Quarterly Economic Update

December 7, 2016

MACROECONOMIC COMMENTARY

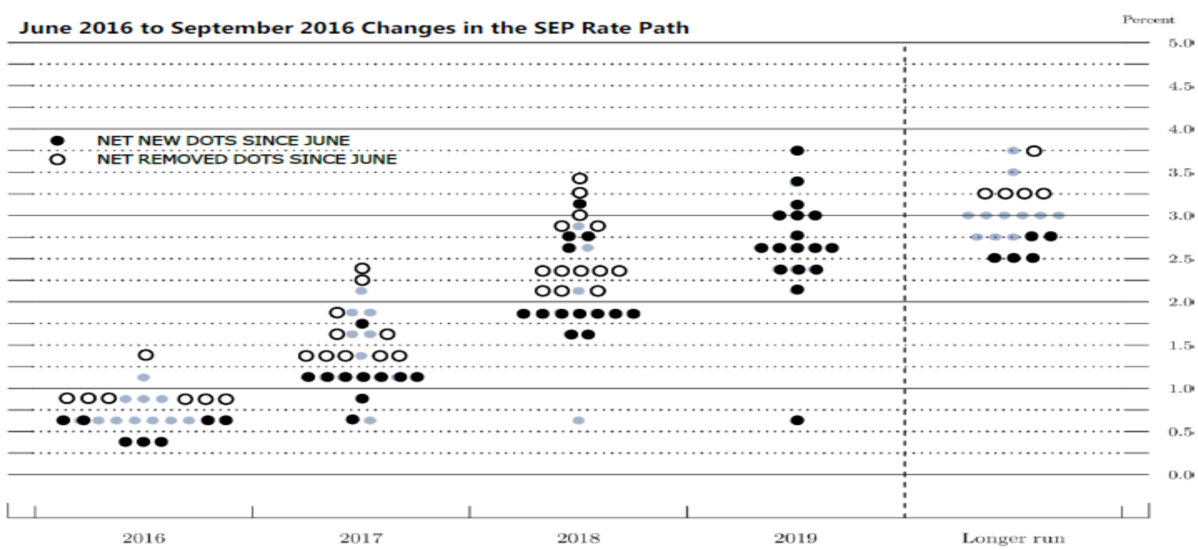
Monetary Policy

By Bobby Long

The Federal Open Market Committee (FOMC) seems to be proceeding along a path to increase the federal funds rate again at their December 13-14th meeting. They have continued to hold the target range for the federal funds rate at ¼ to ½ percent at both their September and November meetings, but communications seem to be guiding to a quarter point increase at the upcoming December meeting barring a significant deterioration in economic or market conditions. Labor market conditions have continued to strengthen and economic activity has improved since earlier in the year, supplying FOMC members with conditions that can warrant a rate increase. Inflation is still running below their 2 percent objective, but has shown some signs of improvement more recently. Market conditions have also been supportive following the recent presidential election. All this has led to an increase in the probability for a rate increase in December.

At the September meeting, the FOMC decided against increasing the federal funds rate, but shifted their language more toward a tightening stance. The statement noted that “near term risks to the economic outlook appear *roughly balanced*,” versus prior language that only noted that risks had *diminished*. The September statement also inserted a new sentence that “The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives.” Federal Reserve Chair Janet Yellen had recently made similar comments in her August Jackson Hole speech, but inserting the comments into the FOMC statement made it official that this view was shared among FOMC members and represented an official shift along the path to another rate increase.

The September meeting also contained updated economic and policy projections, providing a refreshed “dot plot” on the FOMC participants’ expectations for the appropriate path of the federal funds rate.



Source: Evercore ISI

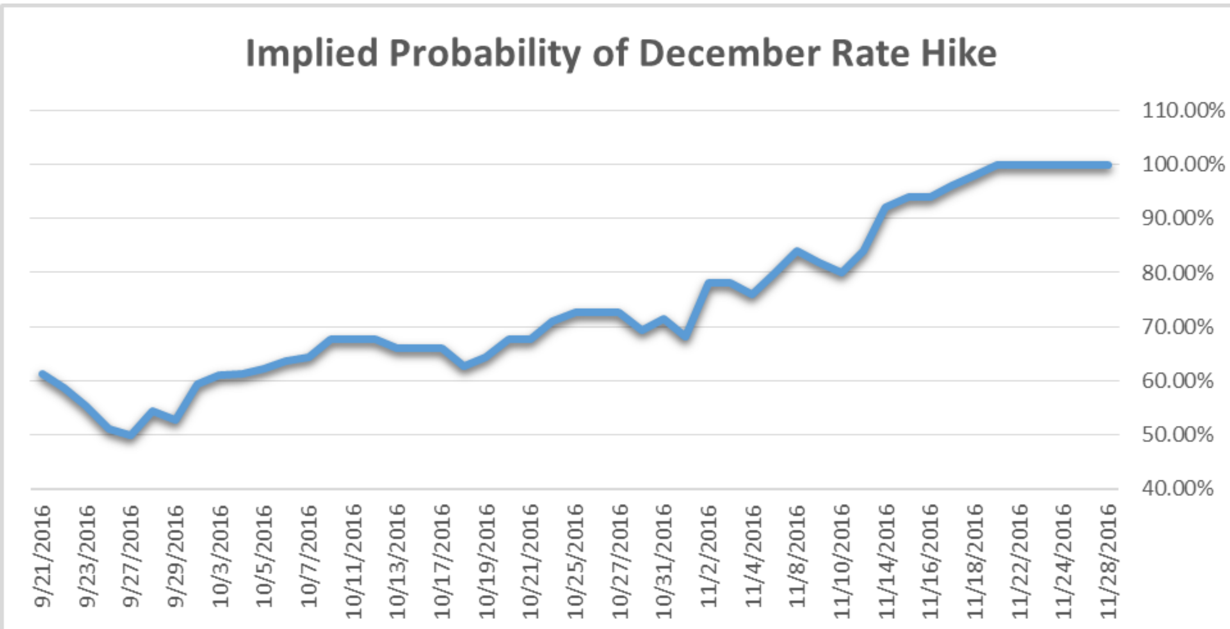
The dots show that participants overwhelmingly still thought it would be appropriate to increase the federal funds target rate at least once before the end of 2016. While the September projections are a little dated at this point, conditions have only improved since then, making a stronger argument that consensus among FOMC members is likely in favor of an increase at the December meeting. The dot plot chart also shows how the dots have continued to shift down, projecting a more gradually pace of rate increases.

The November meeting also resulted in a decision to leave the federal funds rate unchanged. This was mostly expected given the proximity of the meeting only one week ahead of the presidential election and a likely unspoken desire not to make a policy change that close to the election. While the meeting passed with little attention and the statement was mostly repetitive from the prior statement, the November statement did include a more constructive outlook on inflation. It acknowledged that inflation was still running below their two percent objective, but noted that inflation had “increased somewhat” and that market-based measures of inflation compensation had “moved up.” The statement also removed prior commentary that inflation was “expected to remain low in the near term.” While these were small and subtle changes, lower inflation and inflation expectations have been a significant factor that has kept the FOMC from raising rates and removing accommodation more aggressively.

It should be noted that there were three dissenting votes at the September meeting and two dissenting votes at the November meeting. These FOMC members voted against leaving the target range for the federal funds rate unchanged and were in favor of increasing the target by 25 basis points. The dissenters highlighted their views that employment and inflation were at or moving towards the FOMC’s statutory objectives. They also expressed concern that not raising rates could lead to credibility issues with future Fed communications and could make it necessary for more aggressive policy actions later. These dissenting votes highlight growing pressure from within the FOMC in favor of a rate increase.

One looming uncertainty has been the outcome of the presidential election. The FOMC in theory operates outside of the political arena and monetary policy decisions are made independently based on economic conditions, but a new presidential administration does represent a change and can introduce an element of uncertainty on other policy decisions that could impact economic conditions. A Clinton election was viewed more as a continuation of the current administration and with more certainty around policy direction going forward. A Trump election was viewed as a more significant change and a much larger degree of uncertainty around policy direction. As we now know, the election resulted in what was viewed by some as an unlikely outcome and introduced a greater element of uncertainty. Prior to the election, there were concerns that a Trump election could result in a greater degree of volatility in financial markets as markets adjusted to reflect the greater degree of uncertainty under his administration and there were concerns this increased near term volatility could hinder the FOMC’s ability to raise rates in December. Financial markets have responded orderly with equity markets and interest rates moving higher, leaving FOMC members the flexibility needed to increase the federal funds rate at their December meeting if conditions warrant tightening monetary policy.

Odds of an increase at the December 13-14th meeting have increased significantly over the past couple months and currently sit around 100% for a 25 basis point increase. As the chart below shows, the odds have drifted higher since the September meeting before increasing sharply following the November meeting and then again after the presidential election.



Source: Bloomberg

With a rate increase at the December meeting seemingly a foregone conclusion in the market's eyes, the focus will surely be placed on their updated projections for the path of the federal funds rate. Yellen and her fellow FOMC members have indicated they intend to move forward at a gradual pace and slowly remove accommodation with a focus on downside risks, but policy actions will ultimately be driven by the economic data.

One challenge going forward may revolve around their use of guidance and Fed communications as a policy tool. This has been somewhat effective in the past, but may be more difficult going forward under the new presidential administration. The Federal Reserve and the FOMC are in theory independent and apolitical. Members of the Board of Governors are nominated for 14 year terms by the president and confirmed by the senate. There are seven members that serve on the Federal Reserve Board of Governors. Of these seven members, two serve as Chairman and Vice Chairman of the Federal Reserve. Those positions are also nominated by the president and confirmed by the senate to serve four year terms in those roles that can be reappointed to additional terms within their 14 year Governor term. All seven members of the Federal Reserve Board serve on the 12 member FOMC. The other five members on the FOMC consist of regional Federal Reserve Bank presidents. The New York Federal Reserve president has a standing seat on the FOMC. The other four positions rotate between the regional banks on an annual basis, so those four positions turn over at the beginning of every year.

Currently, two seats on the Federal Reserve Board of Governors are empty and the president-elect will have the opportunity to fill these seats fairly quickly in 2017 following other key appointments. Federal Reserve Chair Janet Yellen's term as chairman ends in February 2018 and the president-elect has indicated he will not reappoint her to that position at the end of her term as chairman. Federal Reserve Vice Chairman Stanley Fischer's term as vice chairman runs through June 2018. If Yellen and Fischer were not reappointed to their chairman and vice chairman positions, they could in theory continue to serve out their terms as governors through 2024 and 2020. However, most former chairman and vice chairman resign their governor positions on the board at that time. This leaves the potential for the president-elect to nominate four of the seven positions to the Federal Reserve Board over the next 18 months. With the regular turnover of regional bank presidents and the potential for four new members moving on to the Federal Reserve Board, this FOMC could be a very different committee 18 months from now. The chairman sets the tone on policy and communication and with Yellen now appearing like a lame duck chairman combined with turnover on the committee, this makes guidance and Fed communications as a policy tool extremely difficult and significantly impacts the credibility of any communications. This could potentially increase financial market volatility around policy decisions without a very transparent and telegraphic FOMC that markets have grown accustomed to over the past several years, making the task of normalizing monetary policy much more challenging.

