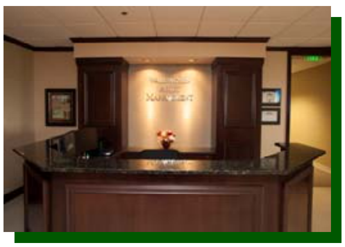
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY REVIEW

2016: FOURTH QUARTER — 112TH EDITION



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COMMENTARY

THE ALMIGHTY DOLLAR

The world's most important currency is flexing its muscles. The U.S. dollar hit its highest level in 14 years against a basket of currencies in anticipation of a stronger U.S. economy in 2017. The recent appreciation was largely based upon President-elect Donald Trump's economic plan of tax reform, infrastructure spending, and deregulation of the economy. A hawkish Federal Reserve (Fed) raised short-term interest rates in December 2016 and December 2015 and has projected two more increases in 2017. The dollar, which has risen back to 2002 levels, weakened during the financial crisis of 2008-2009 but has rallied nearly 40% since 2011. *(Continued on page 8)*

CAPITAL MARKETS SCOREBOARD

Equities	4Q16 Total Return (%)	2016 Total Return (%)
Domestic		
S&P 500	3.8 ↑	12.0 ↑
DJIA	8.7 ↑	16.5 ↑
Russell 2000	8.8 ↑	21.3 ↑
International		
MSCI EAFE*	-0.7 ↓	1.5 ↑
MSCI Emerging Markets*	-4.1 ↓	11.6 ↑

Fixed Income**	4Q16 Total Return (%)	2016 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	-0.4 ↓	1.3 ↑
U.S. Corp - Gov (3-5 Years)	-1.8 ↓	2.0 ↑
U.S. Corp - Gov (10+ Years)	-8.4 ↓	5.7 ↑
U.S. Treasuries Master	-4.0 ↓	1.1 ↑
U.S. Corporates Master	-2.9 ↓	6.0 ↑
U.S. Municipals Master	-3.5 ↓	0.4 ↑
U.S. High Yield Master	1.9 ↑	17.5 ↑
International		
Developed Markets Sovereign Bond*	-8.8 ↓	1.7 ↑

Commodities	4Q16 Total Return (%)	2016 Total Return (%)
Gold	-12.4 ↓	8.5 ↑
Silver	-16.1 ↓	17.5 ↑
Bloomberg Industrial Metals (Spot)	6.6 ↑	21.9 ↑
S&P GSCI Soft Commodities	-10.3 ↓	12.7 ↑

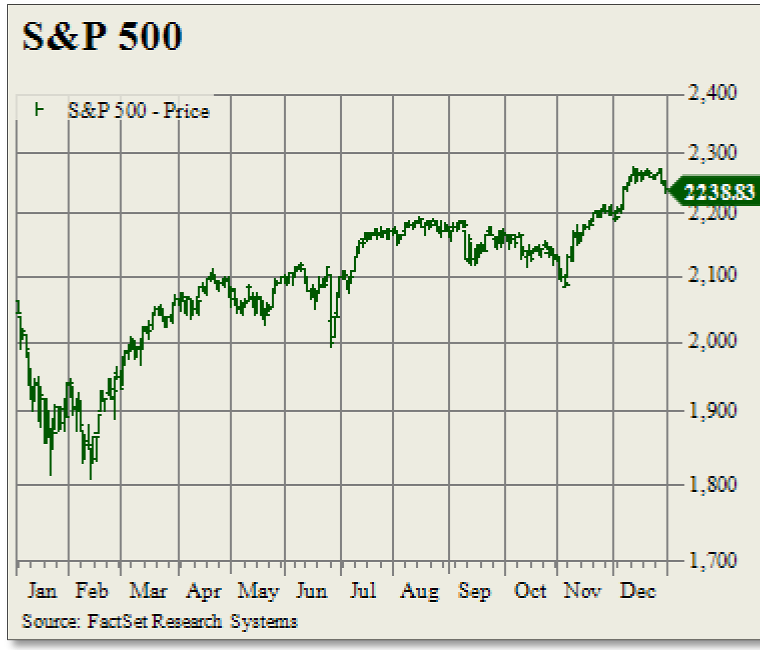
Dollar Index	4Q16 Total Return (%)	2016 Total Return (%)
ICE U.S. Dollar	7.1 ↑	3.6 ↑

