Quarterly Market Letter

RNC GENTER

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Overview

While there were plenty of political surprises in 2016, both equity and fixed income ended up about where we had expected. After a 10% correction early in the year, the S&P 500 slowly but surely moved ahead during the next eight months, and then finished the year up 12.0%, a little above our high single digit prediction, due to the Trump post-election rally.

For fixed income, we had expected subdued, low single digit returns due to rising interest rates. But yields dropped and prices rallied in the early part of the year, surprising us and the market. During the summer, this started to reverse and by November had given back almost all of the gains. Directly after the election, yields climbed even further to finish the year pretty much where we had expected, with low single digit returns for the year. The total returns for the Bloomberg Barclays Indices were, for Intermediate Government/Credit, up 2.1%, and U.S. Aggregate, up 2.7%.

So while the markets had considerable range during the year, in the end, they adjusted to the new political landscape pretty rapidly. Of course most of the adjustment is based on conjecture, as Mr. Trump was able to win the election without having to make too many broad or revealing promises. Thus the markets are still trying to guess the composition and size of any tax reductions, for either business or individuals, or the changes in trade relationships that the new President will implement. Most of all, the health care market is trying to figure out how Obamacare can be dismantled without throwing the whole system into disarray. As a result, we have not made many changes in our portfolios, as we will need more information to make appropriate adjustment with any degree of confidence.

The markets are now accepting the strong likelihood that economic stimulus will help corporate earnings, but probably push interest rates somewhat higher. While this is an appealing scenario, there is substantial risk that these policies will not be implemented effectively, without unintended consequences, or creating significant backlash from either domestic or foreign sources.

2017 will be a year of heightened uncertainty as a new course is plotted and many old assumptions will be challenged. We expect that it will take at least six months to have any clarity about these issues, so there are likely to be numerous head fakes both politically and for the markets. Fortunately, the economy is on increasingly firm ground, and corporate earnings and interest rates are not as vulnerable to these short term influences. We will continue to invest with a longer term horizon, based on solid research, always sensitive to risk.

Domestic Economy

The 2016 fourth quarter GDP (Gross Domestic Product) growth rate is expected to have tapered off to around 1.5%, mostly due to a higher trade deficit caused by the stronger dollar and inventory adjustments. Even with the strong 3rd quarter reading of 3.5%, the full year GDP appears to have grown just below the 2.0% rate that has characterized this entire seven year expansionary period.

As we look ahead into 2017 there is likely to be a tug-of-war between optimism and reality. The perception is that President Trump's business friendly pro-growth policies of less regulation, lower taxes and increased government spending will reignite "animal spirits" and result in a booming U.S. economy, defined as a GDP growth rate of 3.0% or more. The reality is that it will take time and possible compromises of these pro-growth initiatives for Congress to act. This curbs our enthusiasm regarding this year's outlook. While we do expect a little higher growth than the base case of 2.0%, much of the impact from Trump's proposals will probably not be truly felt until 2018.

However, there remain a number of economic metrics that will continue to support current moderate economic growth well before various pro-growth fiscal policies are enacted.

The consumer is in good shape with jobs plentiful, wages increasing, and household balance sheets improving, and continues to be the rock upon which this multi-year expansion was built. With consumer confidence at a six year high due in part to post election optimism, unemployment at only 4.7%, and the prospect of lower personal taxes, consumer spending should continue to provide a solid underpinning to 2017's economic growth.

One area of the economy that has remained depressed but is finally expected to accelerate is capital spending. Lower corporate taxes, repatriation, less regulation and rising profits should be enough to encourage businesses to invest more in physical plant, as well as long postponed labor saving equipment. Another motivation to increase spending would be the rising cost of labor as fewer skilled workers become available to meet rising demand. The economy's true growth is a function of the increase in the number of workers and the output per worker. Since the bottom of the last recession an estimated fifteen million workers have been added to the work force. Productivity, the measure of output per worker, has fallen precipitously in the past several years. Currently, the substitution of labor for capital has appeared to reach a low point. Now, with both renewed optimism and a proposed more efficient tax treatment, corporate capital spending should get better and pull the economy along with it.

