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SPOTLIGHT

THE WAR ON CASH

In early 2016, Harvard professor and former Treasury Secretary, Lawrence H. Summers, wrote an op-ed article for the *Washington Post* in support of his argument for discontinuing the issuance of large-denomination paper currency like the $100 bill and the 500 euro note. Ostensibly, this article was about the affinity that tax evaders, money launderers, terrorists, and other nefarious characters have for these large bills. After all, a million dollars in $20 bills weighs more than fifty pounds, while the same amount, in 500 euro notes, would come in at just about two pounds. The fact that the 500 euro note, in certain circles, has become not so affectionately known as the "Bin Laden" seems to confirm the legitimacy of these concerns. Therefore, it is no surprise that the European Union announced in mid-2016 that they would phase the note out of circulation by the end of 2018. Summers further argued that technology has only made legitimate use of high-denomination bills all that much less common. Those on the other side of the argument dismissed the premise that increased logistical difficulty would play a material role in limiting criminals' access to resources.

Fast forward to the end of this past year, and we are seeing demonetization in practice in one of the world's fastest growing economies. India's Prime Minister, Narendra Modi, announced in early November the cancellation of the country's two highest denomination notes – the 500- and 1000-rupee notes. Somewhat unique to India, however, is that these two notes make up roughly 86% of the currency currently in circulation. This forced move to a semi-cashless society has been enormously disruptive for an Indian economy that still conducts a significant majority of its financial transactions using cash. In fact, a recent study conducted by McKinsey & Co. found that number to be as high as 90%. As a result of this announcement, India's citizens have had to line up for hours to exchange currency, banks have had to back burner other financial services, 215,000 ATMs have had to be recalibrated, and the population has had to go without necessities like food and medical services.

As with the Summers' argument for the United States and Europe, the thesis here is that Modi and Finance Minister Arun Jaitley want to crack down on corruption, tax evasion, and the shadow economy. Given the large percentage of the Indian population without bank accounts earlier in 2016, however, this move could be more about herding people into the financial system. Electronic payments companies like Visa and Mastercard stand to reap the benefits, as do more modern mobile payments companies like Paytm. For its part, Paytm says it added 14 million users since the decision to scrap the higher denomination notes.

That said, the country has also seen volume spikes in less legitimate peer-to-peer Bitcoin services, and even a return to non-cash bartering systems. Shortly after Modi's announcement, Bitcoin was trading on Indian exchanges at a roughly 25% premium to the global average. Other criticisms center around the argument that many global economies have made when presented with similar demonetization propositions in the past: it is more about government grabbing power and infringing upon citizens' financial privacy.

Just a few days ago, however, the world saw the first potential sign that the Indian war on cash may be paying dividends. The country's central bank, the Reserve Bank of India (RBI), announced just after the first of the year plans to reduce its borrowing amount for the current financial year. While the RBI did not outline the specific reasons behind its plan to lower borrowing by 4.2%, analysts suggest that government coffers have swelled as a result of the crackdown on tax evaders. In addition, as part of the mandatory currency exchange process, the Indian government also offered a limited amnesty policy on unreported wealth. Indian citizens can escape prosecution by paying half of the amount as tax and penalty, and deposit another quarter as an interest-free loan with the government for four years. This income disclosure policy was not budgeted by the government, and analysts expect it could amount to several billions of dollars.

Despite some signs of success, there is no shortage of criticism of India's policies coming from a number of global economic experts. Among them is the aforementioned U.S./Europe demonetization advocate, Lawrence H. Summers. While Summers is clearly in support of demonetization as a means to combat corruption, he believes that India's approach is hurting ordinary citizens. He echoes noted criticisms, stating that "we strongly suspect that those with the largest amount of ill-gotten gain do not hold their wealth in cash but instead have long since converted it into foreign exchange, gold, Bitcoin or some other store of value. So it is petty fortunes, not the hugest and most problematic ones, that are being targeted." As with any relatively abrupt, sweeping change to economic or monetary policy, it is likely best not to judge too hastily.