Fiscal Policy

By Michael McNair

The result of the Presidential election has surprised markets and investors are scampering to understand the potential implications of a Trump Presidency. In this edition of the Fiscal Policy Report we will discuss the major policy actions that the GOP controlled government are likely to pursue.

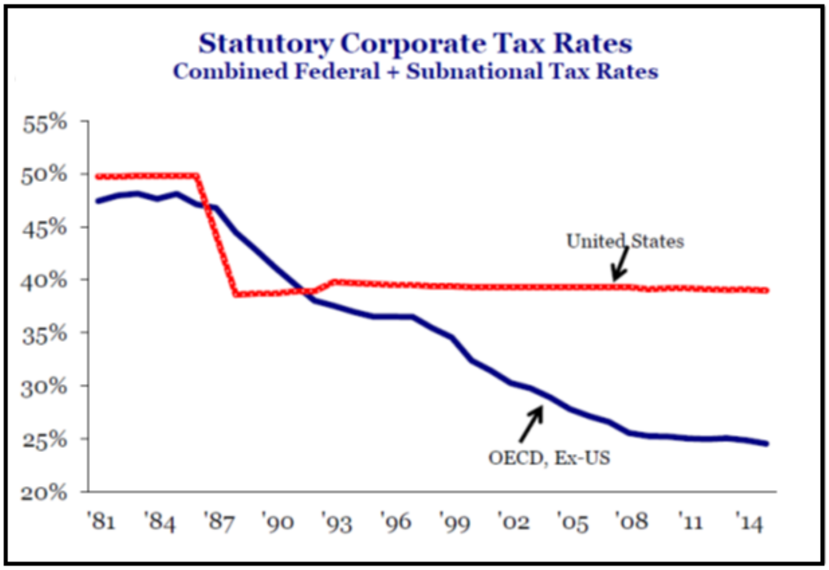
Corporate tax reform is at the top of the Trump administration and Republican Party's agenda. According to the Tax Foundation, the United States has the most burdensome corporate tax policy among all OECD countries and Republicans believe that current tax policy is hurting the country's global competitiveness and job creation.

Source: Strategas

Republicans would like to make a number of adjustments to the current corporate tax law in an effort to increase the country's competitiveness but there is currently no consensus on the best way to achieve this goal. President-Elect Trump's tax plan and the House GOP plan are summarized in the chart below.

Trump & House GOP's Corporate Tax Plans			
	Current Law	Trump Plan	House GOP Plan
Corporate Tax Rate	35%	15% for businesses that reinvest the profits in the business	20%
Pass-Through Tax Rate	Taxed at individual income tax rates	15% for businesses that reinvest the profits in the business	25% maximum
Treatment of Capital Investment	Businesses can deduct 50% of investment costs in the year in which they occur (via bonus depreciation)	Firms engaged in manufacturing in the US may elect to fully expense capital investment but lose the deductibility of corporate interest expense	Businesses can fully deduct the cost of capital investment immediately and eliminates the deductibility of net interest expenses on future loans
Net Operating Losses	Net operating losses may be carried forward over the next 20 years and may be carried back to the 2 prior years and applied against taxable income for a refund		Restricts the deduction for net operating losses to 90% of net taxable income and allows net operating losses to be carried forward indefinitely, and increased by a factor reflecting inflation and the real return to capital. Does not allow net operating losses to be carried back.
Corporate Alternative Minimum Tax (AMT)	20% of AMT income	Eliminates	Eliminates
Tax System	Worldwide system		Territorial, border-adjustable system
Foreign Source Income	Deferred taxes until repatriated	Deemed repatriation of currently deferred profits at one-time tax rate of 10%	Deemed repatriation of currently deferred profits at one-time tax rate of 8.75% for cash and cash-equivalent profits and 3.5% on other profits
Foreign Reinsurance Premiums	Deductible from income tax	No changes currently proposed	No changes currently proposed
Fossil Fuel Tax Incentives	Expensing of intangible drilling costs; percentage depletion; deduction for domestic production of oil, natural gas & coal	Eliminates the domestic production activities deduction	Eliminates the domestic production activities deduction
Tax Credits		Eliminates all other business credits except for the R&D credit	Eliminates all other business credits except for the R&D credit

The focal point for any corporate tax reform will center on lowering the statutory corporate tax rate which has increased relative to other OECD countries over the last two decades.



Source: Strategas

A major hurdle for completing corporate tax reform is the fact that any tax reductions must be offset by an increase in tax revenue elsewhere. For every 1% reduction in the corporate tax rate, policymakers need to find $100 billion of revenue over a 10 year period. Therefore, if policymakers want to cut the corporate tax rate from 35% to 25% they will need to find $1 trillion of tax revenue from other sources.

Most of the tax offsets will need to come from eliminating tax deductions and credits and below we list the possible deductions and credits that policymakers can cut in order to raise the required revenue. It is important to note that all of these tax changes will face stiff political opposition; thus, it is difficult to predict which ones could be successfully eliminated.

Largest Individual and Corporate Tax Expenditures	
Corporate Tax Expenditures	**Estimated Cost (2010-2014), $BN**
Deferral of Active Income of Controlled Foreign Corporations	$70.60
Exclusion of Interest on Public Purpose State and Local Government Debts	$45.30
Deduction for Income Attributable to Domestic Production Activities	$43.20
Inventory Property Sales Source Rule Exception	$38.00
Depreciation of Equipment in Excess of Alternative Depreciation System	$37.10
Inclusion of Income Arising from Business Indebtedness Discharged by the Reacquisition of Debt Instrument	$28.80
Tax Credit for Low-Income Housing	$27.00
Expensing of Research and Experimental Expenditures	$25.60
Inventory Methods and Valuation: Last In First Out	$20.00
Reduced Rates for First $10,000,000 of Corporate Taxable Income	$15.90
Tax Expenditures for Individuals	**Estimated Cost (2010-2014), $BN**
Health Care Exclusion	$659.00
Home Mortgage Deduction	$484.00
Defined Benefit Plans	$303.00
Earned Income Credit	$268.00
State and Local, Sales Tax, and Property Tax Deductions	$237.00
Defined Contribution Plans	$212.00
Charitable Deductions (excluding Health and Education	$187.00
Medicare - Hospital (Part A)	$175.00
Social Security/RR Retirement	$173.00
Cafeteria Plan Exclusion	$163.00
Inside Buildup	$149.00

Source: Joint Committee On Taxation

While there is little clarity on which tax deductions and credits will be eliminated, one source of offsetting tax revenue that is almost certain to be included in any corporate tax reform legislation is a repatriation tax, because it is both a large source of potential tax revenue and faces little political opposition. Under current law corporations are taxed on profits they earn overseas and bring back to the U.S. minus a credit equal to the taxes they paid overseas on that income. Because US corporate tax rates are the highest among OECD countries, companies have been increasingly reluctant to bring their foreign earnings back to the US. A repatriation tax holiday would temporarily lower the tax on the cash companies bring back from overseas (i.e. repatriate) in order to incentivize companies to bring the cash back where it can be taxed. The last time the US created a repatriation tax holiday was in 2005, and US companies responded by repatriating $300 Billion of the ~$600 billion they held overseas. Today, just counting the companies in the S&P 500, there is ~$2.4 trillion in cash held overseas. Strategas Research believes that a repatriation tax holiday would spur companies to bring back over $1 trillion of that cash over the next 12-15 months and raise roughly $180 billion in tax revenue.

Border Adjustable Corporate Tax

The most interesting plan the GOP is pushing as a source of offsetting tax revenue is a border adjustable corporate tax. Under current law, corporations are taxed on their profits, which are roughly defined as revenues minus costs, at a marginal rate of 35%. The GOP's border adjustable corporate tax plan would lower the corporate tax rate to 20% but any "costs" that a company imports would not be deductible from their revenue. However, any revenue that is derived from an export will not be added to taxable income.

For example, under the current law, if Walmart buys a $100 microwave that was produced in China and sells it for $110 in the United States, Walmart is only taxed on their $10 profit and at the 35% corporate tax rate ($3.50 of tax). Under the proposed plan the $100 cost Walmart incurred to procure the Chinese made microwave would not be eligible to offset their $110 of revenue. Therefore, Walmart would be taxed at the new 20% corporate tax rate on the entire $110 of revenue (or $22 of tax).

On the other hand, if US steel produced steel in the US and sold it to a company in Mexico, US Steel would get a tax rebate equal to 20% of the export revenue.

The border adjustable corporate tax is effectively a tariff on imports into the country. This tax would decrease the US trade deficit and likely create job growth as private investment in the country would likely increase. Importantly, the Congressional Budget Office (CBO) estimates the border adjustable corporate tax would also generate over $1 trillion of incremental tax revenue over a 10 year period. This single tax could fund the drop in the corporate tax rate from 35% to 23%.

However, there are a number of issues that lower the likelihood of a border adjustable corporate tax surviving the legislative process. The most obvious issue is that the tax likely violates World Trade Organization (WTO) rules. The WTO generally allows and expects consumption-based taxes, called "indirect taxes," to be border adjusted. However, it objects to income-style taxes, called "direct taxes," being border adjusted. Therefore, the corporate income tax is not considered eligible for border-adjusted treatment. However, there is a case for treating this tax as an indirect, consumption-based tax. Once a business tax allows full and immediate expensing of capital investment spending, it takes on the nature and tax base of a consumption-based tax.

Regardless of the final ruling by the WTO, the fact that it is unclear as to whether this tax is WTO compliant makes it risky to depend on the tax as an offset for corporate tax cuts. Further, if the tax can raise a trillion dollars in tax revenue it means that someone is getting hit with that tax (importers) and they have a trillion dollar incentive to kill the legislation.

Infrastructure Spending

Many investors seem to be betting that infrastructure spending is likely to surge over the next couple of years. We have consistently heard numbers like $550 billion or even $1 trillion in infrastructure spending. However, we believe that the market is getting ahead of itself and the infrastructure spend is likely to be smaller and take longer to enter the economy that the market seems to be anticipating.
The $1 trillion dollar estimate comes from a proposal by Wilber Ross Jr. and Peter Navarro (two top Trump advisers). The Ross-Navarro plan advocates using a tax credit which they estimate will spur $1 trillion of private sector investment into infrastructure. Their proposal is that the government would provide an 82% tax credit for the equity piece of infrastructure projects. They calculate that $167 billion in equity investments could finance $1 trillion in infrastructure spending. Thus, given the 82% tax credit, taxpayers would provide $137 billion of the $167 billion and private investors would provide the remaining $30 billion. More than $800 billion would be borrowed.

