

*“If you don’t read the newspaper, you’re uninformed. If you read the newspaper, you’re misinformed.”*

*- Mark Twain*

The fourth quarter was extremely eventful. The surprise Trump victory in the U.S. presidential election, coupled with the Republican sweep of both houses of Congress, had a profound impact on a global scale. Following the election, we experienced significant moves in equities, interest rates, currencies and commodities. In this edition of Viewpointe, we discuss how this event impacted our general economic, equity and fixed income market forecasts for 2017. We also examine what this means for our portfolios. We conclude with a discussion regarding the many choices we now have when it comes to filling up our tanks at the gas station.

## Economic Review - Trump Bump

The prospect for fiscal stimulus in the form of tax cuts, infrastructure spending and decreased regulation created an investment environment where the potential for improved economic growth and higher inflation dominated investor sentiment. We were surprised by the positive market reaction given the unexpected election outcome and the uncertainty that it created. In the days prior to the election, media sources overwhelmingly were pointing to a Hillary victory with the potential of the Democrats gaining power in the House and Senate. It was not until election night that the consensus view began to shift and the mainstream media began to discuss the possibility of a Trump victory and a Republican sweep.

The immediate equity market response was negative with the futures market plunging deep into negative territory on election night. This negative response was what many would have expected given the surprise result and the uncertainty that it created. The mood quickly changed when the U.S. equity markets opened the next day, shrugged off the election upset and pushed deep into positive territory. So, what happened? Why the positive market reaction to something that few anticipated? How did the markets get comfortable when there was little detail as to what Trump’s policy agenda may or may not include?

Ultimately, investors discounted the lack of detail and focused on the big picture themes that Trump covered throughout his candidacy. These big picture themes included increased infrastructure spending, lower taxes and decreased regulation.

All of these themes were pro-capital markets, and the markets responded favorably. In addition, Trump’s post-election statements have taken on a less controversial tone and he has backed off on some of his more controversial pledges. In short, the markets were taking comfort in the softer side of Trump that seemed to move closer to the Republican establishment.

At the present time we are actively monitoring how, or even if, many of the promises Trump made as a candidate actually transform into policy. We are concerned that investor sentiment may have become overly optimistic as to what will actually be implemented. While some of Trump’s initiatives will undoubtedly benefit the capital markets, it is important to remember enactment will take time. In addition, many of the policy initiatives will require substantial funding. While the Republican’s control Congress, many of its members are focused on a balanced budget. In short, we believe, as with any new president, many of Trump’s plans will take on a smaller scale than what was originally promised.

In conclusion, we have adopted a wait and see approach. While we believe several of Trump’s initiatives will boost U.S. economic growth it will take time for the impact to be felt. In addition, it is likely that there will be some substantial setbacks along the way. Until we get a better feel for the timing and scale of what is actually enacted, we are sticking with a conservative growth estimate of right around 2% for 2017. It is important to note that we are more optimistic as to the growth outlook for 2018. We believe several of Trump’s initiatives will be implemented toward the second half of 2017 and are thus more bullish as to the impact they will have in 2018. We would not be surprised if 2018 growth reaches 2.5% or higher.

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## Fixed Income Commentary - Déjà vu?

For the second year in a row, the Federal Reserve (Fed) hiked the Fed Funds Rate in December bringing the overnight lending rate to a range of .50% to .75%. Rewinding back to the December 2015 rate hike, the 10-year U.S. Treasury yield ranged between 2% and 2.4% in the months prior to the hike. Higher rate expectations were building in the lead up to the Fed's December 2015 hike. To add more fuel to the fire, the Fed's December 2015 dot plot projected four .25% rate hikes in 2016. At the time we were of the opinion that these higher rate expectations were overly optimistic and felt rates would actually drift lower.

We did not get very far into January of 2016 before our suspicions began to come true; 10-year U.S. Treasury yields quickly began to drop bottoming at 1.37% in early July. By Election Day, 10-year yields managed to climb to 1.88%, which although higher than the mid-year lows, was still significantly below the beginning of the year level of 2.24%. The Trump victory, however, quickly changed the dynamics of the fixed income markets.



The prospect of fiscal stimulus, in the form of infrastructure spending, decreased regulation and tax cuts created an environment with higher

expectations of growth and the potential for higher inflation. The combination of these factors was the recipe needed to justify higher interest rates, and higher interest rates are exactly what we received, with the 10-year Treasury hitting 2.6% in the latter half of December.

The million dollar questions at this point are whether or not interest rates will continue to rise, or switch direction and drift lower in 2017? Our response to both questions is yes. How do interest rates go up and down, you ask? Well, it is simply a question of timing. We are of the opinion that rates are likely to drift lower during the first half of 2017. Currently, we believe growth and inflation expectations are a bit premature. These expectations are likely to be tempered as the policy approval process drags on and the breadth of the initiatives is reduced. In addition, even after implementation, it may take a quarter or two before we start to see measurable results. This scenario leaves us in a position where we will likely experience more muddle through growth for the first half of 2017.

