FOURTH QUARTER 2016

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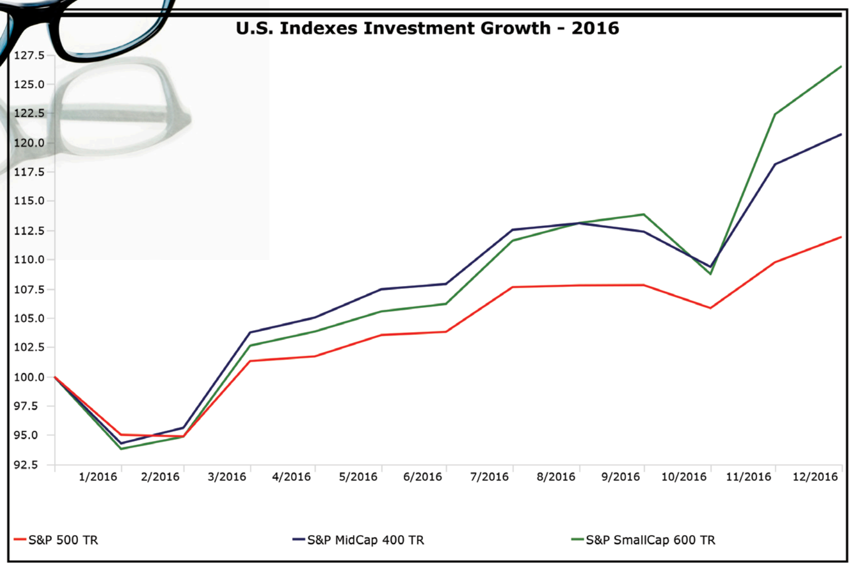
AS WE SEE IT...

What a year! 2016 marked a return of economic growth, and equity markets responded very favorably. Equities, as measured by the S&P 500, gained 3.82% in the final three months and 11.96% for the year as a whole. The bigger story in equity markets, however, were small caps. The S&P SmallCap 600 Index finished the year with a 26.56% return! Mid caps also had a good year, rising 20.74%.



Source: Morningstar

The U.S. economy picked up throughout the year. From Q1's 1.1% and Q2's 1.4% annual real rates, the latest GDP report for Q3 showed real economic growth of 3.5%. Manufacturing and service sector indexes also signal that the pace of expansion has increased once again. In the past year, retail sales are up 3.8%, but have been accelerating, up 5.1% annual rate over the past six months and 7.0% annual rate in the past three months. Labor markets continue to add jobs, and the unemployment rate dropped to 4.6% in November, the lowest level since 2007. This kind of economic strength gave the Federal Reserve confidence and latitude to raise rates by a quarter percent, as nearly everyone expected.

2016 was a year that can be described as a tale of two halves. It began with weakness, as global equity markets sold off immediately following disappointing manufacturing data out of China, and U.S. investors weighed a continued earnings recession among S&P 500 companies against concerns of a potential economic recession after disappointing GDP growth. These fears could also be seen in the beaten down energy sector, as oil prices neared $26 per barrel in February, reflecting dour expectations for global demand. The first half was one of uncertainty and risk reduction.

The second half of the year saw a revamp to a risk-on sentiment, as several former areas of concern either stabilized or improved. Economic data turned to the positive in February, including an upward revision to U.S. economic growth as measured by Gross Domestic Product (GDP) and improved consumer spending. Markets rebounded off the February 11th low, and resumed their upward trend. As a result of this rotation, risk assets globally saw relatively healthy gains through the end of December.

While the year will certainly be remembered for the return of double digit equity gains, these may be overshadowed by some political surprises of historic scale. In June, voters in the United Kingdom shocked global markets by electing to leave the European Union. Market reaction to what has become known as "Brexit" was decidedly negative for only four days, after which security prices stabilized and regained their losses. An even greater surprise was delivered in November, when Donald Trump was elected President of the United States, despite virtually all polls forecasting a victory by Hillary Clinton. Market reaction further defied expectations by rallying sharply through year end in anticipation of expansionary fiscal policies by the new administration.