We are skeptical that the Ross-Navarro plan will spur anywhere near $1 trillion in infrastructure spending. Cornerstone Macro Economist, Andy Laperriere, explains,

"An important limitation of the Ross-Navarro plan is that it does not provide federal funding for projects. Instead, it is a tax credit designed to make it cheaper to finance projects that generate a positive return. But many infrastructure projects don't generate a source of revenue that could pay back investors, including most highway, mass transit, and water treatment projects. Much of the infrastructure that does generate a positive return is in the energy area, and it's not clear how many new projects the tax credit might spur (as opposed to making more profitable projects that would have occurred anyway). In any event, if the Ross-Navarro plan turns out to be the heart of the Trump administration infrastructure plan, it probably won't help companies much that are involved in highway and mass transit projects. Another issue will be financing the Ross-Navarro plan. They argue their proposal would not add to the deficit because the increased taxes that workers and the companies involved in these projects would pay would offset the $137 billion in tax credits provided by the federal government. It is a near certainty that the Congressional Budget Office (CBO) will come to a different conclusion. So if Republicans insist on offsetting the cost of increased infrastructure spending, which is the base case, they will need to find a financing mechanism for the tax credit. There will also be major concerns over the taxpayers providing 82% of the equity of highly leveraged projects."

There is no mention of the Ross-Navarro plan on Trump's website and only a pledge to "invest $550 billion to ensure we can export our goods and move our people faster and safer." While a $550 billion infrastructure spend over 5 years is more realistic than the $1 trillion estimate, we still believe that is a best case scenario and the spending is not likely to impact the economy until 2018.

Further, the Tea Party still has a strong position among Republicans in Congress and they are unlikely to give President-Elect Trump a blank check to increase the deficit. Therefore, any infrastructure spending legislation will need to be offset by increased tax revenue elsewhere. As we have already discussed, the Republican plan for corporate tax reform is also going to require policymakers find ~$1 trillion offsetting tax revenue increases which will face strong political opposition of its own. Corporate tax reform is higher on the GOP agenda than infrastructure spending; therefore, infrastructure spending will be dependent on the ability of policy makers to find more than enough offsetting tax revenue to pay for the corporate tax cuts and still have room for infrastructure spending. We believe that the GOP will find it extremely difficult to find enough revenue offsets just to pay for the corporate tax cuts; therefore, we place low odds on a large infrastructure spending bill. Further, the economic stimulus from infrastructure spending will be muted because it will be offset by higher tax revenue and it is the amount of deficit spending (i.e. spending in excess of tax revenue) that stimulates the economy.

Economic Outlook

By Hunter Bronson

According to the BEA's second estimate for the third quarter, the US economy accelerated to 3.2% growth, annualized, after adjusting for inflation. The acceleration in real GDP was primarily driven by recovery in private inventory investment and government spending from meaningfully negative levels to roughly flat. While personal consumption expenditures were a positive contribution to growth, it did decelerate a bit from the previous quarter. Recent growth trends and confirmation from consumer confidence and transportation activity indicate that growth should continue to accelerate through the back half of the year.
Contributions to the headline real GDP growth estimate of 3.2% were as follows:

- Personal consumption expenditures contributed 1.9% to growth, down from 2.9% last quarter.
- Nonresidential gross private domestic investment, a measure of corporate capital expenditures, was roughly flat and consistent with the previous quarter.
- Residential fixed investment was a slight drag in the quarter, subtracting (0.2)% from growth and marginally improved from (0.3)% last quarter.
- Increased inventories contributed 0.5% to growth in the quarter, significantly improved from a (1.2)% drag in the previous quarter.
- Net exports accelerated a bit, contributing 0.9% to growth this quarter on top of 0.2% last quarter.
- Government spending was roughly flat this quarter after a drag of (0.3)% last quarter.

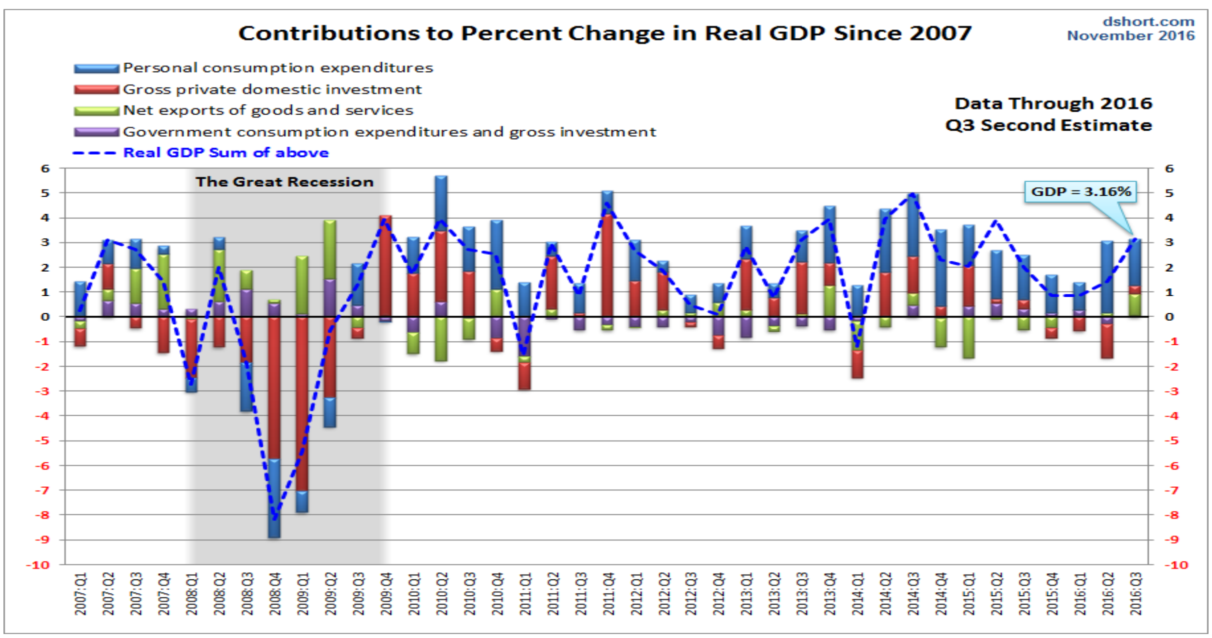


Figure 1: Contributions to GDP

Consumer, Wages, & Employment

The Conference Board's index of consumer confidence increased more than expected in November, reaching new highs since the beginning of the current expansion and nearing highs last seen in 2007.

Figure 2: Consumer Confidence through November 2016

Consumer confidence measures have been sending conflicting signals in recent years, as households have worried over several potential international crises (BREXIT, Greece, Chinese growth, e.g.) and a very contentious presidential election. While most of these issues aren't fully resolved, it seems that market participants and commentators have worked through their major anxieties, and the consumer has largely moved on. Interestingly, the Conference Board indicated that the resolution of the election had very little effect on the November index reading, as the majority of the survey responses were counted before November 8th. It remains to be seen whether President-elect Trump's dovish fiscal talk will continue to spur the consumer on.

The pace of domestic job growth continues to slow modestly, but the unemployment rate has stabilized at a very healthy 4.9% in October. The Bureau of Labor Statistics' November unemployment estimate was unavailable as of the time of this writing. Employment statistics continue to behave as expected, and they indicate that we are firmly within the second half of the business cycle.

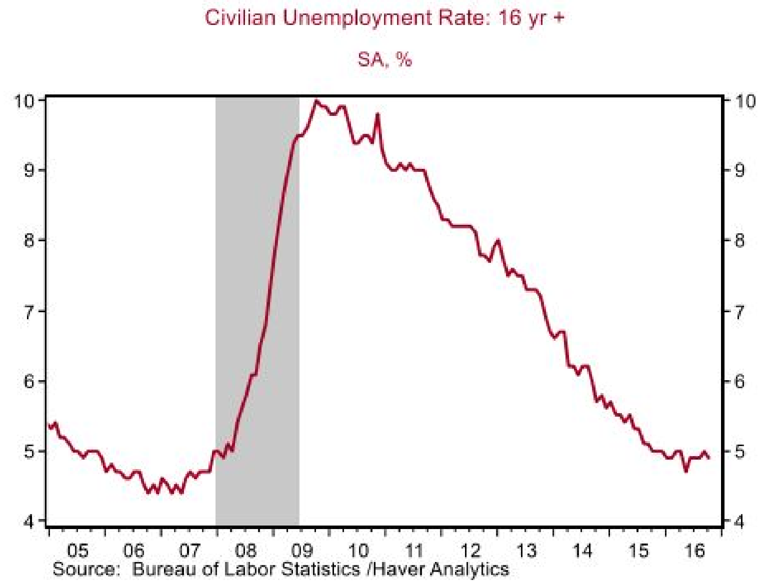


Figure 3: Unemployment is forming a base through October

The unemployment rate does not tend to stagnate for very long (see ’06-’07 in Figure 3 above). We would not be surprised to see the unemployment rate begin to slowly climb out of the base it has been forming since the middle of last year and, possibly, begin to pick up steam through next year. It is important to remember that this is very normal business cycle employment behavior. At this point in the cycle, wage growth is usually a more important indicator of the health of the consumer than unemployment statistics.

Average hourly earnings, a measure of wage growth, continues to slowly grind higher with the October reading at 2.8% and the 3-month average at 2.7%. This is a bit of mixed news. Wage growth is unambiguously good for the consumer, but it has, historically, been at least one percentage point higher at these levels of unemployment.

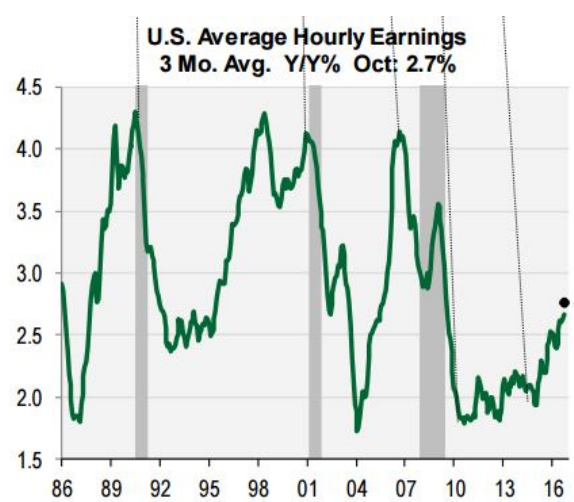


Figure 4: U.S. AHE Source: Cornerstone Macro

As we noted in last quarter's report, at this point in the cycle, lower wage growth is primarily driven by muted corporate profits. According to a report from the Commerce Department last week, businesses may soon have more flexibility to reward their employees. The report indicated that U.S. corporations' after-tax earnings increased by 5.2% in the third quarter over the same quarter last year. This is the first measure of growth since 2014 and the strongest quarterly profit growth since 2012.

Third quarter GDP growth was largely driven by additions to business inventories and net exports – two categories that are usually ephemeral and mean-reverting. We believe that it will be important for consumer spending to pick up the slack in coming quarters - improving consumer confidence, accelerating wage growth, and stable employment are welcome signs.

