**Newsletter Highlights**

**INVESTMENT OVERVIEW**

- Domestic equities continued their positive, low volatility performance during the third quarter. Domestic equities were aided by increased earnings expectations and favorable economic data releases throughout the quarter.

- International equities snapped back from the U.K. vote to leave the European Union in late June on the backdrop of anticipated continual central bank accommodation. In emerging markets, equities rose driven by commodity export driven countries.

- Domestic fixed income had positive returns for the quarter. Negative Interest Rate Policy (NIRP) continued to dominate many developed economies around the world, pushing higher yield seeking international investors toward the U.S. market.

- The markets were strong during the summer months, potentially in anticipation of better earnings in 2017, limited rate increases by the Federal Reserve, and a Hillary Clinton victory in November.

- We try not to be political, but would observe that Mr. Trump represents a more uncertain future to the markets than Secretary Clinton, and the markets do not like uncertainty. The fact that oil prices rebounded from the lows of February inspires some confidence regarding the earnings picture, given that the energy sector and the stronger dollar have been a significant drag on earnings. More stability in the dollar and oil prices should provide some support to U.S. earnings fundamentals going forward.

- Interest rates are low, global central banks are still extremely accommodative, and inflation is low - all of which are a positive for risk assets like equities. However, we do believe that, with all the crosscurrents at work, it would be imprudent to assume wholly positive outcomes. We continue to be patient and will scout for compelling opportunities as they arise.

- The Federal Reserve is not expected to raise rates until December at the earliest (50% probability).

**WETHERBY NEWS**

During the third quarter, we hired Noel Campbell, Financial Operations Associate; Jeremy Eastman, Administrative Associate; Kerina Koch, Financial Operations Associate; and Ben Kooba, Investment Associate. Welcome Noel, Jeremy, Kerina and Ben!

Debra Wetherby, CEO, celebrated 25 years with the firm by hiking 500 miles of the Camino de Santiago. Congratulations Deb!

Congratulations to Jennifer Chan, Investment Associate, who passed the Level III exam of the CFA (Chartered Financial Analyst) Program; Jen Hicks, Wealth Manager, and Trevor Hicks, Director of Technology, who welcomed their new son Austin; Taryn King, Senior Human Resources Manager, and her husband Mike, who welcomed their new daughter Delaney; and Lisa Read, Operations Team Lead, and her husband Michael, who welcomed their new son Liam.
**Impact Investing Update**

- We are excited to support the Thirty Percent Coalition, a national organization working to influence corporations to increase diversity and the number of women on their boards. The Coalition is committed to reaching the goal of having women, including women of color, hold 30% of board seats across public companies. Currently, in advance of the 2017 annual meeting season, we are working with As You Sow to offer clients the opportunity to sponsor or join shareholder resolutions addressing a range of issues including energy, environmental health and waste.

**Financial Planning**

- Our financial planning section topic is 15 Year-End Tax Considerations. When it comes to taxes, it pays to be forward thinking. You can use the 15 savvy year-end tax considerations to help you navigate complexities and optimize your personal tax situation. Three main takeaways of the article are: think ahead, get organized, and contact your tax preparer in November each year to plan for the following year.

**Investment Overview**

*By Andrew Pratt, CFA, Director of Research; and Nick Ongaro, Research Associate*

**Third Quarter Market Recap**

**Domestic Equities:** Domestic equities continued their positive, low volatility performance during the third quarter with the S&P 500 up 3.85%. Domestic equities were aided by increased earnings expectations and favorable economic data releases throughout the quarter.

**International Equities:** International equities snapped back from the U.K. vote to leave the European Union in late June and ended the quarter up 6.50%, as measured by the MSCI EAFE, on the backdrop of anticipated continual central bank accommodation. In emerging markets, equities rose 9.15% driven by commodity export driven countries.

**Commodities:** Commodity performance was mixed during the quarter with grains and livestock selling off sharply while food and materials generally posted positive gains. Energy commodities largely stabilized over the quarter with West Texas Intermediate Crude Oil stabilizing in a trading range between $40 and $50. Gold saw some volatility over the quarter but finished nearly flat.