Not all asset classes ended up with such stellar results. Treasury yields experienced a roller coaster ride in 2016. As spreads widened in the first six weeks of the year, the yield on 10-year Treasury bonds fell. Concerns over slow growth kept rates low through the first half of the year, with the 10-year Treasury reaching a low of 1.36% on July 8, after the Brexit vote. But rates started to tick higher in the second half of the year on signs of stronger economic growth and increasing

continued on page 2

PORTFOLIO COMMENTARY

Equity Portfolios:
Equity and Strategic Multi-Cap

U.S. equity markets rallied in the fourth quarter following the surprise presidential election, with all four major U.S. stock indices hitting record highs. The S&P 500 finished the quarter up 3.82%. Small-caps as measured by the S&P 600, and mid-caps as measured by the S&P 400, were stronger, posting gains of 11.13% and 7.42%, respectively during the quarter.

Economic data throughout the quarter remained positive on balance with stronger GDP growth and an improving employment picture. Investors also appeared to have renewed enthusiasm following a Trump win with the potential for tax reform, deregulation, and a boost to infrastructure spending. Additionally, corporate profits turned positive after five consecutive quarters of negative earnings. Given this backdrop, our outlook for equities remains positive.

Portfolio positioning was adjusted during the quarter with this improved economic outlook in mind. We increased Value stocks on the premise that pro-growth policies will provide the catalyst for a rotation away from Growth stocks. Energy and Financial exposure was increased on the expectation of an improving earnings outlook within those sectors, with a subsequent decrease in Consumer Staples, which tends to underperform during an upward trending market. With the market focused on fiscal stimulus and pro-growth policies, we believe earnings growth will improve and be supportive of further gains in equities.

Income Portfolios:
Total Return and Cash Yield

Fixed income markets finished the year lower, as Treasury yields moved higher driven by higher inflation expectations and a hike in the Fed Funds rate in December. Overall, the Barclays U.S. Intermediate Gov't/Credit Index fell -2.07% during the quarter, but finished the year up 2.08%. Treasury yields declined during the first half of the year, hitting a low in July and then slowly rising until the presidential election. The surprising outcome of the election had investors reassessing inflation and debt expectations due to possible fiscal stimulus under the new administration, pushing yields substantially higher. Yields reached their highest levels in December, after the Federal Reserve raised interest rates by 0.25%, just the second hike in over ten years. In the end, the 10 YR Treasury finished the year at 2.45%, only slightly higher than where it began the year. Credit sectors performed the best during the surge in yields, with high yield and floating rate bank loans among the leading sectors. Longer duration assets, municipal bonds and REITS were among the laggards.

Our Income strategies have been positioned for higher rates for quite some time, with less sensitivity to interest rates, and suffered less drawdown than the broad bond indices. Income Total Return combines broad based fixed income exposure along with a meaningful allocation to alternatives. Alternatives provide returns uncorrelated to the broad market, and were the strongest performers this past quarter. In addition, floating rate bank loans and short duration MBS positions outperformed. In Income SMA, our focus has been building a portfolio with diversified sources of income. Over the past quarter, we saw floating rate bank loans, short duration MBS positions and a multi-sector bond manager provide strong returns for the portfolio, while intermediate bond managers were mixed and preferred securities detracted.

Balanced Portfolio

After taking turns leading throughout the year, equities pulled ahead of bonds by a sizeable margin in the fourth quarter. Overall, the S&P 500 Index moved higher by 3.82%, while the Barclays U.S. Intermediate Gov't/Credit Index fell -2.07%. Bonds held an edge through October, as equities declined up until

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AS WE SEE IT... *continued from page 1*

inflation pressures. The move to higher rates accelerated after the election on November 8. By year end, the yield on the 10-year bond had increased by more than a full percentage point off its low, ending the year about 25 basis points from where it began the year. This move to higher rates led to losses in Treasury securities, holding back the broader Barclays Intermediate Government/ Credit Bond Index, which finished at 2.08% for the year.

Fourth quarter made a significant contribution to a good year in financial markets. Our fully invested strategy across multiple capitalizations in equities and diversified income sources in bonds, created growth for client portfolios. We believe this will continue in the new year.

KEY TAKEAWAYS

- Double digit equity returns in 2016
- Economic growth has picked up
- Markets overcame a rough start
- Political surprises had unexpected reactions

the presidential election. Investors rushed back into stocks after the surprising election results, boosted by the possibility of tax reform, less regulation and fiscal stimulus. In equities, we saw mid and small caps outperform large caps, along with value leading growth stocks. Within sectors, Financials, Energy and Industrials were among the leaders across all market caps. Bonds suffered a pullback, as yields climbed throughout the quarter, driven by higher inflation expectations and an interest rate hike by the Federal Reserve. Corporate credit, including high yield and floating rate bank loans, provided the best returns.