Inflation

The U.S. core CPI (excluding food and energy) indicated that inflation was 2.1% Y/Y in October, while headline all-in inflation was 1.6%. We continue to believe that we are in a world of modestly increasing domestic growth, weaker global growth, dollar strength, and heavy commodity prices.

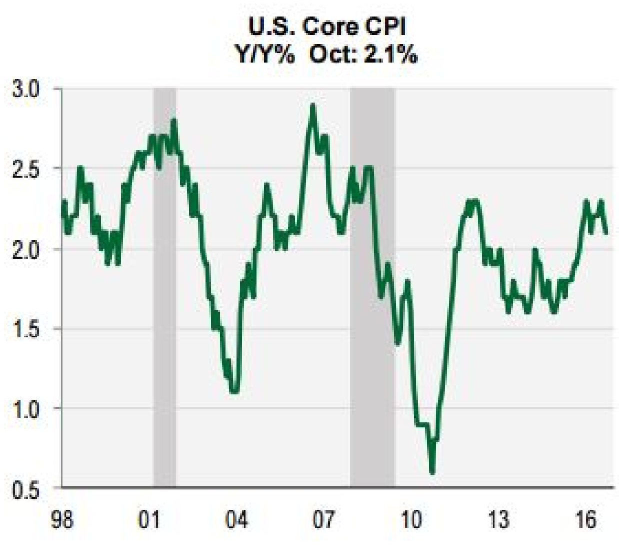


Figure 5: U.S. Core Inflation Source: Cornerstone Macro

All of these factors indicate that inflation should be constrained in the near term, although we have our eye on rising interest rates since the election of Donald Trump. We would not be surprised to see a large infrastructure project floated at some point in his term, which could boost demand for commodity inputs and result in increasing inflation.

Productivity & Investment

Low levels of corporate investment and the resulting anemic productivity levels have been major headwinds to stronger growth, profits, and living standards since the beginning of the recovery. Productivity is thought to be the sum of the size and quality of the capital base, the quality of the labor force, and the interaction between the two. We believe that the new administration could provide a shot in the arm to competitiveness, capital investment, and productivity growth with its plan to lower corporate tax rates.

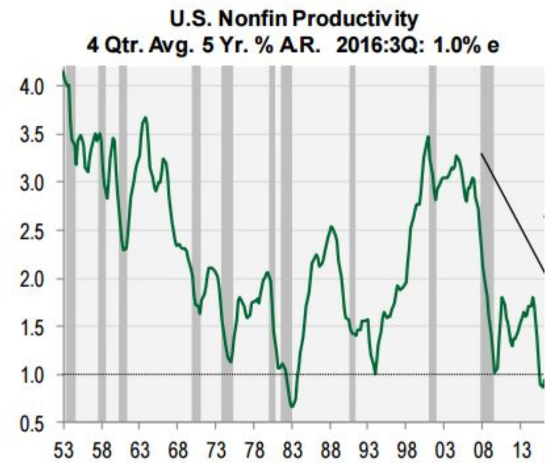


Figure 6: U.S. productivity has been historically weak through the recovery.

Source: Cornerstone Macro

As Figure 6 & 7 indicate, there is ample room for improvement in productivity and capital expenditures as a percentage of GDP.

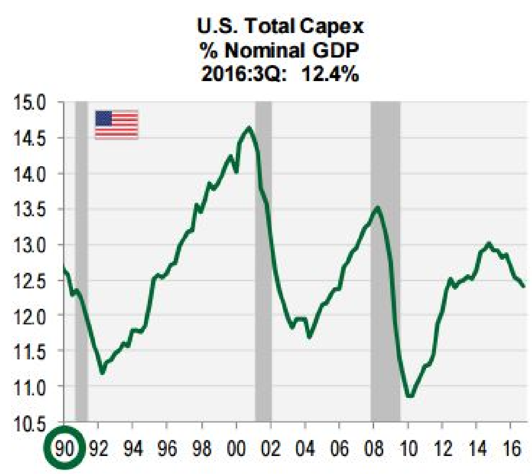


Figure 7: Domestic CAPEX as % of GDP

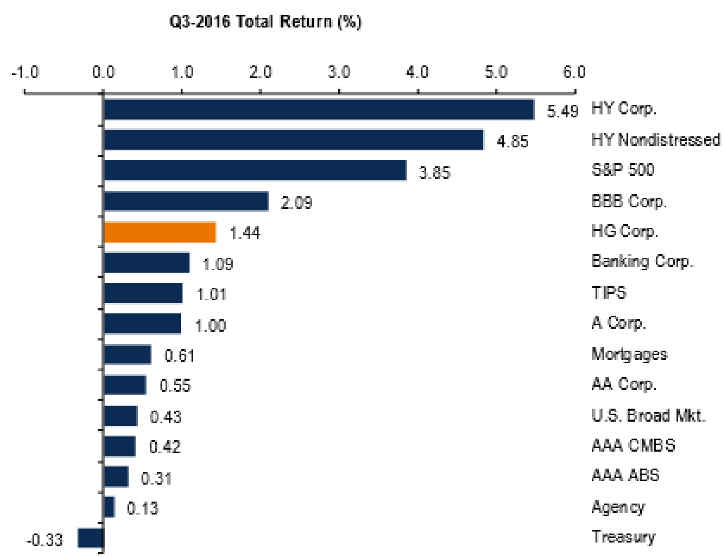
Last quarter, we indicated that weak corporate profits, waning consumer confidence and low levels of inflation weighed on corporate leaders' willingness to reinvest in their businesses through capital expenditures. We mentioned that we were hopeful that consumers would give business leaders the confidence they need to increase investment and kick off a cycle of higher domestic growth. We think that condition is closer now than it was several months ago, as evidenced by the improving consumer confidence and corporate profit pictures. We are now looking for consumers to follow through with spending in the coming quarters and hopeful that the new administration will say and do the right things to instill confidence. If so, corporate decision-makers may finally begin to feel comfortable with investing in the future of their businesses – passing the baton to the next leg of the business cycle.

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting, we were a couple weeks from the end of the fiscal year. Interest rates were a bit more volatile around global central bank news and actions throughout September. After rising early in the month due to a less dovish ECB meeting and Fed rate hike fears, rates moved lower during the second half of the month as the Fed adjusted their economic growth dot plot down meaningfully and the Bank of Japan decided to target their 10-year government bond as a zero return asset class. Performance for the different sectors of the bond market were a mixed bag for the month as high yield corporates performed the best while Treasuries and high grade corporates performed the worst. For the quarter ended September 30, high yield was again the best performer, returning roughly 5.5%. Equities returned just under 4% and high grade corporates returned 1.5% for the quarter. Treasury performance for the quarter was slightly negative. The chart below depicts the total return of for the quarter ended September 30, by sector:

Figure 6: Broad Asset Class Total Return Performance, Q3-2016



Source: BofA Merrill Lynch Global Research

October saw rates continuing to climb higher. Headlines suggesting the end of global quantitative easing coupled with higher inflation expectations in the US, UK and the Eurozone due to higher oil prices, hawkish Fed speakers and less macroeconomic uncertainty all contributed to this increase in rates. The yield curve steepened as the long end sold off more so than the shorter end. The ten year Treasury yield rose 23 basis points over the course of the month, while 30 year yields rose almost 30 basis points. The shorter end sold off some as well, but not to the same degree. Despite the selloff in Treasuries and higher yields, high grade credit spreads actually tightened a bit during the month. While some of the consumer related sectors were weaker, higher beta sectors including pipelines and metals and mining performed very well. High yield credit actually turned in a slightly positive total return for the month as the spread tightening was more significant and the shorter duration of this sector helped offset higher Treasury yields.

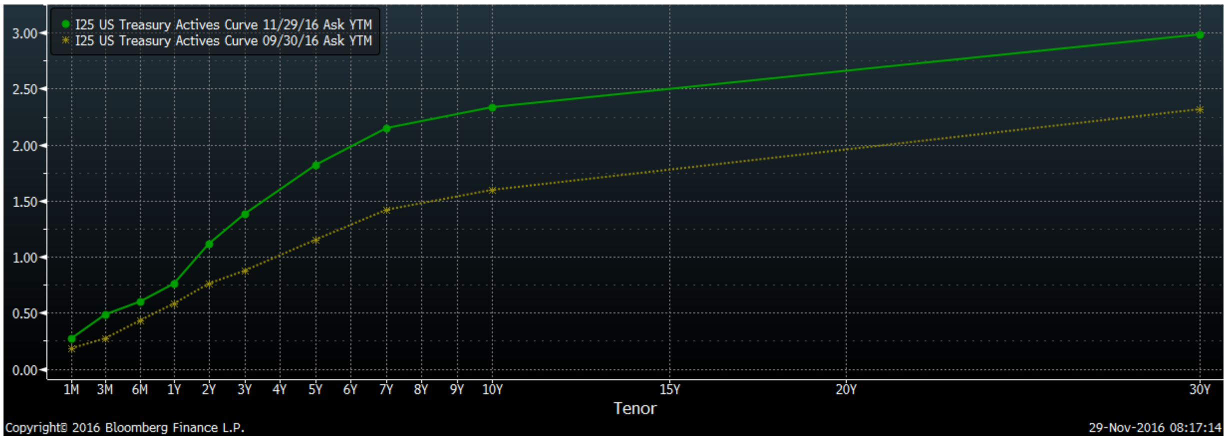
For the month, high yield credit performed the best, followed by mortgages and agency debt, and high grade credit; Treasuries turned in the weakest performance with a -1.15% return.

High grade new issue supply for October was lower versus the previous two months at $101 billion. About half was from the financial sector, the rest was non-financial. Issuance is expected to continue to slow through the remainder of the year as some deals were done earlier in the third quarter after the Brexit announcement and the resulting drop in interest rate levels. This, coupled with smaller M&A backlogs as well as the upcoming holiday season should lead to lower issuance levels.

November started on a much more eventful note. On November 2nd, Federal Reserve policy makers left interest rates unchanged. While noting that the case for an increase in Fed Funds rates had increased, they decided to wait for some further evidence of progress. With the presidential election the next week as well as there being no scheduled press briefing after the meeting, the decision to forgo a rate increase was widely expected. The election results the following week led to serious volatility in the markets. With Donald Trump solidly beating Hillary Clinton despite most voter polls showing the opposite up to the day before the election, the shock of the results was felt globally the following day. Equity futures dropped significantly in the overnight hours as results were coming in and Trump was pulling ahead; Treasury yields initially declined in a flight to safety move. By the next morning equity futures had bounced off their lows but were still negative as Treasury yields reversed and began to move higher. Sentiment improved over the course of the day with equity markets ending sharply higher and Treasury yields increasing notably, particularly on the longer end of the curve. This sell off in Treasuries continued for the rest of the week as bond market investors contemplated the future with Trump as president. Expectations that he and the Republican Congress would make good on pledges for infrastructure spending to help stoke economic growth led inflation expectations higher; this coupled with uncertainty about the outlook for the Fed caused yields to move sharply higher.

