The **Philadelphia** Story

A Quarterly Commentary on the Economy & the Financial Markets January 2017

From: *Philadelphia* Investment Management Group

OVERVIEW

- *The Economy Took One Step Back in the First Half of the Year and Two Steps Forward in the Second Half*
- *Post-Election Expectations Supported Equity Growth*
- *Bonds Moved in Opposite Direction From Stocks in the Year*
- *Market Volatility Will Remain in Both Markets*
- *We Continue to Maintain a Pro-Growth Stance in Equities*
- *Higher Interest Rates Will be a Negative for Fixed Income*

THE ECONOMY

To many, the U.S. appears to be in the late upswing phase of the business cycle, though not all arrows point in the same direction. Key economic indicators show that inflation has risen in the past few months but remains modest, consumer sentiment is improving and the unemployment rate stands at its lowest level since August 2007. However, the late upswing phase also usually exhibits restrictive monetary policy to combat an overheated economy, a scenario that still seems far away, and we are likely to get a large fiscal stimulus package, as well.

A measure of consumer confidence rose in December to its highest level in more than 15 years, as Americans saw more strength ahead in business conditions, stock prices and the job market following the election. The Conference Board Consumer Confidence Index rose to its highest level since August 2001, suggesting that economic growth continued through the final months of 2016. In turn, with benchmark 10-year Treasury yields around their highest in more than two years, the average rate on a 30-year mortgage has hit its highest point since May 2014, potentially posing a risk to the recovery in housing prices. While reports showed that housing prices maintained their steady recovery in October, mortgage interest rates are expected to rise further as home prices outpace gains and personal income.

We are in the midst of the fourth longest expansionary period since the 1850s. The U.S., in December, was 90 months removed from its last economic trough, which occurred in June 2009, according to the National Bureau of Economic Research.

In hindsight, factors contributing to the current upswing seem obvious. After all, the last recession marked the worst downturn since World War II, and the immediate recovery was historically sluggish, preventing the market from getting overheated. Even a modest dose of fiscal stimulus, combined with lower corporate tax rates, could help keep the U.S. economy humming along.

Fears about the U.S. economy have abated. Gross Domestic Product (GDP), the broadest measure of economic output, advanced at a 3.5% annual rate in the third quarter, according to the Commerce Department. The unemployment rate recently dropped to 4.6%, the lowest since the Great Recession ended, and corporate earnings are growing after several quarters of declines. Looking ahead to 2017, consumers' optimism will depend on whether or not their expectations are realized.

Although we have a generally positive view toward the economy, earnings and equity markets, we think it is worth pointing out some possible risks given how quickly and how far markets have moved higher over the recent past. The main risks to equity markets are the surge in government bond yields and the value of the U.S. dollar. Higher bond yields could create a drag on equity valuations and a higher dollar could put pressure on corporate earnings. If the current advances in yield and the dollar moderate, equity markets should not experience much damage. That might change if they continue to accelerate.

The strengthening dollar, however, is re-emerging as a threat to U.S. manufacturers by making their exports more expensive and their foreign earnings less valuable. Over the past two years, the currency has appreciated to a 14-year high in the wake of the election and the Federal Reserve's decision to raise interest rates.

Certainly, a strong dollar increases the currency's purchasing power via cheaper imports, but it will hit U.S. manufacturers reliant on sales in overseas markets. Furthermore, it will likely limit interest in expanding domestic manufacturing and employment while increasing the use of automation.

We are also watching possible political negatives from Donald Trump's presidency, such as escalating geopolitical turmoil, currency wars with China or anti-immigration/anti-globalization trends. Additionally, investors may become wary of improving sentiment and less attractive valuations. Overall, we do think the environment is improving for pro-growth, risk-on areas of the financial markets, going forward.

For financial markets, the era of the Central Bank may be coming to a close. In 2017, tightening monetary policy and brighter

economic fundamentals could ease markets from the grip of the Central Bank, whose policy in recent years has dominated trading in bonds, stocks and other assets.

That shift could portend changes for investors. A long period of ultralow interest rates and Central Bank asset buying has boosted the price of bonds and safe stocks. Now, analysts expect economic performance to catch up as the key driver not the least, as they feel that this Central Bank stimulus will step aside as the dominant form in economic expansion. As we have previously stated, fundamentals will now matter more in analyzing the financial markets.

