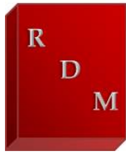


RDM CAPITAL ASSOCIATES
WEALTH MANAGEMENT

YEAR-END 2016 MARKET COMMENTARY
January 2017

STATE OF THE MARKETS

Despite a significant market pullback to begin the year, Brexit over the summer, and a highly contentious presidential election to end the year, equities proved resilient in 2016, with the S&P 500 finishing with a 9.5% return and the Dow approaching the 20,000 mark. ***The RDM Capital large-cap value equity composite returned 13.4% after fees for the year***, bolstered largely by strong performance from overweight allocations to the financial and energy sectors. Notably, we welcomed a market shift from the high-flying "FANG" stocks (i.e. Facebook, Amazon, Netflix and Google) that skewed average market returns higher in 2015 towards more fundamental value stocks that we favor as long-term core portfolio positions.

Looking ahead to 2017, we expect the market-driving events of late 2016 to continue as the year begins. The post-election rally in equities was largely stimulated by, among other things, expectations that the election of Donald Trump as the next U.S. president will lead to various pro-business reforms – expectations that were further bolstered by recent cabinet appointments. We hope that many of the pro-business reform proposals, notably tax and regulatory reform, and infrastructure spending, will become law. However, while we are cautiously optimistic about equities in 2017, we are not ready to chase the recent market returns by aggressively adding to equity positions, as the market to some degree is already pricing in slowly rising interest rates, less regulation, more robust fiscal policy and a generally pro-business agenda. At very least, we are prepared for profit-taking in the first half of 2017, which would present a buying opportunity for long-term investors.

Below are our projections for 2017 developments in several key areas that we are watching closely. We also have included a list of some notable wealth planning rules for 2017 at the end of this commentary.

U.S. Economy

We view the U.S. economy as largely on healthy footing heading into 2017. While inflation is still sluggish due, in part, to low energy prices and under-employment remains an issue for large swaths of the labor force, the economy is generally improving to a 2.5% growth rate. We are optimistic that tax cuts for corporations and individuals, a repatriation tax holiday for corporate funds held abroad, and regulatory reform in the banking industry and energy sector will lead to greater business investment and increased hiring for higher paying jobs. We expect the political debate between Republicans and Democrats over various Republican policy initiatives to last for much of 2017 with any significant policy change to occur towards the end of 2017. Therefore, it is likely that the true economic impact of these reforms will not be seen in U.S. GDP until 2018.

Summary of 2017 Projections

GDP:	2.5 – 3.0%
S&P 500:	2,400 – 2,500
Fed Funds Rate:	1.0%
WTI Crude:	$60 / barrel

For the year, we expect GDP to pick up to the 2.5% to 3.0% range in 2017. While Third Quarter GDP grew at an annualized rate of 3.5%, the economy was far more sluggish at the start of 2016 and likely did not expand at much more than a 2.0% rate for the year. We expect some pick-up in the economic expansion during 2017 as oil prices continue to stabilize and, in turn, provide less of a drag on corporate earnings. Tax reform also should stimulate consumer and business spending towards the latter half of 2017.

On the other hand, macroeconomic events overseas pose some risks to the U.S.

economy. Uncertainty caused by the populist wave spreading across Europe may at least temporarily stifle economic growth in the E.U., which would impact U.S. companies with multinational operations. China also continues to slow, as we have noted many times before. And, a dispute among oil producers could undo the tentative agreement to cap oil supply and lead to oil prices plummeting again. In the U.S., we are wary of the Fed's projected three interest rate hikes in 2017 as higher rates too soon could crimp borrowing in areas such as housing.

