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FOMO

FOMO (**F**ear **o**f **M**issing **O**ut) and TINA (**T**here **i**s **n**o **A**lternative) walk into a bar.

The bartender and some of the regulars recognize them, quickly assess the implications, text their brokers, and start buying US stocks hand over fist; especially the more domestically affected small-cap sector.

Others at the bar catch on and begin to sell interest rates. Any bond which *does not* contain alot of credit risk gets taken down; all the high quality, lowest yielding, stuff. Long-maturity Treasury bonds are hit hardest.

Finally, everybody begins buying the US dollar in exchange for foreign currencies, raising its relative valuation versus the currencies of its major trading partners to the highest level in 14 years (which also means the basket of foreign currencies now trades to its lowest level in 14 years).

That was the 4th quarter in a nutshell. Fundamentals didn't matter very much. Domestic equities and the Dollar continued to climb a wall of hope, extending what you may recall was an emphatically risk-on market environment during the 3rd quarter. Keynes would call it a period of high animal spirits. Greenspan might refer to it as irrational exuberance. These are powerful trends.

Reversing a specific six-quarter trend, S&P 500 operating earnings for the quarter finally exceeded the prior year's, at $28.69/share. The forecast in October had been for over $29. Actual results were lower than final estimates.

What about the fundamental truth that we've now entered a period of higher secular economic growth? Seems like a fair point. However, the historical correlation between real GDP growth and share price appreciation is low. And the 4th quarter rally was pretty much all about value stocks, not growth stocks. This was across the size spectrum. In large-cap land, pure value outperformed pure growth by 9%. The differential was largely due to sharp gains by financial services stocks, which dominate the value indices.

A rally built on bank stocks. We've seen that movie before.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	4Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	3.8	12.0	8.9	14.7	7.0
U.S. Top-cap Stocks	4.1	11.3	8.9	14.7	6.8
U.S. Mid-cap Stocks	3.2	13.8	7.9	14.7	7.9
U.S. Small-cap Stocks	8.8	21.3	6.7	14.5	7.1
Non-US Stocks (**EAFE**)	(0.7)	1.5	(1.2)	7.0	1.2
Non-US Stocks (**Emerg**)	(4.1)	11.6	(2.2)	1.6	2.2
3 mo. T-Bills	0.1	0.3	0.1	0.1	0.7
U.S. Aggregate Bonds	(3.0)	2.7	3.0	2.2	4.3
High Yield Bonds	1.9	17.5	4.7	7.4	7.3
Global Aggregate Bonds	(7.1)	2.1	(0.2)	0.2	3.3
Consumer Prices	*0.0*	*2.1*	*1.2*	*1.4*	*1.8*
Bloomberg Commodity	2.7	11.8	(11.3)	(9.0)	(5.6)
MSCI Wrld/Eq REIT's	(6.2)	3.7	9.0	9.4	1.3
Global 65/35	*0.3*	*9.9*	*4.5*	*8.2*	*5.5*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	4Q 16	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	3.9	10.7	7.1	13.4	6.4
U.S. Mid-cap	5.7	15.3	6.6	13.8	7.2
U.S. Small-cap	10.0	21.8	6.5	14.3	7.2
International Lg. Cap	(2.2)	1.4	(1.8)	(6.3)	(1.1)
International Sm. Cap	(4.8)	(0.5)	0.6	10.1	3.6
Emerg. Mkt. Equity	(5.2)	9.1	(2.6)	2.1	1.7
Balanced/Hybrid	0.7	7.3	3.8	7.6	5.1
General Bond	(2.5)	3.4	2.9	2.8	4.7
High Yield Bond	1.6	13.1	3.5	6.3	6.2
Equity Hedge Index	1.3	5.5	2.1	5.5	2.9

*Annualized trailing returns for periods ending 121/30/16

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Economies, Economics, Prices, and Policy

	12/2016	12/2015
CPI - headline, y-o-y	2.1%	0.7%
CPI - core, y-o-y	2.2%	2.1%
Real GDP Growth, 1-year *	1.7%	2.2%
Employment (000's)	152,111	150,030
Employment / Population %	59.7%	59.6%

** 3Q vs. 3Q, y-o-y*

The American economy continues to expand at a sluggish rate. Despite a strong 3rd quarter, real GDP growth has been only 1.7% during the past year, compared to 2.2% one year ago. During the last seven recovery years, real GDP growth has averaged just 2.2% per annum.

