

Capital Market Review and Outlook

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Executive Summary

In response to stagnant wages and rising inequality, the electorate is upending the political establishment.

Nationalism, expanding fiscal policy, and de-regulation appear to be the new themes.

New directions bring uncertainty. Investors need to prepare for a wider range of potential outcomes.

In the U.S., we believe there will be a modest uptick in economic growth, inflation, and interest rates.

We are emphasizing economically-sensitive sectors. Broad market valuation remains a concern.

We expect future returns to be below normal.



Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

JIC's Investment Outlook

2016 will go down as a year in which the people spoke. I'm not sure too many people predicted the U.K. would vote to leave the European Union, the U.S. would elect Donald Trump, Italy would vote no to reform, and the markets would respond favorably – and in some cases very favorably.

The middle class has finally had enough. As a result of stagnant wages, rising inequality, declining purchasing power, and general economic malaise, they let their fury be known to the political establishment. The challenge for us is to decipher this changing environment.

We believe the following broad themes may dominate not only here in the U.S. but, to different degrees, globally:

1. A change toward nationalism and away from globalism
2. A changing emphasis toward fiscal policy and away from monetary policy, and
3. A shift towards de-regulation from regulation.

In the U.S., while we may have a very general framework on policy direction of a Trump presidency, there are many details that are unanswered. Moving in a new direction certainly has risks -- some known and some unknown. In short, these new directions will lead to increased uncertainty and a wider range of possible outcomes (both positive and negative).

During the past few years, markets have been relatively stable – not exhibiting significant levels of volatility (at least by historical standards). As markets attempt to interpret new policy initiatives and directions, we believe investors should be prepared for higher levels of volatility.

JIC's Base Case Scenario

JIC's normal investment process is to evaluate general macroeconomic conditions and trends, fundamentals and valuation, and technical characteristics. Using that information as inputs, we then develop the various strategies that influence our investment decisions.

The election of Donald Trump as President has both

positive and negative implications for the U.S. economy. On the positive side, Trump has promised to reduce regulations, cut corporate taxes, and increase infrastructure and defense spending. On the negative side, his protectionist and anti-immigrant proposals threaten to stem the free flow of goods, services, and labor.

JIC thinks reducing regulation and corporate tax reform will have beneficial effects on the economy and are the policy ideas most likely to be implemented. While an infrastructure spending bill would also be beneficial (and is needed), there are budget deficit concerns. Those concerns may reduce the size, and therefore the impact, of any infrastructure package.

We are hopeful that the President will back away from his campaign rhetoric and not actively use permanent trade tariffs, but other approaches, to advance his trade agenda. Negatively impacting trade will probably be counterproductive to his goal of stimulating economic growth.

These themes generally suggest an uptick in U.S. economic growth, inflation and possibly interest rates (over time). Currently, we view the risk of recession as low. We believe equity prices already reflect some of these pro-growth changes. But there may be more room for stocks to appreciate.

With that said, valuations here in the U.S. are more extended compared to other parts of the world. The U.S. will likely act sooner on its reflation policies and, for the time being, we would favor U.S. stocks over developed market stocks. However, at some point, reflationary policies will probably start in other large international economies. At that time, given more attractive valuations, we could reasonably see leadership change to the developed international markets.

Since improving economic growth is one of the new administrations major economic goals, the fiscal and de-regulation changes we expect will likely have more benefits to specific sectors of the economy, namely the economic sensitive sectors. As such, we expect value stocks to outperform.

In terms of company size, we remain tilted toward large company stocks mainly as a risk control measure (we are concerned about the valuation levels of small company stocks). With that said, a more domestic-focused economic strategy, at the margin, tends to favor small company stocks. We are closely monitoring these developments and may, at some point in the future, increase our small company allocation.

Our sense is that we have seen the low in bond yields and believe that, over the next few years, interest rates may rise across the maturity spectrum. On a short-term basis we do not believe the FED will aggressively move to raise interest rates – unless wages, inflation, and/or economic growth start to rise well above expectations. A couple of interest rate increases during the next year or so are reasonable to expect.

We have increased our allocation to shorter-maturity bonds. In addition, with the risk of recession low, we have taken credit exposure in both the investment grade and high yield segments of the market.

While predicting short-term stock returns is a fool's errand, against the backdrop of higher than average equity valuations and low (but possibly rising) bond yields, we see longer-term investment returns (both stock and bond) as below average.

So what are the risks to our outlook?

The reality may not live up to the forecasts. Perhaps Congress will not be able to execute tax reform or develop a meaningful fiscal stimulus package. Maybe deregulation is not as successful as the markets hope. It could be that miscalculations on trade lead to an all-out trade war. International events could also have an impact.

It is entirely possible that the markets are overestimating the benefits of tax reform and fiscal spending and underestimating the impact of protectionist trade policies. If that were to materialize, that could be a catalyst for a correction.

In addition, if interest rates were to suddenly rise, due

to a rapid increase in expected inflation, that could have a negative impact on asset prices.

Lastly, during 2017, Europe faces general elections in France, Germany, the Netherlands and possibly Italy. The potential for meaningful populist gains is a significant risk – particularly at a time when European cohesion appears fragile. Concerns about a Eurozone breakup could lead to stalled business and investment decisions while driving increased volatility in financial markets.

2016 Capital Market Performance

To the surprise of many, stocks returned 12.8% during 2016, although a good portion of the increase was concentrated during the post-election period. Bonds returned 2.7% for the year but lost -3.0% during the fourth quarter as interest rates rose. Commodities finally rebounded returning 11.8% after several years of poor returns. Inflation remained below 2.0%.

In terms of stock returns, mid- and small-company, value, and commodity-related were the best performing during 2016. High yield bonds returned over 17%. Laggards for 2016 included short-term, municipal, and developed market bonds although there were very narrow performance differences.

