

## EXECUTIVE SUMMARY

We believe a multitude of events that are taking shape in 2017 will lead to elevated uncertainty and higher capital market volatility over the coming year. The Brexit vote and Italian referendum results will continue to be dealt with well into the new year as Germany and France hold their own national elections in 2017. The China relationship looks likely to reset in 2017 as President-elect Trump appears to be taking a tougher stance with this country when it comes to trade policies and currency practices.

Central bank policies will likely continue to diverge in 2017 as the U.S. goes down the path of higher policy rates with most of the rest of the world continuing to ease. Global interest rates started moving higher at the end of 2016 and we believe the pressure will be on rates to continue to increase in 2017.

On top of those items, the U.S. will transition to a new presidential administration in January. Capital markets were caught off guard by the unexpected victory of President-elect Trump. Following the election, investors tried to reset positions based on this outcome after it had been widely expected that Clinton would win. For the most part, this post-election period was marked by an equity market rally, which pushed the major U.S. equity indices to new all-time highs, but bonds struggled with rates surging higher.

The capital market action post-election leads to the question of whether equities rallied too sharply and whether bonds sold off too much to close out 2016. This Outlook will try to provide some context around how we are going to be evaluating those types of questions in the new year. Frankly, this is both a challenging and an interesting time to explore the potential public policy, economic and capital market environment moving forward into 2017.

Overall, we believe we are entering a year of elevated uncertainty and higher capital market volatility in 2017. If the economic optimism following the Trump election is realized, that would be supportive of equities in the new year. However, much of that optimism is already priced into stocks and any disappointing news could hit equities in the near term. We think interest rates will continue to grind higher, which will be a headwind to bond prices. However, we expect this path to higher rates to be choppy as U.S. rates are significantly higher than many global rates, which could spur some demand for U.S. Treasuries. Fundamentals drive the long term, but the near-term could be impacted by some of these unsettled questions, which we think are the central themes entering 2017.

### Key Themes in 2017:

1. Unsettled European Political Landscape
2. Potential Reset of Relationship with China
3. Divergent Global Central Bank Action
4. Year of Change in the U.S. Under a Trump Administration

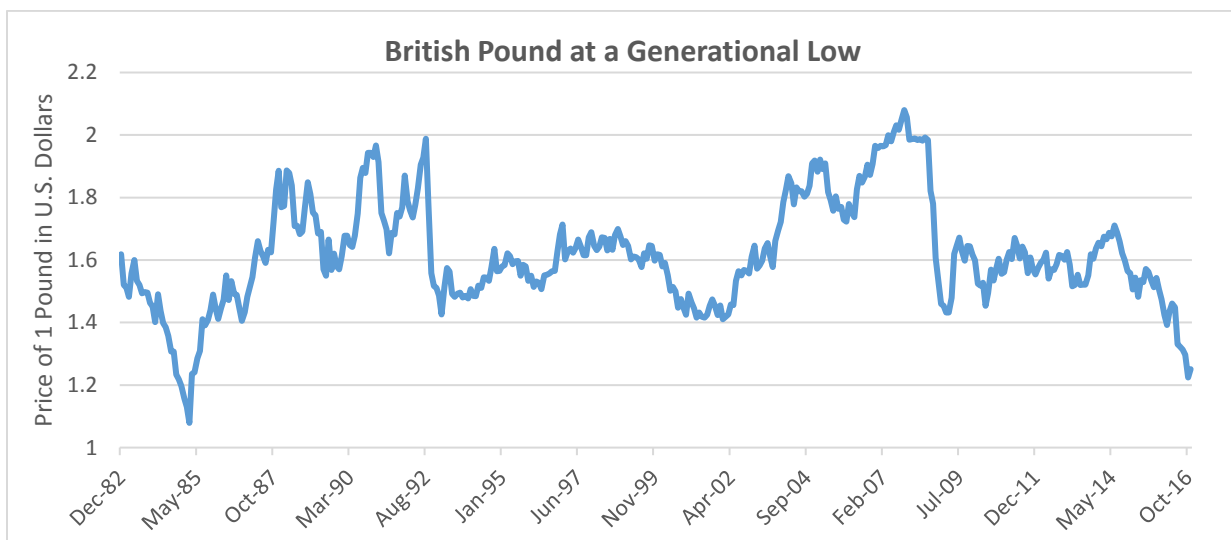
### Potential Key Market Implications in 2017:

1. Higher Levels of Uncertainty & Volatility (Fundamentals Drive the Long-Term)
2. More Dispersion of Asset Class Returns
3. Ongoing U.S. Dollar Strength
4. Interest Rates Grinding Higher

## GLOBAL EVENTS

### Brexit Vote Dominates News

**2016 Recap** – From a global perspective, the decision by British citizens to vote to leave the European Union was an event that dominated the summer. Not only was the outcome of the vote to leave unexpected, but it was also followed by the resignation of Prime Minister David Cameron, who favored remaining in the E.U. Theresa May subsequently replaced him as the prime minister to guide the United Kingdom through the process of leaving the European Union. The weakening of the British pound following that vote reflected uncertainty of what Brexit could truly mean to the country's economy. Fear of slower growth, restricted access to the common European market, and overall increased uncertainty about what lies ahead for the British economy resulted in the pound falling to its lowest level to the U.S. dollar in a generation.



Source: Bloomberg as of 11/30/16. Number of U.S. dollars it takes to buy 1 British Pound Sterling.