One inevitable consequence of a tighter labor market is a rise in inflation. While the Core PCE (Personal Consumption Expenditures), the FED's preferred indicator of inflation, has remained well below the targeted rate of 2.0% over the past several years, we expect it to approach 2.0% this year. Should the economy heat up more than expected and underlying inflation follow suit, then the Fed would either have to become more aggressive in tightening rates or abrogate their inflation target entirely and let it drift higher.

We anticipate another year of moderate economic growth despite the probable tailwind from broader, far reaching changes in U.S. policies. But more encouragingly, we are increasingly confident that the risk of recession has faded and has been pushed further out into the future. This is tempered by possible policy missteps, external geopolitical events, the rise of protectionism, and a strong dollar, any or all of which could constrain the economy despite the new administration's best efforts to provide fiscal stimulus.

Fixed Income Review

For fixed income investors, 2016 will be looked upon as a year with two distinct halves delivering disparate outcomes. The first half was characterized by disappointing economic growth, low inflation, and a depressed/uncertain oil price environment which required the Fed to walk back their expectations for reducing monetary accommodation. This ultimately resulted in declining interest rates.

Whereas the second half, defined by rising populist/anti-globalization sentiments, best exemplified by the BREXIT vote in the U.K. and the outcome of the U.S. presidential election saw improving economic growth, higher inflation, tighter oil supply and an OPEC production cut. This combination helped propel interest rates meaningfully higher for the first time since 2013.

U.S. Treasury Yield:

	3mo	2yr	5yr	10yr	30yr
Year End					
2015	0.17%	1.05%	1.76%	2.27%	3.02%
2016	0.45%	1.21%	1.95%	2.48%	3.08%
bp Change					
QoQ	+17	+45	+81	+88	+76
YTD	+28	+16	+19	+21	+6

Source: U.S. Department of the Treasury

Corporate bonds were one of the best performing sectors in 2016 as the global demand for yield remained strong and overpowered rising supply and leverage trends. This demand drove credit spreads (per the Bloomberg Barclays Credit Index) tighter by 39 basis points. Fortunately, our maintenance of an overweighted allocation to the corporate bond sector, along with excellent credit selection within the sector, allowed us to produce significant out-performance in all of our taxable bond strategies.

For the municipal bond market, the results of the presidential election elevated concerns about deficit spending, inflation, and lower marginal tax rates. This culminated in a particularly rough period of performance. Most of the negative performance occurred in November in the aftermath of the election as investors reassessed their assumptions. In December, the tax-exempt market had become oversold and represented a meaningfully attractive relative value proposition versus Treasuries. For the year, municipal bond returns finished about flat in spite of the worst month of performance in recent memory.

Outlook / Strategy

Any 2017 forecast hinges on the interaction between two powerful forces: the relative degree of success of the Trump administration's economic, trade and geopolitical policies, and the ongoing environment we have endured over most of the last decade, characterized by slow growth and low inflation. While it is impossible to predict how 2017 will play out with any great certainty, one scenario is that the economy performs well in the first half of the year as business and consumer sentiment remains high and Trump is given a honeymoon period to implement his policies. However, this honeymoon ends in the second half of the year as the realities of the weak underlying economic forces assert themselves along with the difficulties (and costs) of implementing many of his policies. If this scenario were to play out, GDP growth would likely remain within the 1% - 3% range where it has been stuck for the last six years, and inflation would only surpass the 2% threshold for a limited time. Likewise, interest rates on the 10-year U.S. Treasury would likely stay within a 2% to 3% range. However, there are several Trump "wildcard scenarios" which could ultimately push 2017 results outside of those ranges. Growth, inflation, and interest rates could surprise to the upside if the Trump administration is able to meaningfully lower taxes, reduce regulations, and increase fiscal (infrastructure) spending. Unfortunately, the opposite could occur if Trump creates a trade war by too vigorously pursuing protectionist policies, makes geopolitical and/or social mistakes, or is disregarded after over-promising and under-delivering on his economic and tax policies.

Taxable Bond

At this time we are maintaining our neutral stance to the index portfolio duration target as we believe the markets will need to see some tangible evidence of Trump's impact before moving rates meaningfully outside of the recent range of 2.20% - 2.60% for the 10-year Treasury. While we will stay underweight Treasuries, they are valuable source of liquidity and an efficient vehicle with which to control interest rate risk. Given that we are not forecasting a recession and are still finding good relative value opportunities, we will maintain our overweight allocation to corporate bonds as we still believe that U.S. corporate debt will remain in high demand as investors continue to pursue higher yielding assets in an environment of low global interest rates.

