The Ten Themes of 2Q 2017

Global stocks posted another solid quarter of gains from April 1 to June 30. In the U.S., small cap stocks rose +2.12%[i] and large cap stocks rose +2.57%[ii]. While these gains were good, foreign markets faired even better with Developed International Markets up +4.67%[iii], and Emerging Markets up +5.08%[iv]. Strong corporate earnings, easy global monetary policies, and the hope of fiscal stimulus continue to be some of the major reasons why stock prices climb to record levels.

While stock markets remain hopeful, bond and commodity markets are being much more cautious. The yield on a 10-year U.S. treasury has dropped from 2.45%[v], to 2.31% during the first 6 months of the year despite the Fed hiking short term interest rates twice. A consensus view to begin the year was that Fed rate hikes would lead to a Great Rotation out of bonds into stocks as investors would sell out of bonds following price drops (due to rising interest rates) and invest that money into stocks. Stocks have held up their end of the bargain; however, bonds have not, as global investors remain reluctant to get rid of them.

There are many reasons why investors have not been willing to sell their bond holdings. One reason demand for U.S. bonds remains high is their relative attractiveness when compared to other countries. The U.S. is widely recognized as a “safer” investment for global bond investors due to a low perceived risk of default. Yet, currently, other weaker countries have lower bond yields, which makes little sense. Global bond yields have remained low because international central banks have been purchasing their own bonds to pump liquidity into their economies and keep interest rates accommodative. These lower global bond yields, ultimately, impact U.S. bond yields.

While hope remains high on the new administration’s pro-business agenda, much that has been promised is yet to be implemented. We reiterate that hope is not a sound investment strategy, and, while we are pleased that stock market gains have boosted portfolio returns this year, our internal research continues to indicate now is not the time to be greedy. S&P 500 earnings growth expectations are coming down, not going up. With stock prices rising again in the second quarter, as overall 2017 S&P 500 EPS estimates went lower, investors are now paying even more for less. Therefore, we maintain that the most prudent strategy is to be slightly cautious in the current market environment. Stay tuned throughout the second half of the year as we objectively measure and analyze the data for any changes that could alter our opinion. In the meantime, **here are the ten themes** that we believe **were most relevant for financial markets over the past three months.**

1. Global stock rally
2. Accelerating growth
3. Fed hiked rates
4. Flattening yield curve
5. Slumping commodity prices
6. Still waiting on fiscal stimulus
7. Global central bank monetary stimulus
8. Corporate earnings expectations
9. Paying even more for less
10. Global stock market performance

Based on our interpretation of the data described in this quarter’s newsletter, the SIA Investment Committee has maintained its cautious 5% underweight to equities. Target allocation changes were made following our June Investment Committee meeting to allocate excess cash generated from previous underweighting changes into an ultra-short duration bond fund to seek additional interest income. Additional, minor adjustments were made to equity allocations to further reduce US stock exposure and increase Developed International and Emerging Markets exposure.

Depending on the design of your specific portfolio, these adjustments may or may not have impacted your overall allocation. Please contact us if you would like to learn more about the factors influencing these decisions and how they may be implemented in your portfolio.

Global stock rally

During the 2Q 2017 period, stocks continued to climb higher in the United States, and even more so across the world. In the U.S., the most widely used stock benchmark for large corporations, the S&P 500 index, added another +2.57% during the quarter taking its year-to-date (YTD) gain to +8.24% by June 30, 2017.

Shares of smaller U.S. companies are also up, but not quite as much as large caps. The Russell 2000 index, the most widely used proxy for small U.S. corporations, gained +2.12% during the 2Q 2017 period bringing its YTD gain to +4.29%, or about 3.95% less than the S&P 500.

In our opinion, the new administration's plans to reduce regulations, lower corporate taxes and increase infrastructure spending are helping to fuel the stock rally. However, the fact that global central banks, such as the European Central Bank and the Bank of Japan, continue to pump record amounts of liquidity into their economies is an even stronger argument as to why stocks of foreign countries are off to such a great start.

