

January 2017

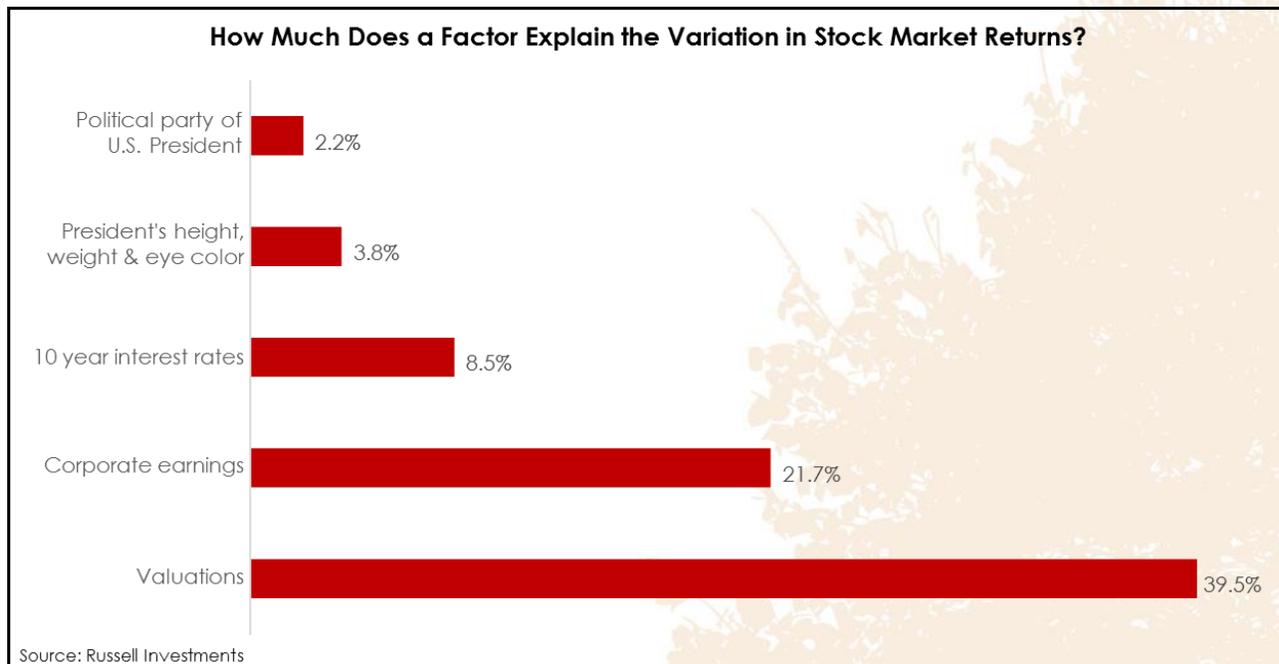
THE YEAR IN REVIEW | 2016 was a year of reversal in many capital markets. U.S. Equities shrugged off the worst start to a calendar year in history (since the inception of the S&P 500 Index in 1957) to claim new all-time highs in December. After declining 10.5% in the first 28 trading days, U.S. Large Cap delivered a full year total return of +12.0%. U.S. Small Cap (+21.3%) topped all asset classes globally. After years of underperformance, Commodities (+11.8%) and Emerging Market Equities (+11.2%) reversed fortune to post handsome gains. International Equities (+1.0%) rallied in the second half of the year to essentially break even for the year. The largest reversal may have been in the U.S. Fixed Income market. After setting a new all-time low of 1.36% in early July, the U.S. 10-Year Treasury yield rocketed higher to 2.62% (nearly double the record low) and closed the year at 2.45%. The price of fixed rate bonds falls as yields rise. Accordingly, the U.S. bond market gave back much of its gain from the first half of the year to deliver a modest full year return of +2.7%. Real Estate (+8.5%) also reversed some of its first half return as yields rose. All in all, the year of reversals was a good one for client portfolios.