One way we use to identify the attractiveness of market segments is to compare their yields (higher yields

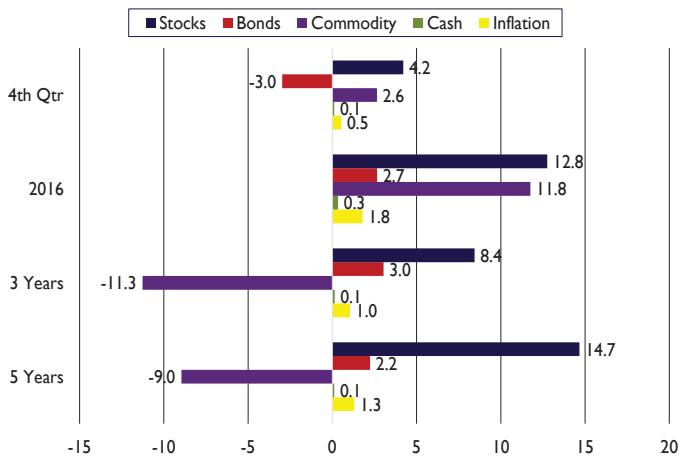
are better). On this measure, stock yields (currently at 4.5%) are still more attractive than investment grade bonds, but have significantly declined during the past several years (as stock prices have risen). A-rated bonds yield around 3.0%. High yield bonds are yielding a little more than 6%.

2016 Stock Market Results

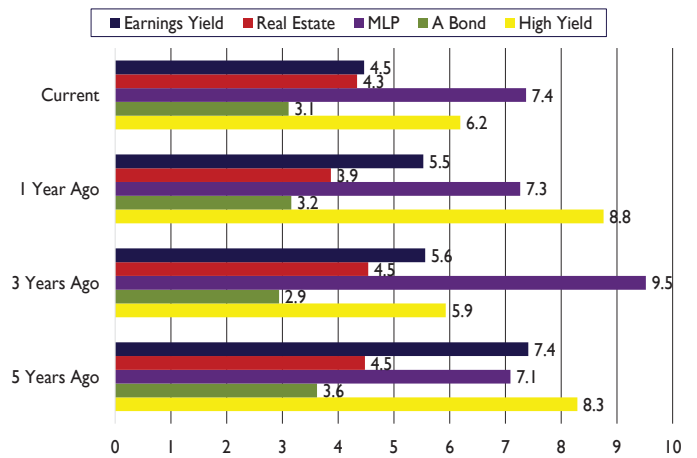
Having any international stock allocation detracted from returns during 2016 but, in particular, developed market stocks which returned 1.6% (compared to the U.S. return of 12.8%). Emerging market stocks returned 10.7%. Emerging market stocks led for a good portion of the year, but fell during the fourth quarter on concerns about the trade policies of a Trump administration.

Small stocks rocketed 21.3% during 2016 ahead of

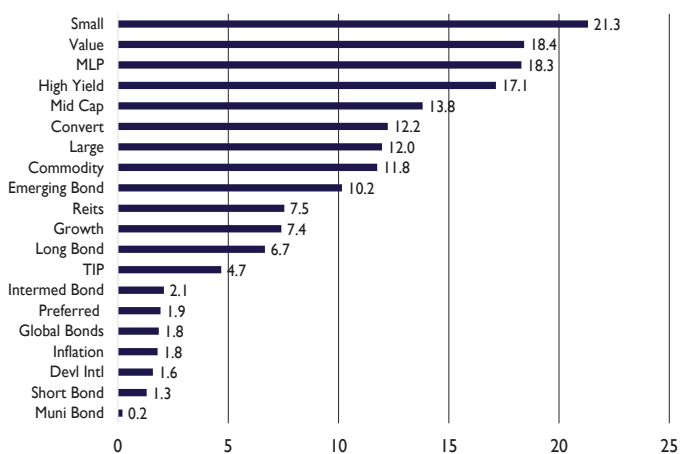
Asset Class Returns



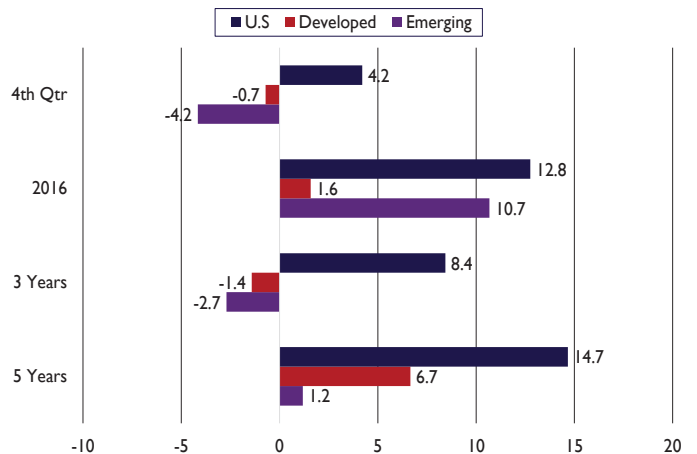
Asset Class Yield Comparison



2016: What Worked



Stock Market Segment Returns



the 12.0% large- and 13.8% mid-cap returns. Nearly all of the small-cap outperformance occurred during the post-election period. Value stocks returned 18.4% during 2016 compared to the Growth stock return of 7.4%. Similar to small company stocks, a disproportionate amount of the performance advantage was concentrated to the post-election period.

