

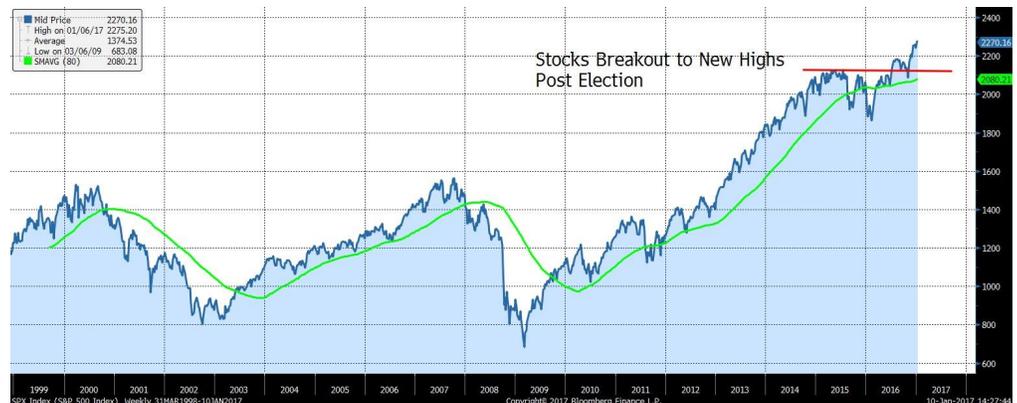
The Stock Market for 2017 How Far We Have Come & How Far Can We Go?

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With the post-election stock market rally pushing the major averages to all time high levels, what we are hearing more and more from clients is, "Can this market really keep going? It seems like it's getting awfully expensive and must be getting ahead of itself." While we think that the stock market trade has gotten a little crowded in the near term, we believe that this increase in skepticism is the kind of healthy sign that we would expect to see amidst an ongoing bullish trend. This mindset presents a sharp contrast to the mass psychology around the market tops in 2000 and 2007 when speculation raged in certain sectors and investors believed that double digit annual returns were an inalienable right as markets couldn't possibly decline. It has not been that way these last couple of years. As we look back at the period from the end of Fed easing in December 2014 until the recent election, we see that stocks made scant progress during that time and history may well conclude that this rolling correction was actually a very shallow cyclical bear market. While the major averages never approached official bear market territory, there were several pullbacks in the 10-12% range and significant corrections certainly occurred in many industry groups such as energy, basic materials, cyclical industrials, retailers and investment banks. Through it all, the one consistent thread has been that the economy as a whole has grown enough to allow for job creation to continue to occur and for corporate profits to continue to expand. This resilience is due in part to the Fed's patience in raising rates and to the corporate restructuring that occurred in the wake of the financial crisis.

The election result provided some long awaited wind for the market's sails as it gave analysts a reason to believe that profits could continue to expand out into the second half of 2017 because of the potential for fiscal stimulus and a more benign regulatory landscape. This fresh breeze brought with



it about 70% of the returns for the year in the last two months alone and decidedly favored economically sensitive cyclicals and smaller stocks. By year end, some healthy returns had blown in with the S&P 500 rising +11.95% for the year, mid cap up a robust +20.70% and small caps still higher at +21.27%. Navigating the waters of international stock markets once again produced some mixed results as the MSCI EAFE Index gained a mere +1.59% on the year while the MSCI Emerging Markets Index returned +11.25% amidst some choppy conditions. Brexit, China concerns and troubles at European banks all contributed to the uncertainty in foreign markets which only served to make the U.S. look more attractive. In spite of all this, there was some effort made overseas in Q4 to form a bottom which is a positive sign for the global economy heading into 2017.

We learned long ago not to get caught up in predicting how long it will last and how high it will go. Our approach focuses on correlating economic fundamentals with market trends to position portfolios consistent with where the data takes us. Still, we are impressed that the market has broken out to new highs amidst an environment of solid jobs gains and improving consumer sentiment. With recent revisions to S&P 500 earnings higher, earnings are expected to increase 8.5% for the coming year which takes us to a forward P/E multiple of 17x. This valuation is slightly above the 25 year average, but remains well below levels that would indicate excess or sustainability issues. Assuming that the Fed can keep inflation at bay and the global economy can make modest strides in the next year, stocks should continue to offer decent return potential.

Risks to that outlook could come from the shifting currents that have occurred in both interest rates and the U.S. dollar. While revised growth expectations were good for stocks near term, they were a catalyst for inflation concerns and higher rates in credit markets. This was seen in the post-election sell off at the long end of the yield curve and with the Fed's move to raise rates at the short end in December. We think that the Fed's move is a

vote of confidence for the economy heading into 2017 as it conveys an expectation that growth will be robust enough to generate some inflationary pressure. While there is some risk that the Fed will tighten too quickly, the rise at the long end is of greater concern to us particularly if it is exacerbated

by government borrowing to finance a stimulus program as higher rates and more debt would be a recipe for slower growth further down the road. The Fed sees this risk and will likely keep hiking rates until they can get the long end to settle down some. This creates a bit of a balancing act as they seek to limit inflation but not growth. A more immediate concern is the rise in the dollar which is due to the rate differential with other developed countries. This has the potential to slow export growth in the coming months and could impact corporate earnings projections. To great extent, the outcome here will be determined by whether we see growth and inflation expectations pick up on a global basis with the risk being weak global growth driving further dollar gains. While it's possible that markets correct or stagnate for a period of time in the next year or two as a function of one or a combination of these factors, we do not see a return to the markets of 2000 or 2008 mainly because the speculative excesses that drove those situations continue to be absent and the economic foundation has been solid enough to keep pushing earnings higher.

