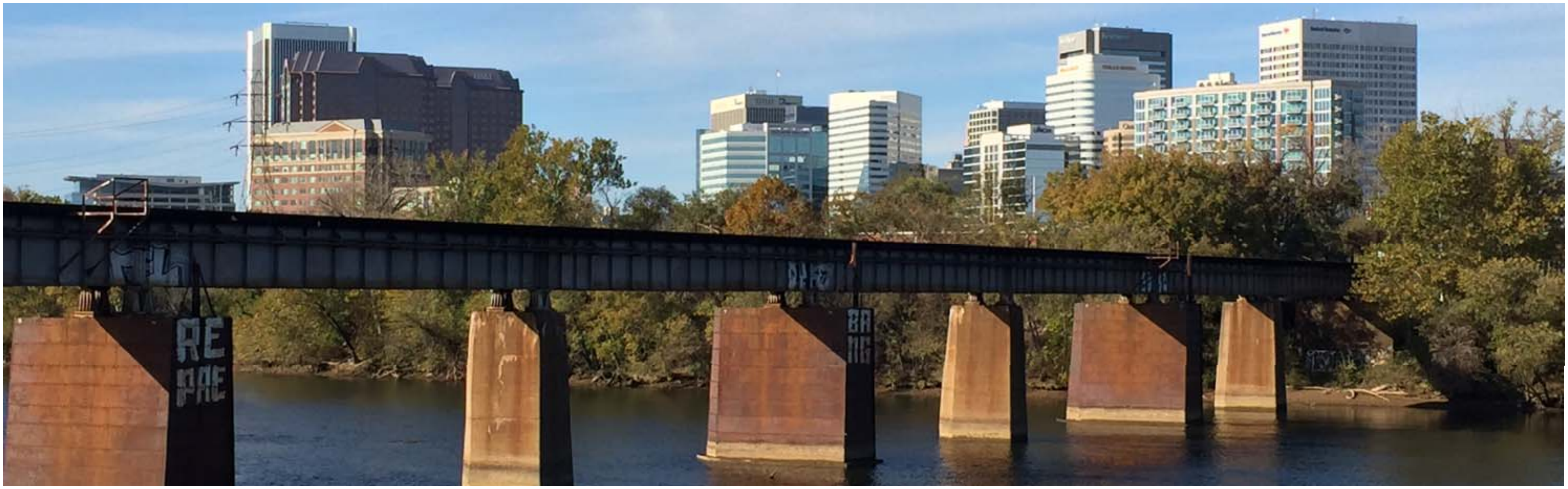


Quarterly Update & Economic Commentary—December 31, 2016

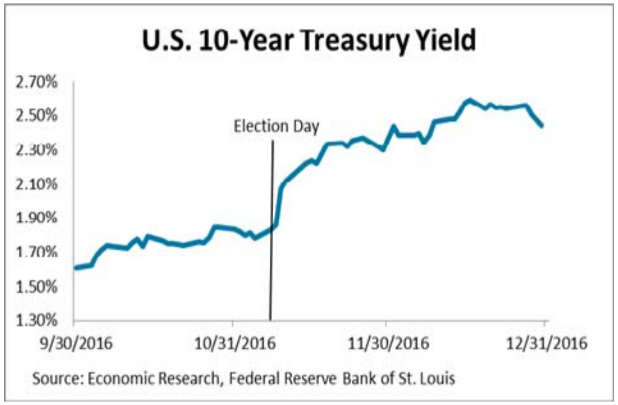
Quarter in Review

The fourth quarter was another strong one for the equity markets. The total return for the S&P 500 for the fourth quarter was 3.82 percent, just slightly less than the third quarter's performance of 3.85 percent. For the year, the S&P 500's total return was 11.96 percent. Small cap companies outperformed their large cap counterparts for the quarter and year-to-date. The S&P Small Cap 600 returned over 11 percent for the fourth quarter and posted an annual return of 26.56 percent. The Financials sector led markets in the quarter, returning more than 21 percent, 16.80 percent of that came since the election. Energy was the second best S&P sector for the quarter and the top performing sector in 2016. The energy sector returned 7.28 percent during the quarter and finished the year positive by 27.36 percent.

