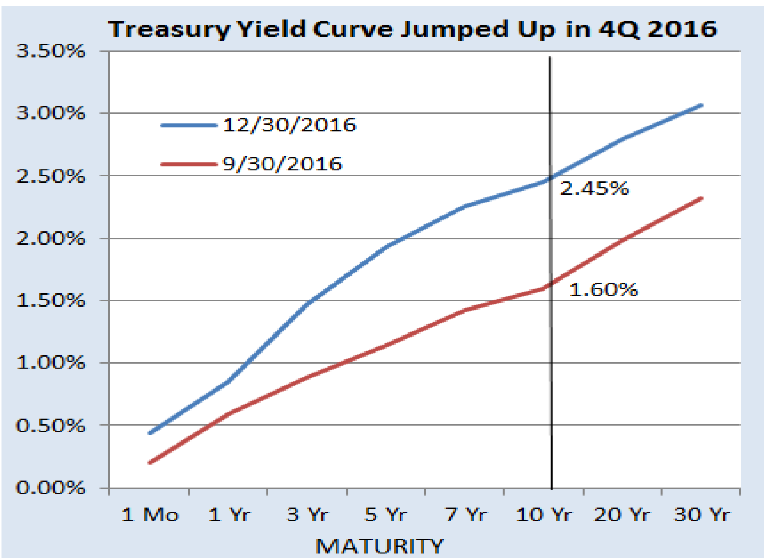
Fourth-Quarter 2016 Market Commentary

Jan. 4, 2017

Investors in the fourth quarter reacted quickly to the U.S. Presidential election of Donald Trump based on their assessment of his policy proposals to cut taxes, roll back regulation and promote faster economic growth. U.S. equities overall moved up although sector performance diverged dramatically. Financials jumped nearly 22% on expectations of reduced regulations and higher interest rates that would boost banks' net interest margins. The energy, industrials and materials sectors also posted strong returns in anticipation of higher spending for infrastructure and defense. On the other hand, the real estate sector gave up 7.5% on concerns of higher mortgage rates.



Fixed-income markets struggled in Q4 as optimism for greater economic growth translated to higher interest rates and expectations of rising inflation. The graph shows how interest rates rose across the Treasury yield curve from Sept. 30 (red line) to Dec. 30 (blue line). Not only did the entire yield curve move higher, but it also steepened, as is typically the case when economic expectations are rising. The vertical line indicates the 10-year Treasury yield, which rose from 1.60% at the end of Q3 to 2.45% at the end of Q4.

The 4Q decline in U.S. government bond prices essentially wiped out all of the gains from the first nine months of the year. Investment grade corporate bonds also declined in Q4, but less so due to narrowing credit spreads. High-yield corporate bonds managed to eke out positive returns for Q4, capping off a gangbuster year. Municipal bonds declined on record new issuance ahead of the election and the expectation that lower tax rates would curb the benefit of the tax exemption for higher-income taxpayers.

Index Performance Data

Equity Index Returns	4Q 2016	Full Year 2016	5-Year Annualized
Dow Jones	7.94%	13.41%	10.06%
S&P 500	3.82%	11.96%	14.60%
Russell 2000	8.83%	21.31%	14.40%
MSCI ACWI	1.19%	7.86%	9.32%
MSCI EAFE	-0.71%	1.00%	6.51%
MSCI Emerging Markets	-4.16%	11.19%	1.27%

Other Index Returns	4Q 2016	Full Year 2016	5-Year Annualized
MSCI US REIT	-4.03%	4.22%	7.54%
Bloomberg Commodity Index	2.66%	11.77%	-8.92%
HFRI FoF Index	0.04%	-0.20%	3.16%

Fixed Income Index Returns	4Q 2016	Full Year 2016	5-Year Annualized
Barclays Aggregate Bond Index	-2.98%	2.65%	2.22%
Barclays 1-10 Year Municipal Bond Index	-2.62%	-0.10%	2.02%
Merrill Lynch High Yield Master II Index	1.88%	17.49%	7.32%
Citi World Government Bond Index	-2.72%	3.78%	3.58%
JPM EMBI Global Diversified	-4.02%	10.15%	5.88%
Barclays TIPS	-2.41%	4.68%	0.89%

