Quarterly Review and Outlook

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EQUITABLE Trust

Trustees and Investment Advisors

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  Senior Vice President
  and Chief Investment Officer
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  W. Keith Keisling, JD, CTFA
  Vice President and Trust Officer

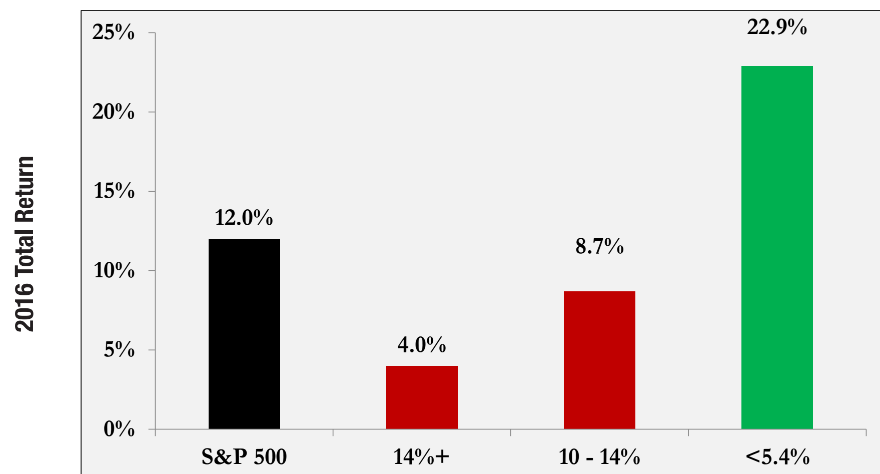
The Wind Has Shifted

Last year brought more surprises than we can list in this space. The US equity markets experienced their worst start in decades but finished with an above-average return. The British voted to leave the EU despite the pollsters' and pundits' predictions to the contrary. The main event, however, was the US presidential election where even Donald Trump might have been surprised.

The markets themselves surpassed expectations by taking the BREXIT and US elections in stride. After a brief wobble, the UK markets soared after the vote there. The stock futures markets in the US recovered from an 800 point Dow decline on election night to a 200 point rise the following day (despite Nobel laureate Paul Krugman's prediction of disaster).

By year end, large company stocks had scored another big surprise. The firms with the highest expected earnings growth rate had, on average, performed the worst while businesses with the lowest expected earnings growth, as seen below, did the best.

Returns By Expected 3-5 Year Earnings Growth



Source: FactSet, Zephyr, and Morningstar

Interest rates soared in the days following the election as the markets began to discount the impact of now-likely tax cuts, infrastructure spending and deregulation in the US economy. As rates climbed, the dollar followed.

"The greatest obstacle to discovery is not ignorance— it is the illusion of knowledge."

— Daniel Boorstin

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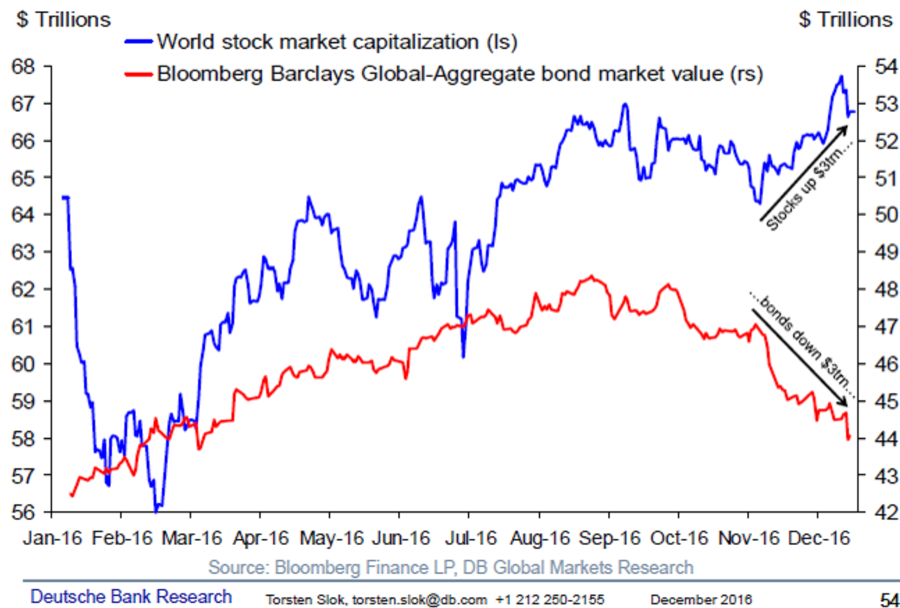
Since the U.S. election in November roughly $3trn have moved from bond markets to stock markets



