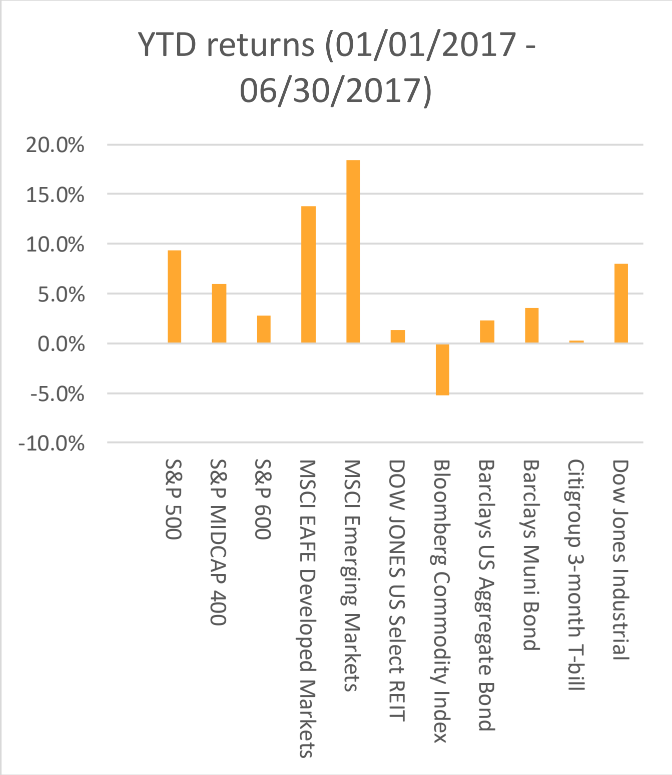
MARKET COMMENTARY: 2017 Q2

We are now full swing into the "Dog Days of Summer" here in Richmond, Virginia, with temperatures projected to be in the 90s or above for the foreseeable future. As things have warmed up throughout the last quarter and as of late, markets have been following in similar stride. Indeed, the S&P 500 closed the second-quarter at 2,423, just 10 points shy of its all-time high. Even broad-based fixed income, as measured by the Barclays Aggregate Bond Index, was positive on the year. The more compelling story outside of U.S. markets and fixed income was International Developed and International Emerging markets. As the chart shows below, these two asset classes are quite clearly leading the pack so far this year.

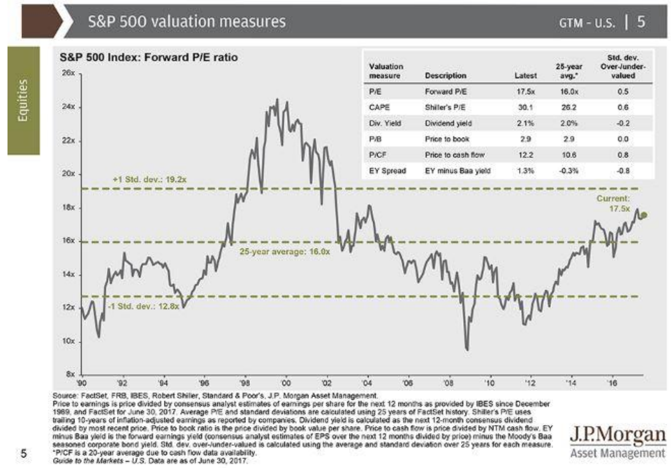


The outperformance thus far of international markets is something we have been waiting to see for some time. Specifically, we anticipated international markets to experience a reversion to the mean – a concept by which an asset class that is far underperforming its historical average will experience a period of strong positive performance. The rationale came from looking at historical correlations and returns, coupled with central bank policy, that lead us to believe we would see the trend change when market forces were correctly aligned. The difficulty, of course, is trying to gauge when things will change and, more importantly, for what period they will continue. In a shorter-term view, we do feel International markets are compelling and we added to our exposure in both International Developed and International Emerging markets last quarter. Our longer-term view – through the scope of what we feel is a foundation for global growth amid lower inflation – leads us to believe these asset classes should prove to be a valuable part of a well-diversified portfolio. As a cautionary note, this does not mean international markets will not experience pockets of weakness; recall the S&P 500 was up only 2.11% in 2011 and 1.38% in 2015 but posted a positive 5-year return of 14.63% from 2011 to 2016. As we know, being successful with a diversified portfolio takes time and patience.

