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Review of Securities Markets, Fourth Quarter, 2016

U.S. stocks rallied strongly in the fourth quarter, with all of the gains coming after the election in early November. The S&P 500 ended the quarter up 3.82%, bringing its full year return to +11.96%. Stocks rose on the expectation that Republican control of the presidency and Congress would lead to pro-business policies that would boost corporate earnings. Expectations for future U.S. GDP growth also increased as the new administration is expected to reduce taxes and increase government spending on infrastructure and defense. The S&P 500 Index reached an all-time high in mid-December before edging downward in the final two weeks of the year.

U.S. small cap stocks significantly outperformed their larger brethren during the quarter and the year. Smaller U.S. companies are expected to get a bigger boost from stronger domestic GDP growth given that domestic sales make up a larger portion of revenue for smaller U.S. companies. Value stocks also outperformed the broader indexes during the quarter and the year, mostly due to strong rallies in Financial and Energy stocks. The Financial sector had been trading at historically low valuations since the financial crisis as new regulations and low interest rates had hurt their earnings potential. Investors expect both of those limitations to ease under a Trump administration. The Financial sector of the S&P 500 Index rose 21.10% during the fourth quarter.

Developed market foreign stocks underperformed U.S. stocks during the quarter and for the year as a whole. Most of the fourth quarter underperformance was attributable to a strong rally in the value of the U.S. dollar which occurred after the election. The expectation of stronger U.S. GDP growth led to an increase in U.S. interest rates which made dollar denominated assets more attractive to global investors. The U.S. dollar appreciated 7.15% during the quarter, and the MSCI ACWI Ex U.S. Index was down 1.25%. Emerging market foreign stocks outperformed developed foreign stocks for the year, but underperformed during the fourth quarter. Emerging market returns are particularly sensitive to the value of the U.S. dollar given the generally high levels of U.S. dollar denominated debt in these countries. As the dollar gets stronger, the value of their debt payments rises. The MSCI Emerging Markets Index was down 4.16% during the quarter.

U.S. bond yields rose sharply during the quarter as inflation expectations increased. Higher expectations of GDP growth coupled with low unemployment led to higher inflation expectations.

Rates were also supported by an additional increase in the Fed Funds Rate, which was announced by the Federal Reserve in mid-December. In that announcement, the Fed said they expect to raise rates three times in 2017. The yield on the U.S. 10-year Treasury ended the year at 2.44%, up from 1.59% at the end of September. The Barclays Aggregate Bond Index dropped 2.98% during the quarter. Municipal bonds underperformed taxable bonds in response to talk of possible lower income tax rates in 2017. Lower tax rates make tax-free bonds less attractive relative to taxable bonds. Treasury Inflation Protected Securities (TIPS) and hedged foreign bonds slightly outperformed the Barclays Aggregate Index.

Commodities, as measured by the Bloomberg Commodity Index, were higher for the quarter (+2.66%) and gained 11.77% for the year. Crude oil rallied late in the year as OPEC agreed to a production cut for the first six months of 2017.

The Year of Living Dangerously

2016 will be remembered as a year that many people would like to forget. Horrifying terrorist attacks, a highly contentious U.S. election, and the death of many icons left many eager to put 2016 behind them. Through it all, investment markets generally held up well. However, 2016 also presented investors with some major pitfalls to navigate. Investors without disciplined investment strategies were at particular risk of making changes to their portfolios that could have harmed their returns.

The first pitfall investors encountered occurred at the beginning of the year. In the first six weeks of 2016, the S&P 500 Index fell approximately 11%. The Fed rate rise in late December, soft economic data in the U.S., and concerns of a hard landing in China all contributed to the decline. At the time, many were sure that the seven-year bull market had run its course. Any investor who acted on that hunch by reducing U.S. equity exposure missed out on the significant rally that followed. By mid-March, the S&P 500 Index had regained all its losses. Just a month later, the index was up another 4%.

The next potential trouble spot for investors occurred after the Brexit vote in late June. Pundits and odds makers had expected Brexit would fail and that the United Kingdom would remain in the European Union. As polls began to close, it became obvious that these predictions were wrong and markets in Europe responded with sharp declines. Over the next two days, the S&P 500 Index fell approximately 6% as concerns grew that the Euro may be falling apart. Investors who sold their stocks during this decline missed the gains when the market recovered and reached new all-time highs just two weeks later.

