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2016 Roller Coaster

Equities Exceed Long-Term Averages

Domestic equity returns reversed 2015 patterns by struggling early and then rebounding strongly later in the year. The S&P 500 dropped 11% during the first quarter, only to end up 12% for the year. That exceeded the long term average of 10% and was an intra-year recovery of 23% - a reason to maintain a long-term investment focus.

Fixed income did its 'risk management' job by cushioning portfolios during the volatile equity periods. Quality bonds went on to produce low single digit returns in the 0-3% range, depending upon the applicable bond index.

Once again, tax efficiency was a benefit of the increased volatility in 2016. Market declines increased our use of tax swaps to lock in losses thus reducing tax liabilities.

Equity Style: Value "Trumps" Growth
The S&P 500 returned 11.96%, but if you separate value and growth styles, the value index returned 17.4% while the growth index returned just 6.9%. See page 2.

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2017 Market Themes

Make Investing Great Again !?

1. Policy changes - Pricing in Expectations
   - market expects reduced financial regulations
   - market expects reduced corporate taxes
   - market expects reduced personal income tax rates
   - market expects easier cash repatriation policy
   - market expects 2-3 interest rate hikes by FOMC
2. Tired Equity Market
   - volatility remains until policy clarity evolves
   - bull market up 231% since low on March 9, 2009
   - duration just hit 94 months, 2nd longest since 1950
   - forward market P/E is now 16.9 above 15.9 average
   - trade policy clarity needed on 'free vs. fair' rhetoric
3. U.S. Economic Growth
   - Goldilocks economy — not too hot, not too cold
   - strong dollar continues to hurt U.S. exports
   - wage and employment growth continues
   - inflation is expected later in the year
   - 91st month of expansion, 4th longest since 1900
4. Oil Stabilizes - After 2015 Decline & 2016 Recovery
   - OPEC is tested with supply agreements
   - shale drilling allows quicker oil supply adjustments
5. Global Environment - More Elections
   - anti-establishment vote threatens European elections
   - elections in France & Germany in spring and fall
   - populist sentiment a threat to Eurozone
   - pressure on European Union as UK's exit evolves
   - elevated uncertainty in China and Russia
6. Focus shift to Fiscal Policy from Monetary Policy
   - global quantitative easing policies are reduced
7. Reflation - Intentional Acceleration of Economy
   - typical result of lower taxes & infrastructure spend
8. U.S. Deficit & National Debt
   - expect pushback against lower taxes & spending

S&P 500 ANNUAL RETURNS LAST 25 YEARS

Year Ending	Total Return Change
2016	12.0%
2015	1.4%
2014	13.7%
2013	32.4%
2012	16.0%
2011	2.1%
2010	15.1%
2009	26.5%
2008	-37.0%
2007	5.5%
2006	15.8%
2005	4.9%
2004	10.9%
2003	28.7%
2002	-22.1%
2001	-11.9%
2000	-9.1%
1999	21.0%
1998	28.6%
1997	33.4%
1996	23.0%
1995	37.6%
1994	1.3%
1993	10.1%
1992	7.6%
Avg. Annualized	**9.2%**

Table Source: S&P Dow Jones Indices

2016 Benchmark Index Performance

Asset Class	2016	As Measured By
Fixed Income		
Investment Grade Short	1.3%	Barclays U.S. Gov/Credit 1-3 Year
Investment Grade Muni	-0.5%	Barclays Muni Bond 7 Year
Investment Grade Taxable	2.7%	Barclays U.S. Aggregate Bond
High Yield Bond	17.1%	Barclays U.S. Corp High Yield
Global Bond	1.5%	Barclays Global Bond
Equity		
Large Capitalization	12.0%	S&P 500
Large Capitalization **Growth**	6.9%	S&P 500 / Citigroup **Growth**
Large Capitalization **Value**	17.4%	S&P 500 / Citigroup **Value**
Small & Mid Cap (SMID)	17.6%	Russell 2500
Small Capitalization **Growth**	11.3%	Russell 2000 **Growth**
Small Capitalization **Value**	31.7%	Russell 2000 **Value**
International Developed	1.5%	MSCI EAFE
International Emerging	11.2%	MSCI Emerging Markets
Gold	8.6%	S&P GSCI Gold Spot Price

Data Source: Tamarac and providers to Tamarac

2016 Performance Commentary

Significant market divergence continued in 2016 as evidenced in chart above. Performance ranged from slightly negative for municipal bonds to over 30% for domestic small capitalization equities.

Within fixed income, the riskiest asset class, high yield, had the highest return of just over 17%. This was a welcome recovery after its late 2015 collapse that was led by the energy sector.

The weakest performing equity asset class was developed international returning just 1.5%. Brexit, anemic European economic growth, and the strong U.S. dollar all put pressure on this asset class.

The real performance story was that of value style equities exceeding growth style. In domestic large-caps, value surpassed growth by 10.5%. There was an even larger divergence in small-caps with value exceeding growth by 20.4%. For mid-caps, the difference was 11.8% in favor of value.

As the table to the left indicates, with all the volatility, the S&P 500 has still exceeded 9% over the last 25 years.