The three S&P 500 sectors with the best 2016 performance included Energy (27.4%), Telecommunications (23.5%), and Finance (22.8%). The three worst performing sectors included Healthcare (-2.7%), Consumer Staples (5.4%), and Consumer Discretionary (6.0%). The remaining sectors (Industrials, Materials, Technology, and Utilities) had returns that ranged from 13.8% to 18.9%. The best performing sectors generally were more economically sensitive. It is noticeable that the performance difference between the worst and the

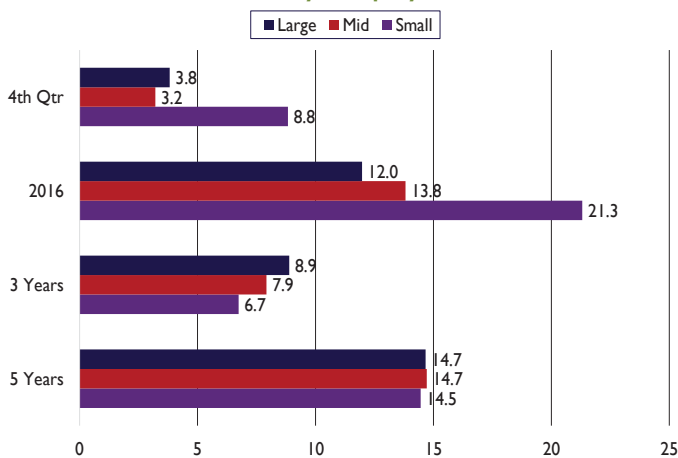
best sector was approximately 30%.

Valuation metrics clearly have increased. Compared to five years ago, the price to sales ratio has increased 33% while the price-earnings ratio has increased 36%. While there has been earnings growth during this time, price appreciation has been significantly greater than earnings growth. At present, the price-earnings ratio stands at 22.4x which is clearly above its long-term historical average, but is not near the Internet bubble levels of the late 1990's.

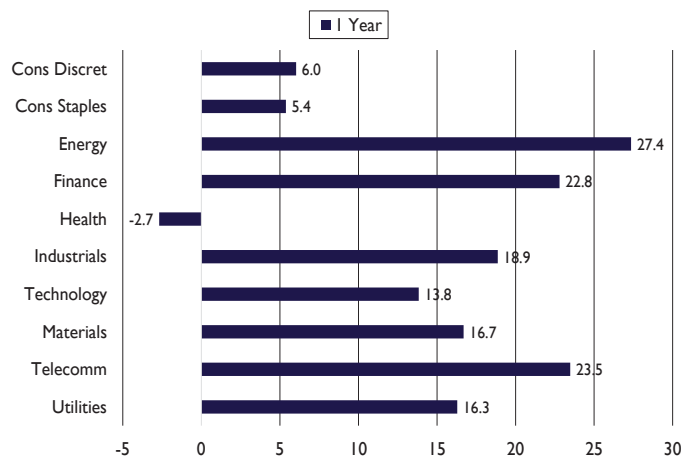
By company size, there is also a significant price / earnings difference between large (22.4), mid (28.8), and small (36.0) company stocks.

Not surprisingly, comparing valuation characteristics to the developed and emerging markets, the U.S. is

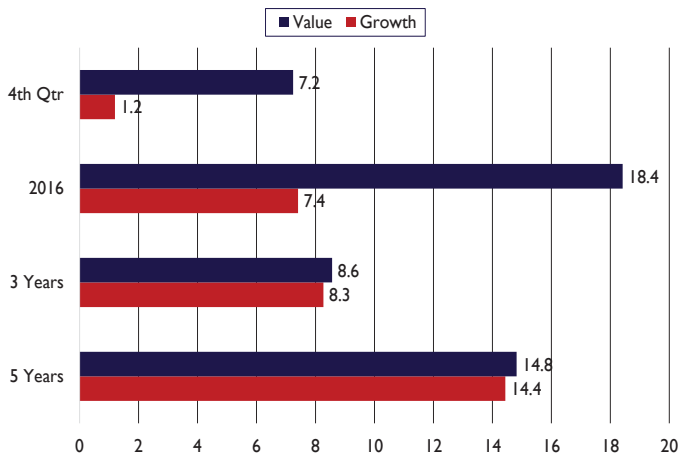
U.S. Stock Market Returns: By Company Size



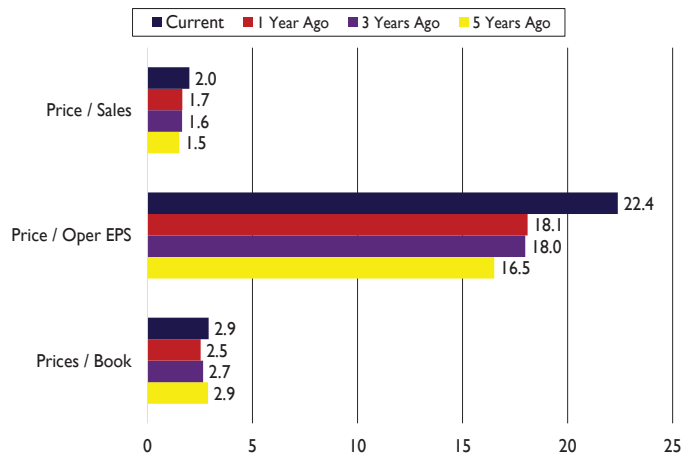
S&P 500 Sector Returns



U.S. Stock Market Returns: By Investment Approach



S&P 500 Valuation Characteristics



generally more expensive. At present, emerging markets offer the most attractive valuations.

2016 Bond Market Results

With the exception of high yield and dollar-denominated emerging market bonds, bond returns were modest during 2016. Municipal bonds had the lowest return of 0.2% while inflation protected securities (known as TIPS) returned 4.7%. The broad U.S. market returned 2.7%. It is interesting to note that, for the traditional bond segments, returns were negative during the fourth quarter when interest rates significantly increased after the election.

