TFC FINANCIAL
The Financial Counselors

COMMENTARY | 4Q 2016
JANUARY 13, 2017

OUR VIEW

2016 Review and 2017 Market Outlook

2016 was much like a play in three acts. Act 1 started with concerns over China and falling oil prices in January, concerns that eased during February and March. In Act 2 concerns about Brexit occupied center stage, with pre-vote complacency replaced by uncertainty about the long journey to negotiate the UK's exit from the European Union. The divisive U.S. Presidential election dominated Act 3, and the year ended with a surprising, and perhaps unsustainable, stock rally driven by optimism about Donald Trump's economic agenda.

Segments of the stock market that were out of favor in recent years were among the biggest winners in 2016. Small company stocks in the U.S. outpaced large company stocks by a large margin, helped by a post-election surge based on expectations that Trump's agenda will help domestically-focused small companies. Value stocks were also strong performers, beating Growth stocks after a long run of growth outperformance. U.S. Small Cap Value stocks gained more than 30% for the year. European stocks lagged the U.S. despite encouraging economic momentum early in the year, struggling to recover from uncertainty created by the Brexit vote. Emerging Market stocks delivered strong returns for the year, but slumped after the U.S. election.

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Rapid swings in sentiment made the bond market particularly volatile in 2016. The U.S. Federal Reserve (Fed) entered 2016 having signaled a plan for multiple rate hikes, but concerns about China and uncertainty about Brexit caused the Fed and the fixed income market to reverse course. Contrary to expectations, long-term Treasuries provided capital appreciation during the first two acts of 2016, and the 10-Year Treasury traded at a low of 1.36% on July 5. By the end of 2016, however, economic momentum and reflationary expectations fueled a reversal in the bond market. Long-term bonds (20+ years) declined by nearly 12% in the 4th quarter, illustrating the perils of being in very long duration bonds during a rapid upward move in rates. The 10-Year Treasury yielded 2.45% at the end of 2016, close to the yield at the end of 2015. Beyond the Treasury market, leading fixed income segments included U.S. High Yield bonds, which gained more than 17% and Emerging Market bonds, which returned approximately 10%.

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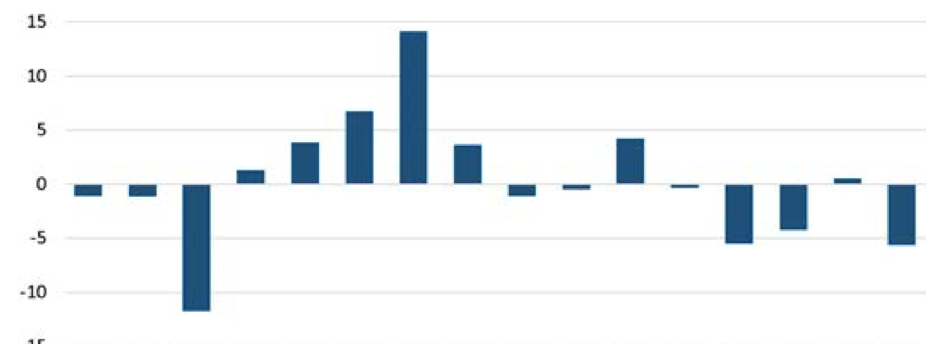
Quarter To Date Returns 12/31/2016

Historical Asset Class Returns



	Short Term Bonds	Short Term Muni Bonds	Long Term Bonds	Global Stocks	S&P 500	US Large Value	US Small Value	US Small Growth	Intl. Large Core	Europe Stocks	Intl. Value	Intl. Small Value	Intl. Small Growth	Emerging Markets	Frontier Markets	Global Real Estate
QTD	-1.1	-1.1	-11.7	1.3	3.8	6.7	14.1	3.6	-1.0	-0.4	4.2	-0.3	-5.4	-4.2	0.5	-5.6
2016	1.6	0.1	1.3	8.4	12.0	17.3	31.7	11.3	1.2	-0.4	5.0	5.9	-1.4	11.2	2.7	4.1
Full Cycle*	2.8	2.5	6.8	2.7	6.5	5.5	7.1	7.4	-0.1	-1.1	-1.2	2.5	2.4	-1.2	-3.5	1.0

TFC Chart
Source: FactSet Data
* Full Cycle is the annualized return from October 2007 peak to present.

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2016 TFC Performance

TFC's Equity portfolios benefited from the strength of U.S. Small Company stocks and from the return to form of Value stocks in much of the world. European equities were a drag on portfolio returns, but the impact was somewhat reduced by portfolio repositioning that increased holdings of European Value stocks and of exporters likely to benefit from the weak Pound and Euro. TFC's core Emerging Markets holdings contributed positively to performance, but Asian Small Company stocks and Frontier Markets lagged in 2016. We continue to be enthusiastic about the long-term prospects for Asia and for Frontier Markets.