For the remainder of the month yields generally moved higher, but at a more subdued pace. At month end the yield on the five, ten and thirty year Treasuries was 1.83%, 2.37% and 3.05%, respectively. Evidence that economic growth is finding more traction has heightened expectations that the Fed will deliver a rate hike at the December 14th meeting to nearly 100%. Given the increase in yields this month there is some question about whether an increase is warranted or not, but at this point there appears to be little on the horizon that could slow this momentum. There is some concern among investors about longer term rates rising even higher from current levels. We could see rates move higher but we do not expect that action from the Fed will lead to a sharp move higher. The market has already incorporated the view that after a probable December increase, two to three increases can be expected next year. At this point we think it is unlikely that rates come down much in the near term because the reasons that led to the increase are still valid – new Trump policies, increasing inflation expectations, better growth prospects, etc.

The chart below depicts the increase in yields across the curve thus far since the end of the fiscal fourth quarter:



Curve Id	3M	1Y	2Y	3Y	5Y	10Y	30Y
■I25 **11/29/16**	0.482	0.765	1.115	1.394	1.841	2.389	3.053
■I25 **09/30/16**	0.274	0.585	0.762	0.875	1.149	1.594	2.315
Difference	**20.8**	**17.9**	**35.3**	**51.9**	**69.2**	**79.5**	**73.8**

Credit spreads have held in well during the month. Investment grade and high yield corporate spreads have remained stable to slightly tighter. On a total return basis the story is different as the selloff in Treasuries, particularly the longer dated bonds, has led to a negative return on the high grade index of -2.7% for the month of November. High yield credit has fared better due this sector's shorter duration and larger excess returns. For the month this sector's total return is roughly -.40%.

Government related sectors fared a little better. Agency and mortgage backed securities returned roughly -1.7% as spreads were fairly stable and the average duration of these sectors is shorter than that of the credit sector as well as Treasuries.

With the volatility in yields that we have experienced over the past several weeks, we have not been terribly active but have added selectively as rates have pushed higher.

We added a couple new corporate issues; Wells Fargo came to market with a new 10-year issue that was priced attactively versus its outstanding debt. With the drama surrounding the retail division, spreads had widened and this was an opportunity to add a bellwether name at an attractive spread. We also added Keybanc's new senior five-year fixed and five-year floating rate issues. Both were priced at attractive spreads relative to their outstanding debt and this was another stable financial name to add to the portfolio.

Credit spreads in general have tightened since the election, most notably in the financial and industrial sectors. We expect spreads to remain stable for the time being as higher total yields will continue to attract investors. Looking further out is a tougher call. Credit spreads are tight and currently below their five year averages. If rates continue to sell off then further spread tightening will be less likely; growth and inflation excpectation could support further shifts into equities. There is still much uncertainty, but we will continue to look for attractive names to add when opportunities arise.

In the agency debt sector we have seen spreads remain stable and fairly tight. After having a couple of our agency issues called early, we did reinvest some of the proceeds into the 10-year FNMA benchmark issue. Our duration was a little short within this sector; therefore, this helped push duration closer to neutral and add some positive convexity which is always desirable, particularly if rates start to decline. In the days after the election results we added another small block of this same issue at an even more attractive yield. Given the move higher in rates we do not expect any more calls to reinvest in the near term but would add selectively if an attractive opportunity arose.

Spreads have remained fairly stable within the mortgage sector as well. As rates have moved higher and we have witnessed more volatility, mortgage spreads have actually tightened a bit and excess returns have been positive. Higher rates have already resulted in lower prepayments and we expect this to continue for the time being. We purchased a 30-year mortgage pool in October to reinvest prepayments and then purchased another 30-year pool in the days after the election when yield levels were substantially higher. These additions helped us to lengthen duration slightly versus the Index and make sure the portfolio would benefit from any move lower in rates. We have kept our weighting stable within this sector and look to add selectively at these higher yield levels as attractive opportunities arise.

Lastly, we added a small block of 30-year bonds within our Treasury portfolio. As rates were moving sharply higher in the days after the election, we thought it prudent to take advantage of the higher yield levels. We were underweight 30-year Treasuries versus the Index and with rates moving higher we felt we needed to reduce that underweight and add some yield. We are still underweight the sector as a whole but the duration remains longer than that of the Index. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

Domestic Equity Strategy

By Allan Carr

As we near the end of 2016, it has been another interesting year in the markets. We started 2016 with growing concerns of the Chinese economic slowdown and declining oil prices. As those fears dissipated, the S&P 500 rallied over 15% off its February lows through late June. We then encountered Brexit which caught investors by surprise but proved to be yet another macro event that was digested quickly. Post the Brexit dust settling, the next 16 weeks the market was virtually unchanged as all eyes turned to the election. The betting odds and polls both indicated a Clinton victory and that was seen by many as the best outcome for markets as she would more or less be the status quo and not upset the apple cart. There was a brief selloff the first week of November when the FBI reopened the Clinton email case, but she was once again cleared the weekend prior to Election Tuesday. The S&P 500 bounced back over 2.5% Monday and Tuesday and sat just 2% off all-time highs as we waited for results.

As results started coming in on election night, it felt like Brexit all over again with investors being caught on the wrong side in positioning as it became apparent Donald Trump would pull off the upset and there would be a Republican sweep. At roughly midnight CST, S&P futures were halted as they hit their max down circuit breaker of 5%. But when the sun came up on Wednesday, things did not look as draconian as the S&P opened down less than 0.7%, and then rallied to finish the day up 1.1%.

The days following the election witnessed investors quickly recalibrating their positions in what has been dubbed the “Trump reflation trade.” With single-party control, the Republicans can end gridlock in DC and move rather quickly on some items such as taxes and fiscal spending, which should lead to stronger economic growth. Stronger growth comes with higher inflation expectations, which causes rates to rise and the dollar to strengthen. The result was a flight to risk assets to unwind the “slow/steady economy” trade that was expected to persist under Clinton. There’s been a substantial bond route with the 10 year Treasury yield going from 1.8% pre-election to just over 2.4%.

With bonds selling off, the “bond proxies” of REITs, utilities, and staples were a source of funds as investors quickly reshuffled to names that were seen as beneficiaries of Trump policies. Financials were the big winner as they should get relief in many forms: steeper yield curve, higher rates, lower tax rates, less regulation, and better growth.

One thing a Trump presidency for sure brings is uncertainty. No one is quite sure what lies ahead or which version of Trump we will get. The biggest worry is Trump’s tough trade stance during the election process and what if any he would act on. The ramifications if he goes haywire on trade/tariffs/treaties could be very disruptive. Too strong of a dollar move could reignite the fears of a slowdown in China as well as impede profits of the U.S. multinational firms like we saw in 2013-2014. If inflation runs too hot it could cause the Fed to be more aggressive which would bring the cycle to an end quicker. Supreme Court nominations, building a staff, possibly replacing Janet Yellen, and countless other political hurdles that will pop up. In sum, the big worries with Trump are the fear of the unknowns and how he will act once in office which is hard to handicap.

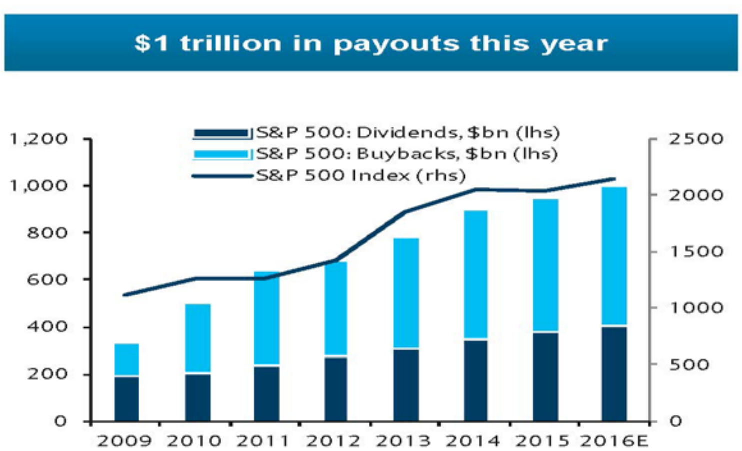
The hope is that he backs off the tough guy rhetoric and instead surrounds himself with intelligent people to focus on less controversial topics such as tax reform and easing regulation. These initiatives have probable odds of passing and would boost the economy. This seems to be what the markets are telling us to expect by what's been seen in the three weeks since the election.

One of the first topics on the Trump agenda is tax reform. It remains to be seen how it takes form, but lowering the corporate tax rate seems highly probable. Using the 20% tax rate suggested by House Republicans could add upwards of 25% to 2018 EPS to some financial stocks. Tobias Levkovich of Citigroup estimates a 20% tax rate could add as much as $12 to 2017 EPS earnings, which would be a 9% boost to consensus estimates.

Repatriation of overseas profits is also highly likely and could be a huge boon for companies and investors alike. The last time the US allowed one of these "tax holidays" was in 2005 and companies brought back $300bn of the roughly $600bn of cash held overseas. Per Strategas, there is nearly $2.5 trillion in overseas profits held by S&P 500 companies. Their Washington DC analyst, Dan Clifton, would not be surprised if upwards of $1 trillion was brought back in a 12-15 month period.

Exhibit 1 from Barclay's shows the rise in the S&P 500 post-crisis along side the growth in corporations return of capital via dividends and buybacks. It goes without saying that a large repatriation would be a big one-time positive for the market as well as permanent tax cuts. Both could be deployed in many productive ways: special dividends, buybacks, raising dividend payout, paying down debt, acquisitions, capex spending, wage increases, hiring, etc.

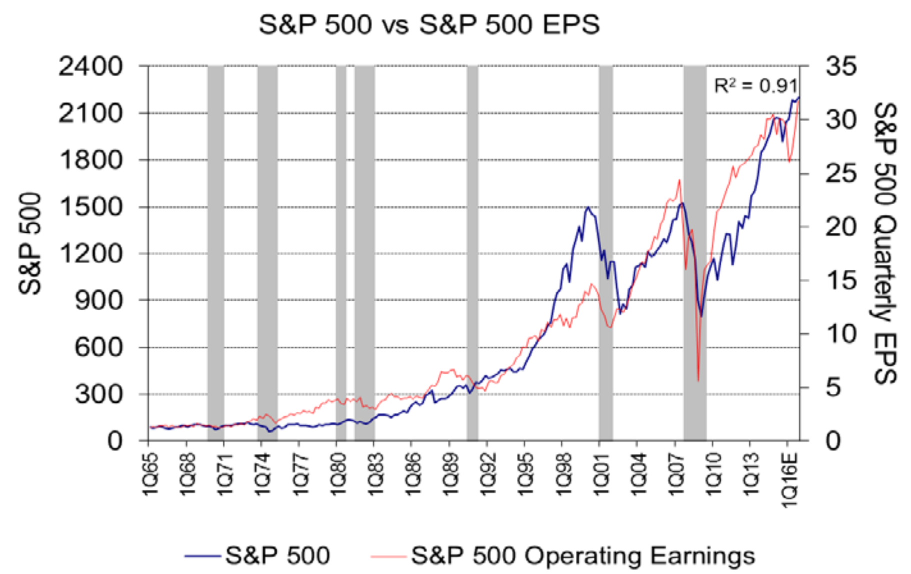
EXHIBIT 1



There is also the likelihood of the Trump administration allowing a one year tax write-off of capex versus depreciation which would certainly increase spending in many industries if enacted. Higher oil prices combined with easing restrictions on the energy companies would be a benefit to oil related capex. The oil patch capital spending has been virtually non-existent the past few years as prices have been depressed.