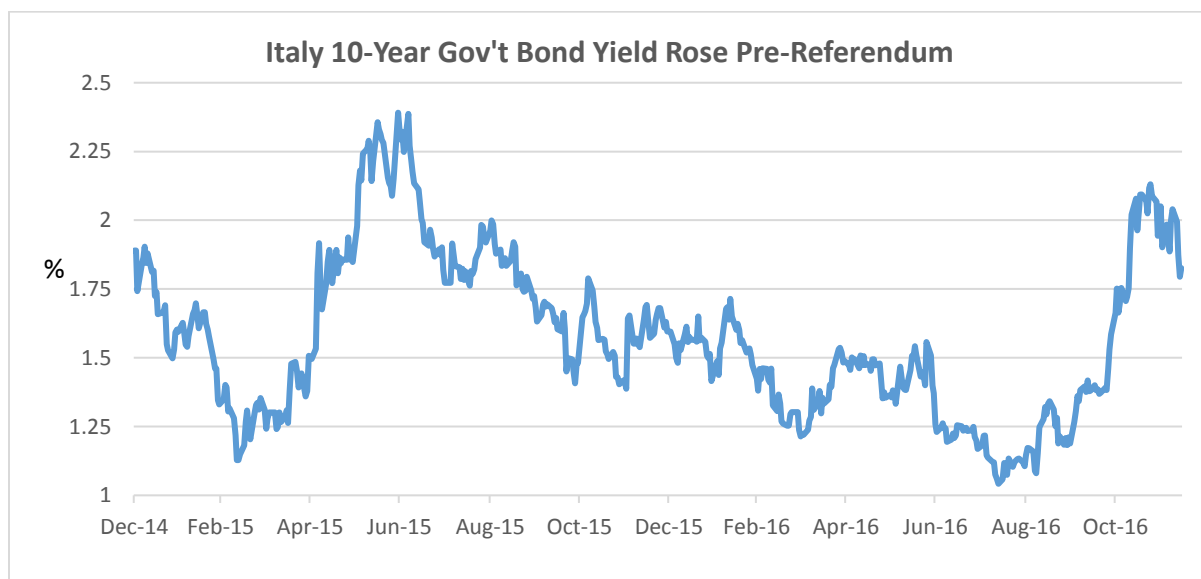
**2017 Expectations** – One of the key steps to the unwinding of the U.K. from the E.U. will likely be triggered in 2017 and it is referred to as Article 50 of the Lisbon Treaty. This will begin the formal negotiations for leaving the European Union. A key obstacle between the U.K. and the E.U. involves immigration. The free movement of people is one of the core freedoms of the E.U., but it is also one of the key issues for the British who want to take greater control of their own immigration policies. The question of immigration drove, in large part, the vote to leave the E.U. If the British do not address the free movement of people to the E.U.'s liking, the "carrot" controlled by the European Union is access to its common market, which is of critical importance to British industries. This will be one of the central negotiating points as the U.K. leaves the European Union and they try to iron out how they will deal with each other outside of the E.U. construct.

In 2017, Article 50 will likely be triggered, but beyond that, it might be a more sporadic year for news regarding the Brexit as it will be in the early stages of the negotiations that are expected to last about two years. However, news will likely trickle out at times from these negotiations providing some insight into progress being made or obstacles being faced between these two parties.

## Italian Referendum Failure in 2016; Germany & France Go to the Polls in 2017

**2016 Recap** – The Brexit vote was the dominant news item in Europe in 2016 and brought into question the long-run efficacy of the European Union project. Furthermore, a referendum on constitutional reform failed in Italy in December and was seen by many as another vote against the established political class. This was followed by the subsequent resignation of Italian Prime Minister Matteo Renzi, causing further questions about what an Italian government would look like moving into 2017. Unlike the Brexit vote or the Trump victory, the failure of the referendum was expected as was the subsequent resignation of Renzi. Italy's historic role in the European project, as well as its size as the third-largest euro zone economy, make developments taking place in Italy over the near-term worth monitoring. Concern exists that an anti-establishment/anti-European Union party could exert more power after this Italian referendum result.

One way markets reflect confidence or uncertainty in a country is through the yields of its sovereign bonds. Clearly, many factors impact the prices and yields of bonds, but the pending Italian referendum likely contributed to yields moving higher for Italian government bonds in the latter part of the year. Heightened uncertainty surrounding the political environment in Italy caused investors to demand higher compensation (yield) to hold Italian government bonds.



Source: Bloomberg as of 12/15/16. Italy Generic Gov't 10-Year Yield.

**2017 Expectations** – Votes in 2016 in the U.K., Italy and the U.S. followed a similar pattern that seemed to repudiate the political establishment. In 2017, elections will be held in France and Germany, the largest two economies in the E.U. With surprise results more of the rule than the exception in 2016, markets will likely view votes in 2017 with a more critical eye understanding that an unexpected outcome might be more possible than polls show. The anti-euro National Front party in France has been a long-standing fixture in French politics, led by the Le Pen family. How well Marine Le Pen fares in the French presidential election will be watched closely.

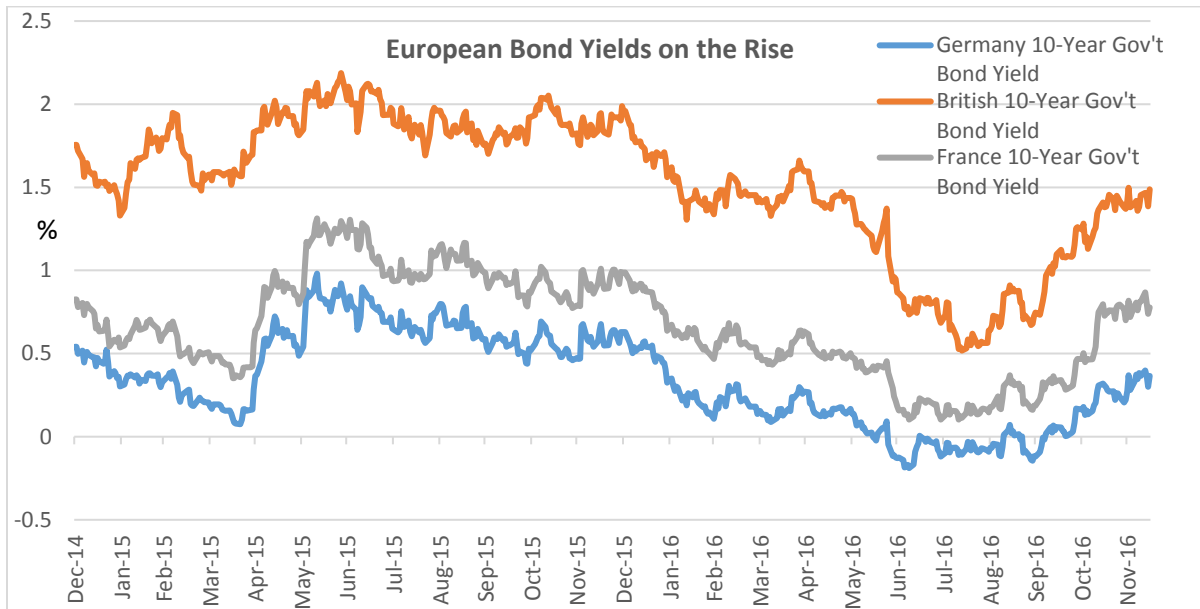
In many ways, election outcomes and the overarching mood of voters in 2016 likely drove German Chancellor Angela Merkel to announce that she would seek a fourth term to lead Germany in 2017. Having led Germany for more than a decade, Merkel represents some stability during a period of upheaval in the European Union. As the largest economy in the E.U. and a driving force behind European integration, some stability from this country would go a long way. However, with the recent experience of elections in 2016, monitoring German campaigns and polls will be an important exercise moving toward the election. Immigration has been a sensitive issue in Germany in recent years as well and might be a central point of any campaigns trying to unseat Chancellor Merkel. In December, Berlin was hit by a terrorist attack and its potential impact on the upcoming election is yet to be seen, but developments surrounding this attack will be important to monitor.

