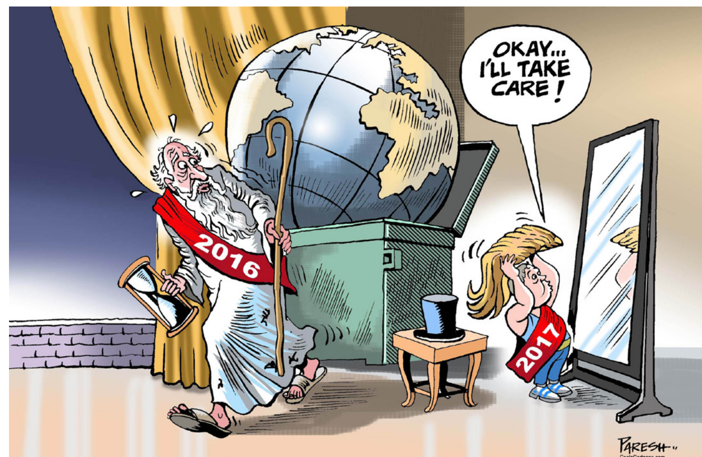
Karp Capital Management

Financial Focus

4th Quarter Report | *Positioning Your Financial World in the Global Economy* | January, 2017

ARE YOU SURE ABOUT THAT?

One word can sum up 2016: **uncertainty**. It drove every factor of the economy and kept the market flat, or down, for most of the year. We haven't seen so many market-driving events since the global financial crisis. After a sharp sell-off at the start of 2016, geopolitical events took stocks on a wild ride. Few people expected wins for the Brexit vote and for Donald Trump and a resounding no vote on the Italian referendum.



But once again equity markets demonstrated resilience, as the S&P 500 made new highs in November and the Dow Jones Industrial Average came close to crossing the 20,000 threshold. This rally was attained with a country divided instead of united after a divisive presidential contest. For the first three quarters of 2016 with the presidential election looming and the Fed's rate hike hanging over our heads, investors didn't know what to make of this pivotal year. Investors were so uncertain of prospects for growth that yields on government bonds around the world fell into negative territory. Each new global story, be it terrorism or new economic numbers, sent yields falling as investors flocked to the safety of bonds. Every time the market looked to break out of a trading range, it would correct itself to stay within a narrow range, suggesting that investors were uncomfortable taking on more equity risk. Two major global events – the Brexit vote and the U.S. presidential election – while previously not viewed as positives for the markets, cleared up the looming uncertainty. Regarding Brexit, initially the market plunged on the news that Great Britain was going to leave the European Union. Global markets seemed to be in turmoil... for two straight days. Then, remarkably, investors took stock of what that truly means to the global economy and markets turned high on a dime/shilling. With the unknown made known, people came in from the sidelines and put money to work in sectors that wouldn't be extremely impacted by the shake-up in Europe. This was nothing compared to what happened domestically. With what seemed to be the longest election cycle of our nation's history, the market just puttered along waiting for the people to make a decision. Donald Trump was not expected to win, and if he did it was expected to have earth-shattering effects on the market. When the final results were tallied, global markets were hectic to say the least. Market futures plummeted and virtually every type of asset sold off. That is, until the next morning when investors sent the market soaring higher than anyone could have predicted. Again, the unknown became known, something was finally certain. A relief rally was ignited with investors flocking to the sectors that they thought would benefit most from a Republican presidency. The industrials, transportation and financial sectors skyrocketed. Promises of lower taxes sent almost every investment style soaring, with small caps as the biggest gainers. The extent to which the bond market reacted was a surprise but a sell-off was not unexpected, as finally the cloud of uncertainty had dissipated. With the stock market skyrocketing and a trickle of positive economic news, the Fed's decision was all but made. We waited nearly a year for

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Market Performance

Here are the performance numbers for the major indices as of 12/31/2016: (total return)

