



INVESTOR INSIGHTS – FIRST QUARTER 2017

WELCOME TO 2017

While we do not write specific predictions every year, we think 2017 might be a year where we should. We enter the year with a number of big surprises from 2016. In fact, 2016 is the poster child for why no one likes to make predictions. So before we get to 2017, let's look back at conventional wisdom from just one year ago. This is what was supposed to happen.

2016

- The stock market will be a safe place to be invested.
- The bond market will outperform the stock market.
- Brexit will be voted down.
- Anyone but Donald Trump will win the nomination for Republican candidate for President.
- Once Trump became the nominee of the Republican Party, Hillary was a shoe-in for the White House.
- The Fed would raise interest rates at least three times.
- The dollar would remain in the range of \$1.10-\$1.20 for the Euro and \$1.40-\$1.50 for the British Pound.
- Foreign stocks would be a better investment opportunity than domestic stocks because their P/Es were lower.
- Oil would remain in the \$30-\$40 per barrel range.
- Real estate, especially high end real estate, would take a hit, some thought a big one.
- GDP Growth would be 3%.

This shows both how inexact predictions are and why people avoid making them or do so in a way that they have so many caveats they might as well not be making them. So with that as a backdrop and with an acknowledgement of our humility in making these, this is what we think.

Bonds

All bond investors will have negative returns in 2017. We think Fed Funds will be in the 1.5%-2.0% area and the 10 Year Treasury will be higher than 3%. These losses will come with no chance for a rebound, and that is the biggest investment problem this reality causes for investors. Bonds have been the safe place to invest since 1981, but one needs to study the last time rates rose from low levels to see how devastating this can be, the annualized return of the 10 Year Treasury in the decade of the 1950s was 0.8% per year. That is not a misprint: 0.8% per year for a total return for the decade of 8.29%. This is

where we are headed, and that is not an opinion. The opinion part are the dates when rates will rise, and we have no way of predicting those dates but expect it to start this year.

Oil

While oil is always volatile, expect it to be very volatile in 2017. The price of oil will range from \$60 to below \$40, and we will likely see \$40 by Labor Day. The current price allows for exploration. Shale and other drilling is in full swing and expect it to continue. It will also expand to places like the UK and France. This surplus oil will increase supply and reduce oil prices in the second half of the year.

Dollar

The Dollar will continue to strengthen relative to the Euro, British Pound and the Yen. The Euro will trade at a discount to the Dollar, and the British Pound will trade within 10% of the Dollar. While this might help us personally when we travel, this is not good news for domestic companies that export, and this surplus will be a head wind for our economy.

Inflation

Core inflation will average 2% or slightly higher. That said, this is something to watch. Low inflation is good for the economy, the market and our debt; but if inflation exceeds 3%, we could be heading for trouble. The last time we had inflation and interest rates this low was after the depression. In that era when the Fed felt the economy was strong enough to raise rates, as we are doing now, rates were pushed too high too fast. The result was a significant decline in stock prices. Now hopefully we have learned from that experience, because raising rates is much tougher than lowering them.

Volatility

All stock markets will have a wild year, with a 20% swing between high and low for the year. Last year the S&P 500 fell 11% before it rose almost 10%, and we expect the same for 2017. This may be good for investors, creating allocation shift opportunities during the year.

The Trump Presidency

Regulations will be subdued and tax rates will be lower, creating a tailwind for business. The repatriation of money from companies will be very slow and impact smaller companies before it impacts large, multinational companies. The Democrats and the Republicans will both feel they have a friend and a foe in the White House at various times as the year progresses. This, we believe, is good for the economy and for our political system as long as it does not create an atmosphere of total uncertainty. Trump's demeanor will be generally more subdued than we have seen him, but there will be flashes of irrationality.

GDP Growth

The new administration and Congress are likely to agree on lower corporate tax rates and the reduction of regulations to some industries. Both of these will be good for the economy, the earnings of our corporations and for GDP growth. For 2016, GDP growth will finalize around 2%. There were signs that it might be higher when the Q3 number was originally 3%. That will be revised lower and Q4 looks closer to 1.5%. So we see GDP growth impacted positively as we progress in 2017. It will get close to 3%, not higher. The talk of 4% or 5% GDP growth is fantasy. That would require significant repatriation of funds from the largest of our companies, and we just do not see that happening. 3% is certainly positive, but not the cure all for a global climate of too many people and not enough jobs.