The final estimate of **3rd quarter GDP growth** was a robust 3.5%; figure 3 has the details. Personal spending's contribution to growth dropped in the quarter. This was more than offset by a combination of renewed inventory accumulation (not a very good thing), an improved net export/import ratio (especially exports), and increased government spending (not an especially good thing).

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period				
Factor	3Q '16	2Q '16	1Q '16	4Q '15
Real GDP Growth	3.5	1.4	0.8	0.9
Nominal GDP Growth	5.0	3.7	1.3	1.8
Final Sales	2.4	3.2	1.1	1.8
Personal Spending	3.0	4.3	1.6	2.3
Private Investment	3.0	(7.9)	(3.3)	(2.3)
- Fixed, Businesses	1.4	1.0	*(3.4)*	*(3.3)*
- Fixed, Residential	*(4.1)*	*(7.7)*	*7.8*	*11.5*
*- Chg. In Inventories **($bn)***	*$7*	*($10)*	*$41*	*$57*
Export growth	10.0	1.8	(0.7)	(2.7)
Import growth	2.2	0.2	(0.6)	0.7
Government Spending	0.8	(1.7)	1.6	1.0

Most economists forecast the GDP growth rate declined in the 4th quarter compared to the 3rd. The Blue Chip consensus is for just a 2.2% annualized growth rate. The Atlanta Fed (usually more accurate than the consensus) is at 2.8%, after some soft December retail numbers. Its forecast had been as high as 3.6% in mid-November, but data since then has been weakish.

Payroll job growth weakened as we moved through the 4th quarter, ultimately increasing 495k jobs. This compared to 575k jobs in Q3. The household survey indicated a very weak gain of only 185k jobs in Q4.

Non-farm payrolls increased by an average of 180k per month in 2016 (+2,157,000 for the year).

Employment factoid: Payrolls dropped over 8.6 million during 2008-9, and have climbed 15.5 million since.

The strong jobs market has inevitably led to rising wages, but increases remain constrained. Average hourly earnings of all private nonfarm employees increased 2.9% from Dec. 2015 to Dec. 2016. Average workweek hours fell, resulting in weekly earnings gains of 2.3%. Real weekly earnings for all employees rose just 0.2% in 2016.

After employment growth, stable prices (low inflation rates) are the Fed's second mandated responsibility -

- ⇨ *Before* seasonal adjustments, **"Headline" CPI** did not change (+0.0%) in the fourth quarter (+0.2% in Q3). *After* seasonal adjustments, it was reported up 0.9%. The index increased 2.1% for 2016, which was a big change from 2015 when it rose only 0.7%.
- ⇨ **Core CPI** (ex-food & energy) rose 0.2% during the fourth quarter (+0.4% in Q3), and increased 2.2% in 2016. It rose 2.1% in 2015.
- ⇨ The **Producer Price Index** for goods and services rose a robust 0.7% during the latest quarter. Overall producer prices rose 1.6% in 2016, after falling -1.1% in 2015. The PPI ex-food & energy was up 1.5% over the past year.
- ⇨ **Import** prices rose 1.8% during the twelve months through December, after falling -8.3% the prior year. **Export** prices rose 1.1% in 2016 (-6.6% in 2015).

Most of the economic discussion in the 4th quarter revolved around the shift in political power in Washington, with both the Congress and the White House now led by a single political party. This has happened surprisingly rarely in America during the past 40-50 years, with the prospect (**not** the promise) for some dramatic changes in tax policy, regulation, global trade agreements, military spending and the relative willingness to go heavily into debt to finance those major initiatives.

As with the Reagan presidency, pundits are anticipating a significant initial reliance on deficit fiscal policy (i.e., increased borrowing), until new initiatives kick in, or "trickle down" to boost what has been a quite low secular economic growth rate. It is obviously *very* early days, and the issues are large and complex. We advise not betting too heavily on "red or black" binary outcomes when it comes to these issues, at least at this time.

On the monetary policy front, global central banks remained firmly planted center stage during the quarter. The Fed edged slightly closer to the sidelines, raising their target Fed Funds rate by 0.25%, to 50-75 bps, and forecast two or three more 25bps increases would happen in 2017. However, it has taken no overt steps to begin reducing a multi-trillion balance sheet. While not as accommodative as the ECB and Bank of Japan, Fed policy remains highly expansionary. The interest rate normalization protocol, at least from the Fed's perspective, appears to remain "lower for longer."

