Market Outlook – July 2017

<u>Where Have We Been?</u>

The year 2017 has proven to be a very positive one for global stock markets to date, and the second quarter was no exception. European stocks jumped 8.4%, while the broader developed foreign stock market was up 6.4%. Emerging-market and larger-cap U.S. stocks gained 3.4% and 3.1%, respectively. Bonds also delivered solid returns in the quarter and for the year to date.

As we look back over the first half of the year, one of the most notable items is how steadily markets have risen, despite ongoing political uncertainty and geopolitical tumult. We believe this serves as a good reminder that over the long term, financial assets are priced and valued based on their underlying economic fundamentals—yields, earnings, growth—not on transitory macroeconomic or political events.

Economic and corporate fundamentals largely still look solid, and investors are pricing in expectations that the second quarter earnings season will demonstrate a continuation of the strong growth trends exhibited so far in 2017. Inflation is lower, but still in the ballpark of the Federal Reserve's 2% target. Additionally, global central banks, including the Federal Reserve, are not seen as becoming too aggressive in raising rates and tightening monetary policy any time soon.

<u>Domestic Forces Behind the Markets</u>

If markets like to climb a wall of worry, then the political situation in the U.S. is a driving force. Four key issues are creating uncertainty in Washington: health care reform; tax reform; the Federal budget; and the debt ceiling. With Republicans having control of the White House, the Senate, and the House of Representatives for the first time in a decade, 2017 began with high hopes for policy initiatives that could prove to be a boon for the markets and for investors. Health care reform, an overhaul of the tax code, infrastructure spending, and deregulation were at the top of the list, and the market reacted with exuberance. Midway through 2017, however, Republicans have few major policy accomplishments to report. Dysfunction, drama, and ethical issues in the White House have combined with Republican infighting on Capitol Hill to bog down the policy agenda.

Economic data continues to improve, albeit slowly, and corporate earnings have been strong. The S&P 500 is still seeing solid earnings growth but the market continues to trade at increasingly high levels relative to earnings. This suggests an expensive market with limited growth opportunities. Growth rates and consumer confidence continue to expand. However, valuations must reflect all risks, including the political and the policy risks, facing the markets. As we have discussed with you, the market is sitting near record highs but there is not much fundamental reason for it to continue trekking higher, at least not at this pace. This leaves investors in a tricky position. Some analysts say that calm markets could give way to turbulence in the second half of the year as high valuations prove unsustainable.

We appear to be in a classic transition to a late stage market cycle. Growth stocks have been very strong for three years while value stocks have lagged. We expect the differential between the two camps to narrow, with value beginning to outperform. Banks have already moved, propelled by a combination of higher yields and an anticipated repeal of onerous regulations. Continued economic growth should also support cyclical areas of the market, such as industrials and materials. Our recent and continued adjustments to client portfolios reflect this changing outlook.

The Situation Abroad

From a big picture perspective, we think the odds favor a continuation of the ongoing mild global economic recovery we've witnessed this year. That should be broadly supportive of riskier assets, such as stocks and corporate debt. In particular, we believe there is still more room to run for foreign stocks versus the U.S. market, given their more attractive valuations and earnings growth potential, even after their strong performance in the first half of the year. The ongoing earnings growth recovery in Europe is welcome news. For the first time in several years, earnings growth among companies in the eurozone is outpacing corporate earnings growth in the U.S. Furthermore, the European Central Bank recently increased its economic growth forecasts for the eurozone for this year and next. Across the bloc, banks are largely well capitalized and ready to lend, and unemployment has fallen to multiyear lows. Emerging markets, which, in the aftermath of the U.S. election faced considerable uncertainty due to the potential for a stronger U.S. dollar, higher inflation, and unfavorable trade policies – now offer attractive opportunities. With the implementation of President Trump's protectionist policy agenda currently stalled, it appears previous concerns for emerging markets have faded. Global currencies, in both developed and emerging economies, are strengthening versus the dollar.

Let Us Not Forget the Value of Diversification

Within our portfolios, we look to bonds for protection, capital preservation, and a regular income stream to meet current and future spending needs. As interest rates rise, and assuming the global economy stays on its current growth trend, we expect returns for core, investment-grade bonds to remain low but to provide our portfolios a steady ballast against equity market volatility. We continue to assess the credit markets and see credit spreads continuing to narrow which means investors are demanding less to take on risk. Considering the objective of bonds in our portfolios, we prefer to avoid additional credit risk for limited additional return of lower quality bonds at this time.

How Will Fed Action Affect the Market?

Though economic and political uncertainties are dominating investor sentiment, one prevailing certainty is a gradual return to more normal Fed policies. Although investors initially expected interest rates to increase rapidly following November's election, they have since tempered those rate forecasts. We believe political hurdles facing President Trump's pro-growth policy agenda combined with modest economic growth, and a persistent inflation rate still below target, are causing the Fed to maintain a cautious approach to interest rate and balance sheet normalization. Current projections anticipate an eight-year process to unwind the Fed's $4.5 Trillion balance sheet. We must remember, however, that the return to monetary policy normalization has only occurred because economic growth has improved enough to allow Fed officials to make the change.

Fed action is relevant to the markets for multiple reasons. By unwinding their balance sheet, more securities will enter the market, and that will allow the market to dictate price and rate. Interest rate increases will have a negative effect on corporate earnings and will increase investor return expectations. Since 2008, Fed action has been highly correlated with equity market returns. As the Fed pulls back we anticipate that market volatility will increase and market multiples will decline over time.

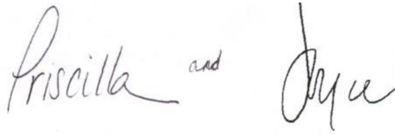
What Should We Expect?

At the mid-point of 2017 global markets remain complex. The year started with great expectation as the post-election rally was driven by: improving earnings, better global growth, and optimism for the Trump policy objectives. Recent data show that global growth may be slowing while the Trump agenda has stalled. Despite these risks, investors continue to give the benefit of the doubt both to the economy and the Trump Administration. However, amid geopolitical unrest, and a number of scandals coming out of DC, many investors are beginning to wonder if the long run bull market is coming to an end. We anticipate slow economic growth, low interest rates, and modest inflation to continue - these factors make the second half of 2017 difficult to

forecast. We know there will inevitably be shorter-term market surprises, including negative ones. Therefore, it is more important than ever to take a long-term investment view when it comes to positioning our portfolios. While there has seemed to be little need for diversified portfolios over the past eight years of a raging U.S. equity bull market, history teaches that this cycle will turn and diversification will be warranted. Moreover, market over-reactions to shorter-term news or outcomes can create compelling longer-term investment opportunities. We continue to watch for these opportunities while not taking undue risk in the near-term.

As always, we appreciate your confidence and welcome questions about your individual portfolio or financial situation.

Best regards,



Priscilla and Joyce