ECONOMY

EXPECT THE UNEXPECTED

The fourth quarter of 2016 saw a surprising U.S. election that markets reacted to positively on expectations of fiscal stimulus by the Trump administration. It was a fitting end to a year that began with the worst start of a year ever for U.S. equity markets, followed by a steady rebound that withstood the unexpected Brexit result, a continued slowdown in China, and a hesitant Federal Reserve (Fed) that finally raised interest rates in December. The equity markets, sitting near all-time highs, have rallied as economic surprises during the year have improved. Global PMI's, interest rates, oil prices, and employment all improved in the "right" direction, which, regardless of political outcomes, could explain a strong year for the stock market. The U.S. economy grew faster than initially thought in the third quarter, increasing at a 3.5% annual rate instead of the previously reported 3.2% pace, the Commerce Department said in its final GDP estimate in late December. This was the strongest quarterly growth since the third quarter of 2014. Stronger consumer spending and business investment were responsible for the upward revision. Consumer spending grew 3.0% in the third quarter after the second quarter's very strong 4.3% increase.

Meanwhile, U.S. consumer confidence continued to march ahead in November. Analysts' consensus as compiled by Bloomberg for the consumer confidence index was 108.5, while the actual number was 113.7, which was the highest reading since August 2001. Lynn Franco, director of economic indicators at The Conference Board, argued that the gains were due to expectations; current conditions actually began to decline moderately. The decline in current conditions was modest, so the consumer portion of the U.S. economy appears to remain on strong footing. The gain in expectations was led by a

ECONOMIC INDICATORS	LATEST	3MO PRIOR	CHANGE*
REAL GDP	3.5%	1.4%	▲
TRADE BALANCE	-45.2	-40.6	▼
UNEMPLOYMENT RATE	4.7%	4.9%	▼
NON-FARM PAYROLLS	156K	208K	▼
ISM MANUFACTURING	54.7	51.5	▲
ISM NON-MANUFACTURING	57.2	57.1	▲
RETAIL SALES (LESS AUTOS)	0.0%	0.5%	▼
INDUSTRIAL PRODUCTION	-0.4	-0.1	▼
HOUSING STARTS	1090	1164	▼
CONSUMER PRICE INDEX	1.7%	1.1%	▲
CONSUMER CONFIDENCE	113.7	103.5	▲
EXISTING HOME SALES	5.6M	5.3M	▲
CONSUMER CREDIT	24.5B	26.8B	▼
CRUDE OIL PRICE	53.72	48.24	▼

Source: Bloomberg. Past performance does not guarantee future results. *The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to U.S. economic growth.

sharp increase in optimism from older Americans. These expectations might be the key in 2017 to sustaining high levels of consumer confidence.

HOUSING

Purchases of previously owned homes climbed 0.7% in November to a seasonally adjusted annualized rate of 5.6 million, the highest pace since February 2007. New home sales also rose in November, reaching their highest level in four months. Purchases of newly built homes increased 5.2% in November. Economists said higher mortgage rates are likely luring buyers into the market because of fear borrowing costs will continue to rise. The average interest rate on a fixed 30-year mortgage reached 4.3% in late December. That was the highest 30-year mortgage rate average since April 2014. In addition to higher mortgage rates, the rise in housing prices driven by low inventory is making home buying unaffordable for many buyers. The combination of higher mortgage rates and housing prices could lead to a softer housing market in the spring of 2017.

EMPLOYMENT AND MANUFACTURING

Employers added 156,000 jobs in the month of December, ending a year of more moderate but continued healthy payroll gains as the U.S. economy nears full employment, while wage growth reached an eight-year high. The unemployment rate rose to 4.7% from 4.6% as approximately 200,000 Americans entered the labor force, which includes those working and looking for jobs, according to the Labor Department. Economists surveyed by Bloomberg expected 180,000 job gains for December. Average hourly wages increased 10 cents after dipping in November, rising to $26 which is up 2.9% year over year, the most since June 2009. Wage growth is expected to accelerate as the low unemployment rate forces employers to offer more to attract from a more limited pool of workers. Job gains for October and November were revised up by 19,000. Overall, job growth slowed in 2016 to an average monthly pace of less than 200,000 from the 229,000 rate in 2015. Many economists attribute this to a low unemployment rate that is supplying firms with fewer job candidates.

The ISM manufacturing PMI grew at the fastest pace in two years for December. The latest PMI reading was 54.7 percent, an increase of 1.5 percent from 53.2 in the previous month as both new orders and production picked up sharply. A reading above 50 means the sector is expanding, while below indicates contraction. Economists expected a smaller increase to 53.7. The gain marks the fourth straight month that the measure has shown a faster expansion. Manufacturers have benefitted from a recovering energy sector, with rising crude prices boosting energy investment. Of 18 sectors, 11 reported growth in December, including oil and coal products, primary and fabricated metals, machinery, computers and apparel.

