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HC FINANCIAL ADVISORS, INC.
2016 Stock Market Review and Outlook for 2017

As election results came in on the night of November 8th, stock futures tumbled 5.7% by midnight on the realization that Donald Trump would win the presidential election with his populist and anti-globalization platform. However, before the markets opened on Wednesday morning, Trump had delivered an acceptance speech that was conciliatory in tone and indicated that he would focus on infrastructure spending, building relationships with other nations, and made no mention of raising tariffs and entering into trade wars. This helped ease investor concerns, and initiated a rally in stocks lasting through December.

Although the stock market rally was spectacular in many ways, it did not help all parts of the market. Industries that appear poised to benefit under proposed policies did very well, with Financial Services up 21%, Energy up 7%, and Industrials up 7% for the quarter. Other industries lost ground in the quarter including Health Care that was down 4%, Real Estate down 4%, Consumer Staples down 2%, and Utilities were flat. This difference also showed up in different indexes. The Dow Jones Industrial Average, dominated by Industrials, Financials, and Energy, was up 9% for the quarter, while the broader market S&P 500 index was only up 4%. For the quarter, the average large capitalization growth fund fell 1.2% while the average large capitalization value fund returned a positive 7.0%.

With the prospect of higher inflation and higher interest rates, bonds staged a dramatic selloff taking the yield on the 10-year Treasury Note from 1.5% prior to the election to 2.5% by the end of the year. This selloff was accentuated in longer term bonds. Investor who owned shares of the 20-year treasury ETF would have realized a loss of almost 15% in their bond investments. Fortunately, our more stable investments in either short-term funds or individual bond ladders weathered the storm much better.

Major Stock & Bond Indexes (Total Return)			*Lipper Mutual Fund Peer Averages (Total Return)*		
	4Q16	2016		4Q16	2016
S&P 500 Index	3.8%	12.0%	Large-Cap Core Funds	3.7%	10.1%
Dow Jones Industrial	8.7%	16.5%	Large-Cap Growth Funds	-1.2%	1.8%
Russell Midcap Index	3.2%	13.8%	Large-Cap Value Funds	7.0%	14.6%
Russell 2000	8.8%	21.3%	Mid-Cap Core Funds	5.8%	15.5%
MSCI EAFE (USD Gross)	-0.7%	1.5%	Small-Cap Core Funds	9.4%	20.6%
MSCI EM (USD Gross)	-4.2%	11.2%	International Large-Cap Core	-1.7%	1.3%
NAREIT U.S. Real Estate Ind.	-3.3%	8.6%	Emerging Markets	-4.9%	8.8%
Barclays US Agg. Bond (3-5yr)	-1.7%	2.0%	Core Bond	-2.7%	3.0%
Bloomberg Commodity	2.7%	11.8%	Intermediate Muni Debt	-3.4%	-0.2%

THE POLITICAL LANDSCAPE:

The surprise election of Donald Trump as President has introduced a great deal of uncertainty into the U.S. political landscape. Most presidents enter the White House with a clear ideological bent and a number of policy proposals. Donald Trump, however, released few detailed policy positions during the campaign. Most of his rhetoric prior to the election was limited to sound bites emphasizing a hard line on immigration and trade, two topics barely mentioned since the election. Since election night, most of the discussion has been around cutting taxes, building infrastructure, and reducing regulations on banks and energy companies. Although some of his appointments raise concern of protectionism based on their backgrounds, since the election, the market has focused on the pro-growth side of these policies rather than the protectionist side, driving U.S. stocks higher and bonds lower on the outlook for higher growth, inflation, and interest rates. While we will have to wait and see how this plays out over the next year, here are a few of Trump's key proposals and the potential economic impact.

