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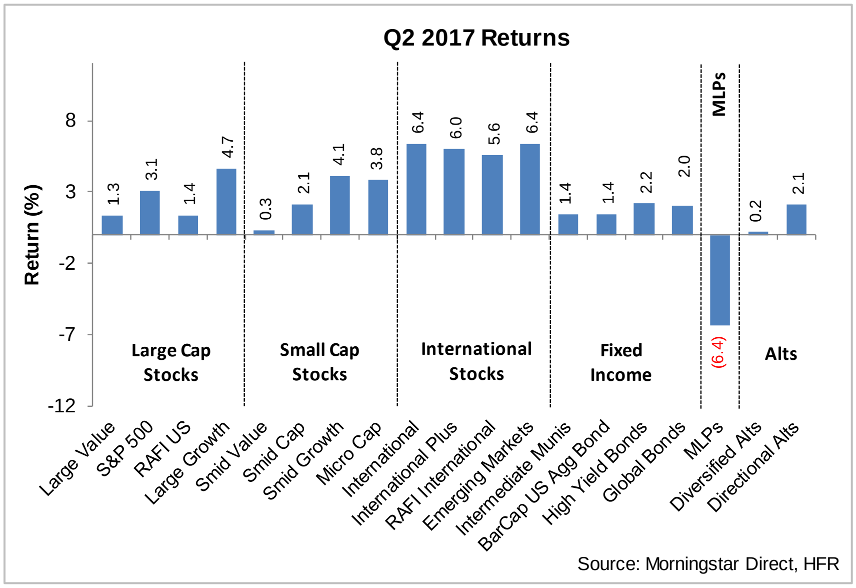
Second Quarter 2017 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 Recap:

- Stocks climbed to a seventh straight quarter of gains, while volatility fell to all-time lows. We have now gone more than a year without a 5% decline in the S&P 500, only the sixth such occurrence since 1950
- Like 2015, the market is being narrowly led by a handful of high priced equities, namely FAANG (Facebook, Apple, Amazon, Netflix, Google). Those names account for half of NASDAQ's and a quarter of the S&P 500's 2017 gains, and have caused a 10% divergence between the growth and value indices
- Interest rates drifted lower despite continued tightening by the Federal Reserve and their announced plans to shrink their balance sheet. Lower yields may reflect growing skepticism that the GOP will implement fiscal stimulus

NEXT Outlook:

- Objective indicators of the economic and market cycle suggest we are not yet at a cyclical peak. Valuations are elevated and we are likely in the market's late cycle phase, but this period can and typically does last years
- U.S. political risk may be the greatest threat to the current rally – most tangibly, the Mueller investigation and prospects for corporate tax cuts
- Markets may be underestimating the Fed's resolve to continue its hiking cycle and the potential impact of shrinking its balance sheet
- Prospects for non-U.S. stocks remain positive amid better valuations, improving growth, and increased political stability

To Our Clients and Friends,

The second quarter proved to be a good one for investors, with broad-based gains occurring across equity and fixed income markets. Equity markets rose for the seventh straight quarter and have now gone more than a year without a 5% decline from peak value – only the sixth time that has happened since 1950. Volatility has all but disappeared this year, with 2017 currently on track to be the least volatile year in recorded history[1].

LONGEST STREAKS WITHOUT A 5% S&P 500 CORRECTION

Start Date	End Date	S&P 500 at Beginning	S&P 500 at End	S&P 500 Gain During Streak	Trading Days Without a 5% Correction
08/19/58	09/08/59	47.30	57.70	22.0%	266
01/04/61	01/09/62	58.36	69.15	18.5%	255
11/26/63	06/08/65	72.38	85.93	18.7%	386
10/12/92	03/28/94	407.44	460.00	12.9%	370
12/21/94	07/12/96	459.61	646.19	40.6%	394
06/28/16	07/11/17	2036.09	2425.53	19.1%	261