International equities did not perform well in the fourth quarter. The developed market index, the MSCI EAFE Net Return, was down slightly by 0.71 percent. Emerging market stocks, as represented by the MSCI Emerging Markets Index, were down by 4.16 percent. Despite the negative fourth quarter, both indexes were positive during the calendar year. The EAFE returned a meager one percent, but the EM Index returned a strong 11.19 percent. The strengthening dollar detracted from returns, especially for the developed market index. In the fourth quarter, the dollar hurt performance of the EAFE by almost eight percent; for the year, it reduced performance by over four percent.

A spike in interest rates impacted the performance of fixed income investments during the second half of the year. The 10-year Treasury Yield, which can be used as a proxy for interest rates, saw an increase of 84 basis points over the quarter; 59 of those basis points came since the election. The 10-year Treasury Yield bottomed in early July at 1.37 percent and finished the year at 2.45 percent, a whopping increase of 1.08 percent. Despite seeing so much volatility in 2016, interest rates finished just 18 basis points higher than a year ago. Interest rate movements undoubtedly hurt fixed income total return. The core fixed income index, the Barclays US Aggregate

Bond Index, lost 2.98 percent for the quarter; the last time the index fell by close to that amount was during the first quarter of 1994 when the index lost 2.87 percent. Despite the terrible fourth quarter for bonds, the Barclays Aggregate Index finished the year positive by 2.65 percent. High yield fixed income, which tends to be more correlated to equities and is less interest rate sensitive, had a good year finishing positive by 17.13 percent, as represented by the Barclays US Corporate High Yield Index.

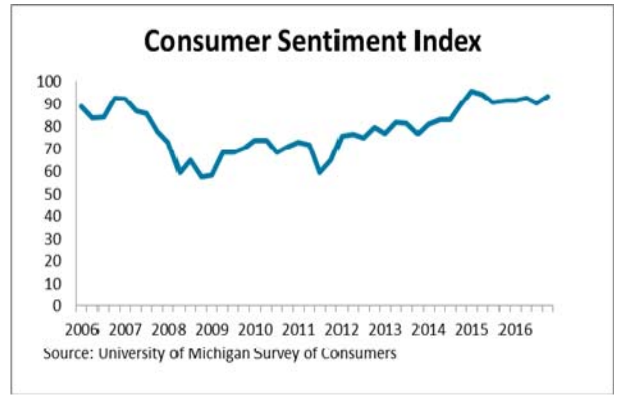


Much of the market returns experienced throughout the quarter is attributable to Donald Trump's unexpected and unprecedented presidential win. The two primary factors that led to his election were the growing frustration with "Washington Insiders" and the continued feelings of marginalization among blue collar workers due to the effects of trade and technology. Though much is still unknown about what Trump is willing and able to achieve, investors can be fairly certain that he will bring change to many aspects of politics. Investors have taken note of his proposed agenda and its pro-growth objectives—the market has heavily rewarded growth oriented sectors since the election.

Throughout the first half of the year, the markets were led by sectors that benefited from low rates and were more defensive in nature; however since Trump won the election, the market leadership has shifted to companies that will benefit from higher interest rates and a stronger economy. Trump's top priorities are expected to include lower income and corporate taxes, passing a massive infrastructure bill, incentivizing companies to keep or bring jobs to the U.S., and healthcare reform.

It is believed that since the GOP not only won the Presidency, but also maintained majority control in the House and Senate, that the President-elect will be able move on his agenda relatively quickly. It is true that while Trump and the congressional GOP agree on the top agenda items, they are not in full agreement with the details. Because of this, it is likely that the big ticket legislative items will take longer than expected and be more diluted than initially advertised.

Even without the expectations for the new President, the current condition of the U.S. economy is relatively strong, and expectations of the future are high. The U.S. Consumer Sentiment Index is at its highest level since 2004, the Consumer Confidence Index reached its highest level since August 2001 and small business optimism moved much higher after the election. The Small Business Optimism Index November reading was 3.5 points above its 42-year old average, marking only the third time since 2007 that the monthly reading was above the average. The current estimate for the third quarter Gross Domestic Product (GDP) was 3.5 percent, which is the highest growth rate since the third quarter of 2014. The employment picture continues to look strong and wages continue to rise.



