INNOVEST MONTHLY MARKET COMMENTARY

December 2016

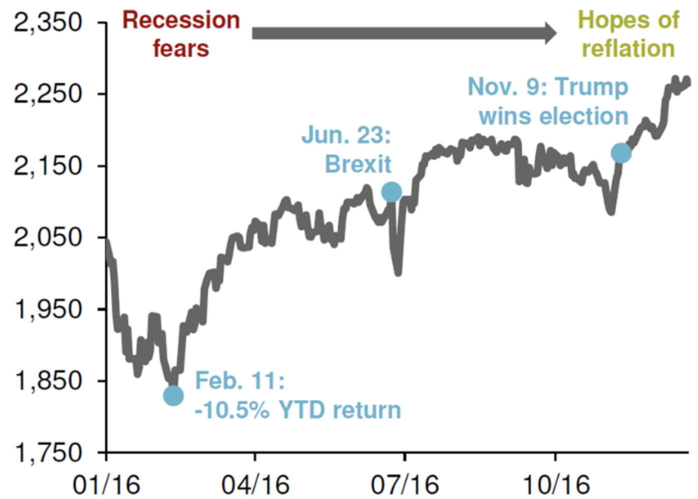
Equities Finish on Top

In a year that was anything but ordinary, from Brexit to the contentious US presidential election, markets largely remained resilient. Domestic equities withstood the turbulence, with the Dow Jones Industrial Average and S&P 500 Index posting robust annual gains of 16.50% and 11.96%, respectively. Both indices, especially the Dow and its industrials and financials heavy composition, reacted to Trump's election and Republicans maintaining majorities in the House and Senate. In the 5 weeks following Election Day, the Dow swelled 8%, its largest gain ever following a presidential election. While the Dow's pursuit of reaching the 20,000 mark for the first time fell just short in 2016, a new year of potential upside and challenges lies ahead. The post-election rally that boosted US equities was arguably fueled more by speculation than tangible fundamentals. Only time will tell whether the equity-boosting prospects of tax cuts, deregulation, and fiscal spending will come to fruition.