*Returns denominated in U.S. dollars

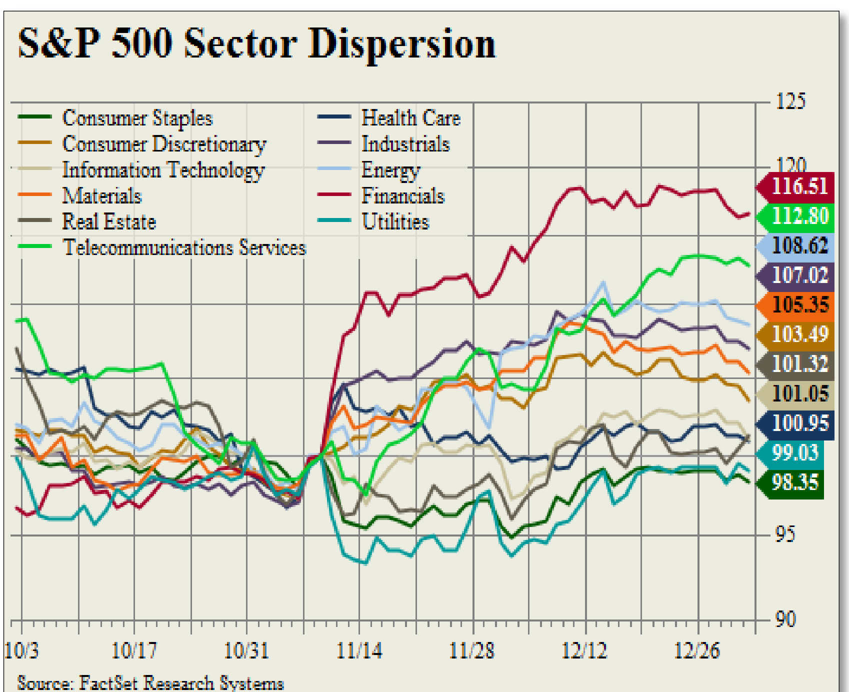
**Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

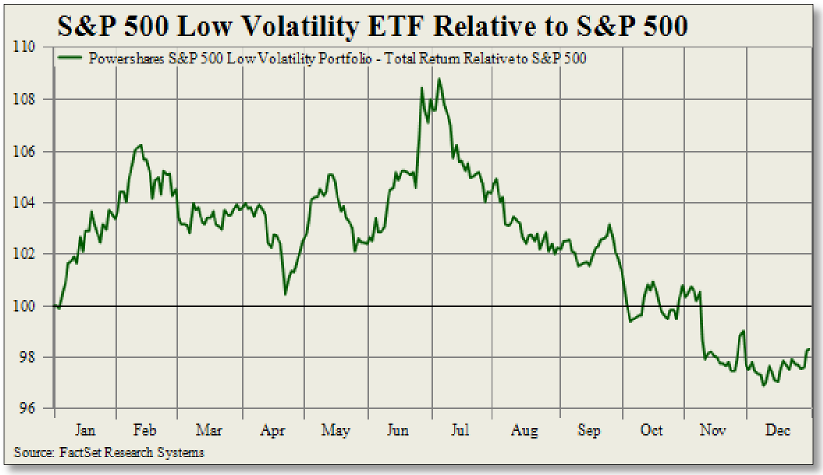
The Standard & Poor's 500 (S&P 500) index finished 2016 at 2,238.83, 1.4% off its all-time closing high of 2,271.72 set on December 13. While the S&P 500 provided increased upside over 2015's meager returns, it came with additional volatility as the index reached lower lows and higher highs than the previous year. The only two years this phenomenon has previously occurred were 1982 and 1935. After starting the first six months of the year behind large cap stocks, the Russell 2000 Index of more volatile small cap stocks significantly outperformed in the final six months as a "risk-on" theme became predominant in the financial markets. International developed market companies continued to lose ground to domestic companies with the MSCI Europe, Australasia, and Far East (EAFE) index finishing the year with a 1.5% total return when denominated in U.S. dollars. Emerging markets fared better as recovering commodity prices helped elevate their often poorly-diversified economies. The MSCI Emerging Markets Index generated an 11.6% return for the year.



The fourth quarter included notable sector dispersion as economic assumptions were reset based upon Donald Trump's odds-defying presidential win. From the end of the third quarter through November 8, the S&P 500 was down 1.3%, and 7 out of 11 sectors had moved less than 2%. In spite of volatile and negative overnight trading in the equity futures markets as the election results became apparent, the S&P 500 rallied over 1% on November 9 and finished the quarter with a 3.8% total return. As investors digested prospects of increased fiscal stimulus and decreased regulation, financial stocks rallied 16.5% after the election. The sector was the top performer of the quarter with a 21.1% total return. Likewise, the Energy and Industrials Sectors were the second and third best performers for the quarter, returning 7.3% and 7.2% respectively. Energy stocks could potentially benefit from decreased regulation, while many industrial companies would benefit from increases in infrastructure and defense spending.



