JOLLEY ASSET MANAGEMENT, LLC

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"In the event Donald wins, I have no doubt in my mind the market tanks, if the polls look like there's a decent chance that Donald could win, I'll put a huge hedge on that's over 100% of my equity positions... that protects me just in case he wins."

Mark Cuban

On the eve of the election we were told by the mainstream media that a Hillary Clinton victory would be good for the financial markets and a Donald Trump victory would be disastrous. For the past seven years investors were brainwashed by the media that any move by the Fed to normalize interest rates would result in a swoon in equity prices. After all, we all know that the Federal Reserve saved the world back in 2008, surely they have the perfect elixir needed by the markets at any point in time. (Never mind the fact that their own policies are what created the problems in the first place.) Please accept my apologies for the sarcasm, but this should settle once and for all that nobody has a crystal ball into short-term market fluctuations and nobody can successfully time the financial markets on a consistent basis. As it turned out, to the surprise of all, the domestic equity markets loved the prospects of a Donald Trump presidency coupled with the prospect for interest rate increases. Led by the strong moves in the financial sector post-election, the equity markets closed out 2016 on a strong note. The S&P 500 advanced 3.82% in the fourth quarter and 11.96% for the year (total return). The year-end close for the S&P 500 index was approximately 22% higher than the lows it visited early in the year when it was down approximately 11%. This was the second consecutive year that U. S. stocks outperformed all the major asset classes including gold (+8%), investment grade bonds (+6%) and long term treasury bonds (+1%).

Index	4th Quarter 2016	2016 12 mos.
DJIA	8.66%	16.50%
S&P 500	3.82%	11.96%
S&P Mid Cap	7.42%	20.74%
Russell 1000/Growth	1.01%	7.08%
Russell 1000/Value	6.68%	17.34%
Russell 2000	8.83%	21.31%
NASDAQ Comp.	1.34%	7.50%

The chart above also shows a few other important trends. Small and mid-cap stocks handily beat large caps and are expected to benefit from many of Trump's proposed policies. In addition, small cap stocks are generally more domestically oriented and less impacted by the strength of the U. S. dollar. As we predicted on numerous occasions it also appears that the "baton" has finally been passed from "growth" to "value" after many years of under-performance. For the year ended 12/31/16 the Russell 1000 Value Index outperformed the Russell 1000 Growth Index by over 10 percentage points. According to Bank of America/Merrill Lynch, this represents the widest spread since 2006. We would point out that while Trump policies are expected to benefit value strategies (more cyclical areas of the market) the Russell 1000 Value Index was 400 basis points ahead of the Russell 1000 Growth index at the end of the third quarter. So essentially the markets were favoring "value" over "growth" well before the election results were known.

After being the hardest hit sector in 2015, energy was the standout in 2016. A late 2016 OPEC agreement also helped drive the sector in the fourth quarter. Financials which we have liked (based solely on valuation) for quite some time, finally paid off as investors loved the idea of rising interest rates (higher net interest margins) coupled with a less onerous regulatory backdrop. It should be pointed out that the Fed did raise interest rates on December 14, 2016 for only the second time since 2008 and predicted three further rate increases for 2017. Materials and industrials also did well as both are likely beneficiaries of higher infrastructure spending. Ironically energy, industrials, financials and materials were all negative in 2015. The valuations in each of those sectors were compelling, which largely explains why "value" trounced the S&P 500 index and "growth" for the year. As Warren Buffett once stated, "Price is what you pay. Value is what you get." The laggards in 2016 were largely the slow growth areas (bond proxy) that investors had piled into seeking above average dividend yields. In our *Investment Outlook—Summer 2016*, we warned that investors (and algorithms) were overpaying for both utilities and consumer staples in an attempt to capture much needed income. The weakness in the healthcare sector was largely a result of the fears over pricing anticipating a Clinton presidency. While many thought a Trump administration might be positive for the sector, that all ended when in a *Time Magazine* article, President Elect Trump stated, "I'm going to bring down drug prices."