As this scenario plays out it should place downward pressure on interest rates as investors begin to question

whether higher growth and inflation will actually take hold. As pro-growth policies are implemented in the second half of 2017 investor confidence should once again build. Increased confidence coupled with an uptick in growth as the result of policy implementation should lead to higher rate pressure toward the second half of the year.

The degree rates will rise greatly depends on how much the Trump administration is able to get implemented during 2017 and the timing of the implementation. While at the present time we are confident that policy will be enacted that boosts second half 2017 growth, the breadth of that policy is still uncertain and thus its impact is unquantifiable. If implementation surprises on the upside, growth and inflation expectations are likely to build and we will see more upward rate pressure. If implementation surprises on the downside, rates will face downward pressure as growth expectations begin to fizzle. Currently, we are anticipating enough policy implementation to slightly boost growth in 2017 with a larger boost in 2018. In conclusion, while we expect rates to go up a bit in 2017, we expect higher rates to be more of a 2018 event.

## Equity Commentary - Higher Earnings on the Horizon

As it stands today, the post-election equity rally ranks as one of the top four best in history. Up until Election Day the S&P 500 increased approximately 6.5% on a total return basis (price and dividend). With the consensus expectation of a Hillary victory going into Election Day it appeared at that time that we were on track to finish the year with an S&P 500 return in the mid to upper single digits. This return level was in range with what we anticipated going into the year. Up until that point domestic equity returns were being nudged higher by a sprinkling of positive economic reports and continued easy monetary policy.

The surprise Trump victory sent a shockwave through the domestic equity markets, resulting in an upside surprise. While the immediate market reaction to the possibility of a Trump victory was negative, when the markets opened the morning after Election Day it was off to the races. Positive equity market momentum has been fairly consistent ever since, with the S&P 500 returning roughly 6% between Election Day and December 19th.

So, why the big equity market run? Strategas Research Partners, one of our premier research providers, sums it up as follows: "U.S. Gross Domestic Product (GDP) had been trending around 2% for the most part since the Great Recession. In 2016, we experienced an extremely soft first half of the year that tempered growth expectations and led many to question whether we were

entering a slower growth phase. This created rather low expectations for equity market returns.”

It is important to note that 2% real GDP in the U.S. is the breakeven point for corporate profits. When economic growth falls below 2%, corporate profits decline leading to business cycle risk. The Trump victory and the accompanying fiscal stimulus that it is expected to entail provide a much needed boost to growth expectations. Domestic stocks rallied under the assumption that if economic growth improves corporate earnings and revenues should follow. The reason being is that when you purchase the stock of a corporation, you are ultimately purchasing the corporation's future earnings. If you believe earnings are going to rise, it seems to follow that you should be willing to pay more for the stock.

Since the election we have seen several of the research shops that we follow increase their S&P 500 earnings estimates for 2017. This increase in earnings expectations has boosted investor sentiment. We are seeing investors flock to a multitude of stocks that are expected to benefit from the anticipated policy changes. While we anticipate this enthusiasm to wane during the first half of 2017, we think it will reinvigorate as Trump's stimulus policies kick in and start to positively impact economic growth

## Asset Allocation - Adjusting to a New Landscape

We did not make any changes to our Lakepointe Classic or Premier models during the fourth quarter. As stated in the last edition of Viewpointe, we trimmed our equity exposure in mid-August in anticipation of a pullback in the equity markets. A pullback in fact occurred and lasted up until Election Day, and then the landscape quickly changed. The good news is we only reduced our equity targets by 2%. The surprise Trump victory demonstrated the importance of not making “bet the farm” moves in the current environment of non-consensus outcomes. While we missed out on a bit of gain from reducing our equity position this was counterbalanced by the run-up that we saw in our small-cap and mid-cap equity positions, which we trimmed to a lesser degree.

The investment landscape changed dramatically since Election Day and we plan on implementing a new portfolio strategy in our mutual fund fixed income model in response. We plan on increasing our portfolio duration early in the first quarter of 2017. We are of the opinion that rates have gotten a bit ahead of themselves and expect them to pullback during the first half of 2017. A longer duration will help us capture a bit more market value appreciation in a decreasing rate environment. It is important to note that we will still stick with a duration that is shorter than the Barclay's Aggregate Bond Index. As the year progresses, we plan on re-implementing a shorter

duration as long as our forecast for higher rates as the year goes on remains intact.

The larger potential portfolio shift is occurring on the equity side of our equity mutual fund model. With all of the talk regarding whether or not an active or a passive fund approach is better; we conducted a thorough analysis of our mutual fund equity portfolios. In conducting this analysis we compared the historical performance of our present fund managers in the large-cap, mid-cap, small-cap and international spaces to their corresponding asset class index fund. We conducted this analysis based upon historical returns going back to 2008. The results showed that our present strategy in the mid-cap, small-cap and international spaces outperformed the index strategy overall. As a result, we decided to stick with our present strategy.

In the large-cap space it was however a close call with our current strategy being pretty much in-line with index performance. This outcome convinced us to dig a little deeper in terms of coming up with an alternative strategy for this portion of our portfolios. Ultimately, we ended up looking at several different alternatives before we concluded that the one which held the most promise was the combination of an S&P 500 index fund and an enhanced index product offered by Doubleline Investments. Over the last nine years our back testing showed that the combination of these two offerings would have outperformed our present strategy. We plan on taking our findings to our Investment Committee and will keep you posted as to our final determination regarding this matter.