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Bond Investors Sell Rates and Buy Credit

A significant trend reversal of market yields took place during the 4th quarter. Sovereign bond yields rose across most of the world as prices declined. We see this in Figure 6. At the high end, ten-year sovereign bond rates backed up 80bps in the US and 85bps in Australia and Poland. German bund yields rose 40bps to a still exceptionally low 0.27%. British gilts rose 50bps to 1.27%. At the other end of the spectrum, yields on Brazilian, Indian and Greek bonds all fell as investors increasingly sought out high coupon securities.

For the full year, sovereign interest rates were a mixed bag in developed countries. Yields in the US rose because of the 4th quarter, but bellwether countries Germany, Japan, and Great Britain saw yields fall in 2016. Select developing markets including Greece, Russia, and Brazil enjoyed a sharp drop in their sovereign bond yields.

We're increasingly interested in the widening spread between the yield-to-maturity of the Global Aggregate ex-US index and the y-t-m of the U.S. Aggregate index. The former was only 0.72% at the end of December, while the latter had risen to 2.61%. With short term rates also much higher in the US than other developed markets, and rising, the dollar's strength looks set to continue as investors take advantage of the global carry trade.

The emerging markets sector was not a bright spot in the global bond space for the quarter, dropping 4%. However, the past year's experience was outstanding, reflecting a 12-month total return of over 10%. By comparison, the Global Aggregate (developed markets) index returned just 4%, and the US Agg just 2.7%.

US Treasury rates rose across the board in 2016. The 3-month T-bill was most influenced by the fed fund's hike, and rose 34bps. The 2-10 year yields increased a relatively modest 15bps for the year, but the reversal since June, and especially since September, spooked bond investors. The yield curve shift was not parallel, with the 30-year's yield of 3.05% nearly unchanged.

Fourth quarter U.S. bond returns were crushed by price depreciation, as Figure 4 reflects. Long duration bonds were most negatively affected. Of these, pure long Treasuries were sold down the most, having the lowest coupons to protect them. They lost -11.7% for the quarter. At the other end of the long-term spectrum, corporate bonds were relative outperformers. A combination of somewhat shorter maturities and much higher coupons protected returns. The long IG Credit index fell 5.8%, long IG Corporates lost 5.1%, and long IG financial services bonds were off less than 3.8%.

High yield bonds were the only major fixed income sector to reflect positive 4th quarter returns. Those with higher starting yields benefitted the most. CCC bonds returned 5.9%. They continue to trade at a 13% discount to par with yields above 11%. BB bonds returned just 1.35% for the quarter, trade at par, and yield 4.7%.

Figure 4: Primary Bond Sector Returns (%)

Index	4Q '16	1 Year	3 Years	5 Years
US Aggregate Bond index	(3.0)	2.7	3.0	2.2
US Gov't/Credit: 1-3 Yrs.	(0.4)	1.3	0.9	0.9
US Treasury: Long	(11.7)	1.3	7.8	2.5
US Inflation-Linked	(2.6)	4.8	2.5	0.9
Mortgage-Backed (MBS)	(2.0)	1.7	3.1	2.1
CMBS	(2.9)	3.5	2.9	3.7
Asset-Backed (ABS)	(0.7)	2.0	1.7	1.7
Inv. Grade Credit, 1-10yr	(2.0)	3.9	3.1	3.5
Inv. Grade Credit, 10+yr	(5.8)	10.7	6.9	5.2
US High Yield Credit	**1.9**	17.5	4.7	7.4
Municipal Bonds	(3.6)	0.3	4.1	3.3
Global Aggregate, ($ hdgd)	(2.3)	4.0	4.2	3.6
Global Credit, ($ hdgd)	(1.7)	7.3	4.5	5.1
Emerg. Mkts Bonds (US$)	(4.0)	10.2	6.2	5.9