Almost going overshadowed in the quarter was the December Fed meeting, which saw the U.S. Federal Reserve raise interest rates for the first time since last December and only the second time in a decade. The Fed really did not have a choice, since market conditions pushed U.S. yields higher following the election. Chair Yellen took the "wait and see" approach to whether the incoming President's policies will force the Fed to raise rates quicker than previously anticipated. The Fed acknowledged that the country was getting closer to full employment—the November unemployment rate was 4.6 percent. The committee's updated rate projections for 2017 show three rate increases.

The European economy is struggling relative to the U.S., but things are slowly moving in a positive direction. The most recent inflation figure was 0.6 percent—well below where central bankers would prefer, but its highest level since April of 2014. The region's unemployment rate has moved under 10 percent for the first time since 2009. The ECB announced they would continue to support the economy by extending asset purchases through 2017, but it did announce that it would reduce asset purchases from 80 billion euros to about 60 billion euros starting in April of 2017.

The Italian government approved a 20 billion euro fund to support its banking sector. The bailout was designed to help the world's oldest bank, which is also the third largest in Italy, Monte dei Paschi di Siena. Monte dei Paschi was the worst of the 51 European banks that went through the ECB's stress testing earlier this year. Of the 20 billion euros being provided from the government, Monte Dei Paschi will consume about a third. The bailout will help keep the bank solvent for now, but the dire economic conditions in Italy will keep pressure on the banking sector for years to come.

As fears over the "Brexit" have declined since the June vote, the Japanese yen has given up much of its gains, having lost over 15 percent over the last three months. A cheaper yen is good for the Japanese economy. November export volume crept toward a two-year high, and the manufacturing outlook has also improved. The Bank of Japan maintained its policy of a negative 0.1 percent interest rate on a bank's excess reserves; it will continue to target the ten-year government bond at zero and keep annual rises in government bond holdings at 80 trillion yen. The large fiscal stimulus project is expected to support economic growth in early 2017 and should prop up inflation, which remains well below the two percent target.

A Look at the Numbers

Name	4th Quarter Performance (%)	2016 Performance (%)
DJ Industrial Average TR USD	8.66	16.50
S&P 500 TR USD	3.82	11.96
S&P MidCap 400 TR	7.42	20.74
S&P SmallCap 600 TR USD	11.13	26.56
NASDAQ Composite TR USD	1.66	8.87
MSCI EAFE NR USD	-0.71	1.00
BBgBarc US Agg Bond TR USD	-2.98	2.65
Wilshire US REIT TR USD	-2.28	7.24
IA SBBI US 30 Day TBill TR USD	0.06	0.20

Forecast In Brief

As we move into 2017, the feeling is a little different than in previous years - economic expectations are high. President Obama and President-elect Trump have very different messaging styles, and this likely impacts how investors perceive the economy. Whereas Obama aimed to provide the country with cautious optimism, much like a corporate executive who sets a low bar that's easier to outperform, Trump's approach is more like that of a salesman. He may have difficulty delivering on the high expectations which he has developed.

Given the high expectations evidenced by rising investor sentiment and the stock market gains since the election, it appears that the risk is to the downside. Trump wants a significant tax cut for businesses and individuals, but in reality he may get something less sweeping. House Majority Leader Paul Ryan wants tax reform too, but he and Trump will likely have different notions of what constitutes "revenue neutral." Another pro-growth initiative that excites investors is Trump's infrastructure spending plan. Though House Republicans are in favor of the infrastructure package, Trump will have to convince them that it won't be detrimental to the deficit. Ultimately, if Trump's policies are somehow revenue neutral, then this by definition would not be fiscal stimulus. Because of that, it remains to be seen whether these policies will actually contribute to additional economic growth.

For U.S. companies, the earnings recession is over. After posting a slight positive gain in earnings for the third quarter, analysts are expecting another positive quarter for earnings growth. As of December 23rd, FactSet estimated that the growth rate for the S&P 500 earnings would be 3.2 percent, and estimates for revenue growth sit at 5.1 percent. If year-over-year revenue growth does reach 5.1 percent it would mark the strongest revenue growth since the first quarter of 2012. Looking ahead to 2017, analysts are bullish on earnings. According to FactSet, for the first quarter of 2017 analysts are projecting earnings growth of 11.2 percent and revenue growth of 8.4 percent. Even if analysts reduce estimates over the course of the quarter, as they are known to do, high single-digit earnings growth for the next quarter and year would be a tailwind for equities.

