TOWNELEY CAPITAL MANAGEMENT INC
ESTABLISHED 1971

2016 in Review and A Look Ahead

January 2017

The past year brought us winners we could not have predicted as the year began. The British vote to leave the European Union, the Chicago Cubs' World Series win and a Donald Trump presidency were all pulling long odds last January. Perhaps one of the few safe predictions is that unpredictable events will happen. These unexpected situations can be serendipitous or catastrophic—or anywhere in between. One key factor affecting the impact of the unpredictable is preparation.

Fiduciary Spotlight

Our job as your investment counselor is to manage your investable assets prudently. We apply our experience, analyses, and custom research to the unique issues facing your organization. We also provide documentation of your investment committee decisions. This institutional memory is invaluable to your organization and we maintain it for you as a standard part of our service. As a result, you gain more time to pursue prime board and committee objectives while your institution's assets are under the care of an experienced professional with a fiduciary obligation to your organization. We handle the details according to your policies and priorities.

In addition to managing your investment portfolios, we can also help with your institution's retirement plan. If you sponsor a retirement plan for your employees, we can assume part or all of the fiduciary burden of operating your 403(b) or 401(k) plan. When you engage Towneley to provide fiduciary services for your retirement plan, you enjoy the confidence and efficiency that come from extending an existing relationship to meet your additional needs. You already know our quality service and attention to detail and we are familiar with your organization's structure, goals, and priorities. We tailor our services to avoid replicating tasks already performed by your plan provider and record-keeper and we offer you the flexibility to revise the scope of our services at any time.

Your Portfolio

Our increase in high-yield bonds paid off in 2016, contributing to overall portfolio returns. Now that the Fed has begun raising interest rates, we expect short-term rates to rise faster than long-term rates, favoring a longer average duration. We also feel that international equities present relative bargains compared to domestic securities. In light of these insights, we have increased average duration in the fixed income portion of your portfolio and increased the allocation to international equities. We anticipate that both of these adjustments will better position your portfolio for the long term. Finally, we tuned out the short-term noise surrounding the election and refrained from overreacting.

Currently we are evaluating equity and fixed income values to determine if a rebalance is warranted to return portfolios to their investment targets.

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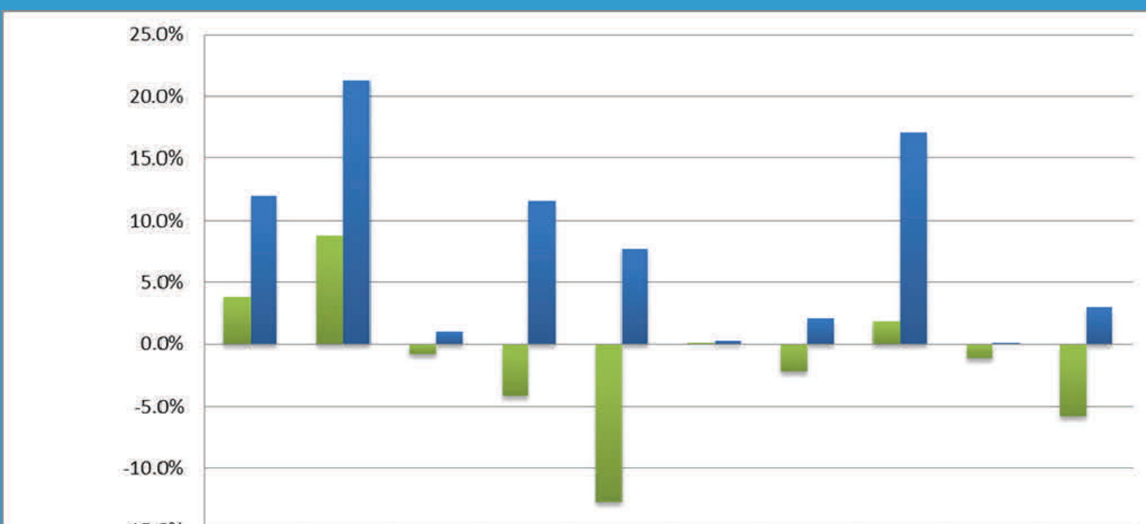
Thoughts from Towneley

For the first time since 2006, Republicans control both the executive and legislative branches of government. While party unity is not exactly at an all-time high, we anticipate many changes ahead. Regulatory reform may quickly boost small business and hiring. Economic improvements due to infrastructure spending are unlikely to occur before 2018, due to the time required to plan, fund, and launch these projects. Corporate tax reform is likely, and personal tax laws may also change, though a stronger consensus is lined up behind changes in corporate taxes.