S&P 500 Sectors	Qtr	Year
Energy	6.6%	23.6%
Materials	4.1%	14.1%
Industrials	6.6%	16.1%
Consumer Discretionary	1.9%	4.3%
Consumer Staples	-2.7%	2.6%
Health Care	-4.4%	-4.4%
Financials	20.5%	20.1%
Real Estate	-5.3%	n/a
Information Technology	.8%	12.0%
Telecom Services	3.5%	17.8%
Utilities	-0.8%	12.2%

The Year Ahead

The one thing we do know about 2017 is that there will be many changes and uncertainty. Exactly what Trump and a republican-controlled Congress will be able to do remains to be seen. Since the election, Trump has called for increased infrastructure spending, lower taxes, dismantling the Affordable Care Act and less government regulation. Even

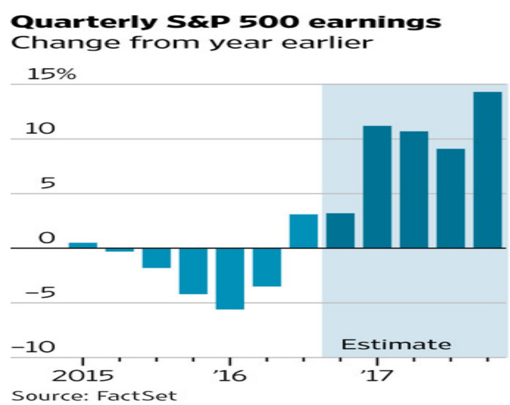
Trump fans must admit that this president-elect is unpredictable and could roil the markets with a single comment or "tweet." Trump believes that his unusual style and methods of communication got him elected and he seems unwilling to change his style or antics now. So one thing we are likely to see is more volatility—and that means the markets can go down as well as up. As you can see from the *Time Magazine* covers from the last few months, nobody quite knows what to think of President-Elect Trump.

We believe the following themes are worth paying attention to in the coming year.

- **Tax reform—**Taxes will likely be cut for both individuals and corporations. While the details will need to be worked out and compromise may be likely this is what we know. Trump would like to cut the maximum tax rate for individuals from 39.6% to 33% and the other two rates would be at 12% and 25%. It is unclear if any change in tax rates would be retroactive to January 1. It is also expected that corporate tax rates will likely be cut from the current 35%. The U. S. marginal tax rate is nearly 39% when including state/local taxes, ranking it highest among all global industrial countries. The median rate for the other 34 OECD countries is less than 25%. When deductions offered in the U. S tax code are considered the actual effective tax rate is estimated at closer to 25%. Trump has called for a 15% rate and 10% for foreign earnings. Any reduction in the corporate tax rate to the 15-20 rate should benefit after tax corporate earnings. There will also likely be some type of repatriation relief where companies can bring back part of the $2.5 trillion held abroad. Obviously, the devil will be in the details, but what will corporations do with all the cash? Will they increase dividends, buybacks, increase hiring, or increase capital spending?
- **Rates will Rise—**It appears that the 35 year old bull market in bonds is officially over. The unemployment rate is 4.6%, and jobless claims have remained under 300,000 for 95 weeks. Consumer confidence is also strong. Furthermore, the infrastructure spending proposed by Trump will likely drive the federal deficit higher and possibly stoke inflation.
- **Infrastructure Spending—**U. S. infrastructure is significantly aged and in need of repair. The Trump administration favors public/private partnerships as opposed to federally funded spending. This will likely take some time before largely impacting the economy and could be more of a 2018 story.
- **Regulatory Reform**—Fewer regulations means lower compliance costs for companies. Possible changes to Dodd-Frank and a potential rollback of the Department of Labor's fiduciary rule could be a positive for the financial services industry. One could easily make the case that regulation has become excessive over the past eight years.

Earnings/Valuations

The third quarter of 2016 was an inflection point with regards to corporate earnings. Earnings at S&P 500 companies rose by 3.1% in the third quarter of 2016, which marked the first year over year rise since the first quarter of 2015. Earnings are expected to rise by 3.2% for the fourth quarter of 2016 and by 12% for 2017. FactSet is projecting first quarter earnings growth of 11%, second quarter of 11%, third quarter of 9.1% and 14% in the fourth quarter (see chart below).



The acceleration in earnings growth is expected to ease valuation concerns. On forward 12 month earnings the S&P is currently trading at approximately 17x, only slightly higher than the twenty year median.

Summary

Earnings appear to have bottomed in the first quarter of 2016 and an acceleration in growth seems likely in 2017. While the bull market is currently the second longest on record, valuations appear reasonable. After taking a backseat to growth for the past several years, value investing seems ready to lead as economic growth accelerates. The thirty-five year old bull market in bonds seems over, and we are currently emphasizing high quality, short duration securities, floating rate securities and treasury inflation protected securities. Protecting capital in fixed income is of utmost concern in client portfolios. Despite the belief that equities are likely to outperform bonds, we believe most clients should maintain a balance between stocks and bonds to protect capital in the event of a market decline. We continue to believe that our conservative value strategy will serve our clients well over the coming year. Thanks again for the confidence you have placed in Jolley Asset Management.

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