AUGUSTINE
ASSET MANAGEMENT

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Morning in America 2.0?

MARKET SUMMARY

Equities

S&P 500	2239
Price / Earnings	21.0x
Dividend Yield	2.1%

US Treasury

2 Year Yield	1.2%
10 Year Yield	2.4%
30 Year Yield	3.0%

US Corporate Spreads

BBB	1.5%
High Yield	3.4%

Volatility

CBOE Market Volatility	14.0

US Economic Figures

Real GDP Growth (3Q16)	3.5%
Unemployment	4.7%
Inflation (Core CPI Y/Y)	2.1%
Fed Funds Rate	0.75%
3 Month LIBOR	1.00%

Commodities

Oil (Brent Crude)	$56.82
Natural Gas	$3.72
Copper ($/lb.)	$2.51
Gold ($/oz.)	$1,148

Foreign Exchange

Euro	$/€	1.05
Japanese Yen	¥/$	117
Chinese Yuan	元/$	6.95

Market summary data as of:
December 31st, 2016

2016 will be remembered as a year of change, upheaval, and unexpected outcomes. Whether regarding the economy, capital markets, or society at large, the year produced pivots and surprises on many fronts. In the following pages, we hope to shed some light and provide context on these current trends and the key factors in the investing environment that affect your portfolio.

Economy

While 4th quarter official figures are still pending, economic conditions in the US and globally in 2016 were similar to that of recent years – about 1.6% domestic and 2.9% global growth, marking the 11th consecutive year below historical rates of expansion. The structural reasons for slow growth – demographics, indebtedness, and low productivity gains – remain headwinds.

Also like recent years, growth was very much back-end weighted, with a soft first half followed by firmer conditions by year end. A year ago, industrial activity was in the midst of five consecutive months of contraction and overall growth was less than 1% for six months.

Thankfully, low growth is still growth and not recession. Though the economy's recovery and expansion from the last recession is lengthy by historical standards, we see little sign that recession is imminent. Periods of economic growth don't end simply from old age, and momentum (consensus 4Q GDP growth forecast of 2.2%) in recent months appears strong enough to make the onset of the next recession unlikely in 2017.

Markets

Capital markets enter 2017 on a high note. Stock indices in the US are near record highs, while bond yields remain low by historical standards. From a valuation perspective, US dollar based assets appear expensive, with the price-to-earnings ratio

of US stocks elevated versus historical norm. With overall earnings per share flat since mid-2014 (and down excluding stock buybacks), appreciation of US stocks in recent years has been primarily through expansion of valuations – investors willing to pay a higher price for stocks offering unchanged earnings. Securities prices eventually reflect their underlying fundamentals, hence the outlook for future earnings needs to substantially improve or recent price gains need to moderate.

