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FINANCIAL

IS THE ECONOMY IN FOCUS?

Market Review **November 2016**

The US economy has been in a slow growth mode over the course of 2016, and we expect that to continue. The labor market has experienced some improvements, namely unemployment and job growth, which has resulted in a rise of household income growth. Ultimately, this has been driving consumption which has been the primary driver of the economic growth that we've experienced, relative to the other growth sources such as investment, government spending, and exports.

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An overarching expectation of slow economic growth is one of the key explanations for the low yield environment. Investment yields and returns are likely to be low over the next several years. Further, this is a global condition, which investors need to prepare for in their financial plans. The duration of our low rate environment combined with the fact that inflation remains below target, indicates the limitations of monetary policy and central banks. Especially when you consider the unconventional policies introduced such as quantitative easing and negative interest rates. Fiscal policy (tax rates, government spending, etc.) may now be used to kick start an inflationary trend. This contributes to the high stakes of the fast-approaching presidential elections.

When will the Federal Reserve raise rates? In September, the Fed was very direct regarding the nearness of a rate change. The Fed is seemingly pleased with the economic progress and it also appears that more members of the Fed are getting on board with raising rates. However, it did reduce the number of projected rate increases to two in 2017, and three in 2018 (as opposed to four). It is noteworthy that the long-term equilibrium target rate is now just under 3%, rather than the 4.5% number stated a couple of years ago. Hopefully, if expectations are for a steadier rate increase, we won't see the kind of negative market reaction that we encountered in January of this year.

Although there is virtually limitless flexibility in monetary and fiscal policy, the concern is the ramifications on the financial markets, causing dislocations. Specifically, the prolonged low rate environment impacts bonds, but also stocks. Low rates have effectively propped up stock prices. Generally, stocks trade at higher prices when yields are low. However, as low rates move even lower, this relationship breaks down and stocks tend to fall in value. This indicates that low rates can lose their power to drive stock prices higher, which we feel is happening today. We also receive regular questions on the impact of rising rates on bond-related assets. We're most pessimistic on the traditional, core bond asset classes because we feel there is limited upside but meaningful downside. It just may not be worth the risk.

Although inflation remains low, services inflation has been higher than goods inflation. Recent trends, namely low oil prices and a strong dollar, have suppressed goods inflation (this has pushed down the price of imported goods). These forces are not necessarily sustainable and therefore we expect to see a rise in core inflation. As these trends shift, it has become increasingly important to now consider the use of inflation protected assets, such as treasury inflation protected securities (TIPS). The price of TIPS has factored in low inflation, and as inflation rises, may create opportunity in this specific asset class.

Low rates and potentially rising inflation are hot topics but not compared to the presidential elections. The 2016 election campaign is unquestionably unique, but the dynamics are not. Corporate tax reform and increased infrastructure spending seem to have some degree of bipartisan support, which will surely impact economic growth. Free trade and immigration are also key topics that will impact the dynamics of our global economy. Historically, the stock markets haven't necessarily exhibited differing returns based on which party takes office. Will this election be different?

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Market Movers

Generally, the global markets pulled back in October. Anticipation of rising rates, persistently low inflation, or the upcoming presidential elections seem to be causing investors to move out of higher risk assets. Regardless, select investments provided shelter in the midst of this uncertainty. Our diversified, Core Allocation portfolios retreated slightly in October, with the lower risk allocations losing less than the higher risk allocations. Since the beginning of the year and over the prior 12 months, the Core Allocation portfolios are well into positive return territory and have performed nicely relative to Morningstar's World Allocation and Tactical Allocation category averages.

Asset Categories	*Oct 2016*	*YTD*
US STOCKS	-3.00%	6.10%
FOREIGN STOCKS	-1.52%	7.97%
US BONDS	-0.03%	5.70%
FOREIGN BONDS	-1.12%	14.57%
HARD ASSETS	-5.46%	10.95%
HYBRIDS	-0.95%	6.58%

*DATA USED IS SOURCED FROM MORNINGSTAR®

US STOCKS were down roughly double that of Foreign Stocks. Small Caps (VB) were the major driver of these losses, with Mid Caps (VO) close behind. Our increased Large Cap (IVV) allocation provided important risk management in our US Stock allocation. Although US Stock markets have performed exceptionally well over the past five years, we remain cautiously optimistic in the near term due to the relative attractiveness of other assets.

Although **FOREIGN STOCKS** dropped in value during the month of October, they displayed resiliency. Developed Large Caps (VEA) and International Small/Mid Caps (VSS) were in the red but Emerging Markets Stocks (VWO) ended in positive territory. Year-to-date, Foreign Stocks have outpaced US Stocks.

US BONDS were generally flat in October, with High Yield Bonds (SJNK) and Bank Loans (BKLN) providing the much needed positive returns. Surprisingly, these are the higher risk US Bond sectors. Our large allocation to these assets have served our investors well over the last year by providing substantial outperformance relative to higher quality US Bond sectors.

Our stance of allocating the **FOREIGN BOND** exposure to emerging markets has been a major driver of our portfolio performance over the last year. This has resulted in making Foreign Bonds our strongest asset category over the year-to-date and trailing 12 month time periods. This category pulled back slightly in the month of October.

HARD ASSETS were the worst performers during the last month, with Precious Metals (GLTR), Master Limited Partnerships (AMJ), and Global Real Estate (RWO) losing value. Yet, since the beginning of the year, these assets have generated very attractive returns. We feel these diversifying investments will be critically important as uncertainty mounts ahead of the presidential election.

Although HYBRIDS are generally thought of as lower risk relative to equities, these assets have outpaced global stocks over the trailing 12-months. Preferred Stock (PFF) and Convertible Debt (CWB) pulled back slightly in October but offer attractive investment characteristics considering the current interest rate environment.