**Fixed Income:** Domestic fixed income as measured by the Barclays US Aggregate index finished up 0.46% for the quarter. The yield curve generally flattened with the front (short) end moving higher associated with Money Market Reform set to take place in mid October. Negative Interest Rate Policy (NIRP) continued to dominate many developed economies around the world compelling yield-seeking international investors toward the U.S. bond market.

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<th>Table 1. Market performance, as of September 30, 2016</th>
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**Global Economy and Markets**

We hope you had a very enjoyable summer of 2016. It was a calm and generally positive period in the equity markets which had their sunglasses on, cutting through the glare and anticipating good times ahead. As we move into fall and the reality of the approaching winter, there is more of a chill in the air of the markets. The warm summer breeze brought an expectation that corporate earnings would start to grow again after a two-year hiatus and that the Federal Reserve may not raise interest rates until December at the earliest. The election polls were also market friendly over the summer, generally favoring Hillary Clinton, although her lead narrowed in September. We try not to be political in our conversations, but would observe that Mr. Trump represents a more uncertain future to the markets than Secretary Clinton, and the markets do not like uncertainty. Optimism is in season, but as usual reality will likely be different from expectations. As the fall begins, markets are becoming more nervous and volatile as they contemplate the possibility of short-term rate increases by the Fed, questions about earnings in 2017 and, given the tightening of election polls, the possibility of a Donald Trump presidency. Will the warm breezes of summer turn into a cold winter headwind? Time will tell. As usual, we are reading the tea leaves, and reporting on our findings.

Let’s run through the state of market indicators, starting with earnings fundamentals, followed by valuation, fundamentals, and the interest rate/liquidity picture. U.S. corporate earnings, as represented by the S&P 500, appear to have declined for the fourth quarter in a row (down an estimated 2% year over year) in the third quarter of 2016 (Figure 2). Earnings growth is expected to resume in the fourth quarter, and continue on into 2017 (Figure 3). The fact that oil prices rebounded from
the lows of February inspires some confidence regarding the future earnings picture, given that the energy sector and the stronger dollar have been a significant drag on earnings for the last 12 months. Continued stability in the dollar and firming oil prices should provide some support to U.S. earnings fundamentals going forward. Meanwhile, other sectors like health care, consumer discretionary, and technology continue their “decent” earnings growth.

Figure 1 shows that the S&P 500 moved higher in the third quarter, despite flat earnings growth while Figure 2 illustrates the expected earnings recovery, with earnings growth expected to resume in the fourth quarter of 2016.

International fundamentals are stable to improving of late, as measured by European employment (trending higher), Chinese retail sales, and a rebound in industrial production (represented by the Global Purchasing Managers index shown in Figure 4). Recovery in certain basic materials prices is helping the earnings picture in emerging markets. The overall earnings picture then appears to be improving, although mainly from a removal of headwinds.

An assessment of equity market valuation is closely linked to the expected earnings recovery in 2017. The S&P 500’s upward price move during July was at least partially in anticipation of better earnings. Markets “discount” or reflect earnings expectations into current valuations, and seem to be looking ahead to better times in 2017 (Figure 5). The July rally caused valuations to appear expensive based on trailing earnings, although the 18x price-earnings (P/E) multiple on $118 of 2016...
estimated S&P 500 earnings will eventually drop to 16X if the 2017 estimate of $134 is accurate. Valuation (P/E ratios) also continues to be upwardly influenced by the low interest rate and inflation environment. An assessment of equity market valuation then is linked to the fundamental outlook as well as the interest rate and liquidity picture which we will discuss next. If earnings come through as expected, then the market is not as expensive as it appears now. If interest rates remain relatively stable, this would be supportive as well. Let’s discuss the interest rate environment next.

**Figure 5: S&P 500 forward price-earnings (P/E) ratio 1985 through 2017**

![Graph of S&P 500 forward price-earnings ratio from 1985 to 2017.](Image)

Source: Datastream

The bond market appears to be telling a more downbeat story about the future than the stock market. Bonds traditionally rally during times of trouble, forcing yields lower. The implied negative growth story inside the ongoing bond market rally may be overstated though, as excess global savings put as much downward pressure on yields as the declining fundamental growth and inflation environment. Market interest rates (those not influenced by central banks) are low, global central banks are still extremely accommodative, and inflation is low (Figure 8); all of which are a positive for risk assets like equities. The ultra-low interest rate environment is a place where the cool winds of change may begin to blow going forward however (Figure 7), and the key questions are when and to what degree. The Fed Funds Futures contract allows us to see the odds of future Federal Reserve rate increases. Right now the odds are less than 50% for a December increase (Figure 6), but the Fed might go against these odds since they are “behind the curve” at this point and know it, and the election year will be over as of December. Ultimately, what is important is not the next interest rate move, but the pace of any future interest rate increases and their ultimate destination. Our feeling is that rates are too low, but there is the potential for them to remain that way.