Figure 5: Primary US$ Bond Yields

US Treasuries	**Dec-16** (%)	**Sep-16** (%)	**Jun-16** (%)	**Dec-15** (%)	*1-Year Change* (%)
3-month	0.50	0.28	0.26	0.16	***0.34***
2-year	1.20	0.77	0.59	1.06	***0.14***
5-year	1.92	1.15	0.71	1.77	***0.15***
10-year	2.43	1.61	1.49	2.25	***0.18***
30-year	3.05	2.33	2.31	3.01	***0.04***
BarCap Aggregate	2.61	1.96	1.91	2.59	***0.02***
BBB Credit	3.80	3.27	3.42	4.34	***(0.54)***
AA Credit	2.64	2.07	2.01	2.63	***0.01***
Agency MBS	2.85	2.06	2.07	2.34	***0.51***
Emerging Mkts ($)	5.79	4.98	5.37	6.39	***(0.60)***
US High Yield	6.17	6.17	7.27	8.75	***(2.58)***
UST30yr - UST2yr	1.85	1.56	1.72	1.95	***(0.10)***

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	**Dec-16**	**Sep-16**	**Jun-16**	**Dec-15**	***1-Year Change***
United States	2.43	1.61	1.49	2.25	***0.18***
Germany	0.27	(0.13)	**(0.12)**	0.64	***(0.37)***
Switzerland	(0.15)	(0.51)	**(0.50)**	**(0.07)**	***(0.08)***
Britain	1.27	0.78	1.13	1.99	***(0.72)***
Poland	3.71	2.87	2.93	2.92	***0.79***
Italy	1.88	1.18	1.30	1.63	***0.25***
Spain	1.43	0.98	1.33	1.85	***(0.42)***
Greece (new bonds	6.72	8.30	8.19	8.34	***(1.62)***
China (5 year)	2.93	2.56	2.70	2.67	***0.26***
Japan	0.04	(0.08)	**(0.19)**	0.28	***(0.24)***
Australia	2.79	1.95	1.99	2.75	***0.04***
Russia	8.45	8.22	8.39	9.52	***(1.07)***
Brazil	11.31	11.49	12.15	16.41	***(5.10)***
India	6.37	6.92	7.44	7.76	***(0.62)***

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US Stock Investors Buy Value

Uncertainty about the Presidential election took the S&P 500 index down from 2168 at the quarter's beginning to its low point of 2085 on November 4th; a decline of nearly 4%. The rather furious "Trump rally" took the index up to 2272 on December 13th; an advance of 9% from the low. After some toing and froing, that's right where the market is today, a little over one month later.

Including dividends, the large-cap S&P 500 returned 3.8% for the quarter. This contributed to a strong 12% total return in 2016. As they did in the 3rd quarter, small-cap stock indices outperformed by quite a wide margin, and mid-caps indices slotted in between. The Russell 2000 index gained 8.8%. Growth stocks sharply underperformed value in the quarter. Size/style performance differentials ranged from a high of 14.1% for small-cap value to a low of 0.5% for midcap growth. Value outperformed by so much in the single quarter that longer term performance differentials are now mixed. Large-growth stocks have still outperformed large-value, while differentials among smaller stocks favor value.

Figure 7: U.S. Equity Market - Size/Style Returns

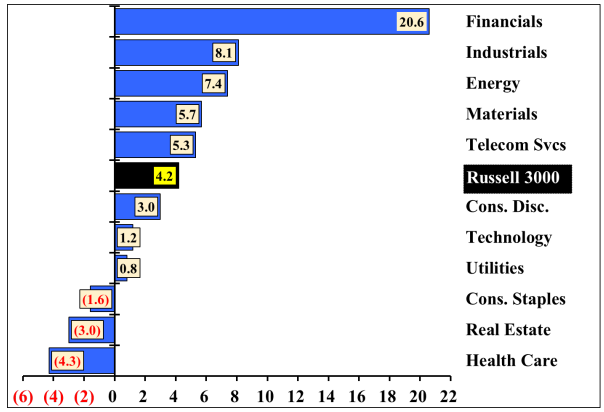
	4Q '16	1-yr	Trailing 3-yrs	5-yrs
Growth				
Large Cap	1.2	7.0	9.5	14.9
Mid Cap	0.5	7.3	6.2	13.5
Small Cap	3.6	11.3	5.1	13.5
Value				
Large Cap	7.2	16.2	8.2	14.4
Mid Cap	5.5	20.0	9.5	15.7
Small Cap	14.1	31.7	8.3	14.3

The performance differential across large-cap market sectors was a large 25% as financial services stocks gained 21% and health care lost 4%. In small-cap space, the quarter's sector performance differential was an amazing 29%. Small financials rallied over 23%, led by regional and community banks.

