Stembrook
Asset Management

Stembrook Market Review — Second Quarter 2017

Building on the momentum of the first quarter, global equity markets continued their advance in the second quarter of 2017. Equities in developed markets outside the U.S. outpaced U.S. stocks in the quarter, up 6.3% and 3.1% respectively.[1] The drop in the U.S. Dollar contributed 2.6% to non-U.S. equity outperformance.[2] Global economies continued their steady, albeit slow, upward climb as both sentiment and hard economic data continue to improve.

The U.S. stock market rally, now in its 99th month, is the second longest on record since 1926. The market has risen 258% over the period, far outpacing the average bull market return of 156%.[3] While all bull markets must end, it would be reasonable to expect this one to be longer lasting and produce higher returns, given the extent of the downturn caused by the global financial crisis. We are carefully monitoring the U.S. market and are moving marginal dollars to stocks with lower relative valuations.

The global earnings picture is beginning to shift, as corporate earnings from outside the U.S. have been growing at a faster rate. Since the beginning of the economic recovery in 2009, U.S. earnings growth has far outpaced growth in non-U.S. markets (see center chart, below). This leaves room for non-U.S. earnings to grow as their delayed economic recovery builds momentum. Recall that future earnings growth drives stock returns over the long run and we see improving future growth combined with lower prices in non-U.S. markets.

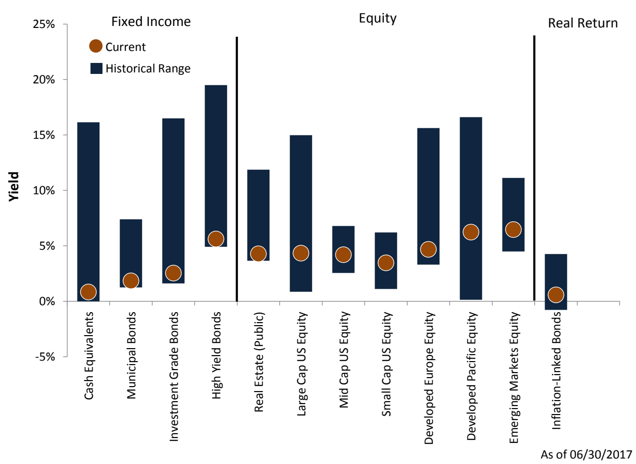
Our proprietary models forecast pre-tax returns ranging from 1% to 2% for fixed income-like asset classes and 4% to 10% for equity-like asset classes (see table to the right). Although our return expectations for bonds have modestly improved and expected returns for stocks have diminished, we continue to favor stocks over bonds. Our views are outlined in the following comments.

Expected Market Returns and Risks
7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility
Inflation	1.7%	1.7%	3.1%
Cash Equivalents	1.1%	0.6%	3.3%
Municipal Bonds	1.7%	1.7%	4.4%
Inflation-Linked Bonds	2.2%	1.2%	4.7%
Investment Grade Bonds	2.3%	1.2%	6.7%
High Yield Bonds	2.1%	0.8%	13.7%
Real Estate (Public)	4.3%	2.2%	18.3%
Broad Market US Equity	8.0%	6.2%	17.5%
Developed Non-US Equity	7.9%	6.0%	22.4%
Emerging Markets Equity	10.2%	6.5%	30.6%

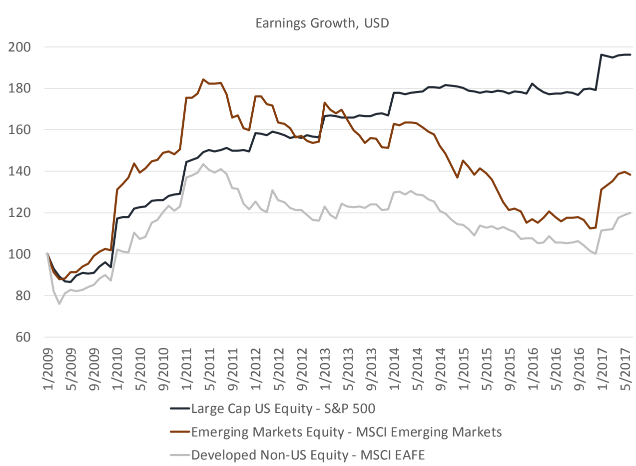
A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



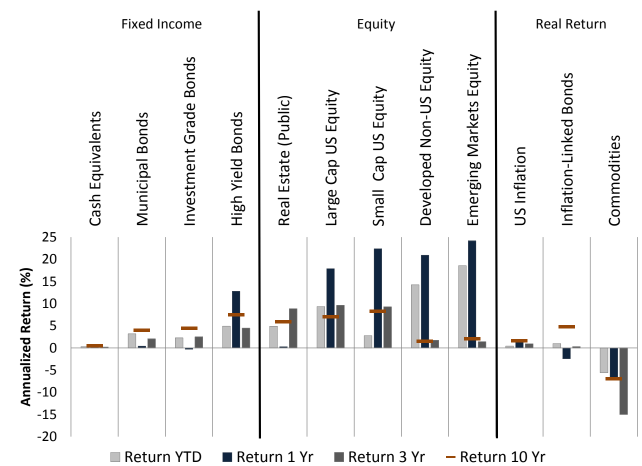
Yields are an indicator of future returns. Orange dots show current yields. Blue bars show historical ranges. Yields are generally low versus their historical range.

Global Earnings Growth



Corporate earnings growth has been stronger for U.S. companies than non-U.S. companies since the start of the recovery, but non-U.S. firms are gaining momentum.