By maturity, long-term bonds returned 6.7%, intermediate-term bonds returned 2.1%, short-term bonds returned 1.3%, and money markets returned 0.3%. While the long-term bond return is accurate its per-

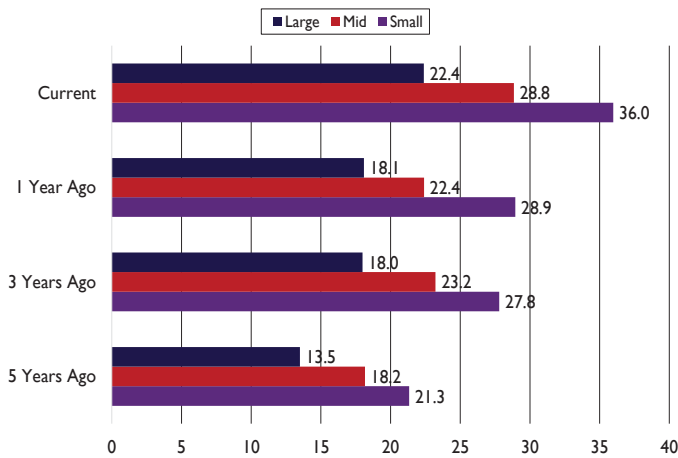
formance is almost entirely attributable to the corporate bond segment of the index.

Corporate bonds returned 5.6% during 2016, mortgages returned 1.7%, and government bonds returned 1.0%.

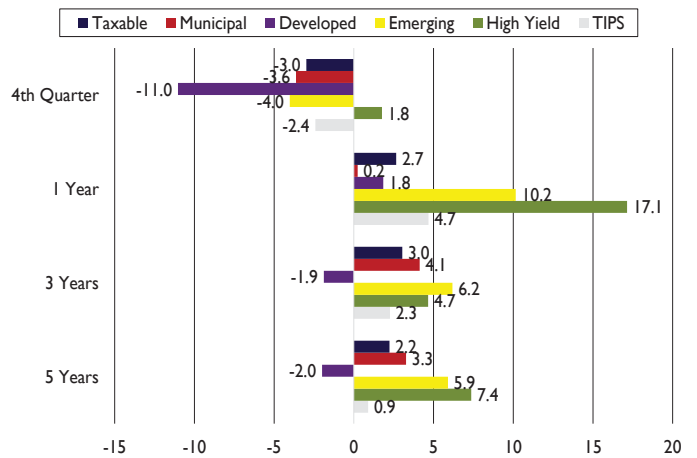
As a result of the fourth quarter rise, bond yields are higher (compared to one year ago) across the maturity spectrum. The shape of the yield curve has remained similar compared to a year ago (gradually upward sloping).

Not surprisingly, high-yield bonds offer a significant yield premium compared to other bond market sectors. With that said, the yield premium received has declined during the past year. In other words, investors are not being as well compensated for taking on

