Investment Update

Fourth Quarter 2016

With the mid-year surprise result of the Brexit vote in mind, we were cognizant that anything was possible in the Presidential election. However, on the morning of November 8th we had no reason to doubt pollsters' predictions of a landslide victory for Hillary Clinton. Nor did we have reason to disagree with the consensus that if Donald Trump were to win, stock markets could fall 5-10% in response to the numerous unknowns surrounding his unconventional candidacy. Control of the Senate was expected to go to the party that won the Presidency, but with so little probability assigned to a Trump victory, there had been proportionately little discussion of what a Republican sweep would mean.

Despite news that the market had indeed briefly fallen 5% overnight, on the morning of November 9th investors' collective attention quickly turned to the Republicans' potential ability to enact business-friendly tax cuts and reductions in regulations and the stock market has moved steadily upwards ever since. With the benefit of hindsight, it is remarkable just how disconnected most of the media was with the electorate, and how unrepresentative of the electorate poll participants appear to have been.

Equity Markets (Total Returns)	4Q16	1-Yr
Dow Jones Industrials	8.66%	16.50%
S&P 500	3.82%	11.96%
S&P Mid-Cap	7.42%	20.74%
S&P Small-Cap	11.13%	26.56%
MSCI All-Country World	4.90%	9.65%
MSCI Foreign Developed Markets	7.11%	5.88%
MSCI Foreign Emerging Markets	-1.36%	10.11%
US Bond Markets (Total Return)	**4Q16**	**1-Yr**
Barclays US Govt/Credit Intermediate	-2.07%	2.08%
Barclays US Govt/Credit Long	-7.84%	6.67%
BAML Municipal Intermediate	-2.45%	0.05%

There is still uncertainty about how President-elect Trump will handle geopolitics and other matters, and market sentiment may be perhaps too optimistic that all of the significant proposed policy changes will be made quickly and easily. However, if nothing else, simply reducing the corporate tax rate would increase profitable companies' earnings. And any policies that aim to make the US a friendlier place to do business could help to reverse (or at least arrest) the trend of the US slipping in the World Bank's rankings of ease of doing business (the US was ranked 3rd in 2008, 4th in 2014, and dropped to 8th in 2016). These considerations along with the fact that the economy already was showing signs of perking up prior to the election has us largely comfortable with the rally and where the markets stand near all-time highs as we enter 2017.

It is worth noting that the rise in the broad stock market since the election has masked quite disparate performance amongst the various sectors and industries as well as larger and smaller companies. A reduction in the correlation of returns between sectors (the extent to which they move in or out of lockstep) is positive and hopefully indicates that investors are moving on from many years where more or less all stocks rose or fell based on expectations for Federal Reserve action. Presumed winners and losers from either the direct or indirect result of anticipated new policies have seen their shares swing decisively and often far further than the 5% change in the S&P 500. While these initial moves were understandable given what is known about possible changes, we think that correctly identifying which companies' shares will fare better or worse from a particular policy outcome will be as unpredictable as the election itself. The President-elect's unconventional willingness to confront companies, even in industries that otherwise would be expected to benefit from his policies, shows that such traditional theses are far from certain. As always, we would give much greater weight to individual company valuations, and longer-term fundamentals and prospects, than the effects of one administration's philosophy.

Even with enthusiasm running high about the more business-friendly environment for US companies, we should mention several items to be cautious about. First is that Trump's stimulus spending plans, which have generated particular optimism for shares in industrial companies, will likely run into significant resistance from fiscal conservatives in his own party.

Second, should he succeed in getting such plans passed, they will likely be funded initially by borrowing, the prospect of which has already pushed interest rates up sharply since the election. An increase in residential real estate borrowing costs could dampen the real estate recovery. Higher rates should also further increase the value of the dollar relative to other currencies, which would once again serve as a headwind to the earnings of exporters after having abated somewhat in the first half of 2016.

Third, while they were popular on the campaign trail, the realization of some of the most dangerous of Trump's trade ideas could be distinctly negative for the economy. Finally, as alluded to before, even the most positive of proposed changes simply could take longer to enact than currently seems to be assumed, or could come out of the legislative process diluted despite having varying degrees of bipartisan support.

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