US Equity 2016 Timeline

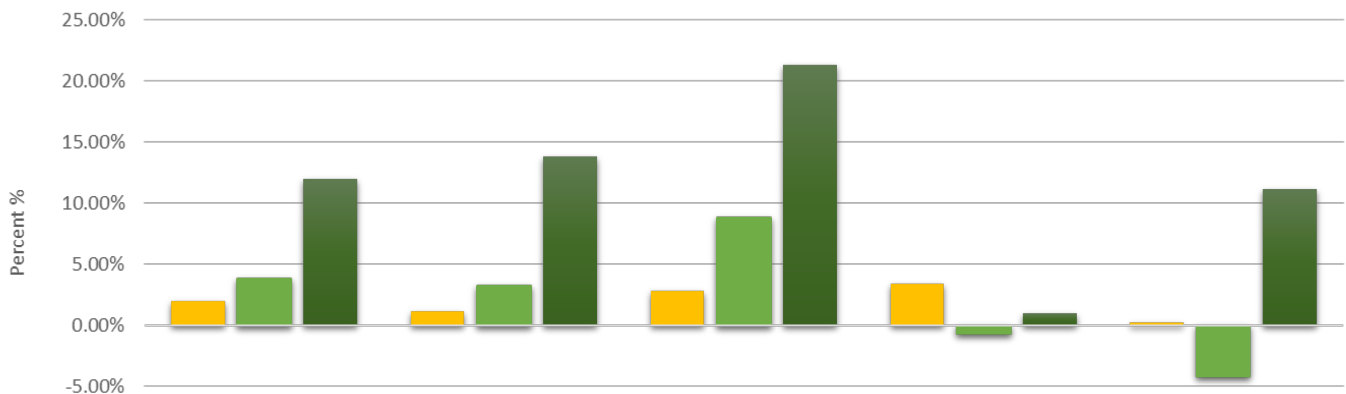
Major events in 2016 and the S&P 500

S&P 500 price index



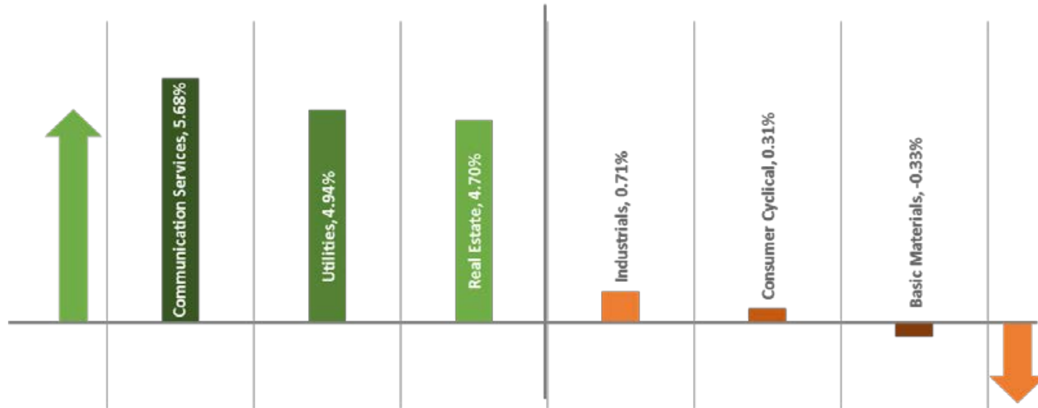
Source: JP Morgan

EQUITIES



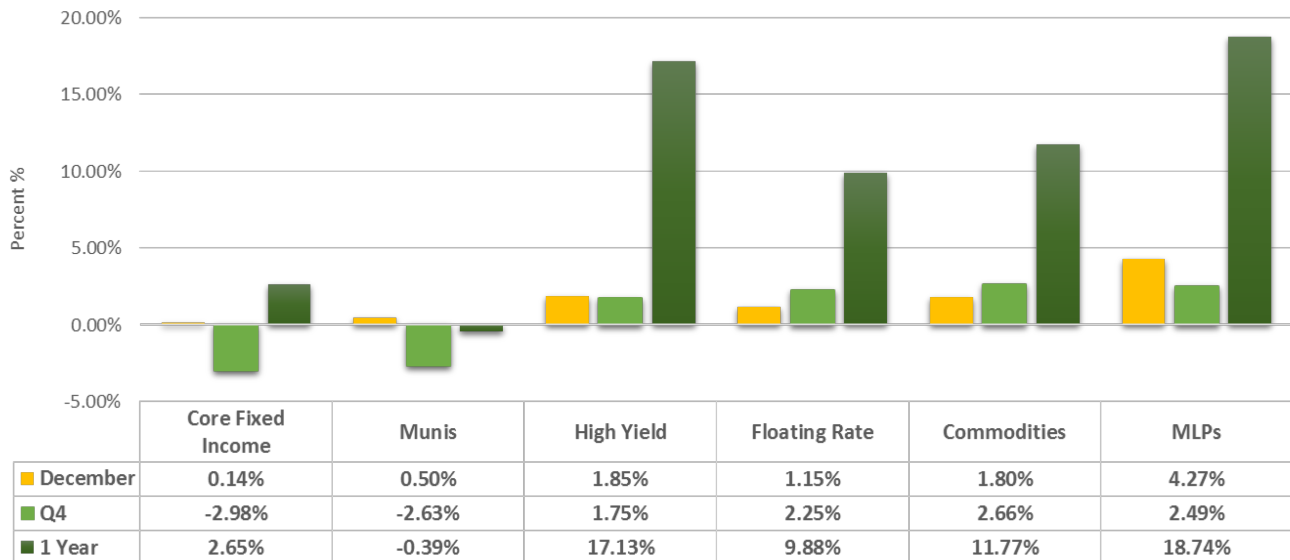
	Large Cap	Mid Cap	Small Cap	International (Dev.)	Emerging Markets
December	1.98%	1.14%	2.80%	3.42%	0.22%
Q4	3.82%	3.21%	8.83%	-0.71%	-4.16%
1 Year	11.96%	13.80%	21.31%	1.00%	11.19%

Benchmark Indexes: Large Cap - S&P 500; Mid Cap - Russell Mid Cap; Small Cap - Russell 2000; International (Dev.) - MSCI EAFE; Emerging Markets - MSCI EM.



