Any hopes of a quiet fourth quarter were dashed in the early hours of November 9th, with the surprise victory of insurgent Republican presidential candidate Donald Trump. More surprising than the election results were the reactions in the financial markets. S&P 500 futures dropped by 5%, triggering a halt in trading, as it became apparent that Trump was going to secure victory. Yet stocks not only reversed those losses the following day but continued to rally into year-end, returning 3.82% for the quarter and 11.96% for the year. The U.S. 10-year Treasury rose a whopping 19 basis points (bps) in a single day from the close on November 8th (when Clinton was still widely expected to win) until the close on November 9th, and by the end of the month had risen to 2.37%, a full 53bps from the 1.84% at October's close. With the rise in yields, the Barclays Managed Money Municipal Short/Intermediate Index fell -3.14% for the quarter, bringing the year-to-date total return down to -0.53%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index declined -2.05% over the quarter, bringing the year-to-date total return down to 1.51%.

For equities, 2016 can best be described as a tale of two halves. In the first half, fear of a global growth slowdown amid plunging oil prices sparked a sell-off which pushed stocks to their low for the year. Those same fears drove bond yields lower- a trend that, when combined with the increased volatility, caused investors to favor more defensive, high-yielding segments of the stock market. Following the Brexit vote in the second-half of the year, bond yields began to rise. These higher yields began to unwind the low-volatility, hunt-for-yield equity trade that dominated the first half of the year. This re-allocation ignited a risk-on mentality in the market, helping large-cap growth stocks recover on a relative basis. After the election, however, hopes of corporate tax reform, deregulation, and increased infrastructure spending sparked a rally in the Financials, Industrials, Materials, and Energy sectors- all traditionally considered "value" investments. Smaller companies, which typically are domestically focused and stand to benefit most from tax reform, vastly outperformed their larger peers. Given this backdrop, the large-cap growth segment of the market once again fell out of favor with market participants who were ignoring fundamentals and chasing performance. This focus on rapid headline-driven rotation is frustrating for long-term, fundamental-focused managers.

The Federal Reserve's decision to raise the Fed Funds Rate on December 14th was met with little surprise or reaction by the market, which had been pricing a near 100% certainty of a hike before the meeting. The labor market showed solid, if unremarkable, improvement in the third quarter, adding a three month average of just shy of 180,000 jobs a month. This jobs growth drove the unemployment rate to 4.6% in November, a new low in the current recovery. Combined with workforce participation remaining broadly stable at 62.7%, this implies U.S. labor market may be approaching full employment.

Chairwoman Janet Yellen acknowledged this in her prepared remarks at the press conference following the Fed's meeting on the 14th, noting only "some" room for further strengthening remained. Inflation firmed alongside employment with core PCE Inflation, the Fed's preferred measure, rising to 1.6% in advance of the meeting, a modest increase but still up substantially from the 0.6% at the start of the year and approaching the Fed's stated 2% inflation target.

With global growth and inflation on the rise, risk assets could fare well in 2017, especially if earnings growth continues to improve. The largest headwind for stocks in the coming months is likely to be political risk, which is difficult to quantify and predict. Since the election, investors have seemingly priced in all of the potential positive outcomes from the Trump administration's proposed economic and trade policies. While we do believe that the trifecta of corporate tax reform, deregulation, and increased infrastructure spending can help domestic companies, details of any policies have been sparse, to say the least, and the timing of any policy changes is an even greater unknown. Politics aside, we remain positive on stocks, as many of the drivers of past performance appear to be still in place: accommodative central banks, mergers and acquisitions, return of capital to shareholders, and an improving global economic backdrop. The run over the past two months has left valuations rich, not extreme, and corporate earnings will need to come through with positive growth in order to drive the market higher. The recent rise in the U.S. dollar also needs to be monitored as continued strength will likely cut into corporate profits. Ultimately, the team at Appleton believes that even with no valuation multiple expansion, equities should be capable of generating modest returns in-line with consensus earnings growth expectations.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is also now active on Twitter: follow us on Twitter at @AppletonPtnrs.

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