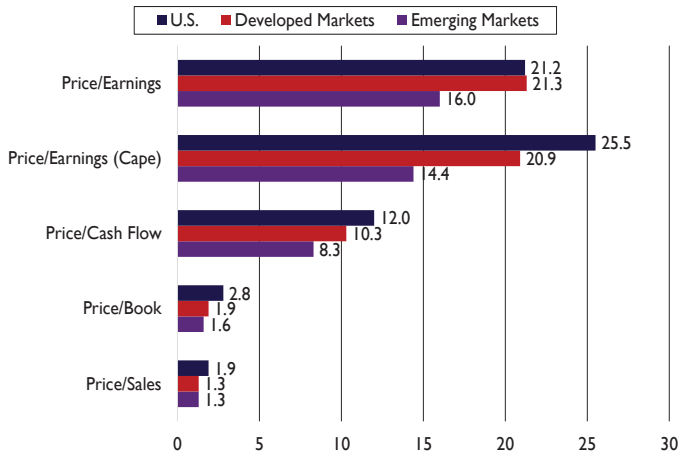
Price / Earnings Ratio by Company Size



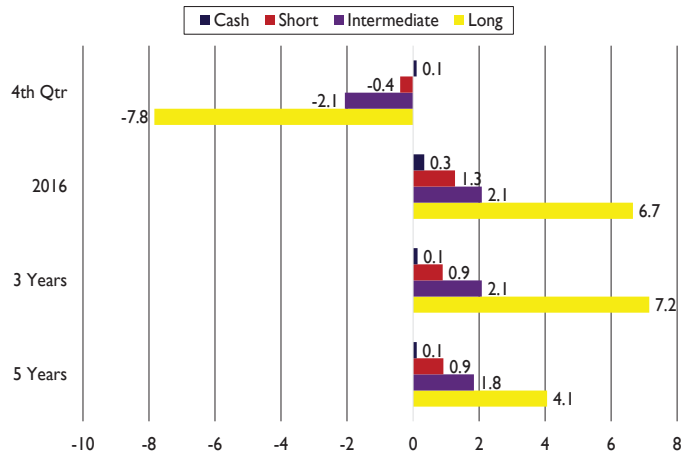
Bond Market Segment Returns



Valuation Characteristics: Developed vs. Emerging



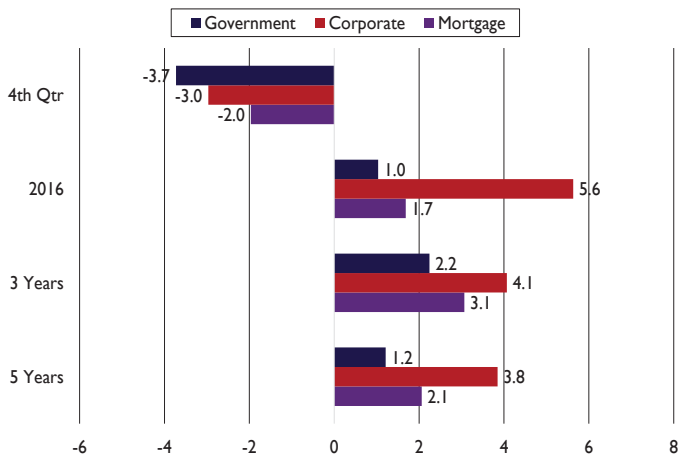
Bond Maturity Returns



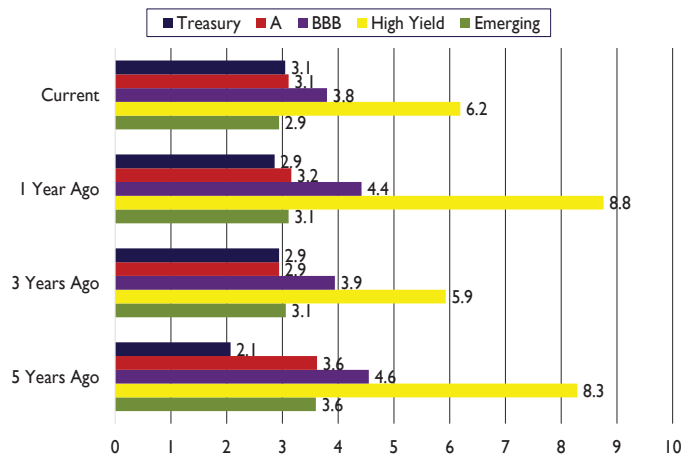
the additional risk of high-yield bonds compared to a year ago.

In terms of our bond allocation, we have established a short-term bond allocation with the expectation of rising interest rates. We also have allocations to both investment and non-investment grade credit as well as preferred stocks and emerging market bonds.