Historical Market Returns



Historical market returns as of June 30th, 2017. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

Global Asset Class Returns

Asset Class Name	Last 10 Years	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Small Cap US Equity	Small Cap 7.5%	EM Eq 39.8%	Inv Grd Bnd 5.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%
High Yield Bonds	HY Bnd 6.0%	Commod 16.2%	CPI 0.1%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%
Large Cap US Equity	S&P 500 5.8%	Infl-Indx Bnd 11.6%	Infl-Indx Bnd -1.2%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%
Real Estate (Public)	Real Estate 4.0%	Intl Eq 11.2%	HY Bnd -26.2%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%
Investment Grade Bonds	Inv Grd Bnd 3.6%	Inv Grd Bnd 7.0%	Small Cap -31.1%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%
Inflation-Linked Bonds	Infl-Indx Bnd 3.6%	S&P 500 5.5%	Commod -35.6%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%
Emerging Markets Equity	EM Eq 1.7%	CPI 4.1%	S&P 500 -37.0%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%
Inflation	CPI 1.6%	HY Bnd 2.2%	Real Estate -39.2%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%
Developed Non-US Equity	Intl Eq 0.8%	Small Cap -0.3%	Intl Eq -43.4%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%
Commodities	Commod -4.7%	Real Estate -17.6%	EM Eq -53.2%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- GDP growth in major economies picked up by half of a percentage point to 3% in the second quarter.[4] As growth improved, inflation slowed to 1.8%.[5]
- After a below-trend first quarter, GDP in the U.S. is expected to rise to a 2.8% annual rate in the second quarter.[4]
- Europe continues to gain momentum, as GDP growth increased to 1.8% in the second quarter.[4] Europe, with its ample labor supply, has potential for increased growth as the headwinds of populist movements begin to fade.
- GDP growth in Japan picked up considerably to 1.6% in the quarter.[4] Japan continues to struggle with an aging workforce and restrictive immigration policies, limiting long-term growth potential.
- Emerging markets' GDP growth is expected to increase to 4.6%. Notable strength continues in India, where growth is forecast to reach nearly 7%. Weakness persists in Brazil, as it remains the only member of the group that is expected to contract in the quarter, albeit slightly.[4]
- The U.S. Federal Open Market Committee raised the Discount Rate by 0.25% to 1.75% at their June meeting, noting that they are closely monitoring inflation. The majority of economists expect the Committee to raise rates one more time this year by 0.25% at the FOMC's September meeting. The reduction of the Fed's balance sheet will also be an important factor to watch in coming months.
- Global manufacturing slowed slightly in the second quarter but remains very strong, with the Global Manufacturing Purchasing Managers Index (PMI) settling at 52.6. There was notable strength in the European Union where the index reached 59.6. Readings above 50 indicate expansion, while readings below 50 indicate contraction.[6]

Currencies

- The dollar continued to retreat in the second quarter, now down 6.4% for the year after 3.6% appreciation in 2016.[7] Despite recent weakness, the Dollar remains overvalued versus other major currencies on a Purchasing Power Parity basis.

Equities

- Emerging market equities continued their robust performance in the second quarter, moving up 6.4%.[8]
- Returns within the U.S. stock market varied. The Nasdaq, dominated by technology companies, continued to rally, up 4.2%.[9] Small cap stocks underperformed the broad market, up 1.7% for the quarter.[10] After a strong year for large cap value stocks in 2016, growth stocks outperformed by nearly 3% during the quarter, mostly driven by strength in the technology sector.[11]

Fixed Income

- The U.S. fixed income market experienced a flattening of the yield curve in the second quarter, as short-term yields rose and medium to long-term yields fell, slightly.
- High yield bonds continue to outperform the broad U.S. fixed income market, up 2.1% in the second quarter.[12]

Current Positioning

- We invest in **lower priced, value-oriented equities, both in the U.S. and abroad** which tend to outperform the broad market over time.
- We maintain our recent shift to marginally **underweight large cap U.S. equity.** After years of holding an overweight position in an outperforming market, valuations have risen to above average levels and our models indicate that a reduced allocation to the U.S. market is prudent.
- We also maintain our recent shift to **overweight developed non-U.S. and emerging market equities**, where valuations and long-term growth potential remain attractive.
- We remain **overweight municipal bonds** for taxable investors.
- Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting hit to bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries** and investing in **corporate bonds, high yield bonds and floating rate bonds**.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses time-tested return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in order to craft your customized solution.

As always, we thank you for placing our trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA   Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: MSCI Europe, Australia, Far East Total Return Index (local and USD), S&P 500.
(2) Bloomberg: Dollar Index. 3/31/17-6/30/17.
(3) J.P. Morgan Asset Management *Guide to the Markets* June 30, 2017.
(4) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated in to USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/17.
(5) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 6/30/17.
(6) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing. As of 6/30/17.
(7) Bloomberg: Dollar Index.12/31/15-12/31/16, 12/31/16-6/30/17.
(8) Bloomberg: MSCI Emerging Markets Total Return Index.
(9) Bloomberg: Nasdaq Composite.
(10) Bloomberg: S&P SmallCap 600.
(11) Bloomberg: S&P 500 Growth versus S&P 500 Value (4.42% versus 1.51%). 3/31/17-6/30/17.
(12) Bloomberg: Bank of America Merrill Lynch US High Yield Index.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/17.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 6/30/17.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Global Earnings Growth: As of 6/30/17.
Sources: Bloomberg
Indices: S&P 500, MSCI Europe, MSCI Pacific and MSCI Emerging Markets forward 12-month estimated earnings growth in U.S. Dollars. Indexed to 100 on January 30th, 2009.

Historical Market Returns: As of 6/30/17.
Source: Bloomberg, Stembrook Research.
Indices: BofA Merrill Lynch 0 to 3 Month US Treasury Bill Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Consumer Price Index – US, S&P 10 Year US TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/16.
Source: Bloomberg, Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index Barclays Capital Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.