Leverage trends appear to have stabilized (especially in the BBB rated segment) as stock buybacks have tapered down. We think the new issue supply will decrease in 2017 as many companies have actively refinanced and extended their debt profile over the last several years. Supply could decline even further if Trump is able to give incentives to companies to repatriate their foreign cash balances. This would cause a significant decline in the amount of issuance coming from technology and pharmaceutical companies, many of which have huge overseas cash hordes. One potential negative that warrants monitoring is the possibility for increased M&A activity under Trump's leadership. We consider TIPS (Treasury Inflation Protected Securities) to be fairly valued and don't forecast their inclusion in our strategy at this time. We still view Agencies as not offering enough yield compared to Treasuries given their relative lack of liquidity.

Municipals

For municipal bonds, the most pressing questions will be the tax reform and infrastructure programs of the new administration. Traditional public finance will be critically important to a national infrastructure plan. Any potential cap on the tax-exempt status of municipal bonds would be counterproductive to this plan. Also, Municipal bonds remain attractive relative to their taxable counterparts. Lower marginal tax rates should not meaningfully impact their relative value proposition as they offer tax-exempt yields of 91% - 118% to similar maturity U.S. Treasuries.

There is a significant bifurcation in credit trends of some state and local governments. Those doing well, such as Washington, Oregon, Texas and Florida generally share positive attributes like good population growth trends and a lack of pension problems. Those performing poorly, such as Illinois, New Jersey, Puerto Rico and Chicago are under severe pressure from unfunded pensions and OPEB (Other Post-Employment Benefits) liabilities. In November, New Jersey had its Standard and Poor's rating downgraded by a notch to A-. When Chris Christie took over as Governor in 2010, the state was rated AA. In six years it has dropped four notches to A- because of mounting pension and OPEB liabilities. Its $40 billion in unfunded pension liabilities are now greater than the $36 billion in outstanding debt.

While we have continued to see downgrades because of unfunded pension funds and bankruptcies, the overall underlying credit trend is positive. In the third quarter, the most recent quarterly data available, upgrades outnumbered downgrades for the 10th consecutive quarter. Fitch reported 106 upgrades across all U.S. public finance sectors and 54 downgrades, an almost 2 to 1 ratio. The par value of upgrades totaled $161 billion versus downgrades of $43 billion, an almost 4 to 1 ratio. However, the State of California and related credits were over 80% of all upgrades, around $134 billion.

While we see the headwinds of unfunded pension and OPEB liabilities and changing demographics continuing for the foreseeable future, credit selection should still allow us to enhance returns. Our strategy is a neutral to defensive duration posture with a bias for revenue bonds (versus General Obligations) and increased pre-refunded issues. Our duration profile will be centered on an overweight to the 1 - 7 year area of the maturity curve as well as a preference to higher coupon bonds. The pre-refunded sector represents historical attractive relative value at this time due to an abundance of supply. These highly liquid securities also offer a safety hedge should Trump's economic policies fail to gain traction. Finally, our emphasis on revenue credits reflects our elevated concerns about state and local pension underfunding. Revenue bonds with dedicated tax flows will be our focus.

The Fed

The uncertainties of the long campaign ended on Election Day, but for the Federal Reserve, they have just begun. The Fed is in for an interesting ride this year. We expect Donald Trump to fill the two available Governor seats in the first few months. Those nominations will provide some color as to the type of central bank desired by the new Administration. As for Congress, we expect to see increased scrutiny of the Fed. There may be an investigation—or an audit—to calm concerns that the Fed has been taking political sides. While we do not anticipate any changes which will meaningfully alter central bank independence, we do expect increased discussion whether to reduce their latitude in the discretionary component of monetary policymaking.

Just as Congress will be evaluating the Fed, the Fed will be carefully monitoring the fiscal authorities in Congress. In the December meeting outlook, some Fed officials had already factored in some projected fiscal activism, which is one reason why the median estimate for rate hikes in 2017 went from two to three. Yellen said the economy does not need stimulus per se, so her Fed will be gauging the substance of the enacted budget. Tightening is likely to be more aggressive if the fiscal measures are seen as simply juicing the economy rather than enhancing productivity.

