Economic and Market Overview

Fourth Quarter 2016

ENVESTNET PMC™

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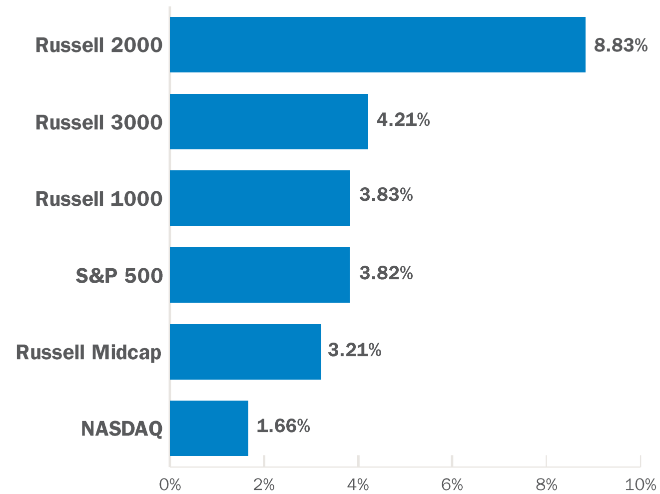
*The following commentary summarizes prior financial market activity, and uses data obtained from public sources. This commentary is intended for **one-on-one use with a client's financial advisor only** as a resource to manage assets and evaluate investment portfolio performance.*

The Economy

On the domestic front, the economy continues to show resilience, and recently, a slight uptick, even seven years into a recovery. There are several positive trends: the employment situation continues to steadily improve; the housing market remains on an upward trajectory; consumer confidence hovers at very high levels; energy prices exhibit few signs of resurgence; and stock prices are at record levels. The results of the US presidential election have also generated a significant surge in enthusiasm in the weeks since the election. The Bureau of Economic Analysis reported its third estimate of third-quarter 2016 gross domestic product (GDP) of +3.5%, higher than both the prior estimate of +3.2% and the +1.4% reading of the second quarter. The employment situation remained stable, with an average of about 176,000 jobs added each month, a level that allowed the Federal Open Market Committee (FOMC) to raise short-term interest rates at its December meeting. The unemployment rate was at a cyclical low of 4.6%.

Broad Market Index Returns
Fourth Quarter 4Q16



Source: Morningstar, Inc.

On a global basis, the environment is not as promising. The U.K.'s decision in June to leave the European Union – "Brexit" – appears to have been only an initial sign of nationalism in the Eurozone. Italy's referendum in December, in which Italians voted down constitutional reforms, has the potential to further jeopardize the EU's viability. GDP growth in the Eurozone came in at a respectable +0.3% in the third quarter, and +1.6% year-over-year. Asia is likely to experience a slowdown as a result of slowing growth in China, but policy reforms enacted by Chinese policymakers could be a catalyst for a turnaround in 2017.

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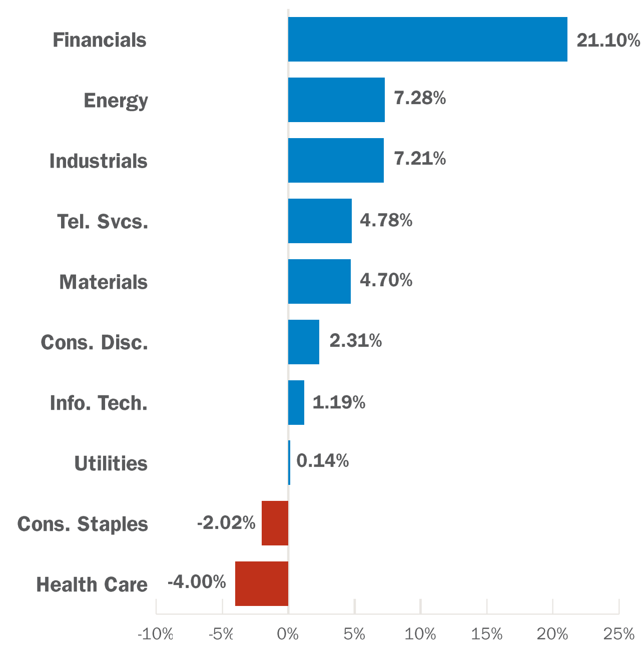
At its most recent meeting in December, the FOMC voted to raise the target range of the fed funds rate by 25 basis points, to 0.50%-0.75%. The committee also indicated that additional hikes can be expected in 2017 and into 2018, with some analysts anticipating the fed funds rate will reach 4% by 2020.

Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the third-quarter 2016 real GDP, a seasonally adjusted annualized rate of +3.5%. This figure is up from the +1.4% annualized growth of the prior quarter, and is an improvement over the prior estimate of +3.2%. The third-quarter results proved to be the most robust since the fall of 2015. The acceleration came despite a slowdown in the increase in consumer spending, which had driven growth in prior quarters. In addition, any uncertainties leading up to the election seem not to have adversely affected results. Inventories were the primary growth driver during the quarter. Although growth is expected to moderate somewhat in the fourth quarter, economists are generally of the belief that the expansion remains intact, supported by a stable housing market, solid consumer spending, a favorable employment situation, and a strong stock market. Another positive sign noted by economists is that consumers have continued to spend while maintaining a savings rate above 5%. Corporate profits rose by +5.8% (not annualized), after falling -0.6% in the prior quarter. Inflation remained very stable in the quarter, with the personal consumption expenditures (PCE) index of prices rising +1.5%, following a +2.0% advance in the prior quarter.

U.S. Equity Market Returns by Major Sector
(GICS Sectors in S&P 500, Fourth Quarter 4Q16)



HOUSING

The housing segment continues to recover steadily. Existing home sales for November (the latest monthly data available) advanced at an annualized rate of 5.6 million units, up about 0.7% from the 5.5 million unit rate reached in October, and up +15% from November 2015. The inventory of existing homes was about four months of supply, down slightly from year-ago levels. Existing home prices in November were down modestly from August, but up about +5.8% higher from November 2015. In the new home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 70, the highest reading in 2016. Homebuilders and analysts anticipate robust housing growth through the end of 2017, but warn that a pullback could occur after such strong growth in recent months.

EMPLOYMENT

The employment situation picked up somewhat in the most-recent monthly report. Employers added 178,000 jobs during November, in line with consensus expectations of 175,000 new jobs, and a material improvement from the gain of the prior month. The three-month moving average has dipped somewhat, but is still at a respectable 176,000, a fairly strong rate after seven years into a recovery. The unemployment rate in November was 4.6%, a cyclical low, and a drop from the 4.9% level in August. Average hourly earnings decreased slightly in November, and have risen +2.5% in the past 12 months. The consensus among economists is that job growth should continue at the current pace for the next several quarters. The FOMC’s decision to raise rates in December should not have a significantly adverse impact on future job gains.

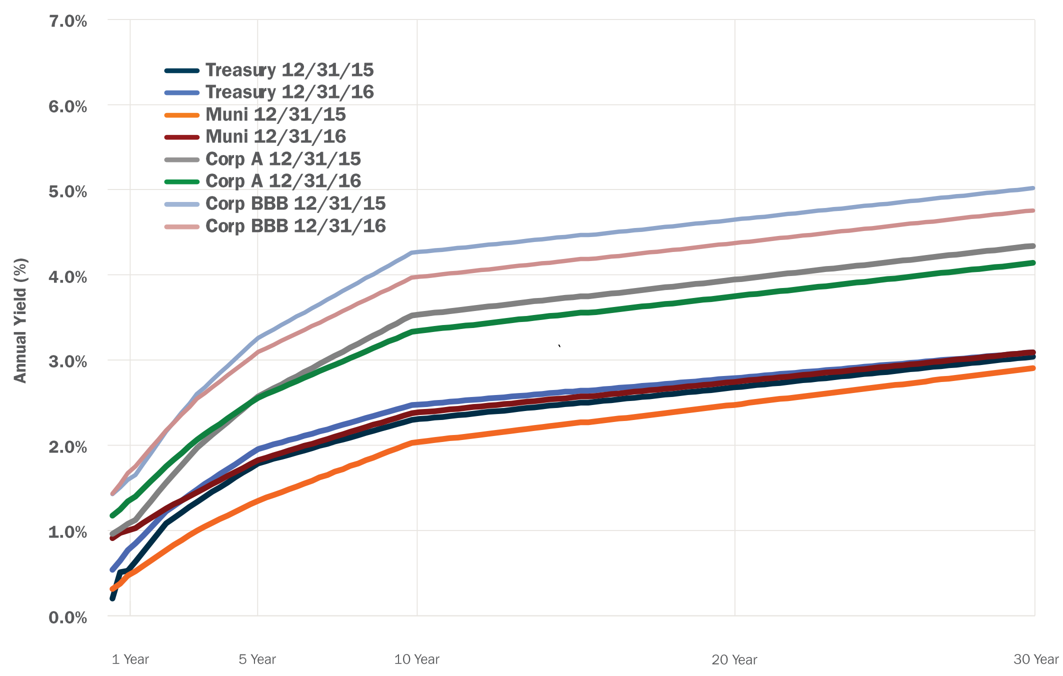
FED POLICY

As had been widely anticipated, the FOMC ended its recent December meeting by raising the target range for the fed funds rate by 25 basis points, to 0.50%-0.75%. In addition to the rate increase, the committee signaled additional hikes over the next year, with the median expectation of committee members being three rate increases in 2017. The FOMC’s estimate of the long-run equilibrium fed funds rate was raised from 2.875% to 3%. The expected increase in fiscal programs coming from the Trump administration should finally provide long-awaited relief for monetary policy, and it is possible that even more hikes will be considered once the impact of such policies becomes clear. Some analysts speculate that the Federal Reserve (Fed) may allow the economy to run somewhat “hot” in order to maximize job growth, thereby increasing the labor force participation rate, which has declined in recent quarters.

