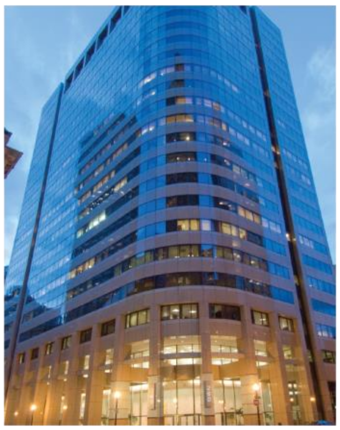
TFC FINANCIAL
The Financial Counselors

COMMENTARY | 3Q
October 13, 2016

OUR VIEW



Markets Rise Despite Continued Anxiety

Global equities advanced in the third quarter, led by segments of the market that were out of favor in recent years. Emerging market equities, value stocks and U.S. small company stocks were among the leaders, while U.S. large company and European stocks lagged. Dividend-paying stocks continued to be among the most popular, as investors discouraged by low yields in the bond market sought higher-yielding alternatives. Global bonds delivered unexciting returns in comparison with equities, though high yield and emerging markets bonds also were popular with investors reaching for yield.

Investors entered the third quarter uncertain about the implications of Brexit, nervous about the U.S. Presidential election, and speculating about the intentions of the U.S. Federal Reserve. The fourth quarter will bring clarity to the U.S. political landscape, and may bring considerably more information about Fed policy and Brexit.

Third Quarter Performance – TFC Portfolios

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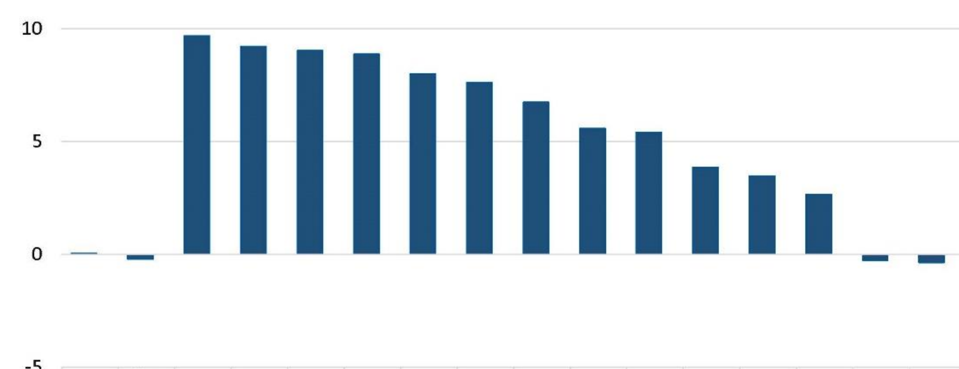
Quarter To Date Returns 9/30/2016

Historical Asset Class Returns



	Short Term Bonds	Short Term Muni Bonds	Intl. Small Value	US Small Growth	Emerging Markets	US Small Value	Intl. Value	Intl. Small Growth	Intl. Large Core	Global Stocks	Europe Stocks	S&P 500	US Large Value	Frontier Markets	Gold	Long Term Bonds
QTD	0.0	-0.2	9.7	9.2	9.0	8.9	8.0	7.6	6.7	5.6	5.4	3.9	3.5	2.6	-0.3	-0.4
YTD	2.6	1.2	6.2	7.5	16.0	15.5	0.8	4.2	2.2	7.0	0.0	7.8	10.0	2.2	24.2	14.7
1 Year	2.1	1.2	11.3	12.1	16.8	18.8	3.5	13.3	7.3	12.3	2.5	15.4	16.2	0.9	18.1	13.1
Full Cycle*	3.0	2.7	2.6	7.2	-0.8	5.7	-1.7	3.1	0.0	2.7	-1.0	6.3	4.9	-3.6	5.9	8.5

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

TFC portfolios benefited from the rotation of leadership during the quarter. Emerging markets led the way from a regional perspective, supported by signs of apparent stabilization in China, a rebound in commodity prices, and slowing dollar appreciation. Growth prospects, favorable demographics and moderate valuations drive the appeal of emerging markets, though we think volatility is inevitable. U.S. stocks also gained ground for the quarter, leadership continued the year-to-date rotation to the small company stocks that TFC typically emphasizes. European stocks lagged and were a drag on performance, as Brexit-related uncertainty played a role in dampening investor confidence in a European economic recovery.

