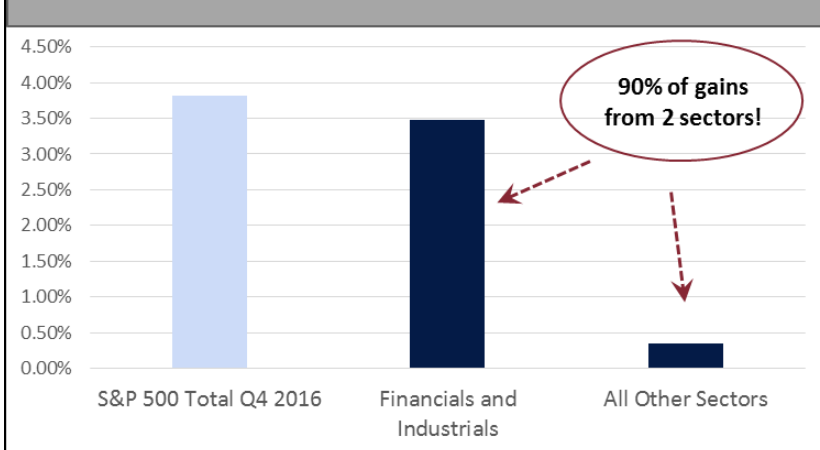


Q4 Market Commentary

Post-Election Economic Optimism Q4 got off to a difficult start, with the S&P500 falling nearly 4% leading up to the presidential election. Trump's subsequent surprise victory then sparked both a stock market and US dollar rally over rekindled optimism that US growth will surge in response to pro-business policies. Meanwhile, weak-growth sensitive assets like bonds and gold sharply declined with the expectation that these same policies might reignite inflation and lead to a faster-than-expected rise in interest rates.

Coinciding with this market reaction was one of the largest spikes in both US consumer confidence and business sentiment in 40 years. Three Trump proposed policies are most often cited as the catalyst for this renewed economic optimism: (1) Massive new government spending on infrastructure projects, (2) business regulatory relief (especially for the banking sector), and (3) tax reform (e.g. lower corporate taxes and offshore cash repatriation). Clearly these proposed Trump policies aren't expected to lift all boats equally. Peering inside the S&P's performance in Q4, we see wide disparities in sector performance, with the vast majority of gains driven by just two of the eleven major sectors (financial and industrial).

S&P 500 Sector Attribution: Q4 2016



Global Spillover

This surge in optimism over US growth has also spilled over into international markets, with European and Japanese stocks actually substantially outperforming US stocks in Q4. This outperformance was driven by a combination of an expected increase in US led global growth and especially the significant rise in the US dollar (which benefits the profits and competitiveness of offshore companies.) Similar to US sectors, not all global markets benefitted from this optimism spillover - emerging market assets suffered, primarily hurt by a strengthening USD and concerns over potential protectionist policies from the incoming Trump administration. ■

Five Things You Should Know about Q4

1. Post-Trump Election Stock Rally

After selling off nearly -4% in the beginning of Q4, stocks surged post-election over optimism related to forthcoming business-friendly policies.

2. Financials Lead the Way

In a largely one-sided Q4 rally, financial sector stocks accounted for roughly 70% of the S&P 500's +3.8% quarterly gain. Meanwhile, healthcare and real estate sector stocks declined.

3. Bonds and Gold Prices Drop

Trump market optimism generated losses in low growth assets like government bonds and gold as investors repriced expectations for of a pick-up in US economic activity.

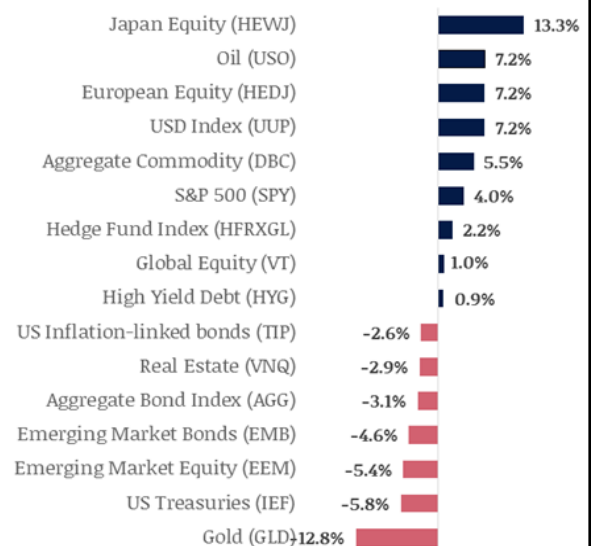
4. Fed Raises Rates...Finally

After a median projection of nearly four rate hikes from Fed members at the beginning of 2016, the Fed finally raised rates 0.25% in its final meeting of 2016. Since prices already reflected this anticipated hike, bonds subsequently rallied over the final weeks of the year.

