SilverOak

WEALTH MANAGEMENT LLC

Fourth Quarter 2016 Market Summary

7650 Edinborough Way
Suite 250
Edina, MN 55435

Phone: 952-896-5700

Visit us at
silveroakwealth.com

Fourth Quarter 2016 Market Summary

Shifting winds based on investors' fears and hopes was the story of the year. Coming into 2016, SilverOak expected increased market volatility and encouraged investors to stay committed to their investment plan and diversified portfolio. We were correct in anticipating increased volatility as 2016 was an eventful year; though many of the year's events could not have been foreseen. Appetite for risk amongst investors was minimal at the beginning of the year as there were legitimate concerns about the world economy. The U.S. economy, in particular the manufacturing sector, was looking challenged. Investors were assessing the magnitude and the ripple effects of a slowdown in China while Europe and Japan were trying to kick start their economies by pumping trillions of dollars into the system.

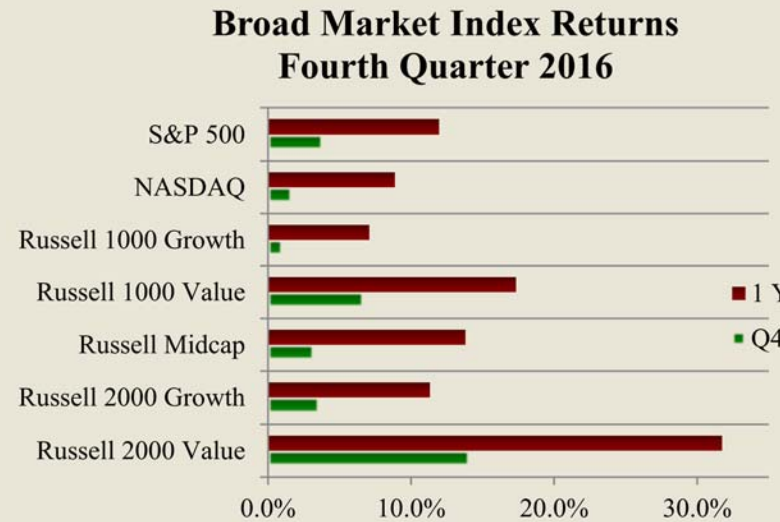
By mid-February 2016, equity markets were down 10% - 20% and credit spreads had reached levels typically associated with recessions. However, as the year progressed, investors looked forward towards corporate earnings rebounding and global economic data improving. Their optimism was undeterred despite the Brexit vote and US presidential election curveballs. The election results furthered optimism due to the new Administration's business-friendly policies. Investors, thus far, have focused on the potential positives of the new presidential cabinet. Lower personal and corporate income taxes, reduced regulation and fiscal stimulus through infrastructure spending are all promises the new Administration is touting to increase growth. Investors have perceived these policies to be a positive for equities, and in particular small cap stocks; while being a negative for bonds due to potential increase in inflation and interest rates.

The fourth quarter is typically a seasonally strong period for the equity markets. U.S. large company stocks, represented by the S&P 500 Index, were up 3.8% during the fourth quarter of 2016 and they finished the year up more than 12%. U.S. small company stocks, represented by the Russell 2000 Index, fared even better returning 8.8% in the quarter and advancing more than 21% for the year.

Value oriented stocks significantly outperformed growth oriented stocks in the U.S. and international markets. The differential in returns between these differing styles of investing was anywhere from 8% to 20%. This was the first time since 2006 that value so significantly outperformed growth.

The bond market was a tale of two halves. Bonds provided the ballast for a diversified portfolio in the beginning of the year as equity markets faltered. Interest rates fell for the first half of the year leading to a 6% return for bonds through the end of July. As economic data became more favorable and investors became more optimistic, interest rates started to increase in July. This lead to a more than -3% return from August through the end of the year. For the full year, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was up 2.65%. Municipals were roughly flat in 2016 as they were hit harder than taxable bonds as the market assessed the potential policy initiatives and impact from the new Administration. These policies, which include lower personal taxes, could reduce the advantage for tax-exempt bonds. However, the likelihood of major changes affecting the municipal bond market is not very high.

The Federal Reserve was expecting to raise the Fed Funds rate four times during 2016; however, they raised rates only once by 25bps in December. They cited global economic risks and financial turmoil as reasons for their slowdown in policy implementation. The Fed is projecting three rate hikes in 2017. While many fixed income managers believe the Fed will raise rates multiple times in the coming year, the Fed does not want to inhibit the economy's progress so they will likely only raise rates if the economic data continues to point to stronger growth.



HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of fourth quarter 2016 real GDP, an annual rate increase of 1.9% from the preceding quarter. The estimate was lower than the 2.2% growth rate analysts were expecting.
- The University of Michigan Consumer Sentiment Index final reading for December was 98.2, which was a large increase from the previous quarter. Consumer sentiment remains high despite leveling off during the past year.
- The ISM Manufacturing Index increased during the quarter from 51.5 in September to 54.7 in December. The ISM Index improved throughout the year after recording consecutive months of concerning data to start the year. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In December, the Conference Board Leading Economic Index increased 0.5% month-over-month to 124.6. The Index has increased gradually over the past year showing steady, but slow growth in the economy.
- The price of WTI Crude Oil was $53.75 at the end of December, which is 13% higher than $47.72 at the end of September. The price of Brent Crude Oil increased 14% in the quarter to $54.96. The price of oil is starting to find an equilibrium around $50. The price of oil was boosted by OPEC and some non-OPEC countries agreeing to cut production for the first time since the late 1990s.
- In December, headline CPI increased 2.1% year-over-year, up from an increase of 1.5% in September. Core CPI, which does not include food and energy, had a 2.2% increase. Inflation levels have increased over the past year as energy prices have risen; however, inflation remains less than historical averages and near the Fed's 2% inflation target.

HOUSING

- Preliminary existing home sales increased in the quarter with a monthly average annualized rate of 5.57 million units from 5.39 million units in the third quarter. The December annualized rate is 0.7% higher than the 5.45 million units in December 2015. Unsold home supply is at the lowest level since 2005.
- Median existing home sale prices decreased during the quarter. However, the preliminary prices for December were 4.0% higher than the levels of one year ago and have been trending up since the beginning of 2012.
- New home sales decreased during the quarter with an averaged seasonally adjusted annual rate of 568k homes sold versus 583k during the third quarter. On a year-over-year basis new home sales increased 12% during the quarter.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose 5.1% year-over-year in October.
- The housing sector has been very strong the past few years with increasing sales and home prices. However, higher interest rates could slow mortgage applications which would negatively affect the housing sector.

EMPLOYMENT

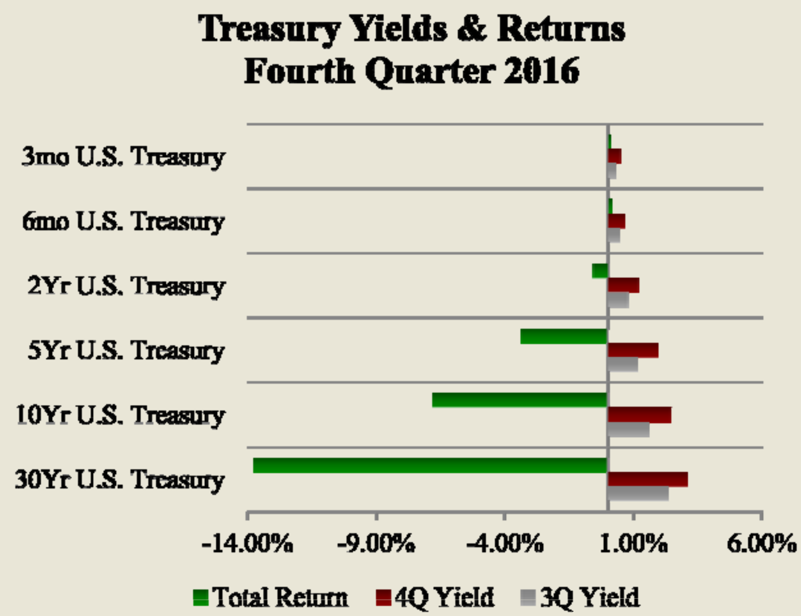
- The labor market was generally positive in 2016. The job growth rate has slowed slightly as the labor market is closer to full employment. However, wages have been slowly rising over the past few years. During the quarter, nonfarm payrolls averaged 165,000 jobs added per month, which is much lower than the fourth quarter in 2015.
- The unemployment rate declined to 4.7% from 5.0% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1973.

