PMA™
PRUDENT MAN ADVISORS

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# MARKET OUTLOOK


## Highlights

PMA's outlook called for higher volatility and a wider range of potential market returns during 2016. Our expectations came to fruition on a number of fronts this year as volatility was certainly back in vogue. While both the bond and equity markets have experienced positive returns thus far, US Treasury returns have recently dropped to the low single digit return levels we forecast coming into the year. Meanwhile equity volatility had increased in the run up to the election, only to see implied volatility decline and valuations surge after Donald Trump's surprise November victory. It has been a massive turn of events and one which has potentially brought forward some of the positive equity and negative fixed income returns we were anticipating in the future. The capital markets had been experiencing strong returns up to the election due to a number of factors including an inactive Fed, increased risk taking and a presumed Clinton victory. However, following the U. S. presidential election surprise, fixed income returns declined precipitously as interest rates moved higher due to perceived inflation risks and the expectation for a more active Fed in 2017. Equity markets swiftly moved higher on the potential benefits of President-elect Trump administration's policies and priorities.

| 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| S&P 500 Stocks 15.06% | Taxable Municipal Bonds 20.91% | S&P 500 Stocks 16.00% | S&P 500 Stocks 32.39% | Taxable Municipal Bonds 16.29% | S&P 500 Stocks 1.38% | High Yield Bonds BB 11.62% |
| High Yield Bonds BB 14.93% | Portfolio Mix 10.96% | High Yield Bonds BB 14.36% | Portfolio Mix 5.52% | S&P 500 Stocks 13.69% | Taxable Municipal Bonds 0.93% | S&P 500 Stocks 9.79% |
| Portfolio Mix 9.95% | US Treasury Bonds 9.79% | Portfolio Mix 11.62% | High Yield Bonds BB 5.19% | Portfolio Mix 12.06% | US Treasury Bonds 0.83% | Portfolio Mix 6.21% |
| Inv Grade Corp Bonds 9.52% | Inv Grade Corp Bonds 7.51% | Taxable Municipal Bonds 11.08% | Inv Grade Corp Bonds (1.46%) | Inv Grade Corp Bonds 7.51% | Portfolio Mix 0.49% | Inv Grade Corp Bonds 5.30% |
| Taxable Municipal Bonds 7.31% | High Yield Bonds BB 6.12% | Inv Grade Corp Bonds 10.37% | US Treasury Bonds (3.35%) | US Treasury Bonds 6.02% | Inv Grade Corp Bonds (0.63%) | Taxable Municipal Bonds 5.27% |
| US Treasury Bonds 5.88% | S&P 500 Stocks 2.11% | US Treasury Bonds 2.16% | Taxable Municipal Bonds (5.42%) | High Yield Bonds BB 5.34% | High Yield Bonds BB (1.04%) | US Treasury Bonds 1.26% |

(Table 1: 2010 thru 11/2016) (Portfolio Mix: 25% Equities/75% Diversified Fixed Income)

