

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We always feel some trepidation when describing our market prognosis for the year ahead. Thus, we take solace from a recent conversation with a 35-year veteran of a major Wall Street firm. The wise gentleman admitted that his firm only gets its forecasts right about 50% of the time. Unexpected events have a way of throwing off the most carefully thought out predictions.

The 2016 year just concluded was the epitome of the unexpected. From the outset of 2016, we were restrained in our optimism for the market. We saw too many issues working to keep the market subdued. But who expected Donald Trump to get elected? Who expected the curious market euphoria that followed his victory? Who expected the Dow Jones 30 to end the year with double digit growth? We certainly did not expect these outcomes – and while not unhappy – we admit that we were about 50% mistaken in our 2016 outlook.

That said, perhaps 50% of our concerns were essentially correct. Most basic, stock prices were quite rich throughout 2016 – and the post-election rally has made them even richer. The market has anticipated that a Republican President and Congress will create a more business-friendly environment that drives up corporate earnings. The key initiatives are lower taxes, reduced regulation, and infrastructure stimulus. Is the market anticipation realistic? Can the Republicans act quickly and effectively?

Our viewpoint at Hudson Advisors is to be temporarily cautious. Despite the one-party dominance in Washington, policy changes take time to approve and implement. The impact on corporate earnings is not immediate. If changes are slow to happen, the market will be challenged to move higher. On the contrary, prompt political action may allow the market to advance further. We will withhold judgment for now and review the outlook at the end of the first quarter.

since 2013. U.S. Government bond prices fluctuated broadly during the year and ended moderately lower.

Equity Market: Stock prices suffered in the early weeks of the year and then recovered and moved slowly upwards for most of the year. The post-election rally produced a strong end to the year. The Dow Jones Industrial Average increased 7.43% in the fourth quarter and was ahead 15.46% for the year. The S&P 500 index gained 3.25% for the quarter and 9.54% for the year. The Russell 2000 index of small cap stocks was also a quite strong performer. It moved ahead 8.83% ahead for the quarter and was up 19.48% for the year. The weak sector was technology with the Nasdaq Composite flat for the quarter and up 7.5% for the year.

Fixed Income Market: The market saw broad fluctuation in 2016. Investors had literally scoffed up U.S. Treasury bonds in the first half of the year. The yield on the 10-year Treasury was 1.47% at the end of June -- down from 2.27% at the end of 2015. (Yields move inversely to prices.) That first half rally was then followed in the fourth quarter by the largest quarterly rout since 1994. The yield was 2.44% at the end of the year.

Just as stock investors were encouraged, bond investors became alarmed at the prospect of higher inflation and a faster pace of interest rate increases. This response supports our long-held view at Hudson Advisors that longer maturity bonds can see steep price declines when interest rates move higher. We fully expect the fourth quarter trend to continue in 2017 and the yield is likely to rise to the 3.0 to 3.5% range.

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices for the fourth quarter and full year 2016. The post-election rally gave the stock market its best year

MAJOR MARKET INDEXES

	4Q 2016 Return	YTD Return
Dow Jones Industrials Composite PR	7.43	15.46
S&P 500 Index PR	3.25	9.54
Russell 2000 Index PR	8.83	19.48
NASDAQ Composite PR	1.34	7.50
EAFE Index NR	-0.71	1.00
Barclays Aggregate Bond Index TR	-3.84	1.04

source: Morningstar®

THE OUTLOOK

The Economy: The stock market performance in 2016 was not all rooted in politics. Economic fundamentals supported the market enormously. The U.S. Gross Domestic Product grew at an annual rate of 3.5% in the third quarter. That followed three consecutive quarters with about 2% expansion. Job growth has been consistent with an average of 200,000 new jobs per month in the past year. The unemployment rate is now down to 4.6%. Corporate earnings have improved after a year of disappointment. The base outlook for 2017 is positive – and will be enhanced if the stimulative policies from Washington do materialize. The economic model from the Wharton School of Business says the proposed tax changes could add from 1.1 to 1.7% to the core GDP growth.