**Figure 6: Probability of a December interest rate increase is**

![Graph showing the probability of a December interest rate increase.](Image)

Source: BCA Research 2016

Turning from the bond market to the Federal Reserve then, and shorter-term rates, we believe that a slightly higher fed funds rate should not have a significant impact on broad economic growth. It is important to realize the broader impact that higher short-term rates could have on corporate earnings though, especially when the market appears optimistic about the future. All else being equal, higher interest rates in the U.S. would mean a stronger dollar and lower energy prices, since energy (oil and gas) are priced in dollars, and both of these factors may impose a renewed drag on earnings (Figure 9). This combined effect is probably why the equity market is hyper-focused on the Fed’s every move. We don’t currently see a reason for grave concern here since we don’t see a reason for the Fed to aggressively hike rates. We do feel there is a good chance the Fed could act differently than the market expects, because we are no longer in an emergency situation in the U.S. and yet policy rates sit at emergency levels. Inflation is still benign (Figure 8), but many strategists see it increasing in 2017, which would give the Fed yet another reason to move. The bottom
line is that the global interest rate and liquidity environment remains supportive of risk asset (equity) pricing.

Figures 8 shows that inflation is higher than previous lows but it is still contained.

Figure 8: U.S. inflation 1980 to 2016

Source: BCA Research

Figure 9: The reasons companies cited for earnings shortfalls in Q3 earnings conference calls

Source: FactSet

To recap then, equity markets appear to be discounting a continued positive environment featuring low interest rates and growing earnings. The major near-term risks remain the Fed’s actual plan for rates, energy prices, unexpected inflation and the election. This could make the fall and early winter a more volatile period for the markets, as we gain visibility on all of these unpredictable items. The tightening of the presidential race in September is somewhat surprising, but so was the UK vote to exit the EU. This is a presidential race where things seem to change on an hourly basis and the most recent release of the 2005 Access Hollywood tape is causing further turmoil in both the Trump campaign and the Republican party. Ultimately though it is earnings that matter to markets, and only time will tell if the markets optimistic expectations about 2017 are correct. At this point we remain reasonably confident about the near-term based on higher energy prices and a reasonably stable interest rate environment.

What about the medium-term outlook? We have written extensively about the persistent low growth, low inflation, low interest rate environment that is dominating the global macro environment for some time now. Many strategists have postulated that the magnitude and duration of global monetary stimulus is a giant experiment that will end “badly.” While this is one possible outcome, it seems less than certain that the end will be necessarily “bad.” It is a possibility of course, and certainly the Fed would like to be able to at least normalize interest rates so that they are in a position to react to any future crisis. But they are unlikely to raise rates in an extreme fashion given the global economic environment. A surge in inflation could change their thinking and lead to a very unpleasant outcome, especially if that surge occurred against a backdrop of slowing economic growth, since in this stagflation scenario there would be no improving earnings outlook to offset the negative influences of higher rates. Optimists are effectively counting on gradual rate increases, gradual but contained increases in inflation, continued moderate growth, and a slow tapering off of the need for so much stimulus. This does not seem like an unreasonable assumption considering the employment situation (Figure 10) and the Fed’s preferred inflation gauge, the Personal Consumption Expenditures Index (PCE), as well as the length and characteristics of the current business cycle (Figure 11). The employment situation has been steadily improving, but inflation remains stubbornly below the Federal Reserve’s target range of 2.0%-2.5%. We are 74 months into the current economic expansion, which is well above the average of 58 months since World War II. It has been a long, mild recovery, always susceptible to external shocks, but not strong enough to create inflation. The economic data has been consistently inconsistent. Sooner or later this expansion will succumb to old age. The conundrum for the Fed is that the hour is growing late, employment is strong, and it would be helpful to have some ammunition in the event of a crisis. It is hard to see the Fed standing still at this point, but it is also hard to see them stomping on the brakes given how close we are to zero GDP growth. Gradual rate increases appear likely with the wildcard being the inflation rate.

