ALPHA CUBED
INVESTMENTS

Investment Letter, Q1 2017

January 6, 2017

A Sea Change in Investment Philosophy

2016 was a year of emotional extremes and saw one of the biggest changes in investment philosophy the market has ever experienced. The year started with the investment community focused on monetary policy which included the first rate hike by the Federal Reserve in many years, plummeting oil prices, and a slowdown in the Chinese economy. These negative factors produced the worst January drop in market history and a subsequent rebound. Following this initial drop and subsequent rebound, we saw a brief shock of fear as British voters unexpectedly opted to leave the European Union, potentially further destabilizing Europe and putting at risk the future of the EU. We then moved into an historic and contentious election cycle that produced unexpected results on just about every level. Concerns, probably generated by partisan politics, that candidate Trump might be too confrontational and unpredictable to govern caused stock index futures to sell off almost 1,000 points overnight as investors realized that his election would become a reality. Then the Sea Change in investment philosophy occurred as the investment community shifted their focus to future potential fiscal policy and the ramifications across the economic system. The following morning, sentiment quickly reversed as the markets embraced the president-elect and the hope of new potentially growth-friendly economic policies. Meanwhile, the fundamental underpinnings of the stock market have not seen much material change; however, the "Trump bump" has caused equity prices to substantially rally on the back of expectations for favorable economic policies—more on that later. Here are the indexes and fundamentals year-to-date and projected for 2017:

	2016 Q1	2016 Q2	2016 Q3	2016 Q4	FY
S&P 500 Total Return	1.35%	2.46%	3.85%	3.82%	**11.96%**
NYSE Composite Total Return	0.63%	2.77%	2.21%	3.13%	**9.01%**
Barclays Aggregate Bond Index	3.03%	2.21%	0.46%	-2.98%	**2.65%**

Source: Bloomberg

	12/31/2015	3/31/2016	6/30/2016	9/30/2016	12/31/2016
U.S. 2016 GDP Estimates	2.5%	2.1%	1.9%	1.5%	1.6%
S&P 500 2016 Earnings Estimates	$127.05	$120.43	$118.89	$117.94	$118.72
S&P 500 2017 Earnings Estimates					$132.92
S&P 500 P/E (Current)	18.4	18.4	19.5	20.2	21.3
S&P 500 P/E (Forward)	17.4	17.1	17.3	16.8	17.5

Source: Bloomberg, FactSet

You can see that all the yearly estimates came in lower than expected for 2016 and that estimates are again quite high for the full year 2017. There is a great deal of anticipation about potential new economic policies with the upcoming administration along with the support of a majority Republican congress. Hope is riding high, and we are optimistic that there could be solid incremental improvement in both GDP and corporate earnings. However, extremes in sentiment should be viewed with caution. We believe there is a lot of difficult work to accomplish between the anticipation of new economic policy and the realization of what that actual policy will look like. When sentiment is running high, it is always good to look at what we consider to be the fundamental drivers of stock prices to get an idea of how much risk we should be taking: valuations, monetary policy, earnings growth, and GDP.

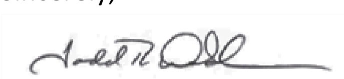
Valuations: The multiple of the S&P 500 is approximately 21.3, according to Bloomberg analyst consensus. This is historically a high level of stock market valuation and indicates that risk has increased.

Monetary Policy: The Federal Reserve has stated they plan to raise rates up to three times this year. It should also be noted that interest rates (as measured by the 10-year US Treasury note) have risen from under 1.4% in July of last year to about 2.5% at year end. This is a rapid and dramatic increase and may signal early inflation concerns. The US dollar has also been strong during this period.

Earnings Growth/Economic Growth (GDP): Consensus S&P 500 earnings growth for 2017 is currently at 22.6% year-over-year, and consensus GDP for 2017 is now forecast at 2.2% (*Source: Bloomberg*). As you can see from the chart at the beginning of this letter, these forecasts can be overly optimistic and come down over time.

Time and experience have taught us that a combination of high valuations along with a Fed tightening cycle can lead to increased volatility. When you combine that with a new presidential administration, we feel that it is prudent to be generally a little more cautious at these levels. Employment and yield curve measures do not currently suggest indications of a recession in 2017 but that still leaves plenty of room for volatility. One of the great things about the American democracy is that the wheels of change tend to move slowly with a strong set of checks and balances built into the system. We remain optimistic that our political and economic system will produce consistently superior results over time relative to the rest of the world. However, it is not at all uncommon for markets to see large shifts in sentiment similar to what we have seen lately so we try to temper our enthusiasm at peaks and stay the course when fear enters the markets. With valuations generally high, the Federal Reserve looking to raise rates and a generally strong US dollar, we generally favor larger, US based companies with larger dividend payouts and even some cash in the accounts (depending on the individual client mandate). It would not be unusual for animal spirits and positive sentiment to carry the market indexes higher during the first quarter of 2017. However, there are many potential catalysts out there including the nascent potential resurgence of inflation, higher interest rates, geopolitical risks with a new administration, the potential for difficult trade negotiations and protectionism or potential weakness outside of the US including China. Whether it is something from this list or something unforeseen, we believe that fundamentals suggest a prudent approach to managing around the volatility that we expect during 2017. We are optimistic about the future but think that there will be good entry points at lower prices if we exercise a little patience and caution right now for at least a portion of the portfolio(s). We look forward to continuing to help you reach your long term financial goals and to speaking with you throughout the year.

Sincerely,



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