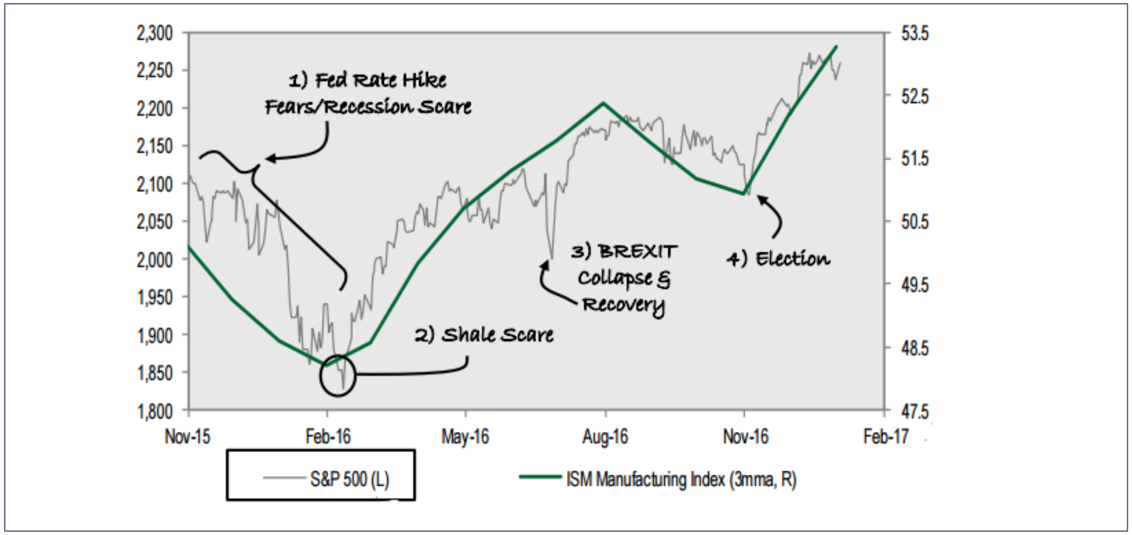
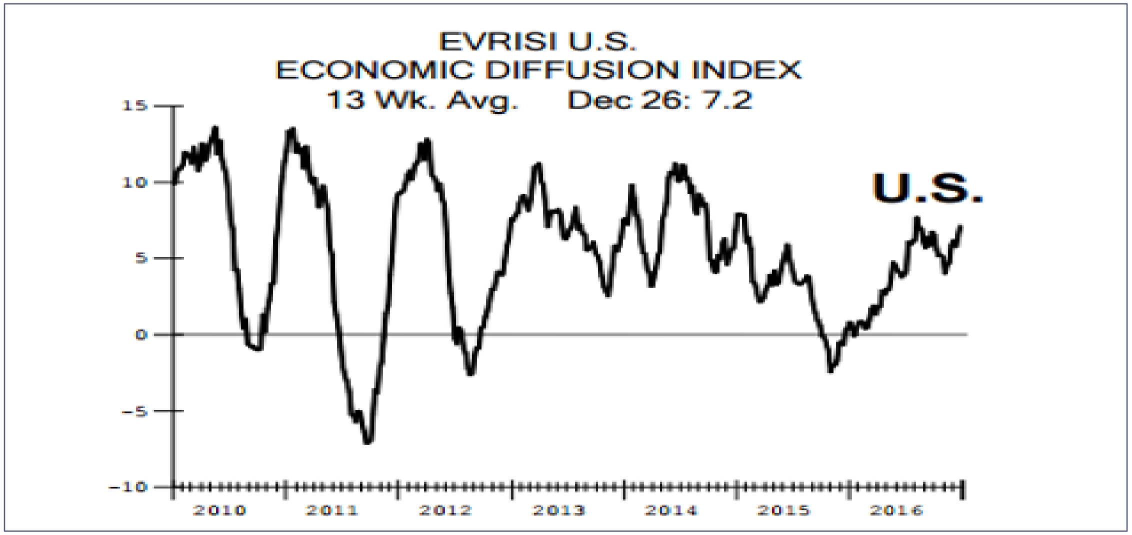
Market Recap

