Market Commentary

4th Quarter 2016

The Stock Market

The surprise election of Donald Trump and the Republican Congressional sweep provided a positive jolt to the stock market, propelling the S&P 500 to its fourth consecutive quarterly gain. Investor resignation to Hillary Clinton's highly anticipated election and four more years of Obama's misguided policies turned to optimism that Trump/Republican pro-growth policies can indeed "Make America Great Again." Any doubt that Trump would back away from his campaign promises was quickly dispelled by his cabinet nominations who are decidedly pro-growth, smaller government advocates. The Index returned 3.8% in the quarter and nearly 12% for the year (charts 1 & 2).

In the fourth quarter, the economically sensitive financial, energy and industrial stocks led the market, reflecting this post-election confidence. The best performing sectors for the entire year were energy, financial and telecommunication. Also, small- and mid-cap stocks outperformed. Small companies stand to benefit more if the onerous burdens of regulation are reduced. They also could be less impacted by changes to trade policy and dollar strength. Notable laggards were healthcare and consumer staples, two sectors that outperformed in recent years. At year-end, the S&P 500 was up 230% over 95 months since the March, 2009 low, making this the second biggest and the second longest bull market on record. By magnitude and duration, the 1990-2000 market was number one, up 417% over 115 months.

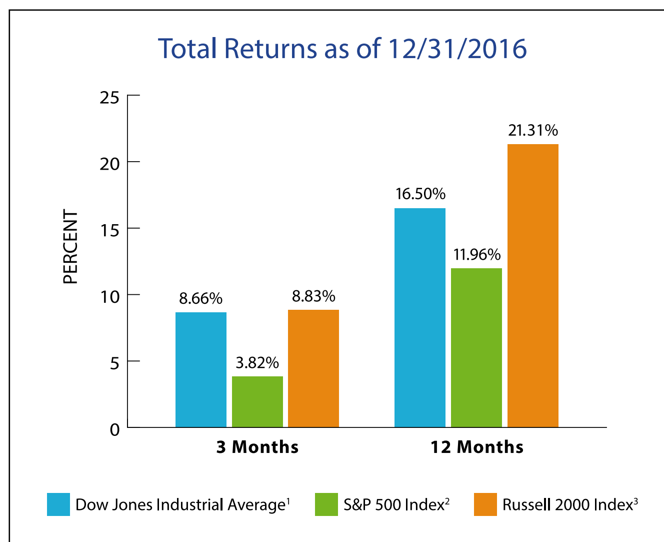

Chart 1

source: morningstar direct

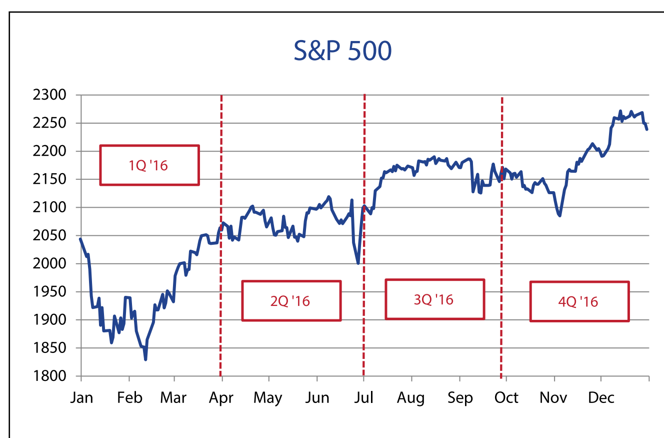

Chart 2

source: strategas research partners
"quarterly review in charts" – january 3, 2017

Past performance does not guarantee future results. You cannot invest directly in an index.

[1] The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

[2] The S&P 500® Index is a capitalization weighted unmanaged index of 500 widely traded stocks, created by Standard & Poor's. The index is considered to represent the performance of the stock market in general.

[3] The Russell 2000® Index is an unmanaged index of the smallest 2,000 stocks in the Russell 3000® Index.