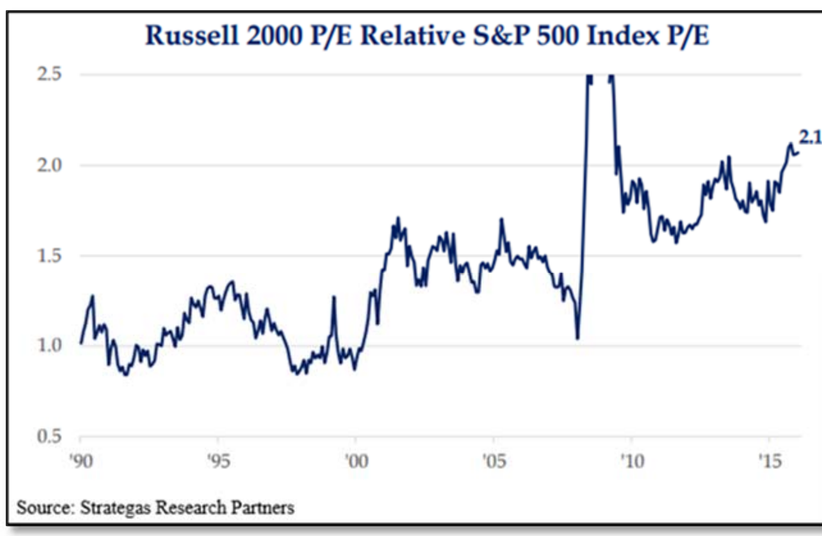
EQUITIES



Only two sectors, the defensive and less volatile Utilities and Consumer Staples Sectors, lost value from November 9 through the end of the year. A post-election increase in bond yields decreased the value of stocks in these sectors which generally have more stable prices and higher dividend yields. Performance dispersion between different companies and industries is likely to continue as increased information about potential tax reform, regulatory changes, and government spending comes to light. Many market commentators believe that a general "risk-on" approach is driving the markets in the interim while specific policy is devised and debated. This change has compounded difficulties for popular low-volatility strategies which recorded massive inflows in the first half of the year. While the S&P 500 Low Volatility Index outperformed the S&P 500 over the first two quarters, it materially underperformed in five out of six months the second half of the year. The index has a very large weighting to typically interest-sensitive high-dividend stocks such as those in the Utilities Sector.

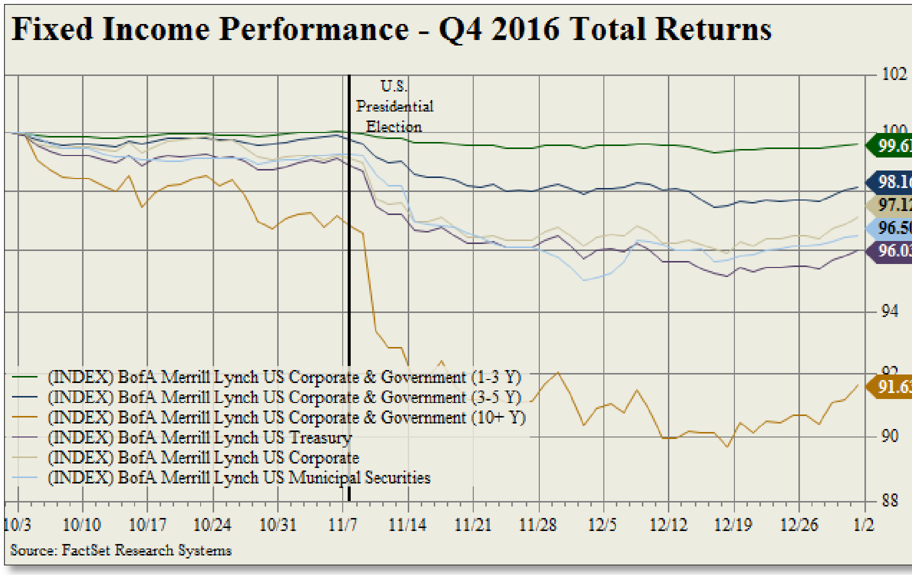
After surpassing expectations, year-over-year (YOY) S&P 500 earnings growth of 3.2% for the third quarter was positive for the first time since the second quarter of 2015. Earnings grew at a rate of 6.2% when excluding the Energy Sector. Energy stock earnings declined 62.6% for the quarter, the eighth straight quarter of at least a 20% decline. While Energy Sector earnings are expected to have declined by a comparatively stable 2.0% in the fourth quarter, earnings for the overall S&P 500 are only expected to have increased 2.8%. Earnings growth is expected to reaccelerate into 2017 with an 11.0% YOY increase in the first quarter. As of January 6, analysts expect earnings to increase 11.4% in 2017.

Due to the expected increase in earnings growth, the S&P 500 is trading at its highest trailing price-to-earnings (P/E) ratio since the recession when earnings were depressed, at 20.3 according to FactSet. While this is above the 20-year average of 19.6, the S&P 500 forward P/E ratio of 16.9 is below the 20-year average of 17.2. Shiller's P/E ratio (the Cyclically-Adjusted P/E or CAPE ratio) is at 28.3 and above its long-term average of 26.0, but this level is still within one standard deviation of historical valuations. After a strong post-election rally, small cap stocks are trading near their highest level relative to large cap stocks since the financial crisis. The Russell 2000 is trading at twice the P/E ratio of the S&P 500. The "Buffet Indicator," or the value of corporate equities relative to domestic GDP, has decreased slightly from its post-crisis high of around 130%. Its current level of 121% is still well below its all-time high of 151% at the peak of the technology bubble.

