DEIGHAN
WEALTH ADVISORS

1 MARKET COMMENTARY

3 PORTFOLIO CHANGES

3 SOUNDBYTES

4 IS THE BOND MARKET IN A BUBBLE?

22 Years

Deighan Wealth Advisors
1994-2016

MARKET COMMENTARY

We began 2016 with our eyes on the Dow Jones Industrial Average (DJIA), which dropped 10% the first month. Headlines proclaimed, "Dow Jones gets worst start in 84 years!" The fear of recession loomed. Economic indicators were weak; the post-recession recovery seemed long in the tooth. However, despite such an inauspicious start to 2016, the index more than recovered. The DJIA rose to 19,762.60, returning 16.5% for the year. Headlines now declared, "Dow Jones approaches 20,000 record!" Other U.S. indices had similarly wild rides in 2016.

ASSET CLASS	REPRESENTATIVE INDEX	2016 TOTAL RETURN:
US Large Cap Equities	S&P 500	11.96%
US Small and Midcap Equities	Wilshire 4500 Completion	18.53%
Developed International Equities	MSCI EAFE (Net)	1.00%
Emerging International Equities	MSCI EM (Net)	11.19%
Hard Assets	Bloomberg Commodities	11.31%
Broad Fixed Income	Barclays US Aggregate	2.65%
Cash Equivalents	BOA/Merrill Lynch T-Bill 3-Month	0.01%

Index Return Source: Standard & Poor's

This reversal of fortunes for equity markets rode in on the coattails of the election of Donald Trump as the 45th President of the United States. On the news of Mr. Trump's victory, overseas markets experienced a brief downturn. Yet, as U.S. equity markets opened for the day, a rally ensued. Mr. Trump's promises of tax cuts, deregulation, and increased government spending on infrastructure seemed likely to come to fruition given Republican control of Congress. But are market valuations based solely on political promises? It remains to be seen whether these political promises are kept and if they will continue to influence market sentiment.

The condition of the U.S. economy has improved considerably from this time last year and is relatively strong. 2016 saw the lowest unemployment rates since August 2007. Unemployment dropped to 4.8% in October and then to 4.6% in November before rising to 4.7% in December, down from 5.0% a year earlier. However, the labor force participation rate remains around 62.8%, well below pre-recession levels of roughly 66%. The Consumer Price Index for all urban consumers (CPI-U) rose 1.7% on a seasonally adjusted basis over the past twelve months ending in November, a substantial increase over the 0.5% of the same period in 2015. Personal Consumptions Expenditures (PCE) rose 1.5% through November, an improvement over 2015 though well shy of the Fed's 2.0% target. Average hourly earnings rose 2.5% over the same period for a gain in real (adjusted for inflation) average hourly earnings of 0.8%. Further, real Gross Domestic Product (GDP) increased at an annual rate of 3.5% in the third quarter of 2016 according to the most recent estimate of the Bureau of Economic Analysis (BEA). The BEA also saw an uptick of $117.8 billion in corporate profits in the third quarter.

Increased oil prices contributed to the rise in inflation. In November, the Organization of the Petroleum Exporting Countries (OPEC) finalized an agreement reached in September to reduce oil production. In the finalized agreement, to take effect this January, 13 of the 14 members agreed to cuts totaling 1.2 million barrels per day, or roughly 1% of global oil production. Indonesia refused and suspended its membership in OPEC. This past December, 11 non-OPEC countries - Azerbaijan, Bahrain,

Brunei, Equatorial Guinea, Kazakhstan, Malaysia, Mexico, Oman, Russia, Sudan and South Sudan - agreed to cut production by a total of 558,00 barrels per day.