DOMESTIC CORPORATIONS

- Corporate operating earnings in the third quarter were higher than the previous quarter as the energy sector rebounded. Estimates for the fourth quarter and 2017 show continued earnings growth and are expected to surpass peak levels set in 2014.
- Operating margins have retreated from highs the past year and a half but remain well above historical averages. Margins could continue to be pressured if interest rates rise and wages increase; however, potential lower corporate tax rates could offset some margin weakening.
- Forward and trailing P/E multiples are slightly above historical averages.
- The U.S. dollar appreciated vs. major currencies during the quarter. Many investors are forecasting the U.S. dollar to continue appreciating with an improved growth outlook and rising interest rates in the U.S.

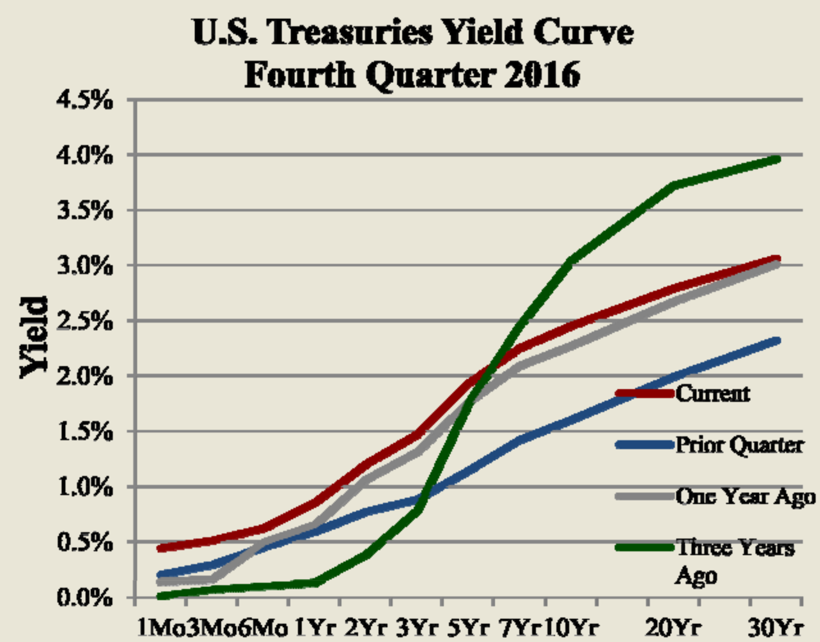
FED POLICY

- In December, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate by a quarter percent to 0.50% - 0.75%. The announcement to raise rates was expected by the market as the Fed had been forecasting the rate hike for a while. The Fed noted the economy is expanding moderately with a solid labor market while inflation remains tame thus they felt a rate hike was warranted.
- The Fed is forecasting they expect to raise rates three times during 2017. While the Fed had planned on multiple rate hikes during 2016, those plans did not come to pass. Multiple rate hikes are more likely in 2017 as economic data point to solid growth and inflation is near the Fed's target.



FIXED INCOME

- Yields increased quarter-over-quarter; however, the long end of the curve rose more than the short end causing the yield curve to steepen. The long end of the yield curve has decreased considerably over the past few years as there continues to be concerns about slow economic growth. However, in the fourth quarter long-term interest rates reversed trend and rose as investors became optimistic that the new Administration's policies will promote growth. Short-term rates rose roughly in line with the Fed Funds rate increase. Short term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- Despite the low rates of Treasuries and other developed sovereign debt, investors continued to buy fixed income for much of the year. Flows into fixed income investments were positive in 2016; whereas equity fund flows were negative. The last two months of the year, equities saw positive fund flows. Many institutional mandates require income and investments that are defensive in volatile markets. Thus, technical factors may still support bond prices despite the upward trajectory of interest rates.

