JJ BURNS



## “Changes are taking the pace I’m going through” David Bowie, *Changes*

2016 proved to be a dramatic and polarizing year. Despite some excellent market returns that marked a strong reversal from 2015, geopolitical events pushed uncertainty to the forefront of investors’ thinking. Music fans also lost a number of great musicians, including Prince, David Bowie, Keith Emerson and Greg Lake, Glenn Frey of Eagles and Merle Haggard to name a few. They will be our guides for this review. Here’s a snapshot of the numbers for 2016:

| Index | 2016 LOW on 2/11/16 | 2/11/16 LOW to 12/31/16 | 2016 | 2015 |
|---|---|---|---|---|
| **Fixed Income** | | | | |
| BBgBarc US HY 2% Issuer Cap TR | <5.16%> | 23.50% | 17.13% | <4.43%> |
| BBgBarc Municipal TR | 1.94% | <1.66%> | 0.25% | 3.30% |
| BBgBarc Global Aggregate TR [Hedged] | 2.12% | 1.79% | 3.95% | 1.02% |
| BBgBarc US Agg Bond TR | 2.25% | 0.39% | 2.65% | 0.55% |
| **U.S. Equities** | | | | |
| Russell 1000 TR [Large-cap Stocks] | <10.91%> | 25.78% | 12.05% | 0.92% |
| Russell 2000 TR [Small-cap Stocks] | <15.93%> | 44.29% | 21.31% | <4.41%> |
| S&P 500 TR | <10.27%> | 24.78% | 11.96% | 1.38% |
| **International Equities** | | | | |
| MSCI ACWI Ex USA NR [All Stocks] | <11.96%> | 18.69% | 4.50% | <5.66%> |
| MSCI EAFE NR [Developed Markets] | <12.78%> | 15.80% | 1.00% | <0.81%> |
| MSCI EM NR [Emerging Markets] | <10.15%> | 23.74% | 11.19% | <14.92%> |
| **Real Assets** | | | | |
| U.S. Dollar | <3.11%> | 6.96% | 3.63% | 9.26% |
| Morningstar US Real Asset Index TR | <3.92%> | 9.21% | 4.93% | <3.92%> |
| Bloomberg Commodity TR | <5.83%> | 18.68% | 11.77% | <24.66%> |
| S&P GSCI Crude Oil Spot | <22.17%> | 86.33% | 45.03% | <30.47%> |
| S&P United States REIT TR | <10.19%> | 20.80% | 8.49% | 2.54% |
| S&P Global Ex US REIT TR | <3.27%> | 7.52% | 4.00% | <2.77%> |

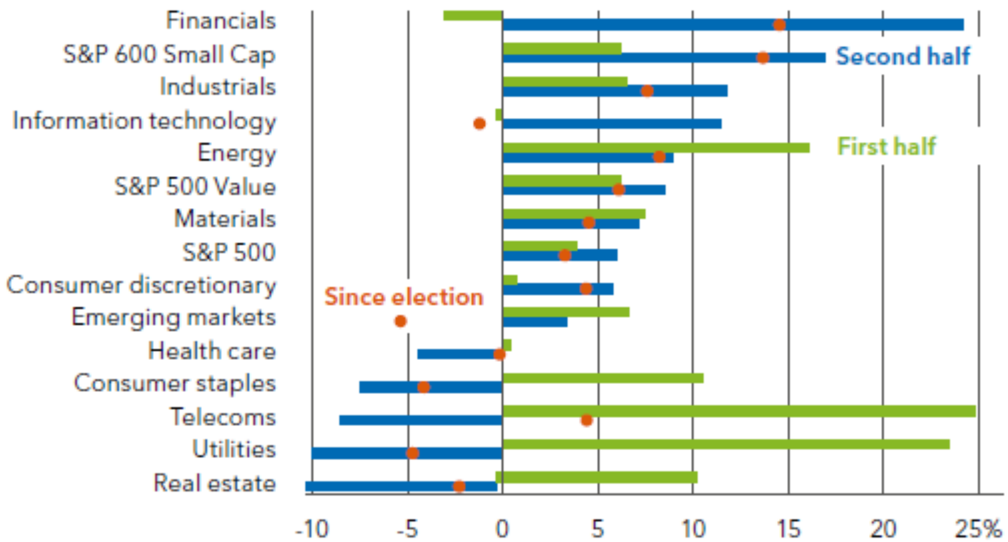
*Source: Morningstar, Inc. All data are USD total returns with dividends and interest.*