A move to a territorial tax system, wherein only money earned in the US is taxed in the US, is likely, but repatriation of offshore profits is a necessary component of a successful move to a territorial system, and the effects of repatriation are unpredictable. For example, it could be that cash held offshore is already pledged as collateral against bonds, so it would not be available for capital investment. Companies' boards could also choose to use their repatriated funds to buy more company stock or increase dividends. While neither of these uses would lead to growth for the company, they would put cash into the hands of investors. Those investors could choose to invest the cash in companies that would use the money to grow.

We plan to dive deeper into the new administration's economic impact as more details of planned changes become available. Meanwhile, we are watching for changes in corporate taxation, which could boost the domestic economy. We also anticipate rising interest rates and their potential economic impact, especially on consumer spending and the housing market. Globally, we are monitoring China's economic health, as a hard landing there will likely cause repercussions worldwide. The EU's stability as Britain plans an exit is another point of interest. Finally, we are keeping an eye on the quality of US trade relationships as the new administration reconsiders trade agreements with other nations. Stay tuned.

Market Returns: Fourth Quarter and 2016



	S&P 500	Russell 2000	MSCI EAFE	MSCI Emerging Markets	S&P GSCI Gold	90 Day Treasury Bill	Barclays Intrm Govt/ Credit	Barclays High Yield Bond	Barclays Muni 3 Year	Barclays Muni High Yield
Fourth Quarter	3.8%	8.8%	-0.7%	-4.1%	-12.7%	0.1%	-2.1%	1.8%	-1.1%	-5.8%
2016	12.0%	21.3%	1.0%	11.6%	7.7%	0.3%	2.1%	17.1%	0.1%	3.0%

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Economic Roundup

The USA

US election results dominated the news, and the markets, in the last quarter of 2016. The anticipation of lower taxes, deregulation, and infrastructure spending set off a market rally that lasted through New Year's Eve. From November 9 to December 31, the Standard & Poors 500 Index returned 5.0% and the Russell 2000 Index gained 13.9%. In December, the Federal Reserve increased the federal funds interest rate, boosting the dollar. During the fourth quarter, the strengthening dollar suppressed gold, while rising interest rates and inflation had the same effect on most fixed income segments. However, over the course of 2016, all the indexes we routinely track posted positive returns.

The UK and EU

The Brexit vote shocked the world, but UK and European stock markets remained unfazed. The UK was up 19.2% and Europe up 7.2% in local currencies for the year. Both the UK and European stock markets were negative after adjusting for the strengthening US dollar though; the pound declined by over 15% against the US dollar in 2016. The strengthening dollar has boosted exports from Europe to the US and should continue to benefit those economies in the near future. Meanwhile, political uncertainty continues in 2017 as many populist groups are competing for election in different European countries. The growing populist movement and its impact on trade and the world economy are things to watch in 2017.

In December, the European Central Bank decided to slow the pace of its monthly bond purchases. As the ECB purchases fewer bonds, historically low interest rates in Europe should slowly increase. Rising commodity prices have also helped to neutralize Europe's deflationary threat and inflation indicators are trending upwards. As inflation and interest rates in Europe normalize, the rate at which the US dollar strengthens may slow. The strengthening US dollar has contributed to international equities' underperformance compared to domestic equities over the last five years. A static US dollar would benefit US investors with holdings in international stock markets. So far in 2017 the US dollar has weakened slightly against other currencies and international equities have outperformed domestic equities through January 29 (3.5% for MSCI EAFE vs 2.6% for the S&P 500).

Asia

The Japanese economy has expanded for three consecutive quarters, but growth has remained slow at less than 1% annualized. Prime Minister Shinzo Abe has repeatedly asked business to increase wages and his pleas may be beginning to work. Wage growth has been negative for most of the months since 1998, but increased in almost every month in 2016. Since the US election, the yen has weakened and corporate profits are improving. These trends favor wage growth in the near future. Continued wage growth would be a hopeful sign for an economy that has been stuck in deflation for two decades.

Emerging Markets

Emerging markets easily outperformed developed international markets in 2016 as the MSCI EM Index was up 11.6% compared to 1.0% for the MSCI EAFE. Brazil and Russia were two of the best performing emerging markets (up 36.8% and 34.1% in local currency respectively).

Brazil is still mired in its worst recession in decades, but rising commodity prices and positive fiscal reforms by new president Michael Temer brought improvements in 2016. Stronger commodity prices also boosted Russia, which spent 2016 in a recession, too. However, the economy improved as the year went on. In China, hard landing risks persist as the country continues to move to a more balanced but slower rate of growth. China relies on credit to sustain its rapid expansion and the increasing debt load should continue to strain the economy. Early in 2016, fear of a hard landing contributed to the decline in the US stock market; increased fears could ignite another selloff.