Nevertheless, risk remains: In recent years, corporate earnings have tended to disappoint, and the end of Central Bank omnipresence, although unlikely to fade quickly, has been indicated before. Furthermore, the expected burst of government spending may not arrive. Fiscal policy remains subject to political constraints, such as fears about government debt increases. Time will tell.

While economic growth has been far from robust and there have been quarters of slow growth from time to time, there remains little evidence to expect an absolute trend lower. Overall, the U.S. economy has continued along a path of recovery, and most indicators are much improved since the days of the Great Recession. Despite the volatility that has accompanied the election season, we believe that markets, both stock and bond, will quickly have to pay greater attention to the economic and corporate realities today versus the many "what ifs" of the post-election policy landscape.

FINANCIAL MARKETS

EQUITIES

The stock market has been moving along in a bullish rising channel for the past eight years, since the bear market bottom in 2009. The uptrend has not been in a straight line, with periods of hesitation, such as early and mid-year 2016, as concerns about economic growth in the U.S. and fears of England leaving the European Union brought on market back steps, at times.

The current rally appears to have been primarily triggered by November's election results and higher prospects for a pro-growth, pro-business legislative agenda. However, we believe fundamental economic and earnings improvements which emerged over the summer are just as important. The rally is also fueled by a not typical year-end seasonal bounce and investors who may have missed the initial rallies adding to positions. For now, investors are looking past issues, such as potential negatives from the political environment, elevated sentiment, stretched valuations and possible concerns associated with Federal Reserve policy.

As chaotic as the markets can be, it is usually cyclical. Some sectors do well in the early stages of an economic recovery, i.e., Industrials and Financials, whereas others do well near the end: Energy and Industrials benefit from rising inflation, as reflected in the fourth quarter, while Utilities and Consumer Staples outperform as investors move away from economically-sensitive to more defensive areas, such as occurred in early 2016.

The pause at year end makes some sense given how much the markets have run in the past seven weeks. Markets have a history of bouncing around big numbers before passing them. There have been expectations of major tax cuts and stimulus spending, much of which have already been priced into the markets, and the more it is talked about, the seemingly more difficult the number is to get through. We feel the short-term sentiment appears to have become a little too optimistic but the longer-term positive trend appears to be in place.

In addition, stocks are, to some, the only choice for income when bond yields are at their lowest level in years. At the end of July, the S&P 500 yielded 2.21% versus 1.37% for the 10-year Treasury. At year end, that yield premium had completely disappeared: the S&P 500's yield was 2.12% compared to the 10-year Treasury's 2.45%. But the equity market's upside will be dependent, to a large extent, on the degree in corporate earnings growth, which will be forthcoming in the months ahead.

Beyond the business cycle, other factors play a crucial role in assessing the stock market's capacity to climb high. The S&P 500 index returned 11.96%, including dividends, putting it in place to deliver a double-digit gain for the sixth time in the past eight years. The Dow Jones Industrial Average overcame its worst ever start to a year and posted its best performance since 2013 with a return of 16.50%, as indicated in the following table. The NASDAQ Composite struggled late in the year but returned 7.50%, its largest gain since 2014. The winner for the year was the Russell 2000, the index of small companies, which achieved a strong total return of 21.31%, a reflection of investors' lack of concern about the dollar and global influences on the smaller domestic-related companies.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	3.82%	3.85%	2.46%	1.35%	11.96%
Dow	8.66%	2.78%	2.07%	2.20%	16.50%
NASDAQ	1.34%	9.69%	-0.56%	-2.75%	7.50%
Russell 2000	8.83%	9.05%	3.79%	-1.52%	21.31%

*Total: price change + reinvested dividends

All in all, most of the gains came in the second half of the year. A rebound in corporate earnings, accelerating U.S. economic growth and stabilizing oil prices helped stoke investor enthusiasm for stocks. The election of Donald Trump as President also supercharged the rally as investors bet the new Administration would usher in business-friendly policies, such as tax cuts, looser regulation and fiscal stimulus.

The eleven broad sectors of the S&P 500 certainly acted differently as a result of the crosscurrents of events which affected the market, as outlined above. The election, to a degree, was a major influence in the fourth quarter, as the Financials area hit a double-digit return of 21.10%, followed by Energy and

Industrials with returns of 7.28% and 7.21%, respectively, as shown in the following table. Real Estate and Health Care, in turn, were the major losers at -4.41% and -4.00%, respectively, due to the concern about higher interest rates and Government's concern about drug pricing, followed by a decline of 2.02% for the more conservative Consumer Staples area.

