CIO REPORTS

The Weekly Letter

DECEMBER 13, 2016

GWIM Chief Investment Office

→ **Who would've thought?** Cubs win! Cubs win! In a year seemingly dominated by the improbable, we find it fitting to highlight some key events that unfolded in a manner unexpected by most. They'll have a lasting impact on the financial markets as we step into 2017, which promises to be another year of episodic volatility and is likely to produce its own unexpected surprises. It can be difficult to position portfolios for such events, both on the upside and downside.

→ **Markets in Review:** Last week equities rose, with the S&P 500 appreciating 3.1% and international equities, as represented by the MSCI EAFE Index, rising 2.9%. Bonds were mixed on the week, with the 10-year Treasury yield at 2.47%, up from 2.38% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 1.3%, while WTI crude fell 0.3% to $51.50 per barrel. Gold also declined, falling 1.5% from the prior week to $1,160.01 per ounce.

→ **Looking Ahead:** In the U.S., indicators of interest this week gauge the strength of the consumer and the state of inflation. In Europe, Markit's Purchasing Managers Index, a comprehensive gauge of economic activity, is published.

Recent Publications

Weekly Letter
A Recovery for Health Care
Regime Change
Washington flips
Outlook still balanced

Monthly Letter
An Evolving Cycle

CIO Outlook
The Forces Shaping Our World

Who would've thought?

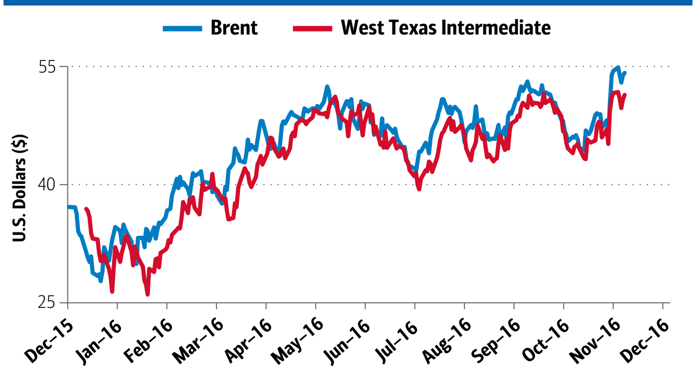
Cubs win! Cubs win! In a year seemingly dominated by the improbable, we find it fitting to highlight some key events that unfolded in a manner unexpected by most. The developments will have a lasting impact on the financial markets as we step into 2017, which promises to be another year of episodic volatility.

Political Upheaval in Europe…

On June 23rd, voters in the United Kingdom took to the polls, and with a 52% majority voted to leave the European Union. The "Brexit" vote was unexpected by commentators and investors alike; bookmakers had put the odds of remaining in the EU at 3–1 on the day of the referendum while aggregate polls gave a "Bremain" vote a 48%-46% edge. The U.K. leadership now expects to invoke Article 50 of the Treaty on European Union in the first quarter of 2017, which will set in motion a two-year period of negotiations for withdrawal.

From an economic perspective, the implications of a Brexit were expected to be quite harsh. Initially such projections proved prescient as main equity indexes fell nearly 10%, the pound sterling plunged more than 10% against the dollar and the Bank of England cut its 18-month projection of gross domestic product by 0.8%, expecting ongoing uncertainty.

Exhibit 1: Oil prices oscillated dramatically in 2016



Source: Bloomberg.
Past performance is no guarantee of future results.

However, in the weeks following the referendum, uncertainty levels normalized as the Bank of England's aggressive actions steadied sentiment and put a floor under the economy.

…and in the U.S.

Across the Atlantic, on November 8th Americans elected a new president. On the eve of the election, pollsters calculated a 71% likelihood of Hillary Clinton winning the White House and a 51% chance of Democrats taking control of the Senate. With a sizable Republican majority in the House, a split government appeared likely. However, the results diverged from projections; Donald Trump won with 306 electoral votes and Republicans retained control of the Senate with 51 seats.

The immediate market reaction was sharply negative, with S&P 500 futures plunging more than 5% in overnight trading and the 10-year Treasury yield dipping to 1.71% before both swiftly reversed and gained during the day. Since then the S&P 500 has gained more than 5% and the 10-year yield touched 2.5% on December 12. Currency movements have also been pronounced, with the U.S. dollar broadly advancing.

