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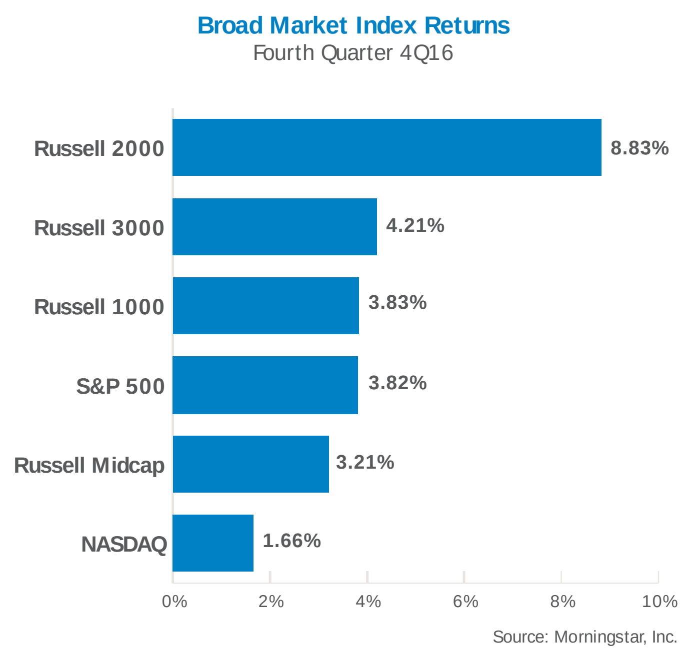
What a year 2016 turned out to be! We're not sure many people last January would have predicted the rest of the year would unfold as it did politically and for the markets. In early 2016, the markets were tanking, with most areas of the market flirting with or in correction territory; yet, as the year wore on, the U.S. markets found solid footing even following Brexit; however, International stocks were a bit of a mixed bag for the year. Emerging markets, after a dismal start to the year, finished quite strongly and were up over 11%. By contrast, the developed market international index barely posted a positive gain. Bonds in general did well through the first three quarters but, with the threat of inflation and higher interest rates following the presidential election, largely moved negative in the fourth quarter.

The Economy

On the domestic front, the economy continues to show resilience, and recently, a slight uptick, even seven years into a recovery. There are several positive trends: the employment situation continues to steadily improve; the housing market remains on an upward trajectory; consumer confidence hovers at very high levels; energy prices exhibit few signs of resurgence; and stock prices are at record levels. The results of the U.S. presidential election have also generated a significant surge in enthusiasm in the weeks since the election. The Bureau of Economic Analysis reported its third estimate of third-quarter 2016 gross domestic product (GDP) of +3.5%, higher than both the prior estimate of +3.2% and the +1.4% reading of the second quarter. The employment situation remained stable, with an average of about 176,000 jobs added each month, a level that allowed the Federal Open Market Committee (FOMC) to raise short-term interest rates at its December meeting. The unemployment rate was at a cyclical low of 4.6%.



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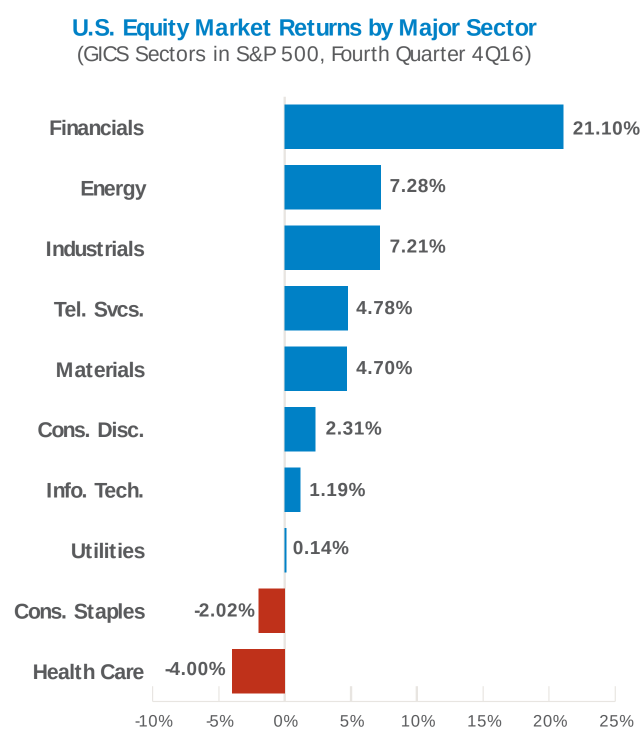
On a global basis, the environment is not as promising. The U.K.'s decision in June to leave the European Union – "Brexit" – appears to have been only an initial sign of nationalism in the Eurozone. Italy's referendum in December, in which Italians voted down constitutional reforms, has the potential to further jeopardize the EU's viability. In the Eurozone, GDP growth came in at a respectable +0.3% in the third quarter, and +1.6% year-over-year. Asia is likely to experience a slowdown as a result of slowing growth in China, but policy reforms enacted by Chinese policymakers could be a catalyst for a turnaround in 2017.