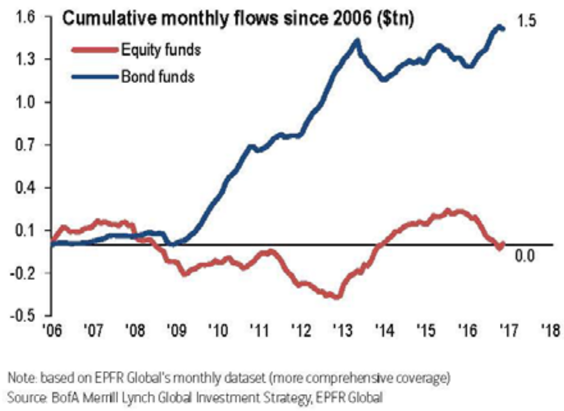
Trump has called for $1 trillion in infrastructure spending over 10 years which Goldman Sachs estimates would be worth roughly 0.5% in GDP annually and would reduce the unemployment rate by 0.3%. That number is likely to be lower but it will still be something to spur growth and hiring. Lower taxes, repatriation, infrastructure spending, capex, and higher growth all paint a more promising earnings picture. There are endless debates on what could cause the market to go up or down but one of the strongest correlations to higher stock prices is earnings growth (Exhibit 2 from Citigroup).

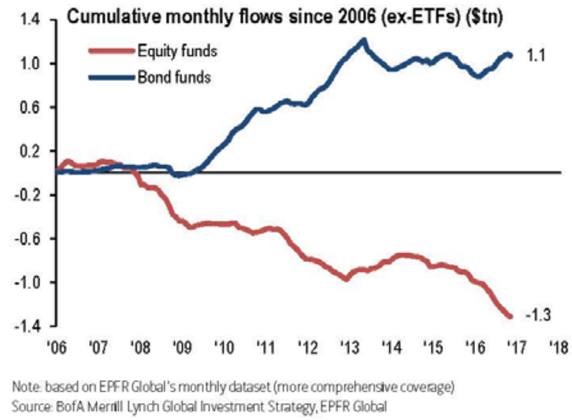
EXHIBIT 2



Earnings growth and capital returns have been the catalysts that have propelled stocks to new highs despite lackluster sentiment and lousy fund flows. Prior to the election, we continued to see large outflows from domestic equities upwards of $150 billion year-to-date as investors continued piling into bond funds. The weekly flow numbers immediately following the election saw the largest outflows from bonds in roughly 3 ½ years at $18B. Combined with the largest equity inflows in two years of $28B, it was the widest weekly disparity in flows on record. But it's not even a blip on the radar when looking at the last decade of flows as seen in Exhibit 3 below from Bank of America.

EXHIBIT 3

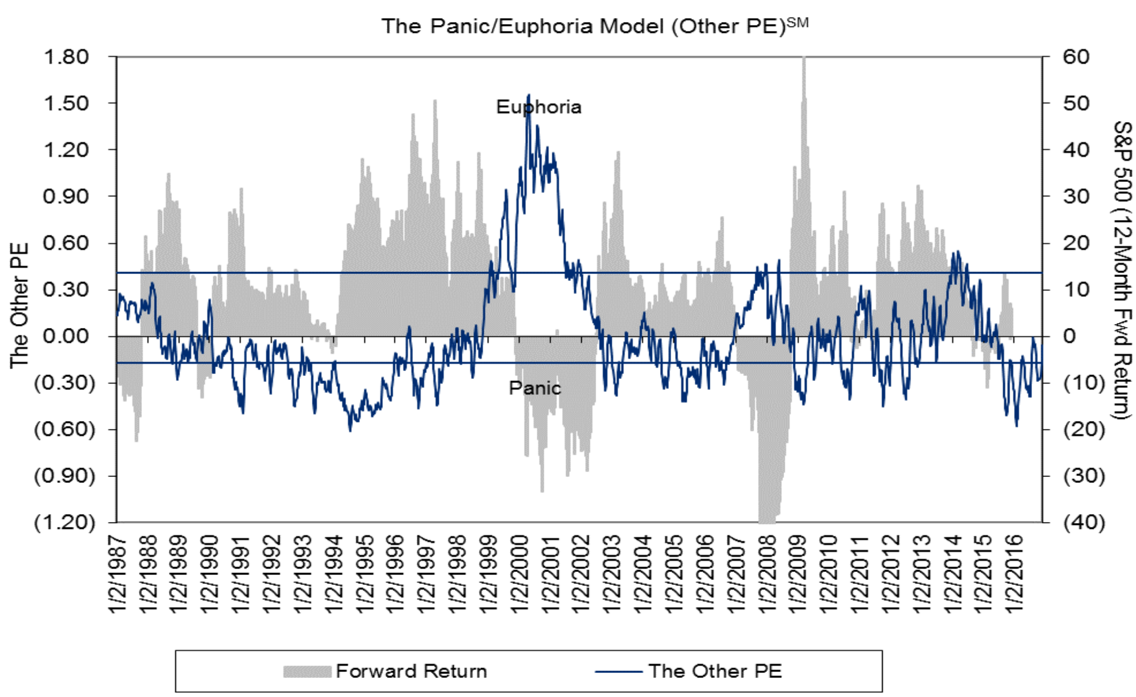




The chart on the left is cumulative fund flows of mutual funds and ETF's which shows nearly $1.5 trillion of global inflows into bonds versus zero for equities. The chart on the right shows fund flows excluding ETF's: $1.1 trillion into bonds versus $1.3 trillion out of stocks. Further rotation seems likely on this front as investors start opening statements and see their bond funds losing money.

Investor sentiment is something we follow closely and one of our favorite readings is Citigroup's "Panic/Euphoria Model" (Exhibit 4) which captures investor positioning via put/call ratios, option prices, short interest, etc. Even with the market making all time-highs, there is no indication of euphoria as the reading remains just inside "panic" territory. Historically, similar readings on this model are highly predictive of higher equity prices over the next 12 months.

Exhibit 4

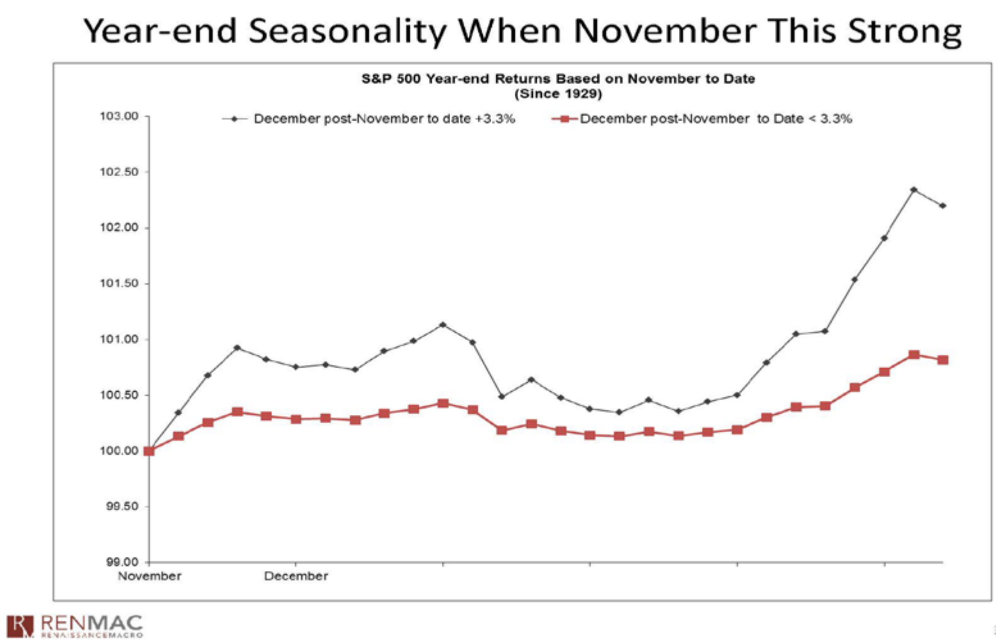


Post the Trump surprise we would characterize the current landscape as having larger tail risk to the downside given the unknowns and uncertainty. On the flip side, the base case just got more compelling if the economy can break out of the "lower for longer" suboptimal growth it's been stuck in. Similarly, the bull case has a much higher cap if the stars align with growth, taxes, repatriation, capex, etc.

We still do not see the usual signs preceding the end of a bull market or a recession looming. Consumer confidence just hit a 7 year high; that is a good thing. Fund flows have been terrible, the yield curve is steepening and not inverting, investment sentiment is dour not euphoric, valuations are not stretched, we aren't seeing an M&A frenzy, and the list goes on. In conclusion, while we will likely see more volatility due to so many uncertainties, we still see the backdrop for domestic stocks as constructive.

As far as activity, we have some put-spread collar protection through December and March. Historically, seasonality has been strong in December. The strength since the election might suggest the market has already pulled forward the December seasonality. But Jeff DeGraff at RenMac says while it makes sense logically, historically that presumption has been incorrect (Exhibit 5).

Exhibit 5

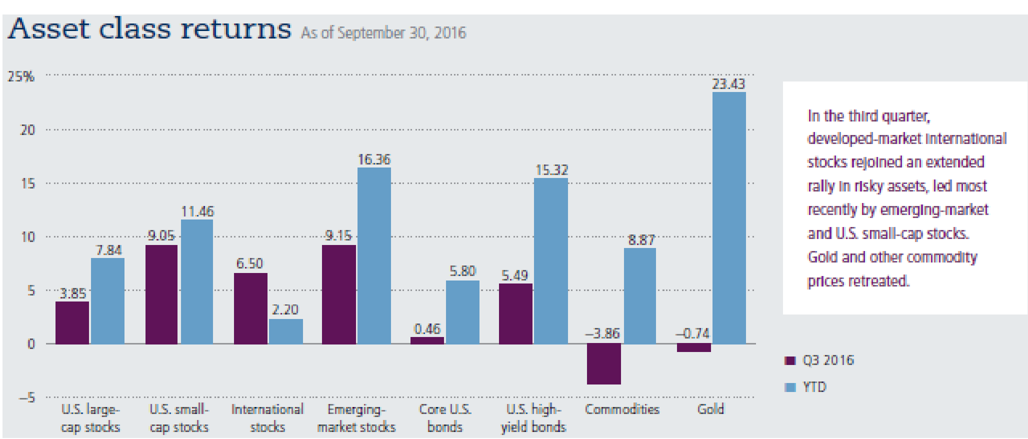


When the S&P finishes up more than 3.3% or more in November, December returns have averaged 2%. When November returns are less than 3.3%, December returns have been more modest at around 0.7%. The S&P just finished November up 3.7% which historically has led to more bullish activity into year-end. Should we see continued strength into year-end we will look to opportunistically layer on additional hedges most likely with June or September expirations.

