Wilbanks, Smith & Thomas
ASSET MANAGEMENT, LLC

Market Returns
Year to date through December 31th, 2016

Index	Return
MSCI All Country World Index	8.5%
S&P 500 Index	12.0%
Dow Jones Industrials Index	16.5%
Russell Small Cap Index	21.3%
MSCI EAFE Index	1.5%
MSCI Emerging Market Index	11.6%
Barclays Capital U.S. Aggregate Bond Index	2.6%
Merrill Lynch High Yield Index	17.5%
S&P/Citi Int'l Treasury Bond Index ex U.S.	1.6%
Merrill Lynch U.S. Treasury 1-3 Year Index	0.9%

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"When the facts change, I change my mind, sir. What do you do?"

John Maynard Keynes

"Reality is one of the possibilities I cannot afford to ignore."

Leonard Cohen

History's turning points are rarely identifiable in advance, but 2017 may well be one. We wrote last quarter that the world was waiting for the outcome of the presidential election, and Donald Trump's surprise victory promises to reset the direction of U.S. policy in ways that could have a big impact on the economy and investment markets. While the markets' reactions to the ebb and flow of news and poll results during the campaign suggested that investors favored a Clinton win, the surge in stock prices and bond yields after the election reflect a collective hope in Trump's ability to find a path out of the malaise that many Americans feel despite the health of our economy. The roots of that dissatisfaction have been the focus of much commentary and discussion.

Trump's win has been as divisive as any political outcome in recent memory with emotions ranging from jubilation to depression depending upon one's perspective. In preparing this letter we've attempted a balanced survey of opinions and views. The short-term economic implications of Trump's proposed policies are relatively straightforward (while still not perfectly predictable) but the bigger story is about the forces that led to his election. One thread that weaves through the macroeconomic analysis around the election is the global shift from policies centered on safety in the form of protectionism, regulation and austerity to ones focused on growth. The debate about the shortcomings of the previous administrations in the U.S. are easy to politicize with Democrats criticizing George Bush's military decisions and budget deficits and Republicans lambasting Barack Obama's social programs and health care plan. It's worth considering the broader perspective, which is that for most of the 21st century the global economy has been on its heels as policy makers confronted a series of crises including the internet bubble in 2001-2002, the housing bubble and near meltdown of the global financial system in 2008, and the war on terror throughout. Policies focused on creating long-term economic growth have not been the top priority of either party in the U.S., nor have they been the focus of our global trade partners.

In 2009 PIMCO's then chief economist Mohamed El-Arien coined the term "New Normal" to describe the economic and regulatory environment following the financial crisis of 2008. The key characteristics of the "New Normal" were stubbornly sedate economic growth, low inflation, low interest rates, delevering of corporate and personal balance sheets, and increasing government regulation. Central banks around the world have gone to unprecedented lengths in their efforts to spark growth, but monetary policy seems to have reached its limit. Given the marked differences between the policies outlined by President-elect Trump and those of the Obama administration, a wide range of economic outcomes are possible over the next few years. Most economists agree that Trump's policies are pro-growth, but they also acknowledge that a policy misstep is more likely under the new administration as we make the transition from monetary to fiscal stimulus. The "New Normal" may be replaced by the "New Abnormal" as markets

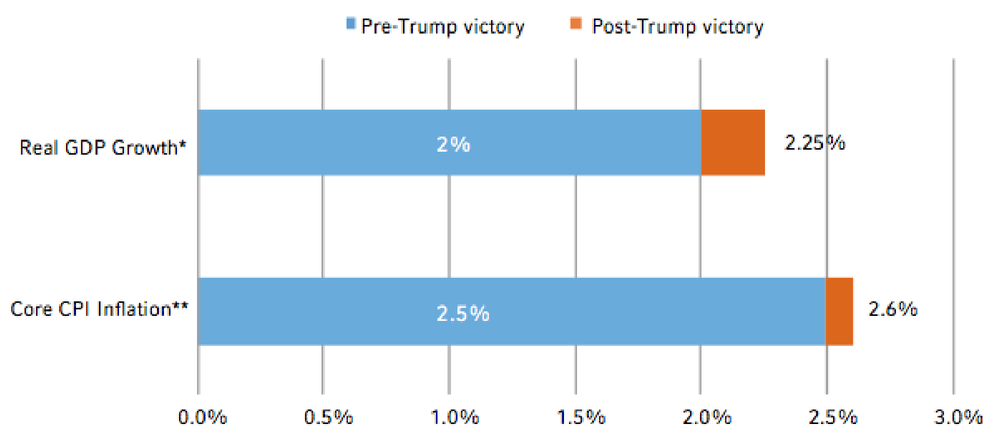
and investors adapt to the rapidly changing economic and geopolitical landscape. The Trump administration has promised to deregulate key industries (including most importantly the banking sector), enact trade policies that favor U.S. manufacturers, and deliver fiscal stimulus in the form of both infrastructure spending and tax cuts. Fundamentally the new policies should propel faster global growth, which, all other things being equal, would be good news for the equity markets. Of course, all other things are never equal, and the risks to the outlook have increased as well. If growth accelerates too much inflation could spike, forcing the Fed to act more quickly than expected. Interest rates have already risen in anticipation of faster growth and higher inflation, and that trend could become a drag on the expansion if it continues. Trump's growth agenda relies on deficit spending at least in the short run, and the U.S. deficit and debt situation has long been a concern.

