Quarterly Strategy Letter

4th Quarter 2016

2016 IN THE REAR VIEW MIRROR

State of the Markets Address

Major asset classes posted stellar results for investors in 2016, with the vast majority ending in positive territory. Global equities, as represented by the MSCI All Country World Index, recorded an 8.48 percent return led by U.S. equities and certain emerging market countries. Meanwhile, bonds also had a respectable year with a 3.91 percent return on the Barclays U.S. Universal Bond Index. Much of the return for the index was derived from outstanding performance in the U.S. high yield bonds space which returned 17.13 percent, based on Barclays data, helping to combat rising interest rates which occurred at the latter part of the year. Finally, alternative asset classes were a mixed bag with the Bloomberg Commodity Index seeing an 11.77 percent increase for the year, led by oil which started the year trading at $37.04 per barrel and rose to $53.72 per barrel by the end of the year. The price of crude for the year was a boon for investors holding a basket of commodities with exposure to the energy markets.

U.S. Equities Trump International

Another up year is in the books and 2016 was the eighth consecutive calendar year to have a positive total return on the S&P 500 Index! This time around the U.S. large capitalization index posted a resilient 11.95 percent total return with 2.41 percent coming from dividends and 9.54 percent from price appreciation. Amazingly to some investors, S&P 500 companies gained more than half of the total calendar year return, 6.7 percent, in the 45 trading days after the presidential election. This was likely due in-part to the potential fiscal policies on the then nominee's docket.

While Trump's victory was a big surprise for some voters, it surprisingly did not startle the markets as much based on the reaction the night of the victory and in the following days and months. As Trump narrowed in on a victory that November 8th evening, Dow Jones futures started dropping and were down a little more than 900 points on the index at its low, a decrease of approximately 5 percent from the close of the index that day. The uncertainty surrounding the unconventional candidate combined with rhetoric regarding trade agreements contributed to the initial negative reaction by market participants. However, by the time the market opened the next day, stocks were flat and actually ended the trading session in positive territory as investors weighed the President-Elect's potential policies and their effects on the United States economy.

Populism Becomes Popular

The U.S. presidential election was one of a few different global head-nods to nationalism and populism in 2016. The Brexit and the Italian reform vote were other indicators that voters were dissatisfied with the status quo of the current government within their own borders. Britain's decision to exit the European Union initially sent shock waves across the investment and political spectrum only to be digested just as quickly. Looking back now, it is hard to believe that it was just this last year that the European Union lost its first member since Greenland withdrew in 1985. The Brexit was one of the major systemic risks for the year and pushed markets down both domestically and internationally. U.S. markets recovered relatively quickly, taking just a few days to recuperate to pre-Brexit levels. Additionally, despite the geopolitical shock, European stock markets also finished the year up 3.18 percent, according to the MSCI Europe Index, although it took quite a bit longer for markets to shake off the potential effects of losing one of the EU's largest economies. International developed markets muddled higher over the rest of the year and finished marginally in the positive, while emerging international markets performed quite a bit better than their developed counterparts.

Fringe Economies Aren't So Fringe

Emerging markets were the surprise victor amongst major equity markets with the MSCI Emerging Markets Index up 11.27 percent in 2016. Cheaper valuations

versus other major markets, combined with monetary policy shifts abroad, or lack thereof, contributed to the rise in emerging economies. Although the group had a strong year, the fundamental economic data didn't do much to support the rally. Much of the return came from two of the largest 'BRIC' members, Brazil and Russia. Brazil finished the year with an incredible return of 66.74 percent while Russia also soared 55.94 percent higher, according to MSCI data. China and India, some of the largest allocations within emerging markets indices, were up just over 1 percent for the year based on the same data.

China finished 2016 on more solid footing than perhaps what it seemingly started on. Throughout the year, the country and investors struggled with the worry of a hard landing as the country tries to reposition its economy and attempts to boost domestic consumption. Last year, China intervened to try and build growth momentum, including depreciating its currency to prop up exports, and relieve some stresses in the financial market. Although we see excesses building within select sectors in China, market appreciation in 2017 is possible especially given the upcoming political party vote.

Frontier markets are sometimes considered the final frontier for investors and the next emerging market asset class. Unfortunately it didn't deliver on that mantra and finished the year as one of the worst regional stock sectors of 2016. Pressure from low commodity prices combined with increasing rates in the U.S. strained on equity prices in these countries. As these higher commodity-reliant countries saw global demand falter and the expectation that capital infusions from international partners decrease, investors fled the asset class. Until inflation recovers, global demand increases, or geopolitical issues are remedied, it will be hard for fringe economies to provide much more than a valuation trade versus other equity markets.