Of the Russell 3000's 4.2% fourth quarter return, the heavily weighted financial services sector accounted for 70% of it. Four of the top five contributors to performance were the large banks JP Morgan, BofA, Wells Fargo and Citi. Industrial and energy stocks combined to contribute just over 1.4% to returns (33% of the total). The three lagging sectors (see Figure 8) collectively held back performance by 1%.

Performance contribution was narrower in large value and growth indices. Financial services companies account for 27% of the R3000 Value's market cap, yet contributed 76% of the index's 7.2% fourth quarter return. Energy and industrials contributed 28% of the quarter's return.

Figure 8: US Sector Returns –4th Quarter 2016



Somewhat surprisingly, contribution to return in small-cap space was not as concentrated as in large-caps. Financial services stocks account for 20% of the Russell 2000 market cap, and returned 23% in the quarter. Yet this provided just 48% of the index's gaudy 8.8% three-month return. Small energy, industrials, and materials companies did excellently in the quarter (11-18% returns) as investors rotated aggressively to domestic "hard assets" plays (AK Steel advanced 111%). Collectively these three sectors accounted for 35% of the index return. Only one small-cap sector did not produce favorable returns; health care stocks fell 6% in the quarter.

For 2016, top sectors were energy (+26%), telecom (+24%), financials (23%) and industrials (19%). Health care stocks lost money (-3%) and consumer stocks posted 5-6% returns.

Per Figure 9, US stocks have become pretty much priced to perfection. At a 20.3x P/E, the S&P is trading fundamentally 35% above where it traded four years ago (15.0x P/E). The P/E ratio for small growth stocks is 65% above where it was four years ago! On the flip side, if 4Q16 earnings for the S&P are **32%** above 4Q15, then 2016 earnings will have grown at an annualized rate of just 3.0% since 2012. Investors are paying up for much higher future growth; it needs to materialize.

Figure 9: One-year Trailing P/E Ratios – Dec. 2016

	Value	Blend	Growth
US Large	17.7	20.3	23.2
US Mid	22.8	24.3	26.6
US Small	25.5	28.9	33.9
EAFE		18.3	
Emerg. Mkts		14.3	

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The US Dollar Trumps Most Currencies

Global stocks ended the year in mixed fashion; bolstered by expectations for an improving world economy and buffeted by currency headwinds. The US dollar strengthened versus most developed and emerging market currencies, creating a wide disparity between local market and US dollar-based returns. At year-end the euro was approaching parity with the US dollar ($1.03).

Developed markets (MSCI World ex-US) returned 6.9% in *local* currency terms for Q4, but *fell* -0.4% in US dollar terms. Emerging markets finished the year on an even weaker note, dropping -4.2% while outpacing developed markets for the full year (+11.2%). Canadian markets rebounded, gaining 3.3% in Q4 and 24.6% during 2016.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 12/30/16	4Q '16	1-Yr	4Q '16	1-Yr
World ex-USA	**(0.4)**	**2.8**	**6.9**	**6.5**
- *MSCI Growth*	*(5.3)*	*(1.9)*	*1.6*	*1.2*
- *MSCI Value*	*4.6*	*7.4*	*12.3*	*11.8*
- Europe ex-UK	(0.2)	(0.6)	5.9	2.3
- Pacific, ex-Japan	(2.7)	7.9	1.2	8.3
- Japan	(0.2)	2.4	15.0	(0.7)
- United Kingdom	(0.9)	(0.1)	4.2	19.2
Int'l Small Caps	**(2.7)**	**4.3**	**5.0**	**7.4**
Emerging Mkts	**(4.2)**	**11.2**	**(1.4)**	**9.7**
- *EM Asia*	*(6.1)*	*6.1*	*(3.1)*	*6.9*
- *EM Europe*	*9.4*	*25.5*	*12.8*	*20.8*
- *EM Lat Amer*	*(0.9)*	*31.0*	*1.2*	*24.3*
- *EM BRIC*	*(3.8)*	*12.1*	*(3.7)*	*7.9*

European stocks ex-UK rose 5.9% in local currency terms, boosted by central bank stimulus measures and investor optimism for an improving global economy. The same ECB's stimulus program that supported stock market advances also contributed to a 6% decline in the euro, turning the local market gain into a loss of -0.2% in US dollar terms. The pound continued its post-Brexit slide, falling another 5% versus the US dollar. For the year, the pound tumbled 16% against the dollar while Britain's stock markets rallied 19% in local terms.