### **Key Takeaway**

A year of pending uncertainty would be a fair description of the European political landscape in 2017. The Brexit negotiations will be in the early stages, but news will likely still come from this unprecedented event. Italy will continue to need to sort out its next government and whether any anti-E.U. parties take on a greater role. France and Germany will both face national elections following a tumultuous year of votes in 2016. France has been the target of terrorist attacks in recent years and, unfortunately, Germany faced that reality as well in late 2016. (Due to the scope of this Outlook piece, we are not reviewing events and conditions in places like Russia and Turkey, which pose their own unique uncertainties.)

We think the unsettled environment in Europe will spur capital market volatility in 2017. The mood in recent elections has favored anti-establishment candidates and although reforms are possible, we believe a larger breakdown of the European Union is unlikely.

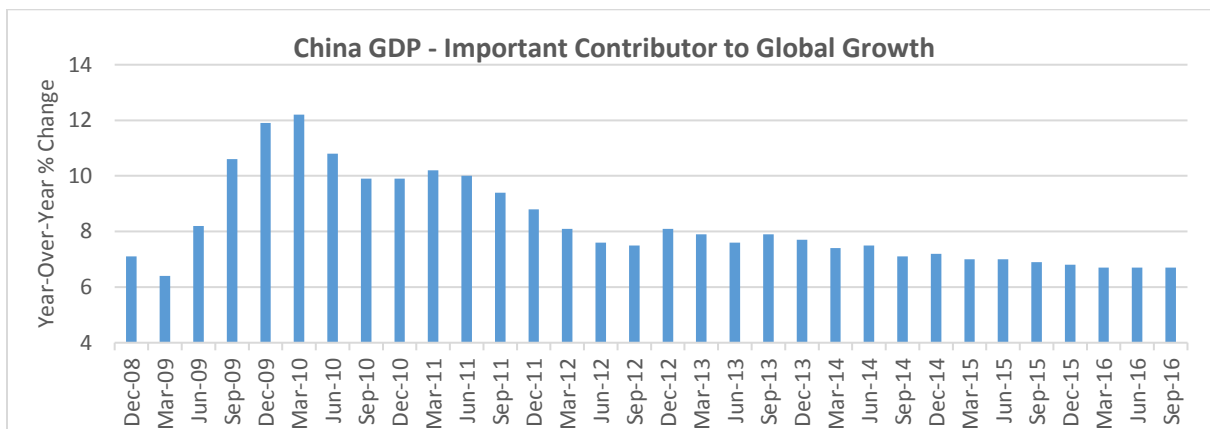
Furthermore, we acknowledge that the world seemed to shift into a rising rate environment following the U.S. elections, but the increases in rates in Europe were beginning even before the Trump victory. If global rates continue to rise in 2017, that will be the first time many of these economies and markets have faced a rising rate environment in years. We will monitor yields of European sovereign bonds in particular in the new year to see if investors are demanding higher interest rates to hold these bonds in 2017. We believe the overall trend will be higher global rates in the new year.



Source: Bloomberg as of 12/15/16. Germany Generic Gov't 10-Year Yield, France Gov't 10-Year Yield, U.K. Gov't Bonds 10-Year Note Generic Bid Yield.

## China – Landing Softly (So Far); Reset of U.S. Relations Coming?

**2016 Recap** – China’s economy has been slowing down as the country has tried to shift some its growth away from exports and toward more domestic consumption. This shift will be over the course of many years and is clearly a challenge for a country of China’s size, the second-largest economy in the world. There has been concern regarding how well this transformation can be engineered and whether China will be in store for a hard or soft economic landing. The good news for China is that it has maintained 6.7% annual growth over the first three quarters of 2016. Certainly, this would be an envious level of growth for many parts of the world. The bad news for China is that this growth rate was at its slowest pace since the credit-crisis period. China continues to play a key role in the expansion of the global economy, so monitoring its growth as it moves through this transformation will be important.



Source: Bloomberg as of 9/30/16. China GDP Constant Price Year-over-Year % change.

**2017 Expectation** – Of all countries, the outlook for China might be the most uncertain as it relates to the U.S. under a Trump presidency. During the presidential campaign, trade agreements and U.S. manufacturing were among the top concerns of Trump, along with China’s currency practices, that he vowed to address once in office. Clearly, a political campaign and public policies that ultimately emerge and get implemented might be different. We will continue to monitor how U.S. policy actions might impact China’s growth in 2017 and beyond. Some key questions regarding trade agreements and whether China will be named a currency manipulator will be important to watch as President-elect Trump assumes office. Also, President-elect Trump had a phone conversation with the President of Taiwan, which breaks historical precedent as China sees this island nation as its own sovereign land. The repercussions of this call with Taiwan are still unknown, but the break in historical norms is noteworthy as it relates to how the president-elect might operate foreign policy, particularly as it concerns China.

One of President-elect Trump’s early targets in his presidency is to remove the U.S. from the Trans-Pacific Partnership (TPP). China was not a part of this agreement, but it could step in and ramp up trade agreements with other Asian countries to try to expand its influence throughout the region as the U.S. pulls out of this trade deal. Trade developments and currency action could be acute headline risks that China faces in 2017. China’s currency has been depreciating in recent years and there might be pressure from the U.S. to stop this practice.



