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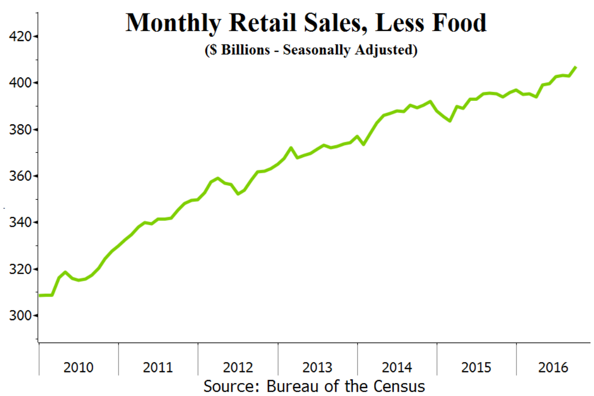
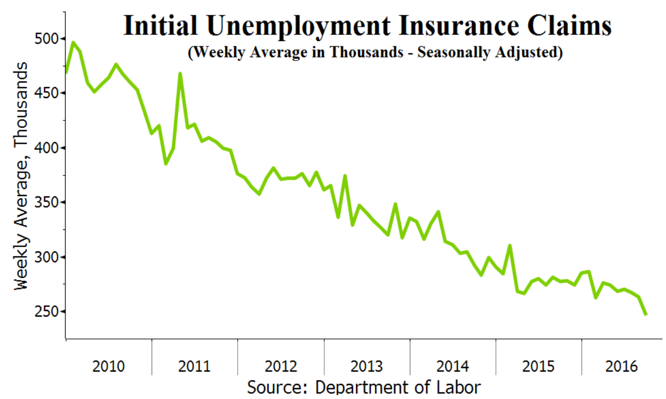
CLIENT BULLETIN: 2016 Review—2017 Outlook

Economic Overview: Late cycle economy still has legs in 2017.

The economy completed yet another period of moderate growth in 2016, with US GDP advancing by about 1.6% for the full year. Consumer spending was once again the workhorse, as job and wage gains led to improving consumer confidence and the willingness to spend. Auto sales stayed firm, while single-family housing starts grew by about 9%. Business spending did not grow in 2016 as budgets remained tight pending the outcome of the presidential election. The economy grew faster in the second half of 2016 versus the first half, offering hope for a stronger 2017.





At present, we expect GDP growth of around 2% in 2017 on the continued strength of housing and the consumer. We also expect a pickup in business spending for 2017. However, this year, the US economy will be facing some crosscurrents that could materially impact the economy. The positive repercussions of potential tax cuts and fiscal spending could be offset by the negative effects of Federal Reserve interest rate increases and a stronger dollar. Higher rates could curb housing by forcing homebuyers to buy a less expensive home and/or reduce spending in other areas. A stronger dollar hurts exports as US products will become more expensive to overseas buyers.

<u>Monetary Policy:</u> Policy normalization in 2017? The Federal Reserve raised the federal funds rate by 0.25% in December, 2015 and by another 0.25% in December, 2016. Since the most recent hike, the yield curve (2yr-10yr US Treasury) has steepened to about 1.3%, indicating the economy can handle the recent interest rate increase. The Fed hopes to raise this rate another 3 times in 2017 and "normalize" interest rates back to historical levels. The LIBOR rate, which is the rate many global companies use to borrow, recently moved above 1%, a level not seen since 2009. Hopefully, this is a sign that global economies are starting to strengthen.

<u>Fiscal Policy:</u> Tax cuts one of the top priorities. The incoming Presidential administration wants to revamp the tax code. The House of Representatives also has a plan to change the tax code. Here are some of the highlights where the two plans agree regarding individual taxpayers:

- Reducing the top federal tax bracket to 33% from 39.6% and do away with the alternative minimum tax.
- Eliminate the 3.8% Medicare surcharge on investment income for high-income taxpayers.
- Itemized deductions would be reduced, with both plans keeping deductions for mortgage interest and charitable donations.
- The estate tax would be repealed.
- The capital gains rate may be lowered to a range of around 16%-20%.
- Both plans offer other tax savings that should be a big benefit to small business owners.