Per Figure 11, in broad international terms only three economically sensitive sectors (financials, energy, materials) produced positive returns in the quarter. All other sectors declined, especially defensive sectors.

European financials gained 18% as global lending rates moved higher after the Fed rate hike. Banks led the way, with HSBC and Lloyds rising double-digits. Energy stocks rallied when OPEC agreed to reduce oil production for the first time in eight years. BP, Total and Royal Dutch Shell were all beneficiaries.

In the Pacific region, Japanese equities rose sharply amid a weakening yen. The yen's 13% decline reduced a 15% local market gain to -0.2% in dollar terms. Like Europe, the financial sector led the way, gaining 31%. Nomura Holdings, Mitsubishi UFJ, Sumitomo Mitsui and Mizuho Financial were top performers. The weak yen also lifted exporters including Toyota, Honda and Fuji Heavy.

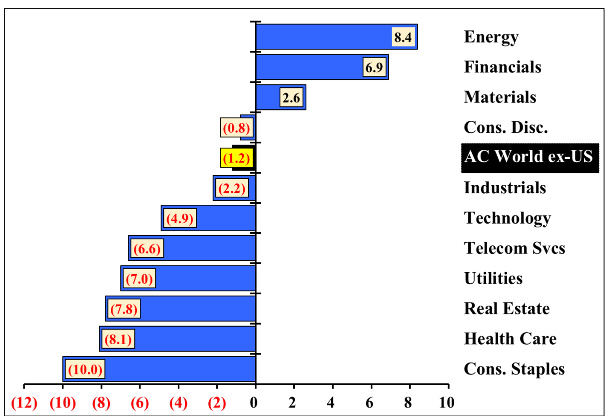
Australian equities followed the same path as Japan, led by strong returns in financials. As with Japan, the Aussie market's 6% gain was virtually erased by a 5% currency decline. After being the top performer in the region in 3Q, the Hong Kong market declined 9% due to weak real estate and insurance sectors.

Emerging markets ceded their leadership position in the final quarter of the year, slowed by the surge in the US dollar and the Fed's interest rate hike. The MSCI Emerging Markets index fell -4.2%. Several currencies touched new lows against the dollar, including the Mexican peso and the Turkish lira. Indian stocks posted their weakest quarter since 2012 (-8%) despite a favorable bond market. Chinese stocks slumped 7% amid concerns over trade relations with the US. The renminbi dropped 4% to an 8-year low against the US dollar. Shares of tech giants Tencent and Alibaba fell double-digits. Other Asian EM markets also declined; including Korea (-7%), Indonesia (-7%), and Taiwan (-3%).

In dollar terms, Russian stocks jumped 18.6% in Q4, and were up a spectacular 55% in 2016. The ruble's gain added 3% to the quarter's returns, and 21% for the year. A surge in oil prices following the OPEC agreement to curb output and speculation that Russia-US relations would improve set the stage for energy stocks (Lukoil, Gazprom) and Russia's largest lender (Sberbank) to advance.

In Latin America, Mexican equities declined most (-8%), hit by fears of slowing trade with the US. The peso declined 6%. Brazilian stocks edged higher (2%), led by gains in commodity-related stocks (Vale, Petrobras). Brazilian stocks returned a spectacular 66% in 2016.

Figure 11: Ex-USA Sector Returns (4th Qtr 2016)



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Back Page Perspectives

We try not to get too political around here. The following table is about as close as we come. It reflects how the stock market, bond market, and jobs "market" performed during each term of the last 5 presidents; just the outcomes. No analysis or excuses provided. That's our readers' prerogative. The investment returns' calculations start from the election date. The employment numbers start from the inauguration date.

We wonder about how much each prior term sets up the next? Did the anemic employment growth during H.W. Bush's term set the stage for the robust jobs growth during Clinton's first term? Did Reagan's blowout 2nd term negatively affect H.W. Bush's only term? The stock market soared during the Clinton years. Did that effectively "steal" returns from the G.W. Bush years?