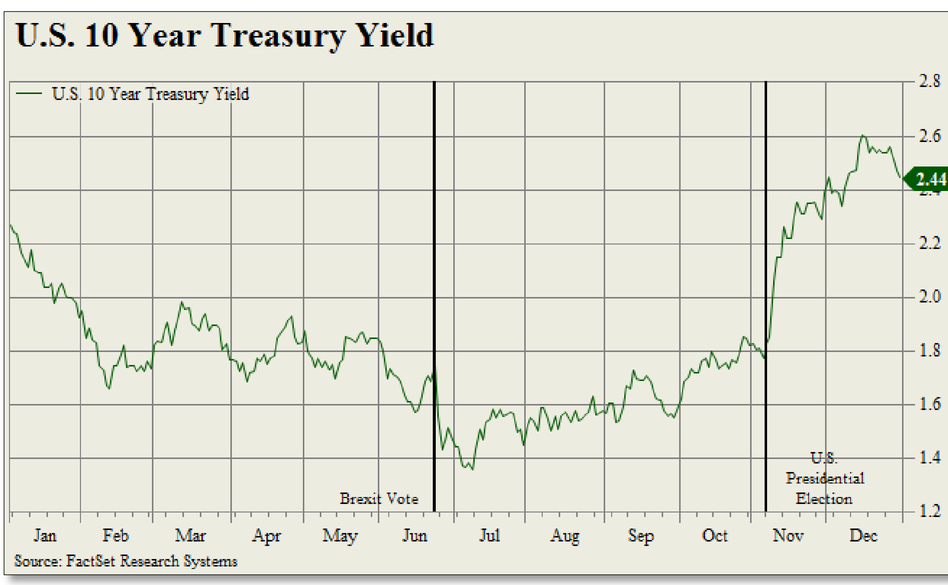


FIXED INCOME

The fixed income markets performed poorly in the fourth quarter as expectations of higher inflation following the election fueled an increase in bond yields (a bond's price and yield move inversely). Longer-term bond prices move more dramatically with changes in yields; the BofA-ML U.S. Corp – Gov (10+ Years) Index returned -8.4% for the quarter, while the BofA-ML U.S. Corp – Gov (1-3 Years) was off only 0.4%. Corporate bonds suffered less than their government and municipal counterparts during the quarter, with the BofA-ML U.S. Corporates Master Index returning -2.9% versus -4.0% for the BofA-ML U.S. Treasuries Master Index and -3.5% for the BofA-ML U.S. Municipals Master Index. Including the impact of currency movements, international government bonds were hit even harder; the BofA-ML Developed Markets Sovereign Bond Index posted a -8.8% total return when denominated in U.S. dollars. High-yield ("junk") bonds, which typically are highly correlated with equities, finished the quarter in positive territory as the BofA-ML High Yield Master Index returned 1.9%.



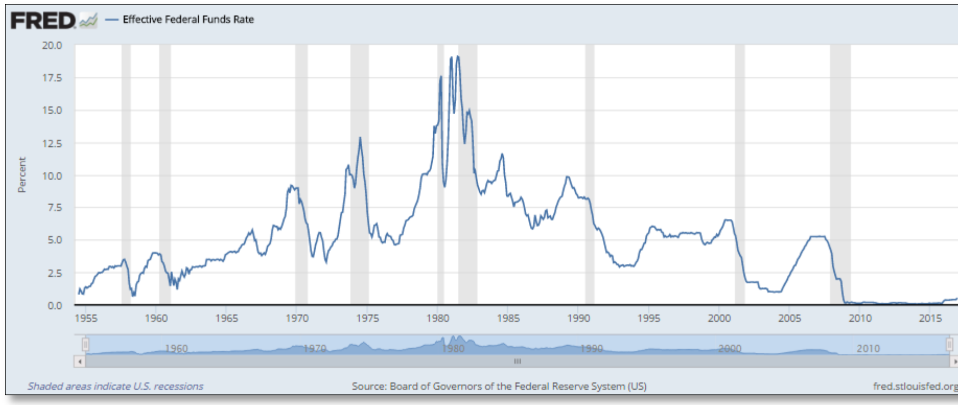
Despite the fourth quarter route, fixed income investments were able to post positive results for the year. This was due to a strong first six months capped by a Brexit-induced flight to quality in late June. For 2016, high-yield bonds led the way followed by investment-grade corporate bonds. The BofA-ML High Yield Master Index posted a total return of 17.5% and the BofA-ML U.S. Corporates Master Index returned 6.0%. Both sub-asset classes of fixed income significantly outperformed Treasuries and municipals, which returned 1.1% and 0.4% respectively for the year.



