FROM THE DESK OF BOB CENTERELLA, CFA: **January 12, 2017**

2016 REVIEW & 2017 OUTLOOK

It was a hell of a year in many ways! Well we made it through another year and each one has its many memories - good and bad. This year the financial markets had some real swings in several assets classes. Bonds were good until they were bad, stocks were bad until they were good, gold was good until it was bad and oil was bad until it was good. Each of these assets saw mad price swings. It was enough to drive you crazy but a good year for volatility traders. Election years are always lively and although half the US population is not happy, there is that other half that is. You have to admit no matter what side you were on, 2017 is going to be an interesting year - good or bad.

The US stock market ended the year with a bang rallying from election day into the end of the year to overcome its worst start ever to a year after declines in January and early February. The S&P 500 produced a total return of almost 12% and the Dow charged towards 20,000 to return 16.5%. The rally continues the bull market into its 8th year that started in March of 2009 with the Dow Jones index at 6,547 - a rise of 3x over that span and a 15% annual return. When the year started we had a wall of worry to overcome including China's economic slowdown, fears of Fed rate increases, Oil price shocks, declining corporate profits, European economic malaise, Mid-East chaos, terrorism and a strong dollar among other things. Then Brexit came when it wasn't supposed to and it looked like we were in for a spiral down but a funny thing happened - after a couple day selloff stocks turned around mid-year and then after some uncertainty heading into the election a post-election rally ensued. Along the way, corporate profits began recovering, the economy rose over 3.5% in Q3, oil prices doubled from a nadir or $26.21 a barrel and Donald Trump defied all media reports and was elected president.

It was a good year with various assets generating positive returns in 2016 and of course we had some losers.

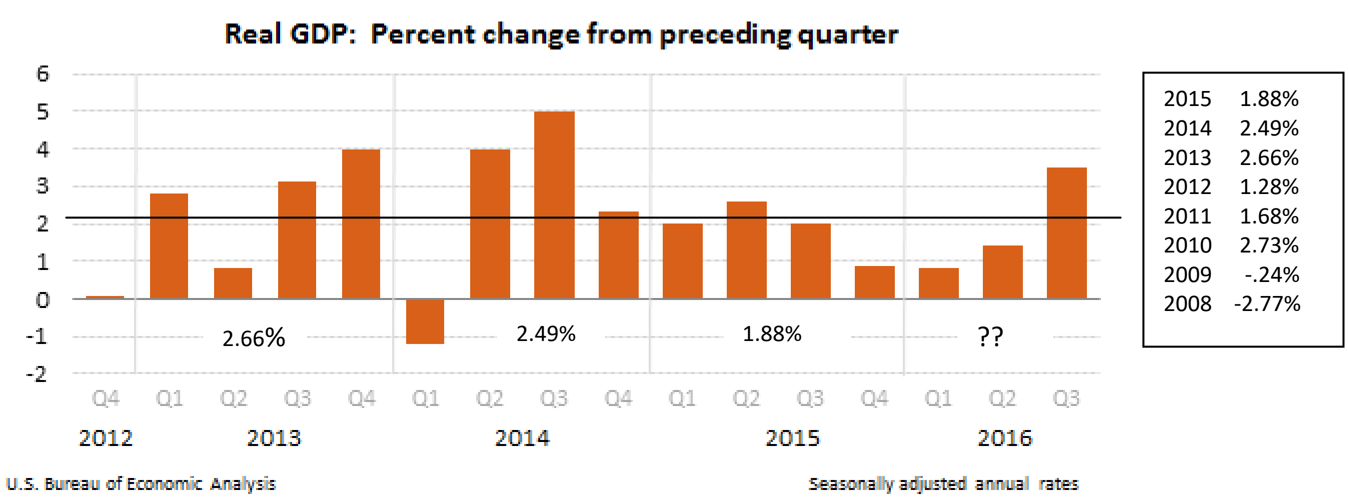
ASSET CLASS	2016 Return%
WTI Crude	45.0%
Brazil Bovespa	38.9%
S&P SmallCap 600	26.6%
Russell 2000	21.3%
S&P MidCap 400	20.7%
FTSE 100 UK	19.1%
US High Yield Index	17.1%
Dow Jones Industrials	16.5%
Silver	15.8%
S&P 500 Tot Return	12.0%
Gold	8.6%
Coffee	8.2%
Euro Stoxx 50	4.1%
Nikkei Japan	2.4%
Barclays Agg Bond	2.4%
Euro/Dollar	-3.1%
FTSE Italy MIB	-6.5%

