High Pointe Capital Management, LLC
One North LaSalle, Suite 2001
Chicago, Illinois 60602
312.726.2500
312.726.6100 fax
www.highpointecapital.com

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High Pointe

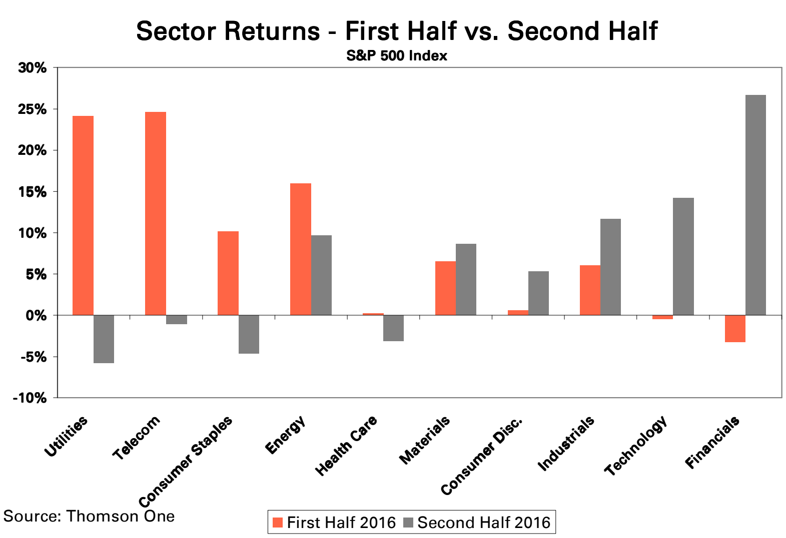
DATE: January 25, 2017
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

A Tale of Two Seasons

It was the best of times, it was the worst of times. The year 2016 had it all. The first six weeks were brutal as U.S. stocks were down 10% by February 11, one of the worst starts to the year. Stocks in cyclical sectors such as Financials and Energy, were down much more while stocks in stable sectors such as Utilities and Consumer Staples, held steady. Numerous reasons for the decline were given by pundits including concerns about the viability of European banks, slowdown in China, crashing oil prices foreshadowing weak economic growth, etc.

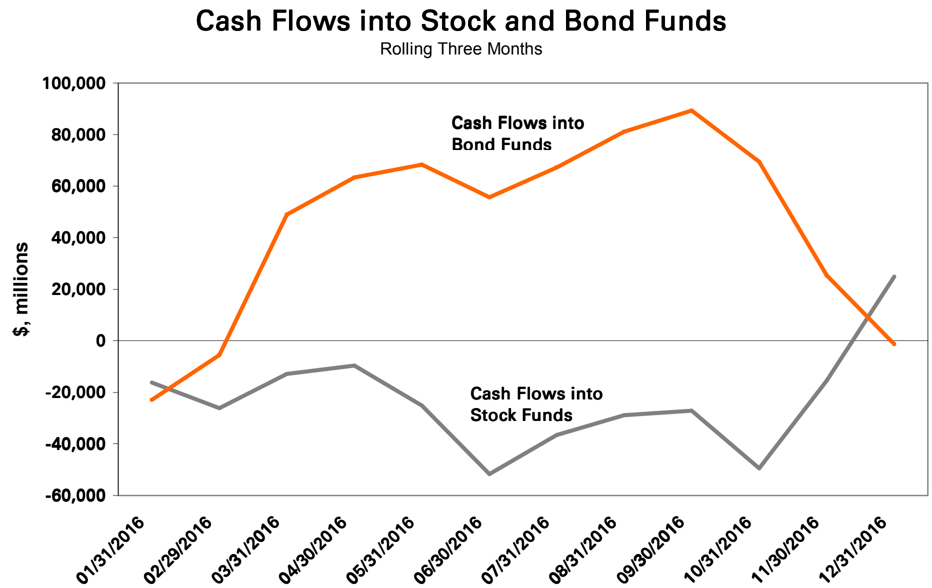
Then, without any signal, the negative sentiment disappeared overnight and was replaced by a positive sentiment driven by strong employment in the U.S. Most stocks that had declined a lot rallied sharply, especially in the second half of the year, and those that had held up well early in the year failed to participate in the gains of the second half.