And finally, the last potential trap of the year was the U.S. election. Shortly before Election Day, the market began to sell off as the polls tightened. Some investors believed the market would sell off sharply if Donald Trump won the election and were not willing to take that risk. As the results

began to come in, and as it became more evident that Trump would win, the futures on the S&P 500 Index began to sell off. At one point they were down as much as 5%, which probably made those who sold feel very smart. However, stock prices reversed later that night as investors began focusing on the pro-growth and pro-business aspects of Trump's agenda. The S&P 500 Index not only recouped the 5% loss on the futures the next day, but also gained another 5% by year end.

If you were an investor who stuck to your strategy in 2016 and did not fall into any of the traps above, you would likely have earned solid portfolio returns. On the other hand, if you had significantly reduced your stock allocation in response to any of the events above, your returns would likely have been lower.

Following a long-term strategy can be difficult and 2016 offered many scary situations when reducing investments in stocks might have felt like the right thing to do. Success in meeting your long-term goals is highly dependent on your ability to follow your strategy, even when it is uncomfortable to do so.

2017 is sure to have its challenging moments in the world and in the markets. By responding to these challenges with discipline, investors can increase the likelihood that 2017 will be a year worth remembering.

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Quarterly Review of Securities Markets: Total Return

Index	Market	Last 3 Months	Calendar Year 2016
Standard & Poor's 500	Large Co. U.S. Stocks	3.82%	11.96%
Russell 1000 Value	Large Co. U.S. Value Stocks	6.68%	17.34%
Russell 2000	Small Co. U.S. Stocks	8.83%	21.31%
MSCI All-Country World ex U.S.	Foreign Stocks	-1.25%	4.50%
Barclays 1-5 Year Gov't/Credit	U.S. Shorter-Term Taxable Bonds	-1.05%	1.56%
Barclays Aggregate Bond	U.S. Taxable Bonds (Broad-based)	-2.98%	2.65%
Barclays 1-5 Year Muni Bond	U.S. Shorter-Term Tax Exempt Bonds	-1.07%	0.07%
JPMorgan Global Ex-U.S. Bonds	Hedged Foreign Bonds	-2.16%	5.46%

Key Economic Indicators

- The latest U.S. GDP figures (third quarter 2016) showed the economy growing at an annual rate of 3.5%, following weak growth in the first two quarters of the year. The third quarter growth rate was the highest reading in two years as increases in consumer spending, business investment and net exports all contributed to the gains.

- The latest U.S. employment report showed job growth that was on the low end of expectations. Nonfarm payrolls increased by 156,000 in December while the unemployment rate rose to 4.7%. The report also showed year-over-year wage growth at 2.9%, which is the highest it has been since 2009.

- U.S. inflation continues to remain low. The latest Consumer Price Index data (November) showed an annual inflation rate of 1.7%. Core CPI (CPI less food and energy) posted an annual increase of 2.1%.

- The U.S. Fed raised the Fed Funds rate by 0.25% at their December meeting. The Fed also raised their forecast for expected rate rises in 2017. They now expect to raise the rate three times in 2017.

- The Bloomberg Commodity Index rose 2.66% during the fourth quarter. The price of oil increased 7.59% to $53.72 per barrel. Gold dropped 12.80% to $1,148 per ounce and silver declined 16.93% to $15.93 per ounce. Even after the fourth quarter declines, gold and silver prices were higher for the year.

Key economic indicators compiled by Jeffrey Blanchard, CFA, Investment Analyst; jeffrey.blanchard@bosinvest.com

Your Quarterly Packet

Enclosed with this Quarterly Summary are performance reports for your consolidated accounts, portfolio appraisals, and a billing statement. You will also receive a statement(s) from your custodian summarizing your account activity this quarter, which we encourage you to review.

Should there be any changes in your financial situation or investment objectives, should you wish to discuss how B|O|S manages your account, or should you have any questions about the information in this packet, please contact your team at B|O|S. Thank you for your continued trust in our services.

Data Sources: Morningstar; Econoday; Bloomberg.com

(1) Source: MSCI. MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. MSCI data may not be redistributed or used as a basis for other indices or investment products.

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