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A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

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As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. But, as wealth managers, it is our job to analyze the world around us and invest in the context of the short- and intermediate-term economic landscapes. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2017

1. U.S. stocks will deliver another good year and exceed their long-term average annual returns of 10%.
2. The Federal Reserve will raise short-term interest rates at least twice in 2017.
3. A repatriation holiday for corporate cash held overseas will be a positive for stock buyback ETFs, enabling them to outperform the S&P 500.
4. The real estate market will increase again, with prices rising at single-digit rates at the national level.
5. The U.S. Dollar will continue to strengthen vs. the Euro and reach parity at some point within the calendar year.
6. Volatility, as measured by the CBOE Volatility Index, will increase over the course of the year.
7. Sectors and industries that appear to benefit from a Trump Presidency, including Financials, HealthCare and (traditional) Energy will, in aggregate, outperform the market.
8. Private income oriented investments, such as in real estate and floating rate bank debt, will provide better returns than traditional bond vehicles, such as the Barclays Aggregate.
9. Core inflation will tick up from its 2016 levels of roughly 2%, but the Core CPI increase will remain below its 3% long-term average rate.
10. Money flows into passive funds, such as ETFs and Index Funds, will continue to exceed inflows into actively managed funds.

Beacon's Four Investment Themes for 2017

Beacon's 2017 Investment Themes reflect our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. Domestic equity will continue its strong post-election run, driven largely by corporate and individual tax reform.
2. The "Trump Trade" still has legs.
3. Be creative in obtaining yield as traditional, investment-grade bonds face headwinds.
4. Be prepared for a return of volatility.

A Glance Back on the Year That Was

In a familiar refrain in the roughly eight years since the Great Recession ended, U.S. stocks and bonds experienced another positive year, at the time of this writing. The stock market shook off a correction that occurred in the January-February time frame and rebounded strongly, with the S&P 500 up 12.5% in 2016 as the year comes to a close. Bonds, meanwhile, moved in the opposite direction, starting off the year strongly and then hung on in the post election period to squeak out a positive return of roughly 2% for the calendar year.

Before we look ahead to 2017, it seems only fair to look back on our 10 forecasts for 2016. What did we get correct and where did we go wrong? In our view, eight of our ten predictions were correct and two were partially correct. We predicted positive stock returns for the 2016 calendar year, but forecast they would be less than 10%. As of this writing, the S&P 500 has slightly surpassed a 10% calendar year gain and seems poised to continue its momentum for the rest of the year. The second of our partially correct forecasts relates to the U.S. Dollar. We forecast that the U.S. Dollar would rise versus both the Euro and Yen. The U.S. Dollar did increase in value versus the Euro in 2016, as the Federal Reserve raised interest rates and Europe recoiled from the United Kingdom's vote to exit the Euro trading block ("Brexit"). However, the Japanese Yen, in the wake of continued government attempts to revive its long suffering economy, outpaced the U.S. Dollar by roughly 6% in 2016.

We did get the vast majority of our calls correct. As noted above, the stock market experienced a correction during the first quarter of the year. Long-term interest rates rose, limiting the gains to U.S. Treasury Bonds. In contrast, credit spreads fell as investors searched elsewhere for higher yields. Hence, most corporate bonds outperformed U.S. Treasury Bond indexes. Real estate prices increased in 2016, as did oil prices. China devalued its currency, acting as the catalyst for a stock market correction in Q1. Inflation remained subdued and indexes based on revenue, such as the Oppenheimer Large Cap Revenue ETF, outpaced the S&P 500. Emerging markets, as represented by the Vanguard FTSE Emerging Markets ETF (VWO), surpassed the S&P 500, albeit in their typically volatile fashion. **Table 1** provides a summary scorecard for our 2016 forecasts.

Table 1: Review of Beacon's 2016 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
Positive stock returns, but below 10%	Partially Correct	Returns positive, but may exceed 10% by year end
Stock market has a 10%+ correction	Correct	Stocks fell 11% over the January-February period
Credit risk preferred to Interest rate risk	Correct	Credit spreads fell, U.S. Treasury yields rose
Real estate prices to rise single digits	Correct	Case-Shiller Home Price Index increased about 5%
Dollar to strengthen vs. Euro and Yen	Partially Correct	U.S. Dollar increased 2% vs. Euro, but fell 6% vs. Yen
Oil prices to increase	Correct	Oil prices increased from $40 to $50+ per barrel
Organic revenue growth firms outperform	Correct	Revenue weighted ETF (RWL) beat the S&P 500
China will devalue its currency	Correct	China devaluated its currency roughly 5% in January
Inflation to fall below its 3% long-term average	Correct	The CPI increased about 2% in 2016
Emerging markets outperform developed	Correct	Emerging markets outperformed the S&P 500

A Closer Look at Beacon's Ten Investment Forecasts for 2017

There is an element of risk in offering predictions, since the future is uncertain. We can state with confidence that some forecasts we offer for 2017 are likely to be correct, some incorrect and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2017 are neither on our list, nor on anyone else's. For example, few strategists at the start of the year forecasted that the United Kingdom would vote to leave the European Union or that Donald Trump would be elected President and that the Republicans would maintain control of Congress. It is often the events that few investment strategists are talking about that result in the most extreme market movements. As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2017.