The graph below shows the performance of various sectors during the first and second half of the year. The dramatic change is obvious – Utilities were up 24% in the first half but declined 6% in the second. Financials were down 3% in the first half but up 27% in the second half. Healthcare stocks performed poorly in both halves, finishing with a decline of 3% for the year.



Source: Thomson One

The average investor chased the market in futility as shown in the graph below. It shows cash inflows into stock and bond mutual funds by investors.



Source: Investment Company Institute

Spooked by the decline of the stock market early in the year, investors withdrew money from equity funds at an accelerated pace. In doing so, they missed most of the run up in the stock market that followed. Then at the end of the year, they chased a rising market. Investors suffered a similar fate in the bond market. Bonds were up early in the year and that attracted investors who poured money into bond mutual funds. That strategy backfired as interest rates increased during the second half causing bond investors to lose money.

Investors' folly depicted by this chart should serve as a caution to anyone tempted to time the market and it should encourage investors to adhere instead to a well thought out long-term asset allocation policy.

The biggest news of the year, of course, was the election of Donald Trump. The stock market has taken a favorable view of his election along with the Republican Party's control of Congress, resulting in a gain of more than 7% since the election. Our view is that the future of the stock market is dependent on economic growth, corporate profitability and valuations. Below, we discuss the prospects for the economy as well as the stock market.

Likely Tailwinds behind the Economy and Stock Market

- Corporate taxes are likely to head lower thus increasing corporate profitability and support stock valuations.
- There might be a one time tax break for repatriation of corporate profits held abroad. This will allow corporations to buy back more of their stock and support stock prices.

- Business regulations will likely decline. This will likely have a favorable impact on profits of companies in certain sectors, e.g., Energy and Banking.
- Congress might agree to more fiscal spending (using borrowed money), something it has been adamantly opposed to during the last eight years. This will increase profitability for certain sectors such as Materials and Industrials.

Likely Headwinds against the Economy and Stock Market

- Debt is high at multiple levels and there is well-documented research that it is hard to achieve economic growth when debt levels are already so high.
- Stock valuations in the United States are high by historical standards and act as a hurdle for future stock increases. Note, however, that valuations in developed foreign markets are more reasonable and in emerging markets are inexpensive, arguing for higher allocations to those markets, other things being equal.
- There is a mismatch in savings and spending. Countries with savings (e.g., China) don't spend enough, and countries that spend (e.g., United States) don't save enough. In a similar vein, increased concentration of wealth is a hurdle to economic growth because the rich have a lower propensity to consume (relative to their wealth) than the poor.
- Demographics of the developed world are unfavorable for economic growth. More people are aging and not being replaced by younger people thus moderating the pace of growth.
- China has been a significant contributor to growth over the last two decades, but it is slowing down. Moreover, China's Financial sector is susceptible to a breakdown because of the enormous amount of loans made for questionable projects.
- Last, but not least, the nationalist movement spreading across the globe has the potential to lead to trade friction and be a lose-lose proposition for all parties.

A careful look at the factors listed above will reveal that most of the tailwinds are likely to play out in the short run whereas the headwinds represent a mixture of short- and long-term issues. We believe the expected short term tailwinds explain the market's 7% plus up move since the presidential election. This trend may very well continue in the near term. Ultimately, however, the headwinds are unavoidable and will likely act as a restraint on the stock market.

At a strategic level, we at High Pointe have maintained a significant amount of exposure to cyclical stocks for quite some time because of their cheaper valuations. At a tactical level, the short-term tailwinds persuade us to continue to maintain a fair degree of exposure to cyclical stocks even after selling some of our cyclical stock winners as they appreciated after the election. As a result, our portfolios are now balanced between cyclical and stable stocks. Over time, however, we expect that the proportion of cyclical stocks will decline and stable stocks will increase as the long-term headwinds gain prominence.

