# 2017 First Half Review & Outlook

## Market Review

> *The markets moved more slowly prior to this century – the ebbs and flows, the decision-making and the conveyance of information. With the advance of electronics and the internet, the speed of dissemination of news accelerated.*
> – Robert L. Rodriguez, award-winning former portfolio manager/managing partner at FPA

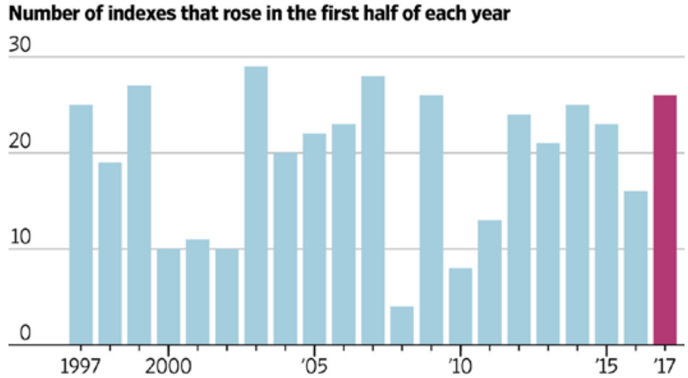
*Equities*

Global stock markets collectively had their best opening half in years. All but four of the 30 major indexes representing the world's biggest stock markets rose—a first six-month performance unmatched since 2009 according to The Wall Street Journal. In the U.S., the Dow Jones Industrial Average and S&P 500 Index each rose 8%, despite President Donald Trump's challenges with the media and advancing his political agenda. Investors attribute the broad breadth of the rally to strengthening corporate earnings, improving global economies and continued support from foreign central banks.

High stock valuations and tranquil trading this year have prompted concerns that investor complacency is setting in. Federal Reserve Chairwoman Janet Yellen warned that asset valuations were "somewhat rich." The S&P 500 Index trades above 18 times projected earnings over the next 12 months, around its highest level in 13 years. Still, this is well below the 26 times forward multiple reached at the dot-com bubble's peak in 2000, according to FactSet.

**Positive Territory**

Twenty-six of the world's top 30 stock-market indexes have risen this year, a first-half performance unmatched since 2009.




Source: FactSet

THE WALL STREET JOURNAL.

*Fixed Income*

U.S. government bond yields amazed many fixed income investors in the year's first half by falling (and prices rising). Expectations were for inflation to flare up causing the Federal Reserve to hike lending rates and Treasury yields following it. What's surprising is that yields have declined despite the Fed raising interest rates twice this year, and signaling the possibility of another increase in the second half of 2017.

Just as unexpected is that inflation rose only 1.4% near quarter end from the prior year, under the Fed's 2% target threshold for raising rates. At the start of the year many investors anticipated inflation would surge as lawmakers cut taxes and unleashed a flood of fiscal spending under the new administration's stated stimulus policy goals. Optimism that President Trump would usher in a new era of economic growth driven by fiscal (government) stimulus rather than monetary (Federal Reserve) policy stimulus has dissipated in the near-term as Washington once again faces infighting and gridlock. That pessimism was punctuated on May 17th by the 10-year Treasury yield's largest one-day decline (and price increase) in nearly a year after reports—disputed by the White House—that President Trump may have interfered with an FBI investigation.