Flying High (Yield)

Among the fixed income markets, high yield continued to lead the pack, increasing 1.85% in December and an enormous 17.13% for the year. As of year-end, the high yield default rate was 3.6%, landing below the long-term average of 3.9%, according to data from JP Morgan. Meanwhile, the election-induced selloff in investment grade and longer duration bonds was partially quelled in December, with core fixed income and municipal bonds generating measly monthly returns of 0.14% and 0.50%, respectively. Post-election flow of assets out of bonds and into equities has resulted in slightly elevated bond yields relative to the recent past, given the inverse relationship between bond yield and price. The yield on the 10-year Treasury concluded the year at 2.45%, dramatically higher than its record low of 1.37% reached in July.

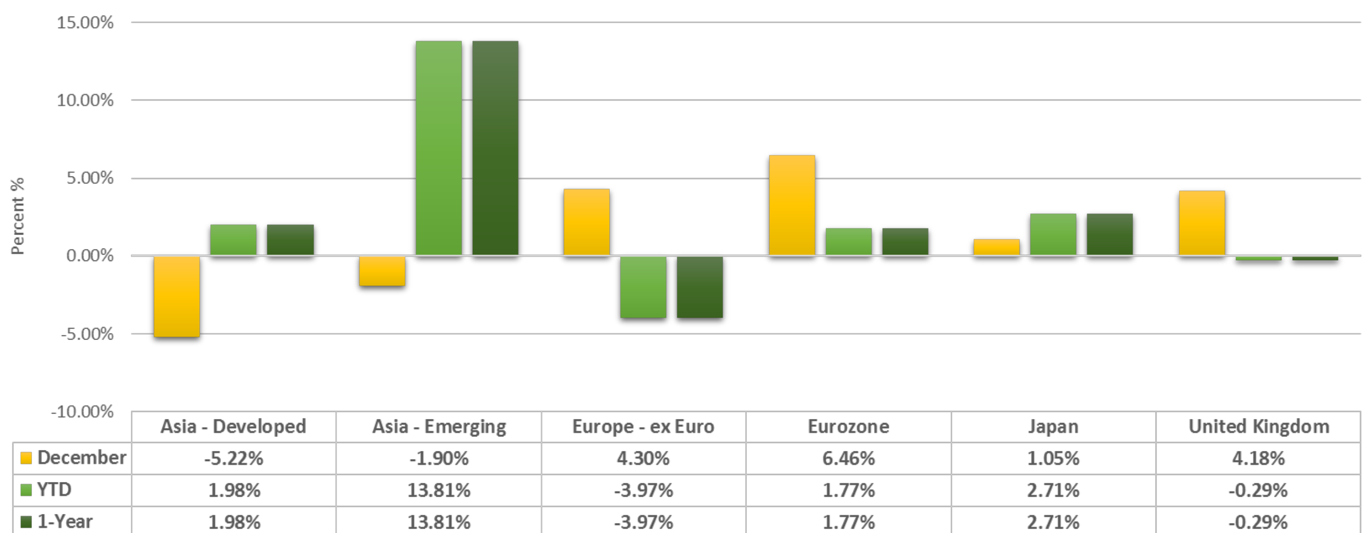


	Core Fixed Income	Munis	High Yield	Floating Rate	Commodities	MLPs
December	0.14%	0.50%	1.85%	1.15%	1.80%	4.27%
Q4	-2.98%	-2.63%	1.75%	2.25%	2.66%	2.49%
1 Year	2.65%	-0.39%	17.13%	9.88%	11.77%	18.74%

Benchmark Indexes: Domestic Fixed Income - Barclays US Agg; Municipal Bonds - Barclays 4-6 Yr Muni; High Yield - Barclays US Corp. HY; Floating Rate – CSFB Leveraged Loan Index; Commodities - Bloomberg Commodity; MLPs - Alerian MLP Infrastructure.