THE CONSENSUS IS OFTEN WRONG | Bob Farrell is a well-known market analyst who headed research for Merrill Lynch for decades. Rule #9 of his “10 Market Rules to Remember” is: “When all the experts and forecasts agree, something else is going to happen.” 2016 provides several examples of the consensus being wrong.

A big consensus view was that bond yields would remain at historically low levels. Larry Summers (former U.S. Secretary of the Treasury) labels the environment “secular stagnation”. Christine Lagarde (Managing Director of the International Monetary Fund) prefers the “new mediocre”. They and a preponderance of Fixed Income analysts have cautioned that tepid economic growth and low inflation would persist and that bond yields would be lower for longer. With nearly \$12 trillion in foreign government bonds with negative yields at mid-year, the consensus was indeed strong. Janet Yellen (Chair of the U.S. Federal Reserve) appeared to join the chorus in her June 15, 2016 press conference after the Fed yet again lowered its expectations for future economic growth and interest rates, noting “But there are also more long-lasting or persistent factors that may be at work that are holding down the longer-run level of neutral rates—for example, slow productivity growth, which is not just a U.S. phenomenon but a global phenomenon.” Within weeks, the U.S. 10-Year Treasury yield vaulted higher after setting its all-time low.

Perhaps the biggest consensus miss of 2016 was the U.S. Presidential election. Political experts and polls overwhelmingly forecasted a victory for Secretary Clinton. The vast majority of market pundits predicted a sharp sell-off in equity markets in the off chance that Donald Trump won the election. Both were wrong. The unexpected happened and equity markets sprinted higher. *We are reminded of the difficulty in predicting both the outcome of and the market reaction to macro events. Diversification and discipline provide ballast as we invest amid persistent uncertainty.*

HOW IMPORTANT IS POLITICS? | After a contentious election cycle and a surprise outcome, it is natural to ask what this means for investment portfolios. Russell Investments recently analyzed what factors had the greatest influence on stock market returns since 1945. The results of this regression analysis are summarized in the chart on the next page.