On balance, however, we expect the U.S. economy to continue its slow-to-moderate growth trajectory barring any major unforeseen geopolitical shocks. We believe we are in an unusually long and slow economic expansion due to the increased regulatory burden that stifled lending and business investment after the Great Recession along with the fact that the housing market was the epicenter of the Great Recession when it usually is a major catalyst for economic recoveries. While it is important to note that most economic expansions do not typically last more than 7- 8 years on average, we think the economy currently is not close to overheating at barely a 2% growth rate with low-to-moderate inflation. In other words, this expansion is unlikely to die of old age soon.

Equity Markets

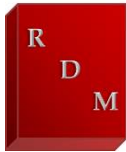
We view equity markets as within a reasonable range of fair value at the moment. At the end of 2015, we projected the S&P 500 to finish 2016 at 2,221, which is less than 1% lower than its closing value of 2,239. Therefore, despite the broad market rally in November and December, equities are currently very much in line with our expectations for the year.

The S&P 500 achieved our projection despite low oil prices and lower interest rates than expected. However, the price-to-earnings market multiple expanded a good deal more than we anticipated to over 19 times earnings, largely due to investor optimism over the November election of Donald Trump and the Republican congressional majority. The market is clearly optimistic that personal and corporate tax cuts are in store, burdensome regulation on businesses such as Dodd-Frank and Obamacare will be rolled back, and interest rates could begin to rise. Each of these factors would be good for businesses, particularly the banking industry.

Looking ahead to 2017, we expect continued modest returns from domestic equities, outpacing fixed income. We believe that S&P 500 corporate earnings could grow 7 – 10% during the year to roughly $132 per share. If earnings were to grow to this level and the market multiple remained at or near 19, the S&P 500 could touch 2,400 - 2,500 prior to year-end. However, if optimism about the new administration fades, the market P/E multiple could retreat somewhat, which would mean only minimal returns for the market next year.

As noted above, we are prepared for a pause in the market rally, which we believe would provide a buying opportunity for long-term investors. We also expect some volatility during the course of the year, as markets become acclimated to the Trump presidency and potential outside-the-box policy proposals, particularly with respect to free trade agreements. We expect oil prices to stabilize in the ~ $60 range as the impact of OPEC production cuts is felt, although these cuts are likely to be offset in part by increased production from U.S. shale producers. Lastly, we believe a tax holiday on the repatriation of corporate cash balances held overseas, a Trump proposal, would be beneficial for equities as it could lead to increased M&A activity, dividend increases and corporate buybacks, which would boost corporate earnings. <u>Within equities, we continue to favor the financial, energy, healthcare, industrial and materials sectors, as they stand to benefit the most from tax and regulatory reform, along with higher pricing expected in commodity markets.</u>

Fixed Income Markets



Fixed income investors finally saw an end to the 30+ year bond bull market in 2016. The presidential election of Donald Trump seemed to herald in a belief that interest rates will finally begin a firm path upwards. President-Elect Trump has frequently asserted that the Fed was politically motivated to prop up markets in favor of President Obama by suppressing interest rates. The rise in yield across maturities, and corresponding fall in bond prices, after the election is a reflection of the belief that Trump will support a more hawkish Federal Reserve than the Obama/Yellen Fed. With Janet Yellen's term ending in 2018, the potential for a more hawkish Fed Chair exists, which will be a negative for fixed income.

In 2017, as discussed below, we expect a less hawkish Fed than the consensus expects, however. At the Fed's December meeting, during which it decided to raise the Fed Funds rate by 0.25%, the Fed projected three rate hikes in 2017. We think this is optimistic and two rate hikes are more likely. Regardless, a rising rate environment is unfavorable for fixed income investors, particularly if bonds are not held to maturity and fixed rate. We favor a multi-asset class fixed income portfolio for those investors in need of yield, in order to diversify interest rate risk. Within these portfolios, we recommend laddering bond positions to take advantage of rising rates and including high-yield non-traditional fixed income securities that have some exposure to positive corporate earnings growth, such as preferred stock or convertible debt.

Interest Rates

Two conclusions can be drawn regarding Fed policy in 2017 and beyond based on the Fed's statements and policy decisions in 2016.

