Redhawk Quarterly Commentary

December 31, 2016

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic topics designed to help make decisions affecting your long-term financial strategy.

Economic Outlook

2016 was positive for stock and bond investors as the S&P 500 was up 12% including dividends, and the Barclays U.S. Aggregate Bond Index recorded a total return just shy of 2.5%. With greater uncertainty ahead of us, we expect a return to normal volatility in 2017, with at least one 10% stock market correction as well as several smaller pullbacks. But that doesn't mean markets are bound to be lower a year from now. Over the last 20 years, stocks have fallen by 14% within the year, but have posted gains of about 10% on average, by year-end.

The Investment Year in Review - 2016 put another tally in the win column for the current bull market, with stocks padding their gains heading into year-end. Long-term investment strategies are not simply measured by what happens between Jan. 1 and Dec. 31, but a quick look back helps to set the stage for the year ahead.

- **A Terrible Start** – Stocks got off to a historically bad start in 2016, dropping 11% from Jan. 1 to Feb. 10 amid plummeting oil prices and growing fears that the U.S. economy was heading for a recession.

- **Brexit Becomes a Household Term** – The U.K. vote to leave the European Union showed that polls don't always accurately predict the future. Global markets reacted sharply to the uncertainty, with the S&P 500 falling 6% over the following two days. However, this would prove to be the extent of the pullback, with U.S. stocks recovering the losses within the next week.

- **Negative Rates** – Sluggish growth and deflationary pressures around the world prompted many central banks to increase monetary policy stimulus. Interest rates moved into negative territory, with as many as half of outstanding international developed-market sovereign bonds carrying negative yields.

- **U.S. Election Surprise** – The presidential election was undoubtedly one of the key market stories of the year, with pre-election volatility to post-election enthusiasm as markets rallied on the prospects of faster growth initiated by policy proposals from president-elect Trump. Notable proposals that could impact economic growth include tax reform for individuals and businesses, an infrastructure spending program, and regulatory changes.

- **Oil Prices Rebound** – It was a v-shaped year for crude, with prices falling to a 13-year low of $26 per barrel in February before rebounding over the course of the year to finish near $53. Expectations for a slight improvement in global demand, coupled with OPEC's announced production cuts, drove oil higher.

- **Another Year, Another Hike** – The Fed raised rates by a quarter point in its final meeting of the year, making a total of two hikes in as many years. The combination of improving economic data and the Fed's communication in its prior meetings made the December hike widely expected. Perhaps the bigger move from the Fed was its forecast for three more hikes next year, which would be the highest number of annual increases since 2006, when the Fed Funds rate was lifted four times.

- **U.S. Economic Improvement** – The U.S. economy gained a bit of traction as the year progressed. After posting growth of just 0.8% in the first quarter, the weakest since the first quarter of 2014, GDP rose by 3.5% in the third quarter, the first period above 3% in two years and the seventh-best quarter of growth since the recovery began in 2009.

- **Another Record** – The stock market set a new record high again in 2016 with the S&P 500 hitting 2,271 and the Dow nearing 20,000 in December.

2016 Asset Category Scorecard

- **Cash –** Real returns for cash (after inflation) remained negative, given persistently low inflation and Fed policy. But periods of market volatility warranted some investment cash reserves for pullbacks.

- **U.S. Investment Grade Bonds –** U.S. bonds held on to modest gains despite the late-year selloff as rates rose in response to expectations for higher inflation.

- **International Bonds –** Global central bank intervention and deflationary pressures kept rates low around the world, limiting returns for international bonds.

- **High-yield Bonds –** Outperformed in 2016 with a return of nearly 17%, with spreads tightening and prices benefitting from an improving U.S. economic outlook and higher oil prices which relieved financial stress on issuers in the energy sector.

- **U.S. Large-cap Stocks –** Another solid year, posting double-digit gains. Valuations benefitted from an improving domestic growth outlook, with the P/E remaining above average. Earnings failed to keep pace, placing added importance on the expected earnings rebound in 2017.

- **Real Estate –** Property markets improved with the economy, but real estate investments could face challenges in a rising-rate environment.

- **Developed International Large-cap Stocks –** There were some bright spots in specific regions, but another year of disappointing expansion in Europe and Japan led to underperformance in international large-caps.

- **Small and Mid-cap Stocks –** Post-election enthusiasm around the U.S. economy produced a strong finish for small and mid-caps. Small-caps led all other asset classes with a better than 20% gain, which is very impressive considering small-caps started off the year by declining into bear market territory.

- **Commodities** – After a dismal performance last year, commodities rebounded in 2016, led by the bounce in oil prices and slight improvement in the global demand outlook, including the U.S. and China.

- **Emerging Markets** – Emerging market stocks rebounded to deliver solid gains, helped by stabilizing activity in the Chinese economy, faster growth in India, and a rebound in commodity prices.

What's in Store for 2017?

- **Economy –** The U.S. economy is starting the year off on fairly solid footing. Job growth is healthy, the housing market is improving, and business spending looks to be picking up. Economic improvement will be a key factor in determining the path ahead for further Fed rate hikes which, alongside policy details and actions from the Trump administration, is likely to be a primary focus for the market this year.

- **Markets –** Earnings growth looks decent and should get some relief from energy-sector profits in a more stable oil price environment. Valuations are full for U.S. stocks, leading to our expectation for moderate earnings growth to be the primary driver of stock market gains. In the bond market, we expect the Fed to hike rates a few times this year, but in a slow, measured fashion, which should set the stage for increasing longer-term rates over time.

- **Investment Actions –** We doubt 2017 will be smooth sailing. The investment environment still looks favorable, but investors should set appropriate expectations, both for long-term returns and near-term volatility. After the sizable outperformance of U.S. equities in 2016 and in recent years, we think the coming year could bring more rotation in market leadership, supporting the need for and value of sub-category diversification. Investors typically compare their portfolio to the most visible benchmark which is the Dow or S&P 500, but it's the appropriate mix of equities, bonds, and alternatives along with diversification across a broad mix of sub-categories, that will ensure that the portfolio maintains its appropriate level of risk and performance that is in line with the investor's long-term goals.

The Stock & Bond Market

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	19,763	-0.9%	13.4%
S&P 500 Index	2,239	-1.1%	9.5%
NASDAQ	5,383	-1.5%	7.5%
Bonds*	$108.07	0.6%	2.4%
10-yr Treasury Yield	2.44%	-0.09%	0.17%
Oil ($/bbl)	$53.83	1.5%	45.3%

Source: Bloomberg. Past performance does not guarantee future results. *Bonds represented by the iShares Core U.S. Aggregate Bond ETF.

Summary

It's not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You have to be patient and disciplined, too. With our Investment Committee and structured monitoring process we are reviewing the underlying investments on a weekly basis to ensure that we are in the top performing sub-categories and investments. Please contact your Redhawk advisor to learn more.