	S&P 500		
		Returns*	
Sector	Weight*	4th Qtr	2016
• Materials	2.8%	4.70%	16.69%
• Industrials	10.3%	7.21%	18.86%
• Telecommunications	2.7%	4.78%	23.49%
• Cons. Discretionary	12.0%	2.31%	6.03%
• Consumer Staples	9.4%	-2.02%	5.38%
• Energy	7.6%	7.28%	27.36%
• Health Care	13.6%	-4.00%	-2.69%
• Info Technology	20.8%	1.19%	13.85%
• Utilities	3.2%	0.14%	16.29%
• Financials	14.8%	21.10%	22.80%
• Real Estate	2.9%	-4.41%	3.39%

12/31/16
*Price + income
Source: Standard & Poor's

For the full year, the market's strength was relatively broad-based, as only the Health Care area remained under the cloud of uncertainty. Seven sectors achieved double-digit returns, led by strong moves in Energy, Telecommunications and Financials. It all adds up to a very muddled market. Energy, a late-cycle sector, is the clear performance leader, but Financials, an early-cycle group, is not far behind. Meanwhile, Utilities, a classic defensive sector, held its own given its strength in the first half of the year.

By year end, the rally left equities looking somewhat expensive and investors fairly bullish, though neither seems extreme at this point. The average stock in the S&P 500 trades at roughly 19.1 times trailing earnings, the highest valuation since February 2004 and above its 20-year average of 16x. Bullish sentiment among small investors is about 43%, according to the American Association of Individual Investors, above its long-term average of around 38%. There is concern, however, that corporate earnings may not grow enough to support current stock valuations, which, as we know, are higher than their historical average.

From a long-term perspective, we believe the S&P 500 appears neither wildly overvalued nor undervalued, but that it is positioned to provide real returns in excess of cash or bonds along with upside potential, going forward. On the other hand, there could be more gains ahead for the Dow because most of the components do not have lofty valuations. The 30 issues trade, on average, about 18x estimated 2016 earnings and 16x projected 2017 profits, not excessive in a low interest rate environment.

There is every reason to believe that we are in the later stages of the cycle, if only because the economic expansion, and the bull stock market that has accompanied it, have gone on for so long; but, as stated, this recovery has not been like many others. Economic growth overall has never moved beyond lukewarm, while the Federal Reserve's bond buying pushed investors into yield-heavy sectors, even as the economy labored on. Now, stocks are finally emerging from an earnings recession, something that usually accompanies an economic downturn but hasn't this time, and we are likely to get a large fiscal stimulus package, as well.

FIXED INCOME

The bond market also had a little tough sledding during 2016, but one would not have known if measured by the yield on the benchmark 10-year Treasury note, which closed at 2.45%, up slightly from 2.27% at the end of 2015, generating the second consecutive year of price declines for the bond market.

However, within the year, bond bulls did have their day. Yields, which fall as prices rise, tumbled nearly a percentage point by summer, with the 10-year Treasury hitting a record low of 1.37% in early July. The rally was then followed by the biggest quarterly sell-off in more than two decades. The Treasury yield climbed 0.84% between October and December, resulting in the largest quarterly price decline since 1994. Although there were a lot of unexpected twists and turns throughout the ride in 2016, the bond market moved along with the stock market in following the domestic and global events, as outlined above in The Economy section.

Overall, there was little change in base interest rates during the year, as set forth in the following table, which shows the yield change for the Treasury market for the quarter and year. Within the first half of 2016, interest rates trended lower, a reflection of slow economic growth, lack of action by the Federal Reserve, plus the rising demand for higher-yielding U.S. Treasurys by foreign central banks, where their own government bonds were in negative yield territory.

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	3 mo.	2 yr.	5 yr.	10 yr.	30 yr.
Dec 31, 2015	0.16%	1.05%	1.76%	2.27%	3.02%
Sep 30, 2016	0.27%	0.76%	1.15%	1.60%	2.32%
Dec 31, 2016	0.50%	1.23%	1.99%	2.45%	3.13%
Change:					
09/30-12/31/16	0.23%	0.47%	0.84%	0.85%	0.81%
12/31-12/31/16	0.34%	0.18%	0.23%	0.18%	0.11%

As we moved into the fall months of the year, economic activity began to pick up along with the anticipation that the Federal Reserve would raise rates, which they did in December. The end result was a sell-off in the bond market, as can be seen by the yield changes between September 30 and year end.