If the Fed plans to tighten when inflation moves up into the desired range, then what implications does that likely hold for the market? The answer is, it depends. If we simply move a bit higher to a relatively modest rate of inflation and the Fed starts to slowly raise rates while growth remains tepid, then perhaps the outcome will be benign for markets since it essentially rep-
represent a continuation of the current situation. A bad outcome would involve a growth slowdown accompanied by increasing inflation (stagflation), or a sudden and rapid rise in the inflation rate. As we have noted repeatedly, the global economy has continued to be lackluster despite continuous monetary stimulus. This has led many to believe that the neutral, non-inflationary level of interest rates is much lower than it once was, and that, as a result, the Fed is not as accommodative as it would appear. This might support the case for limited rate increases going forward, which is in fact the current expectation.

**Figure 10: Unemployment rate 1990 to 2016**

![Unemployment rate graph]

Source: U.S. Bureau of Labor Statistics

**Figure 11: Core Personal Consumption Expenditures (PCE) index (excluding food and energy)**

![PCE index graph]

Source: U.S. Bureau of Economic Analysis

As we enter the fourth quarter, fresh off a summer rally in equities, we once again find ourselves facing the game of expectations versus reality. This time around, expectations are relatively high, meaning the markets must live up to higher earnings, limited Fed rate increases, stable oil, and a Hillary Clinton victory. If these expectations come true, markets may be satisfied and stable. If not, then we may see a reset in the near term. Will we face a continuation of the current low growth, low interest rate, low inflation environment, or something very different in 2017 and beyond? While many foresee a negative outlook, we believe it is too close to call at this point and we are inclined to be mildly constructive. Rising inflation may be the biggest economic risk. We do believe that, with all the crosscurrents at work, it would be imprudent to assume wholly positive outcomes. Our asset allocation conversations in the third quarter have been highly focused on equity market valuations which are elevated relative to history and seem to be anticipating positive earnings news. We don’t see a reason to change our overall positioning at this point, which is pro-growth (with a value bias) and slightly underweight fixed income. We have room to add to risky assets if the opportunity presents itself. As always, we continue to be focused on evaluating any dislocations that may appear going forward. To quote a now famous television series, “Winter is Coming,” but we must first deal with the fall.

**Impact Investing Update**

*By Justina Lai, Director of Impact Investing*

**Thirty Percent Coalition Support**

We are excited to support the Thirty Percent Coalition, a national organization working to influence corporations to increase diversity and the number of women on their boards. The Coalition is committed to reaching the goal of having women, including women of color, hold 30% of board seats across public companies. We are proud to be part of a network of over 80 members – including public companies, private equity firms, institutional investors, professional service firms, national women’s organizations, and government officials – working together to drive toward greater gender diversity in corporate boardrooms. We believe that our partnership with the Thirty Percent Coalition demonstrates our commitment and ongoing efforts to support and promote greater gender equity for the benefit of our clients, employees and community.

**As You Sow Support**

As highlighted previously, we have partnered with As You Sow, a non-profit organization that promotes environmental and social corporate responsibility through shareholder advocacy, coalition building and innovative legal strategies. Through As You Sow, we have been providing clients with the opportunity to use shares of stock they already own to join shareholder initiatives that create constructive dialogue and promote change in corporate practices to address significant environmental, social and governance (ESG) issues. We believe such engagement can help spur business improvements that reduce risk and potentially strengthen long-term value.
Currently, in advance of the 2017 annual meeting season, we are working with As You Sow to offer clients the opportunity to sponsor or join shareholder resolutions addressing a range of issues including energy, environmental health and waste. Please let your Wetherby team know if you would like to learn more or get involved in shareholder engagement.

Financial Planning

By Mike Troxell, CPA, Investment and Tax Associate

15 Year-End Tax Considerations

When it comes to taxes, it pays to be forward thinking. Below are 15 savvy year-end tax considerations to help you navigate complexities and optimize your personal tax situation.

1. Contact your tax preparer in November
   - Simply doing your taxes is not enough. Plan ahead to take advantage of the tax code through credits, deductions, and other opportunities. Contacting your tax preparer toward the end of the year for an evaluation can result in tax savings.