## Financial Planning - Gas Pump Conundrum

Do you ever get overwhelmed by the amount of choices you have to make on a daily basis? Do you ever reminisce about the “good old days” when you had just one or two options and that was enough? Today we are faced with a myriad of choices that not long ago seemed trivial and did not require an hour of research on the Internet in order to make a decision. A recent trip to a local gas station provided me with a good case in point. The station's new pumps now offered six choices of fuel. In addition to diesel, and the regular, mid-grade, and premium gasolines they now offered E85 and E15. While I knew E85 was fairly widespread, this was the first time I had seen E15.

Ultimately, since I drive a vehicle that is flex fuel compatible it got me thinking that I might be missing out on something. As a result, I decided to conduct a little research on the different fuel options. When making a choice at the pump, perhaps the easiest fuel to isolate is diesel. If you own a diesel vehicle odds are you know it and the only choice you really have is between traditional



diesel and bio-diesel. Since bio-diesel is scarce in many regions, if you drive a diesel the choice is rather simple.

Moving on, the next easy fuel to isolate is E85

which simply means the fuel contains approximately 85% ethanol. E85 compatible vehicles (also known as flex fuel vehicles) started to become more widespread beginning around the year 2000. If you drive a vehicle that predates 2000, odds are that it is not E85 compatible. Vehicles that were produced after the year 2000 will state whether or not they can use E85 in their owner's manual or will typically have a notation on the dash or around the gas cap. Even if your vehicle can utilize E85, something to take into consideration is that E85 is approximately 20-25% less fuel efficient than traditional gasoline. This is typically the determining factor in making the decision between E85 and traditional gasoline. From a financial perspective, E85 needs to be 20-25% cheaper than traditional gasoline before it makes sense.

While discussing ethanol it probably makes sense to discuss E15 which contains up to 15% ethanol. While E15 can be used in some non-flex fuel vehicles, its use is still pretty restricted. The reason being is that it burns hotter than traditional gasoline and is more corrosive. In short, unless your vehicle is made for higher ethanol concentrations, utilizing E15 can cause engine damage. My research showed that it would be rare to find a non-flex fuel vehicle built prior to the year 2012 that was E15 compatible. Once again, perhaps the best way to determine if E15 is safe for your vehicle is to consult your owner's manual or your local auto dealer. It is also important to note that E15 typically provides about 5% less fuel efficiency than traditional gasoline. This, once again, needs to be factored in when deciding whether E15 makes sense.

From here, we move onto the three primary choices of traditional gasoline. The three primary choices include: "Regular" (87 octane), "Mid-grade" or "Plus" (88-90 octane) and "Premium" (91-94 octane). The key differentiator between the grades lies within the different octane ratings. Octane ratings deal with how much pressure the fuel mixture can be exposed to before igniting. Simply put, the higher the octane level the more pressure the fuel mixture can withstand prior to igniting. In the old days, this was very important because older

cars could not adjust to fuels with varying octane levels. If you used the wrong fuel the engine would knock or ping, because the fuel mixture ignited prematurely. This could result in permanent damage to the engine.

Modern engine control systems have the ability to compensate for low octane by monitoring knock activity and making the appropriate ignition adjustments. This sophisticated electronic adjustment capability effectively adjusts the engine on the fly and provides a great deal of flexibility in terms of the grade of fuel that can be used. As a result, oftentimes drivers of modern cars receive no material advantage from utilizing higher grade fuel over just standard regular.

Ultimately, the key is to determine whether your vehicle merely "recommends" premium gasoline or "requires" it. Once again, this information should be found in the owner's manual. Typically, regarding cars manufactured in the last ten years, only high performance and/or luxury vehicles require premium gasoline. In the event premium is required by the manufacturer, you should follow the manufacturer's direction.

You have more discretion when premium is simply "recommended" by the manufacturer. Typically such recommendations are based upon prevention of engine build-up and/or superior gas mileage. While premium used to contain detergents to prevent engine build-up, and regular did not, that has all changed as a result of EPA requirements. The EPA currently requires that all gasoline contain detergent to prevent engine build-up. Even though some brands contain more than others, most experts say that there is no concrete data showing that this provides a benefit.

Regarding gas mileage, vehicles differ as to whether premium increases gas mileage materially or not. The best thing to do is to run a test on your own vehicle. To do this, simply select a trip that you repeat on a frequent basis where you drive for a few hours. Drive the trip a few times using a full tank of regular gasoline and calculate your miles per gallon and cost per mile. Then, repeat the same trip using a full tank of premium gasoline and perform the same calculations. Simply do a comparison and determine if you see an increase in miles per gallon by using premium gas and whether your cost per mile justifies using premium.

In conclusion, the simple task of filling up your vehicle has become much more complicated than it once was. Today we are faced with a multitude of choices. By identifying the appropriate fuel type and making an informed decision, you can minimize your transportation related costs. Happy driving!