International Equity Strategy

By Steve Lambdin

Large cap international as well as emerging market stocks performed better than U.S. stocks in the third quarter of 2016. Fueling this rally was a continuing accommodative monetary policy for most central banks outside of the U.S., a delay in raising interest rates in the U.S., a stabilization of commodity prices, and relatively lower valuations in many of these markets. This led to a post Brexit rally around the globe with an increased risk appetite for equities outside of the U.S. Also, low bond yields outside of the U.S. continued to make international equities very attractive. Many long term government bonds outside of the U.S. remained in negative yield territory in the quarter. European shares managed to stage a rally as investors realized that Brexit is not as much a near term worry as previously thought and is going to be a long road once Article 50 is invoked sometime in the first half of 2017. While we saw strength in U.K. equities on a local basis, a weaker British Pound hurt returns for U.S. based investors, as the pound continued to sell off and reached another historic low versus the U.S. dollar. Outside of Europe, Japanese equities were strong as economic growth surprised to the upside. Also, economic data points out of China in the quarter were generally perceived to be surprisingly decent. Commodity prices reversed their recent upward climb as many were very stable in the third quarter, bringing comfort to investors. As investors were willing to seek out more risk in the quarter, this was especially good for the emerging markets. Perhaps as more growth transpires going forward, this will lead to better performance out of this asset class. It is our perception that many investors who have shunned these equities for years are now warming up to them. As the U.S. elections have now passed, all eyes around the world will be on President-elect Trump to see if his agenda can be executed. At this point, we see a lot of moving parts going in many different directions. We feel the path could be full of volatility in the months to come as the global equity markets react to these developments.



Source: John Hancock Investments; Morningstar Direct

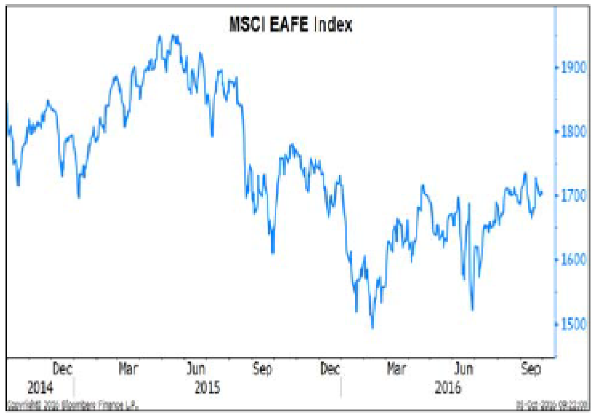
The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +6.43% and +9.03% respectively during the third quarter of 2016 vs. +3.85% for the S&P 500 Index. For our fiscal year, emerging market equities slightly outperformed U.S. equities for the first time in several years, while large cap international equities continued to underperform large cap U.S. equities. As mentioned above, emerging market equities benefited from a greater tolerance for riskier assets in the quarter. The U.S. dollar was somewhat stable in the quarter, as it was nearly flat against the Euro and the Japanese yen, but rose about 3.9% vs. the British Pound. In all, currency provided a very small benefit to unhedged U.S. investors in the MSCI EAFE Index in the quarter. The Pacific basin was stronger than the European region, as the significant strength in Japanese equities in the quarter was the main driver of this performance. From an economic sector standpoint, the basic materials and technology sectors were relatively stronger, while the more defensive sectors of utilities, telecom, and consumer staples were the weakest. Oil was virtually flat to end the quarter as the commodity markets were somewhat uneventful during this period.

Inflation forecast (annual % change)

	Forecasted data					
	2016	2017	2018	2019	2020	5-year average 2016–2020
United States	1.2	1.7	1.9	1.9	2.0	**1.8**
Canada	1.4	1.8	1.9	1.9	1.9	**1.8**
Eurozone	0.2	1.0	1.0	1.1	1.4	**1.0**
Germany	0.5	1.5	1.1	1.6	1.9	**1.3**
France	0.2	0.9	0.7	1.1	1.6	**0.9**
United Kingdom	0.7	2.2	2.0	2.1	2.1	**1.8**
Japan	–0.4	–0.2	0.1	0.5	0.3	**0.0**
China	2.1	2.3	2.5	2.6	2.8	**2.4**
India	5.4	4.9	5.2	4.8	4.4	**4.9**

Source: John Hancock Asset Management, 8/12/16.

So far into the first quarter of our new fiscal year, it's been a rough start for stocks outside of the U.S. Equities in the U.S. have staged a post-election rally at the expense of non-U.S. equities as a significant strengthening of the U.S. dollar has crushed international equity returns thus far. This has pushed the MSCI EAFE Index and the MSCI Emerging Markets Index down -4.00% and -4.35% respectively through late November, vs. +1.9% for the S&P 500 Index. International equities are having a difficult time with higher interest rates in the U.S. as well as post U.S. election drama in what a Trump presidency will look like for the rest of the world. Looking out over the near term, many global investors will remain on the sidelines until the upcoming FED announcement in December. This could set the tone for many of the global equity markets in the months to come.



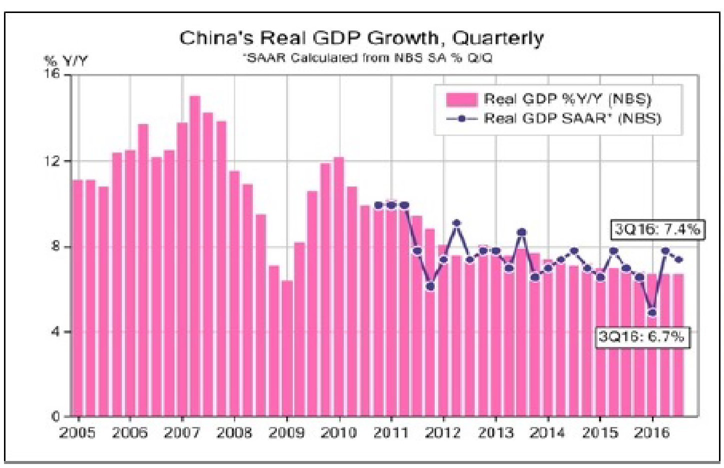
Source: Bloomberg and Davidson Investment Advisors

Asia Update

For the second quarter in a row, the MSCI Pacific region finished as the best performing region within the MSCI EAFE Index, rising +9.4% during the period. The strength in the performance of this region came from Japanese equities. The MSCI Japan Index, which constitutes nearly two-thirds of the Pacific Index, rose +7.4% in the quarter. The yen was relatively stable in the period, as local and U.S. dollar returns were very close one another. During the quarter, the Bank of Japan's (BOJ) new policy measures aimed at helping the banking industry were well received by investors and helped push equities higher. Chinese equities were also very strong, rising +13.9% in the quarter, as rhetoric around growth concerns have receded quite a bit over the last few months. Maybe investors are becoming a bit more comfortable in the government's orchestrated measured slowdown in the economy here.

Source: Evercore/ISI

Chinese economic growth continued to be stable recently as third quarter GDP rose +6.7%, the same pace reported over the previous two quarters. This will give government officials plenty of opportunities to slowdown the growing leverage and curtailing abusive financial risks. Thus far, this has been a bit slow to materialize, as measures of new credit extensions are above expected levels. Recent economic indicators continue to point toward a rebalancing of the economy geared more toward the consumer as retail sales growth is greater than the growth in industrial production. Our view has not changed as we still see the consumer to be healthy at the moment. Industrial production was recently a bit weaker than expected, rising +6.1% in September versus slightly higher expectations, but stable by most measures. Fixed asset growth is still grinding lower and was reported at +8.2% for the first nine months of 2016, but in line with most forecasts. Exports have struggled recently and were reported down -5.6% in Yuan terms in September, the weakest reading in 2016. Retail sales remain strong, rising +10.7% in September, the highest pace of monthly year over year growth in 2016. Inflation continues to remain well contained as consumer prices rose +1.9% in September from the year earlier period. We would expect this to pick up just a bit from these levels over the next few months, but still remain very little of a problem. Consistent with the previous few months, we do not expect to see any action on interest rates or reductions of the reserve requirement ratio over the balance of 2016. At this point, we would not be surprised to see economic growth come in slightly above the official government growth target of at least +6.5% GDP growth this year, as the region's growth outlook seems stable at the moment.



Source: Evercore ISI

Catching most of the investment community by surprise, the Japanese economy grew by +2.2% in the third quarter from a year earlier period. Net exports and residential investment were the main drivers and provided the bulk of growth in the quarter, while capital spending and personal consumption were basically flat. Perhaps this growth will take a little pressure off the BOJ to provide more monetary easing. With the yen's recent weakness, we expect this to provide a lift in exports going forward, and coupled with past government fiscal stimulus, should provide for decent economic growth over the near term. However, we do not know what will happen with potential protectionist policies that could be proposed by U.S. President-elect Trump. This is a complete wildcard at the moment. Industrial production in the third quarter was a much better surprise than what many were expecting as August and September were up +4.5% and +1.5% respectively year over year. This was quite a reversal from the previous quarter and we are optimistic this trend can continue as a weak yen and better demand from other Asian countries can support better industrial production. Small business confidence has been better lately as October readings are at the highest levels of the year and well above the past six month average. Maybe this trend can continue as we move into early 2017. Consumer confidence continues to trickle higher as September's reading of 43 was at the highest level of the year. However, this is still relatively weak by most measures, but progress is progress. Core prices in Japan rose for the first time in eight months in October as deflationary pressures seem to easing. This is probably from oil prices not falling anymore rather than broad based price increases. Will we see if this is a start of a trend upward in the coming months? The labor market remains very tight as the October unemployment rate remained at 3.0%, which is the lowest rate since 1995. Also, the jobs-to-applicant ratio continues to improve, rising to 1.40, which is another signal of a decent jobs environment. We are looking for higher wage growth which should support better consumer spending as these trends continue. Looking out over the next few months, investors will be watching the rhetoric coming out of the new U.S. administration for any clues on the future of trade agreements and potential tariffs directed toward the U.S.'s Asian trading partners. Developments on this front could set the tone for the equity markets here and provide a lot of volatility as this unfolds.