	Latest 1 Month	Latest 3 Months	2015 % Change	2016 % Change	The Close
Dow Jones Industrials	3.34%	7.94%	-2.23%	13.42%	19,762.60
Standard & Poor's 500	1.82%	3.25%	-0.73%	9.54%	2,238.83
NASDAQ- Composite	1.12%	1.34%	5.73%	7.50%	5,383.12
Russell 2000	2.80%	8.83%	-4.41%	21.31%	1,357.13
MSCI EAFE	3.44%	-0.68%	-0.39%	1.51%	1,684.00
Long Term Treasury Bonds	-0.56%	-11.71%	-1.29%	1.31%	
Gold	-2.73%	-13.35%	-11.61%	8.10%	$1,145.90

The S&P 500's best sector performer was energy, up 23% on a total return basis after a dismal 2015 and a late 2016 OPEC agreement to cut production. Financials (+20%) were the second best performer, where most of the outperformance came in the final two months of the year. Industrials and materials (beneficiaries of future infrastructure) spending were also among the best performers rising 14% and 16% respectively. After a strong Q1 & Q2, income producing sectors lost ground amid the rise in rates and growth expectations, with real estate (flat) and staples (+3%) among the worst performers while utilities (+12%) remained slightly ahead of the market. Telecom (+18%) is expected to benefit from corporate tax reform along with less regulation under the new administration in Washington. Healthcare was the only sector to finish 2016 in the red (-2%).

Sources: Thomson Reuters; WSJ Market Data Group, Dow Jones & Co., BTN Research, BofA ML, U.S. Global Investors, U.S. Treasury Department.

Are You Sure About That?

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another rate increase from the Federal Reserve. Now savers would start to earn some income on their bank reserves. The end of 2016 was very different from the beginning. In the new year there is expectation of economic growth through reduced regulation, reduced taxation and stimulative government spending. With the equity markets significantly higher since the beginning of November, investors should be mindful of a few things in 2017. Confidence has steadily risen since the election. In December, the Gallup Poll reported that its U.S. Economic Confidence Index hit its highest level in nine years. Also, the U.S. dollar has reached its highest level in 14 years in the wake of the presidential election, and a strong dollar has traditionally been a headwind for large company earnings with significant international exposure. These factors tell a cautionary tale: While there are reasons to be optimistic about 2017, risks still remain, and the hopes and dreams that the year-end rally 2016 will continue only if it translates into stronger fundamentals for companies and the economic landscape. The question for investors is what will get done in Washington and will it translate into the general economy and benefit the people of Main Street instead of just Wall Street. We are pleased to start 2017 with optimism and not like 2016 in the midst of a correction. While the headlines of Q4 were more positive than negative, many investors are still wondering what to expect from the market as Donald Trump moves into the White House. Please read our first newsletter of 2017 and take a look into the state of the markets and what you can expect in the new year.

The Fed

It was a long time coming, and in December, the Federal Reserve unanimously decided to raise its benchmark interest rate (the federal funds rate) to between 50 and 75 basis points (0.5% to 0.75%). It was only the second time in ten years the Federal Open Market Committee (FOMC) has done so. Also, the Fed slightly accelerated the pace of projected rate hikes in 2017, to three hikes versus a prior estimate of two. In our view, economic fundamentals warranted multiple rate hikes in 2016. The unemployment rate is below the Fed's long-term projection of 4.8% and nominal GDP – real GDP growth plus inflation – has grown at a 3.1% annual rate in the past two years even though the quarterly numbers have been volatile. While all borrowers will be affected by this tightening cycle the largest borrower on the planet is the U.S. Treasury. This will certainly factor into the economic landscape as talks of tax cuts, massive infrastructure programs and growing entitlement programs heat up. Under a Trump administration there is a likelihood of tax cuts in the next year. We think Fed Chair Janet Yellen and the Fed Governors will become increasingly comfortable with their projection of faster rate hikes. This is in contrast to the past few years when they over-promised and under-delivered. This made it difficult to build income generating bond ladders. The Federal Reserve has set the tone for 2017, and reinforced three major trends in the markets: 1) a stronger dollar 2) higher interest rates 3) higher inflation. We believe there are two key takeaways from the last Fed meeting. It is more concerned with inflation than before the election and it's clear that the new political climate is on the mind of the Fed Governors. The stock market is still

