Clarity Must Wait

In the immediate aftermath of the presidential election, equity markets dramatically rose. The S&P 500 index gained approximately 7%, and the MSCI All Country World index gained approximately 6% through the first two weeks of January 2017. The ebullient investor response seemed to be attributable to investor hopes for higher growth in both GDP and corporate earnings in anticipation of favorable policy changes by the new administration. These changes include tax reform and rate reduction for both corporations and individuals, infrastructure spending (thought to promote higher wages, corporate earnings and workforce participation), and a more relaxed regulatory environment, benefiting banks and other corporations. Coming into year-end investors had seemingly ignored (1) the potential for protectionist trade policies which could restrain both earnings and economic activity and (2) aggressive enforcement of immigration laws that could also disrupt employment and the economy.

Ultimately, the performance of the capital markets should reflect current and anticipated economic conditions and corporate earnings health. Assessing the economic landscape, however, is complicated by seemingly infinite economic and policy variables that may materialize. Nevertheless, we, as investors, attempt to assess the risk/reward balance and arrive at a suitable portfolio construction that will participate in market returns corresponding to the risk taken. Herein, we reflect on the prior year and consider the possibilities for the coming year.

Review of 2016

2016 was a year marked by bond and stock market volatility. Interest rates along the short and intermediate portion of the yield curve (1 to 10 years) declined rapidly early in the year as equity markets sold off on economic concerns. Bond prices correspondingly increased as a result of this "fear trade". Post-election, concerns over rising interest rates in anticipation of the same policies that encouraged equity investors' confidence prompted bond investors to sell, thus driving bond prices down and causing interest rates to rise as a result of market action. Five weeks after the election interest rates had risen again to levels exceeding those in the beginning of the year only to again decline slightly in the New Year. As of January 12, 2017 the 5 and 10 year treasury bond were only 14 and 12 basis points, respectively, above their January 1, 2016 levels. The 30 year treasury bond experienced similar volatility early in 2016, recovering coming into the election, and presently is approximately at its January 1, 2016 level. Rates at the short end of the curve rose materially (30 basis points) since the beginning of 2016 while the rates on the 30 year bond had not increased since the beginning of 2016 ("a flatter yield curve"). Throughout 2016 and in the weeks following, movements along the yield curve seemed reactive and tentative.

We question whether movements in the latter half of the year in both the equity and fixed income markets were attributable to the stabilization and continued progress in the rate of economic growth and a corresponding favorable outlook for corporate earnings (which should be the principal driver of share price). The forward looking consensus outlook for 2017 by equity analysts at the time reflected (and continues to reflect) earnings per share growth of approximately 12%. However, asset strategists and forecasters anticipate a rise in the S&P 500 in the range of 5 to 8% for the year. This implies contraction in price earnings ratios during the period.

During the first two months of 2016 the equity markets experienced great volatility fueled by weaker than expected economic data domestically and abroad, the crashing of oil prices, a crisis of confidence in European banks, negative interest rates engineered by central banks in Europe and Japan, lingering concerns over severe turbulence in China's equity markets, a run up in gold prices, a flat corporate earnings outlook for 2016, and a tentative Federal Reserve view of the economy and its own interest rate policies. Risks had increased and unsettled capital markets. While reducing risk by adopting a more defensive equity allocation in most client portfolios seemed to us appropriate, with hindsight the subsequent rebound in the equity markets did not bear out our concerns. Within the equity allocation for most clients, the portfolio emphasized domestic equities, and limited exposure to Europe and currency to the benefit of most client portfolios. The emphasis in most client equity portfolios of investing through passive indexes was beneficial by comparison to active managers. While we continue to have confidence in the active managers represented in client portfolios, we note their underperformance during the past year. Unfortunately, with respect to fixed income, volatility during the fourth quarter of the year in the municipal bond market in particular was magnified by comparison to movement in the treasury yield curve, eliminating year to date bond returns.

For the quarter, the Dow Jones Industrial Average returned 8.66% (16.5% ytd); the S&P 500 and Russell 1000 Indices advanced 3.82% (11.95% ytd) and 3.83% (12.05% ytd), respectively. The Wilshire 5000 gained 4.54% (13.37% ytd), the Russell 2000 Small Cap Index 8.82% (21.28% ytd), and the S&P 400 Mid Cap Index 7.41% (20.73% ytd). The MSCI EAFE Index declined -.71% (+1.0% ytd), the MSCI All Country World Index gained 1.19% (7.86% ytd), and the MSCI European Equity Index declined -.4% (-.4% ytd). The MSCI EM Index lost -4.16% (+11.19% ytd).