At its most recent meeting in December, the FOMC voted to raise the target range of the fed funds rate by 25 basis points, to 0.50%-0.75%. The committee also indicated that additional hikes can be expected in 2017 and into 2018, with some analysts anticipating the fed funds rate will reach 4% by 2020.

Highlights

GDP

The Bureau of Economic Analysis released the third estimate of the third-quarter 2016 real GDP, a seasonally adjusted annualized rate of +3.5%. This figure is up from the +1.4% annualized growth of the prior quarter, and is an improvement over the prior estimate of +3.2%. The third-quarter results proved to be the most robust since the fall of 2015. The acceleration came despite a slowdown in the increase in consumer spending, which had driven growth in prior quarters. In addition, any uncertainties leading up to the election seem not to have adversely affected results. Inventories were the primary growth driver during the quarter. Although growth is expected to moderate somewhat in the fourth quarter, economists are generally of the belief that the expansion remains intact, supported by a stable housing market, solid consumer spending, a favorable employment situation, and a strong stock market.



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Another positive sign noted by economists is that consumers have continued to spend while maintaining a savings rate above 5%. Corporate profits rose by +5.8% (not annualized), after falling -0.6% in the prior quarter. Inflation remained very stable in the quarter, with the personal consumption expenditures (PCE) index of prices rising +1.5%, following a +2.0% advance in the prior quarter.

HOUSING

The housing segment continues to recover steadily. Existing home sales for November (the latest monthly data available) advanced at an annualized rate of 5.6 million units, up about 0.7% from the 5.5 million unit rate reached in October, and up +15% from November 2015. The inventory of existing homes was about four months of supply, down slightly from year-ago levels. Existing home prices in November were down modestly from August, but up about +5.8% higher from November 2015. In the new home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 70, the highest reading in 2016. Homebuilders and analysts anticipate robust housing growth through the end of 2017, but warn that a pullback could occur after such strong growth in recent months.

EMPLOYMENT

The employment situation picked up somewhat in the most recent monthly report. Employers added 178,000 jobs during November, in line with consensus expectations of 175,000 new jobs, and a material improvement from the gain of the prior month. The three-month moving average has dipped somewhat, but is still at a respectable 176,000, a fairly strong rate after seven years into a recovery. The unemployment rate in November was 4.6%, a cyclical low, and a drop from the 4.9% level in August. Average hourly earnings decreased slightly in November, and have risen +2.5% in the past 12 months. The consensus among economists is that job growth should continue at the current pace for the next several quarters. The FOMC's decision to raise rates in December should not have a significantly adverse impact on future job gains.

FED POLICY

As had been widely anticipated, the FOMC ended its recent December meeting by raising the target range for the fed funds rate by 25 basis points, to 0.50%–0.75%. In addition to the rate increase, the committee signaled additional hikes over the next year, with the median expectation of committee members being three rate increases in 2017. The FOMC's estimate of the long-run equilibrium fed funds rate was raised from 2.875% to 3%. The expected increase in fiscal programs coming from the Trump administration should