Tax policy was an issue addressed by both candidates through the campaign and remains in focus after the election. The combined federal and state corporate tax rate of 39% in the U.S. is the highest of all industrialized nations; other nations' corporate tax rates generally fall somewhere in the 20% range. A number of loopholes in the U.S. tax code allow U.S. companies to realize a much lower tax rate making corporate tax reform likely to include some combination of lower tax rates and eliminating loopholes. By eliminating the ability of corporations to defer paying taxes on overseas profits remaining offshore, a lower tax rate could be revenue neutral to the government and encourage more development domestically if profits are brought back into the U.S. The current tax proposal proposed by GOP House members favors a destination based corporate tax structure. This would convert the tax code from being income tax based to being a hybrid value added tax. Under the proposal, imports by U.S. firms would no longer be deductible and export revenues of U.S. firms would no longer be taxed. In addition, interest expense would no longer be deductible. The idea is to incentivize businesses to stay in the U.S. and encourage capital spending domestically. One risk to this structure is that if the dollar does not appreciate, the new tax would be inflationary for imported goods, disproportionately affecting goods such as automobiles, electronics, and appliances.

Personal income tax reform is also on the agenda, although it may have a harder time passing through Congress in its proposed form. Trump's proposal would be to cut taxes on the highest earners while raising the lower tax brackets for lower income earners. "Supply Side" economists would argue that wealthy individuals are more likely to invest the windfall and the resultant increase in economic growth offsets the lower tax rate, keeping tax revenues neutral. The Congressional Budget Office data shows that tax revenue fell from 19.2% of GDP before the Reagan tax cuts of 1981 down to 18.4% in 1989, a relatively small drop considering the size of the cuts. The tax code was much different in 1981, and in addition to cutting the top federal bracket from 70% to 28%, a number of loopholes were eliminated. Although some form of personal income tax reform is likely, deficit hawks in Congress may impede significant cuts over concerns they would increase the federal deficit. Treasury Secretary nominee Steven Mnuchin has also said there will be no absolute tax cut for the upper class.

Infrastructure investment was a theme during the campaign and remains a key piece of Trump's agenda. The proposed one trillion dollars in infrastructure spending is a very big number and would certainly stimulate the economy. This is also an area we have more detailed policy information to analyze through a paper authored by economic advisor Peter

Navarro. Under the proposal, approximately $100 billion per year would be invested in infrastructure over the next ten years. However, instead of traditional government infrastructure investment, the idea is to finance the investment privately through about $250 billion in tax incentives and the creation of an "infrastructure bank". The theory is that the additional 0.5% in GDP generated from increased investment will help fund the investment.

Fiscal policy and monetary policy are the two ways the government can control economic growth. The examples above of cutting taxes and increasing spending are considered fiscal stimulus as they put money into citizens' pockets at the expense of increasing the federal deficit. Monetary policy is conducted by the Federal Reserve and is left for another conversation. Fiscal stimulus was used very successfully during the 1980's under President Reagan as the country recovered from a period of stagnant growth. The main difference is that in 1981, the federal deficit was 30% of GDP versus a much higher 100% of GDP today, unemployment was 7.2% vs 4.6% today, inflation measured by CPI was 12.5% vs 1.6% today, and GDP growth was 0.0% vs 1.6% today. Given the conditions in 1981, fiscal stimulus was able to help grow the economy as inflation fell. Today, with the economy running at close to full capacity on many measures and a very low inflation rate, fiscal stimulus may drive GDP growth for a short time at the expense of higher inflation and interest rates. This could drive the Fed to tighten monetary policy by raising interest rates, thus offsetting the benefits derived from these fiscal stimulus policies.

Finally, deregulation has been a major theme since the election. Reduced regulatory expenses should help boost corporate profits. If banks, for example, have lower capital requirements and are allowed to leverage their balance sheets to trade for their own benefit with the repeal of Dodd-Frank legislation and regulations, their profits will increase. The further removal of other existing regulations including removing restrictions on carbon emissions and decreasing company sponsored healthcare coverage will also increase corporate profits.