From a style perspective, the continuation of expansionary (and extraordinary) monetary policies has had a far-reaching impact on value stocks. Dividend-paying stocks have been big winners, given the lack of yield available through traditional fixed income investments. As we wrote earlier this year, value outperformance hasn't been uniform. U.S. value indexes benefited earlier in the year from the strong performance of telecommunications, utility and REIT stocks. Financial stocks, a major component of value indexes, have lagged the market this year as low (or negative) interest rates hinder bank and insurance company earnings. Leadership shifted in the third quarter, with utility and telecommunication stocks falling sharply amid speculation about a Fed rate hike, and REITs lagged. Technology stocks, particularly high-dividend payers, were the strongest performers in the quarter, and in recent weeks financial stocks started to rally.

Growth is anemic, tepid, or sluggish. We may be running out of adjectives used to describe the weak expansion around the globe.

Economic Outlook: Market Focus on Geopolitics and Central Banks

"Growth is anemic, tepid, or sluggish." We may be running out of adjectives used to describe the slow pace of growth around the globe! The U.S. economy is projected to expand by more than 2% in the third quarter and by nearly 2% for the full year, higher growth than the rest of the developed world. However, estimates declined throughout the quarter, mirroring the trend of corporate earnings estimates. There are many positive indicators that demonstrate a positive, and far from overheated U.S. economy. Employment, wage increases, consumer spending, and housing all appear to be reasonably supportive of continued economic expansion.

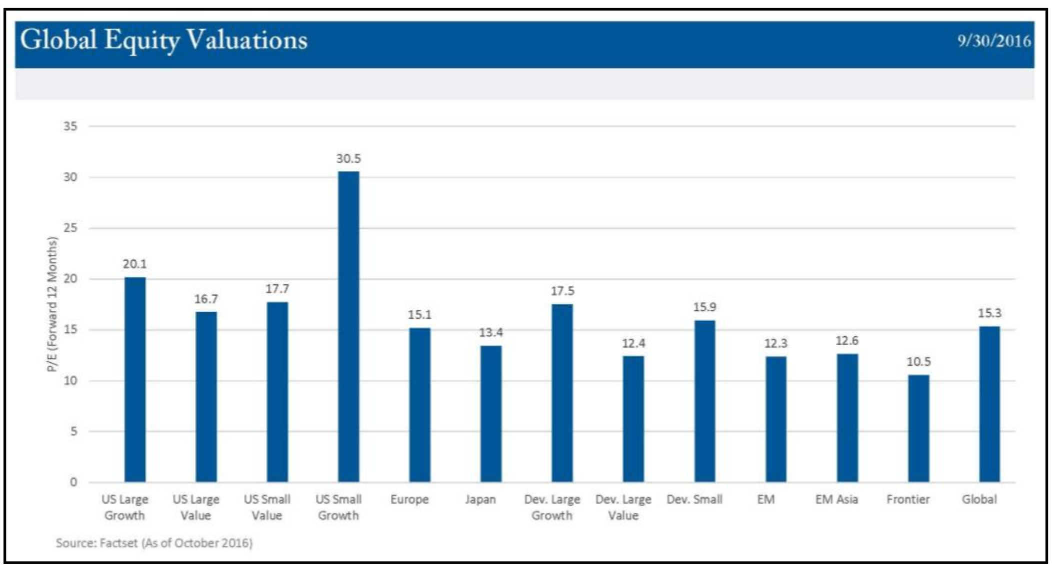
Europe's economic outlook is clouded by Brexit uncertainty. UK Prime Minister Theresa May is planning to formally invoke Brexit by March 2017, and the latest public statements from UK and European leaders are dampening hopes of a seamless transition. Banks are in the spotlight elsewhere in Europe, as Deutsche Bank has been in the headlines for the wrong reasons, and concerns are mounting about non-performing loans in Italian banks. Deutsche Bank is struggling with profitability and capital challenges, and entered the spotlight after the U.S. Department of Justice sought $14 billion from the bank to settle a suit over mortgage-backed securities abuses during the global financial crisis. The Deutsche Bank suit may be settled quickly and for a lower fine, but the problems with Italian banks may be more intractable.

Central bank policies are still in the forefront of investor focus. Although the Fed remained on hold in September, expectations are mounting that the Fed will raise rates in December. We expect the feedback loop between Fed policy and financial conditions to continue to act as a constraint, in that the more policy in the U.S. diverges from the rest of the world, the more the dollar rises. A rising dollar tightens U.S. economic conditions, which in turn makes it more likely for the Fed to delay rate increases. A cautious Fed and the U.S. trade balance may signal the end of the rapid rise in the dollar.