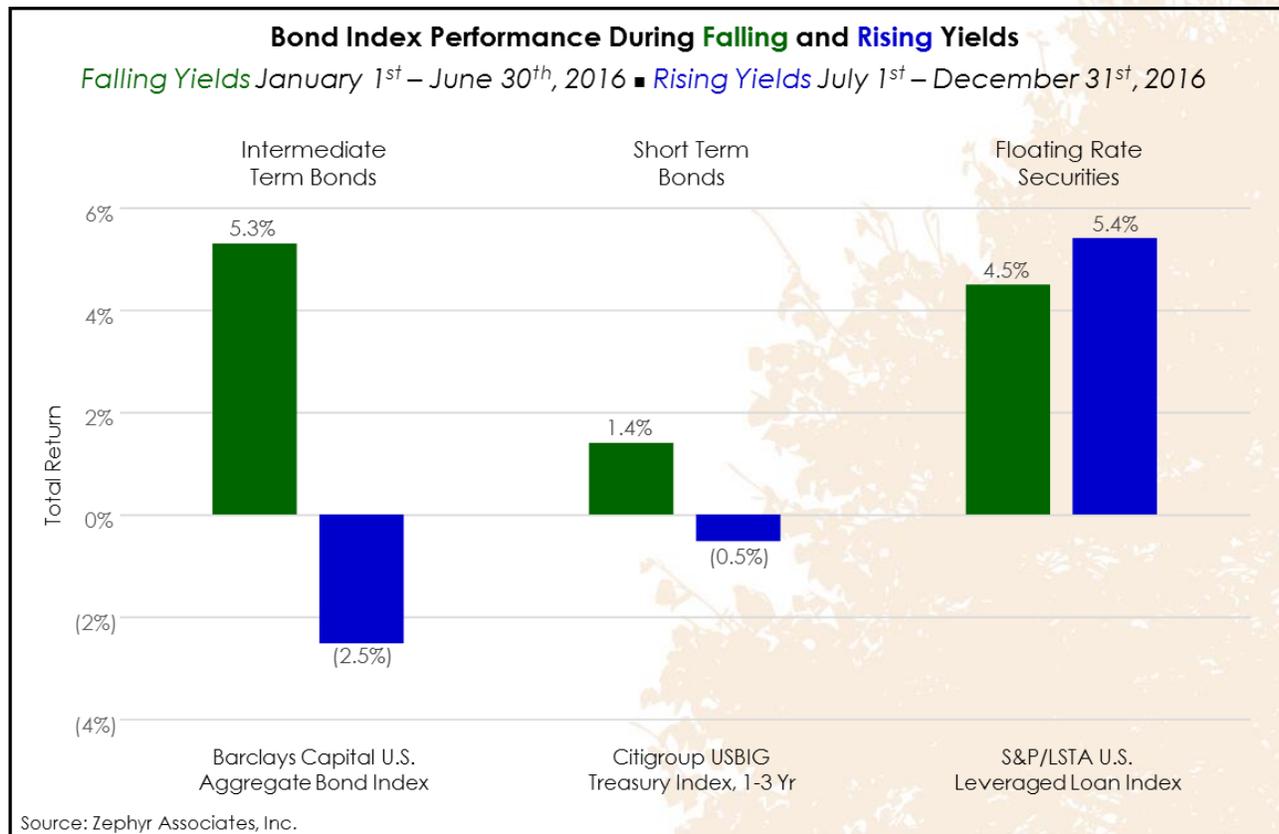


Interestingly, the President's political party affiliation explained only 2.2% of the variation in annual stock market returns over the last 70 years. The analysis suggests it is folly to predict market performance based on politics. With a chuckle, we'd note that the President's height, weight and eye color matter more! As one might expect, interest rates, corporate earnings and valuations (how cheap or expensive an equity market is based on financial metrics like the current price to earnings ratio) are very meaningful. Market and economic fundamentals are indeed the most important factors that shape long-term stock market returns.

BROADLY DIVERSIFY WITHIN FIXED INCOME | In our July, 2016 Quarterly Newsletter, we discussed important changes in the U.S. Aggregate Bond Index since 2008: the index offered lower income, lower inflation protection and higher sensitivity to changes in interest rates than in the past. We concluded that it was important for Fixed Income investors to instead broadly diversify among intermediate term bonds, short term bonds and floating rate securities to capture return and reduce portfolio risk. With the large reversal from falling yields to rising yields in 2016, it is timely to evaluate how each category fared. The chart below illustrates the performance for each index as yields fell in the first half of 2016 and rose in the second half of 2016.

The results match our expectations:

- Intermediate term bonds were more sensitive to yield changes than short term bonds: intermediate term bonds delivered larger gains as yields fell and larger losses as yields rose.
- Floating rate securities performed well in both environments: these assets are agnostic to changes in market yields for fixed rate bonds since they pay a floating (not fixed) rate. It is important to note that this asset class is more sensitive to changes in credit quality and economic conditions than the other two.
- Diversifying beyond the index helps the most when yields rise: a simple diversified portfolio holding 1/3 of each asset class would have returned +0.8% when yields spiked during the second half of the year versus a loss of -2.5% if one just owned the U.S. Aggregate Bond Index.



Looking ahead, we can't predict where market yields are headed, but we remain steadfast in our conviction that clients are best served by broadly diversifying within Fixed Income.

TAX ITEMS | Tax time is here again. Fidelity expects to have complete tax data by mid-February and will both post online and mail its annual Tax Reporting Statement at that time. This information is not distributed sooner in order to avoid a series of corrected tax reports (mutual funds often submit several amendments). This statement will provide information that you will need for your 2016 tax return including Form 1099 Dividends and Distributions, Interest Income, Realized Gains and Losses and Arbor's Investment Management Fees that are debited from taxable accounts. Some clients will also receive Form(s) 1099-R summarizing certain IRA activity. Separately, if you donated any appreciated securities to a charity or made Qualified Charitable Distributions from an IRA, we will send you a summary of each. Please let us know if you have any questions about your tax reporting. Thank you and Happy New Year!