Domestically our economy grew at a revised rate of 1.4% in the third quarter (whereas the original read was 0.7%). The Personal Consumption Expenditures Index (PCE) was 1.4% over the past year versus the Fed's goal of 2.0%. Unemployment has held steady at around 4.3% and below the Fed's target level. Following three consecutive positive reads, the Conference Board Leading Economic Index suggested our economic expansion will continue into 2017. Consumer confidence, which decreased in May, was up slightly in June and at a nearly 16-year high. On the other hand, consumer sentiment was down in June from the previous read in May, but was still up 1.7% year-over-year.

Our economy has been humming along enough that the Federal Reserve (Fed) has now increased rates for three quarters consecutively, with the most recent hike taking place mid-June. Beyond adjustments to the Fed Funds rate (which primarily impact the short-end of the yield curve) the Fed announced plans in June to gradually unwind its $4.5 trillion balance sheet, beginning as early as the end of 2017. Since the Fed owns mostly longer-maturity bonds, reducing its holdings could increase long-term rates and cause the yield curve to steepen. Right now, conditions are such that the yield curve is relatively flat (largely due to modest inflation expectations) and our view is that the Fed will remain accommodative amid current inflation levels, but there is also a risk they fumble the ball. Accommodation, in the right doses, is generally beneficial to investors.

While we continue to remain favorable on equities over fixed income given current economic conditions, we also know the current cycle is in its 9th year – the second longest bull market in history - and the question becomes how much longer U.S. markets can run. We should note first that market cycles are inherently difficult to predict simply on age alone and can vary quite significantly over secular periods. Beyond time periods and economic data, investors look to market valuations to gauge general market attractiveness. And, as valuations are concerned, the following chart shows the current Forward P/E on the S&P 500 is 17.5 and slightly higher than the 25-year average of 16.0. Valuations of the S&P 500 based on Schiller's CAPE appear to be slightly frothier, currently 30.1 versus 25-year average of 26.2.



Despite valuations above long-term averages, we know the growth trend in aggregate company earnings is mainly determined by the rate of growth in the overall economy. Not surprising, many feel as though the new administration will be able to stoke growth (cut regulations, cut taxes, increase infrastructure spending, etc.) which could then justify anticipated earnings expansion, which would hence validate valuations. Analysts also project the earnings growth forecast for the technology sector to be the highest of all S&P 500 sectors in 2017. We find this to be particularly positive since advancements in technology that lead to productivity increases will be necessary to increase long-term economic growth. In other words, we don't want to be greedy but we do feel the backdrop is quite positive right now … the U.S. consumer has generally increased savings and cut debt since the financial crisis; domestic banks have been stressed tested and hold ample reserves; S&P 500 companies hold some of the largest cash balances as a percentage of current assets that has been seen in decades. Risks within the system, in our view, are largely more geopolitical in nature and something to which markets have had resilience.

Best wishes,

Jeff

Disclosure:

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GDP: Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. Though GDP is usually calculated on an annual basis, it can be calculated on a quarterly basis as well. GDP includes all private and public consumption, government outlays, investments and exports minus imports that occur within a defined territory. Put simply, GDP is a broad measurement of a nation's overall economy.

S&P 500® Index: Capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The total return version of the index is used, which reflects the effects of dividend reinvestment.

S&P 400 Index: The S&P Mid Cap 400 Index is the most widely used index for mid-size companies and covers approximately 7% of the U.S. equities market.

S&P 600 Index: The S&P Small Cap 600 Index is a market-value weighted index that consists of 600 small-cap U.S. stocks chosen for market size, liquidity and industry group representation.

MSCI EAFE Developed Markets Index: The Morgan Stanley Capital International Europe, Australasia, and Far East (MSCI EAFE) Index is composed of all the publicly traded stocks in developed non-U.S. markets. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

DJ US Select REIT Index: The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S. The indices are designed to serve as proxies for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

Bloomberg Commodity Index: The Bloomberg Commodity Index (BCOM), formerly the Dow Jones-UBS Commodity Index, is a highly liquid, diversified and transparent benchmark for the global commodities market. It is calculated on an excess return basis and reflects commodity futures price movements.

Barclays U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Brothers U.S. Aggregate Index) is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Barclays Municipal Bond: Covers the USD-denominated long term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prefunded bonds.

Citigroup 3-month T-bill: With income reinvested, representative of the three-month Treasury Bills

Dow Jones Industrial Average: Consists of 30 large-cap blue-chip U.S. companies. DJIA and DOW JONES INDUSTRIAL AVERAGE are registered trademarks of Dow Jones Trademark Holdings LLC ("Dow Jones").

Personal Consumption Expenditures Index: The personal consumption expenditure (PCE) measure is the component statistic for consumption in gross domestic product (GDP) collected by the United States Bureau of Economic Analysis (BEA).