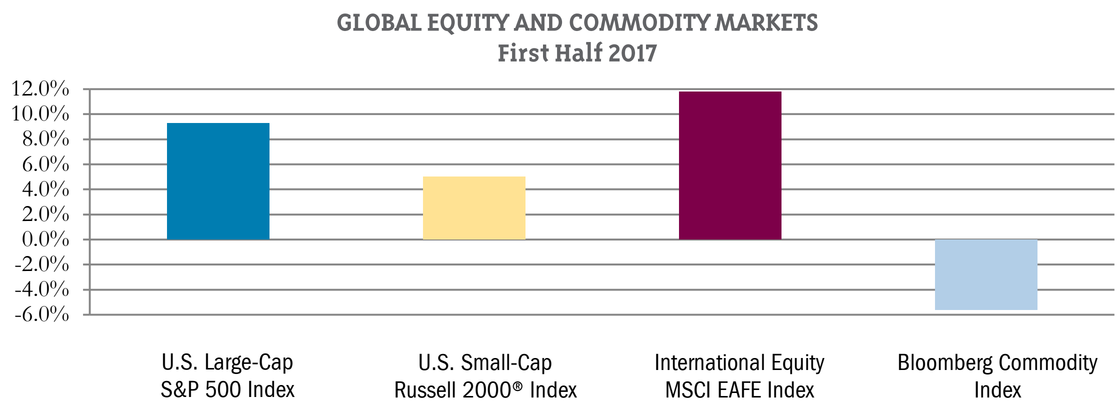
*Global Market Performance*

The broad stock S&P 500 Index advanced by 3.1% for the second quarter and 9.3% for the first half of the year (dividends reinvested). The Russell 2000 Index of small-company stocks gained 5% for the mid-year, underperforming large company stocks after outperforming in 2016. The tech-heavy Nasdaq Composite jumped 17.4% as of June 30, by far the top performer of major U.S. sectors this year. Along with technology, the best performing sectors for the first half of 2017 were consumer discretionary and health care. The worst performing sectors were telecom, energy and commercial real estate.

Developed international stocks gained 11.8% in the first six months of 2017 as measured by the MSCI EAFE Index (in U.S.-dollars), outperforming U.S. stocks as signs of steady economic growth and political stability continued to be evident. Europe in particular has been the beneficiary of surprisingly stronger-than-expected economic conditions. A Eurozone business and consumer sentiment survey released at quarter end jumped to its highest level since before the financial crisis. Strong returns were also buoyed by international equity funds posting seven consecutive months of at least $10 billion in investor fund inflows.

The MSCI Emerging Markets (EM) stock index soared 18.4% so far in 2017 to a two-year high, led by rallies in South Korea, India and China's Hong Kong market. After shunning developing countries for years, investors have once again piled into EM equities, drawn by an improving global economic outlook and favorable (discounted) stock valuations versus developed markets. A weaker dollar has also helped EM local currency prices as well.

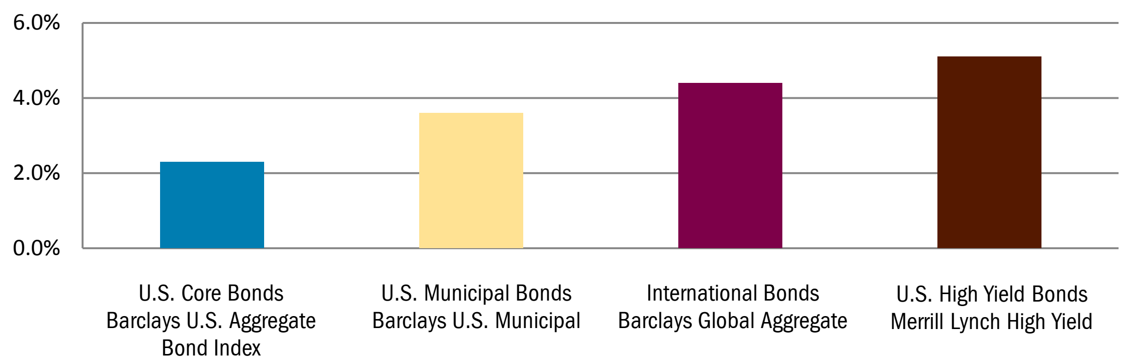
Natural resources and other commodities fell 5.6% for the first half as measured by the Bloomberg Commodity Index. The index measures the collective returns of a basket of 23 commodity futures contracts representing the energy, precious metals, industrial metals, grains and livestock industries. Weakness in the energy sector and some agricultural products led the downturn. Precious metals lost ground in the second quarter, but they have gained in price so far in 2017, helping stem losses in the commodity index. A weak dollar was also an aid to values as many commodities are produced internationally and are typically priced in U.S. dollars.




As mentioned, many fixed income investors were surprised that Treasury yields declined (and prices rose) in the first half of the year amid beginning-year worries of inflation and the Federal Reserve raising rates. The yield on the benchmark 10-year Treasury note settled at 2.30% by mid-year, down from 2.45% at the end of last year and well below its recent peak of 2.61% set in March.

The Barclays U.S. Aggregate Bond Index of high-quality government, mortgages and corporate bonds ended up 2.3% during the first half of 2017. Despite concerns over the stalled Trump administration's economic growth agenda and lower-than-expected GDP (gross domestic product) growth, non-investment grade (junk bonds) still rose 5.1%, as measured by the Bank of America/Merrill Lynch High Yield Master Index. State government municipal bonds gained 3.6% for the past six months as measured by the Barclays Capital Municipal Bond Index. Tax-conscious investors have snapped up nearly $88 billion in new tax-free dividend public bonds this year, up 8% from the same period last year according to Thomson Reuters. That happened as annual borrowing by local governments rose to a seven-year high. The Barclays Capital Global Bond Index was up 4.4% ended June 30, due mainly to stabilized emerging market growth and favorable local currency values versus a weakened U.S. dollar.