So, we look forward to 2017 and see an aging but resilient economic expansion and a new regime coming to power in Washington and bringing philosophies and policies diametrically opposed to those of its predecessor. The transition comes against a backdrop of record-high stock prices and low bond yields. It will be an interesting year! In the sections below we review the strong performance generated by the investment markets in 2016 and look ahead at the outlook for the economy and markets.

Economic Overview

By all measures, President Trump will inherit a healthy economy when he takes office on January 20. The same long-cycle drivers that existed at the beginning of 2016 remain in place including supportive global central banks, low interest rates, and a solid employment picture in the U.S. The economic policies the President-elect outlined during the campaign should support continued global growth. Trump has proposed overhauling the tax code, promoting domestic energy production, rebuilding the nation's infrastructure, and reducing both the burden of government regulations and the trade deficit. His economic team believes that these moves will spark an upswing in economic growth and estimates that his policies could drive average GDP growth of 3.5% a year - a pace the U.S. hasn't seen in more than a decade. The last stretch of sustained growth above that level ended in 2000. By comparison, the recovery that began in mid-2009 has been long in duration but relatively weak by historical standards, with annual growth averaging just 2.1%. Many forces have been blamed for that modest pace, from the household-debt overhang after the housing bubble to overregulation of the finance/lending industry. Still there is no denying that the trajectory of the economy is positive and we expect stronger domestic economic growth in 2017 if Trump can deliver on his promises. Politicians around the world are also likely to take heed of the messages sent by voters in the U.S. and UK last year, so fiscal stimulus in other countries should support global growth in the short run as well. As the chart below from Russell Investments depicts, the consensus estimate is that Trump's policies will add about .25% to GDP growth and .1% to inflation this year.

Trumponomics is directionally pro-growth, pro-inflation
Impact of the November 8, 2016 Trump election victory on our 2017 U.S. macro forecasts



Source: Russell Investments and Thomson Reuters I/B/E/S Datastream, as of Nov. 25, 2016.

While tax cuts and infrastructure spending should give the U.S. a boost, especially in the short term, Mr. Trump's long-term targets seem ambitious. The economy faces potentially offsetting headwinds and tailwinds, including several that will be driven by the evolution of the new administration's fiscal policies. It's hard to deny the potential upside from the large package of tax cuts and infrastructure spending that may be coming: Republican tax cuts and infrastructure plans range from 2% of GDP under the House Republican proposals to 3% under Trump's platform. Corporate income tax cuts could also be a big impetus to business spending, which has been weak in recent years. A lower marginal effective tax rate on investment could stimulate investment and thereby lift productivity growth, raising economic growth in both the short- and longer-term. Republicans have also pledged to reduce the regulatory burden on businesses, which could further support investment.

Given the potential upside of these planks in Trump's platform, the market and most commentators have not yet focused on the possible downsides, but they exist. Tighter immigration and restrictive trade policies are inflationary and could slow the economy, especially over the longer term. We are also wary of the potential economic drag from any offsetting spending restraint that may be imposed by Congress to avoid ballooning deficits. Given the orientation of fiscal measures toward tax cuts and their focus on the upper-end of the income scale the impact on near-term GDP growth may be smaller than projected, and with a lag in implementation it will likely be 2018 before material impacts are felt in the economy.

The chart below, courtesy of Summit Strategies Group, outlines the likely impact of Trump's proposed policies on the U.S. economy and the major investment asset classes. As we will discuss the President-elect's platform should be positive for stocks, commodities, and the dollar and negative for fixed income assets as inflation rises.