Source: LPL Research, FactSet 07/11/17

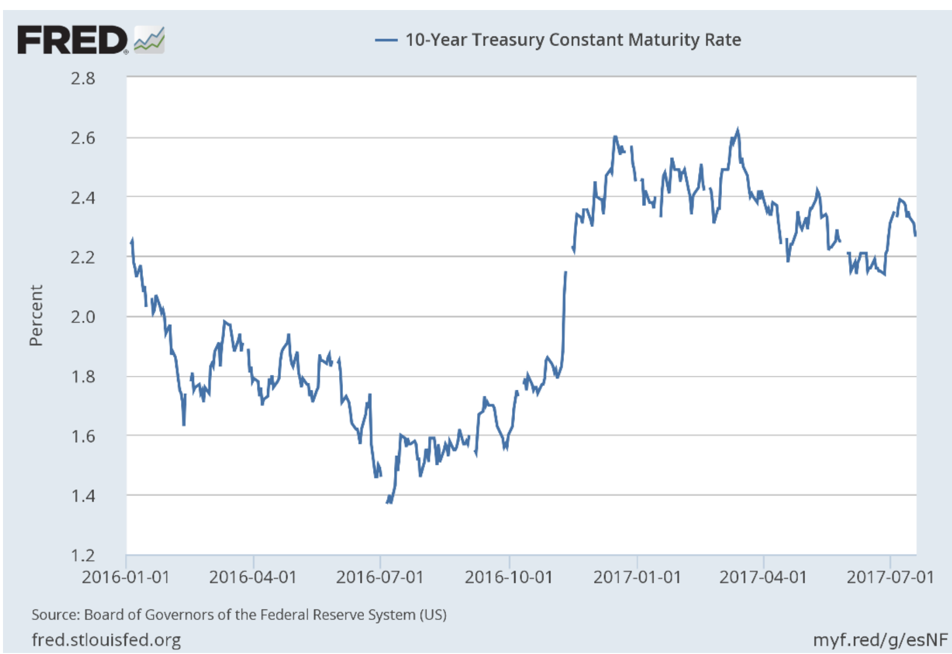
Leading this charge were the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google), which are each up more than 25% on the year. These names alone have accounted for more than half of the gain in the NASDAQ this year and approximately a quarter of the S&P 500 return. They have also caused a substantial divergence of more than 10% between growth and value stocks. This has negatively impacted many active managers, as professional investors have shied away from the excessive valuations embedded in many of these stocks.

[1] As measured by the S&P 500 Volatility Index, or VIX

The momentum of a handful of stocks like FAANG, or a single sector, is always frustrating in the moment for the disciplined, diversified investor. When assets rise due to popular sentiment, they can overshoot their fundamental value. We think back to the tech bubble in the late 1990s as a clear parallel, where the inevitable unwind of sky-high valuations caused significant capital losses for shareholders. This time around, FAANG appears to be comprised of fundamentally better companies with real revenues and (in some cases) real earnings, but we still think price matters. Ultimately, history will judge whether this is indeed another price bubble, or if a new paradigm of company has come into existence truly deserving of astronomical price/earnings multiples.

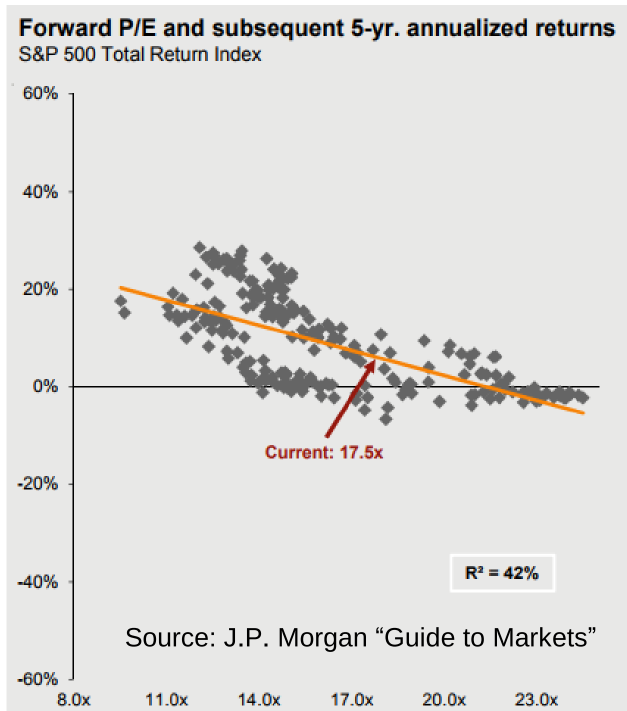
Stock market performance abroad was also strong in the quarter, continuing momentum from the beginning of the year. Like the U.S., international markets have also gone a year without a 5% correction - ironically, since the Brexit vote that was supposed to unleash global chaos. Gains in non-U.S. markets have been especially strong in 2017, boosted by improving economies and increased global competitiveness after years of declining currencies. There is much debate about whether this international outperformance will last, but with better valuations, renewed political stability in Europe, and continued central bank accommodation in place, we are very constructive on their return potential. After a long period of U.S. outperformance (both economically and market-wise), we believe continued improvement off of a low base is a very likely scenario for the international markets.