The anti-growth portion of Donald Trump's campaign that focused on restricting trade and immigration has largely been forgotten by the market. Restricting trade would have a very negative impact on economic growth, likely large enough to offset the benefits of lower taxes and higher spending. The main issue is that the U.S. has a very low, if not negative at times, savings rate that currently stands at 2.4% of national income. In order to grow, the U.S. must import surplus savings from abroad, running massive current account and trade deficits to fund investments. The result of higher tariffs on goods imported from China would either be to straddle growth by reducing investment, the import of goods from higher cost producers, or an increase in the cost of goods imported from China. The latter two would hurt the standard of living for mainly the middle class and negatively impact growth. On the immigration issue, the U.S. has an aging workforce it needs to grow in order to grow the economy. With increased immigration, the U.S. workforce can continue to grow; without this continued influx of workers, the workforce may lessen and lead to stagnant economic growth.

OUTLOOK:

There is a great deal of uncertainty heading into 2017 as the President Elect's views are far from clear. Markets have priced in the best-case scenario of free trade, fiscal stimulus, and deregulation. Optimistically, the free trade advocates Donald Trump has nominated for economic posts would be able to convince the President against implementing damaging trade tariffs. However, given the campaign rhetoric that railed against free trade, there is still a risk of damaging economic policies. It is also not certain that a Republican Congress will completely support each of Donald Trump's proposals. Border adjustments or destination based corporate taxes could get held up in Congress as protectionist as could major cuts to personal taxes and significant infrastructure spending on deficit fears. While stocks have priced in the best-case scenario, the actual impacts are not likely to be felt until late 2017.

Assuming the market has it right and we see massive fiscal stimulus, we would expect to see accelerating inflation with rising interest rates. Historically under a low and rising inflation rate, stocks can do quite well as does global infrastructure, real estate, floating rate loans, and inflation linked bonds. Fortunately, your portfolios already have exposure to most of these asset classes, and we will continue to evaluate the need to increase this exposure. However, given the changing policy positions of the President Elect, we feel it is better to proceed cautiously and patiently and wait until we have greater visibility into policy outcomes before making major changes to portfolios.

In addition to political uncertainty in the U.S., Europe is likely to be a source of volatility in 2017. With the rejection of reforms in Italy, the banking sector is at risk of a significant shakeout. There are also upcoming presidential elections in Germany and France. In France, far right leaning candidate Marine Le Pen, who openly advocates dismantling the EU, is leading in the polls. Britain is also expected to trigger Article 50 and formally submit a plan to exit the EU.

At current levels, U.S. stocks appear quite expensive and are at the high end of their historical valuation range on a price-to-earnings ratio. Valuations are not a good predictor of short or even intermediate-term performance and we could very well see another good year for stocks in 2017 with no sight of a recession on the horizon and continued positive earnings momentum. However, over a five-year period there appear to be much better opportunities outside of the U.S. and in developing markets in particular. Although the current P/E multiple of 16.7 times forward 12 month earnings for the S&P 500 is well below the peak level of 25.0 times forward earnings reached in 1999, they have not reached these levels since the 1996-2003 period. Allen Greenspan made his famous remark about "irrational exuberance" in the market during a December 1996 speech when stock valuations were similar to today. The stock market did not peak until over three years later at a level 110% higher than when the speech was made. Although we do not see an imminent threat to stocks, significantly higher interest rates, geopolitical instability, or an eventual recession are all potential risks.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We are required by the SEC to offer a copy of our updated ADV Part 2 on an annual basis. By the end of April, we will send a summary of material changes to last year's filing. You may request a full copy of the ADV Part 2 at that time. The information in both Part 1 and Part 2 for the ADV is also available online at the SEC website, www.adviserinfo.sec.gov.

We want to meet with you at least once a year to review and update any changes in your goals and objectives, cash requirements or allocation targets. If we don't hear from you, we will be calling to schedule a meeting. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with your questions or concerns.

Stephen C. Biggs, CFP®, CFA

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