Exhibit 1: S&P 500 Price/Earnings

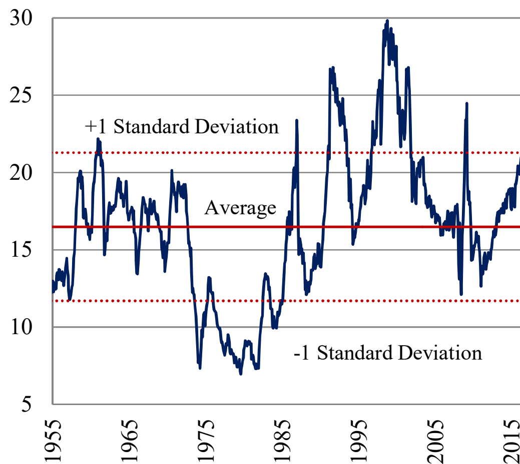


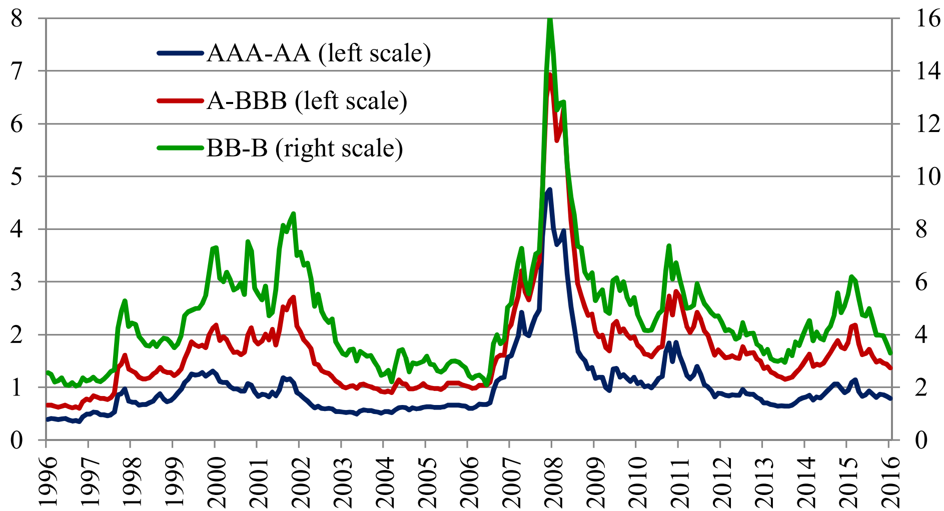
Exhibit 2: BarCap US Aggregate Yield %

US government bond yields, while up from record lows in July, remain unattractive compared with inflation. Since hitting a record low of 1.3% in July, the yield of US 10-year treasury bonds has risen to 2.4% by year end. The core consumer price index was consistently above 2% in 2016, the tight labor market is spurring acceleration in wage rates, and government stimulus is possibly shifting from interest rate suppression to fiscal spending. These developments may add to inflation and suggest that the risk to rates are toward higher rather than lower levels.

Exhibit 3: US 10 Year Treasury Yield %

Credit spreads, the premium investor earns for holding corporate rather than government bonds, performed well in 2016. As recession concerns abated and as the recovery in oil eased concerns in the high-yield energy sector, corporate issues outperformed the overall bond market. Further tightening of spreads may be modest from current levels. However, an outlook for lower recession risk in 2017 suggests credit rather than duration (sensitivity to interest rate changes, rising with maturity length) may be the better rewarded between the two major sources of bond returns.

Exhibit 4: US Corporate Bond Yields Spread Over Treasuries



Financial assets outside the US offer a slightly different value proposition. International stocks, having trailed those of the US for the last five years in dollar terms, trade at valuations below their historical average. Investor concerns regarding the rising populist tide in European politics, slowing growth in China, and the knock-on effects of Fed tightening on emerging markets appear to be already well priced in markets. Meanwhile, international developed market bonds remain perhaps the least attractive asset globally with large portions of government debt in Europe and Japan yielding less than zero (as discussed in last quarter's letter *The Final Frontier?*).

Review & Outlook

By many measures, the consensus view for US stocks is optimistic. Flows into equity funds have been particularly strong in recent months. The amount of margin investors have borrowed to take leveraged bets on market upside has risen to near-record levels. Meanwhile, measures of expected volatility in the stock market have fallen to extreme lows.

Exhibit 5: VIX Stock Expected Volatility

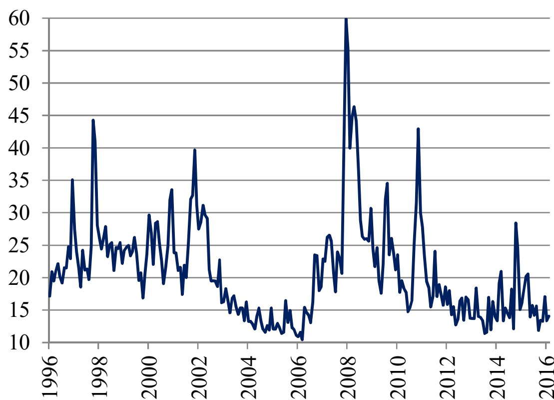


Exhibit 6: Margin Debit Balances $Billions

Investors' positive mood contrasts with the prevailing view a year ago. Recession concerns and the Fed's initial step to tighten policy sparked a double-digit decline in stocks in the early months of last year. While markets recovered as the Fed backed off from its predicted four rate hikes in the year and as rising oil prices eased concerns regarding the industrial sector, the outlook for growth remained uncertain and low. The surprise results in June from the UK referendum on EU membership (Brexit) sent growth expectations and bond yields lower.

Such concerns seemed to change with the bigger surprise in the US presidential election. Based on promises by the new administration to cut taxes, ease regulations, and spend on infrastructure, investor sentiment turned. The glass that was half empty was instantly full, transforming a 6% election night drop in stock futures into one of the strongest rallies in recent years. Bond yields rose on cyclical enthusiasm, while the dollar strengthened to its highest level in 14 years.