trading at levels that ignore the implications and risks that will come with higher market interest rates and a stronger dollar. On the other hand, slightly higher short-term rates are not going to derail U.S. growth. Instead, rate hikes will help prevent a misallocation of capital and problems of asset bubbles down the road. If you are feeling worried about higher rates, keep in mind that the yield on the 10-year Treasury (ending 2016 at 2.44%) is no higher right now than it was 3 1/2 years ago when Ben Bernanke, then Fed Governor, warned that Quantitative Easing would likely begin before the end of 2013. The tell of where interest rates are going will come mid-year when the odds seem high that inflationary pressures will begin forcing a radical change in future interest rate policy. November's U.S. Producer's Price Index report showed a continued firming of producer prices although we have yet to reach the point where the annual price changes are running meaningfully above the Fed's or analysts' expectations. With the Fed now forecasting three rate hikes in 2017, instead of just two, the outlook for banks has improved. We believe the equity rally, led by financials and energy, still has more room to the upside. The reasoning is quite straight forward. The Fed is increasing interest rates on the back of an outlook for a stronger more robust economy.

When They Go Low, We Go High

With the market maintaining a tight trading range for most of the year, opportunities for individual equities to break-out to new highs were often quashed by new developments in the national economy or on the global stage. This kept investors reluctant to go all-in on a bull market. When the economic news was good, this raised concerns of the detriment of a looming rate hike by the Fed, mitigating the positive effects of an ever-improving economy. Bonds continued to soar to the highest levels they've ever seen and fueled the performance of dividend-yielding securities, such as consumer staples. Uncertainty and fear weighed on investors. How will an interest rate hike affect the markets and the economy? Each round of economic news shined a faint glimmer of hope that the economy was picking up steam but investors were aware of the detriments of a rising interest rate environment. This is when it's important to tune out the noise. Pulling your money from the market entirely proved to be a costly mistake. Our strong focus on risk kept us invested in both bonds and equities as the market was ever-changing. When new events spook the market, you don't want to overreact. Look where the economy is headed, not at short-term price fluctuations or the major market indices. We'll always see the ebbs and flows. That's what makes the market healthy. If you see a long-term, unrelenting spike to the upside, fears of bubbles and corrections will keep investors at bay. The fears of 2016 were real and substantial. You need to have a risk adjusted approach. If you allow fear and pessimism to take control, you're not going to see the benefits that investing has to offer. You will be constantly chasing the markets or running for cover. With a Q4 spike in stock prices, we saw the 'green shoots' of change but we have concerns too. Nevertheless, the concerns holding back growth have dissipated. 2017 presents new opportunities and new challenges.

Labors Lost

Last year there was noise and volatility in the markets that treated Amazon and some innovative industry leaders unfavorably. While the tech industry was lagging, Amazon announced a new plan that had investors considering more long term structural economic trends. Amazon unveiled its latest plan to further automate jobs that are currently performed by lower-wage workers. The plan is to create futuristic grocery stores without any cashiers. Shoppers will walk into the store already logged into the Amazon app. Each item removed from the shelf will be added to their 'cart' and when leaving the store, customers will be charged for the groceries they gathered during their human-interaction-free shopping experience. More and more jobs can be done by increasingly sophisticated technology. While this election had a strong focus on bringing jobs back to America, the truth of the matter is that many lost jobs didn't get shipped overseas but rather, were simply automated. Companies continue to make transformational investments in machinery and technology that perform the same tasks at a fraction of the cost of human capital. While Amazon's stock dipped with the rest of the sector, its continual innovation should be acknowledged by investors through a higher valuation. While many worry about the valuation of the markets and keeping up with the major market indices we are looking to position our clients' portfolios for future growth. These companies have continually proven that they are on the forefront of future technologies and investing in the future, and not just moving higher in price because of the hope of tax law and regulatory reform. Amazon has spent decades operating at a minimal profit to set itself up to be a key player in an internet based economy. This move to further automate another facet of our daily life should pay investors in Amazon and other forward thinking companies dividends in the not-so-distant future.

