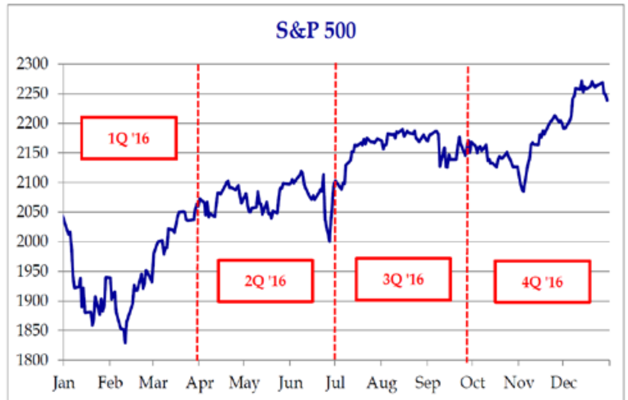
ECONOMIC & MARKET REVIEW

Fourth Quarter 2016

The U.S. equity market had quite a kick into the finish line. The S&P 500 was up 12% for 2016, with 5% of that gain coming after the November election. 2016 was the 8th year in a row of positive total returns for the S&P 500. Even more impressive were small cap stocks, which were up over 21% for 2016. The most eye catching element of the investment markets in 2016 was interest rates. Short-term rates, the area most under the control of the Federal Reserve, moved up slightly. The one and only rate hike of the year by the Fed occurred in December 2016. However, long-term rates were a different story. The 10-year Treasury note started 2016 with a yield of 2.27%, dropped to a low of 1.36% in early July and then rose to 2.45% at year-end. If you had bought the 10 year at the low, it would take you seven years to break even. That is the obvious risk to investors of buying longer bonds at extremely low interest rates, only to see rates surge higher. The summer of 2016 appeared to be the end of the multidecade-long bull market in rates.

Fourth Quarter and Calendar Year 2016 Performance

	4th Quarter	2016
S&P 500	*3.82%*	*11.96%*
Russell 2000	*8.83%*	*21.31%*
Barclays Agg.	*-2.98%*	*2.65%*
MSCI EAFE	*-0.71%*	*1.00%*
MSCI EM	*-4.16%*	*11.19%*



Source: Strategas Research Partners

The Federal Reserve's December rate hike was in response to consistently solid economic reports. The Fed comments released along with the rate hike announcement spelled out their thinking:

"In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1/2 to 3/4 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a return to 2 percent inflation. In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2% inflation. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data." *****

I look for rates to continue to move higher through 2017, but not at the same pace or magnitude that we saw in 2016. The next stop for the 10-year Treasury note is 3.00%, but not before the market digests the rapid move up during the last half of 2016. I also expect the yield curve to steepen, with long-term interest rates up more than short-term interest rates through year-end 2017. One final comment regarding our central bank: Over the past several years, I have been a critic of the Fed as their persistence in keeping rates at unnaturally low levels coupled with money printing/securities buying (quantitative easing), seemed to me to have lingered far too long. These policies represented a significant level of unintended risk. The great news is that the central bank is, at least since November 2016, no longer the only game in town….a much healthier situation.

The economy appears to be okay and aided by a jump in both business and consumer confidence in the last two months of 2016. The return of "animal spirits" has been a missing ingredient for the last several years, especially since the recession of 2008/09. I don't under estimate the impact on growth and markets when both individuals and business owners have a much brighter outlook. A large part of the improved outlook is the expectation that President-elect Trump will deliver on his promise to initiate tax reform, cut regulation, support the fossil fuel industry and focus on the $1-$2 trillion on corporate balance sheets that is located offshore.

Something that seems to be only a remote concern today is our budget deficit. Already high, the potential exists for the budget deficit to become very problematic. An infrastructure spending plan will have to be financed with additional borrowed money. That isn't set in stone because there could be a way to include tax reform, not just tax cuts, coupled with a much smaller tax on repatriated profits and improved tax receipts from faster growth could potentially help finance the infrastructure projects. But, that includes many moving parts and there is no guarantee that all of that will work perfectly.

Finally, I see no reason not to be encouraged, but do not want to be ignorant of the risks. Today, the risks are a potential misstep in trade negotiations, the impact of a stronger dollar, and the political inability to deliver on the economic reforms offered by the President-elect. The stock market has jumped on expectation of better economic growth, but equity valuations are still not overly stretched. There is never a time when all risks disappear, so I'm optimistic about better economic growth in 2017 but more sanguine about the prospects of further significant gains in equities.

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***Federal Reserve press release 12/14/2016**

Disclosures

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