DANN ASSET ADVISORS, LLC

Fourth Quarter 2016 Update

January 15, 2017

4Q16 Highlights

- Trump victory and economic proposals spur stock gains, bond declines
- International markets lag significantly, hurt by Trump win, higher U.S. rates and dollar
- Fed raises rates as expected and highlights additional increases for 2017
- After a stronger third quarter U.S. economic growth likely moderated in the fourth

The table below summarizes the performance of some key indices during the fourth quarter and for the full year:

Market Performance		
Index	% Ch. 4Q16	% Ch. YTD
S&P 500	3.9	12.0
MSCI Developed Markets (excl US)	(0.7)	1.0
MSCI Emerging Markets	(4.2)	11.2
MSCI All Country World	1.2	7.9
US Aggregate Bond (1)	(3.0)	2.7
Liquid High Yield (1)	1.4	15.4
US Dollar Emerging Markets Bond (1)	(4.4)	10.2

(1) Barclays indices

Equities. The last bullet point in our mid-October update was “Clinton leading but election still a wild card.” We had no idea the wild card would produce such unexpected results, both politically and in the markets. Through the third quarter the S&P 500 had returned just under 8%. With the 3.9% gain in the fourth the index turned in a strong year with a total return of 12.0%. As discussed in our 2017 Stock Market Outlook section, we believe the big gains of the fourth quarter moved forward some of the upside that otherwise may have occurred in 2017.

Not shown in the table above is how well small company U.S. stocks did in 2016, especially post election. The Russell 2000 index returned 18.7% for the year even though it had been trailing the S&P 500 around election time. Further, small cap value stocks, which typically perform strongly in anticipation of higher economic growth, took off post election gaining 14.1% in the fourth quarter (31.7% for the year). The U.S. market clearly is anticipating big things from Trump and the Republican controlled Congress in terms of spurring economic growth.

In contrast to the U.S., international markets as a whole had a poor fourth quarter. Part of this is due to appreciation of the U.S. dollar, which has the effect of reducing the value of international investments. In addition, higher U.S. interest rates often lead investors to move money into the U.S. and out of international markets. Finally, some international markets also may have been reacting to the prospect of reduced trade with the U.S. given Trump’s protectionist statements.

Fixed income. After hitting a record low of 1.37% in July and ending the third quarter at 1.61%,10-year Treasury yields made a big move up to 2.45% at December 31. Yields on two year Treasuries, which are more sensitive to Fed actions, rose proportionately more to their highest levels since 2009. For the fourth quarter the Barclays U.S. Aggregate Bond index (with a 5.8 year duration and heavy exposure to U.S. Treasuries) had a negative return of 3.0%. As indicated in

the table, more speculative sectors of the bond market had strong years despite tougher fourth quarters.

Portfolio Positioning

We again took no significant action in fixed income during the quarter. However, for some clients whose fixed income allocations were less than 10% in intermediate term (which we define as three to ten year duration) funds we very modestly increased the intermediate term exposure. We still believe the risk of having significant longer term bond exposure outweighs the current benefit of modestly higher income, but at this point we don't expect inflation to take off. Thus, if rates continue to move up, we expect to add slowly to intermediate term exposure. We anticipate increases in rates in 2017 to be much less dramatic than during the fourth quarter.

The best performing broad U.S. market sectors during the fourth quarter were financials (up a substantial 20%), industrials and energy stocks. Financials benefitted from the significant increase in interest rates (generally speaking, higher rates help financials earnings) and the prospect of reduced regulation with the Republican election victory. Industrials we believe benefitted from the perception of likely higher infrastructure spending, plus the roughly 18 month industrial downturn seemed to trough in the third quarter. Energy benefited from announced production cuts by OPEC and other producing countries. For the year, energy, financials and telecommunications stocks were the top three groups.

The fourth quarter's worst performing sectors were healthcare, REITs and consumer staples, all modestly negative for the quarter. Healthcare had been weak all year, hurt by publicity around overly aggressive pricing at pharmaceutical and medical device manufacturers, several late-stage new drug development failures at large companies and negative political exposure. REITs likely were impacted by the rise in interest rates and perceptions that parts of the real estate market may be peaking. We believe consumer staples lagged as investors focused on sectors more likely to benefit from faster economic growth and less regulation.