2. Review your prior year’s tax return
   - Review your prior year’s tax return to refresh your memory of any questions you had or potential tax planning opportunities that may be available to you. Don't hesitate to reach out to your Wetherby team to help you review your prior tax returns.

3. Maximize your 401(k) plan contributions
   - The deadline for contributing to your 401(k) plan is December 31, or your employer’s final payroll-run of the year. You can contribute up to $18,000 per year ($24,000 if you’re over age 50) to your 401(k) and defer taxes until you withdraw the funds after you reach age 59.5. Also, in some 401(k) plans you can make Roth contributions.

4. If you changed jobs during the year, make sure you don’t over-contribute to your 401(k)
   - 401(k) plans won’t allow you to defer taxes on contributions over the limit ($18,000 or $24,000 if you are over age 50). If you change jobs mid-year the responsibility of tracking the amount you have contributed falls to you, not the employer. If you change jobs, make sure you find out how much you contributed while at your previous employer to ensure you do not over-contribute and become subject to tax penalties.

5. Contribute to IRAs
   - Work with your tax preparer to determine your eligibility when it comes to contributions to a traditional IRA or a Roth IRA. This will help you take advantage of tax-deferred or tax-free growth for IRA assets. The deadline to contribute is the tax filing deadline, typically April 15; no extensions are granted for IRA contributions.

6. Track down all medical receipts
   - If you incurred high medical expenses this year, start compiling your receipts. If your medical expenses are in excess of 10% of adjusted gross income, you may be able to take a deduction to help lower your tax bill.

7. Keep track of charitable contributions
   - If you itemize your deductions, you may be able to take a deduction for your charitable contributions. Be sure to track both cash and noncash gifts throughout the year to maximize your deductions.

8. Contribute appreciated securities to a donor-advised fund
   - Instead of making charitable contributions with cash, consider using appreciated securities (held longer than one year) to contribute to a donor-advised fund. This allows you to avoid paying capital gains tax on the appreciation while taking a full deduction on the value of the securities.

9. Front-load or delay deductions
   - In the event of higher- or lower-than-usual income in a given year, it could make sense to accelerate or defer certain expenses near the end of the year, such as: mortgage interest, medical expenses, property taxes, and charitable contributions.

10. Harvest capital gains or losses
    - If you are in a lower or higher tax bracket than normal, it could make sense to sell securities to harvest your capital gains or your capital losses in a given year. Be sure to discuss this with your Wetherby team if your income is unusually high or low this year.

11. Consider a Roth conversion
    - In a year with low or negative income due to retirement, employment loss, or business losses, it could be a great opportunity to convert traditional IRA funds into a Roth IRA while potentially paying little to no income tax.
12. Make your annual exclusion gifts of up to $14,000

- One of the best ways to pass wealth down to lower generations without transfer taxes is to make annual exclusion gifts of up to $14,000 per year, per person. If you gift over $14,000 to an individual (family or friend) then you are required to file a gift tax return which reduces your lifetime exclusion of $5.45 million (adjusted for inflation).

13. Spend down your Flexible Spending Account (FSA)

- Unlike an HSA (Health Savings Account), funds in an FSA do not rollover as they are subject to a “use it or lose it” policy. If you have funds in your FSA toward the end of the year, try to utilize them on FSA eligible medical expenses such as a medical appointment or eyeglasses. If you don’t make the December 31 deadline for expenses, the IRS provides a grace period for 2.5 months after your plan year ends.

14. Take your Required Minimum Distributions (RMD)

- Traditional IRAs require minimum distributions once a taxpayer turns 70.5. If the RMD is not taken by December 31 there is a 50% penalty. Be sure to work with your Wetherby team to coordinate taking your RMD if you are over 70.5.

15. Make a Qualified Charitable Distribution (QCD) from an IRA

- If you make contributions to charity, and do not need the income from an RMD from an IRA, you can bypass the RMD and give it directly to a charity via a QCD. Using a QCD will avoid the RMD from being considered as income, which means it will not be included in your AGI (adjusted gross income) calculation.

Your individual tax situation is the most important factor when it comes to tax planning. The above tax considerations should be viewed as a helpful guideline and starting point. The three main takeaways we would like to leave you with are: think ahead, get organized, and contact your tax preparer and Wetherby team early!
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