TFC continues to emphasize Small Cap and Value segments within globally diversified portfolios, confident that both segments offer long-term return premiums relative to the market. Although increased awareness of these premiums may reduce the benefit, the rationale behind our "tilts" remains intact. Also, despite considerable attention paid to the active/passive debate, we continue to favor a strategy incorporating both. As passive funds gain in popularity and market share, active managers may start to find more pockets of opportunity to add value.

Fixed Income served as a portfolio hedge in 2016, providing a moderate amount of income while cushioning portfolio downside during Equity market disruptions. The 30+ year bull market in bonds, at long last, appears to be over as rates have moved up dramatically post-election. Bonds may not offer a good value today, but may become more attractive in the latter part of 2017 as rates continue on a path toward normalization.

Economic and Market Outlook

U.S. economic growth was 3.5% in the third quarter, and is expected to be reasonably strong to end the year. Unemployment continues to decline and wages are rising, though labor force participation has not recovered to pre-crisis levels. The disappointing labor force participation rate reflects an aging population and a high level of discouraged workers who have left the workforce.

The Fed “dot plot” signals plans for three rate increases in 2017, though Fed Chair Janet Yellen has signaled that she is open to having the economy run a little “hot” and to allow inflation to rise above the Fed’s 2% target rate. Some analysts speculate that the inner circle of the Fed--Yellen, Vice Chair Stanley Fischer and New York Fed President William Dudley--are expecting to raise rates only twice in 2017. If Fed tightening leads to a strong dollar, the Fed may not need to raise interest rates too much to cool the economy. Ultimately, the three “D’s”--debt, demographics and the Dollar--may keep the U.S. on a course of sub-par growth and low inflation despite the elevated expectations of the market to start the year.

Given uncertainty about the pace of interest rate increases and the possibility that rates could reverse during periods of geopolitical stress, a diversified approach is desirable.

Bonds, though perhaps not that appealing on the surface today, do offer a hedge against downside economic risks. In a rising interest rate environment, some segments of the bond market are more attractive than others. Interest rates may not need to rise that much to slow the economy and ease inflationary concerns, so the market may be overly pessimistic about the pace at which rates will rise. Given uncertainty about the pace of interest rate increases and the possibility that rates could reverse during periods of geopolitical stress, diversification across issuers and quality levels, as well as duration profile, is desirable.

Europe continues to recover, demonstrating improving economic growth, an export sector helped by weak currencies, and continuing progress at reducing unemployment. However, political risk and pockets of stress in the banking systems create continued risks for Europe. European equities may struggle until elections, all scheduled for 2017, in France, Germany and the Netherlands (and potentially Italy) provide clarity about whether populists or market-friendly leaders will be in charge.

Japan faces daunting debt levels and demographic challenges, though Japanese equities have rebounded with help from a falling Yen and government equity purchases. The rise of a consumer middle class and economic rebalancing toward consumer-oriented companies will help some Emerging Markets, but high levels of U.S. Dollar debt and potential for anti-trade policies will hurt others. Countries with excessive foreign currency debt will be particularly vulnerable if the dollar continues to rise.

China remains an unbalanced economy that offers considerable potential rewards and risks, but appears to have the policy flexibility to avoid a near-term hard landing. Like much of the rest of the world, the long-term outlook for China will be jeopardized if the country’s leaders wait too long to pursue necessary reforms.

Trump's Economic Agenda

Expectations for 2017 are generally positive for equity markets, in hopes that the "pragmatic" economic version of Donald Trump wins out over the "anti-growth" version of Trump who often appears in late night Twitter rants. Trump is expected to initiate market-friendly policies, including cuts in corporate and personal taxes, an easing of regulatory burdens and increased infrastructure spending.

However, investors may have unrealistic expectations about Trump's economic agenda, as his tax and spending proposals may face significant obstacles in Congress. Although Republicans control both houses of Congress, Tea Party members in the House of Representatives may object to measures that dramatically increase the Federal budget deficit. Trump's thin margin in the Senate may also force compromise over certain issues. Tax reform will create winners and losers, with special interest groups fighting hard to protect elements of the tax code that favor their constituents.

Policy considerations are likely to have an unusual degree of influence in 2017. The euphoria of the recent equity rally may fade as Trump faces the limitations of presidential power, and uncertainty builds about the specifics of his governing priorities and ability to implement policy.

Vigorous battles are likely to be fought over the border adjustment tax floated by Republican leaders, which would eliminate the ability of corporations to deduct the cost of their imported goods. Retailers such as Walmart are among the potential losers from the border adjustment concept. It seems likely that tax plans will require compromise and deliver less stimulus than expected. Infrastructure spending may also fall short of optimistic expectations, as a shortage of "shovel-ready projects" and complexity of implementing public-private partnership initiatives may cause fiscal stimulus to have a greater impact in 2018 than in 2017.

