QUARTERLY

REVIEW & PREVIEW

FOURTH QUARTER 2016
VOLUME 23 ISSUE 4

Are U.S. Equity Markets "Borrowing From the Future?"

In 2016, the uncertainties that drove investment markets up and down over the past three-and-a-half years did not go away, but they did evolve. On the heels of the surprise win by Republican presidential candidate Donald Trump, the U.S. equity market reached all-time highs. The big question many are asking, given the continued trend of moderate economic growth, is whether domestic equity returns are **"borrowing from the future?"**

Investors have been driven by an optimistic view about the direction of the economy since the election was decided on November 8th. Markets appear to be reacting to campaign promises by President-Elect Trump to achieve faster economic growth through tax reform and fiscal policies, what we refer to as the "Trump Card." The potential for reduced taxes for individuals & corporations as well as new government spending in 2017 and beyond could have a meaningful impact on economic growth.

The Federal Reserve (the Fed) will also play a key role in all of this. The Fed opted to raise the Fed Funds rate in December as positive signs for the economy continued to emerge. Gross Domestic Product for the 3rd quarter was revised upward to 3.5% and the unemployment rate dropped to 4.6%, its lowest level since 2007. The Fed indicated it would continue to raise rates in 2017 to prevent an inflation threat. This combination of factors strengthened the dollar versus global currencies and negatively impacted bond valuations as well.

At the same time, international equity markets face a more challenging environment. Trump's comments about renegotiating trade agreements combined with relative interest rates have threatened developed and emerging market equities. But opportunities related to export and import business resulting from currency fluctuations, changes in commodity prices and interest rate disparities may create a backdrop for non-US economies to grow as well.

The operative word as the financial world enters 2017 continues to be "uncertainty." Among the key uncertainties that we continue to evaluate on a daily and weekly basis are:

UNCERTAINTY	Impact on Markets
Trump tax reform	+ / -
Trump infrastructure spending	+ / -
Fed monetary policy	+ / -
Dollar strength vs. other currencies	+ / -
Growth opportunities in Europe & Emerging Economies	+ / -

In this type of environment, investors need to focus on maintaining a diversified approach.

BOB'S CORNER

When we look back on 2016 we can be thankful for many things, one of them is you! Thank you for your trust in the All Star Financial Team and our discipline. I would also hope you are thankful for your portfolio's lack of volatility. In the 3rd quarter newsletter we reviewed the last 39 months and showed you how our average portfolio went down -1% or greater only 42 days while the domestic stock market went down -1% or greater 105 days. That is 150% less! The reason behind our success is that we have tactically taken on less risk with our portfolios. Our Beta's range from 43% to 85% of market risk, where by our investment policy statements we could be as high as 60-100% of market risk depending on if you are in an Income, Balanced, Conservative or Growth model.

By virtue of taking on less market risk, as the market continues to climb we can't expect to get market performance. As we have preached for years, **"It's not how much you make, it is how much you keep"!!** We believe that the tail end of an 8 year bull market is not the time to take more risk, it is the time to take less risk!

BUILD WEALTH. RETAIN WEALTH.

All Star is passionate about providing a safer way to a successful retirement for people who are serious about their money but uncertain about how to nurture it.

THE ECONOMY

Playing the "Trump Card"

Since 2009, the U.S. economy has generated modest growth with the help of the Fed's easy monetary policy, including its dramatic quantitative easing program. The combination of modest GDP growth and very low wage inflation kept the U.S. economy in a stagnant trajectory. The expectation was for more of the same if Hillary Clinton was elected president, which most anticipated. The "Trump Card" is a game changer. The question is how the economy will respond.

We're in the 8th year of an expansion cycle, the 4th longest since 1900. During this expansion, the average annual rate of growth is a paltry 2.1%. Unemployment stands at 4.6%, a significant drop from a peak of 10.0% in 2009/2010. The reason for optimism, however, is the reversal of corporate earnings after eight straight quarters of decline. Share buybacks by companies helped keep earnings per share steady during this time period despite declining profits, which bolstered stock prices through a depressed earnings environment. Now earnings appear to be headed higher due to a combination of expense management, modest revenue growth, and potential tax savings.

In addition, consumer sentiment has improved as well, and now at levels matching pre-2008 highs. Household wealth has been restored, debt is low and Americans have cash reserves to spend. This is another encouraging sign for the economy going forward.

Looking Ahead

There are a number of variables that could impact our economic outlook. Lower taxes that are being proposed by the Trump administration should entice additional spending by individuals and corporations. At the same time, Fed tightening could create a headwind as borrowing costs increase. The Fed projects up to three additional rate hikes in 2017. However, the Fed made a similar prediction a year earlier, and only raised rates once in 2016. We will continue to closely monitor the Fed's stance and how well it interacts with new policies forthcoming from the Trump administration. Ultimately, we will focus on the momentum of corporate earnings and how the noted economic trends will impact their growth.

BOND MARKETS

Rates on the rise

2016 began with interest rates in the U.S. hovering near historic lows (10-year Treasury Yield was down to 1.37% in July) and Europe and Japan introduced negative interest rate policies for the first time in an effort to stimulate growth. The environment, however, underwent a significant change in the wake of the U.S. presidential election. In a matter of weeks, the yield on 10-year Treasuries rose from 1.88% to 2.45%, a +30% increase. Bond values declined as a result.

The Barclays U.S. Aggregate Bond Index was down -2.98% in the quarter (up +2.65% for the year), while the Barclays U.S. Government Bond Index declined -3.72% in a rising rate environment during Q4. The global index had a positive +1.05% total return in 2016.

Corporate and Emerging Market bonds held up much better. In a challenging quarter, High Yield bonds generated a gain of +1.88% (up +17.49% for the year) while Emerging Market bonds limited losses to -2.7% in the 4th quarter but provided a positive +12.8% total return for the year.

Looking Ahead

Interest rates have trended lower for more than 30 years, but a new era is upon us. The question is how far and how fast rates will rise. In 2016, the Fed's tightening policy was in contrast to stimulative actions of central banks in Europe and Japan. In 2017, we may see central banks across the globe on a more parallel path, which will create different opportunities and challenges for bond and currency markets.

Another key factor to watch is how overall economic conditions impact yield spreads and bond pricing relative to equities. Investors with a diversified portfolio need to pay close attention to the total return earned from their bond holdings. They must be prepared for the role of bonds to change in this new era of rising interest rates.

Quote of the Quarter:

"Out of clutter, find simplicity. From discord, find harmony. In the middle of difficulty lies opportunity." –Albert Einstein

Domestic Stocks

Post-election rally fuels U.S. markets

The stock market was in the midst of a modest selloff leading up to Election Day. As it became apparent Mr. Trump would win the White House, stock futures plummeted dramatically. But as the President-Elect began giving his acceptance speech, investors reversed course. U.S. stock markets began an upward surge that continued to the end of 2016. In the 37 trading days after the election, daily declines occurred on only 9 days. The Dow Jones Industrial Average gained 8% after November 9, with 4% of the gain occurring in the first six trading days after the election.

Small cap stocks were most impressive both in the 4th quarter and throughout the year. The Russell 2000 Index gained +8.8% in the quarter and +21% for the year. The large-cap Russell 1000 Index returned a more modest +3.8% in the 4th quarter. Value stocks (Russell 3000 Value) enjoyed an advantage, with a +7.2% return in the final three months compared to +1.2% for Growth stocks (Russell 3000 Growth). For the year, value stocks prevailed as they returned 18.4% while Growth stocks were positive +7.4%.

We saw significant volatility and shifting leadership among sectors and styles in the 4th quarter. Financial stocks were the biggest beneficiaries of the market's late year rally, advancing +21.1% (up +22.8% for the year). Energy and Industrials were the next best performing sectors, up +7.3% and +7.2% respectively in Q4 (+27.4% and +19.9% for the year respectively). Other positive sectors include Telecom, which was up +4.8% in Q4 (+23.5% for the year) and the Materials sector which was up +4.7% in Q4 (+16.7% for the year). The worst performing sectors for the year and the quarter were Health Care (-4.0% Q4, -2.7% 2016), Consumer Staples (-2.0% Q4, -5.4% 2016), and Real Estate (-4.4% Q4, -3.4% 2016).

Looking Ahead

The question is, did the market "borrow" future returns in the closing weeks of 2016? We can argue the answer may be YES, as there were strong indications that prior to the November 8th surprise, the domestic stock market was on its last legs. A 7+ year bull market run that sputtered the last 3 ½ years as the $4.3 trillion dollars spent on trying to ignite the economy through Quantitative Easing did no more than make a flame and then quickly burn out. Domestic market valuations (as measured by S&P 500 Price-to-Earnings ratio) were nearly 20 to 1 on average and a bit overpriced to their long term average of 17 to 1.

We can rationalize answering NO as well, if the "Trump Card" is effective. New taxing and budget strategies may help promote economic expansion. First, it could create inflationary pressures, naturally driving interest rates higher and leading to a flow of money out of bonds and into equities. Second, lower tax rates could boost corporate earnings, and result in higher wages and more consumer spending, all positive factors for equity markets.

What seems clear is that significant change is coming to Washington. It will have an impact on the economy and U.S. equity markets. We will watch the situation closely and position portfolios to capture the opportunities.

International Markets

Running Scared?

Foreign stocks reacted differently to the election outcome in the U.S. This may be attributed to comments by President-Elect Trump about reevaluating several trade agreements. Aggressive monetary policy and asset purchasing programs from the European Central Bank (ECB) and Bank of Japan (BOJ) supported overseas stocks earlier in the year but failed to have the same effect in the 4th quarter. In stark contrast to the U.S. market, Global stocks (ex-U.S.) declined -3% during the 4th quarter. While developed international market stocks (MSCI EAFE Index) lost -2.3%. A stronger dollar contributed to a difficult quarter for Emerging Market stocks that lost -6.5% over the closing months, but for the year, that asset class registered a gain of +8.75%. Among the leaders in emerging markets in 2016 were Brazil (+60%) and Russia (+46%), which combines for only about a 12% exposure of the overall index and a significant amount of the volatility over the past few years. Stocks in China declined nearly -10% in the 4th quarter but ended the year relatively flat.

Looking Ahead

Emerging markets continue to grow faster than developed markets, but the gap is shrinking. China's economic growth has slowed, as has the rate of growth in oil-producing countries such as Brazil and Russia, due to a drop in oil prices. However, with oil prices solidifying and China's growth stabilizing, there may be more attractive opportunities in emerging markets in 2017. Stock valuations across global markets show more upside potential than what we see in U.S. stocks heading into the New Year. The same is true of dividend yields in comparison to the world's fixed income markets. Patience should reward investors who diversify into overseas markets.

PERFORMANCE UPDATE

The Fourth Quarter

Market Index	4th Qtr	1 Year	3 Years	5 Years
DJ Industrial Average	8.66	16.50	8.71	12.92
S&P 500	3.82	11.96	8.87	14.66
Russell 2000	8.83	21.31	6.74	14.46
S&P Mid Cap 400	7.42	20.74	9.04	15.33
Russell 3000	4.21	12.74	8.43	14.67
S&P Global BMI	**1.33**	**8.84**	**3.79**	**10.20**
MSCI EAFE	-0.71	1.00	-1.60	6.53
MSCI Emerging Mkts	-4.16	11.19	-2.55	1.28
NASDAQ Composite	1.66	8.87	10.14	17.07
Barclays US High Yield Bond	1.75	17.13	4.66	7.36
Barclays US Aggregate Bond	-2.98	2.65	3.03	2.23
Barclays Global Aggregate Bond	-7.07	2.09	-0.19	0.21
JPM Emerging Bond Diversified	-4.02	10.15	6.19	5.91
Barclays US Government Bond	-3.72	1.05	2.26	1.22
Barclays US Credit Bond	-2.97	5.63	4.07	3.85

SUMMARY & OVERVIEW

Investors should prepare for a changing world in the year ahead. We have discussed some of the potential policy changes coming from a Trump administration in this newsletter. To the extent these changes are realized, the impact will likely be felt in both domestic and international markets. In the meantime, we'll be closely monitoring what is likely to be an active year by the Federal Reserve as it continues to seek to normalize its interest rate policy.

We believe the year ahead has the potential for notable opportunity, but given the significant changes that lie ahead, it is important to be prepared for a degree of unpredictability in the markets. **Diversification is the key!**

Is Diversification Dead?

In the aftermath of the great recession, US equity markets have soared to all-time highs. More specifically, US Large Cap stocks have led the charge. After their 37% loss in 2008, US Large Cap stocks have had 8 consecutive years of positive returns. Those years had returns ranging from 1.4% in 2015 to 32.4% in 2013. Most recently, US Large Cap stocks achieved a 12% return in 2016. For some investors, they may wonder whether investing has really become that easy. The fear and **greed** cycle can take over and make people believe that achieving investment success is as simple as investing in the S&P 500. For professional and experienced investors, we are left to wonder whether we have entered a new era where *diversification is dead.*

We believe it is the exact opposite. Diversification is more important than ever.

When fear and **greed** enter our mindset, individual investors often make poor decisions. This is reflected in relative returns. Over the past 20 years (1996 – 2015), individual investors have averaged a 2.1% return on an annual basis*, drastically underperforming investible indexes. In that same time, a 60/40 diversified portfolio has achieved a 7.2%** average return. The primary reason a simple 60/40 portfolio has outperformed is because this hypothetical portfolio does not ***buy high*** and ***sell low***; whereas humans that succumb to the fear and greed cycle often do.

Investors that either self-manage a diversified portfolio or hire an investment advisor to do it for them have underperformed US equity markets the past 8 years. We think it is important to understand what has led to that result and where we may be headed. History has a tendency to repeat itself, and if so, a diversified portfolio will outperform in the years to come. Jumping into US-only portfolio right now, in our opinion, is allowing the **greed** of the past 8 years and the **fear** of "missing out" to guide decisions. We believe making choices based on valuations and fundamentals is a better approach. The asset allocation quilt below shows that U.S. Large Caps (green box) have outperformed other asset classes in recent years (2013-2016). However, asset classes have a tendency to revert to the mean over time, as demonstrated by U.S. Large Cap performance from 2002 to 2012. Now is not the time to chase the returns of the last few years in our view, now is the time to STAY DIVERSIFIED!

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	High Yield -26.9%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Fixed Income 7.0%	Small Cap -33.8	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	High Yield 7.3%	Small Cap 4.9%	Cash 0.0%	Comdty. 11.8%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Large Cap 4.9%	Large Cap 15.8%	Large Cap 5.5%	Comdty. -35.6%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	REITs 2.9%	Cash 0.0%	DM Equity -0.4%	EM Equity 11.6%
EM Equity -6.0%	Large Cap 28.7%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Large Cap 26.5%	High Yield 14.8%	Small Cap -4.2%	Large Cap 16.0%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	REITs 8.6%
DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%

*Average investor returns are based on an analysis by Dalbar Inc. which utilizes the net of aggregate mutual fund sales, redemptions, and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis. **A balanced 60/40 portfolio invested in S&P 500 Index and 40% invested in high quality Us fixed income representative of the Barclay's US Aggregate Index. DM = Developed Markets ; EM = Emerging Markets

OUR MISSION IS TO HELP YOU ACHIEVE YOUR DESIRED STANDARD OF LIVING AND FINANCIAL PEACE OF MIND.

The experienced All Star team of professionals is dedicated to understanding your individual needs and objectives, offering a comprehensive wealth management platform designed with one purpose in mind — to serve you, our valued client.

JUST FOR FUN

Restaurant Recommendation
Lotus Leaf

If you are in the Eden Prairie area or are a fan of Thai food and want to make a destination trip, Lotus Leaf is worth the effort. Located at 7922 Mitchell Road in Eden Prairie, Lotus Leaf offers a variety of Thai selections including a variety of Curry dishes. Most all the chicken, beef and shrimp dishes served are mouthwatering, but one stands out called MASSAMAN CURRY WITH SLOW COOKED BEEF. A southern Thai style curry stew with slow cooked braised beef, roasted peanuts, caramelized onions, and organic potatoes. Curry is gluten free, meat is braised with soy. The atmosphere is pleasant in this is a one-off restaurant that you won't find anywhere else. It can get busy around peak times, but it's worth the wait!

Rosemary Chicken – Sheet Pan Dinner

Ingredients:

- ¼ cup olive oil
- 1 tsp salt
- ½ tsp black pepper
- 2 tbsp fresh chopped rosemary leaves
- 1 lb baby red potatoes (quartered)
- 6 boneless, skinless chicken thighs
- 1 lb asparagus (cut into 2-inch pieces)

Directions:

1. Preheat oven to 425 °F and spray 18" x 13" pan
2. In large bowl mix 2 tbsp olive oil, ½ tsp salt, ¼ tsp pepper, and 1 tbsp chopped rosemary. Add potatoes and toss to coat. Place potatoes on cooking sheet and bake for 23 to 25 minutes until tender.
3. Repeat step 2, adding chicken and asparagus in place of potatoes. Arrange on pan with potatoes and cook for additional 16 to 20 minutes until chicken is done.

CONTACT US

3800 American Blvd. W.
Suite 620
Minneapolis, MN 55431

Phone: 952.896.3820
Fax: 952.896.3819
Toll free: 888.809.7901

asf@allstarfinancial.com
www.allstarfinancial.com

Meet Our Team

Bob Klefsaas, CFP®, AIF®, CFDS – President
Brian Senske, CPA (Inactive), MA – COO, CCO
Alexander Källebo, CFA – Portfolio manager
Chris Murray, Senior Vice President of Private Client Wealth
John Shevlin – Account Executive
David Osterberg, CPA – Tax Advisor
Carl Ermisch – Research Analyst & Paraplanner
Paula Zilka – Executive Assistant
Bill Ristvedt – All Star Private Client Partner for Banks
Adam Neuger – Client Associate