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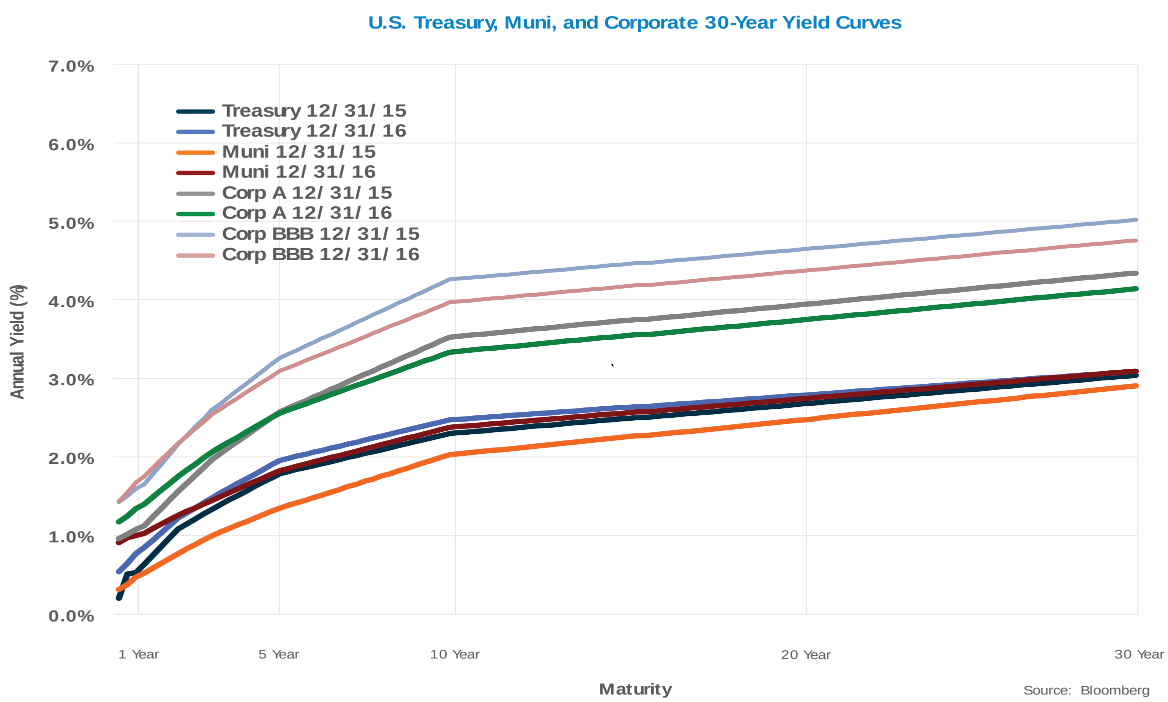
finally provide long-awaited relief for monetary policy, and it is possible that even more hikes will be considered once the impact of such policies becomes clear. Some analysts speculate that the Federal Reserve (Fed) may allow the economy to run somewhat "hot" in order to maximize job growth, thereby increasing the labor force participation rate, which has declined in recent quarters.

Interest Rates

As with the prior quarter, anticipation of a hike in the fed funds rate, an improving economic outlook, and record-high stock prices were a few of the key drivers of the prices of fixed-income securities; however, unlike the lead-up to prior FOMC meetings, there was little doubt that the committee would vote to raise rates, as economic data and the employment situation were strong enough to allow the FOMC to follow through on its well-known desire to take the next step in normalizing rates. Against the backdrop of these factors, which also included the run-up to the election, yields trended higher, accelerating their rise once the election results became known.



As opposed to previous recent quarters, the yield curve steepened, as yields on short-term securities did not rise as fast as those in the intermediate- to long-term end of the spectrum.

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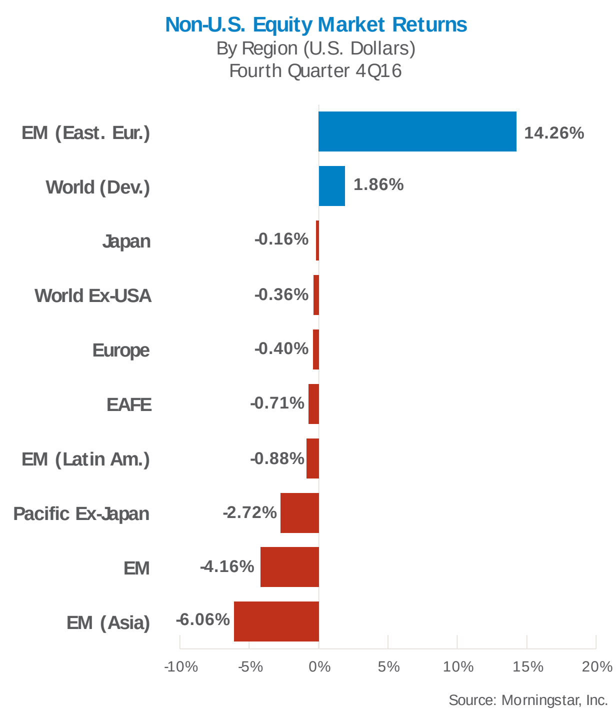
By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note rose substantially, to 2.45%, from 1.60% on September 30. Yield changes along the maturity spectrum were affected primarily by three factors: the run-up to the FOMC's eventual decision to raise the fed funds rate, a continued improvement in domestic economic data, and the perceived impact of the Trump administration's pro-growth economic policies.