Our Balanced Managed and SMA strategies are comprised of allocations to both traditional asset classes, such as stocks and bonds, and alternative strategies. The majority of the portfolio is invested in the traditional asset classes, with a preference for equities, utilizing a variety of active managers and exchange traded funds. We allocate a portion of the portfolio to alternative strategies, which provide uncorrelated returns and can dampen volatility. A preference for equities and active manager performance contributed to performance, while long-short equities were the top performer within the alternative allocation. In light of the shift in leadership in the markets, we increased exposure to large cap value stocks and modified fixed income exposure to decrease the sensitivity to changes in interest rates.

Absolute Return Portfolio

A Trump victory was certainly a surprise which created a shift among investors to riskier assets. U.S. equities rose to an all-time high after the election, as financial markets interpreted Trump's victory as opening the door to tax cuts and spending increases. Given the strong sentiment and pace of the US economy, the Fed elected to hike the federal funds rate by 25bp. The 10-year Treasury yield increased from 1.63% at the beginning of the quarter to 2.45% at the finish. We've been preparing for higher rates for quite some time and have incorporated investments with much less sensitivity to interest rates into our Absolute Return strategy. Currently, we have a meaningful allocation to the alternative asset class, which provided the strongest return in the fourth quarter. Throughout the quarter, we've made minor adjustments to our strategy by reducing our exposure to fixed-income and using the proceeds to increase alternative exposure. Moving into 2017, we believe alternatives will continue to neutralize the effects of overall market movements by delivering returns with low correlation to stocks and bonds.

Faith & Values Portfolio

Performance of equities and fixed income diverged after the surprising result of the presidential election. Stocks got a boost from the possibility of tax reform, de-regulation and fiscal stimulus, while bonds suffered a pull back as investors adjusted to higher inflation expectations and a less accommodative Federal Reserve. Within the Faith & Values universe, screened to meet our criteria, domestic equities, particularly small caps and value managers, led all asset classes. Allocation managers with a preference for equities also posted solid results. Overall, we continue to maintain an overweight to equities, as we believe the economy is on solid footing. Within the equity allocation, the portfolio benefited from allocations to mid and small caps, along with a slight overweight to value. We adjusted fixed income exposure to reduce interest rate sensitivity by adding floating rate bank loans.

Global Portfolio

Global equities finished the fourth quarter down -0.71%, yet delivered a positive 1% for 2016, as measured by the MSCI EAFE NR Index. Domestic markets were the strongest among developed markets, as US equities rose to an all-time high after the presidential election. This was due to investors seeing Trump's victory as a game changer. In Europe, equities profited from the improving economic environment and subsiding concerns about the health of the financial sector. However, unemployment across the continent remains high, and income growth remains anemic. The ECB extended its quantitative easing strategy to December 2017, at a reduced rate of €60 billion per month. In Japan, economic growth has been weak, and renewed deflation has been a persistent problem. Investors also believe the economic policies of Prime Minister Shinzo Abe might not be delivering what they were supposed to. Equity markets in Europe and Japan were both down -0.40% and -0.16% in the fourth quarter, respectively. Among the emerging markets, we continue to see a divergence between commodity producers and manufactures. Stocks in Russia were up 18.6% while stocks in China and India were down -7% and -8%, respectively. Throughout the quarter, we reduced our exposure to Europe due to the political uncertainty with upcoming elections in France, Germany and the Netherlands. The US equity markets continue to have better domestic economic growth, rising relative earnings and a healthier financial sector, hence we continue to maintain our overweight position relative to the benchmark.

Has anything happened we should know about? If there are any changes in your financial situation, investment objectives or specific restrictions, please contact your investment advisor or The Pacific Financial Group, Inc. It is critical to the achievement of your investment goals and the success of our relationship to discuss any changes in your financial needs.

Our clients receive quarterly performance on their accounts. For performance on any of our strategies, please contact your Investment Advisor.

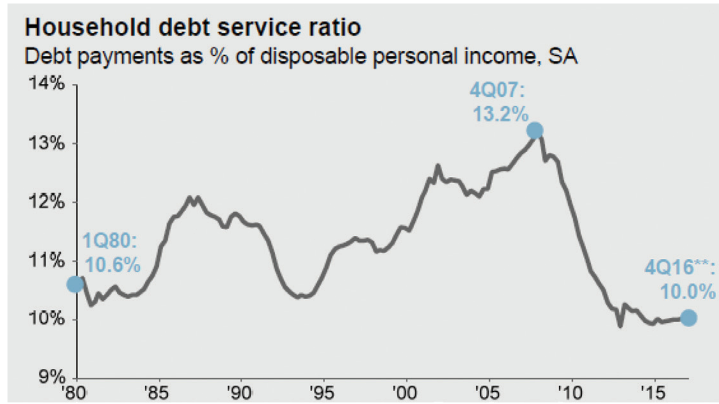
WHAT'S IN THE FUTURE?

