Quarterly Insight

Johnson Private Client Group | Johnson Trust Company | Johnson Institutional Management

Fourth Quarter 2016

Letter from the President

As we enter a new year, I want to personally express my gratitude for your loyalty to our firm over the years. We are humbled by the trust you have placed in us, and our team of employees is more committed than ever to serving you.

The firm enters 2017 on strong footing. We continue to grow at a healthy pace. As has been the case in each of our 51 years, we were able to help more people in 2016 than the year before. This steady growth allows us to continue to invest in all areas of our business. We have hired additional employees across the firm to ensure we deliver the client service experience you have come to expect.

Our efforts to deliver extraordinary client service were recognized in 2016. Barron's, a highly-respected financial publication, ranked us as one of the Top 20 Independent Advisory Firms in the nation. This was the first such ranking of independent firms by Barron's and was based on various aspects of our client service offering and business performance.

Our fixed income team also continues to stand out among the competition. The consistency and expertise of our bond management has sparked interest among institutional investors across the country. This has been an area of growth for the firm in recent years. More broadly, our investment discipline of quality, relative valuation, and diversification was rewarded in 2016 and has served clients well over the years.

We plan to build upon these successes in the coming year and are always looking for ways to improve. To that end, we will continue to explore new and innovative ways to serve you in 2017. We continue to invest in technology and create efficiencies to enhance our ability to provide great service. We also plan to announce some exciting news in the spring that will allow us to help more people.

Thanks again for the opportunity to serve you. We greatly value our relationships with clients and look forward to working with you in the years ahead.

Wishing you a blessed new year,

Jason O. Jackman, CFA, President

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Featuring

Market Update

TOTAL RETURN	4Q 2016	2016
S&P 500	3.8%	12.0%
Dow Jones Industrial Average	8.7%	16.5%
NASDAQ	1.7%	9.0%
Russell 2000	8.8%	21.3%
MSCI EAFE (International)	-0.7%	1.5%
Barclays Aggregate Bond Index	-3.0%	2.7%

Stocks End a Good Year on a High Note

An eventful fourth quarter provided a fitting conclusion to a year that brought significant and often surprising changes in the world and the financial markets. November election results in the U.S. boosted stocks to a strong finish. The Dow Jones Industrial Average gained 6.7% between Election Day and year-end, and nearly reached 20,000 for the first time. The four major U.S. stock indices simultaneously hit all-time highs for the first time since 1999. There were other major moves in addition to stocks, particularly in bond yields and oil prices, both of which essentially doubled during the course of the year.

Market and economic sentiment are at high levels entering 2017, but that was far from true in the early months of 2016. Fears of recession along with China-induced economic distress sent markets tumbling in January and February, and pessimism regarding economic prospects was widespread. Those fears eased in the spring only to be briefly reignited by the shocking outcome of the Brexit vote. Again the market recovered quickly after a short-lived sell-off. Stock futures tumbled as election results rolled in overnight on November 8th, but by morning they had stabilized and a market rally ensued over the following weeks. In the end, an improving economic picture, improving corporate earnings growth, central bank policy, and optimism about potential pro-growth policy changes in the U.S. propelled stocks to healthy gains for the year.

Stocks Weren't the Only Winners

While stocks performed well, other asset classes also delivered strong returns, including high yield bonds and energy-related master limited partnerships (MLPs). MLPs benefited from rebounding oil prices and healthy demand for oil and gas shipments. These developments also helped traditional energy stocks, which were among the best-performing sectors along with financials and industrial companies. Each of these sectors gained more than 20% for the year.