Okay... Let's Make Money

Donald Trump's proposed policies, which include increased infrastructure spending, loosening of bank regulations, and boosting domestic energy output, could have contributed to the respective sectors' rally following the election, but what's also true is that these sectors have been trending up since July 2016 while interest rates hit a low. We think earnings growth is going to accelerate in 2017. That's really what is driving the markets. The shift in the outperformance can be explained by Trump's rhetoric. There has been widespread anticipation around the potential implementation of trade and outsourcing barriers, following Trump's victory. This could have lowered earnings projections for U.S. large corporations/multinationals, given the large-scale foreign exposure that such organizations have long thrived on. Smaller firms operate mostly in the U.S. and are less vulnerable to weakening foreign demand compared to large-cap U.S. multinationals. Economic uncertainty in Europe, Japan and China, coupled with a strong U.S. dollar support this theme. We think this trend will continue through the first six months of 2017 as President Trump's agenda gains traction in the House and Senate. Keep in mind, when domestic growth and inflation are accelerating at the same time we should continue to see a strong dollar vs other developed countries. Furthermore, it looks like President Trump and Congress will push for cuts in the corporate tax rate. Trump believes that tax cuts for investors and business provides incentives to save and invest, and produces

economic benefits that trickle down to the overall economy. This is the basic idea behind supply-side economics. This is in addition to cuts in regulation and less emphasis on government subsidies which directs resources toward politically-favored, and non-efficient industries which would grease the skids for economic growth. We will continue to add to the following sectors and stocks on any pull back; financials, industrials, and technology. We believe the best way to optimize returns while reducing portfolio volatility is to follow actual company and sector fundamentals versus policy speculations when making portfolio decisions. We know optimum long-term returns – with minimum downside volatility – are what every client ultimately yearns for.

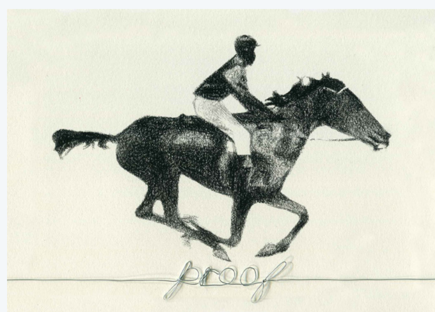
What's Russian for OPEC?

One of the main drivers of deflation across the globe and one of our investment themes in 2014 and through the first half of 2016 was the sudden and unexpected collapse of oil prices in 2014. It's been a thorn in the side of many central banks and a boon in savings for the consumer. However, it did not come without some trade-offs. Unfortunately, if you've become accustomed to filling up your tank for relatively low prices, that could very well change this year. It took years, but at the end of 2016 OPEC (Organization of the Petroleum Exporting Countries) finally came to a deal to moderate oil output to relieve some built up supply and finally allow oil prices to begin a new ascent. While you will lament your next trip to the pump, there are positive attributes to rising oil prices. The incentives that higher prices have on our domestic oil producers will put more people back to work. This is a real benefit for communities across the country that experienced the financial strain of layoffs. The incentives that climbing energy prices provide extends beyond the oil industry. To the chagrin of many, these effects are not only domestic. Many of the antagonists on the global stage rely on oil output to not only fuel their economy, but also their political agendas. The OPEC announcement will be welcome news in Iran and Russia as their budgets heavily depend on crude output. Russia will be in an increasingly better position than it was in 2016. With a more robust budget, Russia has plenty of opportunity to continue advancing its agenda and it will definitely be something to monitor going forward. While we don't expect

anything too dramatic, the news of each of Putin's moves could have an effect on market movements increasing volatility and tension on the global stage. The news flow will cause uncertainty but a focus on the economic fundamentals, both domestic and international, should also be the focus. How can we take advantage of higher oil prices? How will higher prices affect the Fed's timing for 2017 rate increases? We're focusing on domestic drillers and pipeline companies in portfolios.