This outlook explains the decision of the Federal Reserve to increase rate by .25% in December for the first time since 2015. The announced Fed policy is to raise rates gradually in the year ahead – a sign of economic optimism.

The Market: As expressed, our caution about the market is the rich price of stocks. Shares of companies in the S&P 500 are trading at an average of 21 times their past 12 months of earnings. That compares to a 10-year average of 16. The P/E ratio for much of 2016 was in the 18 times range – but was driven even higher by the post-election rally.

To say it again, this run-up in stock prices is based in anticipation of tax, fiscal and regulatory policy changes that will improve corporate earnings. We are looking at what some analyst have called the “iffy bull.” For the market to move higher, we need to see those changes occur and work their way into corporate earnings. At Hudson Advisors, we are hopeful, but are in “wait and see” mode at the current time.

We also are mindful of the stronger U.S. dollar which makes it more difficult for U.S. companies to export. The impact could be to restrain the recovery of corporate earnings needed to support the rich price of stocks.

OUR STRATEGIES

Asset Allocation: For clients investing new money, same as last quarter, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We stagger the time period in which we reach that 55% level. For fully invested clients, we recommend to trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. We continue to believe that U.S. companies are the best equity investment.

Some of the sectors we are like include:

- **HEALTH CARE:** The Congress has passed the Cures Act which boosts drug research and eases government approvals. This action will boost earnings in certain pharmaceutical and bio-medical companies.
- **TECHNOLOGY:** This sector lagged the rest of the market in 2016 – and thus the opportunity for growth in stock prices is good.
- **FINANCIALS:** This sector should be assisted by the increase in interest rates which improves the profitability of many product lines.
- **TRANSPORTATION:** The continued low relative price of energy is good for industries like airlines and trucking.

Fixed Income: Our repeated aversion to bonds with long maturities remains firm. The market is finally accepting our viewpoint. We still believe the risk of a sharp decline in prices is too great a risk for our clients. We prefer to find vehicles such as municipal tax liens and other alternative investments.

Dow Jones U.S. Sectors Total Return (Percent Change for YTD, Ending December 31, 2016)

Source: Morningstar®

Oil & Gas	26.26	Consumer Services	5.99
Basic Materials	20.27	Telecommunications	23.96
Industrials	19.53	Utilities	17.06
Consumer Goods	5.28	Financials	17.35
Health Care	-2.44	Technology	14.22

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Top 25 Performing Stocks for 2016 - US Listed companies with a market cap above \$1 Billion.

Source: Thomson Reuters Eikon ®

Ticker	Company Name	Company Market Cap (USD)	YTD Total Return (0M)
GREL.PK	ATI Modular Technology Corp	\$ 1,134,105,425.50	3,780.1%
CRYW.PK	Carey Watermark Investors Inc	\$ 1,229,008,407.70	3,520.0%
WINS.OQ	Wins Finance Holdings Inc	\$ 3,607,496,460.00	1,400.0%
XREE.PK	Maxam Gold Corp	\$ 1,157,149,322.55	764.2%
GMCL.PK	GMCI Corp	\$ 1,802,005,865.00	601.3%
CLF.N	Cliffs Natural Resources Inc	\$ 1,939,344,704.86	432.3%
FMSA.N	Fairmount Santrol Holdings Inc	\$ 2,627,883,333.72	401.7%
AKS.N	AK Steel Holding Corp	\$ 3,195,930,320.20	355.8%
LIVX.PK	Loton Corp	\$ 2,003,392,160.00	349.4%
NERO.PK	Neuromama Ltd	\$ 36,545,799,942.00	346.2%
UPLMQ.PK	Ultra Petroleum Corp	\$ 1,109,071,870.77	329.9%
X.N	United States Steel Corp	\$ 5,692,873,669.63	319.6%
CC.N	Chemours Co	\$ 4,016,720,106.71	316.9%
CWEI.N	Clayton Williams Energy Inc	\$ 2,086,273,140.36	303.3%
AMD.OQ	Advanced Micro Devices Inc	\$ 10,510,691,239.44	295.1%
CDE.N	Coeur Mining Inc	\$ 1,548,265,085.28	266.5%
NAV.N	Navistar International Corp	\$ 2,563,255,875.40	254.9%
HCLP.N	Hi Crush Partners LP	\$ 1,260,631,231.20	234.5%
NVDA.OQ	NVIDIA Corp	\$ 57,105,900,000.00	226.9%
QUAD.N	Quad/Graphics Inc	\$ 1,372,229,806.08	206.9%
SLCA.N	U.S. Silica Holdings Inc	\$ 4,003,699,038.56	204.9%
RMR.OQ	RMR Group Inc	\$ 1,227,756,064.00	181.5%
TROX.N	Tronox Ltd	\$ 1,199,096,817.50	181.2%
HL.N	Hecla Mining Co	\$ 2,071,303,225.00	177.9%
VHI.N	Valhi Inc	\$ 1,173,489,963.54	167.8%

