CARMICHAEL CAPITAL INC.

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2016 Year End Review
"Poor Pundits and Pollsters!"

It was a pretty good year for stocks, a so-so year for bonds, and a very bad year for pundits and pollsters. Brexit was supposed to be voted down, and if not, it was going to kill the financial markets. Trump was supposed to lose, and if not, it was going to kill the financial markets. Even a vote in Italy in December was supposed to doom European banks if it failed to pass. It failed, but the banks haven't (at least not yet). It seems that very little went the way it was supposed to according to pundits and pollsters in 2016. At least the Cubs finally won the World Series.

After starting the year with one of the worst January performances in decades, the US stock markets rebounded through the summer months. A brief sell-off after the Brexit vote, and another early November slide took stocks to levels that were essentially even with the December 2015 peak of almost a year prior. However, the election results of November 8th were followed by a very brief sell-off that was over by the next morning. By the end of December, the "Trump Rally" was in full swing with the NASDAQ index up 7.5%, the S&P 500 up about 9.5%, and bonds suffering a sharp reversal from a peak in early July to finish the year flat to down.

One of the most interesting aspects of recent events has been that accurately predicting the events themselves could have led to massive losses because markets reacted to those events in ways diametrically opposed to most expectations. Not only are events difficult or impossible to predict, the market's reaction is also still unpredictable. That is why we tend to rely on measures of statistical value rather than on predicting market-moving events or their precise effects market prices. Over time this works well, while over shorter time frames markets can outrun statistical norms to the upside and the downside.

The press has certainly done a good job of covering the somewhat surprising stock market advance on the heels of the victory of Donald Trump in the presidential election. An important development that may have been missed in the hoopla of the election is that the 30+ year bull market in bonds may have finally ended in July when the US 10 Year note reached a yield of 1.35% and the 30 year bond yielded only 2.1%. Since then, interest rates have risen and longer term bond prices have fallen accordingly. As an example, the iShares 20+ Year Treasury ETF (exchange-traded fund) lost 18% of its value in the 5 months following July. We have been wary of making heavy commitments to long term bonds with rates at historic lows, and have opted for hedged, floating rate, or shorter-term maturities to reduce the risk represented by just such an uptick in interest rates. This rise in rates, if continued, could have material impact on stock prices and valuations of all financial assets. The "bizarrro world" of negative interest rates may be giving way to a bond market closer to historical norms. However, the sell-off in bonds may have been overdone on the short term, so we wouldn't be surprised to see bonds prices rally during the year before continuing south if interest rates continue to rise.

After the presidential election, the stock market rose by about 8% through the end of the year as investors focused more on the salutary effects of possible lower taxes, less regulation, and fiscal stimuli. There is precedent for a honeymoon with the market after a business-friendly Republican victory. After

Ronald Reagan won the election in 1980, the stock market rose a similar 8% from election to inauguration day. Unfortunately, that honeymoon was followed by a decline of about 25% from the inauguration into the following year. Stocks were statistically a whole lot cheaper in 1980 than they are in 2017, so some argue that there may be even more risk in today's market. Certainly, it would be reasonable to expect some market volatility as campaign rhetoric meets reality. Talk of a "border adjustment tax" has already alarmed retailers, and they may be considerable push-back from conservative Republicans on any fiscal stimulus that increases deficit spending. Suffice it to say that the risks and uncertainties are many and it would be reasonable to expect a reduction of honeymoon optimism at least at some point during this new year and new administration.

We remained conservatively invested into the election because of the possibility for sudden adverse market reactions. Following the election we have used a combination of ETFs, mutual funds, and individual stock purchases to increase equity exposure as some of the uncertainties facing investors were resolved. However, many old and quite a few new risks remain. Not the least of those risks is the unpredictable nature of the statements made by the president-elect. Just recently, Mr. Trump singled out pharmaceutical companies with some negative comments and the industry lost 3% of its stock market value in a single day. We have done very well in pharmaceutical stocks over the years, but they may prove to be too irresistible a "whipping boy" if the president elect decides to focus pent up voter frustration on a convenient target, whether deserved or not. Consequently, we are taking partial profits in some long-held positions in that sector. However, a few of the pharmaceutical company stocks have been beaten down so far that we may represent good value at these levels, even while we lighten up on older positions.

If the new administration succeeds in weakening the dollar, it may boost the price of gold (at least in dollars). We have added some precious metals positions as the sector appears to be hated enough to represent a good contrarian value at the same time that currency and inflation pressures may benefit it as well. We will also likely add to energy investments that have stabilized after the volatility of the last few years and stand to benefit from the possible changes in taxes, regulations, and tariffs favoring domestic production.

The old rule-of-thumb on Wall Street was that you should take your age and subtract it from 100 to determine the percentage of equities that you should hold in your portfolio. The idea being that you would reduce your risk to equity bear markets as you grow older and have a shorter time-horizon for investing. The age of 0% interest rates has recently pushed investors deeper and deeper into equities as the conclusion was drawn that "there is no alternative (TINA)." That conclusion may begin to reverse in the near future, especially if interest rates begin a longer-term rise from their recent historic lows. That, as well as the uncertainties represented by a new and unorthodox administration, could make for a bumpier ride for investors as we go forward into 2017 and beyond.

We always try to match your exposure to the stock market to your desires and your risk tolerance. That desire and risk tolerance changes over time. We have never had so many clients call and want to either reduce or increase their equity exposure (sometimes both, at different times) in reaction to world events as we have had this year. Changing those levels for you is part of the individualized service that we provide. I would encourage you to review your enclosed reports and give it some thought. Then give us a call and we can discuss what asset allocation you would like and we will shape your portfolio investments to meet that level.

Please review your enclosed reports and statements at your convenience, and give us a call with any questions or suggestions. As always, we will try to make your life easier by sending your tax information directly to your accountant if you would like us to do so.

It has been a privilege to work with you on your investments this past year, and we hope to be able to continue to earn the opportunity to justify your confidence.

Sincerely,

Claude R. Carmichael CFA