1. **U.S. stocks will deliver another good year and exceed their long-term average annual returns of 10%.**

   The Republican sweep of the November federal elections increases the likelihood of tax reform, which was at the center of President-elect Trump's economic plan. He has proposed a cut in the top corporate tax bracket from 35% to 15%, in order to be competitive with the rates of many other sovereign nations. A tax cut flows right to the bottom line without requiring additional resources and is bullish for stocks. President-elect Trump has also proposed a rollback of government regulation on many businesses, another boon for stocks. Calendar year gains for 2016 may top double digits for stocks, depending on the magnitude of the reforms.

2. **The Federal Reserve will raise short-term interest rates at least twice in 2017.**

   Although the economy may not be firing on all cylinders, it has certainly improved over the course of the year. GDP for the first two quarters of the year increased at an annualized rate of less than 1.5%. However, the U.S. economy is poised to close the last two quarters of the year with a GDP growth rate above 3%. The Fed has telegraphed a return to a more normalized interest rate policy, given that we are more than eight years since The Great Recession. A more normalized policy would increase short-term interest rates, providing the Fed with at least some ammunition to cut rates when the next recession eventually appears. In our view, this means that rates will rise at least 0.5% in 2017, with two 25 basis point increases and potentially more if the economy is truly growing at rates in excess of 3% on a real GDP basis.

3. **A repatriation holiday for corporate cash held overseas will be a positive for stock buyback ETFs, enabling them to outperform the S&P 500.**

   More than $2 trillion in corporate cash lies overseas, arguably serving unproductive purposes. A primary reason why the cash lies overseas is that it will be taxed at high rates, 35% before any corporate tax reform, if it is brought back to the U.S. There appears to be momentum on both sides of the political isle to offer a repatriation holiday, where cash held overseas may be taxed at a rate as low as 10%. A repatriation corporate tax holiday last occurred in 2004. The money was used largely for stock buybacks and dividend increases rather than long-term capital expenditures. We think a repeat scenario is likely to occur, disproportionately benefiting firms that repurchase their shares.

4. **The real estate market will increase again, with prices rising at single digit rates at the national level.**

   Despite the uptick in long-term interest rates, we believe that the real estate market remains on solid footing. With the unemployment rate at a multi-year low (4.6%), wages rising and a relatively low level of mortgage rates, the fundamentals of the real estate market remain firmly in place. National real estate indexes, such as Case-Shiller, have recently surpassed their values prior to the housing bubble and look poised to continue their gains, albeit at a measured pace.

5. **The U.S. Dollar will continue to strengthen vs. the Euro and reach parity at some point within the calendar year.**

   The U.S. Dollar edged up against the Euro in 2016, spurred by the Brexit fears we cited earlier. The Fed and European Central Bank (ECB) appear to be pursuing divergent monetary policies, with the ECB maintaining its quantitative easing program and the Fed raising rates. With yields of the sovereign debt of many European nations negative or near zero, external capital should continue to flow into the U.S., pushing the Dollar up and the Euro down. This dynamic, and the superior growth profile of U.S. GDP, will likely result in a Dollar-Euro relationship reaching parity at some point in 2017.

6. **Volatility, as measured by the CBOE Volatility Index, will increase over the course of the year.**

   The sharp rise in U.S. stocks, post the November elections, has resulted in a corresponding fall in volatility. Investors seem to have forgotten about risk, at least for the time being. The CBOE Volatility Index (VIX) has hovered around 12 as the year comes to a close, well below its long-term average of roughly 18-20. The usual suspects, problems in Europe, the Middle East, North Korea and China, may be the catalyst for the increase in volatility. However, we add one more possible "black swan" to the mix - a tweet by President Trump in 2017 that the markets will interpret unfavorably, most likely related to the areas of international trade or national security.

7. **Sectors and industries that appear to benefit from a Trump Presidency, including Financials, and (traditional) Energy will, in aggregate, outperform the market.**

   Some of the biggest winners from the Trump victory have been Financials and Energy. President-elect Trump has proposed cutting back regulations on these sectors, likely increasing their profits. For example, President-elect Trump has proposed scaling back, if not dismantling, the Dodd–Frank Wall Street Reform and Consumer Protection Act a momentous piece of legislation viewed as overly restrictive by many bankers. Jamie Dimon, Chairman and CEO of JP Morgan, has been named new Head of the Business Roundtable, a group of CEOs that gives advice to the President. The Energy sector is poised to benefit from a rollback of environmental regulations and a greater ability to export the enormous shale oil and gas resources found with the U.S. to our trading partners abroad.