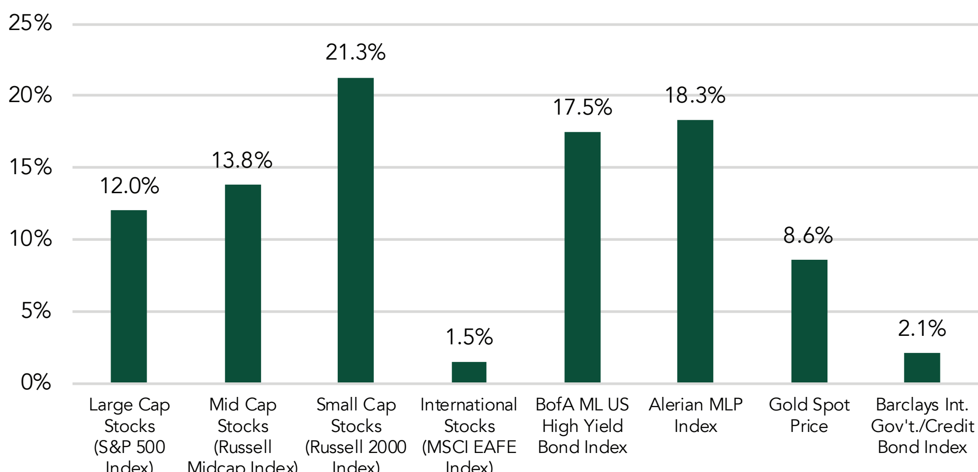
Financial stocks, especially banks, had struggled mightily early in the year and received the biggest election boost. Bank stocks gained more than 60% from the February low through the end of the year. Small cap stocks also gained more than 20% for the year. Health care, real estate, and consumer stocks were notable laggards in the U.S. International stocks underperformed U.S. stocks for the fourth year in a row, and the sixth year out of the last seven. Weak economic growth in Europe and Japan, a strong U.S. dollar, Fed policy tightening, and geopolitical turmoil have all been headwinds.

Will the Momentum Carry Over into 2017?

The biggest and most obvious question on the minds of investors now is whether or not the post-election rally will continue in 2017. The election results generated optimism regarding lower taxes (both personal and corporate), reduced regulation, infrastructure plans, and other proposals that theoretically support stocks. But what seems simple in theory is often much more difficult in practice. This is certainly true in both politics and economics.

There are several factors that could water down the impact of new policies, regardless of their political merits. Although Republicans control both houses of Congress and the White House, there are divergent views on some key issues. President-elect Trump's ideas are at odds with some congressional Republicans, particularly when it comes to the national debt and budget deficits. And some of Trump's proposals regarding immigration and trade deal adjustments could prove to be a damper on the economy. In addition, the lack of a supermajority in the Senate will hinder Republicans ability to maneuver. Finally, even legislation that becomes law will take time to impact the real

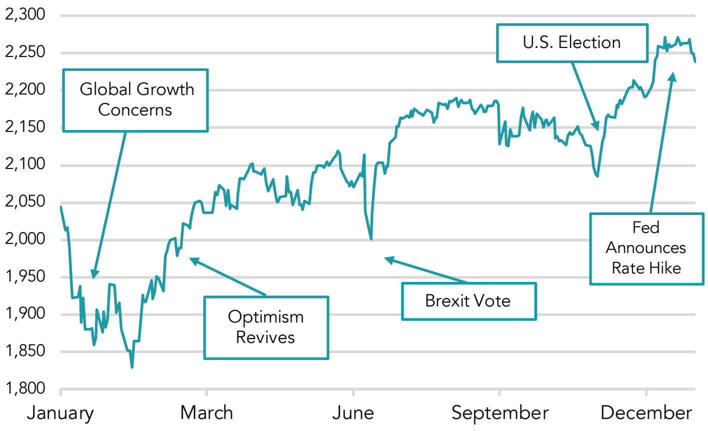
Diversification Was Rewarded in 2016



Source: Factset, Bloomberg

economy. As a result, those looking for instant gratification may be disappointed. If nothing else, 2017 will at least bring some clarity on which of Mr. Trump's proposals will be emphasized in the coming years.

S&P 500 Index Year in Review



Source: Factset

The current state of the U.S. economy may also make it more difficult for politicians to move the needle. The economic expansion is entering its eighth year, and while few would argue the economy is booming, government policy stimulus is typically much more impactful on growth when the economy is in recession or just emerging from recession, as it was in 2008 and 2009. Unemployment is down to much lower levels, and a lack of labor supply growth and productivity of that labor could limit the impact of any reform.

Fiscal Policy Regaining the Spotlight from Monetary Policy

Central banks lost some of the spotlight in 2016 after several years of intense focus and market sensitivity. The massive amounts of asset purchases and other efforts to stimulate economies around the world have become less impactful with each new announcement. Central bank actions are much more impactful on investor sentiment and the stock market when both are at lower levels. As a result, even though the major central banks in the U.S., Europe, and Japan continue to provide significant support, the focus has shifted to fiscal policy.

The Fed is the first of the three major central banks to begin to inch back toward more normal policy. As the U.S. economy has strengthened, the Fed has reduced the amount of asset purchases and so far has increased the benchmark interest rate twice. The Fed remains cautious and deliberate, trying to avoid spooking the market or endangering the economy.