The Fed's Annual Rate Migration

Like geese flying south for the winter in their iconic v-shaped groups, Yellen and her flock pressed forward with their once-per-year migration. Despite the relatively consistent language surrounding 'as needed' monetary policy moves that were expected to happen multiple times over the year, the Federal Reserve raised the federal funds rate just once in 2016. Similarly, after broadcasting the same possibility of numerous rate moves based on inflation and unemployment, rates were only hiked once in 2015 – both occurred at their December meeting each year.

According to the December 2015 Fed dot plot, the FOMC had expected to raise rates to a median level of approximately 1.5 percent in 2016. The federal funds rate is currently 0.75 percent after the quarter point move in December last year. Inflation averaged just over 1.6 percent in 2016, according to Bureau of Economic Analysis data, and seems to be moving toward the Fed's 2.0 percent target, while unemployment is well within the Fed's optimal range. So why aren't rates higher? Truth be told, the Fed has been in a very uncomfortable spot for the last few years due to increased political scrutiny, data contradicting expectations, and a new era of transparency of Fed announcements and policy – and the Fed was thrown more than a few curve balls in 2016.

Market disruptions were a key concern for the Fed during the year after Yellen cited financial market upheaval weighing on the outlook. Global stock markets entered the year tumbling double digits, while a rout in Chinese equities continued. Europe's outlook has improved over the past months, but at the time was still quite uncertain and the Brexit only added to the volatility. We continue to expect multiple tightening moves in monetary policy this year, but the possibility of market volatility or geopolitical risk could drag on our forecasts.

A Resurgence in Inflation

After a few years of declining prices, particularly in crude oil, it seems inflation-related assets are on the mend and showed strong improvement during the 2016 year. After price declines due to a supply glut and curbed demand, oil climbed over 45 percent last year, according to Bloomberg. The U.S. Personal Consumption Expenditure Index, the Fed's preferred gauge of inflation, rallied almost 30 basis points in the early part of the year before fluctuating and moving higher. While tied hand-in-hand, the recovery in oil was driven partly by supply changes along with the aggregate demand changes that affect both inflation and the commodity. After recovering from the early market turmoil, improving economic growth forecasts and the potential for reduced supply buoyed prices. To add icing

to the cake, at their November meeting, OPEC agreed to the group's first production cut in 8 years in an effort to firm up prices. Major producers outside the oil cartel agreed to the cuts as well.

Along with the reappearance in inflation, currencies around the world ebbed and flowed during the year as monetary policies and growth prospects for individual countries and regions weighed on exchange rates. The Chinese yuan saw a few periods of rapid adjustment during 2016 as the basket of currencies the exchange rate is pegged to fluctuated. Intervention from the Chinese government in the valuation of the yuan has been a reoccurring subject, but seems to be improving as new mechanisms are employed to increase the market's influence rather than the government's sway on the currency.

The U.S. dollar experienced a spectacular rise in the past couple years, and seemed to have leveled off before jumping once again at the end of the year. While the initial soaring was largely due to the separation of monetary policy as well as the bifurcation of overall economic growth between the U.S. and the rest of the world, that gap seems to be closing. Regions like the European Union appear to be healing and their monetary policy may be heading toward a similar tightening – a synchronization of policy may be ahead.

Examining Portfolio Positioning

Within the equity allocation, there are five to six primary equity markets investment managers identify: U.S. large cap, U.S. small to mid-cap, international developed markets, emerging markets, and frontier markets. A synching of global recoveries seems to be percolating through each of these asset classes resulting in a calendar year in which all six of the major markets finished the year with positive total returns, according to Bloomberg. U.S. based equities fared the best, especially those which were small to mid-sized, as the Trump victory promotes inside-the-border businesses tied to U.S. dollar consumers. The Russell 2500 Index, which tracks small and mid-sized U.S. companies, resulted in a 17.57 percent gain, rallying 7.98 percent after the election.