EQUITY

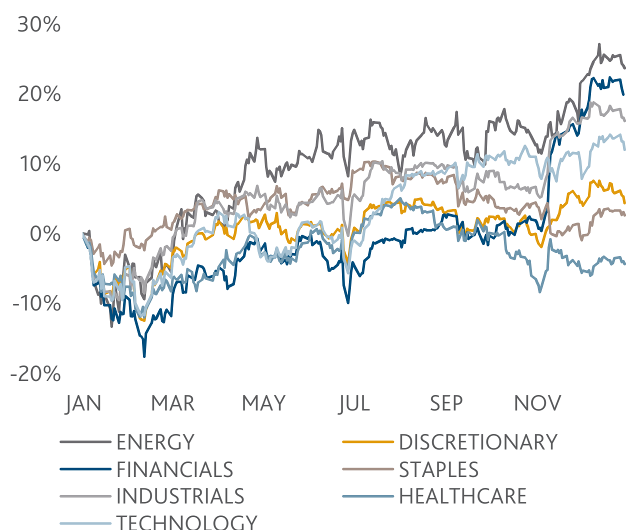
CYCLICAL SECTORS DRIVE FOURTH QUARTER RALLY

U.S. equities began the quarter in negative territory as concerns about global growth and the timing of the next interest rate hike weighed on investor sentiment in October. With the surprise election of Donald Trump in early November, equities rallied in anticipation of faster economic growth as a result of increased infrastructure spending, lower taxes and fewer regulations. Fourth quarter and the full year 2016 were both periods of sharp contrasts in performance by large capitalization equities and stocks in the mid and small cap categories. Returns also differed dramatically between U.S. and international equities as well as between the developed and emerging market indexes.

Financial stocks were particularly strong in the fourth quarter, rising 21.0%, helped by the outlook for higher rates once the Fed increased the benchmark rate in December. This strong performance by Financials as well as Energy (+7.3%) helped to explain the significant performance differential between the value and growth indexes in the fourth quarter and the full year, as the value index is more heavily weighted to these two sectors. Value stocks in general outperformed their growth style counterpart between 8% and 10% in 2016, a complete reversal from 2015 when the growth index returns were on average 8.0% better than value index returns.

In another contrast to the prior year, large cap equity returns in 2016 trailed the returns of mid cap and small cap stocks. The total return for the S&P 500 Index of 12.0% was significantly less than the nearly 20.7% return for the mid cap index and the 26.5% return for the small cap index. A meaningful part of the outperformance came within the fourth quarter as investors turned to more domestically focused stocks. Concerns about the stronger dollar and increased protectionism were believed to negatively affect larger multinational companies with a higher percentage of international revenues.

Within international equities, emerging market stocks sold off in the fourth quarter mainly on concerns about the impact from the stronger dollar. The 4.3% negative return in emerging market equities was led by sharp declines in the indexes for commodity importing countries China (-7.1%) and India (-8.0%). For the full year, commodity exporters including Brazil, Russia and South Africa helped power the emerging market index up 11.3%.



Source: Bloomberg. Past performance does not guarantee future results.

Developed countries' stock returns fared better than emerging market equities in 4Q16, but still trailed significantly for the full year as the MSCI EAFE Index returned only 1.6% in 2016.

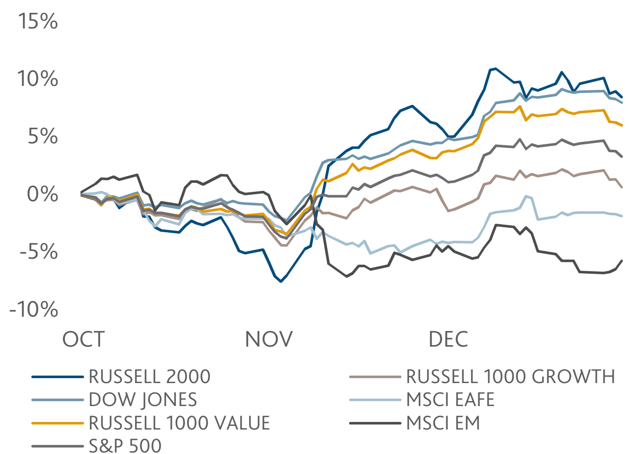
Turning to 2017, Wall Street expects the broad S&P 500 Index to produce about $135 per share according to median Bloomberg consensus estimates. This would translate to about 20.0% of year-over-year earnings growth compared to 2016 depending on how fourth quarter 2016 earnings materialize. While this level of earnings growth seems like a high bar to clear, stabilization in S&P 500 energy sector earnings compared to 2016 could provide a significant boost to the broad index. Meanwhile, the strong U.S. dollar still lurks as a formidable hurdle to both sales and earnings growth for large capitalization multinational companies.