The Stock Market (CONTINUED)

The common characteristics of both bull markets are: no recession, growing corporate profits, moderate inflation, lower oil prices and declining interest rates. One distinction is that at its 2000 peak, the market P/E multiple exceeded 35 times. The forward P/E multiple today is about 17 times, which is slightly higher than average, but normal for a low inflation environment. Another difference is that back then, investor sentiment was wildly bullish, and stock ownership was at an all-time high. During this bull market, there have been net outflows from domestic equity mutual funds and ETFs in five of the last eight years. A recent CNBC poll showed Wall Street strategists, on average, are the least bullish they've been in twelve years. No irrational exuberance here!

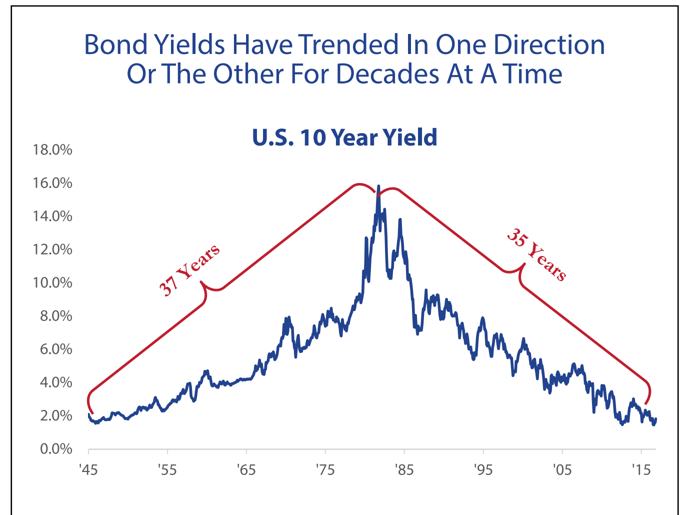

Chart 3

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS" — JANUARY 3, 2017

The Bond Market

As mentioned in our third quarter letter, we believe bond yields marked an important low this past summer. If that proves to be the ultimate bottom for rates, it would mark the end of a spectacular 35 year bull market in bonds. (CHART 3 – AS RATES FALL, BOND PRICES RISE.) Judging from the consistent flow of money into bond funds and bond ETFs, and out of equity and money market funds since the financial crisis began, bond investors have likely become complacent. They seem to view bond investments as low risk, higher return cash proxies. The rise in the 10 year U.S. Treasury bond yield from 1.35% to 2.45% and corresponding price decline since July could be the first step in a long, potentially painful journey for holders of long-term bonds.

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The Bond Market (CONTINUED)

The Federal Reserve, as expected, bumped short-term rates another 25 basis points in December and expressed their intent to raise rates multiple times at a measured pace this year and possibly next. During the last Fed tightening cycle beginning in 2004, they raised rates a total of 425 basis points in nine steps over two years. Of course, any tightening program will be "data dependent" on economic growth, inflation and the U.S. Dollar's impact on financial conditions in foreign economies and markets. This likely ends an era of Fed monetary easing, which had reached the limits of its effectiveness. Some would question whether their near zero interest rate and quantitative easing policies were beneficial at all. Pro-growth fiscal policies should bear more fruit. We believe these will result in more robust GDP growth and upward pressure on intermediate and long-term interest rates. We continue to keep maturities relatively short.