Building 'Builder' Confidence

2016 saw improving new home sale data yet home building stocks have been trading in a tight range with more volatility than most sectors of the economy. This is the backdrop as the most recent National Association of Home Builders (NAHB) survey was the strongest in 11 years. Existing home sales rose to an annual rate of 5.61 million in November and the highest level since February of 2007. In the past 12 months, existing home sales have risen by 15.4%. Overall, the housing market does not appear to be adversely impacted by the increase in mortgage rates. Clearly conditions today are nowhere close to those in place 11 years ago, with sales around 40% of 2005's peak activity and about 60% of the much more normal 2001 housing market. The question going forward is whether improved confidence translates into increased housing inventory. We've started to build a position in clients' accounts in XHB, the homebuilding ETF (exchange traded fund). Large ticket home furnishings have emerged as support to total consumption growth and serves as a strong barometer for the health of the economy. We believe a sector's performance and individual company fundamentals serve as crucial factors in deciding an optimal portfolio mix. Our goal is not to compromise long-term objectives and risk as we adjust the portfolios we manage.



Muybridge's Proof – Before motion picture, Eadweard Muybridge, a photographer, was commissioned in 1872 by Leland Stanford (founding father of Stanford University and Governor of California) to photograph horses to help settle a $25,000 bet as to whether a racehorse's hooves all leave the ground at once when running. After years of technological and personal setbacks, Muybridge succeeded in rigging a series of specially-designed equipment with tripwires to rapidly capture a series of images documenting one full gallop. Please visit juliemeridian.com to view more of Julie's exceptional and interesting work.

Featured Client:
Julie Meridian

Julie Meridian is drawn to the hidden nature of things and the ways context can shift perception and behavior. Julie explores these through both art and design, seeking out the small truths whose presence can inspire serendipitous connections. Through painting and illustration she captures what is unique – to remix it or to hold it in isolation to gain fresh perspective. Julie shows her work at Kaleid Gallery and frequently contributes to Works/San José and Kaleid Gallery. She is continually inspired by the diversity and the spirit of innovation of the South Bay. Much of her work is inspired from her observational skill built up from her career in user experience design. Best known as the lead designer for Adobe Photoshop, Adobe Illustrator, and LinkedIn, she is currently consulting through her business, Make It Legit. She has a B.S. in Computer Science and a minor in Studio Art from Cal Poly, San Luis Obispo. She met her husband Alan there and they were both active at the college radio station (KCPR) and newspaper (Mustang Daily). They have been residents of San José for over a decade.

Digital Legacy

Many times we've stressed the importance of having an estate plan. It's important to lay out a plan with your estate attorney and list all of your assets, both monetary and physical. We usually focus on asset protection and the financial aspects of what's left behind. There are many moving parts of your life that may not be easily figured out once you're gone. You should consider how your surviving loved ones will access the information and accounts you leave them. One way to help alleviate some of the headache is setting up LastPass Emergency Access. It's an online password manager that will help your loved ones access the accounts they need when they're designated a "digital heir". What you leave behind can seem messy and complicated to those who aren't familiar. LastPass shows them the accounts that they need to take care of. Utility and cell phone bills, as well as home and auto insurance need to be settled once you can't handle the monthly maintenance. Winding down an estate is never easy, but if loved ones know what they're looking for and where to look, it will be just a little easier.

All of us at Karp Capital Management thank you for your continued support over the last year. It is a privilege to help you, your family and friends reach financial goals. Please remember that we appreciate your support and we're flattered when you refer your family and friends. If you know someone that would enjoy our commentary on the market, please share the newsletter with them. If they would like to receive our quarterly commentary please direct them to sign up for the email edition at karpcapital.com.

If you have any questions on the preceding analysis, or would like to review your portfolio's performance, please call us at 877-900-KARP. At Karp Capital, we care about your financial world and how it is positioned in the global economy.

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