More political surprises could be in order for 2017. Netherlands, France and Germany are staging major elections this year, which, if populists or nationalists are elected, could mark the end of the EU and the Euro. While there could also be unexpected economic events, several trends are well-established:

- The Fed is expected to continue to raise rates slowly as the economy continues to grow with support from fiscal policy and deregulation from the Trump administration.
- Corporate earnings should continue to rise as the dollar and oil stabilize in price. Rational, growing businesses are increasingly likely to reinvest free cash flow in themselves rather than increase dividends or execute share buybacks. Proposals to cut corporate tax rates will raise expectations.
- Consumer and business confidence measures are still improving, indicating consumers are ready to spend and businesses are primed to invest more. Consumer preferences are changing, favoring the purchase of experiences vs. goods and tilting trade away from traditional stores toward online shopping.
- The business cycle has matured to the point where labor's share of national income will grow, allowing consumers to spend more. Wage growth is currently running at 2.4% annually, a measure not usually a problem for American corporations until it reaches 4%.
- In the years since the financial crisis, money has moved out of equity funds into bond funds, despite an extended period of solid equity market performance. Now, with interest rates beginning to rise, flows are reversing, and funds are flowing from bond funds back to equities (see chart above).
- Roughly half of the US Treasury debt outstanding comes due in the next three years. It seems certain that these obligations will be refinanced rather than paid off. Thus, the federal budget is sensitive to rising rates, and deficit spending will likely reinforce the uptrend in interest rates.

We see the current environment as favorable in the coming months for those equities benefitting most from proposed deregulation and infrastructure spending. We continue to seek high quality companies with strong balance sheets at this point in the market cycle. International stocks are trading well below their long-term trends but we continue to hold them in anticipation of return to average. Where bond investments are appropriate, we see benefits in keeping maturities short to dampen volatility and to increase opportunities for reinvesting at presumably higher rates.

Market Diary Period Ending December 31, 2016

	RATES OF RETURN					
Equities	**Last 3 Mo.**	**YTD**	**1 year**	**3 years**	**5 years**	**10 years**
Global Stock Market (MSCI All Country World)	1.30	8.48	8.48	3.72	9.98	4.16
U.S. Stock Market (S&P 500)	3.82	11.95	11.95	8.85	14.63	6.94
U.S. Small-Cap Stocks (Russell 2000)	8.82	21.28	21.28	6.73	14.44	7.05
International Stocks (MSCI EAFE)	-0.62	1.59	1.59	-1.03	7.13	1.32
Emerging Markets Stocks (MSCI Emerging Markets)	-4.31	11.27	11.27	-2.34	1.55	2.12
Alternatives	**Last 3 Mo.**	**YTD**	**1 year**	**3 years**	**5 years**	**10 years**
Hedge Funds (HFRX Global Hedge Fund)	1.20	2.50	2.50	-0.60	1.60	-0.60
Global Real Estate (FTSE/EPRA NAREIT)	-5.77	4.62	4.62	6.12	9.66	1.87
Commodities (Bloomberg Commodity)	2.66	11.77	11.77	-11.26	-8.95	-5.58
Energy (Bloomberg Commodity - Energy)	10.58	16.27	16.27	-24.44	-16.27	-15.47
Gold (Gold Spot)	-12.30	8.63	8.63	-1.42	-5.97	6.08
Fixed Income	**Last 3 Mo.**	**YTD**	**1 year**	**3 years**	**5 years**	**10 years**
Barclays Aggregate	-2.98	2.65	2.65	3.03	2.23	4.34
Barclays Municipals	-3.62	0.25	0.25	4.14	3.28	4.25
Barclays High Yield	1.75	17.13	17.13	4.67	7.36	7.55

Rates of Return for periods longer than 12 months are annualized. Data is provided by Northern Trust and Hedge Fund Research.

