SIGNATURE RESOURCES CAPITAL MANAGEMENT

Fourth Quarter 2016

QUARTER IN REVIEW

The U.S. election seemed to dominate capital market movement during the fourth quarter of 2016, as investors first withdrew from risk markets leading up to the decision then embraced them after Donald Trump succeeded in defeating Hillary Clinton to become America's 45th President. While strength in the U.S. dollar masked otherwise robust global equity market returns in the aggregate, our tilts to relatively inexpensive (known as, "value") and to small-capitalization stocks boosted portfolio returns, versus the broader markets. While equity markets were positively affected by optimism regarding a Trump administration, fixed income markets were adversely affected by concerns regarding potential policy shifts. Investors began to anticipate higher macroeconomic growth mixed with higher inflation and higher domestic government debt, as well as a less accommodative monetary policy stance from the Federal Reserve. Longer-maturity bonds suffered the most, while corporate exposures fared better on account of the potential for faster growth to boost business activity and profit.

Volatility Ahead...

Looking ahead, we continue to foresee increased market volatility, driven not least by the rather unpredictable nature and emphasis of the new administration. On the radar, too, are political risks in Europe, including tense elections in France, Germany and the Netherlands, along with still roiling financial stresses among the peripheral nations. Geopolitical risk is again rising, with Russia's alleged meddling in U.S. elections causing consternation here and abroad, while battling in Syria defies short-term resolution and Kim Jong-un's missile rattling increasingly threatens to upend regional stability.

...Amidst Risk-Reasonable Return

Potential risks aside, more favorable trends in corporate fundamentals (revenue and profit) may offer welcome valuation support for equity exposures, though we do not foresee growth sufficient to provide the basis for outsized gains. Furthermore, though we expect increased tightening of domestic monetary policy, we believe the Federal Reserve will be patient in setting the course for interest rates going forward. We therefore do not anticipate inordinate stress within fixed income over the near or medium terms.

Reviewing Tolerance

As always, our gaze remains firmly fixed on the horizon, ensuring foremost that clients remain on plan with regard to their long-term financial goals and are comfortable with the levels of prospective risk and return historically expressed by their present portfolio exposures. We thus offer the gentle reminder for clients to address with their advisors any shifts in financial plans and/or thoughts regarding market risk.

Figure 1: Quarter Summary Scorecard

Overall Take				
↗	↑	Equities gained in the aggregate, but it was a wild ride. Value and small-cap stocks were favored		
	↘	Fixed income reversed gains from earlier in the year as yields rose in anticipation of less accommodative monetary policy amidst expectations for more favorable going-forward growth		
Equity				
↗	Domestic Stable to modest improvement in the macroeconomic backdrop, along with a turn to positive for the earnings outlook and a substantial boost from expectations for pro-business policy juiced return, but only after an uncertain start to the quarter		↘	International A strong U.S. dollar weakened generally favorable developed equity market returns for most U.S. investors. Emerging markets struggled for investor attention
Fixed Income				
↘	Domestic A widely expected Fed rate hike and a prognosis for faster macroeconomic growth lifted rates		↓	International Heavy pressure as U.S. dollar strength and a global rate reset reversed strong gains earlier in the year

Macro Focus

Even as the election whipsawed capital markets in the fourth quarter, the economy of the United States proved rather tame by global comparison. With macroeconomic trends generally stronger, including key inflation and employment metrics watched by the monetary policy governing body, the Federal Reserve expressed greater confidence in its intention to lift the target for the federal funds rate. The federal funds rate is the interest rate at which banks loan each other money overnight, and it generally sets the pace for rates across the economy. Both the Bank of Japan and the European Central Bank seemed to express a willingness to continue to provide ample support for their respective economies, even as they subtly limited the aggressiveness they had previously asserted (for the time being, at least). These decisions seemed to echo thoughts in the U.S. that fiscal policy may need to carry more of the burden going forward.

Higher rates in the U.S. relative to those around the world, in addition to the relatively more favorable macroeconomic backdrop, increased the attraction of dollar-denominated assets, thus strengthening the dollar. By year end, the dollar reached a level relative to peer world currencies not seen since 2002. The British pound, which plunged after the "Brexit" vote, continued its slide, as did the euro and the yen.

