—New Albany—
Investment Management

January 30, 2017

Market Insight: First 100 days

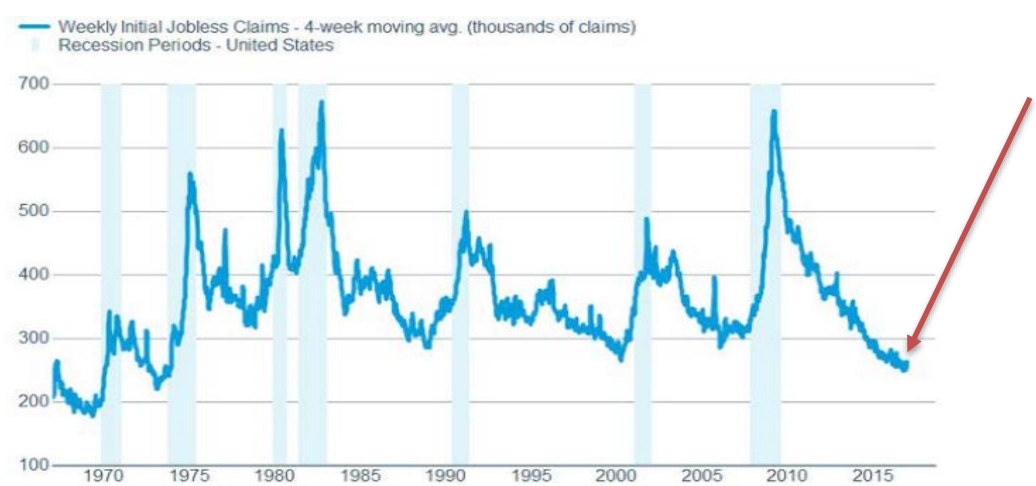
For at least the next 100 days, Washington is center stage for the financial markets. Opinions and emotions are at fever pitch, and skepticism is running high. Though the headlines may seem shocking and volatile, the financial markets are looking beyond the rhetoric and are anticipated positive economic change. Like it or not, the new Trump administration plans to run the US like a business, with a "US first", pro-growth strategy. Some people call it protectionism and heartless; while others view this change as a chance for the US to become 'great again'.

Conventional methodology is being upended, and a new lens of evaluating and negotiating policy will be applied in almost every public arena including healthcare, business regulation, public works, corporate & individual tax structure, foreign trade, and immigration. With radical change expected in all of these areas, the US economy will likely look quite a bit different over the next several years. But will it be better? Will the changes create growth? Will America prosper? Of course no one knows the answer to this, not even President Trump! Only time will tell the success or failure of these new policy initiatives. One thing is for sure, it will take AT LEAST 100 days for the new administration and Congress to settle in and begin crafting new policies, so drawing conclusions at this point is premature.

As investors, it is important to set politics aside, and turn our focus back to the fundamentals that drive the financial markets. Economic growth, inflation, interest rates and earnings are the key underpinnings of the market because in the long run, they drive asset prices, whether it be stocks, bonds, currency, real estate or commodities. Though optimism about the pro-business leanings of the new administration has helped, the recent gains in stocks can be justified by improving fundamentals, specifically, economic growth and earnings, both of which troughed in the 2Qtr of 2016 and now appear to be headed higher. But at the same time there are new headwinds. Interest rates and inflation are also heading higher and valuation remains high.

The data below lays out some of the recent highlights…

- **The consumer is feeling good. The job market is near full employment; Wages and Confidence are rising.** Weekly jobless claims at lowest level since 1974….



Source: FactSet, U.S. Dept. of Labor. As of Jan. 23, 2017.

- **Rising average hourly earnings signal a strong job market…**

Source: FactSet, U.S. Department of Labor. As of Jan. 26, 2017.

- **Consumer confidence has rebounded to pre-recession highs**. This bodes well for solid growth ahead.

