Palisade
CAPITAL MANAGEMENT

PALISADE CAPITAL MANAGEMENT, LLC
ONE BRIDGE PLAZA, SUITE 695
FORT LEE, NEW JERSEY 07024
T (201) 585-7733 • F (201) 585-7552
www.palisadecapital.com

January 12, 2017

Dear Investor:

The final quarter of 2016 was bountiful for equity investors, but less so for bond holders. Most equity indices broke or flirted with record highs in the December period. The interest rate jump after the November election took its toll on bonds, as the Barclays Bond Aggregate Index ETF *fell* almost 4% in the period. Oil continued its slow and steady recovery from the lows of last February, though gold fell in the period.

	Dec 30, 2016	Sep 30, 2016	% Change
S&P 500® Index	2238.8	2168.3	+3.3%
Dow Jones Industrial Average	19,762.6	18,308.2	+7.9%
NASDAQ Composite Index	5,383.1	5,312.0	+1.3%
Russell 2000® Index	3,372.8	3,110.7	+8.4%
VIX Volatility Index	14.0	13.3	+5.3%
Barclays Bond Index – ETF “AGG”	108.6	112.4	-3.9%
10-Year U.S. Treasury Yield	2.48%	1.60%	+55.0%
Gold (ounce)	$1,150.00	$1,313.30	-12.4%
Oil (barrel – West Texas intermediate)	$53.75	$47.72	+12.6%

Data Source: FactSet Data Systems

If a clairvoyant had told us with 100% certainty last January that within the year Britain would vote to leave the European Union and that America would elect Donald J. Trump the 45th president of the United States, our preemptive actions would almost certainly have been wrong. We probably would have sold all our stocks and bought gold. But a funny thing happened on the way to Armageddon: we survived! Financial markets enjoyed good-to-excellent returns in 2016. The bellwether S&P 500® Index rose by 9.5% for the year, and many smaller stock benchmarks did better – especially *after* the presidential election.

So, is this the calm before the storm, or did the markets get it right?

True Brexit – legal, financial, judicial, and regulatory separation from the 28-country European Union – might take years, even decades, to effect. The U.K. ambassador the European Union, Ivan Rogers, resigned this month in frustration over his government’s unrealistic expectation of the time needed to unwind Britain’s complex relationship with the E.U. (the Prime Minister’s government believes two years, and Sir Ivan thinks a decade). We have no clearer idea of the scope of Brexit now than we had before the referendum last June. We’ll put Britain in the “too early to forecast” category, but it’s clear that the Sceptered Isle is not about to sink into the sea!

As to the United States, the situation here is clearer than it is for Britain, though we still have no concrete and firm idea of how President-elect Trump will translate tweets into policy. He does have some broad goals. Among those are (1) repeal and replace the Affordable Care Act, a/k/a Obama Care, (2) encourage repatriation of overseas cash by U.S. multi-nationals, (3) lower corporate tax rates, (4) accelerate spending on U.S. infrastructure, (5) eliminate onerous federal regulations, and (6) institute a system of export incentives and import duties (Border Adjustment Tax) to support domestic manufacturing. Unlike Britain vis-à-vis Brexit, however, it won’t take long to see how Mr. Trump’s policy ideas find their way into law. The 114th Congress has already been sworn in, and Mr. Trump will become *President* Trump on January 20.

But as the old expression goes, God is in the details. After the new president’s ideas have been refracted through the legislative prism, they are likely to look very different than the way they he pitched them during the campaign. Consider the so-called Border Adjustment Tax. Taxing imported goods *would* likely encourage domestic manufacturing. But it might also disrupt the global supply chains of big retailers like Wal-Mart, push up the cost of goods, and force stores to raise prices, perhaps sharply. The counter-argument is that the Border Adjustment Tax would strengthen the dollar and push down the cost of imports, so the net effect of an import tax and a high dollar would cancel each other out – a wash, but with the surviving benefit of a net gain in U.S. manufacturing. That's the theory anyway. Distinguished economists like Martin Feldstein (Harvard University) have embraced this idea. But the country has had some experience with import duties – the crude oil entitlements program of the 1970s was an experiment in tax-driven differentially-priced raw materials inputs. That policy failed miserably, and was a major reason for the infamous gasoline shortages of that decade. Members of Congress, who stand for election every two years, might also view the Border Tax as regressive, *i.e.*, a tax that weighs most heavily on low income families. Is there a politician alive who is skillful enough to explain to his constituents how raising taxes/prices on consumer products must be done to lower tax rates on corporations – *and* win reelection?

So, while Mr. Trump's broad economic plan has drawn cheers from investors – and many elements of the plan *deserve* hearty cheers – there are many risks to its implementation. We fear that enthusiastic investors might not have fully thought through those risks, including the risks of unintended consequences.

Forecasting is a business that tends to make wise people look foolish. Consider the zeitgeist of early last year: oil prices were in free fall and banks' loan portfolios were viewed skeptically. At least one famous financier warned investors against junk bonds as an across-the-board trap for the unwary. Now, consider what *actually* happened: oil prices jumped by more than 60% from their early-2016 lows, bank stocks proved one of the best performing equity groups in the wake of the election, and junk bonds – far from being the dreck that the famous financier told us to avoid early last year – proved to be one of the best performing fixed income categories of 2016 (+17% total return from February-end 2016 to year-end 2016).

In the face of such uncertainty, we tend to revert to what has worked time and again. For equities that formula is straightforward: reasonably priced securities of well-managed enterprises that have secure business models. It helps if those equities pay dividends and have records of steadily rising dividends. In the case of bonds, relative bargains are hard to come by, and *absolute bargains* are nearly impossible to find. Consider that the 10-year Treasury bond yields just 2.4%, barely in-line with inflation – and that yield is up more than 100 basis points from the low of last summer. Thus, we generally prefer higher-yielding common stocks to bonds and preferred shares – though we are always on the hunt for exceptions like "rate reset" preferreds, or short-duration convertible bonds.

No matter what happens in the years ahead, we aim to produce good returns on your investments while taking prudent risks. Some price volatility is unavoidable – even welcome, as it's the feature of the capital markets that gives us the opportunity to buy attractively priced securities and sell fully-valued ones.

Thank you for allowing us to manage your investments. We aim to reward your faith in us with creativity, diligence and good results. That is our only business model.

Sincerely,

Palisade Capital Management