**FIXED INCOME MARKETS**
**First Half 2017**




## Portfolio Review

SFC TIS portfolios overall registered positive returns for the first half of 2017. Our model portfolios somewhat underperformed the benchmark indexes by being conservatively positioned and underweight equities in the midst of a rapidly rising stock market. We do not expect to outperform the benchmarks in times when the stock market is "running hot," as it has since the election of Donald Trump. We do anticipate, nevertheless, that our model portfolios to perform well in more unstable times. For example, during the near year-and-a-half period from May 19, 2015 to November 3, 2016, when the Dow Jones Industrial Average fell 2% amid this current eight-year market advance. And in the second half of the year we expect a more volatile stock market than the first half. History indicates that there's likely to be a pullback in the stock market of over five percent in any given calendar year (see the chart below), which has not happened yet in 2017. When the market declines, we anticipate using our excess portfolio cash to invest mainly in beaten-down stock holdings.

**S&P 500: Max Intra-Year Drawdowns (1928 - 2017)**

| Year | Return | Year | Return | Year | Return | Year | Return | Year | Return |
|---|---|---|---|---|---|---|---|---|---|
| 1928 | -10.3% | 1946 | -26.6% | 1964 | -3.5% | 1982 | -16.6% | 2000 | -17.2% |
| 1929 | -44.6% | 1947 | -14.7% | 1965 | -9.6% | 1983 | -6.9% | 2001 | -29.7% |
| 1930 | -44.3% | 1948 | -13.5% | 1966 | -22.2% | 1984 | -12.7% | 2002 | -33.8% |
| 1931 | -57.5% | 1949 | -13.2% | 1967 | -6.6% | 1985 | -7.7% | 2003 | -14.1% |
| 1932 | -51.0% | 1950 | -14.0% | 1968 | -9.3% | 1986 | -9.4% | 2004 | -8.2% |
| 1933 | -29.4% | 1951 | -8.1% | 1969 | -16.0% | 1987 | -33.5% | 2005 | -7.2% |
| 1934 | -29.3% | 1952 | -6.8% | 1970 | -25.9% | 1988 | -7.6% | 2006 | -7.7% |
| 1935 | -15.9% | 1953 | -14.8% | 1971 | -13.9% | 1989 | -7.6% | 2007 | -10.1% |
| 1936 | -12.8% | 1954 | -4.4% | 1972 | -5.1% | 1990 | -19.9% | 2008 | -48.8% |
| 1937 | -45.5% | 1955 | -10.6% | 1973 | -23.4% | 1991 | -5.7% | 2009 | -27.6% |
| 1938 | -28.9% | 1956 | -10.8% | 1974 | -37.6% | 1992 | -6.2% | 2010 | -16.0% |
| 1939 | -21.2% | 1957 | -20.7% | 1975 | -14.1% | 1993 | -5.0% | 2011 | -19.4% |
| 1940 | -29.6% | 1958 | -4.4% | 1976 | -8.4% | 1994 | -8.9% | 2012 | -9.9% |
| 1941 | -22.9% | 1959 | -9.2% | 1977 | -15.6% | 1995 | -2.5% | 2013 | -5.8% |
| 1942 | -17.8% | 1960 | -13.4% | 1978 | -13.6% | 1996 | -7.6% | 2014 | -7.4% |
| 1943 | -13.1% | 1961 | -4.4% | 1979 | -10.2% | 1997 | -10.8% | 2015 | -12.4% |
| 1944 | -6.9% | 1962 | -26.9% | 1980 | -17.1% | 1998 | -19.3% | 2016 | -10.5% |
| 1945 | -6.9% | 1963 | -6.5% | 1981 | -18.4% | 1999 | -12.1% | 2017 | -2.8% |

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## Market Outlook

So now the question investors are asking is can the global stock market continue its advance in the second half of the year? History shows in the past 20 years, only four first-half rallies have been better than the current global equity surge. Two of them preceded sharp market crashes, while two others came at the beginning of multi-year bull markets. So, in essence, no one knows for sure … or even if so, if it's a positive sign of market events in the distant future. So let's look at indicators we follow for hopefully some enlightenment.

> *Central banks have created huge distortions in the markets, which are going to be difficult to unwind.*
> –Colin Graham, Chief Investment Officer of Multi-Asset Solutions, BNP Paribas Asset Management.