Oil's Rollercoaster

Crude oil entered 2016 in the midst of a multi-month swoon in which the prices of West Texas Intermediate and Brent fell to their 2016 lows in the mid-20s in late-January, down 75% from their highs in 2014. What followed has been an extraordinary oscillation as bears and bulls have fought for market control. In fact, there have been nine price declines and 12 price increases of 10% or more this year. As we approach the finish line of 2016, bulls appear to hold the upper hand, with prices trading north of $50 per barrel, higher by about 44% for the year.

The drivers of oil pricing have been both fundamental and technical. A U.S. shale glut and ballooning inventories in the Middle East, as well as the strengthening of the U.S. dollar, contributed to the initial weakness. December 2015, however, brought the first year-over-year decline in U.S. production since September 2011 and OPEC has recently coordinated supply cuts to regulate prices. BofA Merrill Lynch Global Research maintains a $59 average price target for WTI for 2017. Stabilizing oil prices could help stem the deterioration of earnings within the energy sector.

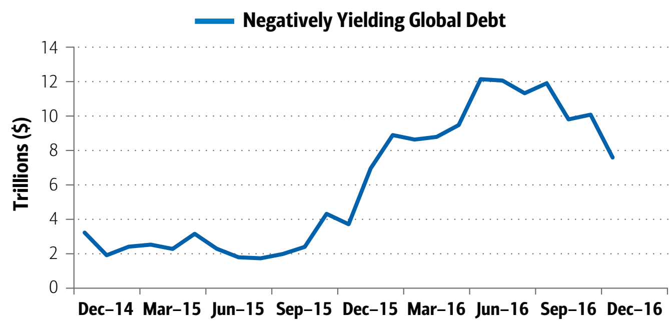
A World Awash in Negative Yields

As central bankers grappled with stimulating their economies post-crisis, a novel approach emerged to circumvent the theoretical "zero-bound" of interest rates—negative interest rate policies (NIRPs). Some analysts have noted the corresponding negative yields are the first in over 5,000 years.

After previously occurring in a more isolated fashion, 2016 has ushered "NIRP" to the forefront of banking vernacular, with the volume of global debt offering negative yields estimated to have peaked in July at $13.3 trillion. In fact, negative yields spanned sovereign issuers, including those within the Eurozone and Japan, and began to penetrate the corporate debt markets, putting 27% of all Eurozone corporate bonds at sub-zero yields in September. The value of negatively yielding debt has since declined, falling to $7.2 trillion as of December 12.

The efficacy and effect of negative yields continue to be analyzed and appear to be mixed; while a modest expansion of credit has been observed in some markets, it has been accompanied by a decline in the banking system's health and profits. Negative yields have also discouraged bank savings and prompted investors to put money in riskier assets. Having made the cost of capital a moot point for investment decisions, ultra-low or negative rates could act as a perverse incentive to firms and governments to undertake projects of questionable value.

Exhibit 2: Value of negative-yielding debt peaked in July



Source: Bloomberg.
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Resurrection of Corporate Earnings Growth

After enjoying an expansion of profits since emerging from the financial crisis, U.S. companies entered a profit recession in 2015. In fact, the duration of the most recent earnings recession began to rival that of the Great Recession, which lasted seven quarters, a span not seen in nearly 80 years. The weakness in profits continued into the current year, but recent results have upended the trend and the U.S. is now poised to deliver solid yearly earnings growth, which could reach the high single-digits in 2017. Many of the headwinds to profits in 2015, such as an exceptionally strong dollar, falling energy and commodity prices and a global slowdown in manufacturing, have dissipated.

Growth in corporate profits is encouraging for equities given their dominant impact on valuations. While equity prices have continued to grind higher in the face of lower or negative earnings growth, much of this wealth creation was built upon the expansion of valuation multiples rather than improved earnings. In fact, some analysts have feared a loss of corporate profitability was signaling the final innings of a remarkably long and resilient economic expansion. The most recent growth in earnings signals that the winds of cyclical growth may remain at the backs of investors.