ECONOMIC POLICIES AND EXPECTED IMPLICATIONS FOR INVESTORS

Policy	US Growth	US Inflation	Equities	Bonds	Commodities	USD
Deregulation	↑	↔	↑	↔	↔	↔
Tax Cuts	↑	↑	↑	↓	↑	↔
Protective Trade Policy	↔	↑	↔	↓	↔	↑
Government Spending	↑	↑	↑	↓	↑	↔
Market Reaction to-date	↑	↑	↑	↓	↓	↑

↑ Positive Impact ↓ Negative Impact ↔ Mixed or Uncertain Impact

Source: Summit Strategies Group

Equity Market Overview

The U.S. stock market rebounded from one of its worst starts ever to post double-digit returns in 2016, overcoming fears about a slowdown in China, the lowest oil prices since 2003, and the surprise Brexit vote. Most of the gains came in the second half of the year with the fourth quarter especially strong on the heels of Trump's election. Investors hope the new administration's more business-friendly policies will be the catalyst for improvements in long-dormant corporate earnings.

The Dow Jones Industrial Average now stands at more than triple the financial crisis low of 6,547 set in March 2009, and the index tried hard to break through the 20,000 level as the year ended. The strong finish was a big relief for those equity investors who stood firm through the 10% decline the markets suffered from January 1 through mid-February, when the Dow hit a two-year low of 15,660. One CIO offered a good analogy when he said "owning stocks in 2016 was like holding a wolf by the ears…uncomfortable while you held on but worse if you let go." [1]

Equity Index	4Q 2016	1 Year	3 Year
Dow Jones Industrial Average	8.7	16.5	8.7
Large Cap Stocks (Russell 1000)	3.8	12.1	8.6
Growth	1.0	7.1	8.5
Value	6.7	17.3	8.6
Small Cap Stocks (Russell 2000)	8.8	21.3	6.7
Growth	3.6	11.3	5.0
Value	14.1	31.7	8.3
MSCI All Country World Index	1.3	8.5	3.7
International Stocks (MSCI EAFE)	-0.7	1.5	-1.1
Growth	-5.5	-2.7	-0.8
Value	4.2	5.7	-1.6
Emerging Markets Stocks (MSCI EM)	-4.1	11.6	-2.2

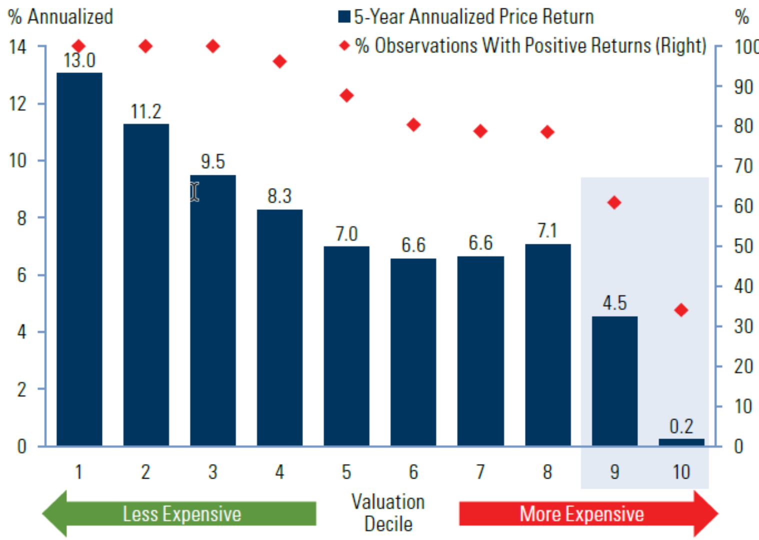
Economically sensitive stocks benefited most from the Trump rally as those sectors and companies best able to capitalize on faster growth took off in the fourth quarter. Small-cap stocks and particularly small-cap value stocks rose, with the Russell 2000 Value Index up 14% for the quarter and 32% for the year, leading all sectors. Value stocks in general outperformed growth in all market segments and all geographies. Large-cap value stocks enjoyed a 17.3% return for the year versus 7.1% for large-cap growth. Dividend stocks, particularly utilities, telecoms and REITs, fell from favor in the second half as global interest rates began to rise and bonds became a more attractive alternative for income oriented investors. Traditional value sectors rotated into favor with bank stocks in particular rallying on rising rates, which help their profitability, and hopes for less burdensome industry regulations.

