Russell 3000 Index, returned 4.5% in November, while the more narrowly defined (yet more well-known) Dow Jones Industrial Average gained 5.4% during the month, posting its best month since March. During the month, the Dow crossed about 19,000 for the first time in its history and set eight new all-time highs. The Dow wasn't the only major index to set all-time highs during the month, as the S&P 500 Index, the Nasdaq Composite Index, and the Russell 2000 Index (a measure of U.S. small-cap stocks) all reached new all-time highs during the month. In fact, all four closed at all-time highs on the same day for the first time since December 31, 1999. Analysts at LPL were quick to point out that investors should be cautious in attempting to draw too many conclusions from this fact: "Many will hear that date [December 31, 1999] and remember that was near the end of an 18-year bull run. What you might not realize is this [all four major U.S. stock indexes closing at all-time highs on the same day] actually happened a grand total of 47 times during the 1990s, with the first instance occurring on December 31, 1991."

Over the final three-plus weeks of November, investors noticeably favored areas of the markets that stand to benefit the most from robust domestic economic growth. Specifically, as Exhibit 2 demonstrates, economically-sensitive sectors such as Financials (+14.1%), Industrials (+9.6%), Energy (+9.1%), and Materials (+8.4%), led the rally for the month. Further, as Exhibit 1 shows, small-cap stocks, as measured by the Russell 2000 Index (+11.2%), which tend to be more skewed toward domestic and production and consumption than their large-cap counterparts, noticeably outpaced large-cap stocks, as measured by the S&P 500 Index (+3.7%) during the month. This suggests that the expectations for strong growth are largely reserved from the domestic economy.

Exhibit 2: U.S. Stock Market Sector Performance (%) as of November 30, 2016

Sector	1 Month	3 Months	YTD	1 Year	3 Years
Consumer Discretionary	5.2	2.1	6.6	3.5	8.8
Consumer Staples	-4.1	-6.4	2.5	5.2	8.5
Energy	9.1	8.9	25.1	12.1	-3.0
Financials	14.1	13.3	19.5	16.6	11.6
Health Care	2.2	-5.1	-2.9	-1.4	9.5
Industrials	9.6	7.2	19.7	16.4	9.6
Information Technology	0.4	2.5	12.9	10.1	13.9
Materials	8.4	5.1	21.7	16.1	6.9
REITs	-2.4	-8.8	4.0	5.4	11.3
Telecom Services	3.7	-3.8	14.2	16.0	6.7
Utilities	-4.6	-3.3	12.4	14.6	11.4

3- Year return figure is annualized.

Note: Sector performance represented as performance of various S&P 1500 sector indexes. Except REITs which is represented by the FTSE NAREIT All Equity REITs Index. Source: Morningstar

On the flip side, the strong absolute and relative performance of economically-sensitive assets and sectors was mirrored by the weak performance of more conservative, defensive, or income-oriented assets. For example, Utilities (-4.6%), Consumer Staples (-4.1%) and REITs (-2.4%) all posted negative returns during the positively trending market. As you may recall, all three of these sectors had been market darlings for much of the last few years as investors by and large scrambled to buy anything that sported a healthy (i.e., above-average) dividend yield amid the ongoing low interest rate environment.

Rising Rates?

Just as November was not a great month for defensive, income-oriented stocks, it was also not a great month for bonds as the Barclays U.S. Aggregate Bond Index lost 2.4% for the month amid rising interest rates across the entire U.S. Treasury yield curve driven by the aforementioned increased expectations for economic growth and expected resulting inflation. As a reminder, bond prices move inversely to yields such that when yields go up, bond prices go down. For the month, the 10-year U.S. Treasury rate registered its largest monthly increase since 2009 as it rose 0.53% and ended the month at 2.37%, up a full percentage point from early July when the rate touched an all-time low of 1.37%, as displayed in Exhibit 3. Yields across the curve experienced increases of approximately similar magnitude.

Exhibit 3: 10-Year U.S. Treasury Yields (%), November 2006-November 2016

Source: Board of Governors of the Federal Reserve System

Not surprisingly, the recent rise in rates has led many market commentators to begin (once again) to call for the end of the persistent low-rate environment and for sharply rising interest rates. Many of these calls are often followed with a clarion call for changes to investors' fixed income strategy (generally to shorten duration or move out of bonds all together).

In response to these calls, we believe three points are worth bearing in mind:

1. It's far from certain that rates will continue to rise.
2. It's far more difficult to tactically time the bond market than most investors seem to appreciate.
3. Rising rates are a good thing for long-term investors as higher rates lead to higher expected returns in the future.