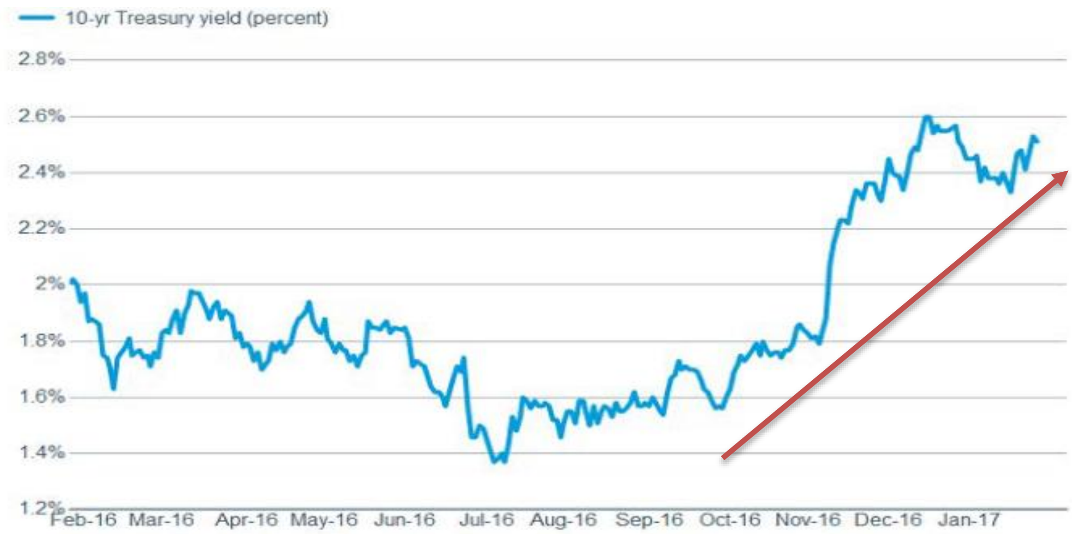
Source: FactSet, Conference Board. As of Jan. 23, 2017.

- **On the corporate side, the confidence has surged as well.** The National Federation of Independent Business (NFIB) noted a record-breaking increase in optimism among small business owners. That optimism was supported by an increase in industrial production in December of 0.8% and a rise in capacity utilization to 75.5 from 74.9, according to the Federal Reserve.

- **S&P Earnings & Revenue Growth Up:** For the 4th qtr. both earnings and revenue growth are expected to grow at 4.2% and 4.7% respectively and will be the **first time the index has seen year-over-year growth for two consecutive quarters since Q4 2014.**