Following the post-election rally in U.S. stocks, fourth quarter earnings season could validate investors' optimistic expectations. The improvement in sentiment appears related to the potential for lower corporate tax rates and increased fiscal spending. After seven consecutive quarters of negative year-over-year earnings growth, 4Q16 could very well break the trend of earnings growth weakness. Potential headwinds for corporate profits heading into 2017 include further strength in the U.S. dollar, accelerating wage growth and pricing power weakness in certain sectors.

Some of the most cyclically oriented sectors of the S&P 500 Index including Energy, Materials and Financials were among the best performing areas of the market in both 4Q16 and for the entire year. The expectation of Trump administration deregulation and pro-growth policies, Chinese government stimulus and the temporary OPEC production cut in global crude oil supplies, helped to push these areas of the U.S. equity market higher in 2016. Some of the future gains in these sectors may have been pulled forward in 2016. This may create a higher-than-usual hurdle for these sectors to outperform the broad benchmark again in 2017.

MAJOR GLOBAL EQUITY INDEXES: 4Q16 PRICE RETURNS

OCTOBER THROUGH DECEMBER 2016



Source: Bloomberg. Past performance does not guarantee future results.

FIXED INCOME

INFLATION, GEOPOLITICAL RISKS, AND DECLINING LONG-TERM GROWTH PROSPECTS

The last quarterly publication argued that the decline in longer rates from December 2015 to September 2016 did not reflect the fact that the Fed had blundered in raising the Fed funds rate at the end of 2015. Rather it appeared that expectations for future growth and future inflation had drifted lower over the first three quarters of 2016. Additionally, uncertainty surrounding monetary policy had dissipated and term premiums had fallen dramatically over that same period. All of these things occurred while core, ex-food and energy, inflation measures, PCE and CPI, were accelerating. In fact, as of September 30, non-energy services, roughly 60% of the CPI basket, had seen their prices increase 3.2% over the prior year. The last publication ended by warning that investors may have grown too complacent about a "lower for longer" rate environment, and that the one factor that could spur a surge higher in rates was inflation.

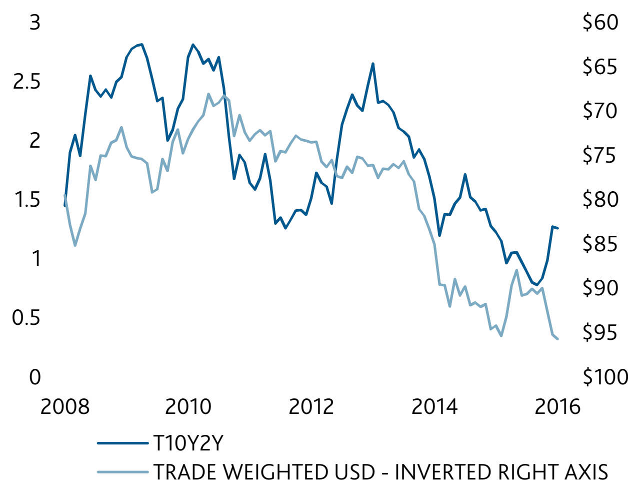
As it became clear Donald Trump might win the election on November 8, U.S. Treasury yields initially fell during overnight trading. The following day, however, the market quickly began to discount a future with accelerating inflation. Much of the move higher in Treasury yields was driven by Trump's campaign rhetoric for massive government spending on infrastructure projects and possible import tariffs. This, combined with improving economic data in the fourth quarter, pushed inflation expectations higher, causing long-term interest rates to surge.

After starting the month yielding 1.83%, the yield on the 10-year U.S. Treasury note rose more than 55 basis points to end November yielding 2.38%. The spike in yields led the Bloomberg Barclays U.S. Aggregate Index to a monthly loss of 2.4% in November marking the worst monthly return since April 2004. It was also the index's eleventh worst monthly performance dating back to December 1979. Needless to say bond investors took it on the chin in November, especially those who were caught off guard by the sudden arrival of the expectation for higher inflation in the future.