2016 in Review: Fundamentals Still Drive the Market



Source: Cornerstone, Goldman Sachs

Improving Breadth of Economic Activity



Source: Evercore ISI

A variety of disruptive macro and geo-political effects drove headlines and played upon the minds of investors in 2016. Between the constant specter of Fed rate hikes, concerns about oil prices, and political surprises in the U.S. and Britain, it seemed as though some event of great consequence was continually driving the market higher or lower. A deeper study, however, suggests that while these headlines may have had an effect upon investor psychology and confidence, the underlying fundamentals of the stock market continued to be the driving forces of any sustained increases or decreases. Throughout the balance of 2016, the ISM Manufacturing Index (which monitors the tone of business confidence across the domestic economy) tracked hand-in-hand with the S&P 500. The indicator peaked and troughed alongside the broader stock market, suggesting that improvement or deterioration of the underlying fundamentals (rather than event-driven headlines) were the drivers of true changes in the direction of the market. While distracting, investors must ignore the “noise” and keep an eye on the fundamentals.

One of the more obscure - but nonetheless important metrics – tracked by the industry is the diffusion of economic activity. Economic diffusion indexes measure the proportion of industries that are positively contributing to economic growth – put more simply, they track the breadth of economic activity throughout the economy at any given point in time. Broader economic participation levels are the hallmark of a healthy economy, whereas more narrow leadership (in both the economy and stocks) tends to breed a more volatile, less stable market environment. Following a substantial decline over the 2014-15 timeframe, it has been encouraging to see a sustained uptrend in this index as key industry groups, including Housing and Energy, begin to contribute to growth in a more meaningful way.

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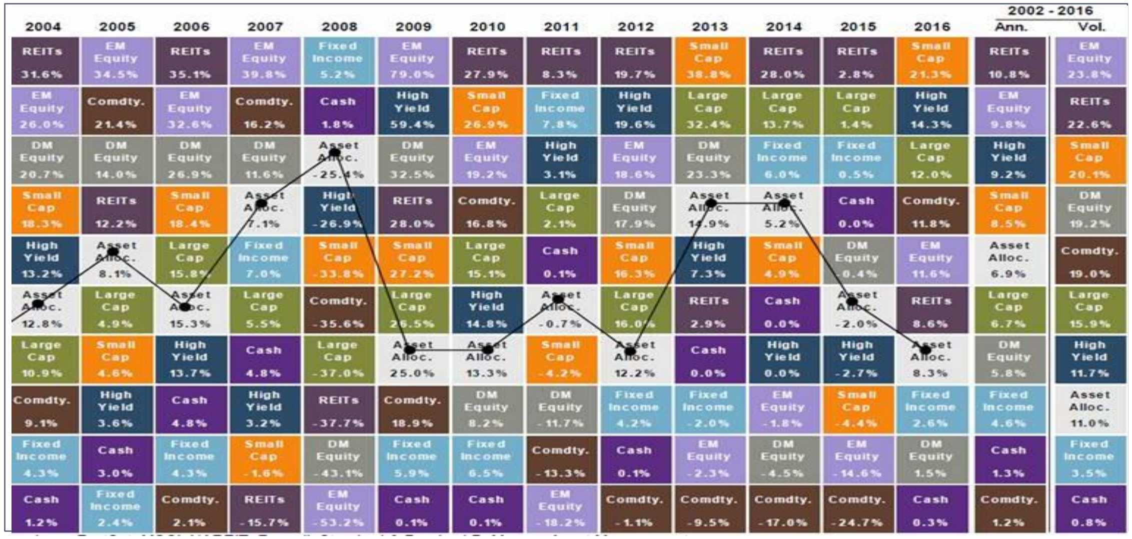
The Importance of Diversification



2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2002 - 2016 Ann.	Vol.
REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	REITs 10.8%	EM Equity 23.8%
EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	EM Equity 9.8%	REITs 22.6%
DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	High Yield 9.2%	Small Cap 20.1%
Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 8.5%	DM Equity 19.2%
High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 6.9%	Comdty. 19.0%
Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	Large Cap 6.7%	Large Cap 15.9%
Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	DM Equity 5.8%	High Yield 11.7%
Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 4.6%	Asset Alloc. 11.0%
Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Cash 1.3%	Fixed Income 3.5%
Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Comdty. 1.2%	Cash 0.8%