Current Economic Environment

Pervasive policy uncertainties punctuate the current economic environment. Populist nationalistic and protectionist sentiment domestically and abroad present further complications that could lead to disruptions in trade and international economic relationships. The Federal Reserve has indicated sufficient confidence in the stability of the economy to signal raising interest rates several times during the coming year though as stated, this remains data dependent. Even though the rate of growth in GDP from quarter to quarter in 2016 was uneven, the trend for consumer spending, employment, modest wage gains, some uptick in business investment, and growth in corporate earnings are all being interpreted as positive signs by the Fed.

Contributing significantly to corporate earnings was the rise in oil prices commencing in the second quarter of the year and financial sector earnings gains during the latter part of the year. Much of the rise in oil prices was attributable to the anticipation and ultimate conclusion of an OPEC production cut agreement that included Russia. It remains to be seen, however, whether the signatories will all comply, and whether re-entry of domestic producers now that oil prices are higher will cause some price softening as suppliers come online. Ultimately, price increase will depend on demand as economic activity increases.

Notwithstanding the rise in oil prices, core inflation has not thus far been viewed as problematic by the Fed, analysts or investors. A strong dollar mitigating the cost of imports is contributing to the containment of inflation.

Presently both the Federal Reserve and analyst consensus estimate the rate of GDP growth to be 2-2.5% per annum. Recent data from both manufacturing and service sectors continue to show growth and improvement supporting consensus outlook. There continues, however, to be imbalances in the economy with respect to employer needs for labor and an available labor supply with matching skills. Further, although the domestic economy is at full employment, there are many who remain "under employed" or out of the labor force. Participation in the recovery has been uneven as labor has thus far received only modest gains in pay (so far not stimulating inflation) while capital has reaped the benefits of increases in asset values.

Outlook

Domestic

Both equity and bond investors often look to the steepness of the yield curve to determine the outlook for economic growth and inflation. Historically, a steep curve in which investors demand a higher rate of interest for investing at longer maturities is indicative of an outlook envisioning stronger economic activity and potential for inflation which must be compensated for by higher interest rates. A flatter yield curve may be indicative of a less optimistic view of the economy, corporate earnings and/or policy risks that may exist, while the tightening of corporate credit spreads as compared to treasuries (as was the case last year) may, to the contrary, signal investor anticipation of improved economic conditions and corporate credit quality.

Great uncertainty remains with respect to the consequences of the Federal Reserve accelerating its program of interest rate increases. Equally uncertain are the timing, efficacy and lasting effects of fiscal policy in the form of direct spending or tax reduction. Protectionist policies may reduce or offset any benefits to be realized if trade is curtailed or imports become more expensive due to tariffs or taxes.

The time horizon for policy implementation is also questionable. Reduction in tax rates can be accomplished relatively quickly (although it must still go through the legislative process), but all else would take more time. Infrastructure spending would not likely be implemented for 9 to 12 months, and it is not clear that we will see economic or earnings impact in 2017, more likely 2018 and tailing off thereafter. Policy initiatives have historically had the effect of pulling growth forward and result in higher government debt, rising interest rates, and a larger debt carry which weighs on future periods. Going forward, demographics (the aging of America), deficits and debt levels will present challenges for the economy and the markets.

In addition to these uncertainties come the risks associated with current asset prices. The S&P 500 closed the year reflecting a 19x price earnings ratio based upon 2016 estimated annual earnings after gaining 12% in a year where analysts projected earnings to be flat with the prior year. Looking forward, analysts estimate 12% earnings growth for 2017 equating to a forward looking multiple of 17x for the S&P 500. Multiples for mid-cap companies are higher although analyst expectations for 2017 earnings growth for mid-cap stocks are comparable to the large caps. The broader measure of smaller cap stocks similarly reflects richer relative valuations.

While multiple variables are supportive of growth in corporate earnings and GDP – it is near impossible to determine what the driving variable will be going forward or the timing thereof.

