

Global unease and promising domestic outlook in 2017

As we welcome 2017, we look back on market activity and what it tells us about the year gone by and the year ahead. Significant political events resonated in the capital markets in 2016, most notably the United Kingdom's vote in June to leave the European Union, a move that parked a two-day downturn in the equity market as investors pondered the decision's effect on the European and global economies. Calm was quickly restored, however, and the equity market rallied just seven days later.

After a slow start, U.S. equity markets enjoyed a prolonged rally for most of 2016, surging after the U.S. presidential election, with major U.S. indices hitting record highs in late November. Subsequently, momentum investors poured into financials, industrials, energy, material and telecom, leaving behind the select sectors of technology and healthcare – thus setting up a potential counter-trend rally.

The U.S. Federal Reserve's plan to increase interest rates up to four times in 2016 was thwarted by timely events, such as the equity market downturn that began the year, the Brexit vote over the summer and the U.S. presidential election in the fall. In December, the Fed raised its target range for the federal funds rate 0.25%. The rate hike and prolonged interest rate rally following the election created headwinds for the bond market, pushing investment-grade yields up and driving prices down. Meanwhile, the dollar remained generally firm against major international currencies, according to Chris Bailey, European strategist, Raymond James, Euro Equities*.

*An affiliate of Raymond James & Associates and Raymond James Financial Services.

	12/30/16 Close	12/31/15 Close	Change	Gain/Loss
DJIA	19,762.60	17,425.03	+2,337.57	+13.42%
NASDAQ	5,383.12	5,007.41	+375.71	+7.50%
S&P 500	2,238.83	2,043.94	+194.89	+9.54%
MSCI EAFE	1,684.00	1,716.28	-32.28	-1.88%
Russell 2000	1,357.13	1,135.89	+221.24	+19.48%

Performance reflects price returns as of market close on Dec. 30, 2016.

Below are additional thoughts on various factors that are influencing the domestic and global markets. Please let me know if you have any questions about how these factors may impact your overall financial plan or ability to reach your long-term goals.

Economy

- “While there are a number of uncertainties in the economic outlook, the largest risk is in global trade,” said Raymond James Chief Economist Scott Brown. “A trade war would boost inflation through higher import costs and disrupt supply chains in U.S. manufacturing. Cooler heads should prevail, but a trade war would undermine economic growth at a time when global trade is already slowing.”
- The U.S. unemployment rate fell to 4.6% from 4.9% in October and 5.0% a year ago. Though the report is promising, we’re not seeing the kind of improvement in participation that one would expect in a tight job market (except for the key cohort: those aged 25 to 54).
- “The job market should continue to tighten in the near term, putting some upward pressure on wages,” Brown said. “Although, consumer price inflation is likely to be moderate. The Federal Reserve should continue to gradually normalize short-term interest rates. Increased government borrowing should lift long-term interest rates.”
- Manufacturing activity still appears to be in a slow patch – neither growing nor shrinking – with lower-than-expected, but above-normal industrial production.
- “The pre-election outlook held that slowing population growth – resulting in slower labor input and economic growth – was the ‘new normal,’” Brown said. “Post-election sentiment suggests that we are going to get some fiscal stimulus, but that likely will be ineffective in boosting growth on a long-term basis due to demographic constraints.”
- Figures are noisy when it comes to housing starts, but the numbers continue to suggest a moderately positive trend in single-family homebuilding.

Equities

- We believe the equity markets are transitioning from an interest rate-driven secular bull market to an earnings-driven secular bull market, which should become increasingly evident in 2017, according to Jeff Saut, Raymond James Chief Investment Strategist, Equity Research. Any weakness should be viewed with a long-term perspective and seen as a potential buying opportunity, depending on your personal goals and objectives.
- As evidence of the earnings-driven bull market, the benchmark S&P 500 reported earnings growth in the fourth quarter, the first time since the fourth quarter of 2014 and first quarter of 2015 that the index has reported two consecutive quarters of growth.
- With the S&P 500 at above-average valuations, according to some metrics, earnings growth will likely have to resume higher in order to justify appreciably higher prices for this market over the next 12 to 18 months. For now, it appears

that economic activity and earnings should pick up in 2017. If this comes to fruition, the current bull market could continue into 2017.