First, the Fed is returning monetary policy to a more normalized course after years of crisis-level rates. Indeed, their stated intention is to hike rates three times in 2017, from the current 0.50% Fed Funds rate to over 1% by the end of 2017. It is worth noting that the Fed projected four rate hikes for 2016, but ended the year with only one in December. Equity markets did not respond well to the first rate hike at the beginning of 2016 and then the subsequent uncertainty caused by Brexit caused the Fed to change course.

Given the experience of 2016, we are skeptical that three rate hikes will actually come to fruition in 2017, particularly given the potential for uncertainty that could arise surrounding the Trump presidency and the impact of fiscal or trade policy changes that may be proposed after inauguration. We are also skeptical of the extent of rate hikes in 2017 given the continued accommodative monetary policies enacted by central banks in Europe and Japan. It would be inadvisable for the Fed to raise rates too quickly in the U.S. while central banks are lowering rates abroad to the extreme of negative rates in several countries, as this would further strengthen the dollar with its negative U.S. export implications. Lastly, the Fed has exhibited a repeated pattern of over-shooting its rate projections and then revising them to a slower path of increases during the current recovery. For these reasons, we are expecting only two 25 basis point hikes over the year.

Second, the Fed will play a lesser role going forward in supporting equity prices. Since the Great Recession, the Fed has played a significant role in supporting equities by lowering interest rates through policy accommodation, including several rounds of quantitative easing. This made fixed income relatively less attractive than equities and caused investor capital to flow towards equities. However, as the Fed continues down its course to a more normalized rate environment in the coming months, we expect the equity markets to rely much more on fiscal policy stimulus and corporate earnings growth as the source of positive returns. We view this as a normal and healthy development for the economy and welcome a return to fundamentals-based investing rather than the short-term obsession the markets have had with every Fed policy statement.

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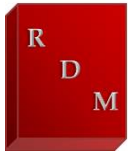

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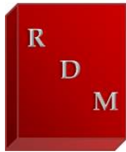
As we close out 2016, we would like to thank all of our clients for your continued trust and confidence in us this past year. We look forward to working with you again next year and wish you and your families a happy and prosperous 2017!



RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

Notable Wealth Planning Rules for 2017

Retirement savings contribution limits:

- $18,000 ($24,000 if aged 50 and over) to a 401K
- $5,500 ($6,500 if aged 50 and over) to an IRA

Income limits to make a fully deductible IRA contribution if covered by a retirement plan at work:

- Single taxpayers covered by a workplace retirement plan, $62,000 with a phase out up to $72,000 (individual filers)
- Married taxpayers where the spouse making the IRA contribution is covered by a workplace retirement plan, $99,000 with a phase out up to $119,000 (married filing jointly)
- Married taxpayers where the IRA contributor is not covered by a workplace retirement plan and is married to someone who is covered, $186,000 with a phase out up to $196,000 (married filing jointly)

Income limits to make a Roth IRA contribution:

- $118,000 with a phase out up to $133,000 (individual filers)
- $186,000 with a phase out up to $196,000 (married filing jointly)

Long-term Capital Gains Rates:

- 0% (for investors in the 10% and 15% income-tax brackets)
- 15% (for investors in the 25%, 28%, 33%, and 35% income tax-brackets)
- 20% (for investors in the 39.6% income-tax bracket)

Estate and Gift Tax:

- $14,000 annual gift tax exclusion
- Amount of assets that are exempt from the estate and gift tax is $5,490,000.
- Due to the spousal portability election, the total exemption for a couple is $10,980,000

Social Security:

- Cost-of-living adjustment of 0.3%.
- Amount of workers' income that is subject to Social Security tax is $127,200

Education Savings:

- $14,000 a year may be contributed to an individual's 529 college savings plan without a gift tax
- $70,000 a year may be contributed to an individual's 529 college savings plan without a gift tax, but no further gifts to that individual for five years