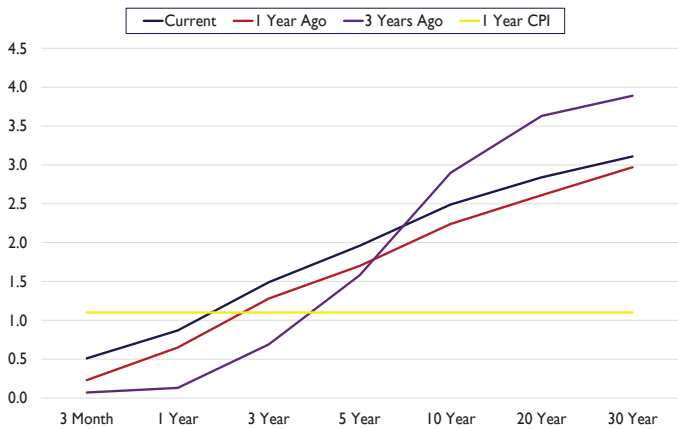
Bond Sector Returns



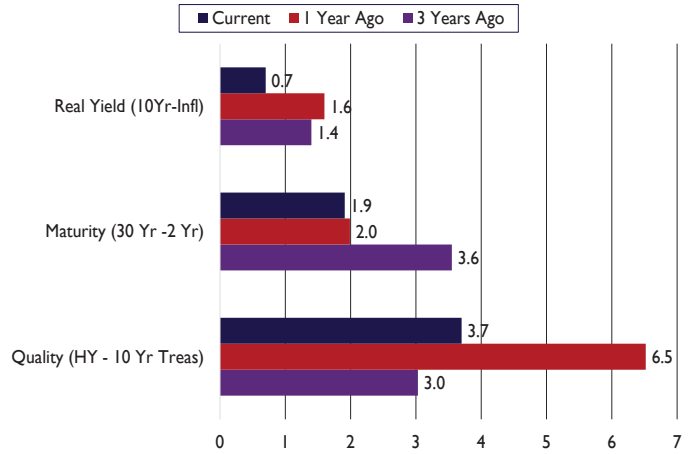
Bond Yields By Quality



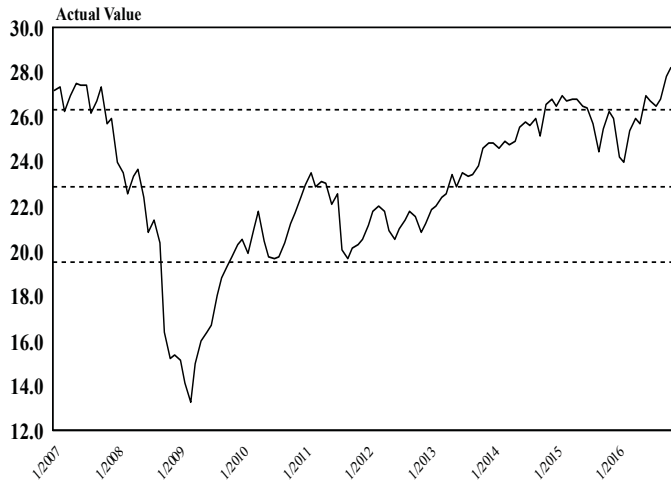
Treasury Yield Curve



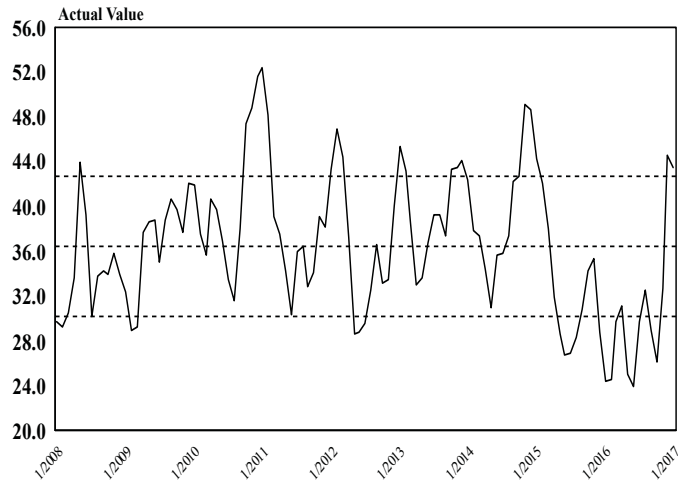
Inflation, Maturity & Quality Spread



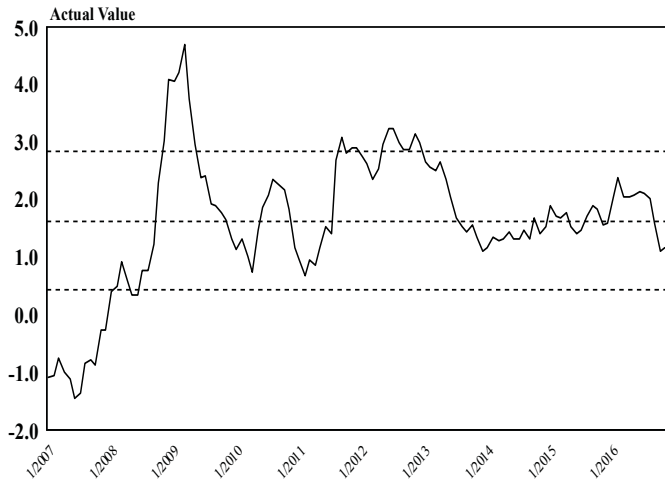
S&P 500 PE Using 10-Year Average Real Earnings



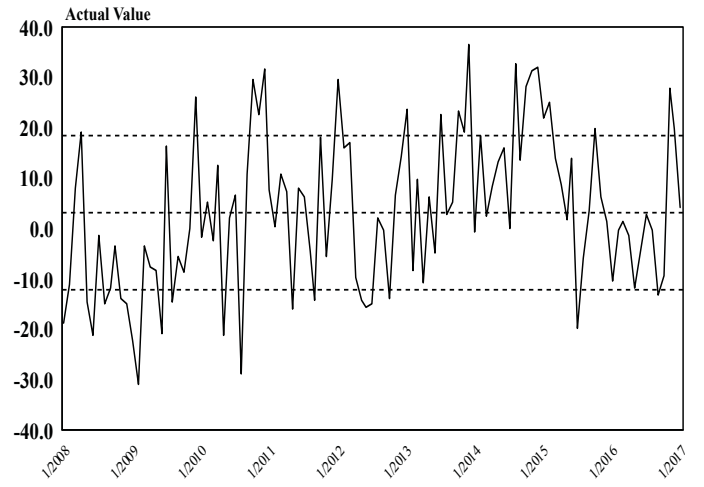
AAII Percent Bullish 8-Week Average



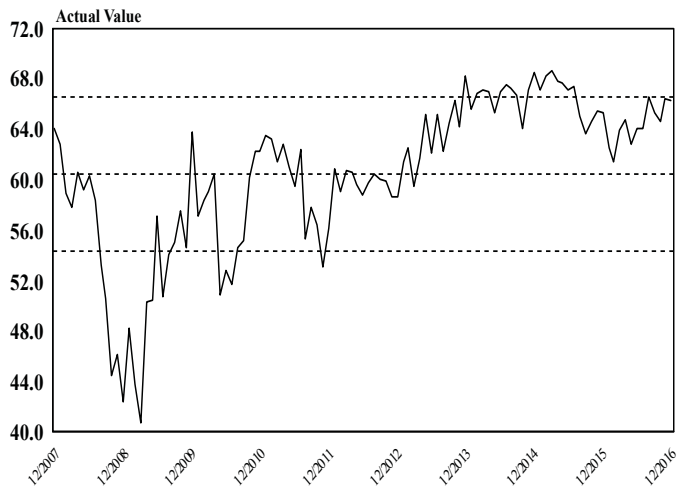
'500 Earnings Yield Using 10-Year Average Real Earnings Less 10-Year Treas