Source: Bloomberg as of 12/15/16. Price of \$1 in Chinese renminbi (yuan).

### Key Takeaway

China plays a key role in the global economy and specifically emerging markets. China is an important consumer of commodities and many emerging Asian countries sell into this country. Slower economic growth in China does not necessarily have an immediate negative effect on the U.S., but it could impact other countries more acutely. If the weeks following the presidential election are any indication, China seems to be a central focus for Trump. He feels China has operated with an unfair advantage when it comes to the United States and he has talked about addressing these issues once in office.

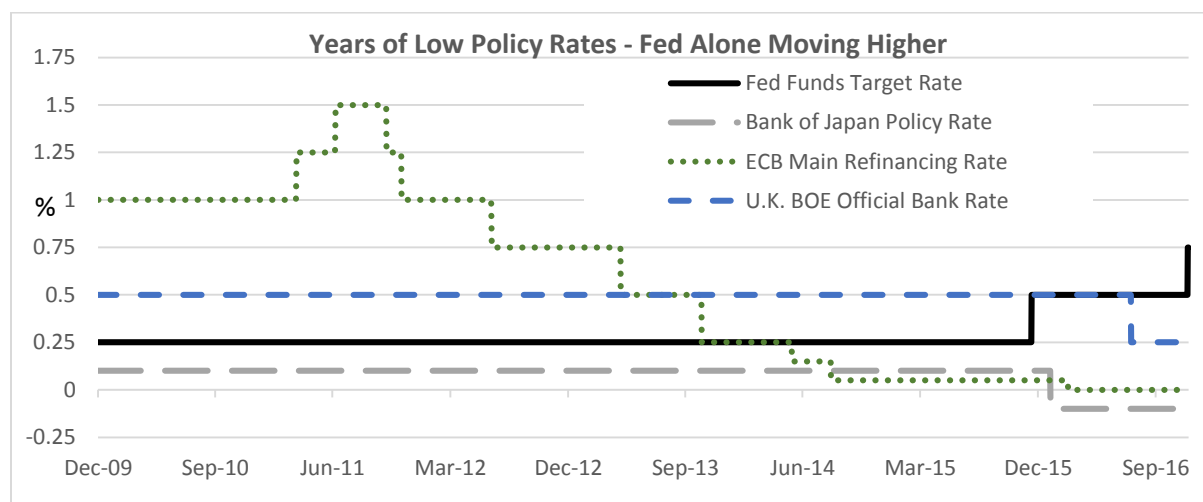
For investors, we think the development of Trump’s policies toward China will be another pocket of uncertainty and volatility in 2017. How China progresses in 2017 could have a direct impact on how the broader emerging market community progresses due to China’s important role with this group. In fact, emerging market equities were among the hardest hit of any asset class in the weeks following the victory by President-elect Trump. Overall, the global landscape seems more uncertain moving into 2017 due to political uncertainties in Europe and concerns about the future relationship with China.

## European Central Bank, Bank of Japan & Bank of England – Stimulus Continued in 2016

**2016 Recap** – The European Central Bank (ECB) continued to engage in its own quantitative easing (QE) program in 2016. Rising rates in the euro zone will be a concern for the ECB if it believes this could be a headwind to economic growth. As the U.S. has been slowly moving away from monetary stimulus over the last couple of years, other global central banks have continued to try to stimulate economic growth through expansionary monetary policy. The ECB has been engaged in a bond-buying program that was scheduled to end in March 2017, but at the ECB meeting in December, it was announced that some bond buying would remain in place throughout 2017, although the amount might slow.

The Bank of Japan continued to operate expansionary monetary policy as well in 2016 including a negative policy rate and bond and ETF buying to increase the monetary base. The Bank of England has maintained low policy rates and cut policy rates from 50 to 25 basis points following the unexpected Brexit vote. It seems evident that British policy makers were trying to cushion some of the unknown economic backlash that could result from the Brexit vote.

Key central banks including the Bank of England, the ECB and the Bank of Japan all cut policy rates in 2016. The U.S. was the clear outlier by raising policy rates in December 2015 and once again in December 2016 in contrast to the rest of the world. (We will discuss the Fed later in this piece.)



Source: Bloomberg as of 12/15/16. Federal Funds Target Rate Upper Bound; Bank of Japan Policy Rate Balance Rate; ECB Main Refinancing Operations Announcement Rate & UK Bank of England Official Bank Rate.

**2017 Expectations** – From an economic perspective, Europe has continued to be mired in slow growth, below-target inflation and high unemployment. The recent rise in interest rates, the Brexit negotiations, political uncertainty in Italy, and pending elections in France and Germany are additional factors that will likely keep the ECB favoring expansionary versus contractionary monetary policy moving into 2017. This will likely be a challenging year for ECB policy makers as they try to navigate political uncertainties, interest rates moving higher, and ongoing weak growth. The ECB has driven European bond yields down and has contributed to the odd circumstance of U.S. Treasury yields being higher than many countries in Europe, like France, Germany and Italy. It would be hard to argue that the U.S. is less credit worthy than these countries, but through monetary policy, the ECB has kept a lid on European rates and those countries sovereign bonds' yield less than U.S. Treasuries. Needless-to-say, central banks wield a lot of power through monetary policy.

The Bank of Japan continues to try to escape deflationary pressures and the Bank of England will likely focus on Brexit developments as it operates monetary policy in 2017. These two countries do not seem to be at a point where tighter monetary policy would be called for in the near future. The U.S. looks likely to stand apart from other global central banks in 2017 as the Fed treads down the path of higher policy rates. Overall, driven by the U.S., we think pressure will be on global rates to move higher in 2017, and, once again, the prospect of higher global rates might further add to capital market volatility in the new year.

### **Key Takeaway**

What do these global central bank dynamics mean for investors in 2017? Diverging central bank policies will add to capital market uncertainty after years of most central bankers following the same playbook of low policy rates and quantitative easing. In our opinion, one of the largest contributors to lower volatility levels in recent years has been the extraordinary expansionary monetary policies employed by central bankers. That period seems likely to be coming to an end in the years ahead. Ultimately, we believe the overall trend in global rates will be higher in 2017 led by the U.S. and this will contribute to elevated uncertainty and volatility in global capital markets in the coming year. Furthermore, as global central bank policies continue to diverge, we think there might be more differentiation among global asset class returns as well.