INTEREST RATES

As with the prior quarter, anticipation of a hike in the fed funds rate, an improving economic outlook, and record-high stock prices were a few of the key drivers of the prices of fixed income securities. However, unlike the lead-up to prior FOMC meetings, there was little doubt that the committee would vote to raise rates, as economic data and the employment situation were strong enough to allow the FOMC to follow through on its well-known desire to take the next step in normalizing rates. Against the backdrop of these factors, which also included the run-up to the election, yields trended higher, accelerating their rise once the election results became known.

U.S. Treasury, Muni, and Corporate 30-Year Yield Curves



Source: Bloomberg

As opposed to previous recent quarters, the yield curve steepened, as yields on short-term securities did not rise as fast as those in the intermediate- to long-term end of the spectrum. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note rose substantially, to 2.45%, from 1.60% on September 30.

Yield changes along the maturity spectrum were affected primarily by the run-up to the FOMC's eventual decision to raise the fed funds rate, a continued improvement in domestic economic data, and the perceived impact of the Trump administration's pro-growth economic policies. Yields at the shortest end of the yield curve rose in line with the 25 basis point fed fund increase, but yields in the intermediate segment of the curve climbed as much as 85 basis points. The yield on the 3-month U.S. Treasury bill settled at 0.50% at the end of the quarter, up about 22 basis points from the end of the previous quarter. The yield on the 5-year U.S. Treasury note ended the quarter at 1.93%, compared to 1.15% on September 30, and as mentioned above, the yield on the 10-year U.S. Treasury note rose to 2.45% from 1.60% over the same period. At the same time, the yield on the 30-year U.S. Treasury bond also moved higher, ending the period at 3.07%, compared to its beginning level of 2.32%. Inflation expectations crept higher, with the Fed's gauge of five-year forward inflation expectations closing at 1.91% on December 31, up from 1.46% on September 30.

In terms of total returns, fixed income securities largely generated negative returns across the spectrum, although most broad-based indices finished the year with slight gains. The Bloomberg Barclays Treasury 5-7 Yr. Index fell -3.8% for the quarter, but concluded 2016 with a 1.3% gain. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index dropped -3.1% during the three months, but posted a +5.6% advance for the year. High yield securities performed well, as stock prices surged, generating an advance of +1.8%, and produced an enviable full-year return of +17.1%. Municipals again disappointed, as the Bloomberg Barclays Municipal Bond Index fell by -3.6% during the quarter, barely eking out a slight gain of +0.3% for the year. Prices of non-U.S. fixed income securities suffered terribly, as the Bloomberg Barclays Global Aggregate ex-U.S. Index plunged -10.3%, reducing its full-year return to +1.5%. Emerging markets bonds reversed course, with the JPM EMBI Global Index giving back -4.2%, but still managing to deliver a 2016 return of +10.2%.

EQUITIES

Equity markets powered higher in the fourth quarter, establishing record highs, as investors focused on the heightened expectations of a new presidential administration and cheered having greater clarity as to interest rate policy. Stock prices were soft for the first month of the quarter, with broad market indices declining almost 4% through the first week of November. However, the election results brought a sharp change of course for the market, as stocks rallied about 8% from their pre-election lows. The S&P 500 Index finished the quarter with a gain of +3.8%, ending the year with a total return of +12.0%.