During the fourth quarter we were more active in equity-only accounts than we've been in recent quarters. For many clients we sold a consumer staples exchange traded fund (ETF) that we'd begun selling in the third quarter. We sold based on our belief that many of the stocks held in the ETF were fully valued and that growth for the group will be harder to come by given our perception of ever-increasing pricing pressures. We also sold for most clients an actively managed international mutual fund where we'd become less confident in the manager's strategy. Proceeds from the sales were put into existing positions and a new actively managed international mutual fund.

<u>2017 stock market outlook</u>. Helped by a 4.6% post-election gain, 2016 was a stronger year for the U.S. market than we expected. Investors and business executives clearly like the prospect of lower corporate taxes and reduced regulation, both of which, assuming they occur, will increase corporate earnings. We believe the combination of Trump's campaign promises and a Republican controlled Congress makes lower corporate taxes and reduced regulation probable – meaning company earnings likely will be higher. While the details of corporate tax reduction and regulatory reform aren't yet known, it seems to us that the post-election move in the markets already reflects much of the potential positive news on these two issues.

Significantly increased infrastructure spending and lower personal income tax rates – if they occur – could be additional fuel to stimulate economic growth, increase corporate earnings, and

move the market even higher. Potential negative factors that the stock market seems to be ignoring are higher interest rates (albeit, coming off historically low levels), potentially more protectionist trade policies and a President who pressures industries and specific companies to act consistent with his views.

Layered on top of the foregoing are two additional issues. First, the U.S. stock market continues on the high side of historical valuation levels, potentially limiting near term upside. However, the current valuation at 17.2x estimated earnings, is not out of line with that of recent years and comparable interest rate levels. Second, based on our perception of Trump's communication and decision-making style, we believe there is a higher probability of something unexpected and potentially negative happening (could be an international incident) than has been the case in recent years. At the least, we believe we are living in a more uncertain world post the U.S. election.

Putting this all together implies to us the potential for a wide range of outcomes for stock prices over the next 12 months. Markets could move meaningfully higher if new economic policies substantially accelerate growth and earnings. Given where valuations are starting from and our skepticism that economic growth is going to take off, we believe this is a lower probability outcome.

More likely, in our opinion, is that the post-election increase in stocks moved forward gains from 2017, meaning the current year sees single digit gains (admittedly, what we expected for 2016) at best. Another possibility is that Trump miscalculates on how to "bring back jobs" or inadvertently creates international tensions, causing markets to decline, perhaps significantly. Acknowledging that we really have no idea what the market will do this year, we'd rank the middle road as most likely, followed by the potential for a decline with the possibility of significant gains being the least likely result.

Regardless of where the market ends 2017 we expect volatility will be significantly higher. We continue to focus on structuring what we believe are high-quality portfolios tailored for each client's particular circumstances.

Economy

U.S. GDP grew 3.5% in the third quarter, the strongest growth in two years and up from 1.4% in the second quarter. Consumer spending increased 3.0%, down from the second quarter's robust 4.3% pace but still reasonably good. Unusually large exports of agricultural goods may have exaggerated the third quarter's strength, but other positive signals were a pick up in inventory investment and nonresidential fixed investment (both reflecting more positive business sentiment). Fourth quarter 2016 GDP will be reported late in January and analysts are expecting growth in the 2.5% range.

In comments released during its December meeting, the Fed projected 2017 GDP growth of 1.9%-2.3% and stated that it expects to raise rates three times during the year. The Fed noted enhanced uncertainty around its forecasts due to lack of clarity on how the Republican controlled government might stimulate the economy through tax cuts and increased spending. From what we've read, a decrease in corporate tax rates seems like a near term priority for the Republicans.

The Fed also will be watching inflation closely in 2017. The recently released employment report showed wages rising at the fastest annual pace since 2009. With the unemployment rate at 4.7%

and many minimum wage increases taking effect this year, inflation may become more of an issue. At least partly offsetting the potential for higher inflation is the strength of the U.S. dollar, up about 7% since the November election. If fiscal policy significantly increases growth the Fed may be more aggressive raising rates than anticipated.

While the stock market certainly has focused on the potential positives from Trump's stated economic priorities, there also may be negative economic impacts if immigration is substantially restricted or Trump errs in publicly calling out companies and industries, causing them to make unwise business decisions to avoid negative publicity. Another wild card will be how Democrats react to and likely try to temper some of the Republicans' economic proposals.

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