AAII Bull/Bear Investor Sentiment Spread



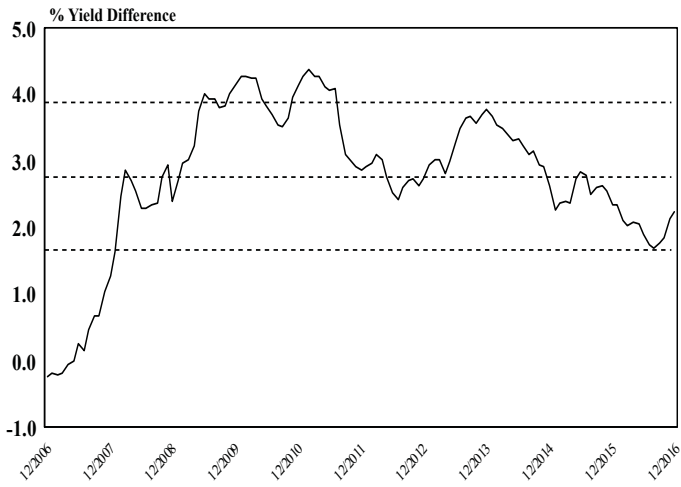
AAII Survey: Stock Allocation



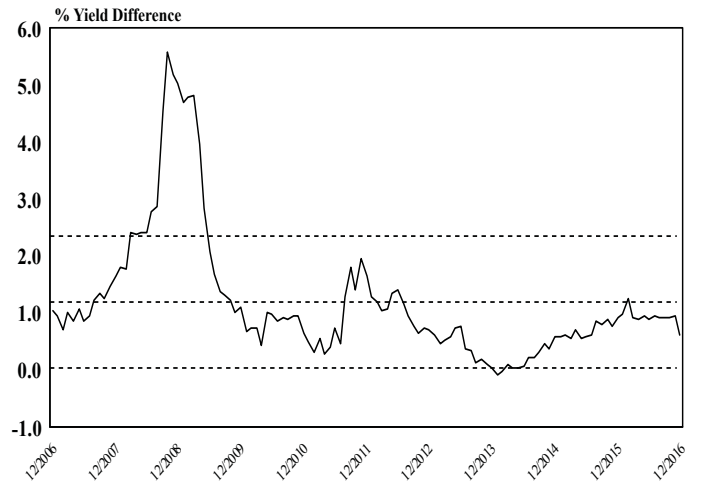
CBOE Volatility Index



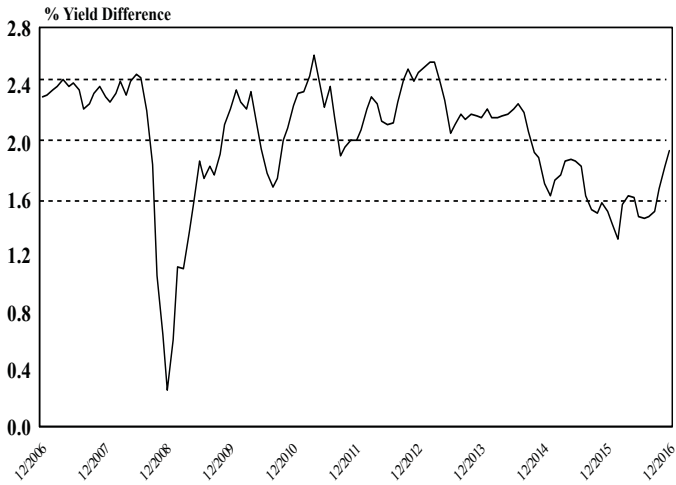
30 Year Treasury Less 1 Year Treasury



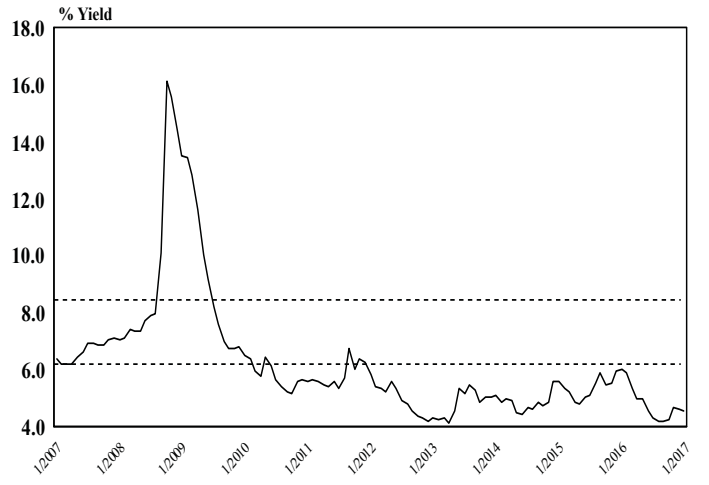
MLA Less 10 Year Treasury



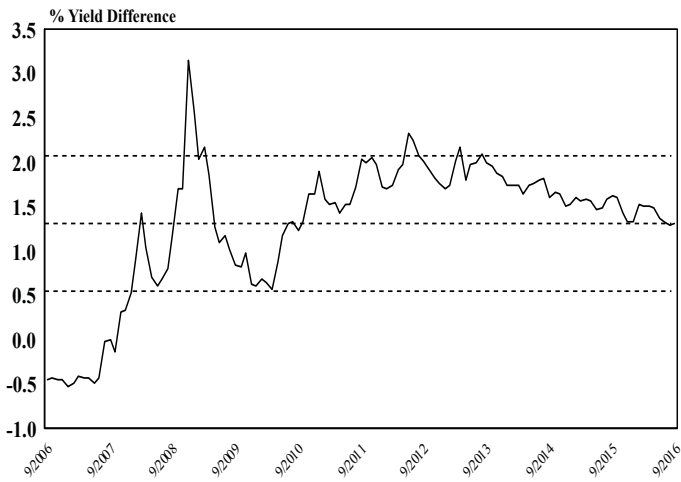
10 Year Treasury Less 10 year TIP



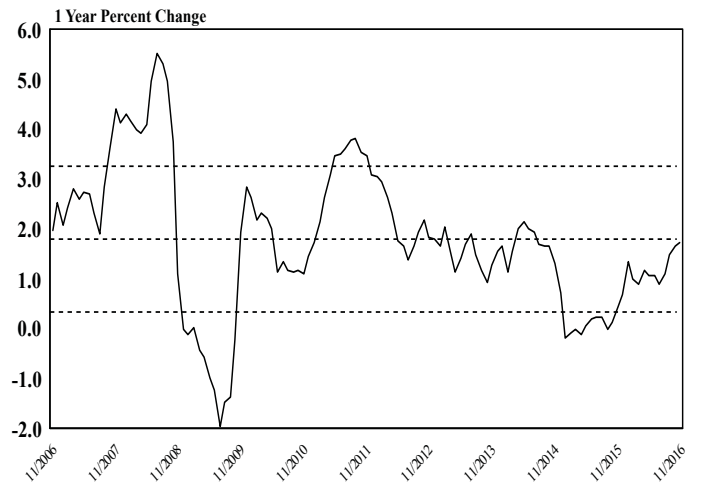
ML Emerging Market Corporate



