INVESTMENT OUTLOOK FIRST QUARTER 2017

The Year in Review and the Year Ahead

		Total Returns	
	Close 12/30/16	4th Quarter	2016
Standard & Poor's 500 Index	2238	+3.82%	+11.96%
Dow Jones Industrial Average	19762	+7.94%	+13.42%
NASDAQ Composite Index	5383	+1.66%	+8.87%
Dow Jones Global (ex U.S.)	213	-1.92%	+1.78%
Barclays Aggregate Bond Index	2610	-2.98%	+2.65%

Investors reacted strongly to the November election results. The stock market shot up and bond prices sank. Seemingly overnight investors became more positive on stocks and more negative on bonds. The more positive view assumes the new administration would be ultra-pro-business by reducing corporate tax rates, increasing infrastructure spending and rolling back regulations. Bond investors feared an increase in deficits and higher inflation. We will see if this pattern holds post the January inauguration. Beyond the political hubbub and policy question marks, investors will spend the new year tracking key economic trends, movement in interest rates and the valuation of stocks. All of these issues will affect investor sentiment and market prices.

The "Big Picture"

Global Economic Outlook. Financial markets will be **most focused on economic and political trends in the U.S. and China** as these two huge economies are the ones most likely to alter overall global growth. The central issues are: will the U.S. economy finally accelerate and to what extent will China slow?

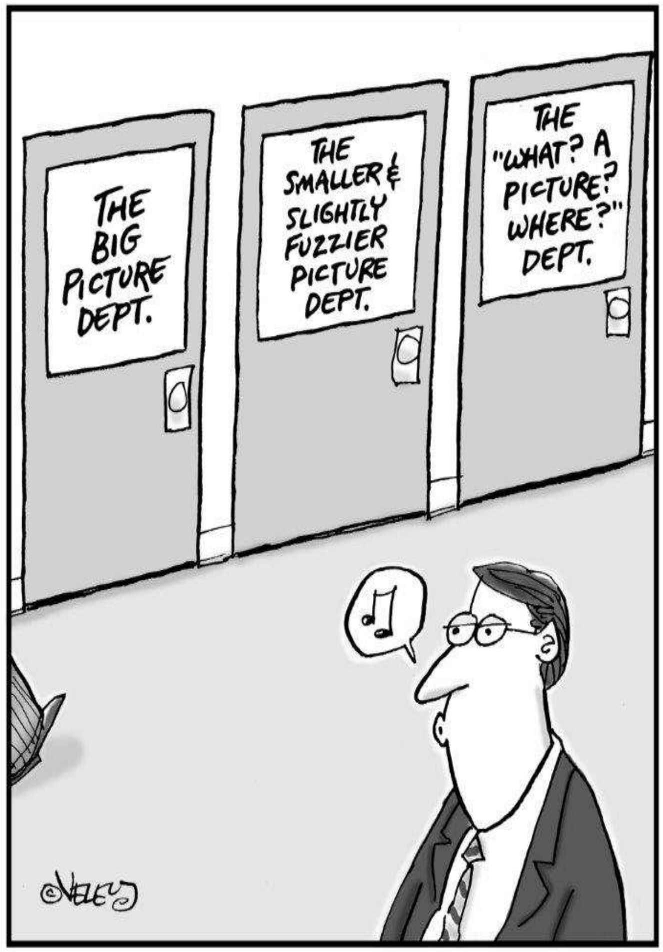
- The U.S. recovery from the sharp recession in 2008 has been sluggish and prolonged by historical standards. The road to faster growth in 2017 and 2018 will depend on the following factors:
  - The timely implementation of a cut in corporate taxes that would improve earnings and allow companies to repatriate foreign deposits at low tax rates.
  - An increase in capital spending as a result of the repatriation of overseas cash.
  - A reduction in personal tax rates and small business tax rates that would bolster spending.
  - An increase in bank business and consumer lending as a result of better interest rate spreads.
- China's economy has been slowing for years. A more serious decline could occur for the following reasons:
  - There is a continued exodus of money from China in search of safer homes.
  - Rising trade tensions between the U.S. and China that could result in damaging trade tariffs and sanctions.

