

Alley Company Quarterly Letter
Stick To Your Knitting

January 17, 2017

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.” – Mark Twain

With 2016 now in the record books and the benefit of hindsight in hand, one can easily point to a year of surprises and things not playing out exactly as people expected.

The stock market started the year with a sudden pullback on fears of slowing growth in China and deflation taking hold around the world. But by year end, the market recovered substantially and the focus turned to the prospect of stronger economic growth in the U.S. and rising interest rates.

Bond yields did a complete round-trip in 2016. The ten-year U.S. Treasury bond started the year with a yield of 2.27% and moved to multi-decade lows of 1.35% by mid-year. But due to a resilient U.S. economy coupled with increasing inflation expectations, bond yields finished the year at 2.45%.

On the political scene, most observers expected a career politician - either Democrat or Republican - would be the nation’s next president. In the end, Washington-outsider Donald Trump struck a chord with the nation’s electorate on an anti-establishment message to voters.

As the calendar turns to 2017, the new administration, in conjunction with a Republican-controlled Congress, has a full legislative agenda: tax reform; an infrastructure spending bill; repealing and replacing the Affordable Care Act; immigration reform; trade tariffs to protect American jobs; and regulatory reform on various fronts - to name a few. With an array of outcomes possible, investors to date have largely embraced a pro-growth and pro-business thesis.

On the surface, the new administration’s agenda has the potential to ignite additional economic growth which has already been accelerating in recent months (Q3 real GDP grew +3.5%). Corporate profit growth is likely to accelerate too on the back of tax reform and other pro-business initiatives. But as Mark Twain suggests, investors also need to stay vigilant on the potential risks, including those posed by new policy actions.

Regardless of the outcomes on the macro front, investors should focus on their asset allocation framework and underlying portfolio holdings. Together, these decisions are a reflection of one's investment goals, objectives, and risk tolerance.

Our guidepost is to remain true to our investment philosophy of investing in high quality companies that have industry leadership positions and to assemble the proper asset allocation that balances the level of risk being taken. Moreover, our knitting is to closely follow the fundamentals of these companies as the best means of achieving investment success. As legendary investor Peter Lynch once noted, "*forget the noise and concentrate on what's actually happening to the companies in which you've invested.*" Said another way, stick to your knitting!

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