Market Outlook: Moderately Positive

Despite the uncertainty about Brexit and strains in the European banking system, the UK and Europe remain powerful economic engines and are the homes for many of the world's leading companies.

U.S. stock market valuations continue to be high relative to Europe, Japan and Emerging markets. Given high relative valuations, slowing revenue growth and margins coming off peak levels, we expect U.S. equity markets to struggle to provide the returns we have seen in recent years. Valuations can be "noisy" indicators and provide the most predictive help at extremes--although U.S. valuations are elevated, they aren't at levels that we consider alarming. TFC looks at multiple valuation metrics including price-to-book, price-to-earnings, price-to-cash earnings, dividend yield and price to cyclically adjusted earnings (CAPE) when evaluating prospective relative returns. Below is one indicator to give a sense of valuation levels. The U.S. small growth asset class looks quite expensive relative to other asset classes, but it is important to note, the asset class consistently trades with a higher multiple and is not as extreme relative to its own history.



Despite the uncertainty about Brexit and strains in the European banking system, the UK and Europe remain powerful economic engines and are the homes for many of the world's leading companies. We retain meaningful investments as a cornerstone of a diversified portfolio.

The Japanese market is inexpensive, but Japan's economic momentum, demographics and fiscal dynamics are far from confidence-inspiring. We are watching policy trends in Japan carefully, however, as the odds are rising for Prime Minister Abe to attempt a "game-changing" policy move to end the country's slow-growth and deflationary mindset. The latest policy initiative from Bank of

Japan, involving targeting of ten-year government bond rates, isn't a game-changer but there may be more initiatives in the works.

There is no doubt that emerging and frontier markets will continue to be volatile, but our long-term outlook is positive, given favorable demographics, stock valuations and growth prospects.

We are in-line with market expectations that the Fed will move very slowly, keeping rates "lower for longer." Our expectation provides a constructive backdrop for both equities and fixed income investments, though the delay in interest rate "normalization" makes it tough for income-oriented investors.

Risks: The Highest Profile Risks Provide Considerable Uncertainty and Will Contribute to Market Volatility

China: China has a difficult balancing act, trying to stabilize growth while taking steps to address structural problems such as poor credit allocation, an overleveraged corporate sector and "zombie" companies that need to be restructured. Dan recently wrote a column about China for *U.S. News & World Report*, which we've included as a supplement to this quarterly letter.

The final quarter of 2016 promises to be as interesting and unpredictable as the first three quarters. U.S. stock market valuations are high, though far below the excesses reached during the technology bubble.

Fed policy: The primary risk to our interest rate outlook is an acceleration of inflation. Wages are drifting higher, but to date wage growth has been far from levels that would force aggressive Fed action. Technology continues to be a disruptive force contributing to slow wage growth and income inequality, though at some point a declining labor pool may create wage pressures.

Recession: Generally positive economic indicators reduce the likelihood of steep recession in the U.S.; the apparent stabilization in China also helps to reduce the risk of a global recession.

Political shocks, including Brexit aftershocks: The potentially messy "divorce" between the UK and the EU heads the list of political concerns for markets. The U.S. presidential election will be in the headlines non-stop until Election Day, and is likely to have a consequential impact on the markets. It's interesting to see how movement in the Mexican Peso appears to correlate to the odds of Donald Trump becoming President, showing how politics can influence the markets. Italy will also be in the news, with solvency concerns about Italian banks in the headlines now, and headlines sure to increase as the country gears up for a December referendum on constitutional reforms. Russian President Vladimir Putin continues to be disruptive--at the center of the conflict in Syria, threatening neighboring countries including Ukraine, and appearing to direct cyber-attacks on U.S. politicians.

Concluding Thoughts: Our View

The final quarter of 2016 promises to be as interesting and unpredictable as the first three quarters. U.S. stock market valuations are high, though far below the excesses reached during the technology bubble. Interestingly, the most overvalued stocks may be the high dividend payers in utilities, consumer staples and telecommunications that are perceived as safe havens. Outside the U.S., European and Japanese stocks are inexpensive relative to the U.S., but the valuation discount may be justified given the challenging economic outlook in both regions. Emerging markets are interesting in valuation terms, as average valuations that are relatively cheap mask dramatic valuation differences between cheap sectors such as banks and expensive consumer-oriented sectors. Politics and central bank policies will certainly influence the markets in Q4, with the U.S. Presidential election, a constitutional referendum in Italy, and continuing discussions about Brexit among the developments with the highest potential to move markets.