We believe portfolio diversification helps address a more uncertain and volatile capital market environment. Especially in the context of U.S. equity indices hitting all-time highs in the latter part of 2016, we believe a well-diversified portfolio including non-correlated assets might make what we expect to be a bumpier ride in 2017 more bearable. A broader perspective on asset classes, which could include some alternative assets and strategies, could further help address some of these uncertainties in the year ahead. We expect interest rates to rise and volatility to follow in 2017 and investors should be prepared for this potential investment climate.



## UNITED STATES EVENTS

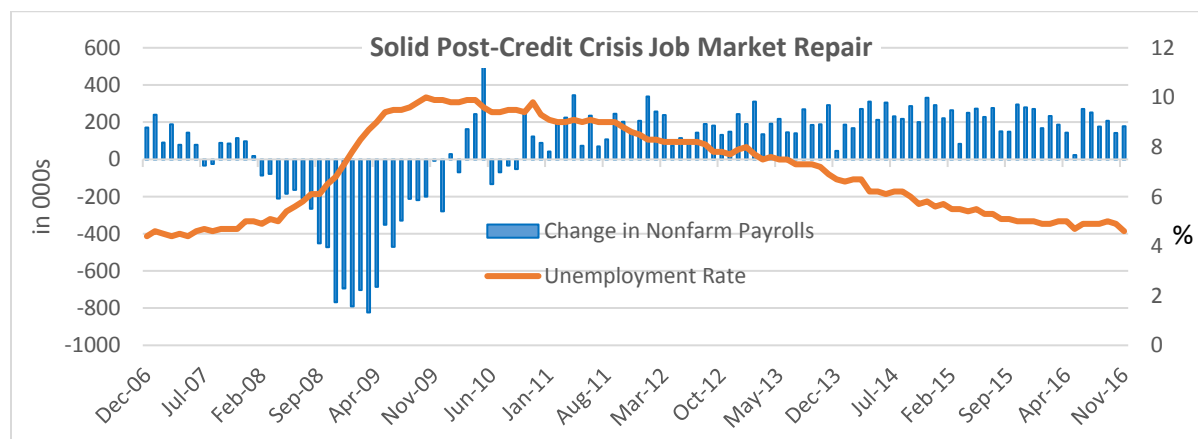
### Public Policy – Federal Reserve Stayed Cautious Raising Rates

**2016 Recap** – Following the first rate hike by the Federal Reserve (Fed) in almost a decade in December 2015, the discussion focused on how many more rate increases we would see in 2016. Most market observers would have likely been surprised to know that no additional rate hikes had occurred during the year until the final Federal Open Market Committee (FOMC) meeting of 2016 in December.

Although it appeared the Fed wanted to raise rates at various times during the year, policy makers kept erring on the side of caution by delaying more rate hikes. U.S. equity markets rallied to new all-time highs following the victory by President-elect Trump, and markets began to price in a near certainty that the FOMC would act at its mid-December meeting. As expected, the FOMC raised rates by 25 basis points to close out the year.

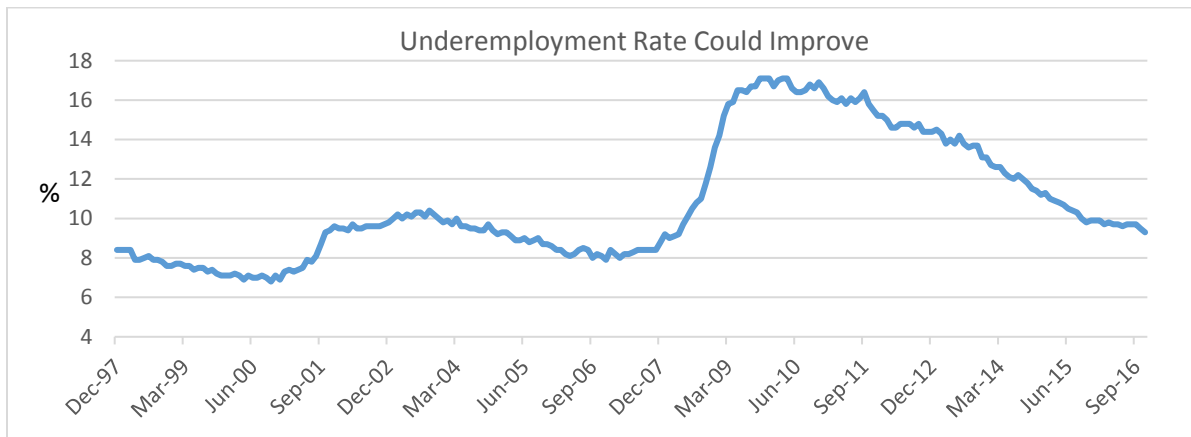
**2017 Expectation** – Fed policy has an important impact on capital markets and that will remain the case in the coming year. Currently, expectations are calling for higher policy rates in the new year with the Fed “dots” showing three potential rate hikes in 2017. President-elect Trump is expected to enact some fiscal spending initiatives on infrastructure projects in the coming year and this spending could be inflationary and add to U.S. debt. The Fed will need to monitor inflation expectations and any needed response after operating through a multi-year period of below target inflation levels.

The Fed operates under a dual mandate of full employment and price stability. The job market has clearly improved since the credit-crisis period with the unemployment rate dropping to 4.6% in November 2016, the lowest unemployment level since 2007. Furthermore, payroll additions remained solid throughout the first eleven months of 2016.



Source: Bloomberg as of 11/30/16. U.S. Employees on Nonfarm Payrolls Total month over month net change in 000s (left scale) & U-3 U.S. Unemployment Rate Total in Labor Force (right scale), both seasonally adjusted.