All-in-all, the Federal Reserve (the Fed) felt the current condition of the U.S. economy was robust enough to warrant raising the minimum Federal Funds rate from 0.25% to 0.50%, the first increase since 2015 and only the second increase since the recession of 2008. The Fed also increased the number of projected rate increases for 2017 from two increases to three. It would seem that at least part of the gains since the election can be attributed to the improved state of the U.S. economy and subsiding fears of recession. That said, current valuations are in part the result of markets pricing in

> Our market outlook is generally positive.

political promises. As the Fed articulated in the Minutes of the Federal Open Market Committee December 12-14, 2016, there is "considerable uncertainty about the timing, size, and composition of any future fiscal and other economic policy initiatives as well as about how those policies might affect [the economy]." However, most members of the committee indicated that "the upside risks to their forecasts for economic growth had increased as a result of prospects for more expansionary fiscal policies in coming years."

The rally at the end of the year also increased bond yields. As interest rates increase, the price of outstanding bonds decreases because investors prefer new bonds that pay a higher interest rate. As the yields on bonds reached a record low in July, investors sought safety, driving up bond prices. Since then, bond prices have fallen and yields have increased as investors expect strong equity markets and a series of interest rate increases in 2017. For a more detailed explanation of why bonds behave this way, see the "Bonds 101" article in this newsletter.

The dollar, also affected by the election, appreciated 2.91% vs. the euro and 6.95% vs. the yuan (China). The promised economic growth and comparatively

> It remains to be seen whether these political promises are kept and if they will continue to influence market sentiment.

higher interest rates make U.S. investments attractive to foreign investors, increasing the value of the dollar. In a static regulatory environment, this dollar rally would pose a threat to continued economic growth. A strong dollar makes U.S. exports more expensive for foreign consumers while at the same time making imports less expensive for U.S. consumers. Further, a strong dollar hurts emerging markets by increasing the cost of their dollar-denominated debt and increasing commodities prices. As the value of the dollar rises, it takes more local foreign currency to make the debt maintenance payments. However, given the new administration's promised tax and regulatory changes, the ill effects of increasing dollar values may be offset at home.

While the dollar surged, the Chinese yuan continued to decline in 2016. In past years, the Chinese government took affirmative action to devalue the yuan to make Chinese exports more attractive in an attempt to maintain economic growth. Now devaluation of the yuan is a concern. Investors are moving out of the yuan over fears that the yuan will continue to lose purchasing power. Chinese corporations are moving to pay off dollar-denominated debts more quickly as the cost of debt maintenance increases. This increases the capital outflows and further erodes the value of the yuan. The sheer amount of debt in China is also cause for concern. China continues to increase their debt. In fact, in 2016 the amount of domestic credit the Chinese government made available surpassed that of 2009. The Shanghai Stock Exchange Composite Index (SCHCOMP) declined by 5.84% for 2016.

Elsewhere in Asia, Japan's Nikkei climbed 3.6%. In December, the Nikkei Japan Purchasing Managers' Index increased to 52.4 in December from 51.3 in November. A reading above 50 indicates an economic expansion. A strengthening U.S. economy coupled with a strong dollar and weak yen will likely benefit the Japanese economy.

In Europe, the Euro Stoxx 600 climbed 4.5%. The positive, albeit lackluster, return on European stocks is due largely to fears regarding the rise of populism amidst European politics. The HIS Markit Eurozone Composite Purchasing Managers' Output Index rose to a 67-month high of 54.4 in December. A reading above 50 shows expansion. This may be due in large part to the weakness of the euro. The European Central bank has continued with its stimulus and quantitative easing causing the devaluation of the euro. This devaluation has made European exports more competitive and contributed to GDP growth. However, the recent victory of populism in the UK and the apparent rise of populism elsewhere in Europe has drawn the fate of the European Union

> Investors are moving out of the yuan over fears that the yuan will continue to lose purchasing power.

into question. Though most analysts believe populist candidates will not prevail in upcoming European elections, we anticipate the specter of populism to weigh down equity valuations in Europe until more mainstream political parties prevail.