5. US Dollar Surges

The USD Index surged +7.2% in Q4, driven by the Fed rate hike and the expectation that Trump policies will drive stronger US growth which might enable the Fed to raise interest rates more quickly in the future. Meanwhile, global growth expectations remain muted.

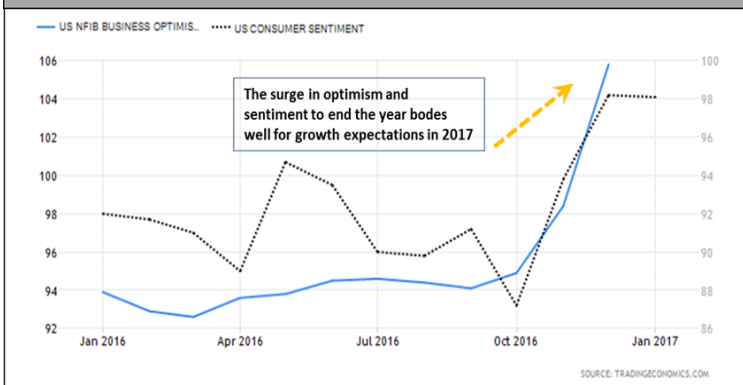
Asset Class ETF Total Returns: Q4 2016



Source: Bloomberg

Winds of Change: 2016 was clearly a year of political surprises. Between the Brexit vote in the UK (which also resulted in a new prime minister) and the Trump election, the political winds shifted towards a more populist and protectionist stance. We believe 2017 will largely be shaped by whether or not these populist winds strengthen into a global hurricane.

Both Business and Consumer Confidence Surge Following the Election



The Global Economy is Healthy

The Global economy is currently healthy and in the sweet spot of the business cycle. Employment has meaningfully recovered, wages have begun to rise slowly (supporting growth), inflation is positive but still subdued enough to provide for interest rates to remain low. As rates are slowly rising in the US, global monetary policy remains highly stimulative especially in Japan and Europe. Also, growth stabilization in China and a rebound in commodity prices have helped emerging economies recover. With the prospect of renewed growth and optimism in the US, the economic weather conditions would seem promising for good asset performance in 2017.

Market Expectations for 2017

It is important to remember that asset returns aren't driven by how good or bad things are - but by how much *better or worse* they turn out to be *relative to the expectations* priced in at the start. As we begin 2017, market expectations are for modest global growth, with the bar being higher for the US relative to the rest of the world (post-Trump effect). The Fed is expected to raise interest rates between two and three times. Inflation is expected to remain low and below the Fed target of 2%. Equity volatility is expected to remain below normal. In other words, markets are expecting the economic equivalent of 72 degrees and sunny!

Reasons for Optimism in 2017

While expectations are for moderate growth in 2017, we think the prospect of even stronger growth is a distinct possibility. This is especially true for foreign markets like Europe and Japan where monetary stimulus continues to be poured in at a record clip. That stimulus, combined with the recent weakening of those currencies

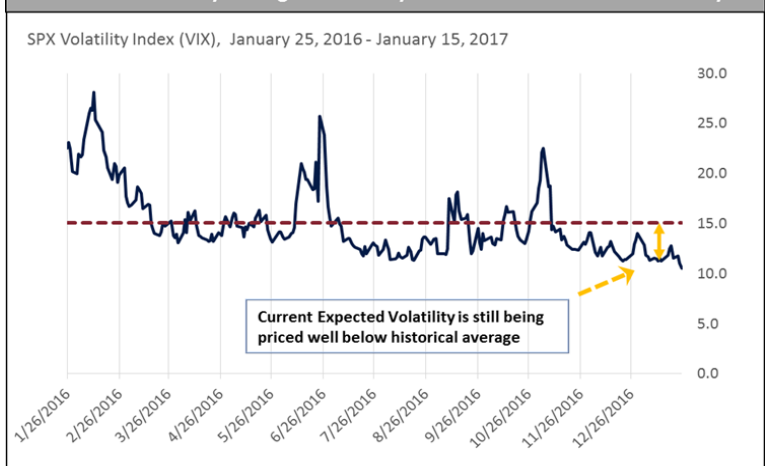
relative to the USD, should bolster earnings in those markets well beyond what is currently expected. After the Trump rally, growth expectations in the US are now highest, but so also is consumer confidence. If the policies underpinning this surge in confidence are properly executed - the result could be a rise in spending and investment that could fuel faster growth.