Source: JP Morgan

The classic "Asset Quilt" of market returns is a testament to the age-old adage, "Don't keep all your eggs in one basket." Diversification gives you a better chance of managing your behavioral instincts through the process of rebalancing – this is well articulated by the diversified composite portfolio (labeled 'Asset Alloc.'). While being diversified means you may never be a top performer, you will also never be the biggest loser. The asset quilt is a useful visualization of the challenge that managers face in their efforts to consistently identify which asset classes are likely to outperform in the year ahead. Over the past 15 years, the best-performing investment categories have been emerging-market equities and REITs. While emerging-markets' promising economic growth prospects and impressive long-term performance may seem obvious, the asset class has been at best a middling performer since 2009. REITs on the other hand have been the top performing category in five of the past seven years. If history is any indication, REITs' performance may 'revert to the mean' at some point over the next few years.

The January Effect

S&P 500 Percentage Returns Through the Month of January and from February to December

Year	Jan %Change	Feb-Dec %Change	Match	Year	Jan %Change	Feb-Dec %Change	Match	Year	Jan %Change	Feb-Dec %Change	Match
1950	2.3	18.1	Yes	1970	(9.0)	8.2	No	1990	(8.9)	(0.1)	Yes
1951	4.2	9.0	Yes	1971	5.1	6.0	Yes	1991	5.2	18.8	Yes
1952	1.4	9.7	Yes	1972	2.2	12.7	Yes	1992	(2.1)	7.1	No
1953	(0.6)	(6.3)	Yes	1973	(2.6)	(17.4)	Yes	1993	0.8	6.6	Yes
1954	4.4	31.5	Yes	1974	(1.1)	(36.3)	Yes	1994	3.4	(4.7)	No
1955	(0.3)	21.6	No	1975	9.2	15.4	Yes	1995	2.4	27.0	Yes
1956	(3.0)	6.1	No	1976	10.4	5.8	Yes	1996	2.4	17.0	Yes
1957	(3.3)	(12.2)	Yes	1977	(4.8)	(7.0)	Yes	1997	6.5	21.1	Yes
1958	3.3	27.6	Yes	1978	(5.0)	7.4	No	1998	0.5	22.8	Yes
1959	0.0	7.5	Yes	1979	3.3	7.6	Yes	1999	4.1	13.5	Yes
1960	(7.4)	4.4	No	1980	7.6	17.0	Yes	2000	(4.3)	(5.5)	Yes
1961	7.1	14.7	Yes	1981	(5.1)	(5.8)	Yes	2001	6.2	(16.3)	No
1962	(3.0)	(8.9)	Yes	1982	(1.9)	15.3	No	2002	(2.1)	(25.1)	Yes
1963	5.4	11.9	Yes	1983	4.9	12.7	Yes	2003	(6.0)	26.0	No
1964	2.1	9.0	Yes	1984	(0.4)	1.7	No	2004	2.0	7.0	Yes
1965	3.9	5.2	Yes	1985	8.3	15.9	Yes	2005	(1.7)	5.5	No
1966	0.8	(14.5)	No	1986	1.0	13.9	Yes	2006	0.9	10.3	Yes
1967	7.5	10.8	Yes	1987	10.6	(10.1)	No	2007	1.5	2.8	Yes
1968	(4.1)	11.8	No	1988	0.4	7.7	Yes	2008	(4.9)	(43.7)	Yes
1969	(0.9)	(11.7)	Yes	1989	7.7	17.2	Yes	2009	(12.1)	31.0	No

Source: Daily FX

The 'January Effect' refers to a well-known stock market phenomenon that is couched in the idea that several seasonal anomalies support rising stock prices. Tax selling by investors in December in order to 'harvest' losses to mitigate any capital gains tax liability artificially depresses stock prices in December, and the liquidity provided by this practice theoretically leads to greater buying in January. Additionally, many retail investors will be receiving bonuses and pay raises going into the new year, and they are likely to direct a portion of that to their investment portfolios. Lastly, market psychology has an effect here as investors try to get ahead of the 'January Effect,' buying stock and actually contributing to the resulting gains. This effect has not been as strong in recent years, and it is suggested that this seasonal arbitrage has now been internalized and exhausted by market participants. It will be interesting to see whether 2017 experiences a 'January Effect.'

Contact: If you have any questions or comments, please do not hesitate to contact us at 703.992.6164. For more information about Harbour Capital Advisors, please visit our website at www.harbourcapitaladvisors.com.