Let it Flow

At the beginning of 2016, MLPs were flailing and some believed positive returns were merely a pipe dream. By year-end, MLPs rebounded, surging 4.27% in December and 18.74% for the year. Commodities followed suit, overcoming a meager start to the year by posting a 2016 gain of 11.77%. Crude oil spearheaded commodity returns in 2016. The benchmark West Texas Intermediate crude closed the year at $53.72 a barrel, marking a 45% increase for the year and its largest annual gain since 2009. Heading into 2017, crude oil's prospects of remaining above $50 a barrel will largely depend on curbing production levels. OPEC's compliance, or potential lack thereof, with production cuts agreed upon in November 2016 will impact crude prices in the New Year.



	Asia - Developed	Asia - Emerging	Europe - ex Euro	Eurozone	Japan	United Kingdom
December	-5.22%	-1.90%	4.30%	6.46%	1.05%	4.18%
YTD	1.98%	13.81%	-3.97%	1.77%	2.71%	-0.29%
1-Year	1.98%	13.81%	-3.97%	1.77%	2.71%	-0.29%

Take a Hike

Finally! In a year originally forecasted to include 4 rate hikes, the US Federal Reserve waited until December to log the lone federal funds rate hike of 2016. For the second straight December, the US Federal Reserve raised the federal funds target by 0.25%, to a range of 0.50%-0.75%. The Federal Open Market Committee (FOMC) sanctioned the rate hike citing improving labor market conditions and modestly rising inflation, although inflation remains below the FOMC's 2% long-term target. While markets anticipated the rate hike, the FOMC unexpectedly increased its projected number of 2017 rate hikes from 2 to 3. As illustrated by the disconnect between the Fed's initial expectations and its actions in 2016, a hawkish prognosis for 2017 is best taken with a grain of salt. Nonetheless, the FOMC's decision to increase the federal funds rate signals an improved outlook on the US economy and acceptance that the economy may no longer need emergency, low interest rates.

Across the Atlantic, the European Central Bank (ECB) also concluded 2016 with a last hurrah, though of a different nature. In December, the ECB announced a decision to extend its bond-purchasing program through 2017, while reducing its monthly purchase volume beginning in April. In addition, the ECB altered its quantitative easing (QE) program in order to broaden the universe of bonds available for purchase. Mario Draghi, President of the ECB, contested that the curtailing of bond purchases beginning in April does not imply 'tapering' of the ECB's quantitative easing (QE) program. While the

ECB's intentions remains cryptic, the bank maintains the flexibility to modify its QE program in response to changes in the economic landscape.

Chalk up another victory for global populism. On December, 4, Italians voted 59% 'No' in a referendum for constitutional reform. Matteo Renzi, the former Italian Prime Minister, fervently supported the bill that proposed a shift in power from the Italian Senate to the Italian Parliament. Renzi resigned as Prime Minster following the bill's resounding defeat. Italian populist parties, led by the Five Star Movement, were the greatest beneficiaries of the 'No' vote. The growing influence of the Five Star Movement in Italy may also pose a risk to European Union stability moving forward.

'16 Going on '17

At market close on the day before Brexit and Trump's election, the S&P 500 had generated year-to-date returns of 3.14% and 6.19%, respectively. Investors spooked out of domestic equities by either event became spectators to the bulk of the S&P 500's 11.96% return for the year. At Innovest, we believe that market timing is a feeble endeavor and recommend staying the course. We will continue to recommend a long-term, diversified investment approach into 2017 and beyond. Please do not hesitate if you have questions or concerns regarding your portfolio.