Exhibit 7: The Trump Rally

Pre-Election Consensus	Post-Election Consensus
Economy	**Economy**
Demographic headwinds	Supply side ready to provide growth
Indebtedness consumed future growth	Deficit spending to spur growth
Low productivity	Infrastructure improvement will drive productivity
Equity Market	**Equity Market**
Low rates mean higher P/E and higher prices	Higher rates portend future growth and higher prices
Non-cyclical earnings growth in favor	Cyclical earnings growth in favor
Regulation a "tax" of profits	Lower taxes and deregulation to help earnings
Bond Market	**Bond Market**
Central banks are dovish	Central banks will become hawkish
Secular deflationary forces result in low yields	Cyclical growth will drive up yields

Will the change of administration unleash a Reaganesque supply-side economic boom as some speculate? While we view lower taxes as a help to economic growth, we have a more measured view of many elements of the economic plan. Lessened regulations would have a minor positive effect, while infrastructure projects, if planned well, may be at least a year away from commencement.

Some of the proposed changes would have a negative effect on the economy and potentially risk recession. Strict limits on immigration and protectionist trade policies could stifle consumer and business spending while spurring higher inflation. Indeed, policies motivated by populist sentiment have a historical record of not ending well.

Hence, we see markets entering 2017 as conferring a great sense of certainty in the potential positives from new government policy while expecting little in the way from potential negatives. The gap between expectations and reality appears wide.

Exhibit 8: Then (Reagan) vs. Now (Trump)

	1980 / Reagan	2016 / Trump
Equity market capitalization % of economy	40%	196%
Debt obligations % of the economy	135%	251%
Equity market price / earnings ratio	9.1	21.0
Bond market yield %	13.0	2.6

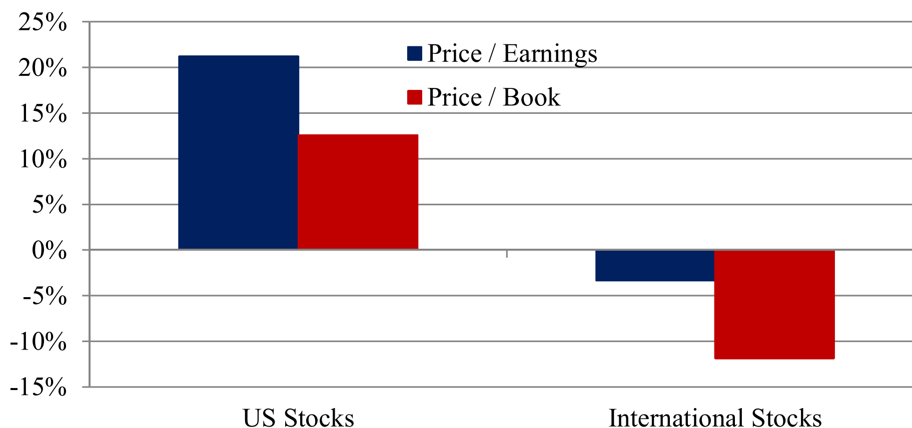
With such sentiment having driven US stock valuations to the 85th percentile of historical observations, the risk-reward proposition from domestic equities looks stretched. At current valuation, much of the speculated growth will need to happen, while lack of progress or diminished scope of reforms present risk to the bullish consensus.

Strategy

Today's market challenges investors to make investments at reasonable valuations on theses that aren't overly reliant on a speculative economic outlook.

Among sectors in the stock market, technology has the dual attraction of the fastest secular growth while having enough cyclicality to perform well should the economy surprise on the upside. Technology stocks generate a free cash flow yield higher than the overall market, supported by the highest return on invested capital among the market's major sectors. With international stock valuations below their historical average, it's hard to see those markets as imbued with excessive optimism. While a contrarian notion, given the outperformance of domestic stocks, value-attentive investors anticipating reversion to mean (as we do) should have exposure that improves both risk and future return. We expect to add stocks from this category in client portfolios in coming months.

Exhibit 9: Stock Market Valuations vs. 15 Year Average



In the fixed income market, we're frankly unsure whether the 35-year secular bull market of falling yields has ended as many now claim. We do see, however, the potential that a tight labor market

may support higher inflation and a cyclical bear market in bonds. The prospect for a non-recessionary economy with rising inflation fits well with our strategy within bond portfolios to favor short and medium term corporate bonds that earn a return by capturing credit rather than term premia.

We've had a cautious view on the weak earnings fundamentals and elevated valuations presented by stocks in recent years. Those concerns remain and guide the amount of risk we take in client portfolios. As we enter a new year, we continue to believe that judicious deployment of capital in select market segments that are fairly valued will produce attractive risk-adjusted returns. We are grateful for your trust, and we look forward to working with you to grow and protect your capital over the long run.

With best wishes for the new year and warm regards,

Jeffrey E. Bernardo Neil J. Sullivan Frederick M. Blum Austen P. Cornell Milena D. Spasova