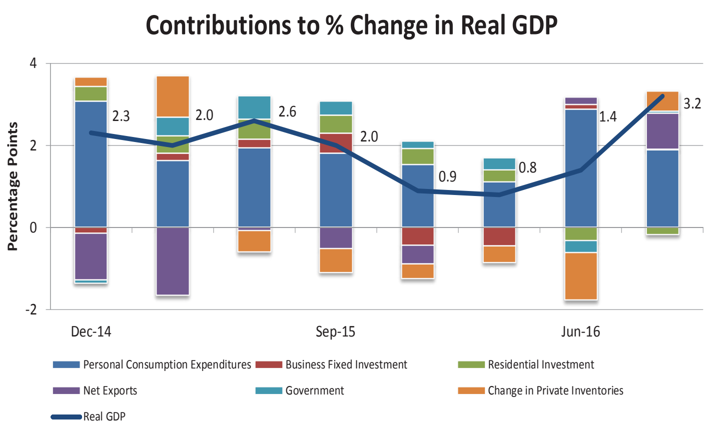
Overall, risk assets have set the pace for returns thus far in 2016 as equity returns have vastly outperformed our forecast for modest single digit returns. (Table 1) While we expected equities to outperform bonds we didn't believe the difference would be quite this large in 2016. Consistent with our outlook, credit sectors did outperform US Treasuries during the year as credit spreads tightened due to stronger commodity prices and positive, albeit modest, domestic economic growth. The high yield sector has done particularly well during 2016 as the rise in oil and gas prices significantly improved the credit profile of many issuers who fall into this category. Investment grade corporate bonds have also done very well during the year following a difficult 2015. While tax-free municipal bonds have experienced significant pressure over the past month, taxable municipal bonds have performed in line with investment grade corporate bonds through November 2016. The persistence of the market has certainly been impressive, overcoming significant volatility related to the BREXIT vote in June and the U.S. Election in November, and providing investors with returns we would love to see again in 2017. Unfortunately, against the backdrop of continued slow economic growth and the prospects of much tighter monetary policy, we anticipate limited returns in U.S. fixed income and a wider range of potential equity returns in the year ahead. (Table 2) Our outlook is made significantly more difficult by the potential priorities and policies of the upcoming Trump administration. President-elect Trump's action or inaction on a number of fronts could lead to divergent outcomes for the U.S. markets and economy. As prudent investors, we never like to finance change. Given the recent upswing in the U.S. economy, we need to remain wary that upcoming policy changes will likely increase market and economic risk in the coming years. Cash returns look increasingly attractive in our estimates.

| 2017 PROJECTED RETURNS | BASE | UPSIDE | DOWNSIDE |
|---|---|---|---|
| Cash Returns | 1.00% | 1.50% | 0.75% |
| US Treasury Returns | 1.15% | 3.00% | -2.00% |
| IG Corporate Returns | 2.00% | 4.00% | -3.00% |
| US Equity Returns | 5.00% | 12.00% | -10.00% |

Table 2 (Gross Projected Returns)

## U.S. Economic Outlook

While we believe the U.S. economy has been stuck in a period of secular stagnation, the potential effects of Trump's policy initiatives will impact the course of the domestic economy. In our midyear outlook, we discussed how we believed increased hostility toward the elite and the establishment power was coming back into vogue. Frustration over incomes, living standards, immigration and changing cultural norms were clearly evident here in the U.S. during the presidential election. Social discontent, while difficult to objectively measure, appears to be growing abroad as well. The rise of nationalism and growing anti-establishment populism are more common place and accepted. We do not see these polarizing forces receding in the foreseeable future. Populist movements are alive and well across most of Europe following the BREXIT vote and U.S. election result. We have a busy European election/referendum calendar in the year ahead with populist platforms gaining popularity in Spain, France, Italy, Austria, Hungary, Germany, the Netherlands and the Czech Republic. Politics are an important component of any economic outlook as potential policy changes feedback directly into the real economy and the capital markets. For example, increased economic and market volatility could be detrimental for credit expansion, a necessary condition for the U.S. and global economies to get back to trend growth rates. Likely U.S. policy changes might include issues such as international trade, financial regulation, healthcare, labor and corporate taxes. Negative feedback into the manufacturing, housing, service and government sectors might derail the mid to late-cycle economic upswing we have been experiencing recently. Conversely, expansionary, fiscal stimulus and reduced regulation could spur spending and capital investment which could more than offset the potential risks of doing nothing. It is our hope that policies will be more about deregulation and tax cuts than protectionism or huge spending. We know that in economics and markets, things take longer to happen than you think they will, and then they happen faster than you thought they could.