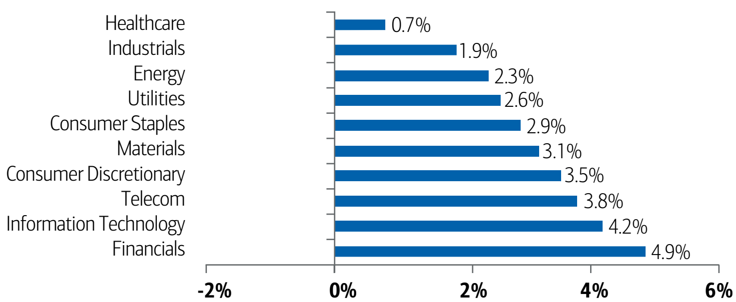
Portfolio Considerations: The current investment environment will bring more unexpected, out-of-the-box, head-scratching surprises. It can be difficult to position portfolios for such events, both on the upside and downside. When they happen, investors should avoid the temptation to make big changes in a knee-jerk fashion. Taking a step back to observe the short-term market reaction can provide valuable insights into positioning and technical dominated moves versus changes in the fundamental outlook. For medium-to-long-term investors, fundamentals such as economic and earnings growth as well as asset valuations matter more. These are still favorable, in our view. Above all, maintaining a disciplined investment process with a goals-based portfolio and regular rebalancing remains a prudent strategy in such uncertain times.

Markets in Review

Trailing Economic Releases

- The U.S. Census Bureau reported that factory orders grew 2.7% on a month-over-month (MoM) basis in October, slightly better than the consensus estimate of 2.6%. This was quicker than the prior month's upwardly revised reading of 0.6%. On a year-over-year (YoY) basis the growth has been recovering since the third quarter of last year on stabilizing energy prices.
- The U.S. Bureau of Labor Statistics indicated that there were 5.53 million new job openings in October, better than the consensus estimate of 5.50 million. Generally demand has remained steady at these levels, which suggests further job creation over the coming months.
- China's Customs Administration reported positive YoY growth of exports for the first time since March. November's 0.1% rise was better than the BofAML Global Research estimate of a 2.0% decline. Meanwhile, imports rose 6.7%, also besting the estimate of -1.0%. The buoyant results, versus expectations, suggest domestic demand picked up, helping support a synchronized gain in global growth.

S&P 500 Sector Returns (as of last Friday's market close)



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	19,756.9	3.1	3.4	16.4
NASDAQ	5,444.5	3.6	2.3	10.0
S&P 500	2,259.5	3.1	2.8	12.9
S&P 400 Mid Cap	1,693.0	4.2	4.1	22.9
Russell 2000	1,388.1	5.6	5.0	23.9
MSCI World	1,760.1	3.0	2.8	8.0
MSCI EAFE	1,677.9	2.9	3.0	0.6
MSCI Emerging Mkts	877.9	2.9	1.8	12.9

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.56	-0.2	-0.3	2.2
ML 10-Year US Treasury	2.47	-0.5	-0.6	0.6
ML US Muni Master	2.60	1.2	0.8	0.2
ML US IG Corp Master	3.43	-0.2	-0.3	5.0
ML US HY Corp Master	6.25	1.3	1.4	16.8

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	178.2	1.3	2.5	12.5
WTI Crude $/Barrel[1]	51.5	-0.3	4.2	39.0
Gold Spot $/Ounce[1]	1,160.0	-1.5	-1.1	9.3
Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.06	1.07	1.06	1.09
USD/JPY	115.32	113.51	114.46	120.22

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.

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Looking Ahead

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Upcoming Economic Releases

- On Wednesday, the U.S. Census Bureau reports retail sales for November. The consensus is for MoM increases of 0.3% for headline sales and 0.4% for core sales. The report may give investors a reading on the strength of the holiday shopping season.
- On Thursday, the U.S. Bureau of Labor Statistics releases its Consumer Price Index for November. BofAML Global Research expects MoM increases of 0.3% for the headline measure and 0.2% for the core reading, which excludes food and energy. The consensus is for YoY increases of 1.7% and 2.2%, respectively. Investors focus on these reports to better gauge the course of the policy interest rate.
- In Europe, Markit releases the preliminary December report on its Composite Purchasing Manager Index for the Eurozone. BofAML Global Research expects a reading of 54.1, a slight acceleration from November's 53.9, signaling that aggregate growth continues at a brisk pace.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	**2016 E**
Target	2,100
EPS	$118.50
Real Gross Domestic Product	**2016 E**
Global	3.0%
U.S.	1.6%
Euro Area	1.6%
Emerging Markets	4.1%
U.S. Interest Rates	**2016 E**
Fed Funds (eop)	0.63%
10-Year T-Note (eop)	2.35%
Commodities	**2016 E**
Gold ($/oz-period average)	$1,260
WTI Crude Oil ($/bbl-eop)	$54.00

All data as of last Friday's close.

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