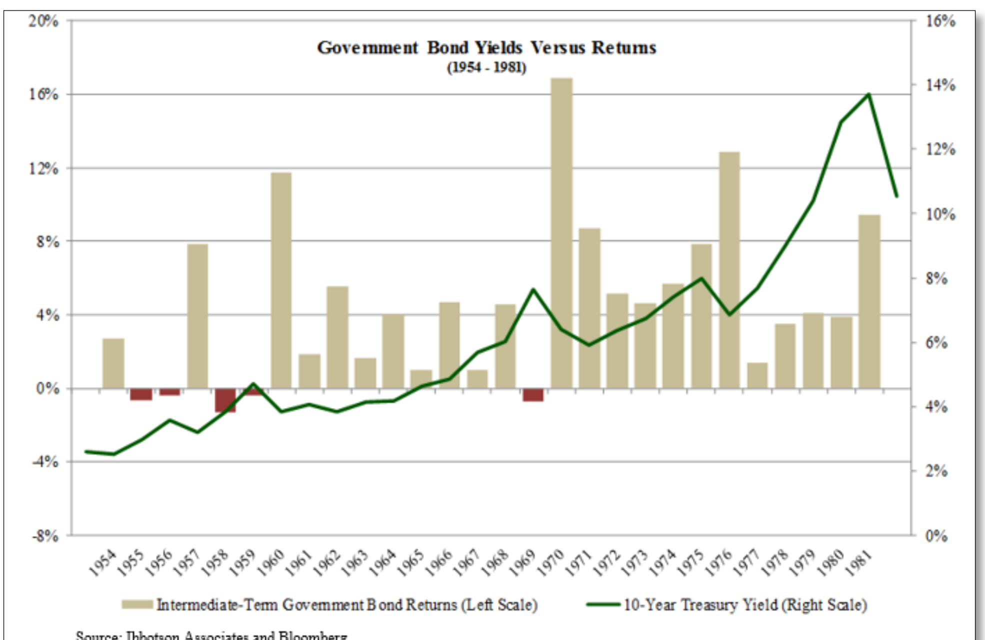
After an abysmal fourth quarter for international bonds, the BofA-ML Developed Markets Sovereign Bond Index still managed a 1.7% total return for the year.

FIXED INCOME

The future direction of interest rates remains a key item of discussion in the fixed income markets. Monetary policy (such as lowering interest rates to decrease borrowing costs and theoretically increase corporate and consumer spending) has been the most prominent means of economic stimulus since the Great Recession. In an effort to spur economic growth, the Federal Reserve (Fed) decided in 2008 to cut its target range for short-term interest rates to 0.00% – 0.25%. This target range was not changed until the Fed implemented a 0.25% increase in December 2015. At that time, Fed forecasts called for four more rate hikes in 2016. The first three never happened; the Fed did not decide to raise rates again until mid-December, when it announced another 0.25% increase to a target range of 0.50% – 0.75%. The incoming Trump administration's platform is considered to be reflationary and interest rates have been on the rise, so it appears as though fiscal policy (such as lowering taxes to increase the amount of money individuals and corporations have available to spend) will take over as the primary means of economic stimulus and monetary policy's role will become less significant going forward. While the seven members of the Federal Reserve Board of Governors have not always been consistent in their outlooks, current market expectations generally predict two more rate hikes in 2017.

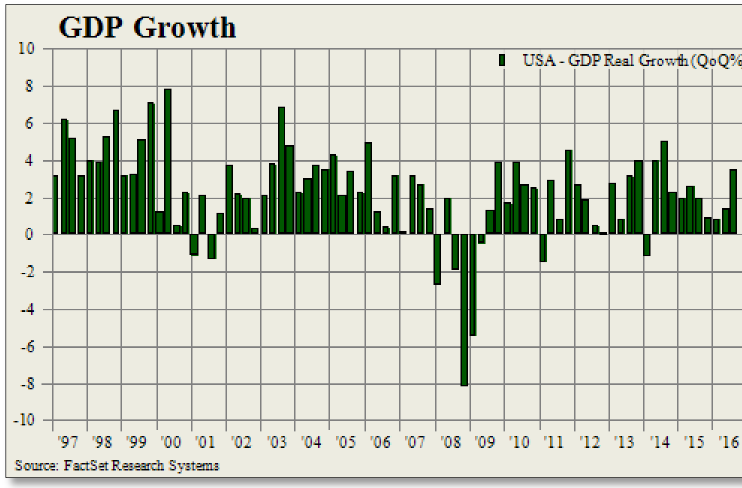


With interest rates expected to continue upward, many analysts have discussed the possible end of the more than 35-year old bull market in fixed income. The yield on the U.S. 10-year Treasury hit a record high of 15.84% in September of 1981, and has since been on a general decline, providing a long-term tailwind for bond prices. Despite the fact that rising interest rates weigh on bond prices, rate increases do not necessarily result in negative fixed income performance. The U.S. 10-year Treasury yield experienced a general uptrend for over two and a half decades from a low of 2.25% in April 1954 until its 1981 peak. During that time, intermediate-term government bond total returns were negative in only 5 years compared to 23 positive years; the total return from the second quarter of 1954 through the third quarter of 1981 was just shy of 200%, or approximately 4.1% annualized, according to Ibbotson data. Even in times of rising interest rates, bonds can still both generate positive total returns and provide a valuable means of hedging volatility due to their often negative correlation to equities.

