The INVESTMENT LETTER

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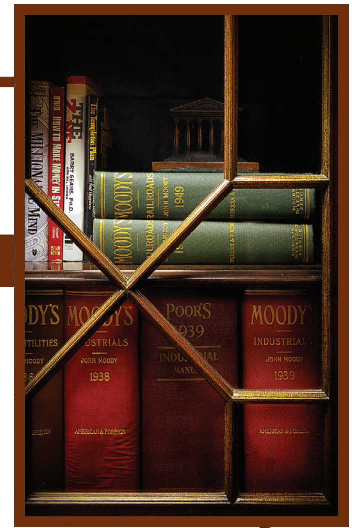

2016 Review / 2017 Preview

As we embark into a new year and look back on 2016, we forecast what might occur over the next twelve months. Though there is never a proverbial crystal ball showing a clear view into what will come, clues from the political and economic environment can often shape expectations for the New Year. We will examine the current economic and political conditions in the U.S., and then turn to provide an outlook of the stock and bond market in 2017.

U.S. Economy Condition

The U.S. economy is healthy according to most, if not all, economic indicators. The U.S. economy has grown each quarter in 2016, based on the U.S. Gross Domestic Product (GDP), with a particular strong third quarter in 2016. Consumer spending accounts for approximately 70% of the U.S. economic output and has been particularly robust in the latter part of the year – by one estimate. U.S. households will spend over one trillion dollars over the holiday season (up 3-4% from last year).[1] Perhaps even more notable, the consumer confidence index, which measures consumer optimism, is at its highest level since 2001. Measures of consumer spending and confidence are particularly important as we head into 2017 given their role in driving economic GDP. Unemployment is low, inflation is not problematic, and the dollar remains strong compared to other currencies.[2] All in all, the economy looks to be in good shape.

While there is good reason to be optimistic about the U.S. economy, there are other areas to watch in 2017. Many large companies have reported declining corporate earnings/profits in 2016: companies in the energy sector, in particular, reported nearly an 80% reduction in profits from 2015 to 2016.[3] Even in light of these declining earnings, stocks have performed well given the surge in stock prices since the Presidential Election. Corporate earnings, however, will be worth keeping an eye on in 2017 because corporations need to increase profits to sustain long-term growth of their securities.

Potential Changes to Tax and Regulatory Policies

Over the past year, Investment Counsel has reminded clients that the particular presidential candidate in office does not significantly impact stock market performance. We maintain this viewpoint, which has only been reinforced by the recent upward trend in most stock prices since the election. Our firm also strongly believes that much of this performance would have occurred no matter which candidate prevailed, as the market simply awaited for uncertainty about the next president-elect to pass.

The president-elect's policies will be worth keeping an eye on in 2017, as the market may respond to changes in the tax system or other regulatory measures he may implement. There are arguments on both sides regarding these proposed policies, and it will remain to be seen which policies take effect in the next year. While the market may fluctuate, even downward at times, it is important for investors to be mindful of the long-term, which withstands presidential terms. In our view, these long-term investment prospects remain strong when investing in high-quality securities.

Investor Outlook

Economic indicators are strong and the political climate is less muddled than in 2016. Most investors recognize these as strong points, but also want to know the year's outlook for stocks and bonds.

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Outlook for Stocks

Even with the Dow nearing 20,000, we believe there is ample opportunity for investors in the stock market during 2017 for two primary reasons. First, for those sectors and securities that have benefitted from the post-election rally their corresponding financial information still indicates they are fairly valued. This may be due to the fact that, for much of 2016, most stocks moved sideways until the presidential election concluded with little volatility. Looking at the year as a whole, these prices do not appear overly inflated.

Second, not all sectors (e.g. consumer staples and utilities) have experienced a surge in prices since the election, and some have even declined. Some of these downward trends may be explained by occurrences outside of the presidential election such as commodity price fluctuations. Whatever the reason for the decline, we believe that these types of movements have left some securities under-valued for long-term growth.

Of course, we must be mindful that these predictions may change as new information and policies develop. We are also cognizant that recessions tend to occur approximately once every five years, with the last true recession in the late 2000s. Our economy is due for downward market correction, which may occur sometime in the next few years. If this movement does occur, investors should not panic—it is a normal occurrence in business cycles. By investing in high-quality securities that offer high dividends, investors can feel confident in the market's direction in the long run.

Outlook for Bonds

Our outlook for the bond market in 2017 is less optimistic than our stock market expectations. In 2016, fixed income vehicles performed less favorably than equities, which is likely due to expectations of future inflation and interest rate increases. Looking to 2017, our expectations of the bond market are tempered for two reasons.

First, there appears to be many opportunities in the stock market, which causes downward pressure on bond prices and possible missed opportunities in the stock market for fixed income investors. Second, in addition to the recent increase to the Federal Funds Rate in December 2016, the Federal Reserve is expected to increase rates again throughout 2017. All else equal, increases to the interest rate causes bond prices to fall. Given the expectation of interest rate increases, investors should remain cautious to over-saturate portfolios with bonds.

To create and maintain a well-diversified portfolio, bond holdings can still carry value for investors. While each portfolio will depend on the investor's specific goals and investing time horizon, using certain strategies can help mitigate some of the risk associated with the bond market and increasing interest rates.

In the end, we are cautiously optimistic about the outlook for stocks and bonds in 2017. We would not be surprised if a recession occurred given historical trends, but there may be plenty of opportunities in the stock market in 2017 and economic indicators appear strong. ■

[1] *http://www.forbes.com/sites/bryanpearson/2016/12/22/holiday-spending-to-exceed-1-trillion-and-11-other-surprising-data-points-of-christmas/#5cad5cc1433c*

[2] *https://www.thebalance.com/us-economic-outlook-3305669*

[3] *http://www.wsj.com/articles/anxiety-weighs-on-u-s-corporate-earnings-1470178294*

Investment Counsel News

Inside the Office

To start the New Year, we will be sending each client a survey to assess our performance. Your honest feedback helps us tremendously!

Outside the Office

Scott spent the holiday season (and tried to stay warm) at his parent's new house on Lake Michigan in Montague, Michigan.