Usually investment managers describe equity markets as a 'roller coaster' during certain periods, but if investors were to reflect on the rate movements of the 10-year Treasury throughout 2016 they would be applying that analogy to fixed income as well. At the start of 2016, bond investors saw the 10-year Treasury yielding 2.27 percent, however, within a month and a half the rate had dropped to 1.66 on February 11th before rallying back to 1.99 percent exactly one month later. This wasn't the last big swing for 2016. Once again bond investors needed to strap in as benchmark rates fell more than 62 percent and hit the lowest recorded yield in the history of the 10-year Treasury on July 8th with a yield of 1.36 percent. The months following were marked by a slow grind higher before a remarkable jump to 2.60 percent after the presidential election.

Although many investors see many equity markets being at or above fair value, the improvement in economic growth data still supports an overweight allocation to equities in aggregate and when compared to some of the other asset classes; our strategies remain marginally overweight equities. Low interest rates across the globe, fiscal stimulus measures in some countries, and consumer sentiment and business confidence continuing to improve make a case for remaining overweight to the equity asset class despite some valuation measures. On the fixed income side, it was a good year to be underweight interest rate risk in bond portfolios as well as to have a higher than benchmark allocation to high yield or floating rate notes, as these assets fared well for bond investors. The Global Investment Management team held, and continues to hold, a marginal underweight to duration, or bonds sensitivity to interest rates, with an overweight to spread (non-Treasury) products like high quality corporate debt and U.S. mortgages.

Glossary

Alternative investments are investments that are not one of the three traditional asset types (stocks, bonds and cash).

Barclays U.S. Universal Bond Index is an unmanaged index comprising US dollar-denominated, taxable bonds that are rated investment grade or below investment grade.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Brexit is an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.

Bureau of Labor Statistics is the arm of the U.S. Department of Labor that researches and publishes a range of data, from inflation and consumer spending to employment, productivity and wages, as well as other economic measures.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Sometimes referred to as "headline inflation."

Corporate bonds are debt obligations issued by corporations. An investment in corporate bonds is subject to a variety of risks including credit and default risk, market risk, event risk, call risk, interest rate risk, foreign risk, and sector risk.

Dow Jones Average (DOW) is a composite of the price movement of 65 stocks, including 30 industrials, 20 transportation, and 15 utilities.

Emerging Market countries have economies that are progressing towards becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU's goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.

Federal Open Market Committee (FOMC) is a committee that sets interest rate and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities.

Federal Reserve (Fed) is the federal banking authority in the U.S. that performs the functions of a central bank and is used to implement the country's monetary policy, providing a national system of reserve cash available to banks.

Frontier Markets are less advanced capital markets from the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. They are also known as "pre-emerging markets".

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. Real Gross Domestic Product is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices. Often referred to as "constant-price," "inflation-corrected" GDP or "constant dollar GDP". Real GDP can account for changes in the price level, and provide a more accurate figure.

High yield bonds are high paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below 'BBB' from S&P, and below 'Baa' from Moody's. Bonds with ratings at or above these levels are considered investment grade. Credit ratings can be as low as 'D' (currently in default), and most bonds with 'C' ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Investment-grade (IG) is typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgement of the rating agency, are projected to have relatively low default risk.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed by Morgan Stanley International to measure the equity market performance of the developed markets in Europe.

Municipal bonds are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects. The interest income from municipal bonds is generally exempt from federal taxes and may be exempt from state and local taxes. Municipal bonds are subject to a number of risks such as interest rate risk, call risk, inflation risk, credit and default risk, and tax risks.

Organization of Petroleum Exporting Countries (OPEC) is an organization consisting of the world's major oil-exporting nations. It was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries.

Personal Consumption Expenditure (PCE) measure is the component statistic for consumption in GDP collected by the BEA. It consists of the actual and imputed expenditures of households and includes data pertaining to durable and non-durable goods and services. It is essentially a measure of goods and services targeted towards individuals and consumed by individuals.

Price-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings.

Russell 2500 Index features 2,500 stocks that cover the small and mid cap market capitalizations. The Russell 2500 is a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities. The index is designed to be broad and unbiased in its inclusion criteria, and is recompiled annually to account for the inevitable changes that occur as stocks rise and fall in value.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

Treasuries are debt obligations issued and backed by the full faith and credit of the U.S. government. Treasuries are subject to interest rate risk, call risk, and inflation risk. As Treasuries are backed by the full faith and credit of the federal government, they have low credit or default risk. As a result they generally offer lower yields relative to other bonds.

Yuan is the basic monetary unit of China.

One cannot invest directly in an index.

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Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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