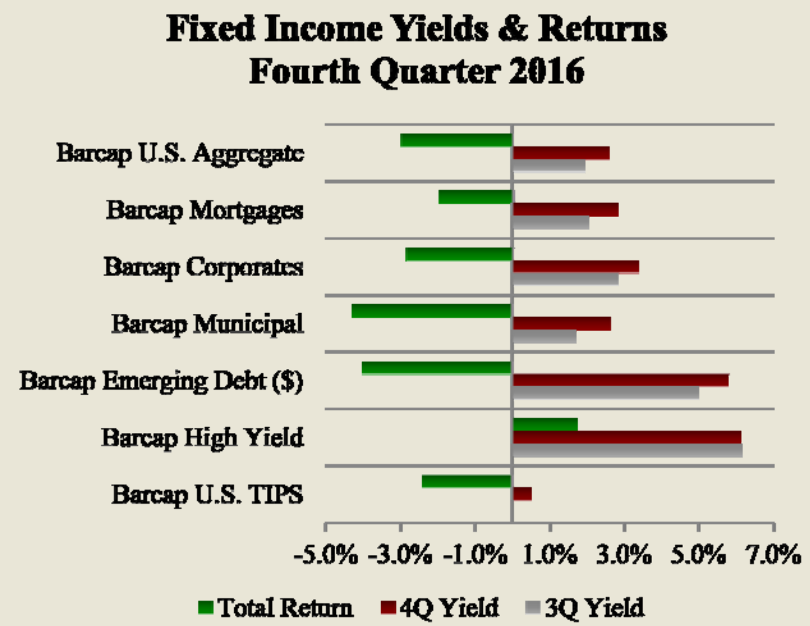


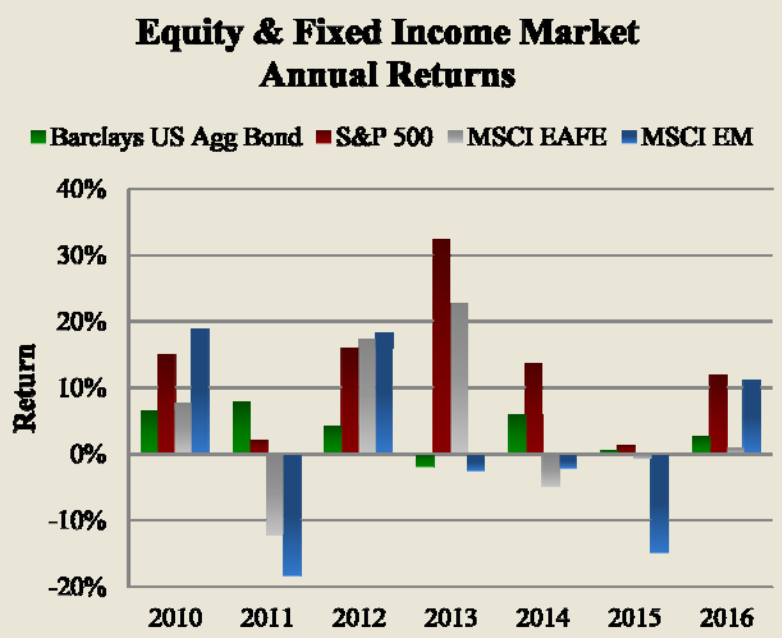
FIXED INCOME (continued)

- Returns across fixed income sectors were negative except high yield and floating rate. Higher interest rates caused the negative returns during the quarter. The Barclays U.S. Aggregate was down almost three percent during the quarter. Municipal returns were down more than taxable bonds as there were concerns the new Administration's policies may reduce the relative attractiveness of tax-exempt bonds. Fixed income returns will face a headwind if global economies are able to sustain low growth as interest rates may slowly move higher.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are starting at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. However, spreads in credit sectors are near historical averages which could benefit credit returns if the economy continues to grow.

EQUITIES

- Risk assets continued their strong performance from the lows set in mid-February. The fourth quarter is typically a seasonally strong period for equity markets and this was the case again this year despite the unanticipated U.S. presidential election result. Investors have focused on the new Administrations policies that could increase growth including lower taxes, reduced regulation and fiscal stimulus through infrastructure spending.
- U.S. large caps had dominated returns relative to other asset classes for the past three consecutive years, which is uncommon. This trend changed in 2016 as a diversified portfolio provided solid returns. Asset classes such as emerging market equities, U.S. small caps, and REITs performed well.
- Recent economic data has pointed to stronger growth; however, the equity markets have many headwinds. Valuations remain higher than average which should give caution to investors if earnings and policy do not meet expectations.