With rates higher than they were halfway through 2016, when the yield on the 10-year U.S. Treasury note sat at its all-time low of 1.36%, it is logical to ask where rates will head from here. That Is not an easily answered question. Empirical

10-YR MINUS 2-YR CURVE WITH TRADE WEIGHTED USD

DECEMBER 2008 THROUGH DECEMBER 2016

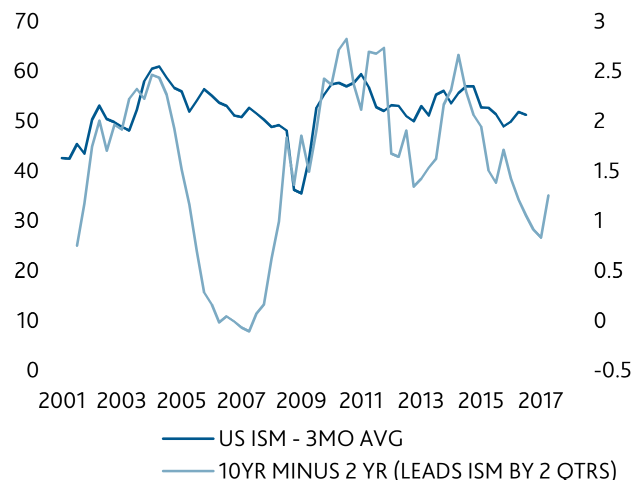


Source: Federal Reserve Bank of St. Louis. Past performance does not guarantee future results.

studies have shown that, as a group, economists struggle to predict the future range of yields with a reasonable degree of accuracy. With that said, it would appear that the recent back up in rates has taken yields from historically unattractive levels to a point where bonds now seem fairly valued if not somewhat attractive relative to other asset classes. This is especially true once an investor accounts for the historically low rate of growth for U.S. GDP. Assuming inflation is kept in check, the current low GDP growth will likely prevent interest rates from going materially higher.

Another macro factor that will continue to impact U.S. rates is the global geopolitical environment. Going forward, that piece of the puzzle, manifesting itself mostly in the currency market, will play a vital role in Fed policy decisions as well as the direction of U.S. interest rates. Since the end of the recession U.S. dollar strength has been met with consistent curve flattening. A flatter curve implies the increased likelihood of an economic slowdown in the future and also tends to drive the market towards a "risk off" atmosphere. As can be seen in the chart to the right that trend diverged in the fourth quarter. Assuming that divergence is unsustainable implies that either the dollar will have to weaken, a scenario that is unlikely given the current global trend in central bank policy and economic growth, or the curve will have to flatten from here. Of course, the relative trend in central bank policy and growth could reverse, which would likely lead to a weaker dollar, reducing the need for the curve to flatten in order for the two data series to converge.

A simple analysis of the rate spread between the 10 and 2-yr bonds and manufacturing activity (ISM) points to an interesting observation. As the chart to the right shows, any significant flattening of the yield curve (10YR MINUS 2YR) has historically been met with weaker ISM data about two quarters later. In turn, a weaker ISM caused market participants to price in declining interest rates in the future. Finally, monetary policy appears to be in line with the dollar, and the market is now closely aligned with the Fed as well. While runaway inflation cannot be precluded and interest rate predictions should be avoided, the preponderance of data suggests that delaying entry into U.S. intermediate bonds is likely a fool's errand. The cost of giving up income today in hopes of interest rates climbing tomorrow increases with each passing day. The longer one waits to invest in intermediate bonds the more interest rates need to increase to justify the loss of today's income.



Source: Bloomberg. Past performance does not guarantee future results.

THE MARKETS AND THE FED DISAGREE

In both the financial press and major media, reporting on how the markets responded to the election surprise has been nearly incessant. At times it may have seemed challenging to discern between news stories linking the election and the market's reaction from political editorializing, the latter more often blatant than thinly veiled.

That the equity markets rallied and fixed income retreated in the final two months is apparent. But, whether these moves are akin to the old adage to "buy on the rumor and sell on the news" remains to be seen. In this case, the "rumor" would be campaign promises, while the "news" would be actual policies implemented. If history can serve as a guide, particularly the amount of time it has taken previous administrations to implement new policies at the federal level, then the move of the past two months might be viewed differently.

