ICR® 4th Quarter Newsletter – January 2017

Boosted by the "Trump Rally" following the election, U.S. stocks advanced in the fourth quarter of 2016 with the S&P 500 gaining 3.25% in the final three months. When it became clear that Donald Trump was the likely winner on election night, Dow futures plummeted almost 900 points. By the time the markets opened the next morning, most of the losses had disappeared, and the turnaround marked the beginning of an equity rally.

From a sector perspective, there were clear winners and losers. Financials posted impressive gains for the quarter as investors priced in anticipated slashing of regulations and rising interest rates – both positives for banks. On the flip side, health care, consumer staples, and real estate all posted negative quarterly returns, though only health care finished negative for the year.

Foreign stocks didn't fare so well, with the MSCI EAFE posting a loss of just over 1% for the quarter. Emerging markets (EM) fell 4.5%. However, due to a strong performance in earlier quarters, EM finished up almost 9% for the year. Fourth quarter weakness in foreign markets reflected a strong U.S. dollar and concerns over the protectionist trade policies discussed by the incoming administration.

While global equity markets added $635 billion in capitalization in November, the global bond market lost almost three times that much – $1.7 trillion – as bond investors ran for the exits. After spiking from 1.86% to 2.64% in the weeks following the election, the 10-year treasury yield settled in at 2.45% to end the year. This gave the Federal Reserve a green light to raise rates in December for just the second time in a decade, and two or three 0.25% hikes are expected in 2017. Although most are predicting further increases in bond yields, low rates for other sovereign bonds could function as an anchor for U.S. rates.

The Rise of Populism

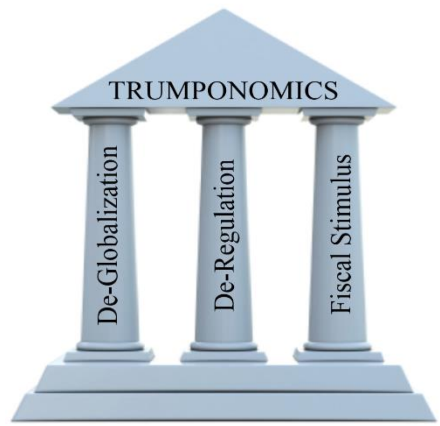
Despite a stunning populist victory in the form of Brexit and very successful primary efforts by populist candidates Bernie Sanders and Donald Trump, political and financial pundits refused to give Donald Trump much of a chance in the presidential election. Furthermore, it was the overwhelming opinion of "experts" that, should he be elected, markets would react most negatively. Obviously, the "experts" were very wrong on both counts.

We see the rising populist movement as being very powerful. Firstly, it is global in its various forms, and by definition it has numbers. It is bigger than Donald Trump, Marine Le Pen or any other individual personality. Secondly, it is rooted in widespread inequality and a growing distrust of current social, political, and economic institutions that are blamed for the inequality. We also see this global movement as very concerning from multiple perspectives, but here we will address the impact for investors.

Historically, populism has often resulted in destructive forms of extremism – both left and right. A common characteristic of recent populist actions is that they increased uncertainty. Just this week, Ray Dalio, founder of Bridgewater Associates, the world's largest hedge fund, gave his views at the World Economic Forum in Davos, Switzerland. According to Dalio, populism is the No. 1 economic issue that market participants should be watching – more important than central banks. He sees it as a greater threat to the European Union than the debt crisis. To his point, the election of Donald Trump has already achieved (at least for the time being) what the concerted effort of central banks around the world had failed to accomplish: it changed investors' sentiment with respect to inflation. The fever of deflationary fear has been broken. Lower for longer (stagnation) is giving way to a new regime of inflationary growth. That's a powerful influence. But, will it stick?

Trumponomics vs. Secular Stagnation
What is Trumponomics, and how will it affect the investing environment? These are the questions clients are asking. While details are yet to be determined, we do know the main pillars of President Trump's economic policies.

DE-REGULATION: Roll-back regulations for manufacturing, energy, and financials.
DE-GLOBALIZATION: America first; Immigration reform; Trade renegotiation
FISCAL STIMULUS: Cut corporate tax; Cut income tax; Infrastructure projects; Military spending



Prior to the election, investors were resigned to an economic environment of secular stagnation as world economies struggled to continue recovering from years of financial excess. Markets had priced in a lower for longer paradigm based on limits imposed by multiple structural imbalances in the global economy. On November 8, all that changed with the surprise election victories by Donald Trump and other GOP candidates, and the secular stagnation paradigm ran head-on into a political reality it had not expected. Since then, markets have embraced Trumponomics and have been pricing in a very different paradigm of inflation boom.

Investment Implications
So, are markets bringing in the New Year with that old FDR campaign song, "Happy Days Are Here Again?" Or have they moved too far too fast and set expectation too high for Trumponomics? While we expect substantial success in rolling back regulations and tax reform, we are less optimistic on the spending front. Trump may get more support for infrastructure from Democrats than from Republican deficit hawks. We also question the timing of infrastructure spending, given full employment and where we are in the credit cycle. Also on the negative side, de-globalization in the form of protectionism and anti-immigration threatens to stem the free flow of goods and services and the efficiencies that inure.

In summary, we see growth being enhanced by roll-backs in regulation and tax policy. We are also encouraged by the reduced correlations between asset classes and sectors, as this creates new opportunity sets. However, given the longstanding structural challenges that remain and increased uncertainty, we consider the investment climate for 2017 to be somewhat different, but no less challenging than before the election. We will continue to evaluate the rapidly changing investment environment and modify allocations to accommodate current opportunities.

We thank you for your confidence and the opportunity to provide your investment advisory services.

Sincerely,

James A. Heine

James L. Cobb

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