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Portfolio Comments
For the Quarter Ending December 31, 2016

Harlan Ellison, a prolific American writer of our time once admonished: "You are not entitled to your opinion. You are entitled to your informed opinion." The last quarter of 2016 provided a stark reminder that even so-called informed opinions can prove spectacularly wrong when almost every pollster and respected media outlet failed to accurately predict the outcome of the U.S. Presidential election. It was in the small hours of November 9th, 2016 that Donald Trump achieved the threshold 270 electoral-college votes and in an outcome that many, right up until the votes were counted, viewed as stranger than fiction the Republican property tycoon, who takes pride in his ruthlessness and ability to drive a hard bargain, became our country's President-elect.

It was increasingly clear as the campaigns drew to a close that a large faction of voters were clamoring for change, with the end result underlining a majority call for a change of regime, not just a change of party. Mr. Trump's victory largely came down to an umbrella rallying cry that he believed America needs fixing and he is the man to take on a job that the incumbents – with Hillary Clinton touted as more of the same – were incapable of getting done. In particular, the working and middle class, who felt disenfranchised by what they view as an unfair economic system run by elites in Washington, responded to the cry, translating this popular anger into votes. Furthermore, despite expectations to the contrary, U.S. markets reacted favorably to this outcome.

After a rocky start to the year as well as summer and pre-election dips, the S&P 500 fared well for the past 12 months closing on December 30th at 2,239 representing a return of 3.83% for the final quarter of 2016 and achieving a gain of 11.98% for the year. Comparatively, The Dow Jones Industrial Average (DJIA) ended December at 19,763 for a return of 8.66% in the past three months and 16.51% for 2016. In the wake of the so-called Trump rally that has sent domestic stock markets on an upward trajectory post-election, both indices hit record closing highs in December of 2,272 for the S&P and 19,975 for the Dow, as the latter repeatedly flirted with the psychologically significant 20,000 level.

As mentioned, in the face of preconceptions, the election of Donald Trump was followed by a surge in both stock prices and in interest rates. The message was that the markets now anticipate higher rates, a rise in inflation and robust growth in the near future, notwithstanding the effects the President-elect's trade and immigration policies may have. Although still vague on absolute numbers, the newly-coined phrase Trumponomics encompasses the following for starters: corporate tax cuts partially offset by income from repatriation of foreign earnings; personal tax cuts (mostly at the higher-end); higher infrastructure and defense spending; Medicaid and Obamacare cuts; and stricter immigration (encompassing the campaign-promised U.S. / Mexican border wall).

In an economy at close to full employment, the net result of the tax cuts and spending is very real fiscal stimulus, with numbers from the Office of Management and Budget and UCLA Annual Forecast predicting, based on attributing estimated numbers to the policies, that the federal deficit will reach over one trillion dollars, approximately double its current level, or 5% of GDP. In response, and coupled with rising inflation, we could expect a more aggressive monetary policy from the Federal Reserve in an attempt to counter-balance the stimulus with monetary offset. This could result in several more rate hikes in the coming year on the back of the much-predicted 25 basis points rise which took place this month, and that brought the federal funds target range to 0.5-0.75%.

This time last year, when the Fed initiated the first rate rise since the financial crisis, the market was poised for more in quick succession. The fact the central bank held off against a backdrop of slow growth and global economic factors has probably helped lead us to the more robust position we are in now. The economy grew at an annualized rate of 3.2% in the third quarter and unemployment, at 4.6%, is the lowest since mid-2007. The 10-year U.S. Treasury Bond yield has risen over a full percentage point in the past six months pushing it over 2.5%, significantly above its lowest level ever of 1.36% on July 8th, with some forecasts putting it at over 3% by the end of 2017 and 4% a year later.

The Fed's moves to contain inflation, through higher rates restricting credit flow and, in turn, business activity could dampen the economic and financial impact of the Trump administration's stimulus package and campaign trail promise to deliver 4% gross-domestic-product growth during this term. Fed Chairperson, Janet Yellen, might be aiming for a more sustainable, longer-cycle pace of economic and wage growth, but with her term expiring in January 2018, tactics that Mr. Trump perceives as undermining his stimulus plans may result in a new Chair in the Fed's top spot in addition to the appointment of two of seven Fed governorships that are currently vacant. What is not factored into this policy tug-o-war is that fact that Trump's own aggressive trade negotiations and stricter immigration could put as much of a ceiling on GDP growth as rate hikes.

The change in regime with its associated policy overhauls will likely asymmetrically affect different equity sectors, with certain industries already enjoying or suffering disproportionate moves during the market 'Trump rally'. Defense and industrials (with the exception of railroads with exposure to Mexico) are expected to benefit from increased budgets, while banks and telecom may receive a boost from more relaxed regulatory environments. Consumer discretionary and certain retail sectors may see growth on the back of rising disposable income. Conversely, in a rising rate environment, consumer staples, utilities and Real Estate Investment Trusts (REITs) may face stock price challenges as investors who were holding them as bond surrogates rotate out of them.

Oil prices have clawed their way back to over $50 a barrel, a long way from their brief stint below $30 a barrel at the beginning of the year. The end-of-year rally was strengthened after The Organization of Petroleum Exporting Countries (OPEC) reached a deal last month to cut collective output to 32.5 million barrels per day beginning in January. OPEC also succeeded in persuading 11 non-OPEC producers – including Russia – to reduce supply in an effort to prop up crude prices. To say it's been a tough couple of years for domestic producers is an understatement, with the Haynes and Boone's Oil Patch Bankruptcy Monitor reporting that as many as 105 North American oil and gas producers have filed for bankruptcy since the beginning of 2015. The prognosis for the coming year is certainly more promising, with some domestic exploration and production companies at the forefront of the current stock rally.