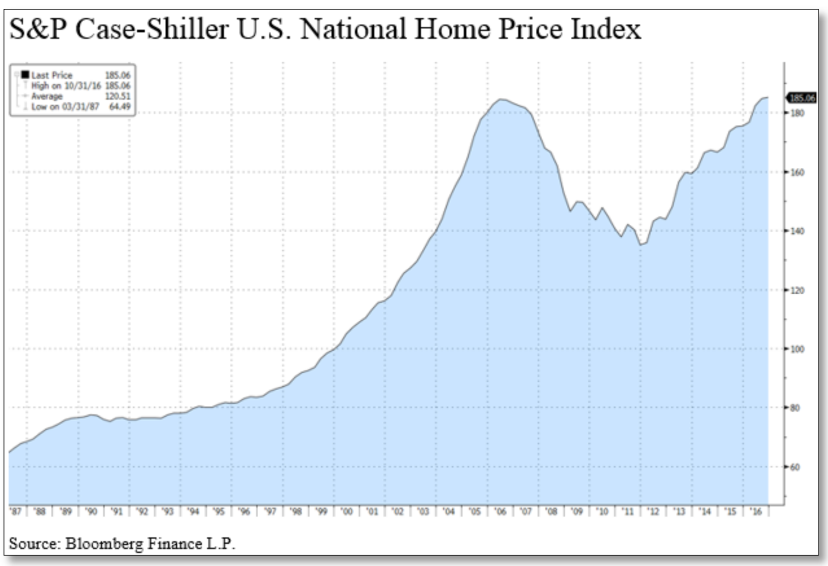


U.S. Economic Growth Continues

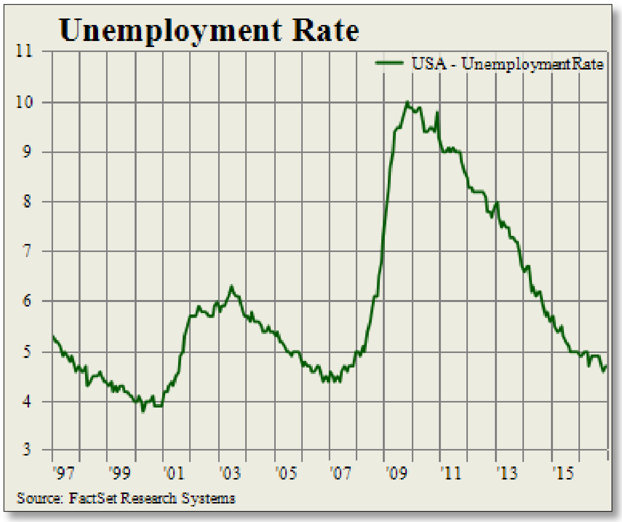
U.S. gross domestic product (GDP) grew at a 3.5% seasonally-adjusted annual rate (SAAR) in the third quarter of 2016, revised up from an initial estimate of 2.9% and a first revision of 3.2%. This was the strongest quarterly growth in two years. Domestic consumer spending, which accounts for nearly 70% of GDP, provided a tailwind as personal consumption expenditures (PCE) rose at a 3.0% SAAR during the quarter. Durable goods showed the largest increase within the segment, bolstered by an annualized 19.9% quarter-over-quarter rise in motor vehicle expenditures. Although a relatively small component of the calculation, GDP growth was further helped by a 10.0% surge in exports. Foods, Feeds, and Beverages exports were up 216.8% (SAAR) over the quarter; soybean exports and inventory building were the primary drivers, providing a 0.6% boost to GDP after five consecutive quarters of inventory liquidation. GDP growth of 3.5% was good news, particularly given the anemic growth of closer to 1.0% over the prior three quarters. Projections for the fourth quarter of 2016 are for 2.0% GDP growth.



Growth in the economy has been aided by the fact that household balance sheets are in good shape as new highs for stock prices and home prices have created record household wealth. The U.S. housing market has recovered from a lost decade as home prices in September surpassed all-time high levels set in July 2006 as measured by the S&P Case-Shiller National Home Price Index. House prices fell 27% from their 2006 highs to the lows of 2012, closing out the worst period for the housing market since the Great Depression of the 1930's. More than 9 million households lost their homes during the most recent collapse. Although still 16% below 2006 levels when adjusted for inflation, home prices nationally have appreciated 37% from the market bottom. However, there has been a wide disparity in price appreciation. More expensive homes have appreciated to a greater degree than less expensive homes, and West Coast and Northeast housing has done better than the rest of the country. Higher home prices as well as stock prices (up 50% from their 2009 lows) caused household net worth to set a new record of $90.3 trillion at the end of the third quarter of 2016. However, higher home prices and mortgage rates have made housing less affordable, especially for first-time home buyers. As a result, home ownership remains close to 50-year lows.