In the UK, a wave of populism carried the leave vote in the UK's referendum on European Union (EU) membership (Brexit). In the wake of Brexit, Prime Minister Cameron, a Conservative, resigned and was replaced by fellow Conservative Theresa May. As the government has worked towards the UK's withdrawal from the EU, concerns over the effect of a potential exit of the UK from the EU's single market abound, especially for London's financial sector. In 2016, the dollar gained 19.46% on the pound. That said, the British benchmark index, the FTSE 100, increased by 17.22% on robust economic data and the promise of government spending and the hope of deregulation.

Our market outlook is generally positive. As we move forward, we may make slight adjustments to weightings in portfolios to

take advantage of evolving macroeconomic trends. However, studies show that market timing is seldom successful. Historical results for market timers are dismal. Successful investors maintain a discipline, thoroughly research their investments, diversify, and manage their cash outflows with prudence.

We will continue to follow this time tested course to build client portfolios that are durable and withstand the test of time. Happy New Year from everyone at Deighan Wealth Advisors!

The Deighan Team

PORTFOLIO CHANGES

REMOVED

Wells Fargo & Company (WFC)

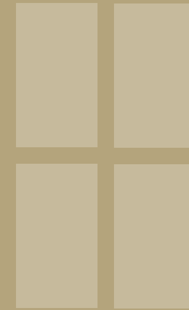
In our last newsletter, we discussed how the incentive structure intended to motivate employees to cross-sell products inspired some employees to engage in illegal and unethical practices such as opening unauthorized accounts for customers at Wells Fargo & Company. Lack of oversight compounded the issue, civil claims were filed, executive compensation was penalized, the CEO stepped down, and the bad news kept rolling in as year-end approached. We became increasingly concerned that recovery from the bad publicity and reputation risk would have a long term negative effect. While some investors view the current share price as attractive relative to peers and the bank's historical trading range, we believe that there are better opportunities elsewhere.

BONDS 101

With all of the discussion in the news about the Federal Reserve's promise to raise the Federal Funds rate by 0.25% as many as three times before the end of 2017, a few of our clients have asked about the risks to bonds and how we are positioning client portfolios. In December of 2016, the Fed raised the current minimum Federal Funds rate from 0.25% to 0.50%. The Federal Funds rate is the rate at which banks loan money to each other overnight. It primarily affects other short-term borrowing interest rates by setting a floor for those rates.

So, how do interest rates affect the prices of bonds? Bond investors earn money in two ways. First, from the interest payments paid by the bond, which are sometimes referred to as "coupon" payments. When bonds were issued in paper form, they included coupons that the owner clipped and redeemed for their interest payments. These days, bond interest is paid electronically, but the interest rate is still referred to as the coupon rate. Second, price appreciation, which is an increase in the market value of the bond. Interest rates on new bonds affect the price of previously issued bonds. If interest rates increase, the market prices of older, lower-interest bonds decrease. This makes sense because who wants to buy your stinky old bond that pays 1% interest, for example, when they can buy a newly issued one in the market that pays 2%? So, your 1% bond needs to be offered in the market at a lower price in order to make it attractive enough – i.e. pay a high enough yield - for someone to buy. This is an example of what it means when it's said that bond prices are inversely related to interest rates. When interest rates go up, bond prices go down. When interest rates go down, bond prices go up.

If an investor buys and holds a bond to maturity, then market price gyrations over the course of the bond's life generally will not matter; the bond will pay its coupon interest rate for the life of the bond, and then return the entire principal or "face amount" to the investor at the bond maturity date. However, if you want to sell a bond before it matures, you risk receiving less than your original purchase price. Other risks are inherent in bonds as well. For the sake of brevity, we will limit this article to two risks that bonds face and save a more in depth discussion for another



SOUNDBYTES

Jenifer Wilson and **Lucie Estabrook** attended the Insiders' Forum conference in San Diego. This conference features some of our industry's most respected thought leaders and provides essential information for helping us better serve our clients.