Regarding the first point, we'll stress first that we don't claim to know where rates are headed. That said, we also don't believe anyone else really does either. The point is simply that while there is certainly a compelling argument to be made for why interest rates are likely to increase in the months ahead, there is also (in our opinion) an equally compelling case to be made for why interest rates may hold steady or even potentially decline in the years ahead.

Further, it's important to keep in mind that we've been reading and hearing these articulate, well-reasoned forecasts for rising rates for more than seven years now since the beginning of the recovery from the financial crisis. Obviously, these calls have not come to pass as the 10-year rate today remains nearly 1.5 percentage points below where it was at the end of 2009 (3.89%) when many of the calls for rising rates were at their loudest. Our goal here is not to dismiss the possibility of rising rates (as mentioned, we think a legitimate case can be made arguing that rates will rise) but rather to recognize that it's not certain that they will or that they "must" rise.

Regarding the second point above, we believe it is a common misconception held by too many investors that it's somehow easy to time the bond market so long as one has a good sense for where interest rates are headed. Notwithstanding the aforementioned difficulty of predicting the future direction of rates, it's important to recognize that in order to effectively trade on such a forecast, one must hold a view on more than just the future direction of rates. According to a research piece published by asset manager AQR, "…in order to add value from 'timing' the bond market, not only must one predict the future direction of interest rates correctly, but also be right on the speed and magnitude of yield moves – a fairly difficult task. The reason for this is because bond prices reflect the market's expectation of the future path of interest rates."

Thus, while it's perfectly reasonable to expect that rates will rise, such a view alone is not sufficient cause for making changes to one's bond portfolio (e.g., shortening duration), as it is still quite possible that rates rise (as predicted) and a short-duration strategy underperforms an intermediate-duration strategy if rates don't rise either (a) as high or (b) as fast as is already expected by the market and thus incorporated into bond prices. For that reason, we are generally cautious about attempting to outsmart the market by tactically altering a bond portfolio's duration in light of an interest rate outlook.

And lastly, as it relates to the third point above, it's critical to note that rising interest rates are ultimately a good thing for long-term investors as higher rates set the stage for higher returns in the future. This is because long-term investors are able to reinvest distributions (e.g., coupon payments and principal repayments) at these now higher rates. However, the cost for these higher returns comes in the form of capital losses experienced today. In a recent blog post, Vanguard describes it as "a classic case of enduring short-term pain for long-term gain."

This reality underscores the importance of investors holding portfolios that are tailored to their unique circumstances, specifically, their ability to withstand temporary losses in exchange for the opportunity for greater long-term returns. An investor's ability to withstand these losses will be determined primarily by the time horizon of their goals and their personal tolerance for risk—two things we work with each of our client's individually to understand before embarking on an investment program.

Trump ¯_(ツ)_/¯

We'll wrap things up by briefly touching on the potential implications of the forthcoming Trump presidency. The headline from this section is borrowed from the title of a recent research piece we came across from Capital Economics which we believe does a fantastic job summarizing our perspective on the issue. Specifically, we believe there is considerable uncertainty surrounding what fiscal, regulatory, trade, and immigration policies (among others) that President-elect Trump will pursue. Our view is that the markets for now appear to have generally convinced themselves that the Trump administration (and Congress) is more likely to execute much of the perceived or possible "good" of the administration's policy platform (e.g., reform/reduce personal and corporate income taxes, boost infrastructure spending, roll-back regulations across a variety of sectors of the economy) than it is to execute the perceived "bad" such as some of Trump's more draconian policy prescriptions on trade and immigration. Given the numerous uncertainties, we think it's likely that we'll see volatility persist in the months ahead as markets oscillate between hope and fear as more information comes to light.

That said, as was our position leading up to and in the immediate aftermath of the election, we are not recommending any changes to client portfolios at this time. We continue to believe that positioning one's portfolio for political events is not an effective long-term investment strategy. As we've seen quite clearly over the last six months, not only is predicting political outcomes difficult but predicting the short- to intermediate-term market impact is even more difficult. We instead choose to focus on building and managing well-diversified portfolios for our clients on the basis of our time-tested investment principles.

As always, please contact us with any questions your have and thank you for your continued trust,

Kathmere Capital Management Investment Committee

Please see important disclosures and footnotes on the next page.

1. “Market Update: Tuesday, November 22, 2016” LPL Research Blog
2. Hurst, Brian; Mendelson, Michael; Ooi, Yao Hua. “Can Risk Parity Outperform If Yields Rise?: Risk Parity in a Rising Rate Environment” AQR Capital Management. July 2013.
3. Barrickman, Josh. “Bonds and The Good News About Rising Rates” Vanguard Blog for Advisors. November 29, 2016.