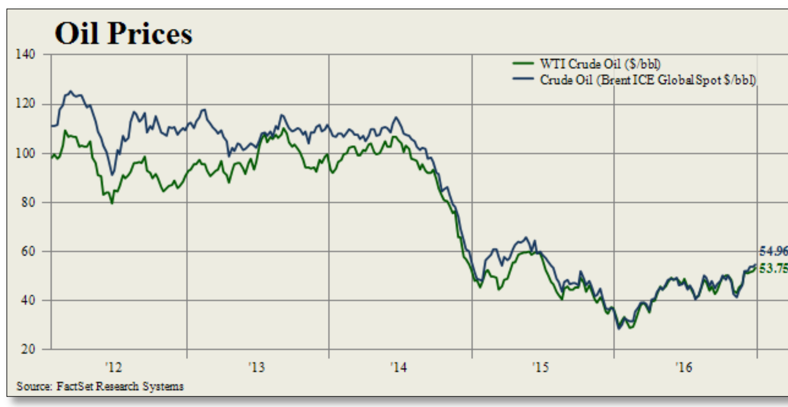


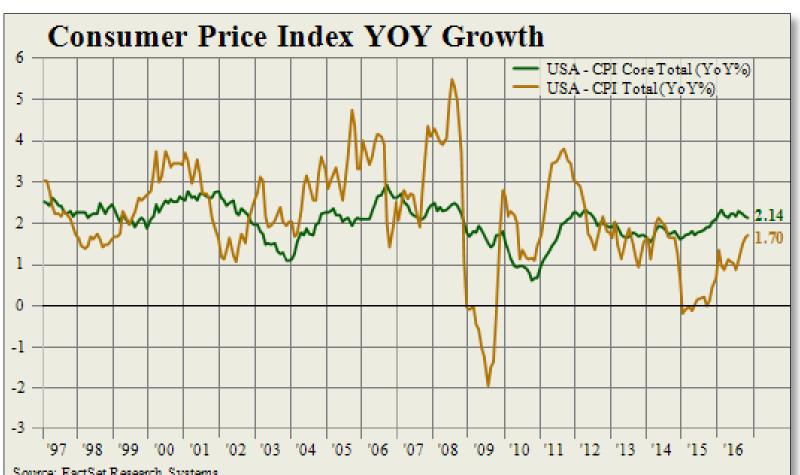
ECONOMICS



Continual improvement in the labor market has been a major driver behind personal consumption. While the number of jobs added in December (up 156,000) was less than in November (up 204,000), job growth was still a positive for the economy. According to the Labor Department, 2.2 million jobs were added in 2016, bringing the total to roughly 15 million since the labor market bottomed in 2010. Job growth has been positive for a record 75 consecutive months. Average hourly wages increased 0.4% in December and have risen 2.9% YOY, the fastest wage growth since June 2009. The unemployment rate ticked up slightly to 4.7% in December from 4.6% in November, which was the lowest rate since August 2007. The labor force participation rate rose marginally to 62.7% from 62.6% in November, but was still near a 60-year low. The big question is whether or not slack in the labor force still exists as 95.8 million people age 16 and over are still not working; fewer than when the participation rate hit a low in 2015, but the improvement has been slow.

The economy appeared to have solid footing at the end of 2016 based upon strong consumer spending, job growth, and wage gains. However, some headwinds exist. The benefit of low gasoline prices is fading as oil prices have doubled from their January 2016 lows. The Organization of the Petroleum Exporting Countries (OPEC) and other major oil-producing countries agreed to cut production by 1.7 million barrels per day in 2017 so oil prices are likely to stabilize at present levels. Business investment remains subdued along with worker productivity; more is needed in these areas if economic growth is to increase. The uncertainties of U.S. economic policy going forward will need to be resolved before the corporate sector will be willing to invest more in plants, equipment, and research & development. Additionally, the strong dollar is making U.S. exports more costly and less competitive (see Commentary).





Consumer prices are also increasing. While inflation remains under control, it is perking up; the Consumer Price Index (CPI) rose at a 1.7% annual rate in November, below the Fed's 2.0% target. Ex-food and energy, the core inflation rate was 2.1%. Inflationary expectations are in some ways more important than actual inflation numbers as they get embedded into economic and financial transactions such as bond yields. Inflationary expectations over the next five years increased from 1.4% in July to 2.0% in December. Yields on bonds have tracked inflationary expectations as 10-year bond yields increased from 1.36% in July to 2.45% at the close of 2016.

COMMENTARY

THE ALMIGHTY DOLLAR
(Continued from page 1)

Why the strong dollar?

A currency's value relative to other currencies is determined by many factors including economic growth, interest rates, inflation, and capital flows. The U.S. economy has averaged annual economic growth of 2.1% since the economic recovery started in July 2009; nothing exceptional, but better relative to Europe and Japan. China was the growth engine of the world for many years, but its growth has slowed recently and many emerging market countries such as Brazil are in recessions. The U.S. economy looks strong on a comparative basis and expectations are that growth will be better under the Trump administration. Fed policy has also buoyed the dollar as the Fed is the only major central bank currently raising interest rates.

U.S. Implications

While many economists consider a strong dollar a badge of honor reflecting foreign confidence in the U.S. economy, there are pluses and minuses. A strong dollar makes foreign imported goods cheaper, which helps consumers and controls inflation. Travel abroad also becomes cheaper for U.S. consumers. Foreign travel would be considered a U.S. import because U.S. dollars end up in a foreign country; it is better for U.S. travelers to pay $1.05 per euro versus the $1.40 exchange rate in 2014. Eurozone travel has become about 25% cheaper in the last two years. Likewise, a stronger dollar has made foreign travel to the U.S. more expensive by roughly 20% for Europeans.

The combination of higher relative interest rates and a stronger economy make the U.S. an attractive place to invest. Foreign investor demand has helped buoy bond and stock prices and put downward pressure on long-term interest rates. The process involves investors abroad selling their local currency, buying dollars, and investing in the U.S. The demand for dollars strengthens the dollar and weakens their local currency. As the dollar strengthens, investing in the U.S. becomes even more attractive. These capital flows create a feedback loop of a stronger dollar trend. There is a potential downside; foreign capital inflows can accentuate financial asset prices and cause asset bubbles which can create problems when they burst.

On the contrary, a strong dollar also makes U.S. exports more costly and less competitive, potentially resulting in slower economic growth at home. Corporations feel the pain of a stronger dollar, especially the multinationals and exporters. The trade deficit will widen under a stronger dollar, especially for goods.

COMMENTARY

Not only are U.S. exports more costly, but a strong dollar makes foreign profits less valuable when converting back to U.S. dollars. Corporate profits relative to GDP have fallen from 10.2% in 2012 to 9.1% in the third quarter of 2016. President-elect Trump's ambitious plans to revive exports, reduce trade deficits, and bring jobs back to the U.S. are in conflict with a strong dollar.

China

The U.S. runs a trade deficit in goods of about $800 billion annually, and approximately 50% of the deficit is with China. This will pose a big trade issue in 2017 as the President-elect has threatened trade barriers for Chinese imports and accused China of currency manipulation. Trade with China may not be a fair game, but China has attempted to support its currency relative to the U.S. dollar. China has spent $1 trillion of its foreign currency reserves to support the weakening yuan as it has fallen from 6.10 yuan per dollar to 6.96 per dollar since 2014, a deterioration of 14%. The weakening yuan has caused capital outflows from China, further weakening the currency; China recently imposed capital outflow controls as another measure of support for the yuan. China still has $3 trillion of foreign exchange reserves, but they are declining rapidly. If the pace continues, it could cause a major devaluation in the yuan to happen in the not too distant future.

Europe

The euro was established as a global currency in 2000. It reached a low of $0.83 in 2002 and a high of $1.60 in 2008. The euro fell gradually from its peak to $1.40 in June 2014 and has fallen over 25% since then to $1.04 in December 2016. The weaker euro has helped European economies but it has made investing in European financial assets less attractive, causing capital outflows and driving up the demand for other currencies (especially the dollar). This has caused a negative feedback loop, pressuring the euro lower. Many economists now expect the dollar and the euro to reach parity again in 2017.

Developing countries

Developing countries are especially sensitive to the dollar. This sensitivity can result in capital, "hot money," flowing rapidly into and then back out of a developing country, destabilizing its economy and currency. Since capital markets in emerging economies are not well developed, many corporations and governments in these countries often borrow in U.S. dollars or euros; two-thirds of emerging countries' debt is denominated in a foreign currency, and about half of it is in U.S. dollars. A stronger dollar makes repaying debt more expensive, which is why Argentina has defaulted on its debt 7 times in the last 85 years and the Asian crisis occurred in 1997-1998. In addition, many commodities such as oil are priced in dollars; a strong dollar makes the commodity more expensive, decreasing demand and hurting those countries that count on revenue from oil production. Venezuela is a prime example of a country that was faring well when oil prices were higher and the dollar was lower, but today is in difficult financial shape.

Conclusion

The dollar has been rising since 2011 and has appreciated 40% against a basket of 26 currencies. Anticipation of fiscal stimulus and tighter monetary policy have been responsible for the dollar's 5% surge since the election. This is not unprecedented. When President Reagan was elected in 1980, the dollar appreciated more than 50%. U.S. trading partners reached an agreement in 1985, called the Paris Accord, to devalue the dollar and it worked; the dollar depreciated and fell to record lows by 1990. The dollar appreciated again from 1995 to 2002, but then fell in value to the lows of 2008 and 2011. After rising 40% from those lows, the dollar is still below its peak levels of 1985 and 2002. This presents a challenge to the Fed because rising U.S. interest rates serve to strengthen the dollar and if the dollar continues to appreciate, it may take another Paris Accord to bring it back down. Trade barriers and tariffs present significant risks and are likely not the answer. The Smoot-Hawley Tariff Act of 1930 implemented them and it decimated global trade and helped drag the U.S. economy into the Great Depression. New trade barriers would devastate global supply chains, hurting manufacturing worldwide including in the U.S. They would also hurt U.S. consumers by making imported goods more expensive.

"When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns - in short, being fooled by randomness."

~ Nassim Nicholas Taleb