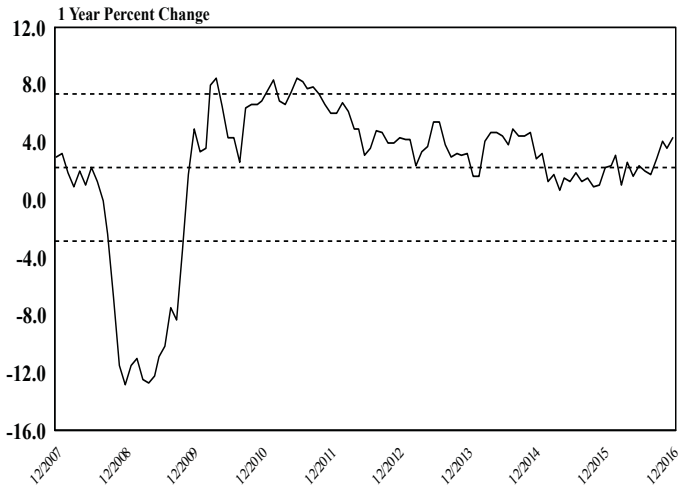
Bond Buyer 20-Bond Municipal Bond Index Less 10 Year Treasury



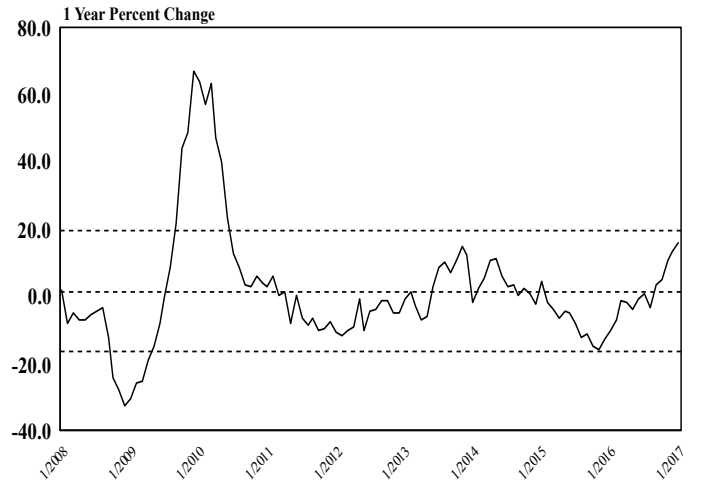
Consumer Price Index



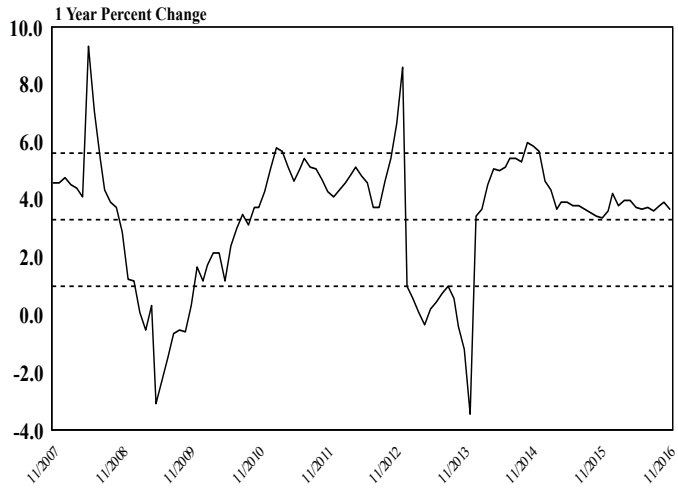
Retail Sales (Excluding Food Service)



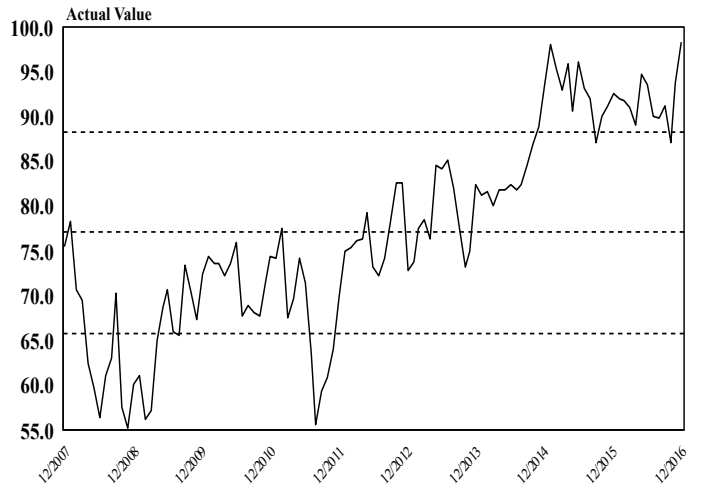
ISM Purchasing Managers Index



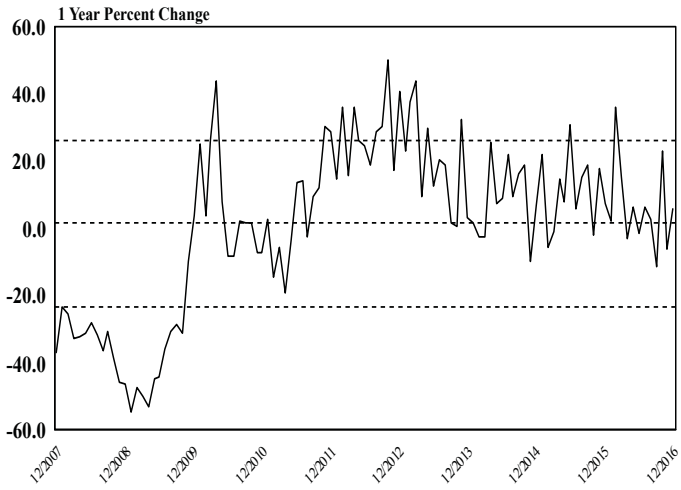
Disposable Personal Income



Consumer Sentiment



Housing Starts



U.S. Dollar to Euro Exchange Rate