Graph 1

Despite the slow growth during this current economic cycle, we think there is a low probability of a recession in the next twelve months. Given the increased likelihood for fiscal stimulus next year, it is very possible that any potential recession could be pushed out another two to three years. A continued long, slow cycle remains our base forecast. On a fundamental basis, we were happy to see GDP bounce back above 3.0% in the 3rd quarter. Despite the recent strength, we are only forecasting 2.0-2.5% growth again next year as the economy should continue its slow growth trajectory. Growth in personal consumption continued to lead the way during 2016 with net exports providing more of a positive contribution during the most recent quarter. Anemic business investment continues to be a sore spot for the economy, which has been especially problematic within the manufacturing sector. Perhaps President-elect Trump's policies and a roll back in regulation can spur future investment and economic growth. The growth we have seen in the housing sector has continued to moderate, recently made more difficult by the higher rate environment. Current mortgage commitments rates are above 4.0%, an increase of over 50 basis points during the past month. That's a payment increase of approximately $100 a month for a $300,000 mortgage, not an insignificant amount for middle class worker. And while credit standards have been easing, many consumers continue to hold back spending for savings as memories of the credit crisis remain firmly entrenched.

The labor picture remains constructive overall for the US economy. While we would expect unemployment to continue to move lower in 2017, there are declining incremental benefits to GDP given we are already close to full employment. Labor participation rates have limited upside given fundamental demographic changes within our society. Certainly the Federal Reserve has achieved its goals in this regard and the Fed can tick the box on inflation now as well. While inflation levels continue to run below the 2% FOMC target level, forward inflation expectations have moved higher over the past month. The FOMC watches this measure very closely. While we believe US dollar strength and tighter monetary policy will constrain inflationary pressures to some extent, inflationary pressures are something we need to watch very carefully in 2017. As risk managers, it is important to keep in mind how inflation can hurt real spending power and asset values.

| ECONOMIC PROJECTIONS | 2017 |
|---|---|
| US Real GDP | 2.25% |
| US Headline CPI | 2.25% |
| US Unemployment Rate | 4.60% |

Table 3

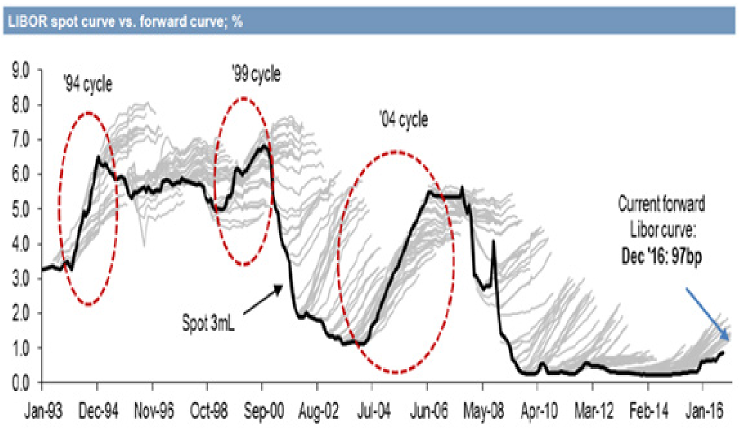
## Expected Returns

The Federal Reserve increased the federal funds rate in December by 25 basis points. This was the first rate increase since December 2015 and only the second in over 10 years. The Federal Reserve is projecting up to three more tightening actions in 2017 followed by additional increases in 2018 and 2019. As the Fed tightens policy, short-term rates should drift slowly higher. Our experience informs us that the front end of the yield curve tends to trade off of economic expectations, while the long end of the curve tends to value itself based on inflation expectations. We forecast a flatter yield curve in 2017 as the curve responds to the more hawkish Fed policy. As a result, we forecast Treasury returns to remain modestly positive in the year ahead with the risk that longer Treasury returns turn negative on a total return basis.

| | CURRENT / SPOT | PMA FORECAST 12/30/17 | EXPECTED RETURNS |
|---|---|---|---|
| 1YR UST | 0.86 | 1.20 | 0.86 |
| 2YR UST | 1.16 | 1.50 | 1.05 |
| 3YR UST | 1.46 | 1.80 | 1.25 |
| 5YR UST | 1.90 | 2.35 | 1.10 |
| 10YR UST | 2.47 | 2.75 | 0.75 |