We would place our odds that growth in the U.S. surprises on the upside over the next two years and China's growth proves to be disappointing. Other major developed economies, such as Europe and Japan, are unlikely to break out of their modest growth pattern in either direction. However, the French and German elections are sure to keep markets on pins and needles. **The bottom line is that we expect modest global growth to be sustained through next year with markets more heavily influenced than normal by political outcomes.**

Interest Rates. Rates have moved up post the election, primarily due to the expectation of greater federal spending, less emphasis on deficits and some upward pressure on key inflation metrics, such as wages. Over the last several years the Federal Reserve ("Fed") has promised more rate increases than it has delivered. Once again financial markets are expecting fewer rate increases in 2017 than the Fed is projecting. **This may be the year the Fed actually follows its own guidance and raises rates more than once.** Can the Fed really remain so cautious in the light of strong employment levels, rising wage costs and higher stock and real estate values? Low rates have been the ballast for stocks for many years. We expect fixed income yields to slowly become more competitive with dividend yields.

Valuations. It is highly probable that the 35 year bull market in bonds ended with the November elections. The prices of stocks have been helped by these low bond yields as well as modest gains in earnings over the past few years. **We do not see broad based excessive valuations in the stock market.** There has been a rolling multiyear correction in the most richly priced sectors of the market. Last year, for example, investors took the high flying biotechnology sector to the woodshed. In prior years we saw similar valuation markdowns in high growth consumer sectors and many pockets of technology. Growth stocks significantly underperformed value stocks in 2016 reflecting greater emphasis by investors on lower valued segments of the market. The Russell 1000 Growth Index was up +7% in 2016 compared to a gain of +17% for the Russell 1000 Value Index, which is a healthy sign that investors are not ignoring valuations.

Investor Sentiment/Psychology. The big mood swings since the election -- greater optimism on stocks/more pessimism on bonds -- will confront legislative reality very soon. We think the odds favor that this optimism will eventually win the day in 2017. With elections in France and Germany coming up in 2017 as well, investors will once again have a chance to digest hard to predict political outcomes.



Financial markets have to continually make assessments on an uncertain future, whether they are earnings results, election results or economic numbers. Surprises obviously result in volatility. **Uncertainty and volatility go with the territory. We expect 2017 to have its share -- no more and no less -- of surprises and volatility.** As we have emphasized in past *Outlooks*, it is part of the job to anticipate future scenarios, but equally important to react to new, hard information -- especially surprises.

Beneath the "Big Picture"

Although equity investors have adopted a more optimistic view since the election, specific investment decisions must be weighed against what is happening competitively in various industries and companies. The fastest growing industries, such as technology and health care, are rife with competition. The technology sector, in particular, has been fertile territory for new competitors to supplant prior leaders. We can see how Facebook and Alphabet (aka Google) have leapfrogged the likes of Oracle, Intel, and Cisco. It is highly likely that we will see some fast growing private technology companies go public in 2017. Companies such as Uber, Snap, and Airbnb could be public before the year is out. In health care, we also see effects of intense, new product competition. Gilead Sciences, for example, was the first to market a miracle drug that actually cures hepatitis C. It generates over $10 billion in annual sales. Unfortunately, two other competitors are also now in the market and despite gaining only a fraction of Gilead's market share, Gilead's stock lost a quarter of its value in 2016.

More mature sectors have also seen the impact of new entrants. The media sector has been disrupted by new programming competitors, such as Netflix. New ways to distribute programming over the internet have affected many cable based mainstays, such as Disney's very profitable ESPN business. Brick and mortar retailers are bewildered by Amazon's online forays. Just this month, Macy's, the largest department store in the country, announced additional store closings and some 10,000 layoffs as consumers continue to do more buying online. So with a "big picture" view that the market is unlikely to experience a significant correction, our investment focus remains on avoiding areas under competitive attack, and emphasizing areas that are positioned for open ended opportunities.

Happy New Year!

Bob Milnamow
President and
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January 2017

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