Why You Should Choose a Fiduciary

The term "fiduciary" again found its way into the mainstream media last year on an episode of HBO's "Last Week Tonight with John Oliver". In citing examples of when a financial adviser might be incentivized to recommend a particular product, Mr. Oliver said, "Generally, it is currently legal for financial advisers to put their own interests ahead of yours, unless—and this is interesting—they are what's called a 'fiduciary'. Because not all financial advisers are bound to act in your best interest, but fiduciaries are, which is a bit weird," Mr Oliver explained.

As most of our readers already know, a trustee is a fiduciary and must place its clients' interests ahead of its own. We owe our clients the duties of care, of loyalty, of good faith and fair dealing, of confidentiality, and the duty to inform and report, just to name a few. But many financial advisers and investment managers operate under a "suitability" standard of care under which they are not required necessarily to put their clients' best interest first. Rather, once they become acquainted with the client and her financial picture, they have met their standard of care if their recommendations are simply suitable under the circumstances.

Fiduciaries are also in the news as a result of the Labor Department's new fiduciary rule set to take effect partly in April with full implementation in January, 2018. The rule's purpose is to help Americans saving for retirement obtain investment advice that is in their best interest by requiring all who provide retirement investment advice for IRAs and retirement plans to follow a fiduciary standard—putting their clients' best interest before

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their own profit. If the Department of Labor's rule is fully implemented, financial advisors will not be allowed to receive payments that create conflicts of interest with their retail retirement investors without meeting a prohibited transaction exemption.

If you are faced with the decision to choose between a fiduciary and a non-fiduciary financial advisor, you should ask, at a minimum, the following questions:

1. Will you have my best interest in mind?
2. Will you have a primary duty of loyalty to me?
3. Will my account be invested in your firm's proprietary products?
4. What will be your fees and all other charges and costs to me, and how will they be calculated?
5. Will potential or actual conflicts of interest be disclosed to me?

If you desire the highest standard of care regarding the investment advice you receive, then you should choose a fiduciary as your financial advisor.

Edward A. Burgess, CFA
Senior Vice President and Chief Investment Officer

William H. Cammack
Chairman

Stephanie S. Fletcher
Vice President

Bruce D. Henderson, CFA
Vice President and Senior Investment Officer

Cynthia L. Jones, JD, CTFA, CFSC
Senior Vice President and Trust Officer

Darlinda H. Jones, CTFA
Senior Vice President and Trust Officer

Jeremy P. Kath, CFA
Vice President and Investment Officer

W. Keith Keisling, JD, CTFA
Vice President and Trust Officer

M. Wickliffe Ruehling, JD, CFP®
Vice President and Trust Officer

M. Kirk Scobey, Jr., JD, CTFA
Vice Chairman

David C. Simcox, JD, CTFA
Vice President and Trust Officer

John C. Steele, CTFA, CFP®
Senior Vice President and Investment Officer

Thomas R. Steele
President and Chief Executive Officer

T. Richard Travis, JD
Senior Vice President and Trust Officer

Scott D. Van Dusen, CFP®
Vice President and Investment Officer

EQUITABLE Trust

Trustees and Investment Advisors

Equitable Trust Company
One Belle Meade Place
4400 Harding Pike, Suite 310
Nashville, Tennessee 37205

www.equitableco.com
Telephone: 615-460-9240
Fax: 615-460-9242
Toll Free: 1-866-442-3564