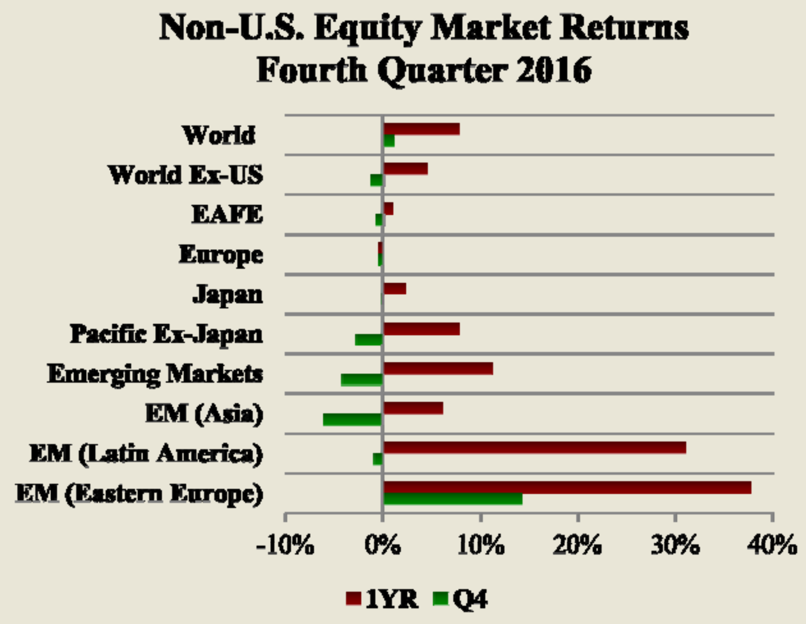


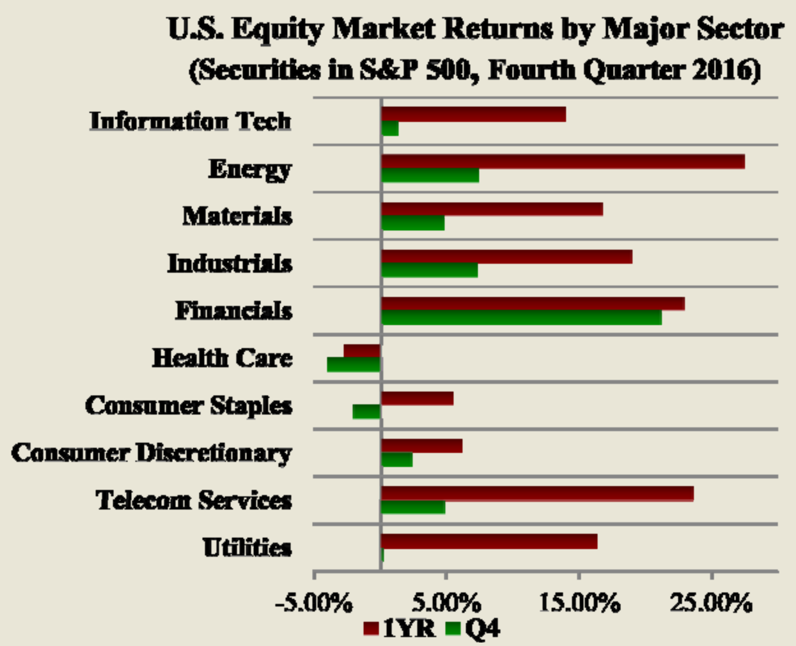
INTERNATIONAL EQUITIES (continued)

- Developed international stocks performed worse than U.S. domestic equities over the past year. The MSCI EAFE index of international markets stocks decreased 0.7% during the quarter. On a year-over-year basis, the EAFE is up 1.0%.
- Emerging market stocks had negative performance during the quarter and underperformed developed markets. The MSCI Emerging Markets Index decreased 4.2% in the quarter as the U.S. dollar appreciated relative to other currencies. However, over the past year the MSCI Emerging Market Index increased 11.2% due to stabilization in global economic growth expectations, improved earnings and higher energy prices.
- European and emerging market companies had declining earnings from 2011 through the beginning of 2016 which hindered equity performance during that period. In 2016, earnings slowly started to rebound as the uncertainty in these regions moderated. Central banks remain accommodative which should assist growth; however, political risks remain elevated for much of the world.

DOMESTIC EQUITIES (continued)

- The Russell 1000 Index of large capitalization stocks posted a total return of 3.8% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 12.1%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 8.8% during the quarter. On a year-over-year basis, the index has increased 21.3%.
- Economically sensitive sectors outperformed during the quarter, led by Financials, Energy and Industrials. Defensive sectors such as Utilities, Consumer Staples and Health Care underperformed during the quarter as investors were optimistic about growth. Value significantly outperformed growth during the year for the first time since 2006. The shift away from high yielding equities towards more cyclical sectors benefitted active managers.





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