Showing a wide range of results, macroeconomic trends outside the U.S. were lackluster by comparison. Even so, we recognized some stabilization and even improvement among the more influential economies. Concerns related to the United Kingdom's planned departure from the European Union eased somewhat, while the bulk of EU members stayed out of focus for the most part. The notable exception was Italy, where a constitutional referendum failed to pass, thus prompting the resignation of its chief promoter, Italian Prime Minister Matteo Renzi. And many Italian banks maintained precarious financial footing. Indeed, Italy's oldest bank was seeking a bailout as the year closed. Meantime, Chinese data promulgated a new stability that, while lower than historical growth, was still robust in comparison to the world's largest economies.

Equity Market Review

The story of the quarter was the equity rally on the heels of Donald Trump's electoral victory. After sagging as much as 3.6% leading up to the election, the S&P 500 soared from the quarter's trough on November 4 to gain 7.7% by year end, leaving the total return for the quarter at 3.8%. As detailed in Figure 2, the broader U.S. equity market (please see index descriptions at the end of this report) was the exception in a challenged environment for international markets.

Figure 2: Trailing Broad Equity-Market Performance

Broad Equity-Market Indexes

	QTR	1 Year	3 Year	5 Year	10 Year
Global	1.19	7.86	3.13	9.36	3.56
World ex. U.S.	-1.25	4.50	-1.78	5.00	0.96
World ex. U.S. Small-Cap	-3.52	3.91	0.76	7.74	2.89
U.S.	3.38	10.89	7.96	13.85	6.34
U.S. Large-Cap	3.82	11.96	8.87	14.66	6.95
U.S. Small-Cap	8.83	21.31	6.74	14.46	7.07
Developed Markets	-0.71	1.00	-1.60	6.53	0.75
Emerging Markets	-4.16	11.19	-2.55	1.28	1.84

Value Component of Equity Indexes

	QTR	1 Year	3 Year	5 Year	10 Year
Global	4.76	12.57	2.77	8.96	2.56
World ex. U.S.	3.29	8.92	-2.40	4.58	0.34
World ex. U.S. Small-Cap	-0.94	8.24	0.69	8.20	NA
U.S.	6.06	15.83	7.82	13.39	4.78
U.S. Large-Cap	7.35	17.40	8.51	14.69	5.50
U.S. Small-Cap	14.07	31.74	8.31	15.07	6.26
Developed Markets	4.17	5.02	-2.14	6.28	-0.22
Emerging Markets	-1.10	14.90	-3.54	-0.27	1.97

Value Component, vs. Aggregate Equity Indexes

	QTR	1 Year	3 Year	5 Year	10 Year
Global	3.57	4.71	-0.36	-0.41	-1.00
World ex. U.S.	4.54	4.42	-0.63	-0.42	-0.62
World ex. U.S. Small-Cap	2.58	4.33	-0.08	0.46	NA
U.S.	2.68	4.94	-0.13	-0.46	-1.56
U.S. Large-Cap	3.52	5.44	-0.36	0.03	-1.45
U.S. Small-Cap	5.24	10.43	1.56	0.61	-0.81
Developed Markets	4.89	4.02	-0.54	-0.25	-0.97
Emerging Markets	3.07	3.72	-0.99	-1.54	0.13

From 12.31.06 to 12.31.16. Total return data for broad market categories annualized for periods greater than 1 year. Past performance is not indicative of future results. One cannot directly invest in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report.
SOURCE: SRCM using data from Bloomberg

Resurgence of Value

The other major story of the quarter was the strong outperformance of value-oriented and small-company stocks. Indeed, the combination of the two investment factors, value and size, led to U.S. small-company stocks being strongest performer amongst all the major groups shown in Figure 2. We detail the value components of the broad-market indexes in the middle section of Figure 2 and show their relative performance, versus their respective broader markets, in the final section of Figure 2.

Value's outperformance in Q4 and its relatively strong performance in 2016 overall proved a welcome turn. Looking back 10 years, value slices among many major markets have underperformed their respective broader benchmarks, with only emerging market value stocks seeing incremental gain. (The index we use to track small-cap stocks outside the U.S. has an inception date later than 10 years ago).