Global Climate toward Nationalism

We have been surprised by the strength of this, so France and later Germany will be critical to watch. If Marine LePen wins the French election, this will spell trouble both for France and the European Union. The German election is more important because it appears the German Chancellor is holding Europe together, so if Angela Merkel were to lose to a nationalist candidate this could spell real trouble for the European Union. Some are suggesting Europe will return to the time when each country has a unique currency. Odd as it seems to students of history that Germany is holding Europe together, if the Germans do vote for a nationalist leader we could return to dealing with many currencies. We believe this will be a disaster for most of Europe, and hopefully the worst does not come about.

Brexit will be enacted quickly. The Prime Minister has told the houses of parliament that she will deliver a Brexit plan in May. She has said Brexit needs to be enacted quickly, and her plan will likely show a way to do so. Article 50 will be enacted likely in the summer, and Brexit will be completed by early 2019.

The economic hit from Brexit has already taken place in the U.K., their currency has been devalued by 20%. We do not see this devaluation continuing as Brexit is enacted, we think a fast Brexit is built into the current currency prices. The cheap price of Sterling will allow for a boost in the UK economy, and the UK may very well now be a place to invest.

India and China

One million people in India reach their 18th birthday every month, and China has been talking about a shift toward a consumer economy for some time. Both of these are the silver linings of the global economy. India has huge plans to increase the middle class in their country, and with a very young population, they will need to do so. China already has a huge middle class with more coming on every year.

This will create enormous opportunities for global companies serving the middle class in a wide range of sectors and industries. Recently, India announced they would allow foreign phone manufacturers to sell their phones in their country. This obviously could be a huge opportunity for Apple. India also announced that the phones would need to be manufactured in India as well. So expect Apple to be making a very large investment in India, and expect earnings to benefit from that in the coming years. Many more examples of this trend will be forthcoming, but India's insistence that phones be built in India is an example of why repatriation of funds from our corporations will not be as swift as has been suggested.

Asset Allocation and Investments

So what does all of this mean for portfolios?

1. Lower Your Exposure to Bonds

Bonds are your biggest problem. Your fixed income allocations should be reviewed. We think this asset class will show losses in 2017, and they are losses that cannot be recovered. You will need to consider an increase in your allocations to alternatives. The growth or total return strategies that are currently being used should be increased, and the conservative strategies should be reviewed as a direct substitute for your short term fixed income.

We have an analysis of the conservative strategies of our alternative investment managers, and it presents an optimistic picture of the use of these portfolios for clients in the rising rate environment we see coming.

2. Expect High Volatility from the Equity Market

You should expect continued volatility in equities. Remember that in 2016 the S&P 500 declined by 10.5% through February 11 before finishing positive 9.5% for the year. We see no reason to believe this type of trend will not continue in 2017.

3. Watch the Price of Oil

If we are right on the price of oil hitting \$40, we have a YieldCO/MLP portfolio that everyone should consider. It is structured as a separate account with very low fees and minimums, and it emphasizes high levels of dividend growth, in the area of 10%.

4. Have Confidence in the Growth of Your Dividends

We continue to believe the market will be led by high quality dividend paying and raising stocks. There was a shift back toward lower quality stocks after our election, but the P/Es of our stock market are too high for that to continue. Our High and Growing Dividend strategy has been an excellent strategy both to weather volatility and to achieve high returns. We see no reason for that not to continue. Our managers, Dearborn Partners, Henderson Global and KBI, are world class managers committed to the strategy of growing dividends.

The emphasis in our strategy of high and growing dividends is the element of dividend growth. Yes, the dividend yields are higher than indices, we look for 50% to 100% higher; but the real key to our success has been higher growth of dividends. Our strategy should not be confused with high dividend strategies being used as a substitute for bonds. These strategies are dangerous as we enter a rising rate environment.

5. Be Open to Illiquid Investments

Your clients do not need liquidity from all of their investments. We live in a world of very high bond prices globally and reasonably high stock prices. There will be some illiquid investment opportunities throughout the year which may very well be beneficial for your clients.

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