Investment Returns

The returns of our main products are summarized below and a discussion of our investment strategy follows in the next section.

Investment Performance (Net of Fees)[1]

For Periods Ending December 31, 2016

	One Quarter	One Year	Five Years	Since Inception[2]
Large Cap Value	8.3%	19.0%	15.8%	9.9%
Russell 1000 Value Index	6.7%	17.3%	14.8%	7.1%
Large Cap Growth	2.6%	9.1%	12.9%	8.4%
Russell 1000 Growth Index	1.0%	7.1%	14.5%	3.9%
International Equity	-1.7%	1.0%	5.3%	1.5%
MSCI AC World ex US Index[3]	-1.3%	4.5%	5.0%	1.1%
Global Opportunity	2.0%	6.5%	n/a	3.7%
MSCI AC World Index	1.2%	7.9%	n/a	5.2%

[1]Performance for the latest quarter is preliminary and subject to change.
[2]Inception Dates: Large Cap Value – January 1, 1998; Large Cap Growth – August 1, 1999; 1998; International Equity – December 31, 2006; Global Opportunity: October 1, 2013.
[3]Gross total return index from December 31, 2006 – December 31, 2009; Net total return index from January 1, 2010.

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Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Performance results are shown in U.S. dollars, net of management fee, and are based on composites of all fee-paying, fully-discretionary accounts. Returns for the periods presented are time-weighted. Results shown include all accrued dividends and interest, realized and unrealized gains and losses. Gross dividends were used to calculate the performance prior to January 1, 2010. As of January 1, 2010, accrued dividends used are net of non-reclaimable withholding taxes. Leverage has not been used in any portfolio in the composite. High Pointe's fee schedules are disclosed in Part 2A of the firm's Form ADV. All fully discretionary, fee-paying accounts are included in at least one composite. The composite results portrayed during the period are compared to the performance of their respective indices because the securities purchased for each of the composites are most closely aligned with the securities comprising these indices.

*The **Large Cap Value** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization in excess of $2 billion that offer good "value" relative to other companies in a similar business, their growth potential, or their historical valuation levels. The **Large Cap Growth** composite is comprised of portfolios invested primarily in growth stocks of companies with market capitalization in excess of $1.5 billion that exhibit high expected earnings growth to maximize capital appreciation. The **International Equity** composite invests in stocks that are primarily domiciled in a country other than the U.S., including emerging markets, without any constraints regarding capitalization or style. The **Global Opportunity** composite invests opportunistically in foreign and domestic companies without any constraints regarding capitalization or style.*

A complete list of firm composites and performance results is available upon request. Returns represent past performance and are not indicative of future results. Investment may result in the loss of principal.

*The unmanaged **Russell 1000 Value Index** measures the performance of those securities in the Russell 1000 Index having lower price-to-book ratios and lower forecasted growth values. The unmanaged **Russell 1000 Growth Index** measures the performance of those securities in the Russell 1000 Index having higher price-to-book ratios and higher forecasted growth values. The unmanaged Russell 1000 Index is comprised of 1,000 of the largest capitalized companies that are traded in the United States. The **MSCI All Country World ex-U.S. Index** measures the equity market performance of world's developed and emerging markets. Currently the index consisted of 47 countries (23 developed and 24emerging countries). The **MSCI All Country World Index** measures the equity market performance of world's developed and emerging markets including the U.S. Currently the index consisted of 48 countries (24 developed and 24emerging countries). A net total return index reinvests dividends after the deduction of withholding taxes, using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treats. These indices do not reflect fees and expenses associated with the active management of separate account portfolios.*

Investment Strategy

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 8.3% for the quarter, outperforming its benchmark, the Russell 1000 Value Index by 1.6% for the quarter, and by 1.7% for the year. During the year, security selection was strong in the Industrials and Technology sectors, but was partially offset by weak selection in the Consumer Staples sector.

