Hayek Kallen
Investment Management, LLC

Fairhope Office:
50 South Church St., Suite C
Fairhope, Alabama 36532
251.928.8999 251.928.8991 Fax

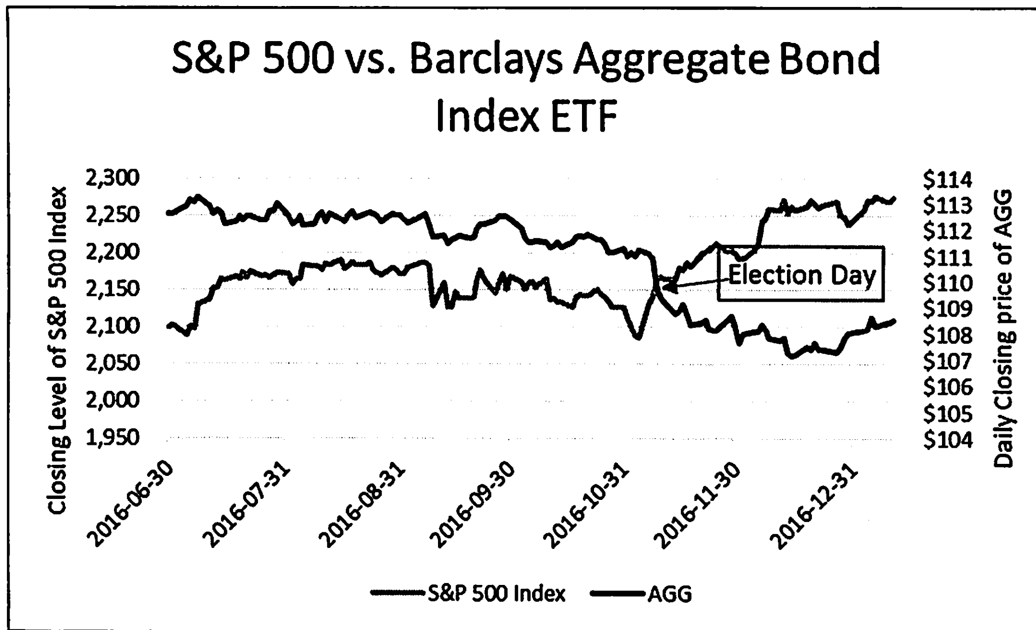
Virginia Office:
3 Boars Head Lane, Suite E
Charlottesville, Virginia 22903
434.465.6565 888.434.5159 Fax

www.HayekKallen.com

President's Letter – January 2017

Phew, what a year. 2016 served as a reminder that markets can be volatile and rarely do they do what we expect them to. We started the year with a monumental sell-off in China (driven by fears of a hard landing over there) that quickly flowed into our markets and at one point had the S&P down nearly 15%. This represented the worst start to a year the stock market has ever seen. When calmer heads prevailed, the markets were able to recover which led to the year's second major bump in the road. In a surprise vote in June, Britain elected to leave the EU and strike out on their own (Brexit). Uncertainty abounded and we saw markets retreat 10-12% in the immediate aftermath of the vote. Again, markets regained their composure and moved along with all eyes focused on the November presidential election. What transpired was historic. A surprise victory for Donald Trump had markets down 5% in premarket trading in the early hours of November 9th. What happened when US markets opened truly surprised everyone.

Despite expectations for a significant selloff, US markets rallied and finished up more than 1% on the day - a 6% change from the premarket levels. These unexpected events caught many investors off guard and set the stage for an end of the year rally in the stock market and a sell-off in the bond market. As an example of the pain that this caused some, it was recently revealed that investment guru George Soros lost more than $1 billion in the aftermath of the election. At the same time that the stock indexes were rallying, the bond market took a different path. Based on the expectations that rates would be rising and inflation would materialize under a Trump administration, the bond market suffered one of its worst quarters in a long time. Longer term bonds were hit the hardest, and yields jumped across the curve. The 10 year Treasury bond hit a high of 2.6%, which is double what it offered at the beginning of the year.



As the election results were digested and the new reality of change in Washington set it, the Fed quietly went about their business in December and raised the Federal Funds rate by .25%. This hike marked the second time in two years that the Fed raised rates (for a total of .5%) thus delivering on their promise to begin the process of normalizing interest rates. What are the implications of these recent events for our economy and the markets? Here are a couple of observations:

- The Trump Rally was interesting for a number of reasons. Foremost among them was the fact that it was not a broad market rally, where everybody benefitted from the expectation of a stronger economy. Instead we saw certain sectors rise dramatically, particularly financials and materials companies, while others saw a muted reaction or sold off (technology, consumer products to name a few). While stronger economic growth will certainly benefit all, what the Trump Rally presented was the outcome of the betting on which areas are certain to benefit from Trump's new policies (or what we think his new policies will be). This dramatic change was driven more by speculation than by fundamentals. For those areas that saw the most benefit, the bar has been set high and close attention will have to be paid to see if the fundamentals improve to support

these assumptions. Remember the expectation of future growth does not always result in higher growth. President-elect Trump is taking on a lot and it remains to be seen if his campaign promises become policy.

- Inflation is coming back onto the scene and rates are likely to rise. The Fed has committed to getting ahead of inflation; that is their job after all. To do this, they have indicated that they will continue along their path of gradual rate increases this year, the timing of which is to be determined. The sell-off in the bond market that took place in the post-election frenzy was dramatic and it appears a bit overdone. What does all of this mean to us? In the short-term rising rates have a negative impact on bond prices; bond prices fall when inflation goes up. But, for investors whose goal is to hold the bond to maturity, those bond prices will recover as maturity approaches regardless what inflation does. Bonds are in our portfolios for two reasons, to reduce volatility and to generate income. The same bonds that we saw dropping in value after the election acted like ballast in the boats through the turmoil in the markets last January and right after the Brexit vote. The good news in a rising rate environment is that as bonds mature and proceeds are reinvested, they will be in bonds offering higher yields. The net effect of this is that portfolio income will go up as inflation increases, thus preserving our purchasing power.

- The market as a whole is fully valued—not overvalued and in imminent danger of a correction, but also not offering opportunity across the board for us value investors. Having said that, it's important to remember that we don't buy "the market." We buy individual stocks and bonds. This strategy allows us to look past areas that we feel are significantly overvalued and zero in on the companies that we have identified as offering an attractive value proposition. Identifying companies who have the ability to grow

their revenue and cash flow will provide us with the means necessary to grow the equity component of our portfolios. Expectations for growth have risen since the election, but we need to find the companies who can turn these expectations into reality.

All things considered, 2017 should be an interesting year. From the White House, to the Fed to events in Europe, there is a lot of change on the horizon. And while change can sometimes be difficult, very little progress can be made without it. As always we are available to speak with you as questions and concerns arise, so please don't hesitate to reach out. We thank you for your trust and look forward to serving you this year and in the years to come.

Eric O. Kallen
President, Hayek Kallen Investment Management