The impact of a Trump administration on the energy sector is an open question, due in large part to the global nature of the industry. The President-elect has given reason to believe that he is a skeptic when it comes to the near-consensus scientific opinion on man-made global warming and will take steps to boost domestic fossil fuel production. Trump has appointed Rick Perry, the former longest-serving governor of Texas, as Energy Secretary, a role that also includes oversight of the nation's nuclear security. Based on prior remarks and policy stances, Mr. Perry will likely seek to minimize regulation, paving the way for increased exploration on home soil. In addition, Rex Tillerson, the former CEO of **Exxon Mobil Corporation (XOM-NYSE)** has been tapped for Secretary of State, and while some question the choice based on diplomatic inexperience and close ties with Vladimir Putin and Russia, he is expected to apply efforts to bolster American energy interests, which could mean a further boon for domestic stocks in the sector.

President-elect Trump's general pro-business regulatory environment goals, and specifically his tax reform agenda, have been credited with a general improvement in business and consumer sentiment with pledges to cut taxes for both households and corporations. The U.S. corporate tax rate currently stands at 35% (not including state and local tax), making it the highest among major developed economies (although deductions such as for debt-interest payments bring it more in line with the average among the rich world).

Steven Mnuchin, the proposed nominee for U.S. Treasury Secretary said that the administration was targeting a reduction in this rate to 15%, Trump's campaign trail promise, although Paul Ryan, the Speaker of the House of Representatives is in favor of 20%. Estimates on the effect on earnings of a percentage cut vary with Thompson forecasting that every 1% reduction in the corporate tax rate would add $1.31 of earnings to the S&P in 2017 from the current level of $131. A full 20% reduction (from 35% to 15%) would imply an increase in earnings of 20% based on Thompson's estimate. This could send the S&P 500 well on its way towards 2,500 assuming the same index earnings multiple, or the index could register more modest gains based on a more conservative multiple than today's.

A further component of Trump's tax reform is a proposal to encourage firms to repatriate at least part of the approximately $2.3 trillion in profits held overseas, which is highly concentrated in the pharmaceutical and technology sectors. U.S. corporations such as **Apple Inc. (AAPL-Nasdaq) Microsoft Corporation (MSFT-**

Nasdaq), and **Pfizer Inc. (PFE-NYSE)** currently hold billions overseas partially to avoid paying the 35% tax at today's rates that would be levied if the money were brought home. To encourage repatriation, there is talk of a one-time cut in the tax rate to 10% with the rationale that the funds on U.S. soil could be applied to jobs and business development and the tax receipts would benefit the fiscal stimulus plan. Other effects of the move would be to help shrink the current account deficit and further boost the dollar.

Less popular among corporations will be Mr. Trump's desire to impose a 35% tariff on the products of any company that chooses to move production to less expensive locations abroad. This appears to be a more problematic proposal since it would raise the cost of goods for Americans and introduce political interference in the complicated supply chain decisions made by companies seeking to maximize efficiency. This could impact competiveness and, in the long run, hurt wages. It remains to be seen if such a sweeping policy will be implemented or if Mr. Trump will continue to single out and dissuade individual companies from allocating jobs overseas.

The American presidential election cemented a year characterized by a rise in populism around the world previously highlighted by Britain's vote to leave the European Union (which the High Court has now ruled requires a parliamentary vote) and, more recently, Italy's constitutional referendum vote, the result of which led to the resignation of the Democratic Party's leader, Matteo Renzi, as prime minister after the resounding rejection of his proposals that he claimed would revive the country's faltering economy. His failure to gain support was seen as a voicing of discontent with the incumbent government.

The world, in many respects, continues to be a volatile space highlighted by yet another tragedy in Europe when the driver of a truck, who is suspected to have had terrorist affiliations, ploughed into a busy marketplace in Berlin, alongside the continued tragedies witnessed in Syria and other unstable regions. The new presidency creates a time of uncertainty for America's allies, although foreign leaders who have met with Mr. Trump have largely reported feeling reassured. It is likely that allies will be called to spend more on defense and contribute to the cost of American troops abroad, but increased defense spending from Washington will also bolster deterrence against hostile factions worldwide. We can hope that the outcome is more stability, both politically and economically.

Recent financial and economic headlines have been dominated of late by a lot of talk and speculation of macro factors coupled with a large dose of the unknown as we enter a New Year and change of presidential regime. Much depends on whether the Mr. Trump in office will closely resemble the hard-talking, uncompromising figure of his election trail or the more pragmatic diplomat evident in his acceptance speech, who will surround himself with a competent cabinet. As with any major change in the political status quo, the economic ramifications of Trump's presidential term won't be known for some time to come and, in the meantime, we shall have to get comfortable with higher levels of uncertainty.

Somewhat lost in the bluster of change is that corporate revenues, earnings and profit margins bounced off their second quarter 2016 trough to uptick in the middle of the year, strengthening our conviction that the best investment plan is a long term one that focuses on the fundamentals of individual securities to identify those that represent quality, demonstrate competitive advantages and we believe are currently undervalued. As we enter a new year and a new era, we appreciate your continued confidence in us as your financial advisor and wish you and your families a healthy, happy and prosperous 2017!