Q4 MARKET REVIEW AND ECONOMIC OUTLOOK 2016

"We haven't seen numbers like this in a long time. Small business is ready for a breakout…..business owners feel better about taking risks and making investments." – Juanita Duggan, president of the National Federation of Independent Businesses.

The major U.S stock market indices climbed higher in the fourth quarter, with the Russell 1000 and S&P 500 capping off their 8th consecutive year of gains. After a difficult start to the year, all of Bowling's equity strategies outperformed their benchmarks in the fourth quarter, net of all fees and expenses. We are hopeful that the elections removed an uncertainty from the market, and that valuation of individual companies will come back into focus again. Historically, such a change has been good for our portfolios.

The market gains in the fourth quarter coincided with an improvement of economic indicators as new jobless claims dropped to the lowest level in four decades. American manufacturing expanded in December at the fastest pace in two years and consumer confidence climbed to a 13-year high. Perhaps most importantly, U.S. small-business optimism surged in December by the most since 1980. In response to improving economic conditions, the Federal Reserve raised interest rates in December for the 2nd time in the current tightening cycle and hinted at possibly raising rates 3 times in 2017. Based on this outlook, the U.S. dollar hit a 14-year high as higher interest rates make a currency more attractive, particularly compared to the negative interest rates currently in place in the Eurozone. Those who were predicting the end of the U.S. dollar as the world's reserve currency back in 2009 have been proven epically wrong.

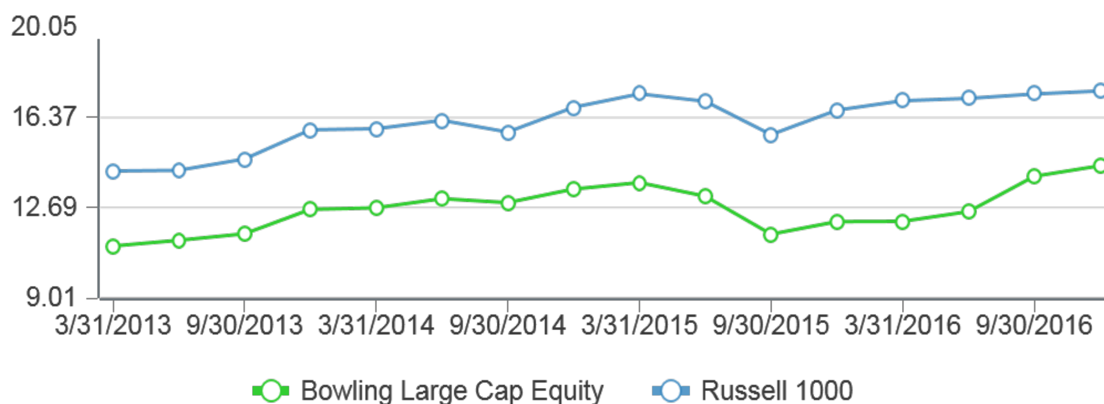
The U.S. election results were yet another example of why it's a really bad idea to base investment decisions on short-term predictions or news media noise. The polls appeared to have the Democrats retaining control of the presidency and financial market pundits seemed to be mainly of the belief that a change in power would be a potential risk for the stock market. Not only were the polls wrong (at least with respect to the Electoral College), but even if one was prescient enough to predict the outcome of the election, it would have most likely led one to sit on the sidelines as the market digested a Donald Trump presidency. As the election results rolled in on the evening of Tuesday, November 8th and it became more and more likely that President Elect Trump would win, the overnight U.S. stock market futures were down more than 5%. In the pre-market session the following Wednesday morning the stock market had pared the losses to about 3%, and by the end of the day all the U.S. stock market indices were solidly in positive territory. For the next 23 trading days the market continued going on a tear, rising 6.5%. Investors who went on a month long vacation around the U.S. elections would likely have been better off than those who tried to engage in market timing.

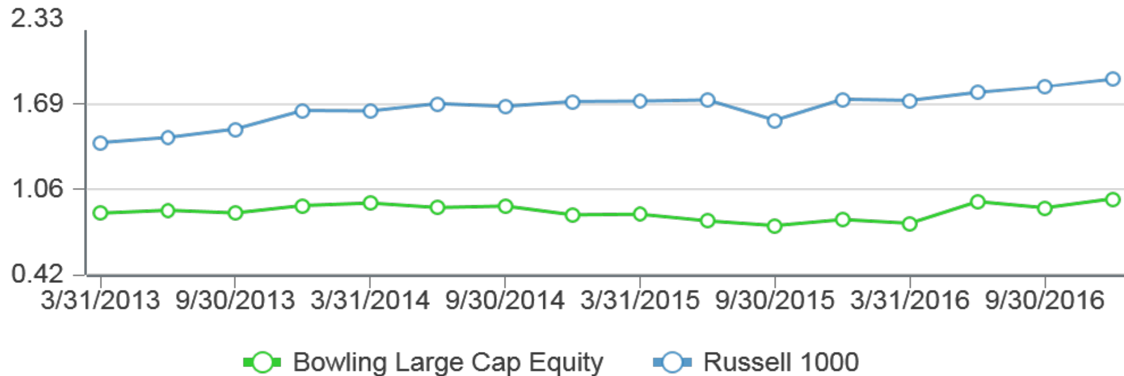
During the quarter, we realized that several clients we talked with seemed to be surprised when told that their Large Cap Equity accounts had approximately doubled over the last 5 years. 2013's gain of 41.11% was a distant memory and a couple of long-time clients also seemed surprised to learn that their account values were well above the pre-crash levels of 2007.

2016 was in fact a challenging year for our Large Cap Equity composite on a relative basis, but prior to 2016 the portfolio had outperformed its benchmark 3 years in a row. Since inception in 1988 the portfolio has outperformed its benchmark in approximately 2/3 of the calendar years, but unfortunately there is no strategy that outperforms its benchmark every single year. Over a long period of time our investment process has worked out very well for our investors.

With respect to our process, absolutely nothing has changed. The investment team is the same, the average tenure at the firm is approximately 20 years, and the way we construct the portfolio is the same. Our process is quantitative in nature, which means that it is based on hard numbers rather than someone's forecast of what the future may hold. While fairly involved, at the core our process is value-based, meaning that it identifies stocks that are trading at a discount to the market on financial metrics such as price/earnings, price/book value, and price/sales. These metrics are tracked continuously and from a valuation standpoint, our portfolio in 2016 looked exactly like it has during the previous 3 years of outperformance.

Two of these metrics, the price/earnings ratio and price/sales ratio are shown in the following chart. The price/earnings ratio is a metric that reflects how much you are paying per dollar of company earnings when you buy a stock. For example, if a stock was trading at $10/share and the company was earning $1/share in profits, the price/earnings ratio would be ($10/share) / ($1 profits/share) = 10. The price/sales ratio is a similar metric that shows how much you are paying per dollar of underlying company revenue. In the charts, the green line is our Large Cap Equity composite and the blue line is the Russell 1000, which is our benchmark and represents the largest 1000 listed companies in the U.S.





While the absolute level of these metrics can drift over time, on a relative basis the valuation metrics we track have remained consistently below the market. While these are just a couple of the 50+ metrics we track, from a statistical standpoint the portfolio in 2016 was very similar to the previous 3 years (or the previous 20 years for that matter). Unfortunately the market simply did not reward our strategy last year.

The Silliness Season Commences

As the calendar turns over into 2017, it's time once again for Wall Street strategists to put forth their fairy tales concerning what will happen in 2016. It's really quite amusing that any of this can be done with the utmost of sincerity, while using very complicated words to hide the fact that they are simply making stuff up that can't be accurately predicted. Despite the fact that Wall Street analysts have collectively predicted positive annual returns for the last 20 consecutive years (and we know, in fact that returns are not positive every single year) apparently they believe that investors are waiting on the pronouncements with baited breath because they keep doing it. Quite honestly, we believe Punxsutawney Phil would have better odds.

As we have mentioned in past letters, analysts' annual forecasts tend to cluster around the long term annual stock market return of approximately 10%, when in reality the actual stock market return only falls between 8-12% approximately one year out of twenty. The good news for analysts is that 2016's return narrowly missed falling within that range. The bad news for the analysts, however, is that they picked a bad year to be bearish (for them). According to Birinyi Associates, Wall Street strategists predicted an 8% gain for the S&P 500 in 2016, a "bearish" departure from the average prediction of 10% since 2000.

CXO Advisory Group recently ran a study in which they analyzed 6,582 U.S. stock market forecasts from analysts and stock market "gurus" between 2005 and 2012. This list included some fairly well known market "experts" such as Jim Cramer, Gary Shilling, and Marc Faber (one of the most famous "permabears"). All of these forecasts were made publicly, meaning they appeared on television, in magazine articles, etc. Not surprisingly, they found that on average forecasters were correct on only 47.4% of their calls, slightly lower odds than a coin flip. Gary Shilling, who won a Nobel Prize in economics, was only correct on 15 of his 41 public forecasts for a success rate of a meager 37%. If a Nobel Prize winner can't accurately forecast the stock market, who can?

Interest Rate Increases

Several quarters ago we took an in-depth look at stock market returns during periods of rising Federal Reserve interest rates. At the time many of the headlines revolved around the potential for rising interest rates to be bad for the stock market, and we received a number of client inquiries to that effect. What we pointed out at the time was that most of the time the stock market goes up in the months and years following a Federal Reserve interest rate increase. The determinant factor that decides the fate of the market seems to be the ***reason*** for the interest rate increase. If the Federal Reserve is raising interest rates due to an inflation shock, which is rare, then rising rates do in fact have a negative impact on stock market performance. However, if the interest rate increases are due to a strengthening economy then stock market gains tend to follow. The current trend of rising Fed interest rates is entirely due to signs of economic strength, as inflation has remained below the Fed's 2% target.

We are now a full year in the current Federal Reserve tightening cycle, with the first interest rate increase occurring in December of 2015 and the second in December of 2016. The chart below shows how the recent performance of the S&P 500 compares relative to the last 6 interest rate tightening cycles.

Fed Increase Date	S&P 500 3-Month Return	S&P 500 6-Month Return	S&P 500 12-Month Return	S&P 500 18-Month Return
August 1980	9.5%	11.0%	-2.7%	4.1%
February 1983	10.9%	13.4%	10.9%	20.5%
October 1986	13.3%	20.0%	6.4%	12.2%
February 1994	-1.5%	3.3%	7.4%	25.4%
June 1999	-6.2%	7.7%	7.3%	-2.1%
June 2004	-1.9%	7.2%	6.3%	12.5%
Pre-2015 Average	**4.0%**	**10.4%**	**5.9%**	**12.1%**
December 2015	1.4%	3.8%	12.0%	?

As can be seen in the chart, S&P 500 returns have typically been positive 6, 12, and 18 months following the initiation of a Federal Reserve interest rate increase campaign. The last year has been no exception, with the S&P 500 logging a gain of 12% following the interest rate increase in December 2015.

BOWLING PORTFOLIO MANAGEMENT LLC 4030 SMITH ROAD SUITE 140 CINCINNATI, OH 45209 (513) 871-7776
WWW.BOWLINGPM.COM

This report is provided for informational purposes only and should not be construed as a recommendation for the purchase or sale of any security nor should it be construed as a recommendation of any investment strategy. There is no guarantee that any opinion, forecast, estimate or objective will be achieved. Certain information has been obtained from sources that we believe to be reliable: however, we do not guarantee the accuracy or completeness of such information. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

Bowling Portfolio Management LLC ("Firm") is an investment management firm serving both tax-exempt and taxable clients, offering a variety of investment management strategies. The Firm is an SEC-registered investment adviser and is dedicated to the practice of professional investment management. Bowling Portfolio Management LLC claims compliance with the Global Investment Performance Standards (GIPS®). If you would like to receive a complete GIPS compliant presentation and/or the firm's list of composite descriptions please contact Kathy Wayner at Wayner@bowlingpm.com or 513-871-7776. Performance is expressed in U.S. Dollars.

The Large Cap Equity Composite includes all discretionary, tax -exempt accounts investing primarily in large cap value equities, with account market values above $50,000. Effective January 1, 2006, closed end funds are no longer utilized in the strategy. Effective January 1, 2012, taxable accounts are no longer included in the composite. The benchmark for the firm's Large Cap Equity strategy is the Russell 1000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Equity Composite includes all discretionary accounts investing primarily in small cap equities. The benchmark for the firm's Small Cap Equity strategy is the Russell 2000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Value Composite includes all discretionary accounts investing primarily in small cap value equities. The benchmark for the firm's Small Cap Value strategy is the Russell 2000 Value Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.