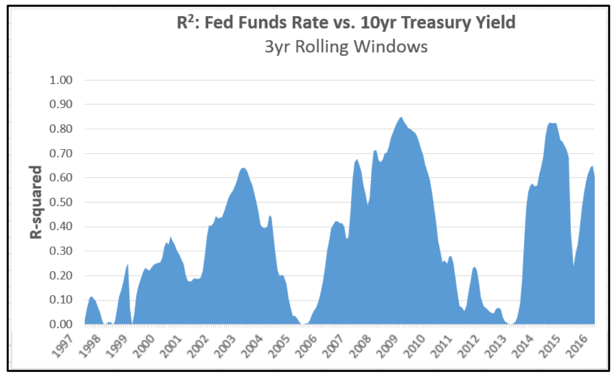
Administration / Economic Measure	4 Years Before	First Term	Second Term	Full Presidency
Reagan				
S&P 500 TR	52%	59%	94%	209%
Agg. Bonds	11%	75%	63%	185%
Payroll Growth	12%	6%	11%	18%
Bush				
S&P 500 TR	94%	72%	N/A	72%
Agg. Bonds	63%	51%	N/A	51%
Payroll Growth	11%	2%	N/A	2%
Clinton				
S&P 500 TR	72%	87%	115%	303%
Agg. Bonds	51%	32%	28%	69%
Payroll Growth	2%	11%	9%	21%
G.W. Bush				
S&P 500 TR	115%	-16%	-7%	-22%
Agg. Bonds	28%	34%	12%	51%
Payroll Growth	9.1%	0.2%	0.2%	0.4%
Obama				
S&P 500 TR	-7%	59%	64%	161%
Agg. Bonds	12%	36%	10%	49%
Payroll Growth	0%	2%	7%	9%

all numbers are cumulative percentages for the stated period

Trump's first term is up next. The pages of history wait to be written. He's inheriting a slowly growing economy that has produced a record 75 straight months of jobs gains (prior record was 48 months), and a stock market that has risen consistently well during the last two terms, but is now fundamentally overvalued. Finally, while bond returns have not been particularly outsized since the Reagan administration, the Aggregate index yielded only 2.11% on Trump's election day. Viewed solely through the prism of history, Trump's first term could ultimately be quite challenging.

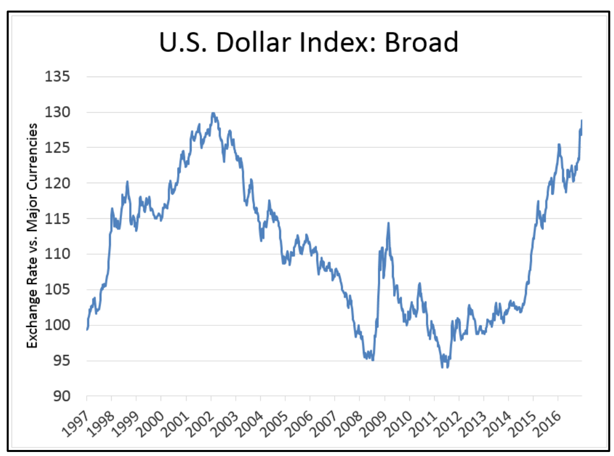
FOMC projections entering 2017 are for three hikes in the fed funds rate. This is more than market consensus, which up to now has felt the economic environment was not robust enough to expect more than two hikes per year during 2017-18. We'll see.

With term interest rates up sharply in the same quarter as December's rare Fed rate hike, the natural tendency is to link the two closely and expect a 75 bps increase in the 10-year Treasury during 2017. That would take it to nearly 3.25%. We would be careful with that conclusion. As the following graph reflects, the historical correlation between changes in the fed funds rate and 10-year Treasury yields has been anything but stable. We're reluctant to expect a purely parallel shift in the yield curve just because the fed funds rate is rising.



Higher long-term inflation expectations find their way directly into term bond yields, in a manner that is often neither low nor slow. Thus, inflation is our biggest concern for high quality bond portfolios. Once inflation is evident, we believe the Fed will surely follow.

The quarter's other big mover was the US Dollar. Per the below graph, its strength since 2011 has been rather extreme. A strong Dollar favors imports, crushes exports, reduces inflation, lowers interest rates, and hollows out domestic manufacturing. Watch out here.



Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA

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