Despite Trump's disdain for Janet Yellen, his win might be a blessing in disguise for the Fed. With many policy wonks, including some inside the Fed, wondering how they will they ever unwind the central bank's large balance sheet and restore normalcy to monetary policy, Trump's fiscal stimulus might be the special ingredient needed. In the U.S. and abroad, monetary policy appears less and less effective. By injecting fiscal stimulus, the Fed will essentially have more "cover" to raise rates and normalize policy, thereby increasing preparedness for the next recession when it will need to cut rates again. This probably won't occur in 2017, but if the economy can withstand higher rates the Fed may decide against reinvesting any bonds on its balance sheet and instead let them roll off. Fiscal stimulus and pro-growth policies from the President could take pressure off of the Fed, however; the Fed seems skeptical about the impact these policies may have on the economy.

European elections will lead the headlines overseas in 2017. The Netherlands, France and Germany, which combined make up three of the six founding members of the European Union and about 56 percent of the euro zone economy, head to the polls this year. The citizens of these three countries are doing relatively well from an economic standpoint, but immigration has become the central focus of the campaigns. Terrorist flare-ups across the continent, combined with the refugees flooding in from the east and Mediterranean Sea, have fomented a level of anti-immigration sentiment not seen since the dissolution of the Soviet Union. In turn, nationalistic parties in every country are gaining more ground. Though establishment parties are currently expected to retain power during the 2017 elections, last year should be enough evidence to prove that nothing is certain when people go to the voting booth. In addition to these elections, the progress and terms of the U.K.'s exit from the European Union will be closely watched. Greece will need further support from the European Stability Mechanism and European Financial Stability Facility; it is expected that Greece will get the support it needs but there remains animosity between the two sides. There are a number of geo-political issues that could reverberate throughout Europe. Relations between the U.S., Russia, the European Union and Turkey could all surface as potential risks to markets. The ECB's decision to taper bond purchases in April will only add to the fragility of Europe's economy.

Conditions in Japan are ripe for an economic revival following the rapid depreciation of the yen after Trump's election. The question is whether corporations in Japan will take advantage of low rates, a weak yen and the rising price of their shares. Japan saw these same conditions in 2013 but the effort to jumpstart growth and target inflation in the country was not successful. This is because Japanese companies shied away from domestic investment projects and wage increases for their employees.

A Trump presidency is expected to elevate tensions with China. On the campaign trail, the President-elect was vocal in naming China a currency manipulator. This has been a popular declaration on campaign trails for almost two decades, but what most observers fail to mention is that most countries, including the United States, have manipulated their currencies. One of the big benefits of quantitative easing was to weaken the U.S. dollar and make U.S. exports cheaper. As the Chinese yuan has strengthened because of its high correlation to the dollar, Chinese goods have become more expensive in many parts of the world, which has hurt the Chinese economy. It would not be surprising to see the Chinese government significantly de-value the yuan to help the Chinese economy—something that would almost certainly compel a Trump response. The President-elect is also threatening to put a tariff on goods coming into the U.S., which would ultimately make Chinese goods more expensive in the U.S. and hurt the export-driven Chinese economy. This could spark a trade war, which might be difficult for the U.S. to win because of the Chinese government's willingness and ability to subsidize the economic sectors most important to China's economy. In addition to the economic issues mentioned, there is also concern over how the Trump administration will handle China's military actions in the South China Sea. Expect an interesting year of U.S.-Chinese relations.

With equity markets moving higher and sentiment on the rise, it is natural to want to chase returns and take on more risk. For most investors it is important to keep the allocation that is best suited for your goals and objectives. Additionally, with interest rates on the rise, investors may be tempted to shed fixed income exposure, but it is important to remember fixed income tends to be a good diversifier to equities, and that the expected drawdown is much lower than with equity investments. There are ways to reduce interest rate risk in fixed income investments, including the shortening of duration, owning lower quality fixed income or investing in fixed income outside of U.S. borders. With this said, it is important to continue to understand the risks—some of these strategies will reduce interest rate risk but increase correlation to equities. If anything in your financial situation has changed, please let us know so that we can determine whether a change in your portfolio is necessary.

— Robert Moyer, CFA, CFP®, CAIA
Director of Research

1640 Huguenot Place
Midlothian, Virginia 23113
Phone: 804.323.1886
Fax: 804.323.1889
www.acgworldwide.com