For the past several years, the Fed has been imploring fiscal authorities to resume their traditional role as a catalyst for growth and inflation, saying that rates can only be normalized when they do. In other words, the Fed has been looking to resume its conventional role as the control unit, not the power unit, of the financial economy. With a unified Republican government at the helm looking to cut taxes and possibly embark on a wave of new spending, it appears the time has arrived for the fiscal and monetary authorities to revert back to their standard functions.

Yellen's term ends in January 2018, so we expect the noise around the Fed to build up during this summer. In terms of economic policy, most, though not all, of the action during the winter and spring will be on the fiscal side. Everyone will be watching, and reacting, to that, including, and perhaps especially, the Fed.

Equity Outlook

In 2017 we expect corporate earnings to accelerate from the snail's pace of this last year. Most companies registered gains of 5 - 10%, but EPS (earnings per share) for the broad S&P 500 index rose only 1 - 2% due to the complete collapse of energy sector earnings. Now with that sector starting to rebound, we expect at least a 6% increase this year. That growth rate would be higher, except that international companies will bear the brunt of a strong U.S. currency as their foreign earnings translate to fewer dollars. Most will struggle to produce even small gains in aggregate earnings. This most directly impacts large multi-national industrials and global consumer staples. However, some industrials that are more domestically focused may well be beneficiaries of a new stimulative infrastructure spending bill already being drafted in Congress. If this spending helps pick up the pace of GDP growth, then the dollar is likely to stay strong, putting even more pressure on multi-nationals. It may be feast or famine within this one sector.

The same may be true as the Republicans go about unwinding Obamacare. Over the last four years this has created both winners and losers amongst the health care sector. Will unwinding the program just reverse the tide? We think this is not likely, as not many legislators will vote to have as many as 15 million Americans lose their health care coverage. There needs to be a period of planning and transition before a new policy can be implemented. We still prefer pharmaceutical companies which should continue to see broad coverage gains without the threat of government pricing of individual drugs caused by Hillary, Bernie and the Democratic Party platform. There may well be other winners, but it is too soon to make anything other than a guess. So we will simply wait to have more facts before coming to any conclusion.

Our outlook for the Energy sector is detailed further in the next section, but it essentially remains unchanged. While oil and natural gas prices have both recovered dramatically from their lows of early last year, we expect oil to make further gains over the next year or two. We will maintain our strong commitment to large cap, oil oriented exploration and production companies.

Now that the market is adjusting to the prospect of higher interest rates, banks have had another leg upward in their valuation. Interest income, a major source of earnings, should start to increase almost immediately as the reinvestment rates for their bond portfolios rise. This effect has been missing for the last eight years, as the Fed has pursued their near zero interest rate policy. But it must be remembered that this positive impact is cyclical and will likely go away when interest rates eventually peak and start to come down. So we are not willing to pay very much for this increase in earnings, and are becoming skeptical that P/Es on banks should be any higher than 13 - 14x, where they are trading today. Dividend yields on most banks are now under 2.5% for what we consider to be a highly regulated utility type business. This seems insufficient reward for an investment with modest growth prospects.

With the steady support of good earnings, we expect 2017 to be a good year, but not as good as 2016. But most importantly, the risks of recession have faded somewhat, as we see concrete reasons why earnings could accelerate into 2018 due to lower taxes and more stimulative economic policies.

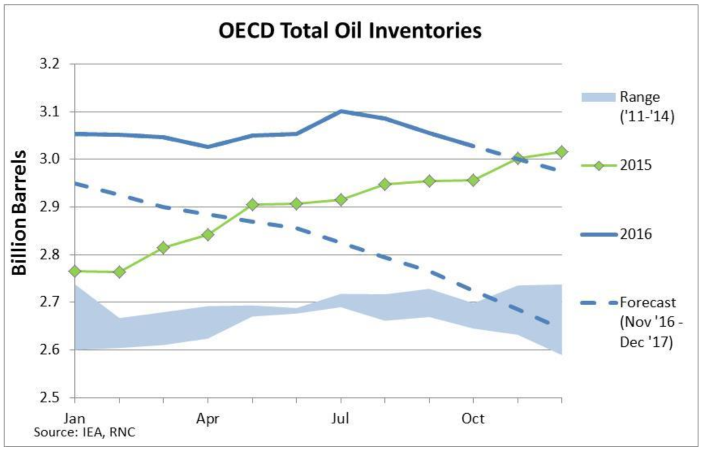
Energy Market Outlook

We remain overweight the energy sector based on our constructive view for crude oil prices over the next 12 - 24 months. Our holdings are heavily skewed towards oil production as opposed to natural gas.