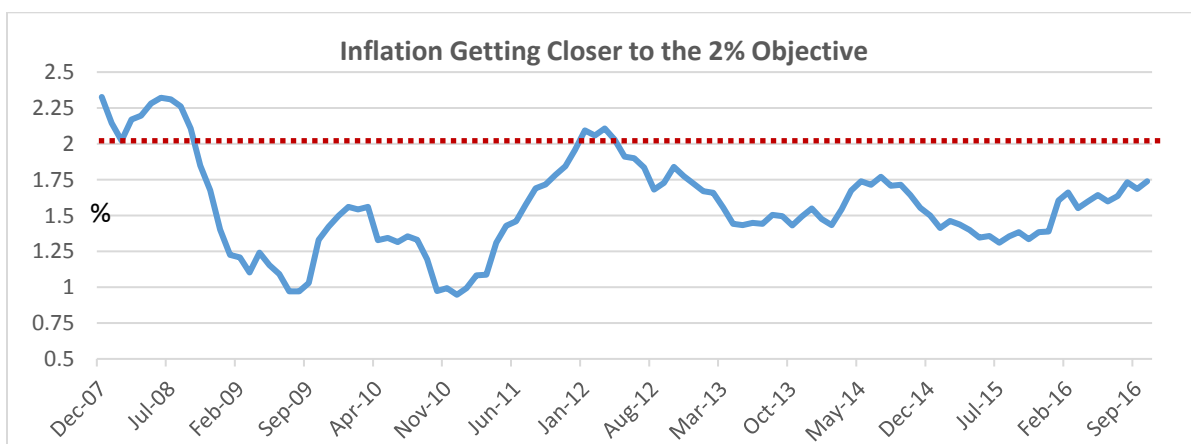
Although the pace of growth in the job market will likely slow in 2017 and the job market has clearly tightened in recent years, we believe improvements could continue in the new year. For example, an area like underemployment continued to remain elevated in 2016 and while improved, could be a source for more job gains in 2017. This underemployment rate reading accounts for part-time workers who want full-time jobs and discouraged workers who want to work, but have given up looking for a job.



Source: Bloomberg as of 11/30/16. U.S. U-6 Unemployed & Part Time & Marginally Attached as a % of Labor Force, seasonally adjusted.

This could be particularly true if President-elect Trump is successful in spurring stronger overall economic growth, ramping up infrastructure projects, and reinvigorating domestic manufacturing operations. All of this is yet to be seen, but the market seems to be pricing in some probability of these events happening under the new administration.

Price stability has been harder to achieve from the Fed's perspective. Most people think of price stability as inflation control, but that is only one side of the equation. The Fed targets an annual inflation level of about 2% and price level changes have been below this point in recent years. The Fed's preferred measure of inflation is the personal consumption expenditures (PCE) price index. On a core basis, the PCE price index increased in 2016, but remained below the goal of 2%. We think price level changes will continue to move higher in 2017.



Source: Bloomberg as of 10/31/16. U.S. Personal Consumption Expenditure Core Price Index, year over year % change, seasonally adjusted.

### Key Takeaway

The Fed talks about monitoring incoming economic data as it relates to making policy decisions. We expect that incoming data to be supportive of the Fed increasing policy rates in 2017. We believe the job market will make ongoing progress in 2017, but believe it will also naturally slow compared to recent years as the U.S. moves further away from the credit-crisis period. Consumer confidence readings were at or near multi-year highs in late 2016 and wage growth has been on an uptrend as well. These factors will all be important to monitor moving into the new year because strength in these areas could lead to more consumer spending – the driving force behind U.S. economic growth. We also anticipate that inflation levels will continue to climb, especially if wage growth accelerates. We expect this rise to be in an orderly fashion, but anticipate that the core PCE price index could get closer to 2% in 2017.

With this backdrop, we think the stage is set for more rate increases by the Fed in 2017. Once again, we think policy makers will be cautious when it comes to increasing rates, and they would rather err on the side of not raising rates versus raising them too quickly. However, we think the environment will be supportive of higher rates and the Fed will move more frequently in 2017 than it did in 2016. Inflation expectations could increase further in 2017 with infrastructure spending expected to accelerate. We think two or three rate hikes in 2017 is a reasonable expectation at this point, but ultimately the pace of rate hikes will depend on incoming economic data in the new year.

### U.S. Economy & Markets – A Year of Change Ahead

**2016 Recap** – Without much doubt, the incoming administration of President-elect Trump will have an impact on the market and the economy in 2017 and in the years to come. As just discussed, the Fed will also likely continue to shift away from expansionary policy to higher policy rates in the new year. These two important events from a public policy perspective will lead to a year of change in U.S. markets and the U.S. economy in 2017.

In the short run following the election, markets reacted with optimism that more spending, and less regulation and taxes, would benefit companies. The major U.S. stock indices – the Dow Jones Industrial Average, S&P 500 Index, NASDAQ Composite and the Russell 2000 Index – hit all-time highs, but small caps, as measured by the Russell 2000 were the clear standout following the election. (All tables show returns year to date through November 8, performance following the election from November 8 through December 15, and year-to-date returns through December 15, 2016.)

Small-cap companies tend to be more domestically focused, so some of the pending trade uncertainties likely impacted these companies less so than their large-cap counterparts. Needless-to-say, U.S. equities responded to the Trump victory in a positive manner.

	YTD as of	11/8/16 -	YTD as of
	11/8/2016	12/15/2016	12/15/2016
U.S. Equity Index Returns			
S&P 500	6.7%	6.0%	13.0%
Russell 2000	6.5%	14.5%	22.0%
NASDAQ Comp.	4.9%	5.3%	10.4%
Dow Jones	7.7%	8.7%	17.0%
Russell 3K Growth	3.9%	4.4%	8.6%
Russell 3K Value	9.3%	9.1%	19.3%