In the fourth quarter, the Federal Reserve and global pronouncements drove investors to expect stronger growth, higher inflation and potentially a faster pace of interest rate increases. As stated, the growth narrative was accentuated by the prospect of greater spending, lower taxes and lighter regulations under Donald Trump. In addition, higher fiscal spending typically requires more issuance of Treasury bonds for funding when demand for bonds has diminished over the year. The year-end sell-off shrunk the total return in the Government bond

market to 1.14% for 2016, as measured by the BofA Merrill Lynch Treasury Bond index.

Some analysts believe that the long cycle of lower interest rates is coming to an end and that the record-low close set in July marked the bottom of the 10-year yield. Investors betting on higher yields have pinned hopes on Mr. Trump's fiscal stimulus and its boost to the economy. At the same time, rising bond yields can cut growth momentum. Treasury yields are the base benchmark used to set long-term borrowing costs for many U.S. consumers and businesses, i.e., mortgage rates.

The election outcome has strengthened the "reflation" theme, namely, the expectation that the Fed will be patient and fiscal spending will likely increase. The shift from monetary to fiscal policy could well result in a steepening of the yield curve. As shown in the Base Interest Rates table above, yields increased 80-some basis points in the 10-year and longer maturities during the fourth quarter.

The yield swing in 2016 reflected a sentiment shift among global investors. Earlier in the year, expectations of a prolonged period of sluggish growth, low inflation and large monetary stimulus from major central banks had investors piling into government bonds, especially long-term debt.

The tide began turning later in the year as data pointed to improvement in global manufacturing and inflation. The prospect of larger fiscal spending, lower taxes and lighter regulation by the newly-elected President accentuated the narrative toward stronger economic growth, higher inflation and less generous monetary policy. The sell-off was also helped by the Federal Reserve's signal of three interest rate increases in 2017 due to a brighter outlook for the labor market.

As can be seen in the following table titled Fixed Income Returns, all sectors of the investment grade market had negative returns for the fourth quarter, with the longer maturities showing the greater loss as a result of the major yield increases.

Fixed Income Returns

Index	4th Qtr	YTD
Corp/Govt	-3.50%	2.92%
Int. Corp/Govt	-2.02%	2.15%
Long Corp/Govt	-8.37%	5.68%
U.S. Government	-3.96%	1.14%
- Intermediate	-2.11%	1.14%
- Long	-11.23%	1.23%
Corporate	-2.88%	5.96%
- Intermediate	-1.89%	4.17%
- Long	-5.35%	10.72%
- **Quality**		
- AAA	-4.73%	3.18%
- AA	-3.02%	3.80%
- A	-3.13%	4.38%
- BBB	-2.57%	8.15%
Municipal	-3.50%	0.44%
- Intermediate	-2.25%	-0.05%
- Long	-4.33%	0.70%

Source: BofA Merrill Lynch

The Government sector was the major loser due to its high degree of liquidity and lower yield. All in all, investment grade corporates were the better performing sector, both for the quarter and year, which is attributable to their higher yields and lack of credit concerns, given the current economic environment.

We remain overweight in investment grade corporates but recognize the near-term risk from rising interest rates and steeper yield curves. While rate spreads between Treasurys and corporates are well below levels seen at this time last year, investment grade credit continues to be attractive to us from a fundamental valuation perspective and remains an attractive yield solution relative to U.S. Treasurys and speculative grade credit.

The municipal market saw fund outflows during the fourth quarter, reversing course after steady inflows over the past year. Further outflows could pressure the market in the short term. Trump's planned personal income tax cuts would lower the effective value of tax-exempt interest income for investors in the highest tax brackets. This would make municipals less attractive and could lead to a rise in yields.

As stated, a change in interest rates will adversely affect the price change of longer-maturing bonds. Therefore, we continue to view value in the shorter end of the yield curve, as we anticipate further rate rises in 2017, led by the longer-maturity sector.

Overall, we expect economic growth will accelerate modestly in the U.S., partially due to a range of pro-growth initiatives from the Trump Administration. We think some of these same factors will likely put upward pressure on inflation and we expect corporate earnings to continue to recover. Should events come to pass in this manner, it would probably mean an environment in which government bonds struggle and equity prices rise unevenly. More important, we expect 2017 to be a year in which selectivity grows in importance as markets become more dynamic and divergent.

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