Developed equity markets outside the U.S. slipped in the final quarter of 2016 and trailed U.S. stocks. Performance for the year was unexceptional as the MSCI EAFE managed to squeak out a 1% gain in 2016. The MSCI ACWI ex U.S. Index (which has greater emerging markets exposure) was down 1.3% for the quarter and up 4.5% for the year. Foreign stocks started 2016 on a sour note as markets sold off amid economic and political uncertainty. Expectations of a stronger U.S. dollar and the combined impacts of the refugee crisis, terrorism, and the volatile Chinese economy (foreign countries export more to China than the U.S. does) carried over from 2015 and weighed heavily on these markets all year. After rallying for the first half of the year foreign markets were shocked by the "Exit" vote in Great Britain, and while that sell-off was brief non-U.S. equities could not overcome investor preference for the U.S. With Japan still flat on its back economically and the fate of the EU undetermined there is probably no more contrarian

[1] 2016 Market in Review: *Barron's,* December 31,2016

call than the case for international stocks, but they are inexpensive and will benefit from stronger growth just as U.S. stocks will.

Emerging markets stocks were weak in the fourth quarter but still performed well over the course of the year. GDP in the EM basket of countries expanded an estimated 3.9% and commodity markets showed signs of stabilizing. Performance results were bolstered by money flows into the sector. Debt investors flocked to the higher yields available in these countries and equity markets benefited as investors followed the momentum during the first nine months of the year. The emerging markets sell-off following the presidential election was driven by fears of a shakeup in globe trade agreements, higher U.S. interest rates, and the stronger dollar. The MSCI EM Index posted a decline of 4.2% for the quarter but still managed a respectable total return of 11.2% for the year. Looking ahead to 2017 the base case expectation among EM experts is for economic momentum to persist with growth in the 4.5% range, but the trade policies of the Trump agenda create a huge unknown. Trump's two main targets, China and Mexico, account for 23% and 15% of U.S. imports of manuafactured goods respectively, and protectionist tarriffs aimed at those two countries will impact all emerging economies due to the sensitivity of those countries to Chinese economic performance. [2]



Data as of December 31, 2016.
Note: Based on 5 valuation metrics for the S&P 500, beginning in September 1945: Price/Trend Earnings, Price/Peak Earnings, Price/Trailing 12m Earnings, Shiller Cyclically Adjusted Price/Earnings Ratio (CAPE) and Price/10-Year Average Earnings. These metrics are ranked from least expensive to most expensive and divided into 10 valuation buckets ("deciles"). The subsequent realized, annualized 5-year price return is then calculated for each observation and averaged within each decile. Past performance is not indicative of future results.
Source: Investment Strategy Group, Bloomberg, Datastream, Robert Shiller.

While optimism about economic growth and corporate earnings abounds, stock investors in the U.S. face an uphill climb due to expensive valuations. Goldman Sachs estimates that domestic stocks have risen to their 9th or 10th decile of long-term valuations, and as the adjacent chart courtesy of Goldman Sachs Investment Management demonstrates expected returns decline as valuations rise. High stock valuations don't necessarily mean that losses are imminent; in fact, five-year stock returns have been positive more than half the time after equities reach current levels. With earnings and valuation being the two factors that drive stock returns, and valuations at these high levels, corporate earnings are increasingly in focus. We're upbeat on the earnings outlook overall and expect that as the U.S. earnings recovery continues our exposure to small and mid-cap stocks will add value as they have since the election.

Despite the generally encouraging earnings outlook there is no denying that today's high valuations increase the risk of owning stocks. We continue to rebalance portfolios to conservative target allocation mixes where appropriate to match client needs and risk profiles, and we are taking a measured approach to getting new accounts and new money invested in equities. The melt-up in risk assets since the election has fully priced in investors' renewed enthusiasm and we are left to wait and see how the economy and corporate earnings will perform. While there are plenty of reasons for optimism there is no way to predict how stocks will respond to the mix of faster growth, higher inflation, and higher interest rates that we expect. The current bull market will be eight years old on March 10, and we believe a cautious approach is appropriate despite recent strong performance.

[2] *Outlook - Half Full,* Goldman Sachs Investment Management Division, January 2017

Bond Market Overview

Bond yields ended 2016 just slightly higher than where they began it but rode a roller coaster in between. The 10-year U.S. Treasury note yield rose from 2.27% to 2.45% leading to the second straight year of price declines for that benchmark security. The small increase in yield belies the huge shift in sentiment that began at midyear as improving economic data and a perceived shift in Fed sentiment led investors to expect stronger growth and higher inflation.