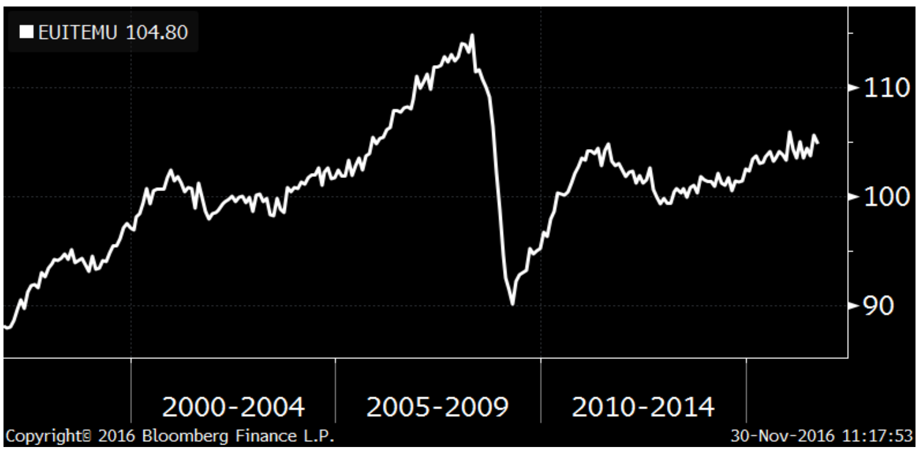
Source: Evercore ISI

Europe Update

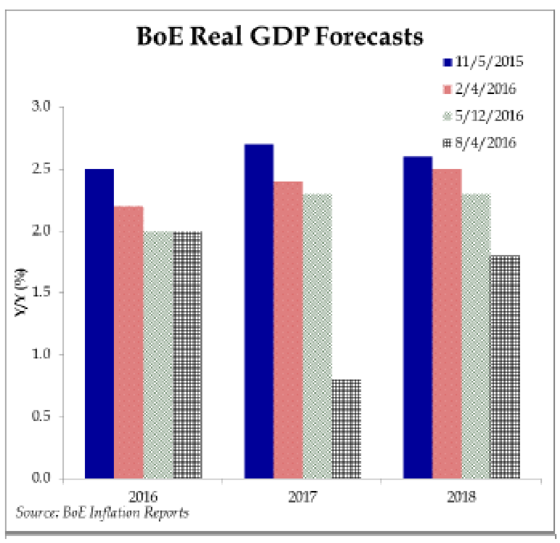
European equities quickly erased the pain from the Brexit slump as investors came to the conclusion that the fallout from Brexit probably will not disrupt the global economy over the near term. There is just too many decisions and issues to address for this to be an immediate disruptor to the landscape. In addition, second quarter earnings season was generally thought to be decent in Europe and the expectation of continued monetary policy stimulus was enough to bring comfort to investors in the region. The MSCI European Index (ex. U.K.) rose +6.3% in the third quarter, which was a nice rebound. However, not everything was rosy to investors in the period. Many were very worried about the banking sector in Europe as Deutsche Bank came under severe pressure from a potential $14 billion fine by the U.S. Department of Justice (DOJ) related to past mortgage fraud. Making matters worse was German Chancellor Merkel vowing not to bailout Deutsche Bank and putting pressure on the DOJ to lower the fine. Beyond Deutsche Bank, Italy's banks are under pressure as the record low rate environment has devastated profitability in the sector. No doubt, rising interest rates would help the sector tremendously. As mentioned previously, we still do not know what the longer term implications with regard to Brexit are going to be, even as the European Central Bank (ECB) recently lowered its economic growth forecasts taking this into consideration. At this point, we believe the upcoming votes across Europe on a number of issues, the continuing stress on the European banks, and developments with Brexit will dominate investors' attention in early 2017 and set the tone for equity markets.

The modest economic expansion continued in the third quarter as GDP rose +.3% from the previous quarter, or +1.6% from the year earlier period, which was at the same clip from the previous quarter. This was basically in-line with most economists' expectations. The German economy, while growing, posted the weakest rate of growth over the last four quarters, expanding only by +.2% in the quarter, or +1.5% from the year earlier period. Net exports were a big drag on the country's growth in the period. Continuing its recent trend, the Spanish economy posted another solid result as second quarter GDP rose by +.7%, as this country has a lot of spare capacity in labor. In addition, the French economy returned to growth in the quarter after being weak in the first half of 2016. Third quarter industrial production, while a bit up and down from month to month, was up about +1.0 from a year earlier. While fluctuating from month to month, most industrial goods remain positive when viewing them on a year over year basis. The index of executive and consumer sentiment regained some strength and rose to 106.5 in November, the highest level seen this year. This is consistent with the moderate recovery that is going on in the region. Retail sales continued its recent weak trend as third quarter sales were reported up +1.4% from a year earlier, as we saw deceleration throughout the quarter as September was the weakest month in the quarter. There is still very little help from the consumer. Prices are showing a little strength as the November CPI rose +.6% from a year earlier, which is the fastest pace over the last several months. Perhaps this will put an end to deflation rumors in the region. We saw just a small improvement in employment as the September unemployment rate was reported at 10.0%, consistent with the last few months. While getting better on the margin, we still see way too much slack in the workforce and this presents a real issue if the consumer is to eventually contribute to growth in the region.

Industrial Production Level in Euro Area



The debate continues as to what Brexit will mean for the U.K. economy. We have seen a multitude of different projections over the last few months, but the truth is, nobody really knows at this point. What we do know is that equities quickly rebounded from the recent referendum and achieved strong local currency gains in the quarter. However, a very weak pound depressed returns for U.S.-based investors. Also, economic data points put to rest the fears of an immediate economic fallout from the vote. The growth engine continued in the U.K. as GDP grew by +.5% in the quarter from the previous quarter, or +2.3% from the year earlier period. This rate of growth was above most estimates as the region posted its 15th straight quarter of economic growth. The services side of the economy continues to be the leader and was the strongest in a year. Retail sales shook off any Brexit issues as October sales were up +2.0% from the previous month, or +7.6% from the year ago period. This was rock solid as cooler weather led to a huge surge of winter clothing and shoe sales. Going forward, this pace will be difficult to keep up. Inflation still remains very contained as October core CPI was up only +1.2% year over year, not even close to problematic levels. However, we believe we may have seen the bottom in this data point and we would expect core CPI to rise in 2017, but still not be a major issue. At its recent November meeting, the Monetary Policy Committee (MPC) opted to maintain its benchmark interest rate at .25% as well as maintaining its bond purchase target to 435 billion pounds, including 10 billion in corporate bonds. With strength in the economy, we see no reason to cut interest rates any further unless some unexpected development happens with Brexit. The employment situation continued its recent trend as the September unemployment rate fell to 4.8%, which is near 12 year lows. However, employment only rose by 49,000 workers in the third quarter, with ending employment at a new record of 31.8 million workers. Wage growth still remained steady but somewhat uninspiring, as September wages only grew +2.3% vs. the prior year. We will see what happens with this as we get into 2017 as Brexit begins to unfold. As we enter 2017, the economy has been surprisingly resilient in the face of Brexit discussions. How long this can continue is the key question. The direction of these discussions will no doubt set the tone for the equity markets.

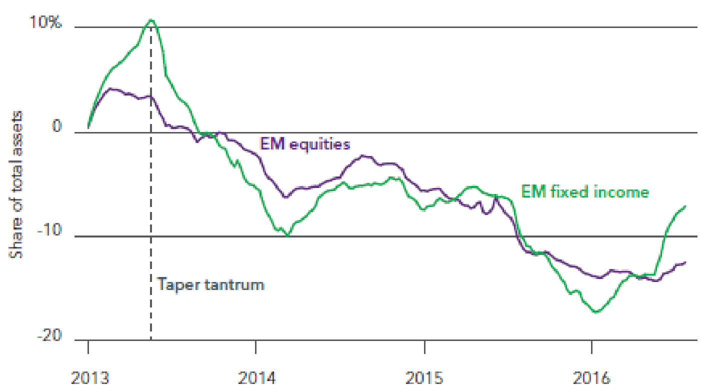


Source: Strategas

<u>Emerging Markets</u>

The emerging market equities were a major beneficiary of a risk-on environment in the quarter. In fact, this was the strongest quarterly performance in the last few years. Commodity prices were very stable and business fundamentals are beginning to turn positive after a weak few years. In addition, we continued to see the lack of interest rate hikes in the U.S. as a net positive for this asset class, as was the case in the previous quarter. The MSCI Emerging Markets Index (net) rose +9.03% in U.S. dollar terms in the third quarter of 2016, which is the fourth consecutive quarter of gains in this index. Chinese stocks were very hot in the period, rising +13.9%, as banks were especially strong in the quarter. Other Asian countries posted good gains as well, mainly benefiting from strong currencies. However, we did see some weakness in certain countries. Turkey experienced some lingering weakness from the recently failed coup attempt and Mexico was weak from the potential renegotiation of the North American Free Trade Agreement (NAFTA). Going forward from here, investors are beginning to take a fresh new look at emerging market equities, as many regions have stabilized substantially over the last year. Technology is now a much larger part of the index, while materials and energy weights have been cut in half over the last several years. The consensus among investors is that technology exposure is a long term winner. With such a long period of underperformance, we could see a long runway of better performance at some point. In addition, valuations still remain somewhat attractive relative to other parts of the world. With all of this in mind, we are still looking to add to our exposure here even as there is always plenty of risks out there on many fronts in the emerging markets.

Turning the ship
Emerging market funds flows, 2013-2016



Sources: BlackRock Investment Institute and EPFR, September 2016.
Notes: The chart shows cumulative fund flows since January 2013, expressed as a percentage of assets at that point.

International Equity Activity/Strategy

At this point, we continue to be somewhat optimistic on the prospects for further gains ahead in most equity markets classes going forward. While the lead up to and the results of the U.S. elections have been a bit tough on international equities to start our fiscal year, we do expect better global economic growth in 2017 vs. 2016 as a reason to be optimistic going forward. Corporate earnings could be a bit better than anticipated as growth picks up, which could surprise the markets somewhat. However, we should not be surprised to see a bit more volatility in many markets if this transpires. We are already seeing interest rates and commodity prices rising off near bottoms, perhaps signaling better growth ahead. We will probably see divergence by region, as Asian prospects may be better than Europe from the continued uncertainty surrounding Brexit. The emerging markets outlook may actually be better than the outlook for international large caps for the first time in several years, which could push fund flows to this asset class. Even though the U.S. Fed will most likely begin raising interest rates in December, central banks outside of the U.S. continue to be rather accommodative, which we expect to continue for most of 2017. Valuations continue to be somewhat "in the middle of the road" in our opinion. Neither too expensive nor cheap from our perspective.

We recently added a small nominal amount of $17 million to our emerging markets index (EEM) in November as market volatility pushed the price of EEM below one our recent put options. We expect to be a little more aggressive with regard to our put writing on EEM going forward in an effort to add to this asset class after an extended period of underperformance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.7% of total assets and approximately 10.5% for MSCI EAFE equities, which still remains below peer group averages. *(Credit is given to the following entities for charts provided: Strategas, Bloomberg, Fidelity Investments, John Hancock Investments, Evercore ISI, Blackrock Investment Institute, EPFR, Davidson Investment Advisors, and Morningstar Direct)*