Bottom 25 Performing Stocks for 2016 - US Listed companies with a market cap above \$1 Billion. Source:

Thomson Reuters Eikon ®

Ticker	Company Name	Company Market Cap (USD)	YTD Total Return (0M)
LGYVD.PK	Legacy Ventures International Inc	\$ 1,161,486,000.00	-98.8%
AEEEX.PK	Asia Equity Exchange Group Inc	\$ 1,260,600,000.00	-82.3%
FTT.N	Fitbit Inc	\$ 1,637,841,882.12	-75.3%
ENDP.OQ	Endo International PLC	\$ 3,670,780,846.59	-73.1%
HTZ.N	Hertz Global Holdings Inc	\$ 1,788,756,015.20	-69.7%
JUHL.PK	Juhl Energy Inc	\$ 18,520,787,130.00	-63.9%
MYGN.OQ	Myriad Genetics Inc	\$ 1,140,499,504.29	-61.4%
RH.N	Restoration Hardware Holdings Inc	\$ 1,252,638,223.60	-61.4%
PBYI.OQ	Puma Biotechnology Inc	\$ 1,130,315,424.40	-60.8%
ALNY.OQ	Alnylam Pharmaceuticals Inc	\$ 3,212,871,255.36	-60.2%
PCRX.OQ	Pacira Pharmaceuticals Inc	\$ 1,208,093,708.60	-57.9%
WUBA.N	58.com Inc	\$ 4,051,693,996.00	-57.6%
JUNO.OQ	Juno Therapeutics Inc	\$ 1,995,676,662.85	-57.1%
PTLA.OQ	Portola Pharmaceuticals Inc	\$ 1,268,845,519.92	-56.4%
SFUN.N	Fang Holdings Ltd	\$ 1,507,967,224.40	-55.6%
DATA.N	Tableau Software Inc	\$ 3,207,281,635.65	-55.3%
INFN.OQ	Infinera Corp	\$ 1,227,427,435.86	-53.1%
LC.N	LendingClub Corp	\$ 2,070,018,037.50	-52.5%
GPRO.OQ	GoPro Inc	\$ 1,224,324,442.38	-51.6%
FSLR.OQ	First Solar Inc	\$ 3,334,570,287.94	-51.4%
THC.N	Tenet Healthcare Corp	\$ 1,478,593,402.16	-51.0%
LTRPA.OQ	Liberty TripAdvisor Holdings Inc	\$ 1,135,302,701.40	-50.4%
HMHC.OQ	Houghton Mifflin Harcourt Co	\$ 1,334,639,035.10	-50.2%
ROGP.PK	Royale Globe Holding Inc	\$ 1,611,487,500.00	-50.0%
ACHC.OQ	Acadia Healthcare Company Inc	\$ 2,896,272,541.10	-47.0%

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