During the year, our investment in the construction industry benefitted from strong execution and the anticipation of increasing infrastructure spending. In the Technology sector, our investment in technology services performed well by returning cash to shareholders and focusing on its core business. In addition, our investments in the financial services industry benefitted from Fed actions and the election, as investors anticipate that the period of ultra low interest rates is finally over.

During the quarter, we increased our investments in the Materials and Energy sectors and decreased our investments in the Consumer Discretionary and Technology sectors. In the Technology sector, we sold an investment in the Semiconductor industry that had performed well. In the Consumer Discretionary sector, we reduced our exposure to the automotive industry and invested the proceeds in Broadcasting. In the Telecommunications sector, we sold an investment that had profited from its global network as demand increased. We reinvested the proceeds in the Specialty Chemicals, Integrated Oil and Gas, Pharmaceuticals and Food Retail.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 2.6% during the quarter, exceeding the Russell 1000 Growth Index by 1.6% for the quarter, and by 2.0% for the year. During the year, the portfolio benefitted from strong stock selection in the Consumer Discretionary and Industrials, but was partially offset by weak selection in Consumer Staples.

During the year, our investment in the Automotive Retail industry performed well as concerns of a market peak eased. In addition, our Cable industry holding profited from its focus on product improvement and customer satisfaction. In the Financials sector, our investment benefitted as economic indicators improved.

During the quarter, we decreased our investments in the Materials and Technology sectors and increased our investments in the Financials and Consumer Discretionary sectors. In the Technology sector, we repositioned our investments out of storage and internet services and into the consulting and payment industries. In addition, we sold a Fertilizer company that struggled in a weak environment and an airline that executed well in a favorable environment. We reinvested the proceeds in the Consumer Finance and Pharmaceuticals industries. In the Consumer Discretionary sector, we reduced our investments in automotive and leisure industries in favor of internet retail and restaurants.

International Equity

High Pointe's International Equity strategy produced a return -1.7% during the quarter, trailing its benchmark, the MSCI All Country World ex-US Index, by 0.4% for the quarter, and by 3.5% for the year. During the year, stock selection was weak in the Financials and Technology sectors but was partially offset by strong security selection in the Industrials sector.

During the year, our investment in European Communications Equipment struggled as emerging market sales disappointed. In the Telecommunications sector, our UK investment suffered as regulatory pressure increased. In addition, our UK Bank holding declined with the uncertainty surrounding Brexit. On the positive side, our emerging market Construction Materials investment executed well with sales growth and debt reduction.

During the quarter, we increased our investments in the Financials and Telecommunications sectors and decreased our investments in the Consumer Discretionary and Industrials sectors. We also reallocated our investments out of the UK and emerging markets and into the Pacific and continental Europe. Specifically, we sold emerging market investments in the Internet Retail and Internet Service industries and reinvested the proceeds in Telecommunications sector. We also repositioned our European holdings out of Automobile Manufacturers and into Brewers.

Global Opportunity

High Pointe's Global Opportunity strategy produced a return of 2.0% for the quarter, outperforming its benchmark, the MSCI All Country World Index by 0.8% for the quarter, but lagging it by 1.4% for the year. During the year, our investment in the North American Pharmaceutical industry struggled as concerns arose regarding its business practices. In addition, our investment in the US Healthcare Service industry faced a contentious and ongoing contract renegotiation. On the positive side, our emerging market Construction Materials investment executed well with strong sales. In the Technology sector, our US technology services holding performed well by focusing on its core business and shareholder value.

During the quarter, we increased our holdings in the Financials and Utilities sectors and decreased our investments in the Materials and Technology sectors. We also reduced our investments in the UK and increased our investments in the Pacific region.

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Thank you for entrusting us with the responsibility to manage your investments!