Monetary Policy

- As expected, the Federal Open Market Committee (FOMC) raised the federal funds target range by 25 basis points, to 0.50-0.75%, while the Fed's Board of Governors approved a similar increase in the discount rate to 1.25% from 1.00%.
- Seasonal adjustment boosted the price of gasoline, food prices remained split and shelter costs continued to outpace the overall Consumer Price Index.
- While nominal hourly earnings have been trending moderately higher – reflecting a tighter job market – growth in inflation-adjusted earnings slowed over the past year.
- The Fed's Federal Open Market Committee (FOMC) raised the federal funds target range by 25 basis points, and the Real GDP growth estimate for the third quarter was revised upward to 3.5% from the previous estimate of 3.2% in November, while consumer spending led the way with 3% growth, up from the previous estimate of 2.7%.

Global

- Concerns continue to circulate over a surprise devaluation by China, which could threaten emerging market stability and commodity demand levels. While the nation's ongoing credit and debt bubble poses a potential risk to the outlook, we foresee no near-term catalyst for a crisis, according to Paul Berg, CFA, Cougar Global Investments*.
- A major demographic transition is occurring among China's working-age population, which shrank in 2016 – a legacy of the One Child Policy – and the yuan has fallen to its lowest level against the dollar in more than a decade.
- Exchange rates remained uppermost in the minds of international investors outside the United States as the dollar remained generally firm against major international currencies
- European currencies remain weak against the dollar, but the focus across the region going into 2017 likely will be centered on political developments such as Brexit discussions and upcoming elections in a number of countries, including France and the Netherlands.
- Italian banks remain stressed, and the second half of December saw moves by the nation's government to offer formal support. The European Central Bank also confirmed a \$579 billion stimulus in the eurozone.
- Generally, international markets trade at a discount to those in the United States. This reflects a greater level of event uncertainty but also means that returns have the potential to be higher if realities turn out to be less problematic than expected.

Fixed income

- The 2017 bond market stands to be much more unpredictable and altering relative to the stationary interest-rate environment of recent years.
- “Near-term, risk markets have more room to run with economic and fiscal policy optimism,” said James Camp, CFA, Managing Director of Fixed Income, Eagle Asset Management*. “Through Q1 of 2017, the market is going to do well. The curve is steep. There’s a term premium. Let’s not forget that we opened 2016 with a big downdraft. This is a retracement from Brexit low yields and not particularly concerning.”
- We are entering the year with a significant yield disparity among top economic powers that will continue to have mitigating influence on U.S. interest rates until these global rates close the gap.
- “Municipal bonds are unbelievably attractive right now,” said Benjamin Streed, Raymond James CFA, Strategist, Fixed Income. “They’re trading above Treasuries in terms of yield across the curve, so for investors that pay high marginal tax rates, munis look fantastic.”
- There are numerous headwinds tempering interest rate swings: global market influences such as interest-rate disparity, central bank immersion, demographics, U.S. dollar strength and corporate earnings.
- “Asset allocation is important and, from a strategic standpoint, we are staying the course,” said Doug Drabik, Raymond James Senior Strategist, Fixed Income. “Rising interest rates and the widening of municipal market spreads further emphasize decent opportunities for fixed income.”

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Bottom line

- U.S. equity experienced a downturn in the beginning of 2016, but enjoyed a prolonged rally as well as a surge following the U.S presidential election.
- As the dollar holds firm against major international currencies, China and Europe are bracing for major political and economic decisions in 2017, which could impact market stability and commodity demand levels.
- Though each of the major U.S. indices hit record highs following a post-election rally in November, it is well-advised to keep a long-term perspective when it comes to diversification and your financial goals.
- We will continue to monitor political developments or economic shifts both domestically and abroad, carefully assessing how they may affect your financial plan.
- When reviewing market activity and investment performance, it is important to have a long-term perspective and keep in mind your personal asset allocation and the role a well-diversified portfolio plays in helping you reach your objectives.

As we head into the new year, please let me know if you have any questions about market events or how to position your long-term financial plan for the year ahead. I look forward to speaking with you.

Sincerely,

A handwritten signature in black ink, appearing to read "Larry Cavalea". The signature is fluid and cursive, with a large initial "L" and "C".

Larry Cavalea
Registered Principal

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