Davenport Asset Management Quarterly Update | Q4 2016

December 31, 2016

2016 will certainly be remembered as an exciting year for equity investors. After an inauspicious start, with the S&P 500 Index down nearly 11% through February 11th, domestic equity markets surged higher. The S&P ended 2016 up 12.0% while the Russell 2000 Index managed an astonishing 21.3% gain. Along the way, investors were met with major surprises in the forms of "Brexit" and a Trump victory. Each was initially thought to be a material negative, yet stocks powered higher. Earlier in the year, we noted rampant pessimism and ample cash on sidelines could provide fuel for upside. In the end this proved to be the case, perhaps even more so than we anticipated.

The fourth quarter was particularly fruitful as Trump's victory prompted a rally. The S&P jumped 3.8% while the Russell advanced 8.8%. To say the election caught investors flat-footed would be an understatement. The results were quickly perceived by markets as a plus and optimism surrounding lower taxes, fiscal stimulus and deregulation took hold. Many investors had been crowded into areas that would have benefited from the status quo and were underweight areas that could benefit most from a Trump presidency. In recent weeks we have witnessed a violent rotation as investors have abandoned "defense" and embraced a reflation trade in anticipation of improved growth and higher interest rates.

Shares of domestic companies have benefited disproportionately given Trump's protectionist rhetoric and the U.S. dollar strength that has accompanied newfound growth and rate expectations. This explains the outperformance of the small-cap oriented Russell 2000, which has a domestic bias. Conversely, large U.S. multinationals and companies that outsource heavily have been market laggards given both currency headwinds and potential policy headwinds. Meanwhile, bonds and income-oriented investments like utilities have suffered as interest rates have moved higher. The same applies to consumer staples stocks that were perceived as defensive. We have cautioned for a while that these perceived "safe" investments had become much riskier than investors realized due to a "fear bubble," although we didn't predict a Trump victory would cause that risk to manifest itself.

So what are the threats to this newborn rally? For one, the market has already discounted significant change well ahead of any true policy implementation. Any missteps could prompt a market setback. Also, many elements of Trump's protectionist ideas could hurt global trade and impair certain industries. Shares of many retail and apparel companies have recently suffered given the potential for new tariffs on imported goods. And then there are interest rates. So far, markets have managed to rally alongside rising rates as investors have chosen to emphasize the improved growth that should accompany higher rates (not to mention rates are still low by historical standards). However, rates increasing too much could slow the economy and depress equity valuations.

Market Returns	Q4 2016	YTD
U.S. Large Caps	3.8	12.0
U.S. Mid Caps	3.2	13.8
U.S. Small Caps	8.8	21.3
International Developed Markets	-1.0	-1.9
Emerging Markets	-4.2	11.2
Interm. Term Bonds	-2.1	2.1

Source: Morningstar Direct. Please see Important Disclosures on following page for index definitions.

All told, the market may have borrowed something from 2017 with this wild close to 2016. Thus far in the Trump era, investors have been frantically swinging money between sectors to reposition for anticipated change. They may have discounted too much too soon for both the perceived winners and losers. We are hopeful that we are entering a new era of economic expansion, but are cautious about chasing many of the supposed winners after outsized gains. We also think there may be some value in areas that have been hurt by or left out of the "Trump trade." Speaking more broadly, we note the market's recent gains come after an 18-month period of trading sideways and valuations are close to historical averages.

Bond Market Update

The first half of 2016 saw rates fall with indexes returning 4% or more through the end of June; that was the good news. The second half of the year was a reversal with rates climbing higher and November having negative returns across every index. The yield on ten year Treasuries, the global benchmark, started the year at yield of 2.3% and fell to 1.4% on July eighth after the Brexit vote. The yield as of year end was 2.5%.

A precipitous drop in the price of oil and global concerns that a slowing China would lead to depressed global economic growth were the catalysts for the fall in rates for the first half of the year with returns from long term treasuries gaining nearly 13%. The returns of the same measure were down over 12% by mid-December with most sectors ending the year at roughly 2.5% total returns. The high yield sector, coming off a horrible 2015, returned over 17% for 2016.

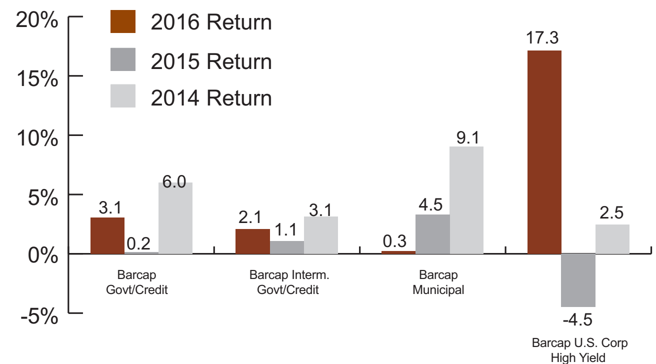
The second half rise in rates was a shock to most investors. November, which saw ten year rates climb 58 basis points (BP) and thirty-year Treasury rates rise 46 BP, contributed to the carnage from the end of July to the end of November. Losses of over 4% for broad measures of the high grade bond