Table 4

Cash and Ultra Short market returns are looking increasingly attractive on a relative risk/return basis versus comparable markets. The SEC's 2a7 money market reform in October 2016 and related fundamental and technical factors have made this segment of the market more attractive than it has been for the better part of the past decade. In addition, yields and spreads are attractive on a relative basis versus longer securities and the shorter maturity characteristics in this sector limit price volatility. Historically, the market tends to under-predict higher cash rates (LIBOR) prior to Fed hiking cycles and over-predict yields the rest of the time. (Graph 2) Higher short-term rates than currently predicted will benefit cash and ultrashort-term investors.

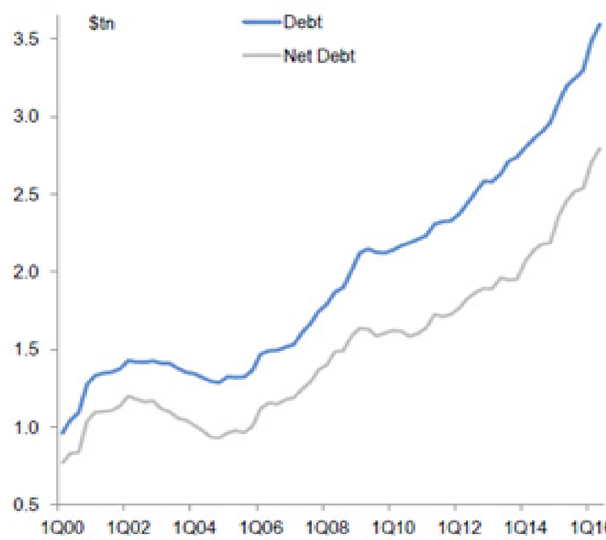


Graph 2 Source: J.P. Morgan

## CREDIT

While we believe we are in the mature bull stage of a credit market, we do not believe that the market is primed for a material correction yet in 2017. High quality investment grade spreads remain relatively attractive on an expected return basis versus similar maturity U.S. Treasuries. On a fundamental basis, while sales and earnings growth for U.S. corporations have been relatively weak, we would expect growth to improve over the next year for many industries. It is important to note that different industries are at different points in the credit cycle. While the banking industry is just entering a bull market, retail industry credit fundamentals have been deteriorating. The current credit cycle expansion has already been longer than we normally experience although risk premiums indicate the current expansion could last several more years. That said, corporate leverage has increased over the past year and interest coverage measures have deteriorated somewhat. This has been driven by active bond issuance combined with modest earnings growth. While investment grade non-financial credit fundamentals are unlikely to improve in the near term, stronger profit margins and earnings are expected to improve slightly in the year ahead. Positive technical factors from negative net supply and continued global quantitative easing should help credit spreads as well. Risk premiums were significantly lower overall two years ago versus where we are today. Spreads should remain relatively unchanged over the course of the year. As prudent investors, we do prefer higher quality companies at this point in the cycle and, as was the case this year, sector considerations will be of particular importance in generating relative performance. U.S. policy uncertainty, a stronger U.S. dollar, geopolitical shifts as well as the potential impact of new anti-trade measures are risks we are watching very closely. We do not think this is the point in the cycle to reach for yield.

Total Debt of High Grade companies continues to increase



Graph 3 Source: Capital IQ, Bloomberg, J.P. Morgan

## MUNICIPALS

Municipal spreads have continued to tighten along with the corporate market year-to-date. High quality taxable municipal bonds are trading slightly ahead of comparable rated corporate debt but slightly behind similar bullet agency debentures. While a further correction in the tax exempt municipal market may create attractive relative value opportunities, the taxable municipal market is relatively rich. Changes in tax policy present a huge technical risk for the tax exempt sector in 2017. If the personal and corporate tax rates are indeed cut, demand for municipals is likely to decrease. From a fundamental credit perspective, the outlook for municipal credit quality is more uncertain compared to past business cycles. We see a bifurcated market potentially developing as it relates to credit quality. While the majority of issuers still possess stable to improving credit profiles, several larger issuers have seen their credit profiles deteriorate or become structurally imbalanced. There is significant variance in credit risk across certain state and local governments who have large unfunded pension obligations and suffer from political dysfunction. As taxable municipal supply of $40B is expected in 2017, we continue to emphasize larger deals and higher quality issuers when possible within our portfolios.