At the corporate level, the plan is to cut the tax rate to 15% from 35%, and to offer a cash repatriation holiday to US corporations on the $1.3 trillion that is being kept overseas to avoid the 35% tax. The one-time rate would be 10%.

In addition, the new Administration wants to ramp up spending on the nation's infrastructure, while incentivizing US oil and natural gas companies to drill and produce more domestic energy. Finally, the new Administration wants to renegotiate trade deals and bring jobs back home. All of these measures are decidedly pro-growth, benefitting the stock market while negatively impacting the bond market. Of course, these measures have to be approved by Congress. Some lawmakers are concerned the federal deficit will continue to grow if these tax cuts are implemented and may place roadblocks to getting these measures passed.

<u>Fixed Income:</u> Bonds still an important asset class.
Since the election of Donald Trump bond prices have declined and interest rates have risen. It seems you can't read a newspaper or watch a business channel without someone telling you that bonds are a bad investment.

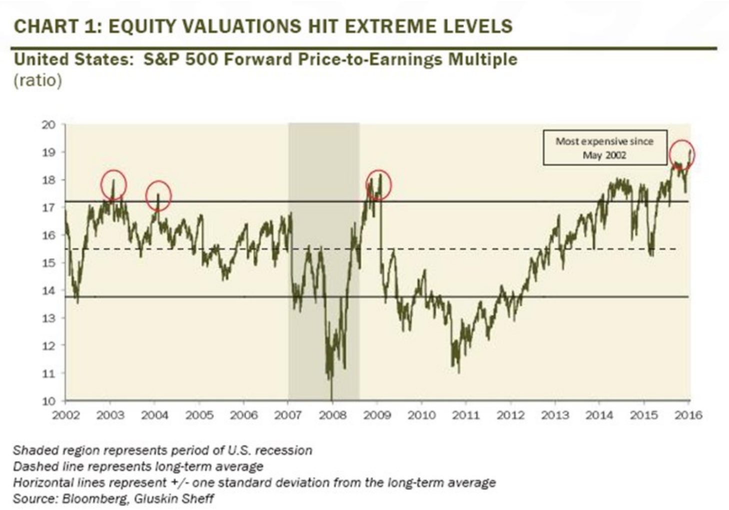
Well, that's not necessarily true. First, bonds are an important part of asset allocation along with stocks and cash. Second, when you buy a bond you collect a coupon for a number of years and then *(this part is important)* you get your money back when the bond matures, assuming the bond was bought at or below $100. If interest rates have risen, you can re-invest the principal from your maturing bond into another bond that is paying a higher rate. There have been periods in history where stocks drop 20% or more in a short period of time and prices don't recover for years. Bonds, on the other hand, can lose you "purchasing power" due to inflation, but in nominal terms, should never lose your principal as long as you hold them to maturity.

While we expect fixed income returns to be more muted in 2017, they should still be part of a diversified portfolio. We have shortened our duration, or "interest rate sensitivity" in most portfolios, mitigating the potential for short-term price declines if interest rates continue to rise.

<u>Equity Markets:</u> Active management to shine in 2017?
The S&P 500 rallied strongly after the Presidential election and finished the year up double digits. About half of the gain for the year occurred in the final seven weeks of 2016 and is another example of why market-timing is so difficult. At present, the stock market is expensive based on forward price-to-earnings ratios. In fact, the market has not been this expensive since May, 2002. It should be noted, though, that the S&P 500 continued higher from 2002-2007 on the back of strong earnings growth. The US needs a similar scenario this time around. Without a pick-up in earnings, the stock market as a whole will have difficulty making much headway next year. However, the stock market is a market of stocks, and opportunities exist in financials, health care, and consumer staples. The health care and consumer staples areas provide recurring cash flows, less sensitivity to economic conditions, and higher dividend yields.