The year began with uncertainty and pessimism, recovered (partly due to a bottom in oil prices) and then finished the year with the ‘Trump rally’ following the November U.S. elections.

We continue to be both heartened and concerned that various markets continually shake off uncertainties in favor of higher valuations. Bitter elections, conflicts, terrorism and supply gluts seem to have only short-term impacts, and markets (U.S. stocks in particular) remain resilient. We see the year as having three different return periods – the first half, second half and post-U.S. election through December 5, 2016 (below):

**Accelerating rotation**

U.S. equity sector and EM performance, 2016

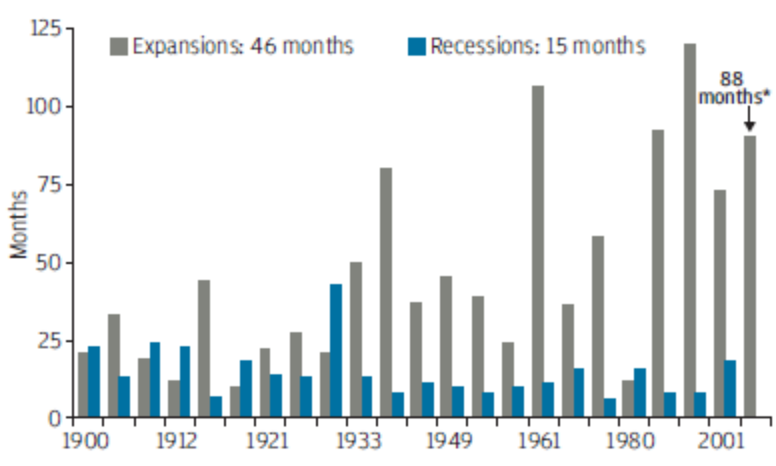



Sources: BlackRock Investment Institute, S&P, MSCI and Thomson Reuters, Dec. 5, 2016.
Notes: The bars show total returns for a range of S&P 500 indexes and the MSCI Emerging Markets Index for the first half of 2016 (green) and the second half to date (blue). The dots show returns since the U.S. election on Nov. 8.

The second-half (blue bar) and partial post-election results (orange dots) demonstrate what market expectations are for the incoming Trump administration: more economic growth, higher interest rates (good for banks), a strengthening dollar (negative for emerging markets?), further investments in energy and industry, and broadly, a preference for risk assets (e.g. smaller-cap stocks). Before we read too much into these results, we must caution that these are short-term reactions to Trump's election. No formal policies have been laid out, and the devil is always in the details. The broad themes are evident, though, and deserve further scrutiny.

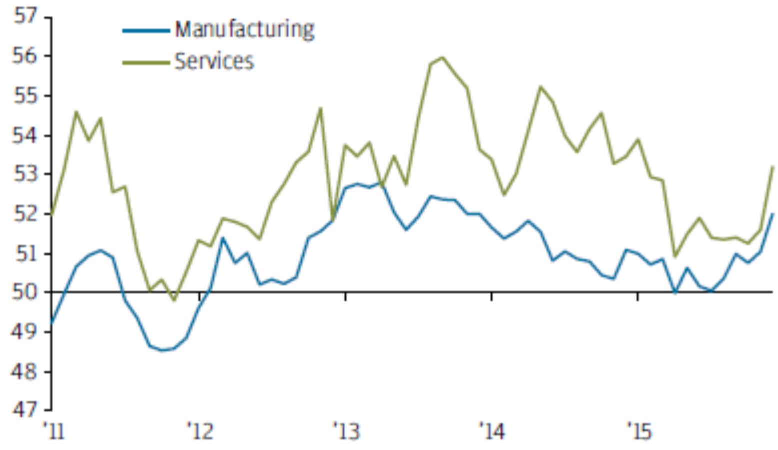
### "So tonight I'm gonna party like it's 1999" Prince, *1999*