Broadly speaking, given the portfolio tilts that emphasize these equity characteristics, both the value and size factors boosted the performance of our portfolio relative to their benchmarks. As we often have stated, we understand these characteristics, along with others to which we tilt our investment portfolios, to generally provide long-term incremental improvement over broad benchmark returns. There is not, however, an immutable financial law that governs returns over all time frames. Furthermore, even as tilts do affect returns, there is no predictable pattern as to when and how (even *if*, depending on the investment time horizon) those incremental returns may be realized. This general unpredictability can undermine attempts to time markets. Furthermore, the likelihood of even long periods of underperformance is why we *tilt* our portfolios to favor these factors, instead of allowing them to dominate portfolio exposures.

Fixed Income Market Review

As noted already, in the wake of the unanticipated Trump victory, equity markets rebounded rather remarkably from a mid-year stall, with our preferred value-oriented and smaller-capitalization stocks performing particularly well. The consensus regarding the turn in fortune was premised on the potential for President Trump to reignite domestic growth through deregulation, revision of the tax code and other pro-business (particularly domestic business) policies. On the other hand, various campaign promises lifted concerns that America's balance sheet might weaken, including a heavy emphasis on potentially increased spending on domestic infrastructure. The combined potential of faster growth and a worsening federal government budget deficit reignited expectations for future inflation. Considering both scenarios, the Federal Reserve maintained a bias for less monetary accommodation heading in to 2017 after an early December increase in the target for the federal funds rate[1]. Altogether, rate pressures left fixed income markets severely lagging gains in the equity markets during Q4.

The Bloomberg Barclays U.S. Aggregate Bond Index was off more than 4% from the end of September through mid-December before bouncing to close the quarter down 3%. Returns for longer-duration bonds, meaning those that mature further out in the future, were particularly weak. Bonds with 20 years or more until maturity were off more than 12% in Q4. Those performance trends reflected the revised growth, inflation and monetary policy expectations. Corporate bonds, on the other hand, while also pressured, fared relatively well as their "spreads" in yields over U.S. Treasuries[2] compressed and because of more positive views regarding going-forward growth. Though inflation-protected bonds were relatively less affected, the generally longer maturities also resulted in relatively weak total returns.

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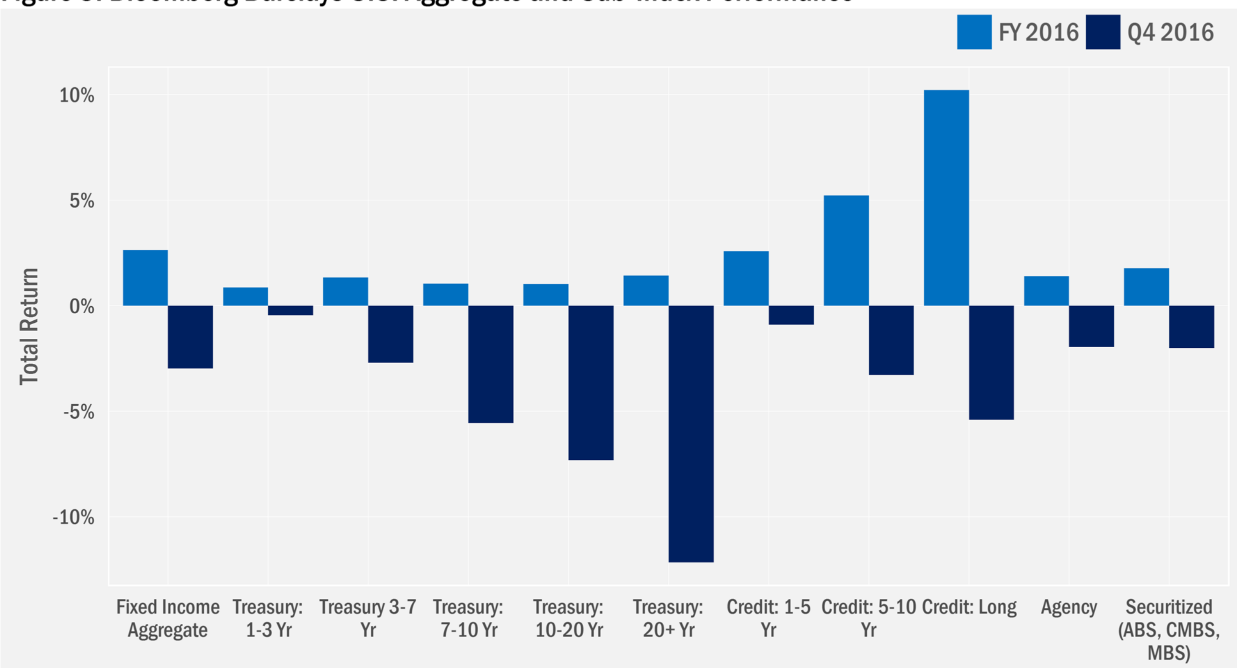
1 The fed funds rate is the rate at which banks loan each other funds overnight. The Federal Reserve establishes a target for this rate, seeking to modulate macroeconomic activity. A very helpful primer on the workings of the Federal Reserve can be found here: https://www.stlouisfed.org/in-plain-english