8. **Private income oriented investments, such as in real estate and floating rate bank debt, will provide better returns than traditional bond vehicles, such as the Barclays Aggregate.**

   In some respects, bond investors have been spoiled since the early 1980s as they have benefited from a secular decline in interest rates. The party, for bond investors, may be over with interest rates slowly rising. The benchmark, 10-Year U.S. Treasury Note has increased about 1% from its summer low and looks poised to grind higher in an environment where the Fed is raising rates and real GDP exceeds 2%. In our view, less traditional sources of income, such as those from real estate and floating rate securities, will provide better returns than "plain vanilla" fixed rate bonds.

9. **Core inflation will tick up from its 2016 levels of roughly 2%, but the Core CPI increase will remain below its 3% long-term average rate.**

   Inflation has been moribund since The Great Recession, and, indeed, the market fear for much of the past eight years was on deflation. Inflation tends to move hand in hand with interest rates. Although we do not expect inflation to be a major problem in 2017, we do expect it to tick up from its current level of roughly 2%. However, excess capacity, increasing automation and cheap imports from overseas (due to a strong U.S. Dollar) will likely keep the Core Consumer Price Index (CPI) restrained and below its historical 3% growth level. We focus on the Core CPI since it excludes the volatile Food and Energy categories and is the main inflation gauge monitored by the Fed.

10. **Money flows into passive funds, such as ETFs and Index Funds, will continue to exceed inflows into actively managed funds.**

    Active managers, in both the hedge fund and mutual fund spaces, have had a rough go of it for the past several years, often failing to keep pace with the S&P 500 and other low cost index funds. Investors have noticed and have continued their trend of adding money to passive vehicles, such as ETFs and index funds. We see the trend continuing, especially in light of the recently passed Department of Labor Fiduciary Disclosure Rule which requires brokers to invest in products that are best for clients, rather than being merely "suitable." Brokers may still seek to peddle high commission products, but, at the margin, they will likely rebalance capital in the direction of passive, low cost vehicles.

Beacon's Four Strategic Wealth Management Themes for 2017

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2016, along with specific investments to implement them. Some of our recommended investments will apply to all clients, but since our financial plans are custom tailored, not all investments may apply to your particular situation.

1. **Domestic equity will continue its strong post-election run driven largely by corporate and individual tax reform.** Some of the biggest factors influencing stock prices are revenues, profits and perception. All appear to be trending in the right direction for 2017. We mentioned the likely corporate tax cuts resulting in immediate increased profits for most firms, but the Trump administration also plans income tax rate cuts for most individuals. Combined with the wealth effect, generated from rising home and stock prices, consumers are poised to increase spending in 2017. Consumer confidence measures have trended up steadily throughout the year, adding further fuel to the market's fire. Equity investments, such as Core, Income & Appreciation and Accelerated Return Strategy, remain a staple in most Beacon portfolios and we may look to increase this allocation for clients, when appropriate.

2. **The "Trump Trade" still has legs.** Although stocks have increased sharply since the November elections, there have been some disproportionate winners and losers. The old saying, "A picture is worth a thousand words" applies to the "heat map" of S&P 500 performance on November 9th, shown in **Figure 1.**

   Clear winners have been Financials, Energy and Healthcare. Relative losers have been traditional "safe haven" equities, such as Utilities and Consumer Staples. In our view, this "Trump Trade" still has legs since the post-election winners were starting at lower than historical valuations and the relative losers were starting at more lofty valuations. We aim to capitalize on these potential movements where possible through individual security selection as well as targeted sector allocations within our ETF portfolios.

Figure 1: S&P 500 Performance: November 9, 2016

Source: Xe.com

3. **Be creative in obtaining yield as traditional, investment-grade bonds face headwinds.** Traditional, fixed coupon bonds cannot overcome the mathematics of rising interest rates. When interest rates rise bond prices fall, other things equal. Fortunately, bonds offer income in the form of coupon payments. Although we are not expecting a surge in interest rates in 2017, we believe investors will be fortunate to earn their coupon payments on a net return basis. Fortunately, income does not come only from fixed rate bonds. For select clients, we expect to offer private and public investments in the floating rate loan or real estate sectors that may provide attractive income while not being as directly affected by interest rate risk embedded in traditional bonds.

4. **Be prepared for a return of volatility.** The post-election stock market honeymoon cannot last forever. Although we expect an upward path for stocks in 2017, the path may be rocky. Complacency often sows the seeds for future volatility as investors take risks that often negatively manifest themselves down the road. As noted earlier, stock market volatility is more than a third lower than its historic levels and, at some point, may rise. In our view, the best way to handle volatility is not to panic, but rather to have a portfolio that may withstand the unpredictable drawdowns in the market. We remain committed to a diversified portfolio for nearly all of our clients, including equity, fixed income, alternative and hybrid investments. Although it is a rare occasion that all of these investments show positive returns over any particular period, it is likely that at least one segment is working, providing clients with the fortitude to stick to their well thought out long-term financial plans. Achieving your goals is, ultimately, more important than beating any financial index.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day.

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