China Shanghai Index	-12.3%
Mexican Peso	-17.0%
Biotech Index	-19.4%
CBOE VIX Volatility	-22.9%

In general, Value stocks beat Growth handily and Small/Mid Cap stocks outperformed Large Caps. Equities outperformed bonds by a wide margin although High yields bonds had a comeback year. Gold seesawed to a large gain early in the year only to decline once equities rallied and ended with a gain of 8.6%. Oil was the big winner up 45% while natural gas (not listed) was up 57.6%. On a sector basis in the US the leading groups were Energy (+27.4%), Financials (+22.8%), Industrials (+18.9%) and oddly, Utilities (+18.2%). Financial stocks rallied sharply after the election on the indication of higher rates and less regulation in a Trump regime. Energy stocks rose with oil and Industrials climbed on the hopes of higher infrastructure spending under Trump. On the weaker side of returns, Healthcare (-2.7%), Consumer Staples (+5.4%), and Consumer Discretionary (+6.0%) underperformed the broader market.

ECONOMY

Although we saw GDP grow 3.5% in Q3, for the last 8 years we've seen a muted recovery with GDP growth around 2.1% per year on average and not a single year with growth above 3%.



Meanwhile, the unemployment rate has dipped to 4.7% as more people are working but inflation remains stubbornly below 2%. Wage growth is positive but anemic and the wage gap continues to grow between the haves and the have nots. Most of the other economic signals are positive such as the manufacturing index, the services index, home sales, and durable goods orders to name a few. We are entering a period of political uncertainty of a new administration but with potential good news ahead of what I call the "4 Legs of the Trumpenomics Stool". Those 4 legs are the promises of (1) lower tax rates, (2) repatriation of overseas taxes for corporations, (3) higher infrastructure spend, and (4) less financial regulation. Overall, economists are looking for GDP growth ticking up a bit to 2.5%+, which would be similar to 2013-2014 period. Depending on how much of Trump's agenda gets implemented and how fast, the GDP growth rate should land between 2.25% and 3.0%.

The headwinds we face could be a new trade policy, a strong dollar, and the unknown of repealing Obama's ACA. Consumer spending could also slow for a few reasons - first, higher energy prices will hit consumer's pocket as each $10 rise in oil cost households about $30 Billion in discretionary spending. Second, higher interest rates could also be a headwind to consumer spending. Mortgage rates are already up about .7% since the election which would raise mortgage payments over time and reduce available income to spend. But housing should remain resilient due to the solid labor market. Finally, the Fed should not be in a hurry to raise rates too quickly as in the last 70 years a recession has ensued half of the time within 2 years following tightening cycles. That would coincide with this ominous fact pointed out by a former colleague - every Republican elected since 1901 and Teddy Roosevelt has experienced a recession within the first 2 years in office. And with the Fed now tightening this year ...