Risk aversion drove the market for the first half of the year. Yields fell almost a full percentage point from January through early July as concerns about China's economy and the fate of the European Union sent investors flocking into the perceived safety of U.S. government bonds. All of that decline and more was reclaimed by year-end and the sell-off in bonds in the second half of 2016 paralleled the "Taper Tantrum" of 2013 that followed then Fed Chair Bernanke's comments about the end of quantitative easing. The Treasury yield jumped .84% between October and December, the largest quarterly gain since 1994, and reminded investors once again of the bond market's sensitivity to expectations about central bank policy.

As the table below reveals our fixed income portfolios were well-positioned for the interest rate environment in 2016. Our relatively short duration and relatively long credit portfolio tilts were rewarded last year with lower volatility and higher returns as corporate bonds outperformed Treasuries and shorter maturities generated returns roughly in line with longer maturities while avoiding the price fluctuations that long-term bonds endured.

Fixed Income Index/ETF	4Q 2016	1 Year	3 Year
Barclays U.S. Aggregate Bond Index	-3.0	2.6	3.0
iShares 1-3 Year Treasury Bond ETF	-0.4	0.8	0.6
iShares 3-7 Year Treasury Bond ETF	-2.8	1.2	2.0
iShares 20+ Year Treasury Bond ETF	-12.6	1.2	8.1
iShares TIPS Bond ETF	-2.6	4.7	2.1
SPDR Barclays Mortgage Backed Bond ETF	-2.4	0.9	2.8
iShares National AMT-Free Municipal Bond ETF	-3.4	-0.2	3.9
SPDR Barclays Intermediate Term Corporate Bond ETF	-2.0	4.2	3.0
SPDR Barclays High Yield Bond ETF	1.3	14.4	2.4
PowerShares Senior Loan ETF	1.7	9.2	2.1
SPDR Barclays International Treasury Bond ETF	-9.9	0.6	-2.9
iShares JPM USD Emerging Market Bond ETF	-4.6	9.3	5.4

The key question facing bond investors now is whether the reversal in rates that began last summer signaled the end of the three-decade decline in interest rates. The record low yield reached in July may have been the culmination of the bull market for fixed income assets after years of low inflation, aging demographics, improving global supply chains and technological innovation. Those long-term secular forces have been magnified in recent years by cyclical factors including weak global growth, low commodity prices and extreme central bank policies including quantitative easing and negative interest rates.[3] The tide seems to be turning as that mix of forces is dissipating. The Fed has moved off its near-zero rate policy and ended quantitative easing, energy and other commodity prices have firmed, and the general outlook for global growth has improved. That backdrop combined with the expected expansionary and inflationary impacts of the Trump administration's fiscal policy platform likely sets the stage for a gradual increase in interest rates. Our bond portfolio allocations reflect that view and continue to favor credit over duration risk, and we will maintain our allocations to high yield where appropriate for as long as the economic data remain positive. By seeking return from bonds that benefit from better business conditions and avoiding the interest rate risk of long term bonds we aim to achieve the dual objectives of reasonable income and capital preservation in what remains a very challenging environment for investors seeking safety and yield.

[3] *Fidelity's Perspective on Rising Interest Rates*, Fidelity Investments, December 2016.

Summary

2016 will be remembered as the year when populism collided with the policy and regulatory aftermath of the financial crisis. Wikipedia defines populism as "a political style of action that mobilizes a large, alienated element of population against a government seen as controlled by an out-of-touch closed elite that acts on behalf of its own interests." The Brexit vote and the election of Trump were responses by dissatisfied electorates and they demonstrate the challenges incumbents face in implementing dynamic policies that adapt to changing needs and preferences of citizens in today's world of real-time communication. The success or failure of the new policy regimes around the world will determine the performance of the global economy and investment markets in the years ahead.

Setting politics aside we believe the policy backdrop in the U.S. will be favorable for global growth in 2017. As always there is plenty to worry about in a world of geopolitical and economic tensions, climate change, and any number of other challenges. Uncertainty around the new administration's diplomatic and trade tactics have heightened the risks of "black swan" events, and with global investment markets sanguine about the outlook a misstep by the new administration could prompt a quick reversal of the current bullishness. Still, our outlook for looser fiscal policy, still-accommodative monetary policy and a lighter regulatory burden supports the case for a healthy economy. David Shipley of Bloomberg News wrote that the best antidote to populism is responsible, responsive government. Regardless of political affiliation we should all hope that the new administration delivers exactly that. If so, the outlook for the global economy looks good.

Happy New Year, and thanks as always for the opportunity to work with you.

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