This new view could take one of several forms. The current view, which for argument's sake is an overly enthusiastic response for a business friendly government, would characterize the rally as suspect. Alternative explanations could be a short covering bounce, rising inflation expectations (at least in the bond market's view), or mere routine seasonality. The truth should reveal itself over the coming months.

Our views on the near-term outlook for equities, defined as the next twelve months, stem from a belief that market prices should reflect current economic conditions and their recent trends; to be contrasted with investing principles that demonstrate a company's worth over the long run is the discounted present value of its future cash flows. Eight key economic measures are listed in the table. At year's end, two of these factors were bearish, five were bullish and one was neutral.

With more than 40 years of data, we think these metrics can help investors set realistic expectations, not establish specific predictions, for the coming year. These factors are not robust enough by themselves to time the markets, and we caution readers from doing so. We do feel, however, these measures are useful tools for linking the current economy with near-term equity results to frame meaningful conversations. Along with underlying economic principles, each is listed below and continues onto the next page.

• Fed Funds Policy – Historically when the Fed has most recently hiked short-term interest rates, more often than not equities have performed worse than average in the next 12 months. The opposite has also been observed, when the Fed has most recently cut, stocks have generally performed better than average.

ECONOMIC INDICATOR	LATEST	SIGNAL
FED FUNDS POLICY	0.75%	BEAR
STEEPNESS OF YIELD CURVE	1.95%	BULL
UNEMPLOYMENT RATE	4.60%	BULL
WTI OIL PRICE	$53.72	BEAR
S&P 500 INDEX	2238.83	BULL
S&P/CASE SHILLER HOME PRICE INDEX	191.79	BULL
PRODUCER PRICE INDEX	0.50%	BULL
PHILADELPHIA FED SURVEY	21.50	NEUTRAL

Source: Bloomberg

• Steepness of the Yield Curve – The difference between yields on the US 10 Year Treasury Note and Fed Funds, or 30 day T-Bills as a proxy, measures the steepness or slope of the yield curve. Inverted yield curves, when long rates are below short rates, have generally presaged weaker-than-average equity returns over the coming year.

• Unemployment Rate – When there are more workers this month compared to six months ago, equities have often returned more than average over the next 12 months. Falling unemployment rates can be viewed as a bullish sign.

• Oil Prices – Historically when oil prices rise significantly compared to last year, stocks have tended to underperform. It would seem that if oil prices rise modestly, consumers nationally cut back an amount roughly equal to the increased spending in oil producing regions. However, if oil prices rise too greatly, typically the threshold has been 20%, the boom times in the oil regions fail to overtake the slowdown in the rest of the country. A bullish sign is indicated when oil prices fall or rise less than 20% compared to the prior year.

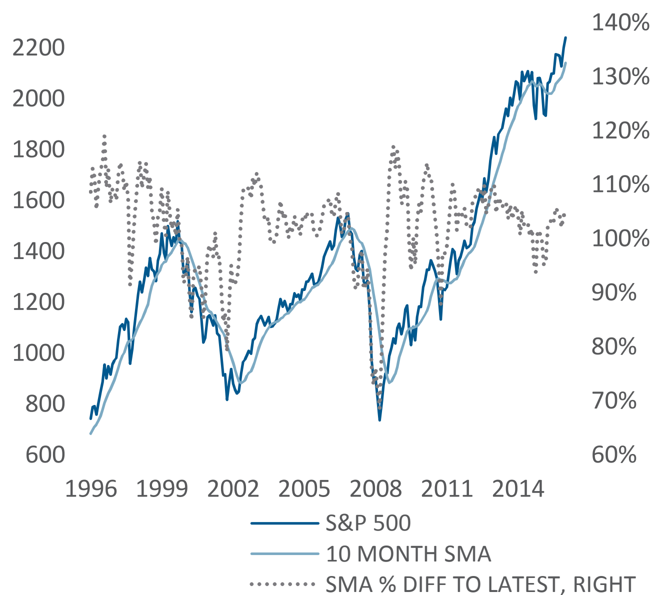
• S&P 500 – The relationship between the S&P500 and its trailing 10-month simple moving average (SMA10) is helpful to determine equity momentum.[1] When the latest monthly read on the S&P500 is greater than SMA10, momentum persists and the markets usually, but not always, head higher. When stocks fall below the SMA10, the decline can often continue.

• S&P/Case-Shiller Home Price Index – Economists have long held that rising home values induce consumers to spend and call this the wealth effect. Rising consumer spending could translate to higher corporate profits.