Bond portfolios were broadly positive in Q2 as both interest rates and credit spreads declined. Though still about 1% higher than the all-time lows reached in July 2016, the yield on the 10-year Treasury bond has drifted lower from approximately 2.60% after the Presidential election to 2.25% today. Intuitively, one would not have expected yields to fall amid three interest rate hikes by the Federal Reserve. A dip in recent inflation data is certainly one culprit. However, we also suspect the ineffectiveness of the Republican party in moving forward their agenda is a significant factor (curiously, a concern ignored by equity markets). With the prospects for significant fiscal stimulus dimming – that is, tax cuts and increased government spending on infrastructure – economic growth, inflation, and thus interest rates may all be lower than initially expected after Trump's surprise victory.



Policy effectiveness aside, we still believe the market may be underestimating the Federal Reserve's resolve to continue its current path of rate hikes. Calm markets and "good enough" economic data has provided them a window to increase short-term rates and give the Fed ammunition to fight the next cyclical downturn. There is also a very real possibility that President Trump will replace five of its seven voting members in the next 12 months, including Chair Janet Yellen. These replacements will almost certainly be more hawkish (more inclined to raise interest rates) than the current members. When combined with the Fed's stated intention to shrink its balance sheet later this year – which will result in the removal of a massive, price-insensitive buyer of Treasuries and Agency mortgages from the bond market – we believe this is a very powerful shift in policy that may have a profound impact on interest rates.

With this perspective in mind, we continue to position fixed income portfolios with lower duration (sensitivity to interest rates). Instead, we favor incorporating modest credit risk to benefit from an ongoing positive economic backdrop. We do not necessarily expect interest rates to soar in the months or years ahead; however, the anemic coupons currently offered by high quality intermediate bonds are just not enough to compensate investors for even a modest increase. A 1% increase in the municipal yields, for example, would wipe out about three years' worth of income. That tradeoff is not particularly appealing to us.



With regards to the stock markets, there are several items that bear watching. For us, valuations feature most prominently, although in the short-run there is admittedly very little correlation to stock market performance. At a 17.5x forward P/E multiple, the U.S. market remains expensive (about 10% above average), but still well short of all-time highs. History would suggest this should depress forward returns over a longer-period, but it will likely take a catalyst beyond simply valuation to disrupt the current rally.

To that end, political risk may very well be the biggest threat to current market momentum. Markets have largely shrugged off the daily drama coming out of Washington – perhaps due to headline fatigue or simply a shift in focus back toward fundamentals – but there is no promise that lasts indefinitely. Special counsel Robert Mueller's investigation into President Trump, for example, certainly has the potential to create chaos. The prospects for tax reform represent an even more tangible threat. With such slim majorities in the House and Senate, it has become clear that a divided GOP will struggle to piece together meaningful tax reform, a much more complex effort than simply reducing the statutory rates. At a minimum, we hope to see some level of corporate tax cuts passed by the end of next year. A failure to deliver on this part of the agenda would (likely) cause a negative backlash in the markets, as many have anticipated this boost to corporate earnings.

Despite these risks, the fundamental backdrop for stocks is relatively firm. As we discussed last quarter, corporate America has emerged from an earnings recession and growth has thus far come through as expected. Moreover, global economic growth is starting to emerge in a meaningful way, such that we have entered a period of coordinated gains across geographies. This is something we have not seen in many years, and suggests the potential for a broader base of support to stock market performance moving forward (rather than simply the artificial boost of central bank stimulus).

We must also acknowledge that, based on a range of objective indicators, the economy does not yet appear to be at a cyclical peak. Whether it is the slope of the yield curve, capital investment levels, or the gap between real and potential output, the mosaic of data available to us indicates a recession is not on the immediate horizon. And while market corrections or volatility can happen at any time, it is less likely that an extended, substantial bear market will occur without an economic recession.

The late cycle stage of a bull market can and often does persist for a meaningful period of time. J.P. Morgan has indicated the final stage of a market cycle typically lasts two years and has lasted as long as five years (in the lead up to the tech bubble). Meaningful gains still exist in this part of the cycle and thus there is a large opportunity cost for those who attempt to time it. This is not to say investors should go out and blindly load up on equities. Rather, we provide this insight as a reminder that we should maintain our asset allocation despite the market's broader risk factors; stocks are capable of delivering substantial gains in what otherwise may seem to be a precarious environment.

Part of being a disciplined investor is understanding this dynamic, and understanding that it is all but impossible to time the market. Ultimately, we create strategic asset allocation targets for a reason – they are based on a longer-term view of asset risk and performance and are built in the context of the investor's individual circumstances. Periodic bouts of volatility are part of the normal investment experience, but a diversified portfolio is designed to mitigate those swings and to keep your objectives in focus. Our job is to help guide you through this process and to ultimately protect and build your wealth over time.

As always, if you feel as though your individual circumstances have changed or your view of portfolio risk has evolved, we encourage you to call or stop by our office at your earliest convenience.

Kindest regards,
Your Investment Team
7/24/2017