As far as global monetary policy, the calm has been broken as of late. The first half of 2017 ended with big moves in global bond yields and currency exchange rates, sparked by a belated realization by investors that central banks are easing off the stimulus accelerator of extraordinary low lending rates and unprecedented bond-buying programs. Tightening comments recently from central bankers (most notably European Central Bank President Mario Draghi), have now challenged the favorable conditions that have lifted bonds and stocks together this year, and kept instability low. The assumption by analysts that inflation was trending too high for central banks to raise lending rates is seriously in question given recent contrary data. If central bankers are right, and economic growth is solid while inflation is being held in check, then bond holders may suffer. Stocks in theory should do better in this scenario, but to the extent equity valuations have been inflated by historically low interest rates, then there is arguably a headwind toward much higher stock prices for the year.

On the geopolitical front, President Donald Trump has faced challenges in implementing his economic stimulus agenda. So far Mr. Trump, with a Republican-dominated Congress, haven't enacted major changes to fiscal policy or taken significant trade protectionist measures as promised. In France, pro-Europe Emmanuel Macron romped to election victory, allaying fears about the rise of anti-European Union sentiment thus slowing regional economic growth. And despite military tensions around the world, stock markets have been stable and rising. Measures of volatility (the VIX) during the first half were at or near multi-year lows, not only in the U.S. but also in Europe and Asia. Analysts expect more instability (a higher VIX) at some point in the future but, of course, don't know the cause or when it will occur.

On the economic front, gross domestic product (GDP, or the measure of value of U.S. goods and services produced) has exhibited signs of expected future improvement over the past trending sub-2% GDP growth. This potentially positive development remains uncertain, especially after a somewhat disappointing first quarter but an expected better Q2. So the jury is still out.

Now let's review perhaps the most important indicator we follow—corporate earnings—as company profits drive stock prices in the medium to long term. Consensus expectations are for 7% S&P 500 Index operating earnings per share (EPS) in the second quarter versus the remarkable 14% rise in Q1. If so, this would mark the fourth consecutive quarterly EPS gain. And although year-over-year comparisons will be more difficult than Q1, EPS growth in the high single digits will potentially be necessary for stocks to break out of its current stalled trading range. Over the past five years, companies have been beating expectations by roughly 3.5%. If that trends holds, EPS gains could come in near 10% for Q2, which could continue the market's trajectory through the third quarter. Thus far, with admittedly just a few companies having reported, a majority have beaten expectations. This is a positive trend.

> *Strategies involving risk reduction should ultimately outperform "faux" surefire winners generated by central bank printing of money. It's the real economy that counts and global real economic growth is and should continue to be below par.*
> —Bill Gross, Janus Capital Group portfolio manager; legendary bond investor

Given our somewhat mixed view on stocks and concerns about bonds as of late, other or "alternative" investment strategies are a higher portion of clients' portfolios than in prior years. Such alternative investments include long/short equity (investments that can bet for and against individual stocks), hedged equity (protecting some of the downside risk of stocks), equity options writing (selling stock puts and calls), multi-strategy stock and bond funds, natural resources, etc.

Historically, equity alternative strategies have had similar returns to stocks in periods of lower-than-historical returns, with less than half the volatility (or "downside" risk). During periods when equity market returns registered in single-digit or negative territory, these strategies outperformed the S&P 500 Index on a risk-adjusted basis. For bonds, other investments include alternatives to tradition investment-grade government/corporate bonds that, for example, can increase in value during a rising interest rate cycle (as we have now) when traditional bonds lose value. So in light of high equity valuations and the potential for lower returns, along with rising interest rates and possible declining bond prices, we believe we are in a favorable environment for these alternative strategies in clients' accounts.

Although we expect a bear market to happen at some point in the future (though we're not predicting it will happen soon), it's important to recognize we are not "market timers" (trying to time when to get in and out of stocks). Corrections come and go. But market timers get burned time after time as they have to make two correction decisions: exactly when to get out of stocks and when to get back in. An impossible task! As we stated, when another market correction hits, alternative investments should help cushion account losses. And we then plan to use excess account cash to buy more stock investments at lower prices to potentially profit client accounts when the market inevitably rises again.

We appreciate your continued confidence in our services. Your inquiries are welcomed.

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**Sources**: 361 Capital, *Weekly Briefing*, July 3, 2017; *Advisor Perspectives*, Bob Rodriguez – We are Witnessing the Development of a "Perfect Storm", June 27, 2017; First Trust, *Monday Morning Outlook*, July 3, 2017; Marketfield Asset Management, *The Weekly Speculator* (multiple publications); Janus Capital Group, *Investment Outlook by Bill Gross*, June 2017; JP Morgan Asset Management; *Investment Insights*, Q2 2017; State Street Global Advisors SPDR ETFs Chart Pack, June 2017; USA Today (multiple publications); The Wall Street Journal (multiple publications).

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