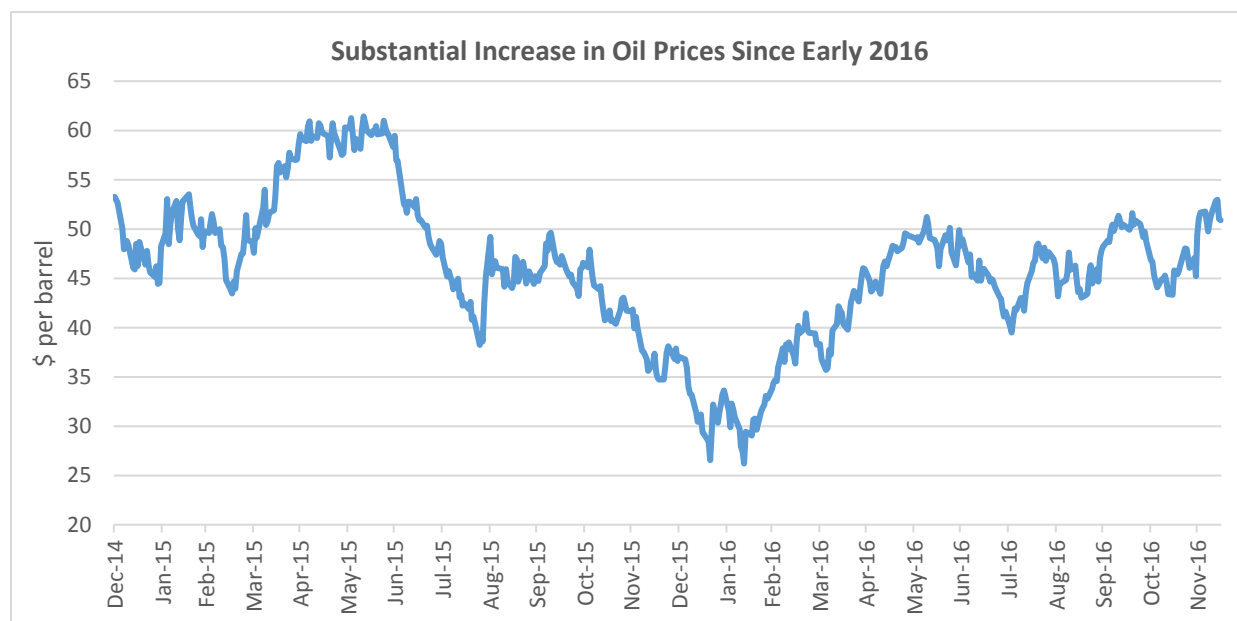
Source: Bloomberg as of 12/15/16. Total return.

Anticipation of a more positive business environment with less regulation, lower taxes and increased infrastructure spending drove certain stock sectors higher in the weeks following the election. There was noteworthy dispersion among stock sector results following the election. In particular, financials, telecom services, materials, and industrials showed strong gains. The areas that came under pressure were the more interest rate sensitive sectors including utilities and real estate as interest rates rose dramatically after President-elect Trump's victory.

	YTD as of 11/8/2016	11/8/16 - 12/15/2016	YTD as of 12/15/2016
Energy	16.9%	10.1%	28.6%
Financials	5.1%	18.4%	24.5%
Telecom Services	9.4%	10.2%	20.5%
Industrials	10.6%	8.2%	19.6%
Materials	10.2%	7.8%	18.8%
Info. Technology	12.5%	3.0%	15.8%
Utilities	16.5%	-1.8%	14.4%
Cons. Discretionary	2.1%	6.0%	8.3%
Cons. Staples	6.6%	-1.1%	5.5%
Real Estate	-0.9%	-0.3%	-1.2%
Health Care	-3.9%	2.2%	-1.8%
<b>S&amp;P 500 Index</b>	6.7%	6.0%	13.0%

Source: Bloomberg as of 12/15/16. Total return.

Utilities went from one of the best performing sectors in the first ten-plus months of the year to the bottom half of the table after the election. Utilities are sensitive to interest rates and this sector clearly struggled as rates rose post-election. Financials got a boost post-election, likely driven by the belief that the regulatory environment will be less burdensome under a Trump administration. That factor also favored energy companies, which got an additional boost from a surprise OPEC announcement on the last day of November, that this organization had agreed to oil production cuts. This boosted oil prices higher and they hit their highest level in December since the summer of 2015. While it is hard to predict where the price of oil will go in 2017, it seems unlikely in our opinion that the lows from the beginning of 2016 will be revisited in the new year and a higher base has likely been put in place.



Source: Bloomberg as of 12/15/16. Generic Oil Futures contract, \$ per barrel.

Results were more varied for international equities. Emerging markets were particularly hard hit after the election due in part to higher interest rates and potential concerns around the pending global trade environment. Developed international equity markets were impacted in large part by the rise of the U.S. dollar post-election. Higher interest rates and expectations of a more aggressive Fed in 2017 led to one measure of the U.S. dollar hitting a more than decade high. This measure compares the dollar against a basket of global currencies, both developed and emerging markets, and goes back to the end of 2004. It hit its highest level in December since the tracking of this index began and under the current global monetary policy environment, dollar strength will likely stay elevated.

	YTD as of 11/8/2016	11/8/16 - 12/15/2016	YTD as of 12/15/2016
<b>Developed (\$)</b>			
MSCI EAFE	-0.6%	0.9%	0.3%
MSCI Europe (x. U.K.)	-2.5%	0.7%	-1.8%
<b>Developed (local)</b>			
MSCI EAFE	-1.5%	7.1%	5.5%
MSCI Europe (x. U.K.)	-3.9%	6.6%	2.4%
<b>Emerging (\$)</b>			
MSCI Emerg. Mkts.	16.3%	-4.8%	10.8%
<b>Emerging (local)</b>			
MSCI Emerg. Mkts.	11.9%	-2.3%	9.4%

Source: Bloomberg as of 12/15/16. Gross total return on a U.S.-dollar and local-currency basis as noted.

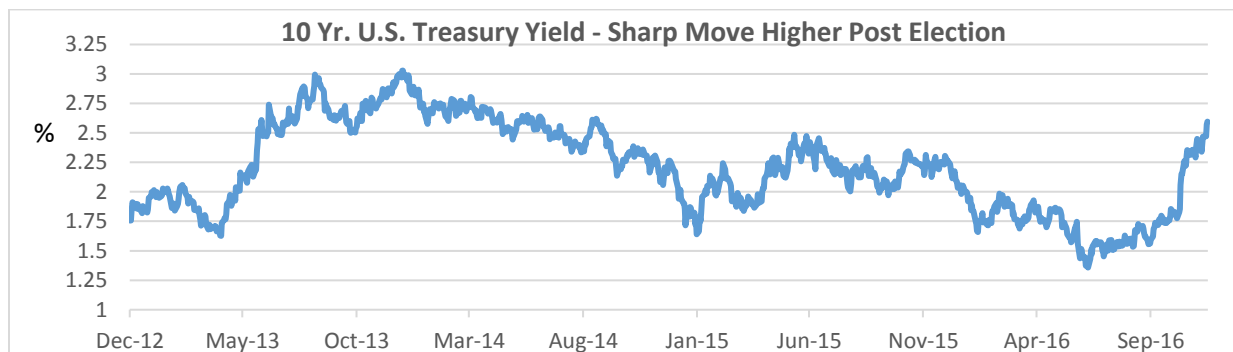


Source: Bloomberg as of 12/15/16. Bloomberg Dollar Spot Index. Includes both developed and emerging market currencies in a basket compared to the U.S. dollar.

