MARKET Insights

October 2017

Third Quarter Report Card

The Goldilocks economy continued to reward investors in the third quarter with the S&P 500 gaining **+4.5%**. International markets and US small-caps outpaced US large-cap stocks, as the MSCI EAFE and Russell 2000 indices returned **+5.5%** and **+5.7%** respectively. Our efforts earlier this year to diversify client equity allocations paid off for clients' portfolios, as additions to international markets and small cap stocks contributed significantly to returns for the quarter.

After rallying in July and August, the bond market saw some weakness in September as interest rates began climbing with the ten-year Treasury bond ending the quarter with a yield of **2.33%**. Despite some volatility in interest rate movements, the Barclays US Aggregate Bond index generated a return of **+0.9%** for the third quarter. We continue to expect interest rates to climb higher and are maintaining an underweight position to long-term fixed income. We have been working throughout the year to reduce interest rate risk, with yields remaining relatively low for most of 2017. These efforts have proved profitable for clients: returns in the fixed income portions of our clients' portfolios have outpaced the Barclays Aggregate Bond index in 2017.

+5.7%

Quarterly gains for U.S. small-cap stocks outpaced large-caps.

+5.5%

International stocks had strong 3rd Quarter showing.

+4.5%

Steady gains for S&P 500 continue in 3rd Quarter.

MARKETS	Q3 2017	YTD 2017
Blue Chip Large Stocks S&P 500	+4.5%	+14.2%
Small Company Stocks Russell 2000	+5.7%	+10.9%
International Stocks MSCI EAFE (in US $)	+5.5%	+20.5%
Investment Grade Bonds Barclays US Bond Aggregate	+0.9%	+3.1%
High-Yield Bonds Barclays US High Yield	+2.0%	+7.0%

INDICATORS	LATEST	PREVIOUS
Economic Growth US Real GDP	+3.1% 2017 Q2	+1.4% 2017 Q1
Inflation CPI	+1.9% Aug.	+1.7% July
Interest Rates US 10-Year Treasury Yield	2.33% Sept. 30th	2.27% June 30th

Source: FactSet indexes, as of September 30, 2017.

Where Do We Go From Here?

Prior to 2017, U.S. stock market averages outperformed the major global equity indices. This was due partly to the US government and Federal Reserve's actions in the depths of the financial crisis. The Fed's monetary policy has proved quite effective not only in stimulating economic growth but also in fueling growth in asset prices, which has bolstered stock market returns since 2009. As a consequence, US stocks now appear to be among the most expensive relative to other global stock markets.

> ***"Companies in Europe are in the midst of an economic recovery and delivering earnings growth similar to those in the US a few years ago."***

The S&P 500 index currently trades at about 18x forward earnings, compared to the historical average of 14x. Global markets appear cheaper, trading at about 14x forward earnings, which is close to the long-term average. As a result of lofty valuations, many US investors doubt the staying power of the current bull market, worrying that we are due for a correction or worse. While we believe that current conditions do not foretell a recession in the US, we recognize that other markets represent better investment opportunities. Companies in Europe, for example, are in the midst of an economic recovery and delivering earnings growth similar to those in the US a few years ago. Furthermore, the correlation of foreign stocks to US markets has been steadily declining, which makes the diversification benefit of investing globally more attractive.

European equities are of interest to us. Economic growth is trending up, unemployment is falling from high levels and credit demand is growing. As previously stated, the US shows few signs of recession risk, but because the US is farther along in its economic cycle, profit growth is bound to level off. A reacceleration in US growth is certainly possible, but the likelihood is that continued European economic strength will be higher. Thus, we have begun increasing client allocations to European equities while still maintaining existing US equity position sizes.

Bottom Line – What It Means for Investors

At the beginning of the year, we identified 3 themes. Here's where we stand.

THEME 1 — Maintain a pro-growth investment stance, favoring stocks over bonds

Stocks continue to outperform in 2017 with the S&P 500 returning **+14.2%** through the third quarter, versus the Barclays Aggregate Bond Index which returned **+3.1%**. We continue to employ our "pro-growth" strategy, but have been adjusting the mix of investments within equities by adding more to US small-cap stocks and global markets by allocating to European equities.

THEME 2 — Shorten duration in bond portfolios, allocate away from government debt

Interest rates have remained within a rather tight range this year, as the yield on the US ten-year

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Treasury note has fluctuated between **2.62%** and **2.04%**. While the lack of movement has seemed confounding, the ten-year Treasury could easily broach **2.6%** and head toward **3%** within the next twelve months. We have appropriately positioned client portfolios to avoid this interest rate risk, by shortening duration. We also recently reduced high yield and emerging market bond exposure in light of lofty valuations in those sectors and the generally low level of yields offered for such credit risk. Proceeds have been added to short-term investment grade fixed income.

THEME 3

Diversify global equities selectively, avoiding "anti-globalization" risk

Additions to European equities and international markets overall have added incremental returns to our clients' portfolios. The anti-globalization theme has not materialized. Current tax reform measures would be positive for US markets. We have positioned client portfolios to take advantage of continuing, broad global growth, and are monitoring emerging markets, which have benefited greatly from the resurgence of global economic growth this year.

CURRENT ASSET ALLOCATION RECOMMENDATIONS

Asset Class	Sector or Geography	Recommended Positioning
Equities	US Large Cap	Remain overweight in financials, industrials, technology and healthcare.
	US Large Cap	Underweight utilities, telecom, consumer staples and "low volatility" proxies.
	International Developed	Adding exposure to European markets.
	Emerging Markets	Neutral, favoring Asia over LatAm, S Africa and Russia.
Fixed Income	Government Debt	Shorten duration, avoiding long maturities (10+ years).
	Municipal bonds	Attractive yields relative to comparable taxable credits.
	Bank Loans	Substitute traditional high yield bonds via floating-rate, senior secured loans.
	High-Yield	Underweight, as current yields are less compelling.
	Inflation-Indexed	Moderate allocation to profit from potential increase in official inflation.
	Emerging Market Debt	Underweight due to less attractive relative yields.
Alternatives	REITs	Underweight due to interest rate sensitivity.
	Commodities	Negative on oil and base metals, Chinese demand declining.
	Absolute Return	Satellite allocations to arbitrage, buy-write and credit relative value strategies.

Conclusion – Q3 2017 Results

Our decision to keep a pro-growth investment stance by overweighting stocks relative to bonds in client portfolios has proven correct thus far in 2017, and we plan to continue with this theme by diversifying the allocation toward international stock markets

Our recommendation to shorten the maturity profile ("duration") in Fixed Income allocations has added value to client portfolios, both by outperforming the broad bond market (Barclays US Aggregate Index) and by reducing client exposure to increasing interest rates. We continue to believe that remaining positioned with low duration is prudent for clients at today's relatively low levels of interest rates.

Lastly, we expect our decision to reduce high yield and emerging market bond exposures will further protect client portfolios from interest rate risk. We have used proceeds from these allocations to add to shorter-term investment grade bonds. This provides "dry powder" for client portfolios to re-deploy in the next market correction for stocks, or when longer-term fixed income yields are more attractive.

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