<u>Financial Market Scoreboard</u>
<u>Calendar 2016 Total Returns</u>

<u>Equity Indices</u>	
S & P 500:	+11.9%
Dow Jones:	+16.5%
Nasdaq Composite:	+9.0%
<u>Fixed Income Indices</u>	
Long Term Treasury ETF:	+1.2%
Barclay's Govt/Credit:	+3.1%

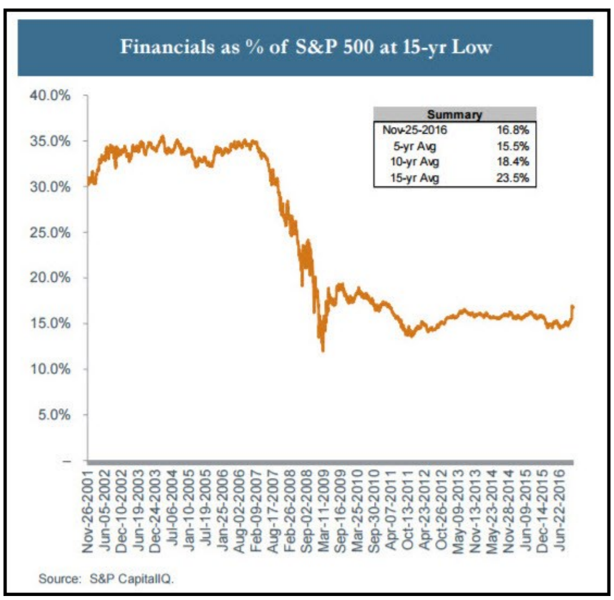


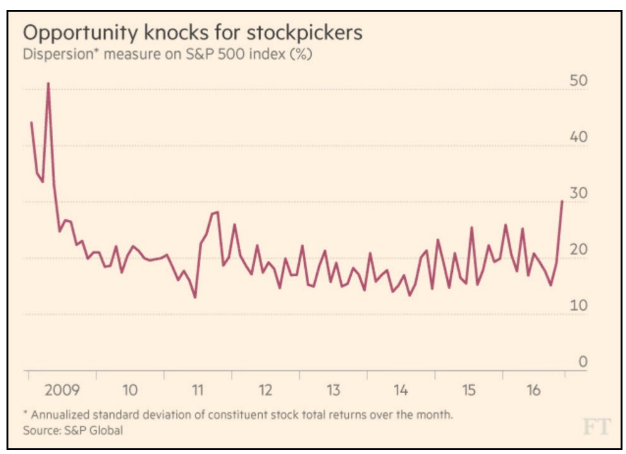
<u>Investment Outlook:</u> Select equities should shine in 2017.

We were pleasantly surprised by the above-average returns generated in the domestic markets in 2016. We can only hope for the same in 2017, but that may be too optimistic. The Federal Reserve policy of gradual interest rate increases should keep Treasury returns in check. Short and intermediate-term corporate bonds should hold their values as long as the economy remains on track. A low single digit return should be all that is expected this year.

Equities appear to be the asset class that offers the most opportunity in 2017. Much has been written about the rise of Exchange Traded Funds (ETFs) and indexing. Active managers have performed poorly in recent years as the correlation among stock returns across all sectors and industries was very tight. That began to change as correlations declined in the second half of 2016 and we expect low correlations to continue in 2017. This should provide an opportunity for active managers to beat their benchmarks.

One sector that we find attractive is financials. Financials as a percentage of the S&P 500 hit a 15 year low in late 2016. The fallout from the 2008 recession led to greater regulations and capital requirements on financial institutions. In addition, extremely low interest rates restricted their ability to grow earnings. As a result, financial services stocks traded at the lowest price-to-earnings and price-to-book ratios of any sector in the S&P 500. Since the Presidential election, there is optimism that regulations will be rolled back and pro-growth policies will lead to higher interest rates. Both outcomes would go a long way to accelerating earnings growth for financial institutions. Coupled with low valuations, and the possibility of strong dividend growth, this sector could do very well in 2017. We added to this area in the fourth quarter, 2016 and expect to look to increase exposure again as opportunities arise.





<u>Administrative:</u> As required by SEC regulations, Cypress Capital is providing its Privacy Policy for 2016.

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