It seems there is always a global concern arguing for defensive portfolio posturing. We continue to monitor the risks outlined above and will incrementally adjust the portfolio based on new information. We do remain cautiously optimistic, as we think the pessimistic mood in the market is influenced by the recent memories of that Great Recession and a painful adjustment to a lower return and slower growth world.

As always, we welcome your comments and questions.

Sincerely,

Jim　　　Renée　　　Dan

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Why China Should Be Part of a Long-term Investment Portfolio
By Daniel S. Kern, CFA, CFP®, Chief Investment Strategist, TFC Financial Management

Investing in China is a controversial topic, with China bulls and bears almost as far apart as supporters of Clinton and Trump. Bulls and bears talk "at" each other, often with red faces and raised voices! Although the debate about China may be as polarized as the Presidential debate, it is possible to present an unbiased view that acknowledges both sides of the argument. Despite the significant challengers on the horizon for China, long-term investment portfolios should include investments in Chinese stocks.

Addressing the risks
Slowing GDP Growth: Many commentators cite the slowdown of Chinese GDP growth as a reason to avoid China. GDP growth according to official statistics, which was 11.4% in 2005 and in double-digit levels as recently as 2010, fell to 6.9% in 2015. Private estimates are for Chinese GDP to fall further in 2016 than official statistics would indicate, with consultancy Capital Economics projecting 5% growth. An important consideration, however, is the size of China's economy in 2016 relative to its size in 2005. China's economy is more than 5 times larger today, so 5% growth on a much larger economy base is still quite robust! In a recent speech Matthews Asia's Andy Rothman commented about the need to "get away from the obsession with China's GDP growth rate."

Debt: China's corporate sector binged on debt in recent years, in large part because of massive infrastructure spending initiated to stabilize the economy in response to the Global Financial Crisis (GFC). Private debt in China represents more than 200% of GDP, far higher than the peak of U.S. private debt before the GFC and approaching the high reached by Japan in 1990. The explosion of debt creates fear that China will face a banking crisis and hard landing, repeating post-bubble cycles experienced in the U.S., Europe and Japan.

The debt picture may be more nuanced than alarmist headlines would indicate. The central government is the largest shareholder in most of China's major banks, and a significant portion of the private debt was extended on behalf of the government as a form of fiscal stimulus. In the words of Rothman, "the potential bad debts are corporate, not household debts, and were made at the direction of the state, by state-controlled banks to state-owned enterprises." Although China's corporate debt is uncomfortably high, household debt is low and government debt is only 44% of GDP. China's overall debt, including corporate, household and government debt, is comparable to that of the U.S. and UK and considerably lower than that of Japan, France and Canada. That may not be unequivocally great news--as 255% debt/GDP ratio is still uncomfortably high--but it's important for context-setting. Perhaps most importantly, very little of China's debt is owed to external parties, so China (at least for the time being) has considerable latitude as to the approach and timing of structural change to reduce its private debt.

State-owned enterprises: China's leaders face a difficult balancing act: maintaining enough growth to preserve social stability while addressing the need to restructure debt-laden, money-losing state-owned enterprises. The slow pace of reform among state-owned steel, coal and electricity companies that dominate China's "rust belt" is a concern, but the stereotype of China as an export-focused, state-dominated economy isn't true anymore. Exports are a small part of China's economic output, and the private sector is the dominant economic engine for the country.

Embracing the opportunities

A "slower-growth" China accounts for about 1/3 of global growth, a higher proportion than was the case in 2010 when China's GDP growth was 10%! Private sector employment is more than 80% of total employment in China, and outside of the manufacturing sector there are more jobs than job seekers. China may be the best consumer story in the world, and the rise of the "consumer class" in China is very real. Real household income rose more than 130% over the past decade, a noteworthy advance compared to nearly non-existent income growth for developed market households. China's consumers are in good shape, with high savings, low debt, and rising household income. Retail sales in China gained 10.6% year over year in August, continuing a strong multi-year trend. The middle class, about 8% of the population today, is expected to triple to 300 million people by 2020 An aging population also provides opportunities, as 16% of the population (220 million) are age 60 or older today. Some of the most exciting opportunities are with the consumer-oriented companies that benefit from rising incomes, healthcare companies that support a more affluent (and aging) society and industrial companies helping to improve manufacturing consistency. Many of these companies didn't exist ten years ago!

Addressing China's structural problems, including high corporate debt and sluggish state-owned enterprises, won't be an easy process, but is likely to result in slower growth, pressure for currency adjustments and continued volatility rather than a crisis or hard landing. Despite the risks and volatile ride, China is likely to be an attractive investment destination for the patient investor.

Disclosures: