Market Review and Outlook
PERSONAL CAPITAL Q4 2016

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Executive Summary

+ Donald Trump was elected president. Contrary to most “expert” predictions, U.S. stocks responded favorably. Sector returns after the election also caught most off-guard, yet again proving the difficulty in trying to outguess the market.

+ All major asset classes finished positive for the full year of 2016. In Q4, U.S. stocks rallied after the election while other asset classes declined. It is becoming difficult for many not to be drawn toward U.S. stocks and away from international stocks and fixed income, but we remain confident in the ultimate success of a diversified approach. The ninth year of a bull market is not the time to chase what has already done well or to be greedy.

+ Heading into 2017, uncertainty reigns in capital markets. This is not necessarily bad, but it means bigger moves in either direction are more likely. The first year of a president’s term has historically been the most volatile part of the presidential cycle. With Trump, that is likely magnified, but there are reasons for optimism. It is important to remember that historically stocks have shown to go up more than they go down.

+ High stock valuations and low bond yields suggest expectations should be moderated for US assets over the next few years. International assets are more favorable on a price to earnings basis.

+ Fear surrounding bonds is greater than we can remember, but we think it is excessive. The right mix of bonds should continue to provide portfolio stability and outperform cash over the next three to five years.

+ The election results suggest there is a good chance for tax reform. Early proposals from Trump and the House GOP suggest a meaningful tax cut for the highest earners and a modest benefit for most other taxpayers. Married couples will fare better than singles. We don’t think possible tax changes should impact investment strategies at this point.

+ Personal Capital managed portfolios performed well. Returns for both the quarter and year compared favorably relative to similar blended benchmarks of traditional indexes. Our tactically weighted approach to U.S. stocks outperformed major capitalization weighted indexes like the S&P 500.

+ Just over five years after launching, Personal Capital passed $3.5 billion in assets managed on the first trading day of 2017 and is now helping over 10,000 clients manage their wealth.
Donald Trump’s surprise victory was the big story in Q4. So-called market experts widely agreed a Trump win would send markets swooning and spark a rally in gold and Treasuries. And for a few hours on election night, they were right; S&P 500 futures quickly plummeted over 5%. However, by the end of the next day, the market rallied all the way back and finished positive.

U.S. stocks advanced over the remainder of the year. The S&P 500 returned 4.0% for the full quarter and 12.0% for the year. Small company stocks were the biggest winners, with the Russell 2000 index up 9.0% for the quarter. At the sector level, financials was the best performer after the election. This is logical, but health care was one of the worst - it was viewed as under assault by Clinton and was expected to rally if she lost. Once again, the exact opposite of what most analysts expected, which made Q4 yet another great example of the extreme challenges and risks that come from trying to outguess the market. Even if you are right about what happens in the world, it is easy to be wrong about how markets will react.

Expectations around Trump’s “America First” and big infrastructure spending policies led to an increase in the dollar and a spike in interest rates. As a result, other major asset classes posted gains for the year, but fared poorly following the election. International stocks were up 4.9% for the year, but lost 1.9% in Q4. The US Aggregate Bond market returned 2.4% for the year, but lost 3.1% in Q4.

*Source: Yahoo!Finance / Indices represented by SPY, VEU, AGG, VNQ, IAU, DBC (total return) / Date created: 01-05-2017*
Once again, 2016 felt unsatisfying for globally diversified investors who are focused on the Dow or S&P 500. U.S. stocks have dominated this bull market. The S&P 500 has more than tripled from its low while international stocks have yet to double. Since mid-2011, international stocks are actually lower, based on the FTSE All-World ex US Index. The longer these trends last, the harder they are to resist. It is emotionally difficult to sell what is doing well and own or buy what is not. Most people eventually do the opposite and give up on what isn’t working. Unfortunately, this is a recipe for poor long-term performance over full market cycles and is the primary reason most investors don’t do well.

The same is true within U.S. stocks when it comes to growth and value styles. Value has earned a reputation for higher long-term returns and many piled into it around the sub-prime crisis. Since then, until this year, growth has consistently outperformed. Many gave up their former beliefs and piled into “great” growth companies concentrated in the technology and health care sectors. In 2016, value regained leadership and significantly outperformed. We prefer an equal weight to both, but the key is having a decent allocation to each and sticking with it by rebalancing periodically over time.

That is equally if not more important at the global level. U.S. stocks were much more expensive than international stocks on a price-to-earnings basis when 2016 started, and that gap widened during the year. It is hard not to be drawn toward U.S. stocks and away from international stocks and fixed income, but we remain confident in the ultimate success of the approach and the logic behind diversification. The ninth year of a bull market is not the time to chase what has already done well or to be greedy.

After Trump, the next most important story of Q4 was a second rate hike by the Fed. It came in December along with indication for three more hikes in 2017. The Fed could no longer ignore a 4.7% unemployment rate (the lowest since 2007), all-time high stock prices and signs of rising inflation. The hike itself was widely expected, but the commentary and forecast that came with it was more hawkish than expected. Rates across the yield curve (and mortgage rates along with them) rose, driving bond prices lower in Q4.

On the corporate front, earnings generally exceeded expectations and M&A activity was robust. The biggest deal announced was AT&T’s acquisition of Time Warner for $85 billion. Other notable tie-ups include CenturyLink and Level 3 Communications and Baker Hughes and GE’s oil and gas business.

Personal Capital managed portfolios performed well for Q4 and the full year. In U.S. stocks, our more evenly weighted size, sector and style approach outperformed traditional capitalization weighted indexes. Our long-term structural overweight to emerging markets hurt a little in Q4, but added value for the full year compared to the Total International Stock Market. The use of a diversified approach within bonds added value over the US Aggregate Bond market. Alternatives posted strong absolute returns for the year but a decline in gold Q4 created a drag in the quarter.
Capital Markets Outlook

Heading into 2017, uncertainty reigns. This is not necessarily bad, but it means bigger moves in either direction are more likely. The first year of a president’s term has historically been the most volatile part of the presidential cycle. The likely reason is the first year comes with the biggest potential for impactful legislation.

It is easy to be scared of stocks right now, but there are two main reasons to try to avoid emotion. First, and most important, stocks go up more than they go down. Second, the Fed and other major central banks have printed a lot of money over the last several years. Some of that has already found its way into equity prices and this is responsible for a good portion of the gains in the current bull market. But, especially if inflation starts to creep higher, it is entirely possible that we’ve only seen the beginning. If stocks continue to post even bigger gains compared to cash or bonds in the coming years it will be risky not to own them.

With Trump, there is no political record to look back on for guidance. We do know he has bold ambitions and controversial ideas. Regardless of your views on Trump, we believe the possibility of many very different outcomes has to be acknowledged.

On the positive side, he has been successful in many aspects of his life. The fact that he won the election against all odds is impressive no matter how you look at it. Assuming he dedicates himself to bettering the economy and creating a positive legacy, there is a strong hope he will be a positive for the capital markets and stock prices. If he pursues big infrastructure spending, it will provide a short-term jolt. Even if protectionist policies prove problematic in the long-term, they are likely to boost jobs and spending before that.

Or...there’s the opposing view. Trump’s business life has been notoriously volatile. His companies have declared bankruptcy between four and six times depending on whose counting methodology you prefer. Protectionist trade policies could cause significant disruption and lost productivity over time. He is already using Twitter to threaten companies and telling them how they should act. And he is likely to massively increase the deficit, which could lead to higher borrowing costs or destructive inflation.

Ultimately, it is too soon to know what to expect, which will likely remain the case for some time after Trump takes office. Markets and stock prices don’t know either, and they will adjust to the latest information and expectations as things evolve. Leading into the election, we stressed that who is president is just one factor among many. That is still true. Corporate earnings, China, Fed activity and fundamental valuations are likely to be just as or more impactful on stock prices. Countless unknowns will emerge.

Corporate earnings have momentum and company balance sheets are in pretty good shape. S&P 500 earnings are projected to have risen 3.2% in Q4, which isn’t exceptional but if maintained in 2017 should be enough to support current stock price levels. A strong dollar will create challenges for US companies, but for now earnings seem to be trending in the right direction.

Unemployment is low and housing prices are at an all-time high (though remain below 2006 levels when adjusted for inflation). All of this bodes well in the near-term, but it is worth remembering that bear markets usually start when unemployment is low and things feel good. They rarely wait until the bad news is completely disseminated.
MARKET FUNDAMENTALS

US equity valuations are high, but not extreme. Depending on whose numbers you believe, the forward looking PE on the S&P 500 ranges between 17 and 19. This is higher than historical averages, but feels reasonable when you consider that interest rates remain well below historical averages. The US 10-year Treasury ended the year with a 2.45% yield. When interest rates are higher, they create a more attractive and less volatile alternative which makes stocks less valuable.

The combination of high stock valuations and low yields in the United States means return expectations for the next three-to-five years should be moderated. We believe single-digit annualized returns are much more likely than double-digit returns. Periodic negative years should be expected.

Sentiment remains a bullish factor, in our view. There are very few individual investors or big names in the industry calling for big gains. Meanwhile, there is a huge pile of cash on the sidelines which could capitulate and come pouring into stocks if they can maintain momentum for another quarter or two.

Diversified investors have a brighter outlook and take much less risk, in our view. The forward-looking PE for the MSCI EAFE, a proxy for developed international stocks, is 15 and for the MSCI emerging markets index it is 12. Those feel reasonable. Much of the US outperformance over the last five years, and especially since the election, has been driven by a stronger dollar. On a purchasing power basis, the dollar now looks expensive.

International developed bond yields are higher than they were this summer, but remain low. Emerging market bonds still offer yields close to 6%. TIPS (inflation protected Treasuries) outperformed traditional treasuries last year, and we believe that as a portion of a bond portfolio they continue to have a favorable outlook.

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<th>SECTOR PERFORMANCE RELATIVE TO S&amp;P 500</th>
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**POST-ELECTION (11/8/16- 12/31/16)**

**PRE-ELECTION (12/31/15- 11/8/16)**

*Source: Yahoo!Finance / Sectors & Index represented by XLY, XLP, XLE, XLF, XLV, XLI, XLK, XLB, VOX, XLU, & SPY (total return) / Date created: 01-05-2017*
Fear surrounding bonds is greater than we can remember. To us, that is a bullish indicator for the asset class because markets tend to reward the unloved. Yields remain low which means bonds are unlikely to provide big returns, but hopes for big returns are not why most people should own bonds to begin with. Their role is to provide income and stabilize portfolios. They are good at this because they often go up when stocks go down, and because most bonds are simply less volatile by nature.

The Fed has indicated it expects to raise rates three times, or 0.75%, in 2017. This provides a good baseline assumption, but is by no means certain. Rates could very easily stay where they are or rise even faster. Trump’s policies are likely to increase the deficit which could lead to a faster rate increases in market rates whether the Fed likes it or not.

For the sake of argument, let’s say rates go up 1% next year. The US aggregate bond market has an effective duration of a little over 5. That means the bond market would experience a price decline of around 5% in this scenario. After interest payments, this would mean an actual loss of about 2%. This is similar to how 2016 played out. Rates were up slightly yet the US aggregate bond market still returned a positive 2%, according to Barclays. This isn’t exciting, but isn’t problematic either. Meanwhile, rates are now a little higher, which provides a little bigger cushion for next year. At the extreme, if the 10 year Treasury yield rose to 5%, it would create some short-term losses, but it would only take a few years of interest payments to make them back.

Things start to look even better if you own a properly diversified bond portfolio. Personal Capital managed accounts include Treasuries, TIPS, liquid and high-yield corporate bonds, developed and emerging international bonds, and in some cases municipal bonds. In any given year, some of these will do better than others. Led by emerging-market bonds and high-yield corporate bonds, our typical bond portfolio returned about 5% in 2016 even though rates were up. That shouldn’t be the expectation in a rising rate environment, but it shows how different parts of the bond market can help at different times.

Alternatively, if you are highly concentrated in long duration Treasuries or preferred stocks, we do urge caution and would like to reiterate that these bonds could be hit hard if rates rise faster than expected. Bonds with longer maturities are more sensitive to interest rate changes.
Trump and Taxes

What does the election mean for your taxes?

The unexpected Republican sweep of the White House and both houses of Congress opened the door for a strong possibility of meaningful tax reform in 2017. The president-elect and House GOP have presented similar proposals, but there are key differences between them.

Both would simplify federal income tax brackets from seven down to three, 12%, 25% and 33%. Since the highest current bracket is 39.6%, this would greatly benefit those earning significantly more than $500,000 per year. For the other 99%, under Trump’s plan there are some subtle shifts in where brackets would start, but they wouldn’t amount to a meaningful change in what is owed. Married couples who earn between $50,000 and $500,000 would pay slightly less. However, single filers in the $125,000 - $450,000 income range would actually pay a little more.

On the positive side, the standard deduction would be increased which will benefit many filers. So in some sense, Trump’s proposal can best be summarized as a real tax cut for the rich, a mixed bag or small tax cut for most, with a modest transfer from single filers to married filers. On a positive note, because of the lower brackets and a reduction of allowable deductions, both Trump’s plan and the GOP House plan would effectively eliminate alternative minimun tax (AMT) and the confusion it brings.

### COMPARISON OF CURRENT INCOME TAX BRACKETS TO PRESIDENT TRUMP’S PROPOSAL

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<tr>
<td><strong>Married Filing Jointly</strong></td>
<td>10% 15% 25% 28% 33% 35% 39.6%</td>
<td>10% 12% 25% 33% 35% 39.6%</td>
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<tr>
<td><strong>Individual</strong></td>
<td>10% 15% 25% 28% 33% 35% 39.6%</td>
<td>10% 12% 25% 33% 35% 39.6%</td>
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Source: kitces.com
Regarding capital gains and qualified dividends, Trump’s proposal would keep rates the same, but would lower the threshold where the 20% rate kicks in (from 15%). Right now, only those in the highest tax brackets, or well over $400,000 in income, pay the 20% rate. Under Trump’s plan, this would start to impact married filers at around $225,000 and single filers at around $120,000. The 3.8% Obamacare surtax would be eliminated. Once again, this primarily benefits the highest earners.

The House GOP plan would reduce capital gains rates. It allows filers to exclude 50% of their investment income and then pay ordinary income on the other half. This makes the effective rates 6%, 12% and 16.5% based on the new brackets, which is a significant cut for many. This plan would also repeal the 3.8% surtax.

The bottom line on capital gains is we don’t believe most investors should change their behavior in anticipation of a possible change. If legislation is passed, depending on which plan it most closely resembles, it either won’t reduce capital gains rates or will reduce them only modestly. For those currently facing the 3.8% surtax, there could be greater incentive to delay capital gains. But even then, diversification is usually more important than getting cute with tax rates when there are concentrated positions involved.

The estate tax is likely to be repealed, which is good news if you expect to have more than $11 million. As with anything requiring legislative action, we’ll have to wait and see what happens and status quo remains a real possibility.

Thank you for your interest.

Sincerely,

Bill Harris, Craig Birk, and Kyle Ryan
The Personal Capital Advisors Investment Committee
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