Optimism reigns, and things are getting better. While last year was a tough act to follow, developments on the horizon have the potential to spur significant economic growth. Investors have responded very favorably, and markets have built up robust momentum. Investors aren't the only ones feeling optimism. Consumers are also feeling pretty good these days. Automakers reported cars and light trucks were sold at an 18.4 million annual rate in December, up 3.1% from November, up 5.2% from the year earlier, and the fastest pace for any month since 2005. Auto sales hit another new annual record in 2016, showing plenty of confidence on the part of consumers.

Employment is healthy, and we expect this to continue. Labor markets continue to tighten, as economic growth keeps adding more jobs. Overall, the jobless rate dropped 0.3 points in 2016, and we expect a similar gradual drop in 2017. Wages are showing long-awaited growth, up 2.9% from a year ago. While wage growth is an inflationary source, is it really a bad thing for Americans, on average, to make more money? Employment continues to expand, while wage growth is accelerating and consumer debt service obligations remain very low by historical standards. Look for continued growth in consumer spending in the months ahead.

Inflation appears poised to rise further this coming year. The prices paid index jumped to 65.5 in December from 54.5 in November, with 18 commodities rising in price while just 3 declined. Claims that rising prices are just a reflection of the rebound in oil prices are too narrow a view. Yes, energy prices have been on the rise, but rising economic activity is starting to put pressure on a wide variety of inputs. There is also still a massive amount of excess liquidity in the system. Inflation off of low levels has historically been helpful for equities, but serves as a headwind to bonds.

On monetary policy, the Federal Reserve has recently been much more talk than action. It is possible that this year, the Fed can actually deliver. Their forecast of 3 hikes looks quite possible. A March hike is a low likelihood, as we would expect the Fed to wait closer to mid-year. Although the US central bank may continue to raise rates over the course of the year, the European Central Bank (ECB) and Bank of Japan are likely to continue asset purchases, as they look to support growth in their respective economies. We anticipate that this liquidity should continue to shore up international equity markets.



Source: FactSet, FRB, J.P. Morgan Asset Management

Expect trade to be a drag on GDP in Q4, as a stronger dollar and slow global growth continue to be factors. The good news is that, so far, there's been no large visible effect of Brexit on trade. Although exports and imports to the UK declined in November, both remain in line with the levels seen before the June referendum. One could expect some widening in the overall domestic trade deficit, as US consumers buy imports with their healthy gains in income. If we make the US a better place to invest global capital – which appears to be happening – the overall trade deficit will grow, not shrink.

We're currently in a bull market for optimism. Hope has returned in spades, largely from expectations for significant policy change, following the presidential election. Greater fiscal spending plans in the United States are expected to accelerate growth, capital spending, and earnings. While we too are optimistic, it appears that markets are discounting every proposed policy making it through Congress in a speedy fashion. Using history as a guide, it may be prudent to lower some of these expectations, as well as lengthen their timelines.

We remain optimistic for investing in the coming year. You should be too.

KEY TAKEAWAYS

- Consumers are optimistic
- Employment growth continues
- Inflation could pick up

FOURTH QUARTER 2016

RETIREMENT AND ANNUITY COMMENTARY

Aggressive Strategy

The Aggressive Strategy is offered through our retirement plan program and is designed to provide the investor long-term capital appreciation. As its name suggests, the Portfolio seeks higher returns by typically accepting a higher level of risk/volatility than the broader market.

The final quarter of the year was quite positive in equity markets, especially for small caps. Small caps outpaced mid caps, which, in turn, beat large cap stocks. Equity returns outside of the U.S. were generally negative, with the MSCI EAFE NR Index (Europe, Australasia and the Far East) losing -0.71%. Emerging Markets faced the strong head winds of a strong dollar, and the MSCI Emerging Market Index dropped -4.16% over the past three months.

Financials were the best performing sector for the quarter, rising 21.1%. After years of cost cutting and with interest rates expected to rise, the outlook for financials improved dramatically. Real estate was at the bottom, losing -4.4%. In style, value had a large advantage over growth.

