FLAGSTONE

FINANCIAL ADVISORS, INC.

MARKET REVIEW
CALENDAR YEAR 2016

What Happened:

We had a tumultuous market in 2016. Stocks began the year in decline, but finished strong. It was also an election year, which always heightens investor anxiety. After the election, however, investors seemed upbeat about the prospects of economic growth promised by the new administration, pushing the market higher.

2016 brought about an interesting shift in the financial markets—the correlations between stock sectors began to fall. In the eight years since the 2008 Financial Crisis, correlations averaged 82% as compared to the 50% historical norm. Now, according to *Barron's*, correlations between sectors is only 57%. That is great news for our clients' actively managed mutual funds and ETFs because as correlations fall, the probability of exceptional performance increases dramatically.

One stock sector that suffered surprisingly poor performance in 2016 was health care, with negative returns of 10%-20% for the year. For the past five years or so, this sector has been the rock star of the market. Given the demographics of our country's population and the many exciting medical advancements underway, we expect this sector to regain its market leadership again.

As you review your portfolio's performance for the year, it is important to understand how asset allocation impacts investment risk and returns. Building a balanced portfolio with divergent asset classes lowers overall risk and provides a level of protection against market corrections and disruptions. Because these asset classes have low correlations to one another, they move in different ways and are affected by different events and economic circumstances. A performance leader one year may be a laggard the next. The point is that it is impossible to predict with certainty how any particular investment or asset class will perform in the near-term. What we can do, however, is select investments within each asset class that have proven to be consistent performers, with excellent long-term track records and low fees, relative to their peers. In so doing, we are assured of getting good relative results within each asset class that we own. The overall performance, however, will be a blended result of the various asset classes in our balanced portfolios, delivering performance in the middle range.

2016 Annual Performance:

S&P 500 Index (large stocks)	11.96%
MSCI EAFE Index (international stocks)	1.00%
Barclays U.S. Aggregate Bond Index (bonds)	2.65%

Prognosis:

With the market near all-time highs, we are often asked about the likelihood of a significant fall in stock prices. Corrections of 10% or so are very common and should be expected. These pullbacks tend to be short-term in nature and occur once or twice each year on average. More significant drops of 20% or more—bear markets—tend to occur during recessionary periods and when investor euphoria is sky-high. Currently, we see no signs of impending recession or investor euphoria, so we think any near-term corrections will be relatively minor.

We are optimistic about corporate earnings going forward. After five consecutive quarters of earnings declines, stock analysts expect fourth quarter 2016 earnings to increase by 4.4% on a year-over-year basis. For the 2017 calendar year, earnings are projected to grow by over 11%. That is a solid endorsement of stocks going forward.

Many analysts also expect better performance in the international markets. After several years of poor performance, stock valuations and dividend yields are very attractive relative to U.S. stocks. We believe there are good opportunities in the international markets in 2017.

Bond returns will probably remain in the lower range of historical averages as interest rates are expected to slowly creep upward. We continue to like bonds, however, because of the excellent stability and diversification benefits they provide.

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