Let's start with the economy. Many complaints have arisen around the 'lackluster' growth in America's recovery, but optimistically, we see a long U.S. expansion (currently the 4th-longest since 1900) with potentially lower downside risk for a deep recession when the cycle ends.




Source: BEA, NBER, J.P. Morgan Asset Management; data are as of October 31, 2016.

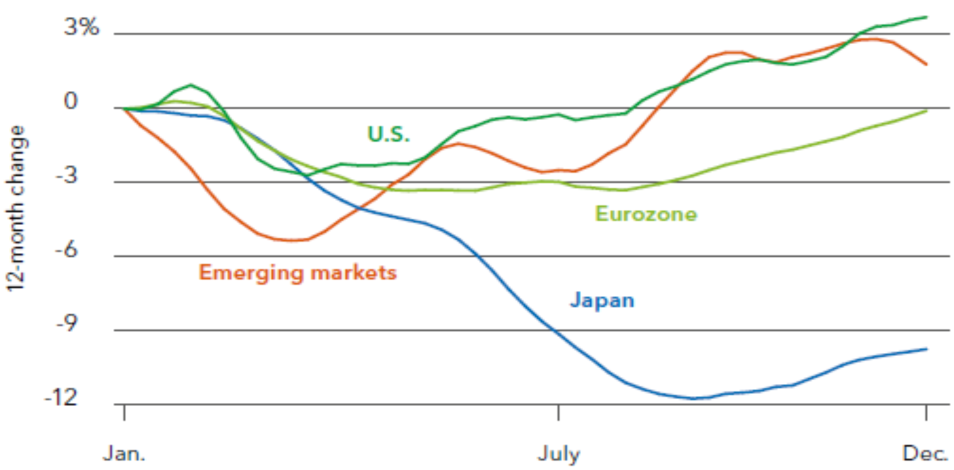
Globally, we see signs of growth based on trend changes late in the year. PMI data represented below indicate improving trends in manufacturing and services, as readings over 50 indicate expansion. In this case, we focus on the trend as well as the reading.




Source: Markit, J.P. Morgan Asset Management; data are as of October 31, 2016.

Some of this optimism has rolled over into equity-earnings forecasts for 2017. The S&P 500 recently ended a multi-quarter earnings recession that was partially fueled by depressed energy prices. Political and (possible) forward economic policy clarity has raised expectations for higher earnings which ultimately drive stock prices, though these projections will be continually revised during the year ahead:

Changes in U.S., eurozone, Japan and EM earnings estimates, 2016

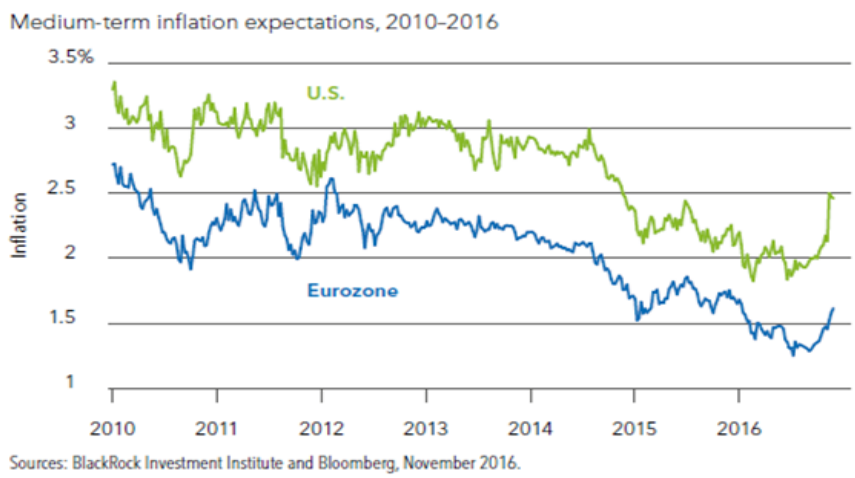



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, Dec. 2, 2016.
Notes: The lines show the change in 12-month earnings estimates for the MSCI U.S., Emerging Markets, EMU and Japan indexes. The estimates are rebased to zero at the start of January 2016.

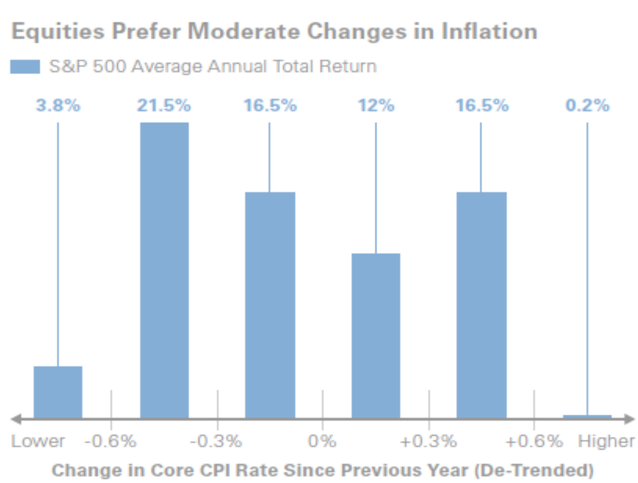
Optimism is highest for the U.S. and emerging markets, which have endured several years of poor reception from investors. Despite the expected headwinds of a rising dollar, EM countries may still benefit from developed market imports of their goods, stabilizing commodity prices and improving local economies. While investors aren't as optimistic about Eurozone and Japanese markets relative to the U.S., specific overseas companies, industries and regions still offer attractive valuations and expectations.

**"Johnny come lately, the new kid in town / Everybody loves you, so don't let them down"** **Eagles, *New Kid in Town***

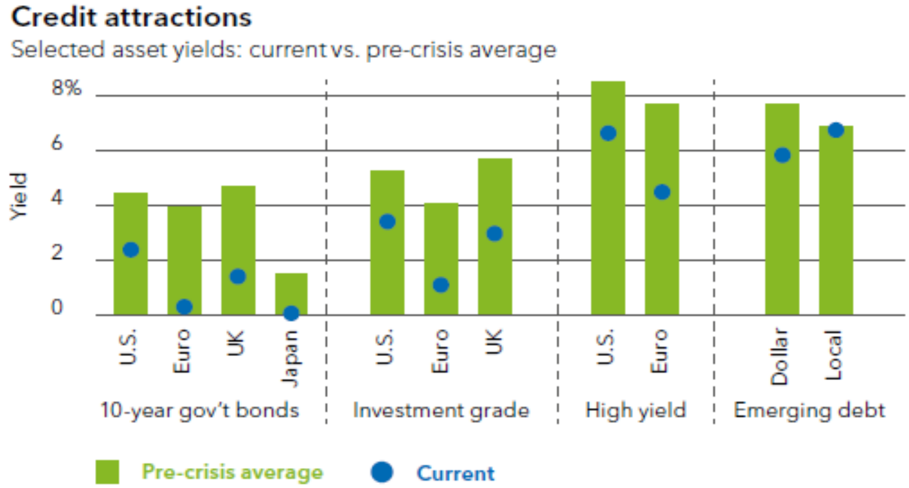
One result of Donald Trump's election has been the return of 'normal' interest rates and higher inflation expectations.  Although rates were expected to rise and inflation was already rising before the election, Trump's unabashed pro-growth policies pushed the markets into open acknowledgment of regime change.  Despite any specific details other than lower taxes, fewer regulations, more infrastructure investment and possible trade restructuring, investors sensed a long-awaited change.  Market interest rates and Fed-controlled rates rose, the U.S. dollar strengthened, and inflation expectations continued to rise.  More important was the tangible expectation that the period of post-Crisis monetary policy will finally give way to fiscal stimulus on the part of central banks and governments.  These direct investments are expected to push global growth higher and make the case for risk assets such as stocks.  A return to 'normal' rates and some inflation are highly desirable for growth; the issue, of course, is how severe the changes are and what the timing will be.  As we can see, market expectations for five-year forward inflation have changed dramatically over the past few months:




Slow and steady is always the preferred course with inflation, as demonstrated in the graph below relating stock prices to inflation changes:

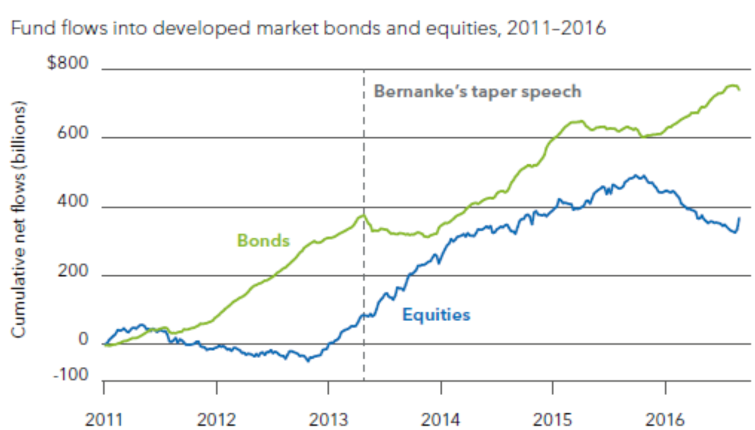


Interest-rate changes have also attracted investor attention as well. Many ‘lower for longer’ forecasts for the U.S. have been revised to ‘normalization’ (higher rates with more yield ‘spread’ among maturities), with credit assets being more attractive than government bonds. This chart demonstrates where yields are currently positioned versus their pre-crisis averages:




Sources: BlackRock Investment Institute, Thomson Reuters, Bank of America Merrill Lynch and J.P. Morgan, December 2016. Notes: The pre-crisis average is based on the five-year period before the financial crisis (2003-2008). Corporate bonds are based on Bank of America Merrill Lynch U.S. Corporate Master, Euro Corporate, UK Corporate, U.S. High Yield Master and European High Yield indexes. Emerging debt dollar is based on the J.P. Morgan EMBI Global Diversified Index; EM local is based on the J.P. Morgan GBI-EM Diversified Index.

Generally, when interest rates rise during an expansion, high-yield, investment-grade-corporate and municipal bonds outperform government bonds. Given the yield levels above and the U.S. continued expansion, there is still expectation for selected pockets of good returns in bond land. Note that stocks traditionally have done well in rising rate environments, as GDP and earnings continue to grow. Most market observers now believe that bonds will be a weak performer over the latter part of this cycle as rates normalize. One downside to this normalization is the impact it may have on investors. We have previously noted the amount of assets that have flowed into fixed-income mutual funds since 2009, the end of the crisis. The perception of government bonds as ‘safe assets’ implies that portfolios may have been misallocated to benefit from the recovery in stocks, and may suffer losses going forward.




Sources: BlackRock Investment Institute and EPFR, November 2016.
Notes: The lines show cumulative fund flows since January 2011. Ben Bernanke's tapering speech is when the then Fed chairman flagged the gradual end of bond purchases by the central bank.