## U.S. AGENCIES

Agency spreads have tightened over the past several years as net supply has decreased. In general, agencies have preferred issuing callable Agency debt to fund their portfolios versus issuing bullet debentures. Callable agencies generally trade rich versus comparable maturity bullet agency issues when one accounts for the value of the imbedded call option. Many investors don't have the tools or experience to correctly value callable Agencies. Diminishing supply and the lack of high quality investment alternatives have combined to push bullet agency spreads tighter to similar maturity Treasury paper. Agency discounts trade flat to Treasuries when adjusting for liquidity. While we don't see a lot of value on Agency spreads at present, we prefer selective longer Agency bonds. Generic global benchmark agency bonds are most attractive during the new issue period as secondary spreads tend to tighten quickly to the curve following new issue. We remain neutral on agency mortgages as we remain concerned on potential supply and extension risk which could negatively impact returns. We continue to like the relative value seen in certain segments of the Agency CMBS market.

## 2017 EXPECTED NET SUPPLY

| | Total | Discounts | Long Term | Bullets | Callables |
|---|---|---|---|---|---|
| FNMA | -40 | 10 | -50 | -50 | 0 |
| FHLMC | -40 | -5 | -35 | -40 | 5 |
| FHLB | 50 | 45 | 5 | -5 | 10 |
| Total | -30 | 50 | -80 | -95 | 15 |

Table 5. Source: JPM, FNMA, FHLMC, FHLB

## U.S. EQUITIES

We would expect to see continued volatility and some large price swings in the equity markets in the year ahead. Overall, we believe stock returns will remain positive given our economic outlook and the prospect for earnings growth in the year ahead. We would assume that some of the Trump administration's proposals will be enacted although they will likely be watered down somewhat in their final form. Given the difficult expected return environment for fixed income in addition to expected tax cuts, we wouldn't be surprised to see some sector rotation into equities out of fixed income. Market valuations have moved much higher in 2016 and debt issuance has increased, so the equity markets do appear relatively more expensive than in recent history. The market is trading at 17x 2017 forward earnings estimates versus the ten year historical median level of 14.5x. If earnings can grow as expected, a difficult task most recently, and multiples hold steady, we should see mid-single digit equity returns with the potential for upside. U.S. policy mistakes, disappointing economic performance, geopolitical risks and Eurozone issues create downside risks to our forecasts.

| S&P 500 EPS Growth | Start of Year Expectations | End of Year | Difference |
|---|---|---|---|
| 2011 | 13.4% | 15.7% | 233 |
| 2012 | 9.5% | 5.9% | -364 |
| 2013 | 9.1% | 5.9% | -317 |
| 2014 | 9.9% | 7.1% | -276 |
| 2015 | 7.6% | 0.3% | -733 |
| 2016 | 6.8% | 1.3% | -551 |
| 2017 Expected | 11.3% | * | * |

Table 6: Source: IBES/Barclays

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John Huber, CFA, leads Prudent Man Advisor's asset management business and investment process. He is responsible for portfolio management and directs the advisor's research and trading efforts. Mr. Huber is a proven investment leader with over 20 years of experience managing institutional portfolios. He received his Bachelor of Arts from the University of Iowa and earned an MBA in Finance from the Carlson School of Management at the University of Minnesota. He is a Chartered Financial Analyst (CFA) charter holder and a member of the CFA Society of Minnesota.

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