• Producer Price Index (PPI) – Inflation is long known to rob investors of return. Historically, when recent producer inflation has been less than average, equity returns 12 months out have been higher than average. Curiously enough, when we analyzed the data, we did not find a strong relationship between the Consumer Price Index (CPI) and stock returns.

• Philadelphia Federal Reserve Survey – This monthly survey of business owners has served as a rare, but strong contrarian indicator. When business owner optimism measures near pessimistic lows, equities often, but not always, returned more than average.

Taken individually each of these measures has economic merit. Taken together they give a broad view of the economy. This economic framework provides insights relative to the average 12-month equity return of about 8%, excluding dividends, over the past 40 years. Reviewing the indicators monthly can be helpful to understand whether the economic winds are against or with equity returns for the near term. Even when the economic winds are bearish, stocks can still have positive returns. On the other hand, despite favorable current economic conditions, routine equity volatility can result in stock price declines that ignore economic reality, especially for periods of a year or less. Often when stocks move against the economic winds, geopolitical factors have held greater sway. Such may be the case in 2017.



Source: Bloomberg. Past performance does not guarantee future results.

[1] "A Quantitative Approach to Tactical Asset Allocation", Mebane T. Faber, Journal of Wealth Management February 2009

ECONOMIC OUTLOOK

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	We expect the U.S. economy to expand at about a 2.0% rate in 2017 against a backdrop of heightened policy uncertainty.
Federal Funds Rate	Citing the potential for inflationary pressures in 2017, the median projection from FOMC governors is for three quarter point rate hikes in 2017.
Inflation	Core PCE inflation was 1.6% year over year in November compared to 1.4% a year earlier; a strong dollar could continue to cap domestic prices.
Employment	Without growth in the labor participation rate in 2017, we expect the U.S. unemployment rate to remain between 4.5% and 5.0%.
Consumer Confidence	U.S. consumers' outlook reached multi-year highs in December; the positive sentiment could be contingent upon the implementation of pro-growth policies.
Oil	A tentative deal between OPEC and Russia could support oil prices heading into 2017.
Housing	The housing recovery is likely to move slowly forward in 2017, as increased demand is offset by higher interest rates.
International Economies	The IMF sees subdued growth in the U.K. euro area and Japan driving subpar global GDP growth of 3.4% in 2017.

ASSET ALLOCATION	UNDERWEIGHT	NEUTRAL	OVERWEIGHT
Fixed Income		●	
Equities		●	
Alternative Investments			●

CURRENT OUTLOOK

We've re-set our fixed income allocation to neutral weight and have further increased our bias towards core, investment grade U.S. bonds. Within equities, we maintain our neutral weighting following the post-election rally and against a backdrop of heightened U.S. policy uncertainty. Given our expectations for increased periods of both bond and equity volatility in 2017, we've moderately increased our overweight to alternative investments. More conservative investment objectives will include greater weights to alternative investment strategies that best complement fixed income allocations. Conversely, more growth-oriented investment objectives will include greater weights to alternative investment strategies that best complement equity allocations.

FIXED INCOME	UNDERWEIGHT	NEUTRAL	OVERWEIGHT
Core Bonds		●	
TIPS			●
Non-Investment Grade	●		
International	●		

CURRENT OUTLOOK

We have increased our target allocation to core, investment grade bonds, but remain neutral due to our adoption of the BB BC Intermediate Government/Credit Index as our fixed income index. We recommend an underweight to below investment grade bonds amid a compression in spreads and an underweight to international bonds due to currency volatility risk. Finally, we recommend an overweight to TIPs in an effort to provide protection against rising interest rates in 2017.

EQUITIES	UNDERWEIGHT	NEUTRAL	OVERWEIGHT
Large Cap		●	
Mid Cap			●
Small Cap			●
Developed International	●		
Emerging Markets		●	

CURRENT OUTLOOK

Our outlook for U.S. equities remains positive relative to international equities amid concerns surrounding post-Brexit economic weakness in the U.K. and euro zone. We expect corporate tax reform and further U.S. dollar strength will disproportionately benefit mid and small cap U.S. equities relative to their large cap peers. Our outlook for international developed market equities is constrained by uncertainty surrounding Brexit negotiations and key 2017 elections in the Netherlands, France and Germany.

The above weightings represent the current tactical position relative to MainStreet Advisors strategic weights.

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NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			