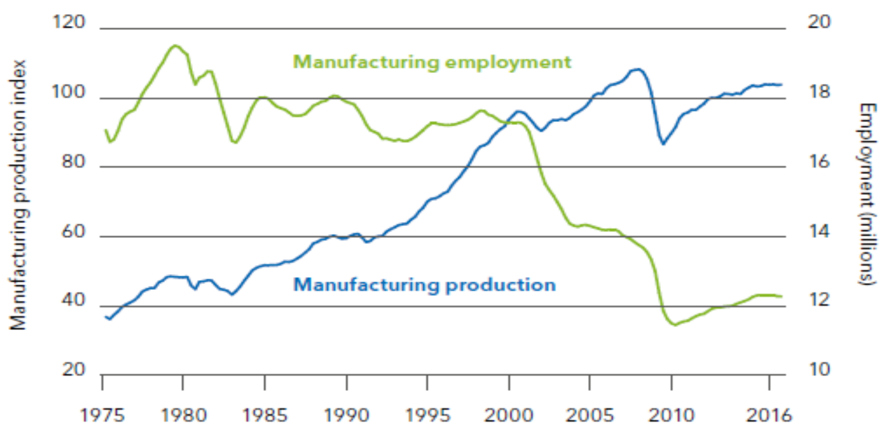
A potential benefit, however, is that downward pressure on bond prices may lead to equity fund inflows, which may provide support for stocks later in the cycle.

**“Cry a little bit of these working man blues, here comes that workin' man” Merle Haggard, *Workin’ Man Blues***

Clearly, expectations and promise are high entering the year despite the potential decoupling of U.S. economic policy from the global economy that appears to be in the works. Populist movements in Europe have gained momentum from the Brexit and U.S. election results. Russia and China are increasing their political and military hegemony in expanding spheres such as the Middle East and Asia while also managing broad economic transformations. Europe and Japan continue to struggle to find the right mix of growth-focused fiscal and monetary policies while remaining engaged in the global community. Our collective will in this long period of general post-war peace and prosperity is being tested as never before.

Decreasing jobs, stagnant incomes and declining economic freedom are three key issues facing the current governing regimes in the world. While these are measureable trends, their causes may be different than the popular view in (for example) the U.S.:

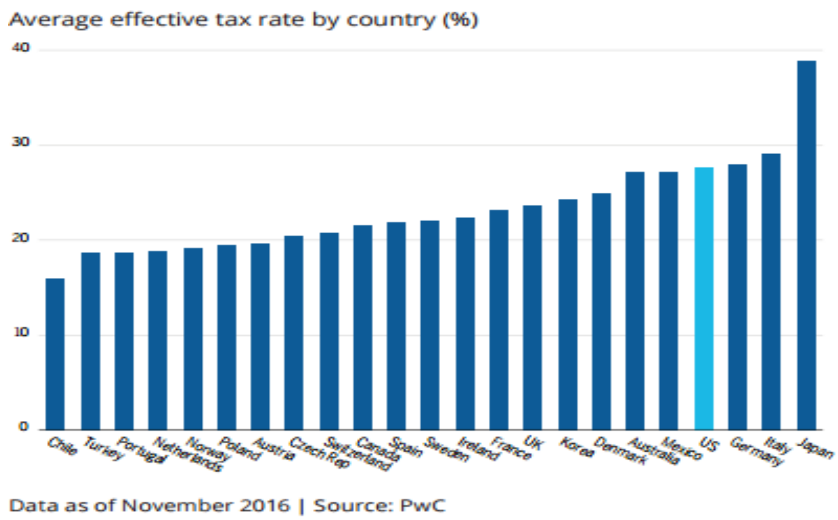
U.S. manufacturing production and employment, 1975–2016




Sources: BlackRock Investment Institute, Federal Reserve and U.S. Bureau of Labor Statistics, November 2016.
Note: The base year (100) for manufacturing production is 2012.

U.S. manufacturing production has increased steadily for decades while employment has fallen. This trend is largely attributed to technology improvements (e.g. use of robotics, computers) and global competition. Longer term, the trend is expected to continue in the U.S. and other developed economies, regardless of the U.S. president-elect’s proposed tariffs and trade negotiations.

