January 2017

Dear Investor:

"My New Year's resolution was going to be to quit all my bad habits, but then it occurred to me- no one likes a quitter." -Anonymous

For many of us, the New Year symbolizes a fresh start. We begin the year with a determined spirit, hoping that this will be the year we finally stick to our inspired resolutions. Many historians credit the tradition of the New Year's resolution to the ancient Babylonians, who made promises to the gods for a chance to start the year off on the right foot. Before committing to their promises, they spent time reflecting on the year they were leaving behind. In many ways, the New Year was as much about looking back as it was about looking forward.

In this spirit, I'd like to begin by reflecting on the major market events of 2016. Early on, equity markets were challenged by fears of higher rates and slowing global growth. In addition, markets reacted harshly to the uncertainty following Brexit at the end of the second quarter. Fortunately, bonds provided stability through the first half, as concerns about future rate hikes cooled. While there continued to be market volatility prior to the U.S. election, the overall trend in equities was decidedly up in the second half of the year. Aided by post-election expectations of tax reductions, infrastructure spending and deregulation, ten out of eleven S&P 500 sectors were in positive territory for the year. The same factors helping equities were a significant headwind for bonds, which sold off at year-end as the specter of higher rates, again, appeared.

Traditional Asset Class Returns Q4:2016			
Asset Class	**Benchmark**	**Q4:2016**	**2016**
US Stocks	S&P 500	3.82	11.96
US Gov't Bonds	Barclays Capital Intermediate Gov't	-2.18	1.05
Cash	3 Month T-Bill	0.07	0.26

US Economy

The U.S. economy continued on its modest growth trajectory in 2016. Recently revised third quarter gross domestic product (GDP) growth of 3.5% was the fastest in two years. While some moderation is expected in the fourth quarter, growth for the year should come in around 2%. Furthermore, hourly earnings in 2016 rose 2.9%, a seven year high, which should be positive for consumer spending – a key driver of GDP growth. With an economy close to full employment, companies are increasing wages to retain workers.

US Stocks

Overall, equities did well in the quarter. There was significant outperformance in the financial sector in the fourth quarter with financial stocks in the S&P 500 up 21%. As a result of the year-end rally, financials were one of the strongest sectors in 2016 with a 23% return. Anticipation of a lighter regulatory environment and the potential for higher rates drove investor enthusiasm. Energy and industrial stocks were also up in the quarter with both S&P sectors appreciating 7%. The prospect of less regulation and an accelerating economy aided both sectors. The strongest sector in 2016 was energy (up 27%), primarily due to the recovery in oil prices. The healthcare and real estate sectors were the worst performers in the fourth quarter, both down 4%. Fear that rising interest rates would reduce loan demand hurt real estate stocks. Healthcare was the only S&P 500 sector with negative returns in 2016 (-2.7%). Price increases have been a key source of growth for healthcare companies and calls by industry watchdogs to limit increases has caused investor interest in the sector to wane.

US Bonds

Although much media attention has focused on the stock market rally on the heels of the U.S. election, the significant sell off in bonds has received much less attention. The potential for significant fiscal stimulus in 2017, while a potential boon to the equity market, significantly increases the likelihood of higher interest rates. The ten year treasury at 2.44% is only modestly higher than what it yielded this time last year. However, the move pre- to post-election was meaningful, with the 10 year treasury yield advancing over half a percent in the weeks after the election. Increasing interest rates negatively impacted bond prices resulting in negative returns in the short run, but not enough to erase previous gains, leaving investors with a return of a little over 1% for the year.

Diversifying Asset Classes

Asset Class	Benchmark	Q4:2016	2016
Foreign Stocks	MSCI EAFE	-0.71	1.00
Emerging Markets Stocks	MSCI Emerging Markets	-4.16	11.19
US Mid Cap Stocks	Russell Mid-Cap	3.21	13.80
US Small Cap Stocks	Russell 2000	8.83	21.31
REITs	MSCI US REIT	-2.96	8.60
Commodities	Bloomberg Commodity	2.66	11.77
MLPs	Alerian MLP	2.04	18.31
Foreign Bonds	Citigroup Non-USD WGBI	-10.84	1.81
Emerging Market Bonds	JPM EMBI Global	-4.21	10.19
US Inflation Protected Bonds	BarCap US Treasury TIPS	-2.41	4.68
Floating Rate Loans	Credit Suisse Leveraged Loan	2.25	9.88
US High Yield Bonds	BarCap US Corp High Yield	1.75	17.13
Convertible Bonds	BofAML Convertible Bonds	3.14	11.94

US small cap stocks led asset class performance for the quarter and the year aided by a relatively healthy U.S. economy and investor's hope for economic acceleration in 2017. Foreign bonds and stocks were laggards in the fourth quarter as the dollar experienced a sharp rally post-election visa vie other currencies. Foreign bonds struggled the most as the sector also had to contend with a move higher in interest rates globally. Both asset classes were the weakest performers for 2016.

Conclusion

The Babylonian's annual practice of reflection is an important tradition. The most significant lesson we can take away from 2016 is that markets, and politics, are unpredictable. Investment decisions should not be influenced by "expert" predictions about the political climate or the rate environment.

As we enter 2017, investors have begun to speculate that the future Trump administration could facilitate loosened regulations, lower tax rates, and increased government spending. Familiar conversations about multiple rate increases in the US have already begun and there is a lot of discussion around the possible outcomes of national European elections. As investment managers, our job is not to predict the future, but to stay committed to our investment philosophies. We will continue to strategically allocate and diversify our portfolios while focusing on high quality investments. In an inconsistent world, we create our own consistency- one that lies in our commitment to you and our investment process.

Happy New Year,

David B. Smith, CFA
Chief Investment Officer, Investment Management Group