Policy and Geopolitical Considerations

Policy considerations are likely to have an unusual degree of influence in 2017. The euphoria of the recent equity rally may fade as Trump faces the limitations of presidential power, and uncertainty builds about the specifics of his governing priorities and ability to implement policy. Likewise, the bond slump may slow, as yields could rise more gradually than expected if economic growth disappoints or geopolitical events create a rise in risk aversion. The most important policy considerations include:

Trade policy: Trump's administration is likely to formally label China a currency manipulator, the start of a lengthy process full of sound and fury but little substance. Trump may also impose tariffs or restrictions on Chinese steel. However, the 45% tariffs threatened during the campaign will likely serve as bargaining chips rather than serious policy moves, and the trade wars feared during the campaign may not materialize. If Trump moves more aggressively on trade than currently expected, equity markets will likely take a turn for the worse.

Immigration: Immigration was one of the highest profile issues in the campaign, but investors hope that Trump's priorities will be directed toward law-breaking illegal immigrants and refugees from "ungoverned" states such as Syria and Somalia. Major curbs on immigration would harm economic growth, and innovation would suffer if stricter limits are imposed on the entry of highly skilled workers.

Populist movements: 2016 was the year of the populist movement, with Brexit and the election of Donald Trump upending the political establishment in the Western world. The European "project" is increasingly fragile, with French, Dutch and German elections, negotiations for Brexit and instability in Italy all holding the potential to disrupt the status quo. Geopolitical stability in Europe would provide a boost to equities, particularly hard-hit financial services stocks.

The Dollar: Rising U.S. interest rates may boost the Dollar, helping domestically-focused companies while hurting exporters and moderating U.S. investor returns in non-dollar equities . A rapid Dollar appreciation would be more disruptive than a gradual appreciation, and a rapid move upward in the Dollar would cause the Fed to revisit their plans to hike rates in 2017.

Limitations of government policy: Certain trends will be difficult to stop, regardless of how many tweets come out of the Oval Office. Pressure to maintain manufacturing jobs in the U.S. may have unintended consequences, as companies may replace people with robots if forced to keep plants open in the U.S., or consumers may rebel if iPhone or other consumer goods prices double in response to protectionist measures. Tariffs aimed at single countries may also have unintended consequences, as many Presidents discovered during their tenure. The U.S. may "punish" China or Mexico by imposing tariffs, but U.S. consumers may substitute imports from other low-cost countries rather than pay up for higher-priced products "Made in America."

Events outside the bubble of Washington D.C. could disrupt Trump's economic agenda. China's seizure of a drone may be the first in a series of "proportionate" reactions to perceived provocations from Trump. Concerns about China's militarization of the South China Sea may be an early test of Trump's foreign policy approach, as will increasingly close ties between China and countries such as the Philippines that historically have been close allies of the United States. It seems inevitable that North Korea will "act out" soon after the inauguration, testing Trump while South Korea is in a state of political chaos. Vladimir Putin is also likely to explore how friendly Trump will be toward Russian interests, a test for Trump and his non-traditional selection for Secretary of State, Rex Tillerson. Foreign policy challenges could interrupt the equity rally and renew the appeal of bonds as a safe haven in an uncertain world. Dynamic portfolio rebalancing and a globally diversified asset class mix continues a sensible course.

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Closing Thoughts

Years ago, TFC measured portfolio performance against the Dow 30 Index! We've come a long way from our Dow 30 days, but we continue to look for opportunities to improve how we communicate about performance. We plan to make incremental changes to performance reporting in 2017, providing an additional benchmark that we think will help us to better explain portfolio performance. Our objective is to provide clarity about what is (and isn't) "working" when we report performance to you. We will provide a structure that makes it easier to distinguish the positive and negative contribution from asset allocation decisions (stock vs. bonds; U.S. vs. International vs. Emerging/Frontier), investment selection decisions (which funds we use to implement asset allocation decisions), and style tilts (value, size and quality). We'll share more details on our reporting changes as we get further into the year.

Although chances of an equity market pull-back are elevated, the economic and policy backdrop is reasonably favorable for risk assets. Admittedly, the U.S. economic recovery is "long in the tooth," but we see few signs of recession or economic bubble, and economic momentum is positive in much of the world. U.S. stock market valuations are elevated, but still remain below the extreme levels of first quarter 2000. European and Japanese stocks are inexpensive relative to the U.S., but the valuation discount is reasonable given the outlook differences.

The biggest risk we see on the horizon is for a major policy mistake in the U.S., Euro Area or China. Consequently, policy is a focus. We continue to monitor the risks outlined above and will incrementally adjust the portfolio based on new information.

2016 Income Tax Information

For taxable portfolios, your account custodian (Charles Schwab, Fidelity or National Advisors Trust) will be mailing Form 1099 Report(s) to you by mid- to late February. This report will include income and realized gain/loss information and summary of fees and expenses. However, please be aware that these reports may be revised and corrected by the reporting custodian through March 2017. Please also note that you may view our summary of investment management fees through the client login/portal access of TFC's website.

As always, we welcome your comments and questions.

Sincerely,

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For joint marketing with other financial companies	No	We do not share
For our affiliates' everyday business purposes— information about your transactions and experiences	No	We do not share
For our affiliates' everyday business purposes— information about your creditworthiness	No	We do not share
For nonaffiliates to market to you	No	We do not share

Questions?	Call 617-210-6700 or go to www.tfcfinancial.com

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