Potential Headwinds…

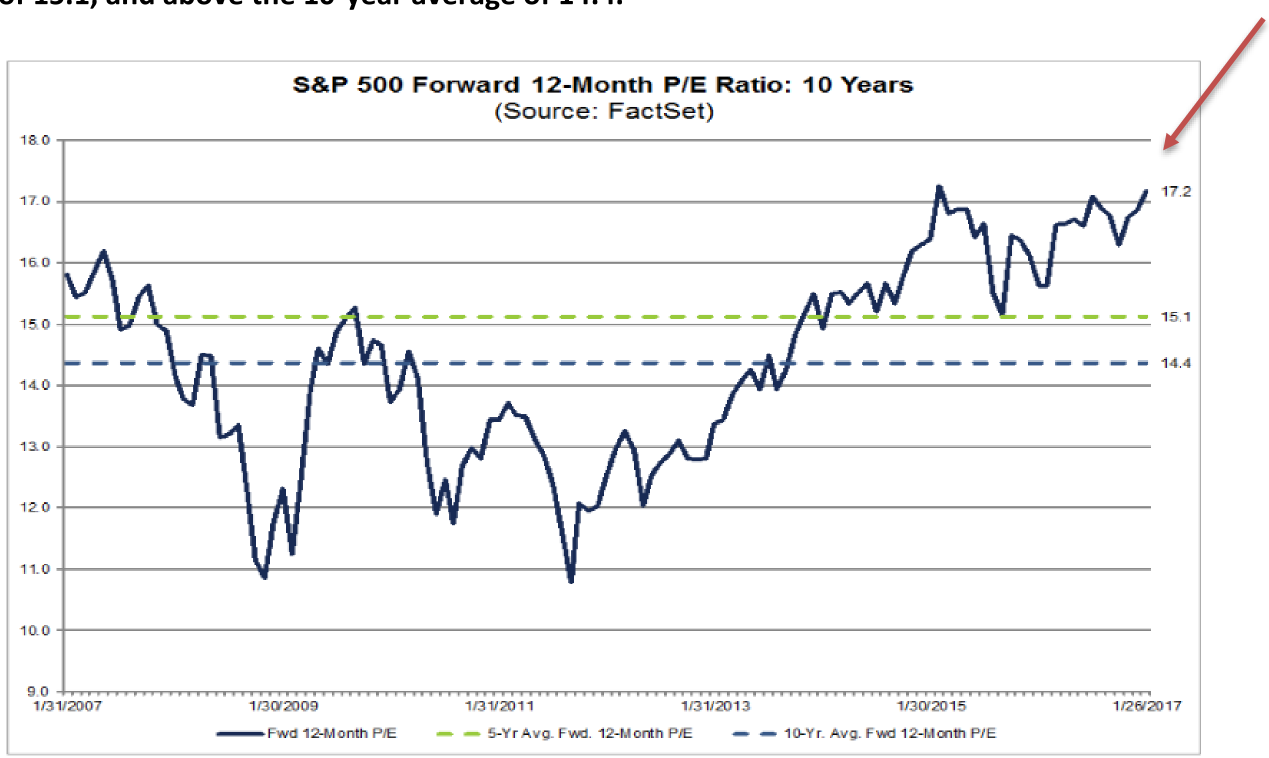
- **The 10yr treasury rate that is a major benchmark for mortgage rates, has risen over 100bpts** since the summer and has made borrowing more expensive. This will affect home buyers.



Source: FactSet, Federal Reserve. As of Jan. 26, 2017. Past performance is no guarantee of future performance.