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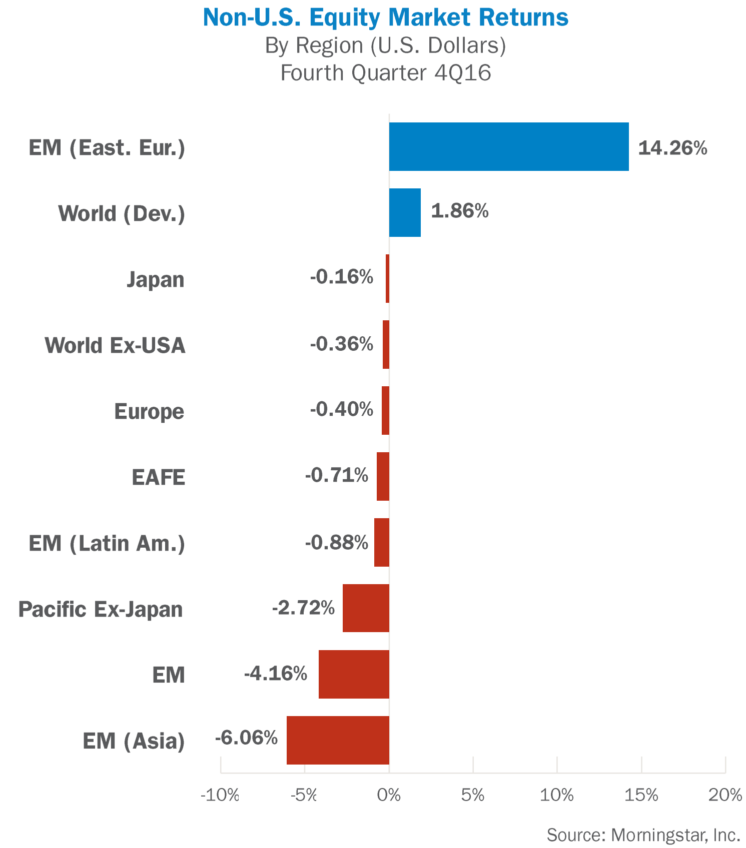
Dispersion in returns seems to be increasing, as the ten primary economic sectors generated wide variance in performance, making sector and security selection especially important. As with the prior quarter, the performance disparity between the best- and worst-performing sectors was substantial, coming in at more than 2,500 basis points for the three months. Financials, energy, and industrials were the strongest performers, delivering gains of +21.1%, +7.3%, and +7.2%, respectively. The health care, consumer staples, and utilities sectors were the poorest relative performers, posting returns of -4.0%, -2.0%, and +0.1%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +3.8% total return, bringing its 2016 advance to +12.1%. Within the large cap segment, value stocks materially outperformed growth stocks. Small cap stocks, as represented by the Russell 2000 Index, again substantially outperformed large caps, ending with a total return of +8.8%. Small cap value outperformed small cap growth by about 1,000 basis points. The Nasdaq Composite, dominated by information technology stocks, finished with a gain of +1.7% and a full-year advance of +8.9%. The Dow Jones Industrial Average of 30 large industrial companies gained +8.7%, contributing to its 2016 gain of +16.5%.



Real Estate Investment Trusts (REITs) lost ground, as interest rates continued to rise during the quarter. The DJ US Select REIT Index posted a loss of -2.5%. Commodities posted solid gains, with the Bloomberg Commodity Index advancing +2.7%, bringing its 2016 return to +11.8%.

International stocks generated decidedly worse performance than US equities overall, as the surprise results of the presidential election have raised concerns of more protectionist US trade policies. In addition, Europe continues to struggle with a sluggish recovery and fallout from an influx of refugees from Middle Eastern countries. Within this context, international stock indices were mostly lower. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the US, declined -1.3%. The MSCI EAFE Index of developed markets stocks fell by -0.7%, and produced a 2016 return of +1.0%. Regional performance was generally negative. Eastern Europe was the strongest performer on a relative basis, with the MSCI EM Eastern Europe index posting a return of +14.3%. China and the Asia region were the poorest relative performers, with losses of -7.1% and -6.1%, respectively. Emerging markets performance was negative, as the MSCI Emerging Markets Index declined -4.2%, but still managed to generate a +11.2% full-year gain.

Outlook

The U.S. economic outlook has changed with the election of Donald Trump as President, initially evidenced by the reactions of both the equity and fixed income markets. The perceived pro-growth policies of President-elect Trump encouraged equity investors, who have driven stock prices up by almost 8% since the election. At the same time, the attendant potential for higher inflation further cautioned fixed income investors. Whatever the case, the Trump administration and the Republican-held Congress are likely to make significant changes to immigration and trade policy, tax law, government spending, and regulation, at the very least. How all of this plays out is uncertain at this point. Many economists believe that although tax cuts may not be as large as promised during the campaign, reductions to personal and corporate taxes could amount to about $1 trillion over the next decade. In addition, government spending on defense, infrastructure, and veterans seems likely to increase substantially. Whereas the combination of lower taxes and increased spending should provide a boost to economic growth, the consensus among economists is that long-run equilibrium real GDP growth is not likely to significantly exceed 2% annually. Several potential risks are also on the horizon, including the potential for further disintegration of the European Union following 2016’s Brexit, a hard landing by China’s economy, escalation in aggression by Russia, and increased terrorism.

Brandon Thomas, *Chief Investment Officer,* Envestnet | PMC

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI, and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market, and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across 4 Emerging Markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS) foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index, and includes Treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1,000 largest US companies in the Russell 3000 Index (which comprises the 3,000 largest US companies). The **Russell 2000 Index** is an unmanaged index considered representative of small cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market, and measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. **Fed Funds Rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the U.S. Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US, and is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and essentially is a measure of goods and services targeted towards individuals and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor's and MSCI Barra.