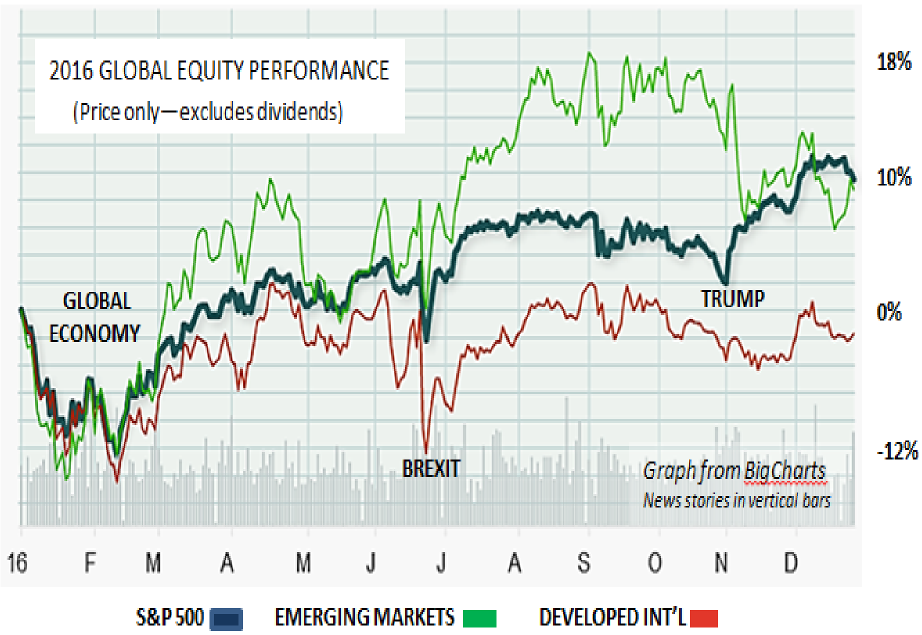
Source: FactSet

Notes: HFRI FoF Index performance as of 11/30/2016; Returns are total returns except for the Dow Jones & MSCI US REIT (price returns); Citi World Government Bond Index is the hedged index.

The Federal Reserve's quarter-point rate hike in December and its indications for as many as three moves in 2017 demonstrated its confidence in the economy, supported by the latest drop in the unemployment rate to 4.6%. Similarly, the Conference Board's Consumer Confidence Index hit a 15-year high in December, and business confidence also rose, boosted by Trump's tax-cut proposals that include a tax holiday for companies to repatriate profits earned abroad.

U.S. and International Equity Performance Throughout 2016

The graph below begins with the steep fall in global equity markets at the start of 2016 amid fears of a global economic slowdown and hard landing in China. The plunge in WTI crude to a low of $26.19/barrel in February added to investors' worries. As these fears subsided, equities staged a strong recovery, particularly emerging markets (shown in green). In late June, the surprise outcome of the Brexit referendum, when the U.K. voted to leave the European Union, pushed equities down, especially developed international markets (shown in red) with significant trade links with the U.K.



As concerns waned about Brexit, global markets bounced back quickly and were led by emerging markets. Post-election, U.S. equities (in dark blue) appreciated while emerging markets tumbled on fears of Trump's plans for protectionist tariffs.

2016 will be remembered not only as a year when politics had a major influence on investment performance, but also because it witnessed a 45% rise in oil prices, a substantial strengthening of the U.S. dollar, and the possible end of a 35-year bull market in bonds. The number of hedge fund closings in 2016 was on track to be the largest since 2008, following years of disappointing returns and high fees.

In closing, we refer back to the Conference Board's press release announcing the 15-year high in consumer confidence. "Looking ahead to 2017, consumers' continued optimism will depend on whether or not their expectations are realized." Although Trump's election has been termed a "populist" vote, it remains to be seen whether the benefits will accrue to the general population. Given the uncertainties around bilateral relations, trade agreements, policy and regulation, we caution against excessive optimism that is accompanied by greater risks.

Details about HPM Partners' outlook for the economy and capital markets can be found in our January 2017 Economic Outlook and Market Forecast report, and in our Annual Outlook to be published in mid-January.

With best wishes for the New Year,

Investment Publications Group: Ben Pace, Karim Ahamed, Mimi Lord, Patrick Murray and Tom Cohn.

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