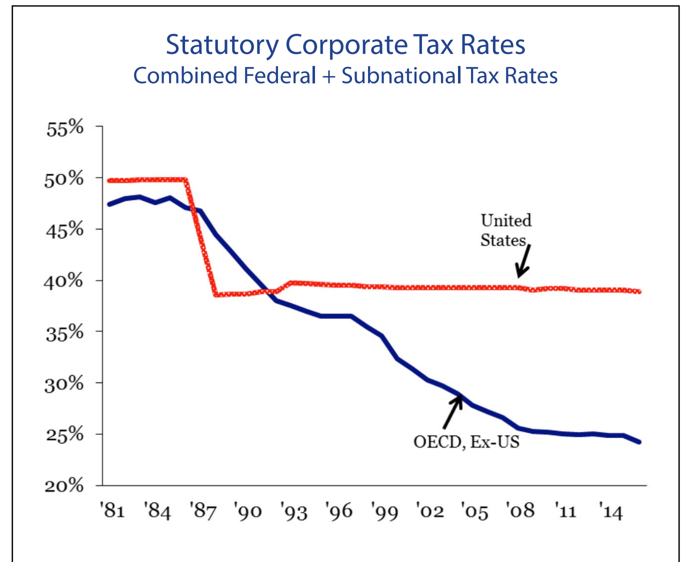

Chart 4

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS" — JANUARY 3, 2017

The Economy

The economic expansion continues to mature, and in our opinion shows no sign of peaking. In 2017, we expect GDP growth of nearly 3% aided by the rebound in oil prices, housing and improved capital spending. Unemployment is very low at 4.7% and wages are starting to rise. Business optimism should improve, encouraged by a better tax and regulatory climate. As a case in point, there are 24 energy projects totaling $48 billion that have been stalled or rejected due to climate change rules. Many of these rules resulted from Obama's executive orders and regulatory overreach. They could be reversed by the new administration relatively quickly. Also, Moody's estimates that the 1000 largest U.S. based

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The Economy (CONTINUED)
nonfinancial companies hold $1.7 trillion in cash. The majority is kept overseas to avoid onerous U.S. taxation (CHART 4). Tax reform/reduction could encourage companies to repatriate this cash for investment in the U.S.

Tax reform could be transformational to corporate behavior. Repeal of Obamacare could also result in significant tax reduction, especially if the 3.8% tax on investment income is terminated.

One of the possible limiting factors on the Trump administration's agenda is the U.S. debt burden and the growing deficit. (CHART 5) Trump begins his presidency with a debt-to-GDP ratio of 77% vs. Obama's 52% and Reagan's 25%. Currently 50% of U.S. government debt matures within three years, so if rates rise, interest expense will soon become a drag on the budget. We expect the Treasury will begin financing with longer maturities to lock in today's historically low rates.

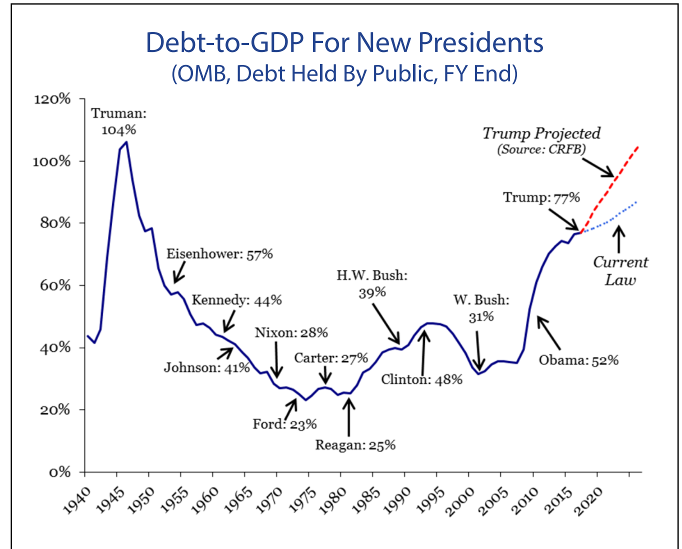

Chart 5

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS" – JANUARY 3, 2017

Politics
Elections matter, and seldom has one mattered more than this last one, especially when a Clinton victory would have resulted in policy veering even further left from the already radical course that President Obama took the country. The election of Donald Trump represents a pivot toward pro-growth policies. Possible policy changes with the biggest potential impact on the economy and markets include: tax reform/reduction, repeal and replace Obamacare, regulatory relief, energy policy, infrastructure and defense spending, immigration policy and trade policy. Of all these, tax

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Politics (CONTINUED)

reform could be the most contentious and have the biggest impact on profits, investor behavior and stock prices. Longer term, trade policy could have a negative impact if Trump begins abrogating free trade agreements and imposing tariffs. There may be some wisdom, however, in his criticism of the Trans Pacific Trade Pact which awaits congressional approval. Any pact requiring 5000 pages and two million words hardly seems the stuff of free trade! Another long-term positive is that Trump, and not Clinton, will be nominating judges to fill Supreme Court vacancies over the next four to eight years.

In summary, we view Trump's upset victory as potentially the most important pivot in U.S. economic, social and foreign policy since Ronald Reagan. The potent mix of tax reform, regulatory rollbacks related to climate change, healthcare, and the financial and energy sectors should eventually get America back on the right path. Much of this agenda will take time to implement and there is always a risk that the market will grow impatient with the inevitable fits and starts along the way, but we feel there is reason to be optimistic.

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