We were honored to participate in and sponsor events this past quarter including Junior Achievement Hall of Fame North, the Olympia Snowe Women's Leadership Conference, and Bangor Land Trust's "Pedal the Penobscot." We also spent many hours in our regular duties as Board or Committee members of organizations including Bangor Symphony Orchestra, Penobscot Theatre Company, Sarah's House of Maine, Penobscot County Bar Association, and several other local charitable organizations. We are blessed to enjoy a vibrant cultural and civic-minded community here in **beautiful Bangor, Maine!**

Finally, congratulations to **Jenifer Wilson** for achieving the rank of black belt this past quarter. Jenifer has studied Shotokan Karate for seven years at Eastern Maine School of Self Defense.

time. One risk to the investor is that the bond issuer will not be able to make the required principal and interest payments. This is called default risk – the risk that the borrower (the company) defaults on its obligation and does not repay the lender (you, the bond holder).

Another risk, and one that is popping up a lot lately in news articles about bond mutual funds and bond Exchange Traded Funds (ETFs) is that of not being able to find a buyer when you wish to sell your bonds. This is known as liquidity risk. Treasuries and other government bonds tend to see a lot of trading activity on a given day. There are plenty of buyers and sellers willing to trade these bonds. These bonds are highly liquid – i.e. easy to sell and convert to cash. For more thinly traded bonds, there may be few or even no bids in the market on a given day. The bonds are said to be illiquid and the seller may need to drastically reduce the offering price in order to attract buyers. Some investors are concerned that a number of funds and ETFs contain illiquid bonds. If there is a widespread sell-off in the bond market, then those funds and ETFs will not be able to keep pace with investor redemptions and will need to sell their portfolios at fire sale prices – meaning lower value returned to investors who cash out.

We hold bonds in different ways in client portfolios depending on each client's specific needs. For some, we buy individual bonds, typically municipal bonds which are tax-free at the Federal level and may also be state-tax-free, high-quality short-to-intermediate-term corporate bonds, and FDIC insured CDs. We keep bond maturities in the short to intermediate range to minimize the risk of rising interest rates. This enables us to replace maturing bonds with higher interest rate bonds and CDs.

We use both actively-managed bond funds, and passively-managed bond ETFs in client portfolios. The portfolio managers of actively-managed funds make adjustments based on their macroeconomic models and issue specific factors. Choosing actively-managed bond funds enables us to hone in on a specific sector of the bond market, or a management style that we believe will outperform a bond index or may provide a lower level of risk. We also utilize a floating-rate loan fund, where the interest rate moves up or down along with a benchmark in order to protect against interest rate risk. Passive bond ETFs track bond indexes. Indexes are usually determined on the basis of issuer-type (corporate or government bonds) or credit rating. A major benefit of the passive bond ETFs that we utilize is that the management and administrative costs are low and they often trade at no transaction cost to our clients. We understand the impact of expenses on portfolio returns and always do whatever we can to minimize those costs.

While we look at stocks like the sails on the boat that catch the wind of market growth, we consider bonds the defensive side of the portfolio - the keel that keeps the portfolio sailing in the right direction. While bonds are not without risks, we take a cautious approach to building this part of a balanced portfolio regardless of the interest rate environment.

TELEPHONE 207-990-1117

www.deighan.com

DEIGHAN WEALTH ADVISORS
455 HARLOW STREET
BANGOR, ME 04401

JEAN M. DEIGHAN, JD, CFP®
CHIEF EXECUTIVE OFFICER
jeandeighan@deighan.com

JENIFER L. WILSON, CFA, CFP®
PRESIDENT
CHIEF INVESTMENT OFFICER
jeniferwilson@deighan.com

LUCIE E. ESTABROOK, CTFA
VICE PRESIDENT
CHIEF OPERATING OFFICER
lucieestabrook@deighan.com

DEREK A. JONES, JD
ASSOCIATE FINANCIAL ADVISOR
derekjones@deighan.com

TYLER D. HOXIE
PORTFOLIO ADMINISTRATOR
ASSOCIATE ANALYST
tylerhoxie@deighan.com

KAREN S. MITCHELL, CAP
OFFICE MANAGER
karenmitchell@deighan.com