As stocks rallied post-election, bonds struggled and rates increased due in part to the assumption that spending might be inflationary and more debt might be needed to pay for these projects. Rate-sensitive U.S. Treasuries were among the hardest hit pockets in fixed income post-election as rates rose. The yield on the 10-year U.S. Treasury is a key measure of interest rates and it moved from about 1.83% at the end of October to around 2.6% by December 15 – a more than 75 basis point increase. Clearly, this sharp rise in interest rates had a negative impact on bond prices and erased some of the gains from fixed income over the first ten-plus months of the year.

	YTD as of 11/8/2016	11/8/16 - 12/15/2016	YTD as of 12/15/2016
Bloomberg Barclays U.S. Agg.	4.9%	-3.1%	1.6%
Bloomberg Barclays U.S. Treasury	3.8%	-3.4%	0.2%
Bloomberg Barclays U.S. Corporate	8.1%	-3.1%	4.7%
Bloomberg Barclays U.S. High Yield	15.1%	1.2%	16.5%
Bloomberg Barclays EM USD Agg.	12.3%	-3.2%	8.8%

Source: Bloomberg as of 12/15/16. Total return.



Source: Bloomberg as of 12/15/16. U.S. Generic Gov't 10-Year Yield.

**2017 Expectation** – One expectation we have for 2017 is that interest rates will continue their climb higher, but the ride will likely be a bumpy one for investors. A fair question to ask moving into 2017 is whether rates have increased too much too quickly following the election. This is especially important considering similarly-dated sovereign bonds in many other countries remained well below U.S. Treasury rates as year-end approached. The yield on the 10-year U.S. Treasury is at its highest level since 2014 and with global rates still low, demand could rise for U.S. bonds in the near term (further supporting U.S. dollar strength). If that is the case, fixed income markets could be choppy at the outset of the year.

Similar to the observation of the sharp move higher in interest rates post-election, the same question could be asked for U.S. equity markets. Have equities rallied too sharply based on expected policy outcomes that have yet to be formalized, much less implemented? This question is almost impossible to answer, but again, we believe it will lead to a more volatile equity market environment entering 2017.

### Key Takeaways

As rates grind higher in 2017 with the Fed becoming less accommodative, we think we will be entering a challenging time for bonds and a period of higher overall capital market volatility. Major U.S. stock indices hit new all-time highs late in 2016. With stocks hitting new highs, valuations have increased as well. If earnings do pick up moving forward, then an argument can be made that the current increase in stock prices is reflecting that expectation. Therefore, it will be important to monitor how businesses react in the coming quarters and whether they can grow earnings to justify higher P/E multiples. (At this point, the “P” or Price has gone up in anticipation that the “E” or Earnings will follow.)

The general perception in the market is that Trump will create a more business-friendly environment, but these policies have yet to be finalized or implemented. However, there have also been some public comments from Trump about specific businesses considering moving jobs out of the U.S. or charging the government too much money on certain projects. While these comments are understandable based on President-elect Trump’s election platform, this news can be a headwind to certain businesses or industries as well. Fiscal policy efforts (government spending and lower taxes) look like they will take over some of the heavy lifting of economic stimulus from central banks in the coming years.

## SUMMARY

The stock market rally post-election anticipates a lot of positives coming into the U.S. economy moving forward. The key will be whether these expectations are realized or whether some disappointments occur along the way. We will watch these dynamics closely because U.S. markets near all-time highs and elevated valuations give little room for error. We think the Fed compounds this period of higher volatility as increasing policy rates will likely be the course of action in 2017. The market has not operated under any sort of tighter monetary conditions in several years, so we believe it will take some time for capital markets to adjust to higher rates.

Ultimately, we remain positive on the U.S. economy moving into 2017 and believe the U.S. will continue to grow during the coming year. We think the risk for a recession in the U.S. is low and economic fundamentals look supportive of ongoing economic expansion. Furthermore, we expect public policy will be more business friendly with lower taxes and less regulation, which could boost growth at a faster rate than we have experienced in recent years. If businesses can grow revenues and earnings at a stronger pace, that would likely be supportive of equity markets. We will need to monitor whether this good news is already reflected in the stock market or whether a better environment develops that continues to support further stock appreciation. We think it will be unlikely to see more valuation expansion and equity market progress will need to be driven by earnings growth. We will monitor earnings in 2017 as a guide to where stocks might go under the assumption that valuations will not expand. The impact of dollar strength will also be important to watch due to the effect it might have on company earnings.

Bonds will likely face the headwind of higher rates in 2017, which we think could be a multi-year theme. This will pose a challenging environment for fixed income as rates move higher. We believe volatility, which has been subdued in recent years due in part to extraordinary expansionary monetary policy, will pick up in 2017 as the Fed moves further down the path of higher policy rates. It is important to note that while the Fed is moving down this path of higher rates, we are starting from a very low point and rates will remain low from a historical perspective even with a few rate hikes in 2017.

As we stated at the outset of this report, this is both a challenging and an interesting time moving into 2017. We think the key themes for the year point to elevated uncertainties and higher capital market volatility in 2017. Greater dispersion in asset class returns could increase as well. We think interest rates will continue to grind upward in 2017, but that path will likely be choppy. Also, as the Fed tightens while the rest of the world continues with easy monetary policy, U.S. dollar strength will likely remain elevated in the new year. We believe diversification among a wide variety of non-correlated asset classes, which could include some alternative assets and strategies, might help address what we expect to be a more volatile capital market environment in 2017.



## DISCLOSURES

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