Mr. Trump’s plans for tax reform are expected to have a positive effect in the U.S. as well, and appear to be the most popular ‘plank’ in his platform. A combination of lower corporate tax rates (see below), a tax-repatriation ‘holiday’ for foreign earnings held abroad and a lessening of regulations is expected to be the proper ingredients for a growth cocktail. Balancing personal and corporate tax-rate changes may have negative effects on the debt and the deficit, however, and may face congressional opposition.




### “Ooooh, what a lucky man he was” Emerson, Lake and Palmer, *Lucky Man*

President-elect Trump is the first man to enter office in a generation without a recession hangover. Growth, wages, stocks and inflation are all recovering or growing. The levels and depth of change may not be the same as in past recoveries, but the trend is assuredly positive. We were reminded of our overall good fortune by some recent comments from Jamie Dimon, CEO of JP Morgan Chase bank to Carlyle Group CEO David Rubinstein:

**“AMERICA HAS THE BEST HAND EVER DEALT OF ANY COUNTRY ON THIS PLANET TODAY AND EVER. AND AMERICANS** don’t fully appreciate what I’m about to say. We have peaceful, wonderful neighbors in Canada and Mexico. We have the biggest military barriers ever built, called the Atlantic and the Pacific. We have all the food, water and energy we will ever need. We have the best military on the planet and we will for as long as we have the best economy. And if you’re a liberal, listen closely to me on that one. OK, because the Chinese would love to have our economy. We have the best universities on the planet. There are great ones elsewhere, but these are the best. We still educate most of the kids who start businesses around the world. We have the rule of law, which is exceptional. If you don’t believe me, we can talk about Brazil, Russia…Venezuela, Argentina, China, India. Believe me, it’s not quite there. We have a magnificent work ethic. We have innovation from the core of our bones. You can ask anyone in the room…it’s not just Steve Jobs. We’re the widest, deepest financial markets in the world has ever seen. I just made a list of these things. It’s extraordinary. It’s extraordinary. And we have it today.”

### “Yes I've gotta have faith… I gotta have faith-a-faith-a-faith” George Michael, *Faith*

Our long-term optimism on markets and growth remains undimmed, but we realize that the bumpy road ahead just got bumpier. The world’s most important economy is now being managed from a business perspective (i.e. profit and growth) rather than one of governance (i.e. focus on equality and idealism). How this shift plays out in policy directives, and how they are received globally, is a huge question mark in our minds. We’ll have more detail on these topics in our winter webcast.

As always, we welcome your comments, questions and feedback. We wish you and all you hold dear a healthy, happy and prosperous new year.

-Your Wealth Management Team at JJ Burns & Company

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Unless otherwise stated performance numbers refer to indexes, which cannot be invested in directly and have no fees or trading expenses associated with them.  All index data provided by Morningstar, Inc.

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Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe.  It includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.  The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe.  It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market.  The Barclays U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Citi World Government Bond Index (WGBI) provides a broad benchmark for the global sovereign fixed income market.  It measures the performance of fixed-rate, local currency, investment grade sovereign bonds, currently includes sovereign debt from over 20 countries denominated in a variety of currencies.

The Morningstar® US Real Asset Index is a diversified portfolio of four different asset classes that have historically displayed high sensitivity to inflation.  Real assets are defined as TIPS, commodity futures-based strategies, real estate investment trusts, and inflation-sensitive equities such as upstream commodity stocks and master limited partnerships

The S&P U.S. REIT Index defines and measures the investable universe of publicly traded real estate investment trusts domiciled in the United States.  The S&P Global REITis a comprehensive benchmark of publicly traded equity REITs listed in both developed and emerging markets.  The S&P 500® index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The MSCI ACWI index captures large and mid-cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries.  The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada.  The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries.

The Bloomberg Commodity Total Return index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. The index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity.

Charts and graphs from Wellington Management (p. 7) and Goldman Sachs Asset Management (p. 4).