



Market Perspectives

FLEXIBILITY IS KEY FOR 2017

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The result of the 2016 U.S. presidential election has positively impacted investor sentiment and significantly raised expectations for U.S. economic growth, corporate earnings, and interest rates. As sentiment rises in anticipation of favorable policy decisions ahead, and while it's logical to have a positive outlook as a result, we are cautious as to when lower taxes and higher federal spending will have an impact on economic activity and corporate profits. In short, we think investor enthusiasm has moved ahead of fundamentals. Because the legislative process required to lower taxes, increase fiscal spending, and reduce regulation unfolds in its own time, any expected change may not even occur until the latter part of 2017 or, even more likely, 2018. When today's enthusiastic investor comes to the realization that the anticipated economic benefits of a Trump presidency may be realized over a much longer time frame, we very well may see a pullback in the equity market from its recent highs.

Initially, we thought the markets would have taken this degree of uncertainty differently, and as such we are adjusting to this wave of investor enthusiasm. If actions and policy changes go as expected, we do think that by the end of 2017, the longer-term benefits should lead to higher GDP growth and higher corporate profits, driving stock prices higher by the end of next year. This perspective, coupled with indicators showing that domestic economic activity is modest but solid, has led us to modestly raise our outlook for GDP and corporate profits. It's important to note that this current period of economic expansion will last longer, with interest rates higher and federal deficits larger. Bond investors might not welcome these macroeconomic trends, but equity investors will. However, between now and then, and specifically because the market has already priced in this positive sentiment, we would not be surprised to see downside volatility for periods when such sentiment shifts.

Despite enthusiasm, uncertainties do remain, including:

- The details of the potential tax cuts
- The level of deficit spending that Congress will approve
- Whether trade will be negatively impacted with restrictions on exports/ imports
- Labor market dynamics

These uncertainties will be top-of-mind for investors in 2017, and we expect increased market volatility as a result. In the meantime, the equity markets will likely display an upside bias during this "honeymoon" period. But as previously stated, some pullback would not be a surprise.

While the growth outlook for the next few years is likely better, the longer-term outlook of 5-10 years remains largely a function

of what drives economic growth, population growth, number of workers, and rate of productivity growth. These factors have experienced a slowing trend for many years now, and any policy that increases productivity, or the number and talent of workers, will likely have a beneficial long term impact for the U.S. economy.

While equity values are at all time high levels, the news has been less welcome for fixed income investors. Long-term taxable fixed income securities have seen sharper declines, but most bonds are still positive year-to-date considering the run-up that occurred previously (*Figure 1*). Higher rates may be a headwind to short-term returns, but should ultimately benefit fixed income investors who are reinvesting at higher yields.

Our expectation is that the legislative process will favor addressing tax rates before tackling infrastructure and defense. The potential for tax reductions, if done well and beneficial to the middle class, can lead to slightly accelerated economic growth and a corresponding uptick in corporate profits. Given the low unemployment rate, which is currently 4.6%, a fiscal stimulus could add wage pressure. President-elect Trump is expected to appoint two hawks to fill the empty seats on the Federal Reserve's Board of Governors, which would be a negative signal to the fixed income market and set the stage for Chair Yellen to be replaced by a hawk in early 2018. A meaningful increase in inflation will likely benefit Treasury Inflation-Protected Securities (TIPS).

On the other hand, reflationary policies such as the ones President-elect Trump has proposed tend to be credit-positive, and corporate taxable bonds and floating rate bonds will likely do okay in such

FIGURE 1
Total Return

Index	November	Since Election (11/9/16-11/30/16)	YTD (as of 11/30/16)
Barclays US High Yield	-0.47	-0.09	15.01
Barclays MBS	-1.71	-1.64	1.67
Barclays US Aggregate	-2.37	-2.24	2.50
Barclays US Corporate	-2.68	-2.47	5.40
Barclays US Treasury	-2.66	-2.53	1.14
Barclays Municipal	-3.72	-3.92	-0.92
Barclays Municipal HY	-5.95	-5.61	1.59

Source: Bloomberg, December 2016

an environment, while those that exhibit negative interest rate sensitivity will likely face challenges. One of the approaches we have taken for clients is to invest in a variety of credit sensitive and floating rate income securities. Such strategies are performing well compared to Treasury and Corporate bonds.

So what does all this mean for investors? Over the next year, we expect equity returns to potentially reach all-time highs and potentially generate solid returns. We originally thought equities might have a so-so return, but it all depends on what policies are enacted and when, and which stocks perform as a result, but the upside might take shape. Although U.S. equities are at record highs, and we believe valuations are full but fair, they might go even higher

in an expansionary policy environment, with lower tax rates and additional fiscal stimulus. Investors need to have a flexible state of mind as we begin to see what policies take hold in 2017. As for fixed income returns, we expect investment grade fixed income to generate low returns. We expect non-investment grade bonds and loans to outperform investment grade as the extension of the economic cycle and better earnings support credits.

Overall, we remain cautiously optimistic about the outlook and will keep a close eye on shifting economic dynamics as we move into the new year. In the meantime, we wish you a very happy holiday season.

Index Definitions

Bloomberg Barclays Aggregate Bond Index: comprised of U.S. government, mortgage-backed, asset-backed, and corporate fixed income securities with maturities of one year or more.

Bloomberg Barclays U.S. Municipal Index: a market-value weighted index that covers the U.S. dollar-denominated, long-term tax-exempt bond market and has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg Barclays U.S. Municipal High-Yield Index: covers the U.S.-dollar denominated, non-investment grade, fixed-rate, municipal bond market and includes securities with ratings by Moody's, Fitch and S&P of Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Treasury Index: includes all publicly issued, U.S. Treasury securities that are rated investment grade, and have \$250 million or more of outstanding face value.

Bloomberg Barclays U.S. Corporate Index: measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.

Bloomberg Barclays U.S. MBS Index: The index measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA, and FHLMC.

Bloomberg Barclays U.S. Corporate High-Yield Index: covers the U.S.-dollar denominated, non-investment grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch and S&P of Ba1/BB+/BB+ or below.

Indices are unmanaged and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

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There are inherent risks with fixed income investing. These risks may include interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond. *When interest rates rise, bond prices fall.* This risk is heightened with investments in longer duration fixed-income securities and during periods when prevailing interest rates are low or negative.

Investments in below-investment-grade debt securities which are usually called "high-yield" or "junk bonds," are typically in weaker financial health and such securities can be harder to value and sell and their prices can be more volatile than more highly rated securities. While these securities generally have higher rates of interest, they also involve greater risk of default than do securities of a higher-quality rating.

Floating rate loan securities generally trade in the secondary market and may have irregular trading activity, wide bid/ask spreads and extended trade settlement periods. The value of collateral, if any, securing a floating rate loan can decline, may be insufficient to meet the issuer's obligations in the event of non-payment of scheduled interest or principal or may be difficult to readily liquidate.

Returns include the reinvestment of interest and dividends.

All investing is subject to risk, including the possible loss of the money you invest.

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Diversification does not ensure a profit or protect against a loss in a declining market.

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