STOCKS

Last year I said I had guarded optimism for stocks entering 2016 and thought we could get high single digit returns. The S&P returned around 12% after a strong Q4. This year I am a little less guarded and a little more optimistic. However, my first hesitation is valuation. Stocks aren't cheap anymore, there is a lot of positive news already built into prices. We need the 4 legs to hold for the stool to remain standing and then for that to lead to higher Corporate Profits. Corporate profits are the key to the puzzle for stocks to move higher. We finally broke a string of 6 quarters of negative earnings last quarter with growth of 3.2% and it looks like Q4 should also show growth at around 3%. For 2017, analysts are showing optimism with earnings growth projected at 11.5% and revenue growth of 5.9%. This equates to a forward Price/Earnings ratio of 17.1x which is at the higher end of its range and above the 5-yr average of 15x. Last year at this time the PE was 15.3x forward earnings. So stocks are more expensive. Since the market is forward looking, companies need to deliver the goods, show accelerating earnings gains through the year, and give solid outlooks for the year ahead. That momentum can push stocks higher.

But a stronger dollar is a little concerning in that it may keep multinational companies from announcing more positive guidance. We need to keep an eye on how the dollar fares because if it continues to rise as has done since the election, this could have an effect on exports as well as squeeze profits when companies translate back to dollar from foreign currencies. My second hesitation is the level of bullishness has crept up and there aren't enough bears out there. The contrarian in me says that we could be in for a pullback to scare away some bulls. So I am not forecasting a straight line up, but a jagged line which does move higher but after fits and stops. A mild correction of 4-7% should not be a surprise. I also think given the higher valuation of the overall market it could be a good year to be a stock picker and not just play the market. There are pockets of lower valued stocks out there and our job is to find and invest in them. To be specific, I'm looking for a range between 7-12% return for stocks this year with good stock picking getting you to the higher end or above.

International stocks have had a nice move lately and have lost some attractiveness but easy money should continue to provide some gains. There will be several pockets of political noise with Brexit coming to a head, then Italy, France and German votes of various sorts. But growth appears to be gaining momentum overall due to easy monetary policy committed by the ECB through December. China growth is still suspect and Japan continues to be stuck in neutral no matter what they do. Having said all that, I continue to view international stocks as having a place in a portfolio for diversification purposes. I prefer investing in a broader sense rather than picking out individual markets and would be cautious of emerging markets given the strong dollar.

BONDS

I've been neutral on bonds for several years now and I hold that view into 2017. With the fed poised to deliver 3-4 rate increases in 2017 I find it difficult to think bond prices will go higher. Odds are that prices will drop and yields will rise. Since the election the yield on the 10-yr UST went from 1.6% to 2.45% at the end of the year. That caused a negative return of the Bond Aggregate of -3.1% and a drop in the 10-yr of around -8%. In the world of bonds, that is a huge move! Overall in 2016 the Bond Aggregate delivered a return of just under its coupon at about 2.4%. This after a flat return in 2015. With the bias for 2017 for higher rates, I look for flat to negative bond returns. Here is the scenario analysis: If the economy grows faster due to Trump policies and higher inflation, then bond yields are likely to rise and returns could be negative -- but if policies are watered down and tough to implement and growth stagnates then expectations will be lowered and returns will be in the 2-5% range. So my recommendation for fixed income is short term, including high yield over long term and floating rate over fixed rate. Floating rate instruments like bank loans should do well in a rising rate environment. Be careful of Preferred stocks as these are long duration assets and will decline as rates rise, but some Preferreds can be attractive for getting higher yields for income. If yields move higher with the 10-yr closer to 3%, then bonds start getting a little more attractive.

So in summary I like equities compared to bonds and I still prefer US to International. However, there is a place in a diversified portfolio for each of these assets. Each of us has a different goal for our portfolio and your allocation will depend on your unique set of circumstances. I'm staying on the side that says in 2017 things will improve --Trump policies will get mostly implemented and make a difference, the economy will strengthen, corporate profits will rise, the fed will increase rates but at a slow pace, and stocks will move higher. There are many negative scenarios one can paint but my brush is going to paint positive this year!

HAVE A BLESSED AND HAPPY NEW YEAR ! MAY MY FORECASTS COME TRUE AND WE ALL HAVE A PROFITABLE YEAR TOO.

-Bob