Higher Interest Rates – A Long-term Positive

The election set off a spike in bond yields even before the Fed announced its second hike in December. Yields rose abruptly in the wake of the election, dragging down the Barclays Aggregate Bond Index by 2.4% in November, making it the fourth-worst month for bonds since 1994. For the year, this index still returned 2.7%. While rapidly-rising rates may cause bond investors short-term pain, there are also some advantages.

First, the upward pressure on yields helped correct an ongoing structural dislocation between bond yields and economic fundamentals. Given the potential for meaningful fiscal stimulus in the coming years, it makes sense that inflation expectations would rise, and for rates to price in modestly-better future growth. That is precisely what happened, with inflation and growth expectations both contributing almost equally to the rate increase. The bond market now appears more fairly valued.

Next, the long-term benefit of investing at higher yields almost always outweighs the short-term pain of rising rates. As interest rates rise, bond returns may turn negative for short periods, but patient investors are generally rewarded over the following three-to-five year periods.

In order to extend losses and break this pattern, rates would need to rise well above the Fed's current estimate of long-run equilibrium. The Fed estimates that the Fed Funds rate will plateau at 3.0%, implying longer-term bond yields don't have much room to rise beyond current levels. Though fiscal stimulus may help improve economic growth over the short run, our economy faces several long-term structural issues that likely limit the amount rates will rise. Elevated corporate leverage, an aging population, large government deficits, and stubbornly-low productivity are all long-term economic headwinds that will help constrain the terminal rate. In the end, the post-election adjustment in rates has brought yields back to more reasonable levels. We believe that the correction has helped improve the return outlook for traditional bonds going forward.

New JIC Blog: Beyond the Numbers

Earlier this year, JIC began a new pursuit: blogging. With over 50 years of experience helping clients with some of the biggest decisions in life, we believe we have some collective wisdom worth sharing with the ever-growing online community. On our blog, you'll find our thoughts and opinions on investing, the economy, current events, money management, retirement and estate planning, budgeting, and strategy – all the advisor essentials.

However, with "Beyond the Numbers" we hope to share who we are, at times moving beyond our financial bread and butter, and sharing our experiences and unique sources of value. With each article written by a single member of the JIC team, we hope to uncover why wealth management and the art of living well are so intertwined.

Please look for new articles featured under the Perspective tab on our website, as well as links from our Facebook, Twitter, and LinkedIn accounts. Enjoy!

A New Initiative: JIC Thrive

At JIC, we know there is rarely a boring moment in life. There's always news to absorb, possibilities to ponder, options to consider, and decisions to make. There is no shortage of financial information available in the media, but people are looking for answers to their specific questions from someone they can trust. We've become good at answering these questions over the years, and we're noticing younger people are often the ones asking them.

In response to this, JIC is excited to announce a new initiative: JIC Thrive, which is focused on extending a helping hand to the "next" generation - those new to big decisions and eager to learn.

In our eyes, the next generation isn't a group defined by age, but a new wave of people beginning to think about some big picture topics: paying off loans, building credit, buying a home, advancing their career, saving and budgeting, starting a family, investing for the future, and thinking seriously about retirement. Our goal is to give people guidance that brings confidence and financial peace of mind so they can "thrive" in all aspects of life.

In 2017 and beyond, JIC Thrive will be working on these topics and available to answer questions and engage in dialogue. We will be hosting a series of events in Cincinnati that will be aimed at exploring a specific topic or question. At each event, a short presentation will be followed by time for networking. The JIC Thrive Team will be there to chat, answer questions, and connect with anyone interested in taking hold of their future. For those unable to attend these events, we will be posting the topics on our blog, and our Thrive Team will be accessible by phone or email to discuss.

Here are examples of questions the Thrive Team can address:

> We're expecting our first child. What should we be thinking about?

> I've got the budgeting and saving thing down, but what do I do with this accumulated cash?

> Someone at the Christmas party said something about an "estate plan," and I don't really know what that is. It sounded important. Where should I start?

> I know retirement is a long way off, but how much should I be saving now?

If you or someone you know would be interested in hearing more about JIC Thrive or the events in Cincinnati, please contact your Portfolio Manager or send an email to JICThrive@johnsoninv.com.

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About Us

Johnson Investment Counsel, Inc. is Greater Cincinnati's largest independent wealth management firm, managing over $8 billion in assets. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-based, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs and more. Johnson Investment Counsel has built strong, long-term relationships with individuals and families, charitable organizations, foundations and corporations through three divisions: Johnson Private Client Group, Johnson Trust Company, and Johnson Institutional Management.

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