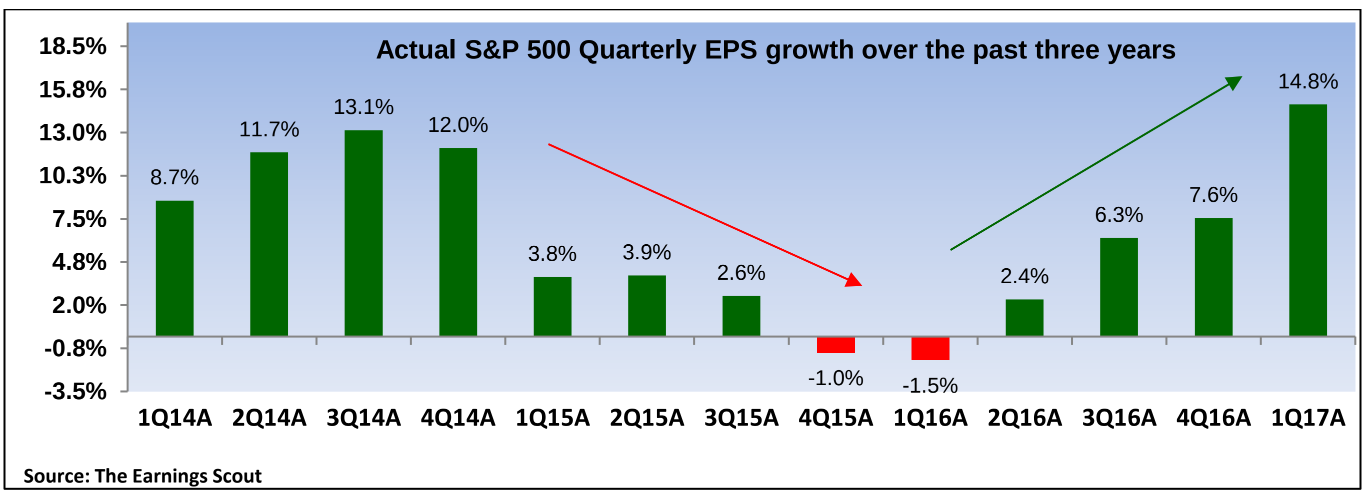
Don't believe us? Check out how financial markets are voting. You will see lagging U.S. stock returns compared to the MSCI Emerging Markets index, which collectively is made of countries such as Brazil, China, India and Turkey, and the MSCI Developed International index, which is mostly Europe and Japan.

Name	Index	2Q 2017 Return	2017 YTD Return
Emerging Markets	MSCI EM	5.08%	18.22%
Developed International	MSCI EAFE	4.67%	12.94%
Large Cap U.S.	S&P 500	2.57%	8.24%
Small Cap U.S.	Russell 2000	2.12%	4.29%

Source: Bloomberg

Accelerating growth

In mid-to-late April 2017, corporations released their finanical results for the first three months of the year. Like Tony the Tiger, they were not just good, they were g-r-r-reat! In fact, they were the best we've measured in over five years. In total, 75% of the companies in the S&P 500 exceeded their Wall Street 1Q 2017 earnings estimates on average growth of +14.8% from last year's 1Q 2016 period. Further, 66% of those companies topped their sales goals on +7.2% growth. Since the new administration had very little time for its plans to impact economic results during the first three months of the year, we believe the easy monetary policies of central banks across the world, in addition to very easy comparisons from a year ago, were the major reasons why growth accelerated more into 1Q 2017.