Changes in Treasury Rates for 2016					
	12/31/2015	6/30/2016	6 Mo Change	12/31/2016	12 Mo Change
3 Mo Treasury	0.17	0.35	18 BP	0.53	36 BP
1 Yr Treasury	0.60	0.44	-16 BP	0.87	27 BP
2 Yr Treasury	1.05	0.58	-47 BP	1.23	18 BP
5 Yr Treasury	1.76	1.00	-76 BP	1.95	19 BP
10 Yr Treasury	2.27	1.47	-87 BP	2.45	18 BP
30 Yr Treasury	3.02	2.29	-73 BP	3.04	2 BP

market occurred during this period. August, September and October had negative returns but it was post-election period that witnessed the bulk of the damage. The election results and the potential for radical change in Washington Trump suggested raised the specter of a robust economy associated with higher inflationary pressures. At the close of the year over $1 trillion dollars in market value had been wiped out in the high grade bond market. The defensive structures of our models benefited our clients by insulating them form the downward price action of long portfolio structures.

Our view is that President-elect Trump may orchestrate significant changes to the tax laws and implement major efforts to improve the infrastructure of the U. S. Accordingly, we expect domestic growth to be above the 3% threshold with the result being a gradual rise in rates throughout 2017. The Federal Reserve may find itself being more aggressive with their path towards a "normal" rate environment as resources are drawn down, wage inflation accelerates, and commodity pressures build. Until there is some clarification about what Trump will be able to accomplish we will maintain a defensive structure.

2016 Bond Index Returns



Source: Barclays Capital. Please see below for index definitions.

Important Disclosures

Disclosures: Any opinions expressed here are statements of judgment on this date and are subject to future change without notice. This information may contain forward looking predictions that are subject to certain risks and uncertainties which could cause actual results to differ materially from those currently anticipated or projected. The information contained herein has been compiled from sources believed to be reliable; however, there is no guarantee of its accuracy or completeness. There is no guarantee that a company will continue to pay a dividend. The investment return and principal value of an investment will fluctuate. Investing in securities carries risk including the possible loss of principal. Small and mid cap company stocks may be more volatile than stocks of larger, more established companies. The portfolios may invest in foreign securities which are subject to additional risks such as currency fluctuations, political instability, differing financial standards and the potential for illiquid markets.

Performance shown is historical and is no guarantee of future results. Investing in securities carries risk including the possible loss of principal. Performance is shown net of fees.

Index Definitions: U.S. Large Caps represented by the **S&P 500 Index**. U.S. Mid Caps represented by the **Russell Midcap Index**. U.S. Small Caps represented by the **Russell 2000 Index**. Bonds represented by the **Barclays Capital Intermediate Government/Credit Index**. International Developed Markets represented by the **MSCI EAFE Index**. Emerging Markets represented by the **MSCI EM Index**.

The **Barclays Capital U.S. Corporate High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures, and 144-As are also included. The reported returns reflect equities priced in U.S. dollars and do not include the effects of reinvested dividends. The **Barclays Capital Intermediate Government/Credit Index** is an unmanaged index composed of debt securities with maturities from one to ten years issued or guaranteed by the U.S. Treasury, U.S. Government agencies, quasi-federal corporations and fixed rate dollar denominated SEC-registered corporate debt that are rated investment grade or higher by Moody's Investors Service and Standard and Poor's Corporation or Fitch Investor's Service, in that order. The **Barclays Capital Municipal Bond Index** is a market value weighted index of investment grade municipal bonds with maturities of one year or more. The **Barclays Capital U.S. Government/Credit Bond Index** measures the performance of U.S. dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year. The **Lipper Equity Income Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Equity Income Fund category. The **Lipper Large Cap Growth Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Large Cap Growth Fund category. The **Lipper Large Cap Value Funds Index** is an unmanaged index of the 30 largest funds in the Lipper Large Cap Value Fund category. The **Morgan Stanley Capital International Europe, Australia and Far East (MSCI EAFE) Index** is an unmanaged index composed of the stocks of approximately 1,000 companies traded on 20 stock exchanges from around the world, excluding the U.S., Canada, and Latin America. The **Morgan Stanley Capital International Emerging Markets (MSCI EM) Index** is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The reported returns reflect equities priced in US dollars and do not include the effects of reinvested dividends. The **Russell 2000® Index** measures the performance of the 2000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market. The Russell 2000 Index is a trademark/service mark of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. The **Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000, which represent approximately 25% of the total market capitalization of the Russell 1000. The Russell Midcap Index is a trademark/service mark of the Frank Russell Co. Russell® is a trademark of the Frank Russell Co. The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. **An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment**.

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