2 Generally speaking, due to the incremental risk related to individual companies, corporate bonds offer higher yields than U.S. Treasuries of a similar maturity.

A Fair Year Disguised

Fixed income market trends for the fourth quarter, too, were decidedly different than that those of the full year. As shown in Figure 3, despite the year-end sell-off the broader fixed income market closed the year meaningfully in the green, up 2.6%. And it is worth noting that while the S&P returned just a bit less than 12% for the year, the equity index was underperforming the bond market on a year-to-date basis until just before the U.S. election. Those gaps should serve as a useful reminder that we should maintain a longer-term perspective in regard to our investment returns, even as we remain cognizant of and ensure our comfort with the potential volatility we may see over shorter-term horizons.

Figure 3: Bloomberg Barclays U.S. Aggregate and Sub-Index Performance



From 12.31.15 to 12.31.16. SOURCE: SRCM using data from Bloomberg

New Year Just Begun

This year almost certainly will bring with it more surprises for the capital markets. Central bank policies are likely to remain divergent, perhaps heightening the influence of currency moves on portfolio returns. Corporate fundamentals may continue to improve, but valuation support for U.S. stocks is not in our view sufficiently robust to see substantial incremental gain. International equity markets may offer more reward—emerging markets in particular—but much depends on the world retaining some manner of geopolitical and financial calm. All considered, we find sound reasons for investor caution and even temperament.

In sum, the New Year gives as much reason for optimism as it does for concern—not out of the norm for most years. With that balance in mind, we offer our many thanks to clients for their continued trust in our work. This commentary included, we hope that the increased communication from the Investment Team has served to provide greater insight into our thinking as well as a meaningful springboard for your conversations with your advisor as you revisit your long-term financial plans.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Asset classes and their respective indexes mentioned in this report include the following:

International (global non-U.S. dollar-denominated) fixed income: The Bloomberg Barclays Global Aggregate Index is a multi-currency benchmark that measures global investment grade debt and includes fixed-rate treasury, government-related, corporate and securitized bonds from developed and emerging markets issuers while excluding U.S. dollar-denominated debt.

Domestic (U.S.) fixed income (Fixed Income Aggregate): The Bloomberg Barclays U.S Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds.

Global equity: The MSCI ACWI Index captures large- and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set.

International equity: The MSCI ACWI ex. USA Index captures large- and mid-cap representation across 22 Developed Markets countries and 23 Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.

International small-cap equity: The MSCI ACWI ex. USA Small Cap Index captures small cap representation across 22 Developed Markets countries (excluding the U.S.) and 23 Emerging Markets countries. The index covers approximately 14% of the global equity opportunity set outside the U.S.

International value equity: The MSCI ACWI ex. USA Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 22 Developed and 23 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The index targets 50% coverage of the free float-adjusted market capitalization of the MSCI ACWI ex. USA Index.

International small-cap value equity: The MSCI ACWI ex. USA Small Cap Value Index captures small-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 23 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The index targets 14% coverage of the free float-adjusted market capitalization in each country.

Emerging markets (EM) equity: The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 Emerging Markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Domestic (U.S.) large-cap equity: The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization.

Domestic (U.S.) small-cap equity: The Russell 2000 Index tracks the performance of U.S. small-capitalization stocks and is comprised of the smallest 2000 companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

Opinions expressed herein are subject to change without notice. SRCM has exercised reasonable professional care in preparing this information. The information has been obtained from sources we believe to be reliable. However, SRCM has not independently verified or attested to the accuracy or authenticity of the information.