In terms of total returns, fixed-income securities largely generated negative returns across the spectrum, although most broad-based indices finished the year with slight gains. The Bloomberg Barclays Treasury 5–7 Year Index fell -3.8% for the quarter, but concluded 2016 with a 1.3% gain. The Bloomberg Barclays U.S. Corporate 5–10 Year Index dropped -3.1% during the three months, but posted a +5.6% advance for the year. High-yield securities performed well, as stock prices surged, generating an advance of +1.8%, and produced an enviable full-year return of +17.1%. Municipals again disappointed, as the Bloomberg Barclays Municipal Bond Index fell by -3.6% during the quarter, barely eking out a slight gain of +0.3% for the year. Prices of non-U.S. fixed-income securities suffered terribly, as the Bloomberg Barclays Global Aggregate Ex-U.S. Index plunged -10.3%, reducing its full-year return to +1.5%. Emerging-markets bonds reversed course, with the JPM EMBI Global Index giving back -4.2%, but still managing to deliver a 2016 return of +10.2%.

Equity Markets

Equity markets powered higher in the fourth quarter, establishing record highs, as investors focused on the heightened expectations of a new presidential administration and cheered having greater clarity as to interest rate policy. Stock prices were soft for the first month of the quarter, with broad market indices declining almost 4% through the first week of November; however, the election results brought a sharp change of course for the market, as stocks rallied about 8% from their pre-election lows. The S&P 500 Index finished the quarter with a gain of +3.8%, ending the year with a total return of +12.0%.



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Dispersion in returns seems to be increasing, as the ten primary economic sectors generated wide variance in performance, making sector and security selection especially important. As with the prior quarter, the performance disparity between the best- and worst-performing sectors was substantial. Financials, energy, and industrials were the strongest performers, delivering gains of +21.1%, +7.3%, and +7.2%, respectively. The healthcare, consumer staples, and utilities sectors were the poorest relative performers, posting returns of -4.0%, -2.0%, and +0.1%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +3.8% total return, bringing its 2016 advance to +12.1%. Within the large-cap segment, value stocks materially outperformed growth stocks. Small-cap stocks, as represented by the Russell 2000 Index, again substantially outperformed large caps, ending with a total return of +8.8%. Small-cap value outperformed small-cap growth by about 1%. The Nasdaq Composite, dominated by information technology stocks, finished with a gain of +1.7% and a full-year advance of +8.9%. The Dow Jones Industrial Average of 30 large industrial companies gained +8.7%, contributing to its 2016 gain of +16.5%.

Looking Forward

The U.S. economic outlook has changed with the election of Donald Trump as president, initially evidenced by the reactions of both the equity and fixed income markets. The perceived pro-growth policies of President-elect Trump encouraged equity investors, who have driven stock prices up by almost 8% since the election. At the same time, the attendant potential for higher inflation further cautioned fixed-income investors. Whatever the case, the Trump administration and the Republican-held Congress are likely to make significant changes to immigration and trade policy, tax law, government spending, and regulation, at the very least. How all of this plays out is uncertain at this point. Many economists believe that although tax cuts may not be as large as promised during the campaign, reductions to personal and corporate taxes could amount to about $1 trillion over the next decade. In addition, government spending on defense, infrastructure, and veterans seems likely to increase substantially. Whereas the combination of lower taxes and increased spending should provide a boost to economic growth, the consensus among economists is that long-run equilibrium real GDP growth is not likely to significantly exceed 2% annually. Several potential risks are also on the horizon, including the potential for further disintegration of the European Union following 2016's Brexit, a hard landing by China's economy, escalation in aggression by Russia, and increased terrorism.

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We think one of the most important lessons from 2016 is the fact that no one can really predict the future consistently and this is particularly true with the markets. We can talk about possible trends and outcomes based on current information, but the world is inherently unpredictable and constantly changing. What can cause significant moves in the market (both up and down) are often unexpected events.

The point we want to make here is that no one knows what is going to happen going forward, no matter what the various pundits pontificate. It is important to have a balanced and diversified portfolio for the long haul. Such a portfolio may not keep pace when the market is red hot, but it is also likely to fall less when the market retreats sharply.

Eventually we will see rotation in the markets and areas that have done well suddenly struggle and areas that struggled suddenly perform well. The problem is we don't know when these rotations will occur While the S&P 500 has been doing extremely well the past few years, we can go back in history and find periods when the S&P 500 went nowhere for many years and people wanted little to do with stocks.

As hard as it is sometimes to have a diversified portfolio, we continue to recommend it. We have been in this business long enough to have experienced (along with many of our clients) both the tech bust and the financial crisis. In those down periods we were very happy to have those diversified portfolios.