Investment Style

Growth & Value

We include growth, core (blend) and value securities in our portfolios. As a general rule, growth stocks have the higher price/earnings ratio (P/E), higher value to free cash flow (FCF), lower dividend yield, and lower debt to FCF levels. Value style includes companies with lower P/E ratios, lower values to FCF, higher dividend yields, and higher debt to FCF levels.

In addition, growth stocks tend to have earnings expectations higher than average with new products/services. Value stocks have lower earnings and are sometimes going through a management transition, legal issue, or have some temporary dark cloud over them.

Our strategy is called Growth At A Reasonable Price or more commonly known as GARP. This blends aspects of both growth and value into a portfolio by looking at equities that we believe will deliver above average growth but are not too expensive.

Equity Sector Commentary

Rising interest rates reduce the relative attraction of higher yielding defensive sectors. This adds caution to our outlook on telecoms, consumer staples, utilities and REITs.

An expanding economy and a reduced regulatory environment, in addition to improved net interest margins, support our positive outlook on financials & energy sectors. These are currently value style sectors.

The majority of technology stocks' revenue is from outside the U.S. Corporate tax reform for repatriation of cash overseas can support domestic operations and stock buybacks. Fears of trade wars are a concern but may be a bit overblown. Our outlook is positive on technology stocks which include both value and growth styles.

Summary of Tactical Views

Asset Class	Current Tactical View
Cash	Increased. Money market yields are nearly zero so this is more of a shorter term defensive position. If rates continue to rise, albeit gradually, cash can be moved to fixed income to pick up yield.
Fixed Income **Investment Grade** **High Yield**	Reduced & Defensive. We are currently positioned defensively within fixed income in three ways. We have a lower overall fixed income allocation than the longer term strategic targets; we use lower duration targets (higher than last year but lower than long-term targets) to reduce sensitivity to changing interest rates; and we have a reduced allocation toward direct high yield (higher risk) exposure.
Equity **Large-Cap** **Small & Mid-Cap**	Increased. We increased domestic large-cap exposure and reduced small and mid-cap exposure compared to long-term targets. The net effect is an increased allocation to equities. We've reduced REIT exposure as the yield won't be as attractive to other yields if rates rise. We continue to favor U.S. stocks.

Tactical views are focused on the shorter term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer term market cycles up to 10 years.

Summary

Selected Tax Proposals (House and Trump plans)

Top Individual Tax Rate:	May change from 39.6% to 33%
Top Capital Gains Rate:	May change from 23.8% to 16.5% or 20%
Top Dividend Rate:	May change from 23.8% to 16.5% or 20%
Corporate Tax Rate:	May change from 35% to 20% or 15%

Some key 2017 market dynamics that we are positioning portfolios for:

1. Corporate earnings and changing policy will drive stock valuations.
2. Stocks are a bit more expensive as the S&P 500 forward P/E multiple increased to 16.9 as compared to a 25 year historical average of 15.9.
3. Lower personal tax rates may increase the value of corporate bonds as compared to municipals.
4. Fiscal policy, de-regulation, and inflation will be themes throughout the year.

How do you position for this list of inter-connected and ever evolving factors? We stay disciplined and dynamic at the same time. We've increased the number of holdings and reduced the position size in many portfolios. We've maintained diversification and used 'pooled investment vehicles' (also know as mutual funds and exchange traded funds—ETFs) to complement individual securities. We use a blend of both municipals and corporate bonds to participate in more fixed income markets.

It goes without saying that the FOMC meetings and potential Fed interest rate hikes will have an impact on both the bond and equity markets. Having said that, FOMC communications have been very clear and moves have been very gradual up until this point. The market has liked this path and is pricing in 2-3 rate hikes this year.

Slow, modest, balanced, cautiously optimistic, reasonable are all applicable descriptions of our outlook.

Sincerely,

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Sources include: JP Morgan Global Asset Allocation, *The J.P. Morgan View*, January 13, 2017. Brad Sorensen, *Schwab Sector Views: Sectors and Politics*, January 12, 2017. Goldman Sachs Economics Research, *U.S. Economics Analyst: The 2017 Political and Policy Outlook*, January 9, 2017. MFS, *By The Numbers*, January 9, 2017. Jeffrey Kleintop, *The CURE for a calm market: Four risks for 2017*, January 9, 2017. JP Morgan, *The investment outlook for 2017*, December 31, 2016. JP Morgan Market Insights, *Guide to the Market*, December 31, 2016. Goldman Sachs Portfolio Strategy Research, *US Sector Views*, December 27, 2016. Goldman Sachs Asset Management, *2017 Investment Outlook: The Long Cycle Continues*, December 15, 2016. Data source providers include Thomson Reuters, Tamarac and providers to.

All portfolios have the same core discipline but may be impacted by the views above to different degrees. Some use individual stocks, individual bonds, mutual funds, exchange traded funds, or are a combination of all of these security types. We customize each portfolio by considering other holdings, liquidity needs, different tax brackets, risk tolerance, financial goals, etc. The views expressed in this newsletter accurately reflect CMH Wealth Management's opinions about the investments and/or economic subjects discussed. This publication is designed to provide general information about economics, asset classes and strategies. It is for discussion purposes only since the availability and effectiveness of any strategy is dependent upon individual facts and circumstances. The information contained herein has been obtained from sources believed to be reliable, but we cannot guarantee its accuracy or completeness. Opinions and estimates expressed herein are as of the date of the report or the date referenced and are subject to change at any time.