Potential Market Headwinds for 2017

We see three major risks to the otherwise rosy calm currently expected for 2017: 1) Trump policy balancing act, 2) continued global populism, and 3) Fed turning more hawkish than expected. Considering these one at a time:

- 1) Trump policies have the potential to deliver both economic headwinds and tailwinds. Markets have thus far focused on the business friendly tailwinds of lower taxes, reduced regulation, and enormous infrastructure spending. There are also the trade/protectionist policy headwinds. These include disrupting global supply chains, eliciting retaliatory trade policies, and destabilizing China, the world's growth engine.
- 2) The UK and US are not the only countries demonstrating populist movements. 2017 will likely see populist contests in the Netherlands, France, Germany, and Italy. A victory in any one of those countries could further threaten the stability of the European Union and the Euro (with severe global ramifications).
- 3) Finally, there's the Fed. Tepid global growth and weak commodity prices have kept inflation well below target for many years - offering the Fed breathing room to keep interest rates extremely low while employment recovered. Now that global growth is on the rise and commodities recovering, the risk of an upside surprise in inflation is possible. If inflation were to spike unexpectedly, there is a chance that the Fed would be forced to accelerate the current anticipated pace of rate hikes...potentially hurting both stocks and bonds.

Markets are Currently Pricing in Relatively Low US Stock Market Uncertainty



An Apples to Apple 2016 Asset Class Comparison

How am I doing?

2016 was another good year for stocks, with the S&P 500 returning 12%. Inevitably, when stocks have a good year, investors start looking at their own portfolio returns with a twinge of performance envy, asking “why didn’t my portfolio return over 10%?” When asking that question, most will conveniently forget about the 10% loss the S&P had during the first 30 trading days of 2016...that by mid-June the S&P return was still 0%...or that 2/3rds of 2016’s return occurred within just 30 days post-election. Our point being - a 100% stock portfolio can be very volatile, and investors may not be able to hold on during that kind of rollercoaster ride. Many behavioral studies have shown that investors routinely choose to bail on their portfolios after big losses, missing the recoveries and damaging their long-term results. As a consequence, most have portfolios designed to take only 50—60% of the risk of stocks (i.e. 10% volatility). At this risk level, most investors are willing to stay with their investment plan and ride out short-term losses.

Now, let’s discuss investor expectations. The physics of investing is such that, in the long-run, market returns are proportional to the amount of risk taken. That means comparing your lower risk portfolio returns to a high-risk benchmark is a fundamental (though common) mistake. The same is true when comparing high-risk and low-risk asset classes (like bonds or stocks). Whether portfolios or asset classes, it is more fitting to compare risk-equalized returns (as we do below). In this chart, we adjust asset class performance to reflect the results as if similar “moderate” risk had been taken in

each (i.e. roughly 10% volatility). This apples-to-apples comparison allows investors to see how asset classes performed on an even risk playing field, and better assess their own performance. You will find the return of US stocks hardly stands out in this exercise.

Adjusting to a Common Volatility Highlights Asset Class Efficiency

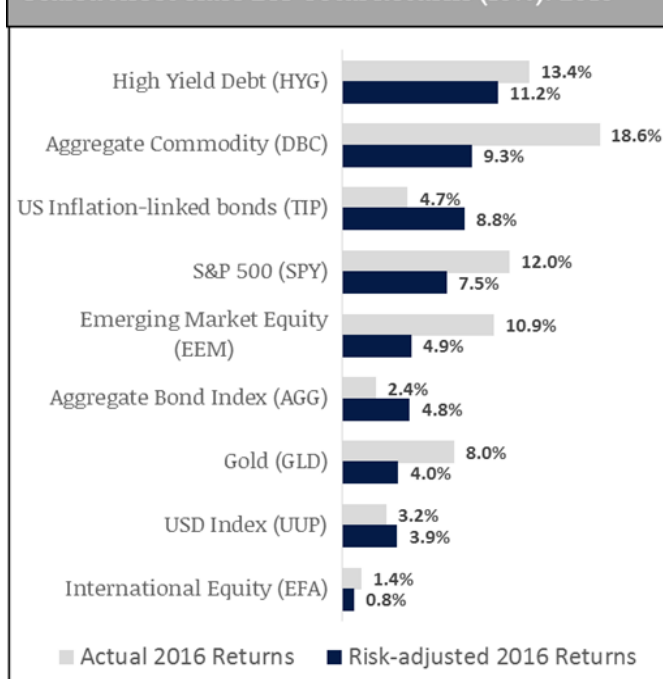


This exercise also highlights the benefits of diversification. While the S&P 500 had a risk-adjusted return of roughly 7%, that return was erratic over the course of the year. By comparison, a portfolio that combined different sources of return can deliver a more steady, reliable comparable return (See chart above). A more reliable return through diversification offers the following benefits: (1) a lower probability of loss / higher probability of gain over any time horizon, (2) affords portfolio withdrawals with lower risk of inopportune timing, and (3) the ability to stick with your financial plan.

Understanding the risk differences of high-risk asset classes and well-diversified portfolios is akin to appreciating the distinction between lightning and electric power. Over time, better risk efficiency translates into lower probability of loss, and much higher probabilities of achieving your financial goals. To attain this, investors must remain patient and avoid the urge to concentrate their risk and chase returns. ■



Scaled Asset Class ETF Total Returns (10%): 2016



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