Our Aggressive Strategy normally holds a blend of large, mid, and small cap stocks due to the long-term nature of this strategy. Small and mid cap exposure made the highest quarterly contributions in the strategy.

Moderately Aggressive Strategy

The Moderately Aggressive Strategy is offered through our variable annuity optimization program, as well as our retirement plan programs. The Moderately Aggressive Strategy is designed to provide long-term capital appreciation with a moderately high level of risk/volatility.

Equities ground lower through October, but jumped dramatically following Trump's surprise election as President of the United States. Small caps posted the largest quarterly gain, followed by mid caps. Small-caps, as measured by the S&P 600, rose 11.13%, while mid-caps, as measured by the S&P 400, were up 7.42%. The S&P 500 finished the quarter up 3.82%. Economically sensitive cyclical stocks rallied in anticipation of increased infrastructure spending. Market optimism gave a clear advantage to risk assets. Small cap and mid cap exposure was modestly increased in the strategy, and value was increased.

Our Moderate Aggressive Strategy usually holds a blend of large, mid, and small cap stocks due to the long-term nature of this strategy. International exposure was de-emphasized.

Moderate Strategy

The Moderate Strategy is offered through our variable annuity optimization program, as well as our retirement plan programs. The Moderate Strategy is designed for more conservative investors, who wish to have income and capital appreciation through a blend of fixed income and equity securities.

Equities finished the quarter with a definite advantage over fixed income sectors. High yield was the only bond sector to end in the black, as interest rates moved higher on inflationary expectations. As widely expected, the Federal Reserve hiked interest rates a quarter percent in December, which also added negative pressure to Treasury prices. Credit sectors lost less than governments, and small and mid cap outpaced large caps. The Barclays Intermediate Government Credit Index was down -2.07%.

Economic data supported a preference for risk assets. Equity was increased in the allocation mix. Government bond exposure was reduced further during the quarter, with an increase in credit. Small and mid caps were also increased.

Moderately Conservative Strategy

The Moderately Conservative Strategy is offered through our retirement plan program and is designed to provide the investor income and long-term capital appreciation. As its name suggests, the Portfolio typically has a low level of risk/volatility with the primary goal being capital preservation. Typically, this Portfolio

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does not hold more than 20% equities, with the remaining amount allocated to fixed income securities.

Fixed income sectors ended the past three months below their starting points, with Treasuries down the most. High yield turned in the only gains. Broad bond indices were modestly negative. Bonds, as measured by the Barclays Intermediate Government Credit Index, finished the quarter with a -2.07% loss. Labor markets continued to tighten and wages inched higher, adding to the market's view of rising inflation. After holding off for 12 months, the Fed hiked interest rates. Portfolio duration was decreased with further reduction of government exposure.

Q4 2016 HIGHLIGHTS

- *GDP growth for Q3 2016 was revised up to 3.5%, the highest growth rate in two years. This was boosted by higher than expected growth in consumer consumption, investment in structures, intellectual property products and government expenditure.*
- *The U.S. Consumer Price Index (CPI) increased 0.20% in November.*
- *The unemployment rate dropped to 4.7% in December, the lowest jobless rate since August 2007, with 495,000 jobs created during the quarter.*
- *Consumer Sentiment increased in December to 98.2, the highest reading since January 2004.*
- *The personal savings rate declined to 5.5% in November.*
- *Retail Sales increased in November by 0.1%, following a rise of 0.6% in October. Nine of the 13 major retail categories had gains in November, while auto sales were a drag.*
- *New single family home sales increased 5.2% annually in November.*
- *Home prices, as measured by the S&P/Case-Shiller Home Price Index: Composite 20, have steadily climbed this year, up 5.1% in October versus one year ago. Seattle tops the list of major cities with the highest price increase of 10.7%.*
- *Housing starts dropped in November by 18.7%, following a 9 year high in October with a 25.5% increases month over month. Permits for future housing dropped by 3.8%.*
- *Construction spending increased 0.9% month over month, boosted by an increase in single family construction, private nonresidential construction and public construction spending.*
- *The Markit Manufacturing PMI increased to 54.3 in December, boosted by new orders and production volumes.*
- *The ISM Non-Manufacturing PMI index maintained at 57.2, its highest level since October 2015.*
- *The ISM Manufacturing PMI index rose to 54.7 in December, the highest reading in two years. New orders, production, and employment all reached highs for the year.*

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