Policy initiatives may also present short term benefits but result in unintended consequences. For example, the stronger dollar (significantly rising in 2016, reflecting the stabilizing and gradually strengthening US economy and divergent foreign central bank policies) may benefit consumers by restraining the price of imports but may depress corporate profits as a result of currency losses and reduced export activity. A stronger dollar is also problematic for emerging market borrowers who have borrowed in dollar denominated debt.

A more relaxed regulatory environment may promote greater economic activity and spur animal spirits, but may also lead to higher risks. In equity markets that are fully priced, policy missteps often lead to greater volatility.

Although analysts are projecting that a reduction in the corporate tax rate could increase corporate earnings by 10%, the overall tax plan by the new administration is a moving and opaque target. The earnings implications of a reduction in corporate tax rates have also not yet been factored into analyst earnings outlook. Tax policy encouraging repatriation of foreign earnings by multinationals could give rise to further share buybacks boosting equity markets but border taxes and tariffs could disrupt trade and dampen corporate earnings.

Possible changes in the tax regime for investments presents risks and rewards depending on outcome, phase in and grandfather rules. The cost of capital for corporate and government issuers could be affected – for better or worse – depending on legislative outcomes, and the value of investments may be significantly affected. We will closely monitor developments.

Finally, capital markets, sectors, and individual companies have reacted to continuing tweets from the President-elect. Investors and analysts are attempting to navigate markets (trying to determine what policies will follow) as they are periodically affected by a storm of tweets. We continue to be cautious. As exchanges between the President-elect and Congress over taxes and policy have been increasingly reported in the press and on other media, and as China and the incoming U.S. administration have elevated the rhetoric of the trade policy, interest rates have declined and the US dollar has given up some gains – evidence of uncertainties and discomfort with the policies and/or methods that may be pursued by the new administration.

Abroad

Recent economic data for Europe indicates modest economic improvement and a modest increase in inflation (in part attributable to rising energy prices). Corporate earnings in Europe are, however, significantly below their 2007 peak. Although European share prices rose last year, it still remains that share prices have not been earnings validated. Populist sentiment in both Italy and France continues to pose challenges and threats for the EU. We will also learn more about the stability of the EU and the Eurozone currency union once details for Brexit have been negotiated and Brexit implementation proceeds. Finally, European banks continue to be under pressure, recently highlighted by a bank failure in Italy, though notably such failure did not have significant broader repercussions due to a capital base much improved since the financial crisis.

China continues to be a highly leveraged economy susceptible to liquidity risks and pressure from capital flows. Recently China has interceded in currency markets to support the yuan, and is continuing a delicate balancing act of stimulus, capital protection, and currency stability while in the background looms the uncertainties of the United States' trade policies under the new

administration. China will continue to stimulate and provide liquidity to its highly leveraged economy. Still reliant on exports, a trade disruption could adversely affect Asia's largest economy.

Portfolio Construction

In light of the uncertainties outlined above, maintaining a portfolio diversified by asset class and sectors is necessary to arrive at the appropriate balance of risk and reward. A cautious approach to risk at this time is warranted, as is meaningful participation in equities. Historically, investing in high quality fixed income securities of moderate duration offset some of the risks of equity investing while still providing a contribution to the portfolio through current yield. For the many years of declining interest rates this was an effective strategy that also yielded periodic appreciation in the bond portfolio as a result of declining interest rates. Going forward, current return may be offset by declines in bond prices (as was the case for municipal bonds in 2016) as interest rates rise. We continue to focus on duration and volatility in the bond portfolios of our clients, although any exposure to interest rates is subject to this risk.

Recently, we invested in a prime money market fund that maintains a dollar value and seeks to generate a higher yield than core money market funds by investing in short-term certificates of deposit, commercial paper, repurchase agreements, and other high-quality short-term fixed income securities. Because this fund is not exclusively invested in government securities, in the event of loss, value could settle below one dollar per share, and if fund liquidity dropped below certain thresholds, withdrawals could be limited for a short while (not more than 10 days in any 90 day period). We view these consequences as unlikely given the high quality of the securities invested in and the highly liquid and short-term nature of these securities. This is a prudent step in providing for a short-term alternative to the conventional bond portfolio. Short-term interest rates have recently risen substantially, and as they continue to do so the fund will capture the increased yield. We will continue to monitor the outlook on interest rates and may further allocate funds to this alternative.

When there is greater clarity with respect to economic policy and international relations, we will use our best judgment to adapt to changes in the investing environment.

January 17, 2017

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

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