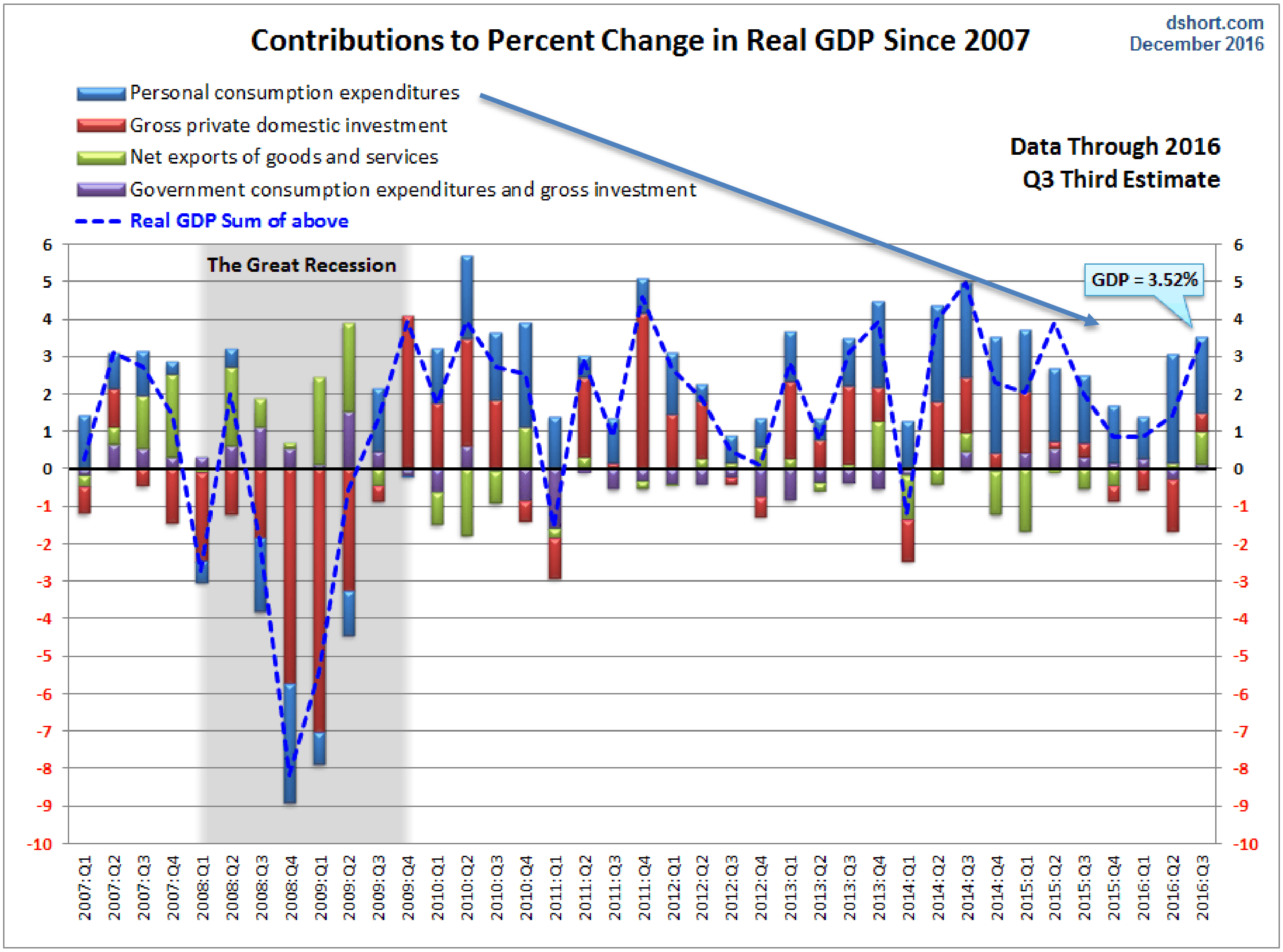
- **Inflation pressures is something the market has not had to contend with for over a decade.** Wages are moving higher, and the recent Consumer Price Index (CPI) showed prices at the core level (ex-food and energy) rose **2.2% year-over-year, which is above the Fed's target of 2%.** In response, the Fed has indicated will likely raise rates "a few times a year" through 2019.

- **High Valuation:** The forward 12-month **P/E ratio is 17.2. This P/E ratio is above the 5-year average of 15.1, and above the 10-year average of 14.4.**



Potential Swing Factor: GDP could get a big boost from Business Investment & Government Spending.

- The chart below shows quarterly GDP (blue dotted line) and its components (color bar). Since 2Qtr 2015, Personal Consumption (blue) has been the main contributor to growth while Business Investment (red) and Government spending (purple) was flat to negative. On the business side, much of the drag was from reduced spending in the energy sector, but some was also due to high regulation, unfavorable tax policies, and Obamacare. Now with energy prices stable to rising, and the potential for favorable changes for business investment, GDP is likely to get a boost from Business Investment. In addition, with Trump's pledge to increase infrastructure spending, government spending will likely be adding to GDP. Trade (green) is still the wild card as the strengthening dollar could hinder exports and be a drag on GDP.



In sum, while it is indeed a new show in Washington with fiscal policy the lead act, the financial markets will still ultimately take their cue from the fundamentals. Yes, the change is a radical departure from the last eight years, when monetary policy around the globe was propping up the markets with cheap money. Now the markets must rely on organic growth and innovation to justify prices moving higher. Markets will be driven by the efficiency of capitalism as investors direct cash to promising businesses and deny it to those destined to wither. The next 100 days and even four years may be a bumpy ride, but as Warren Buffet said, '**It's never paid to bet against America."**

Investment Strategy: Sitting tight and letting the dust settle in Washington. In mid-November risk positions were increased slightly and no changes have been made since.

Investment Allocation: Due to expected volatility and rapid sector rotation in equities, broad diversification is essential. On the bond side, rates will likely continue to creep higher over the year, thus duration is short with exposure to investment grade and high yield corporates, and floating rate bank loans.

As always, please contact me with any questions or concerns.
Kind Regards,

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