The supply of natural gas in the United States is prolific and readily accessible. As a result, even though demand is growing about 3% per year, there is more than enough natural gas available in areas such as the Barnett (Texas) and Marcellus (largely Pennsylvania) to provide for domestic needs for several decades and probably longer. We expect that prices will continue to vacillate seasonally between $2.50 and $3.50 per million cubic feet (mcf). At $2.50, natural gas can start to displace coal as a fuel for domestic electric power generation. This increases demand and will keep the price from sinking much further. On the other end, $3.50 will incentivize additional natural gas production activity, and this increased supply will limit further upside price moves.

So even though demand growth will be favorable, with prices near our $3.50 upper bound, we find the outlook unappealing for the companies with a greater focus on gas production.

On the other hand, we expect the price of crude oil to continue trending upward due to shrinking inventories and muted global production. We believe the recently announced OPEC production cuts will only accelerate this trend. The graph below shows the historical range of global oil inventories (shaded area on graph) as well as the most recent and forecasted levels. After reaching an all-time high of 3.1 billion barrels in June 2016, inventories have been declining and we project that this will continue and perhaps accelerate though most of 2017. We estimate normal levels of inventory currently to be around 2.8 billion barrels, a little higher than historically, due to additional inventories needed to support normal annual demand growth of close to 1%.



There is a very high historical correlation between declining inventories and rising prices. Below normal inventories, our forecast for later in 2017, might lead to significant upward price pressure. As of now we expect prices in 2017 to range between $55 and $65 per barrel, but with risk to the upside. Looking out further, prices in the $70s are likely to be the equilibrium where the marginal cost of production converges with OPEC's domestic budgetary needs. Prices above $80 would allow high cost areas such as the deepwater offshore and the Canadian tar sands to reenter the picture, although these would need many quarters before they had any significant impact.

U.S. production has bottomed out recently at about 8.5 million bpd. We do not expect this to rise unless prices move higher from here. But with our higher prices scenario, we do see production starting to expand late in 2017 and into 2018. This will mean a significantly higher level of new development activity, because of the need to both replace depleting wells (average weighted production life of most fracked oil wells is about three years) and find new oil. In the next 6 - 24 months this will shift our energy sector investment attention more towards oilfield service companies that currently are struggling with very low utilization levels and price concessions. When oil prices reach $75 per barrel, the U.S. could increase production to 10 - 11 million bpd over time, helping to alleviate potential price spikes. In the longer run, this will shift power away from the recently reenergized OPEC cartel, but in the near term they will still be in control. The recently announced OPEC cuts total 1.8 million bpd, including Russia's (not a member of OPEC) commitment. While there will almost assuredly be cheating on these pledged levels, even a 1 million bpd reduction (our base case) would be enough to bring inventories down to below average before the end of the year assuming demand growth remains steady.

As mentioned before, there is some chance that the price pendulum overshoots to the upside. If the US and/or global economic growth accelerates, driving up demand, then either price must rise, or OPEC will have to bring on more production. If supply disruptions occur in nations torn by civil strife (Libya, Nigeria, Iraq, Venezuela, Yemen) then prices would accelerate to the upside. The reason for this seemingly precarious balance is that the supply of new oil coming on stream for the next 2 - 3 years will be quite muted by the severe exploration budget cutbacks made in 2014-16.

Each year global production shrinks by 4 - 5 million barrels due to ongoing depletion. So each year new production must replace this loss and cover the 1 million barrels of new demand. In the last two years there simply has not been anywhere near this level of discovery or progress on new projects. Several large developments, started earlier in the decade, are coming on in 2017, replacing the 2016 depletion, but the pipeline of projects has grown increasingly thin for 2018 and beyond. So prices will have an upward bias for many years to come.

Our oil company holdings are specifically chosen for their advantaged oil assets and their ability to execute existing and new oil projects. Each should see growing production with the added tailwind of rising prices. We expect several more years of superior performance from this sector.