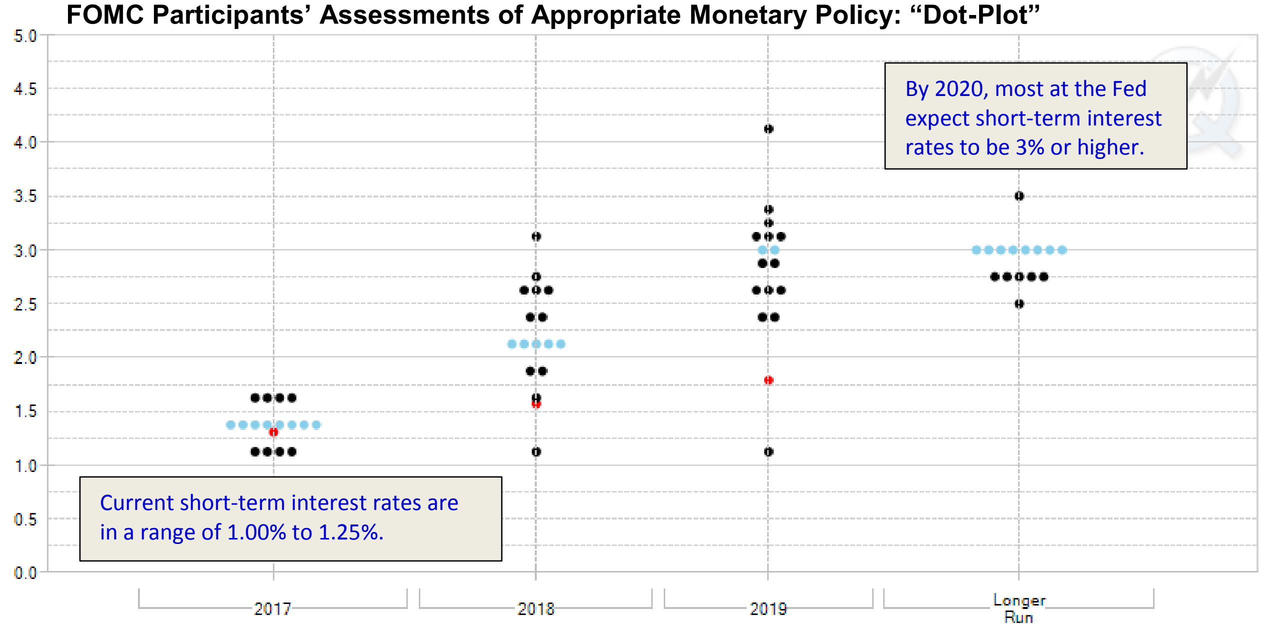


Fed hiked rates

With S&P 500 earnings growth accelerating into 1Q 2017, global central banks stimulating, stocks rallying and Wall Street sentiment on Trump still bullish, the Fed decided to raise interest rates, again, in June by +0.25%. The Fed has now raised rates three times in the last seven months. Normally, this would contribute to the value of the U.S. dollar strengthening, however, the dollar weakened further during the 2Q 2017 period. Another development that runs contrary to normal expectations is that long-term interest rates are not rising with short-term rates. If these trends persist, the Fed's "dot plot" below (the dot plot is where members of the Fed "guess" where they think interest rates will be in the future) may not play out as expected.

U.S. Dollar Index – DXY

FOMC Participants' Assessments of Appropriate Monetary Policy: "Dot-Plot"



Blue dots indicate the median projection. Data is based on the economic projections published on June 14, 2017.
Red dots indicate the effective rate implied by the year-end FedFund future price.

Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

Flattening Yield Curve

The U.S. yield curve (the spread between the interest rate on a 2-year note and a 10-year U.S. treasury bond) fell during the 2Q 2017 period by 20 basis points (or 0.20%) to 0.93%. What does this mean?

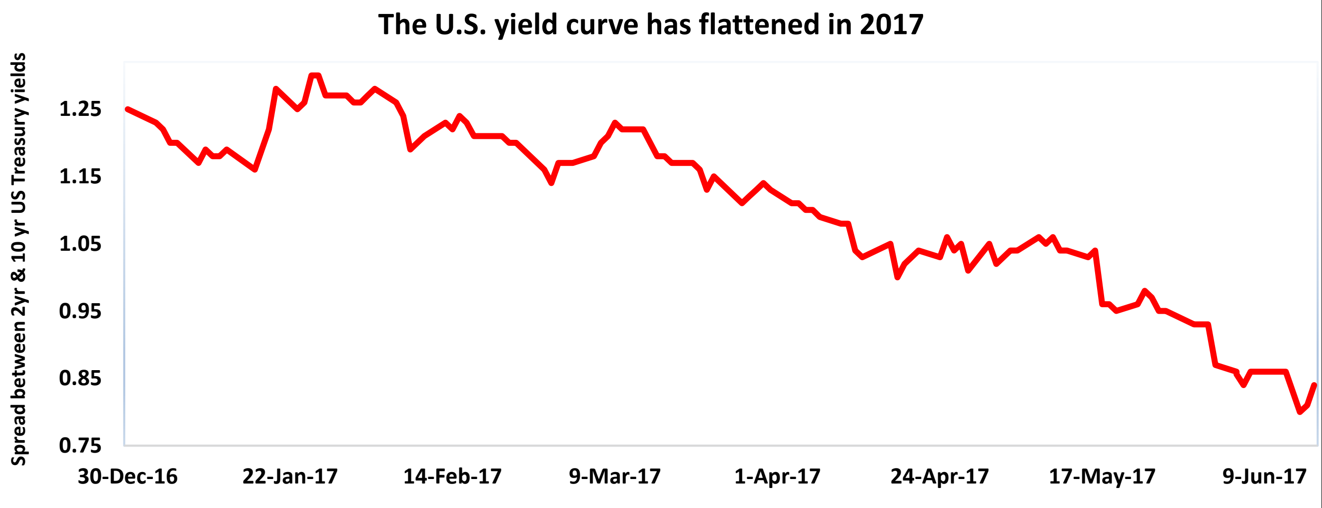
When the spread narrows between the rates on 2- and 10-year notes, it usually indicates less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice: once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

With the rate on a 2-year note at 1.38% on June 30, 2017, and the 10-year bond at 2.31%, the curve is far from inverted; however, the narrowing of the spread between the "2's and 10's" has the bond market signaling "caution" as the difference narrowed 20 basis points this quarter and 32 basis points YTD.

Check out how interest rates moved during the second quarter and YTD below. Notice how the yield has narrowed based on the spread between 2- and 10-year yields, compressing throughout the year. The real question is, why is the bond market cautious while the stock market is at, or near, all-time highs?

Date	2-yr U.S. Treasury yield	10-yr U.S. Treasury yield	Spread between 10-yr and 2-yr yield (yield curve)
December 30, 2016	1.20%	2.45%	1.25%
March 31, 2017	1.27%	2.40%	1.13%
June 30, 2017	1.38%	2.31%	0.93%

Source: U.S. Department of Treasury



Source: U.S. Treasury Department, The Earnings Scout

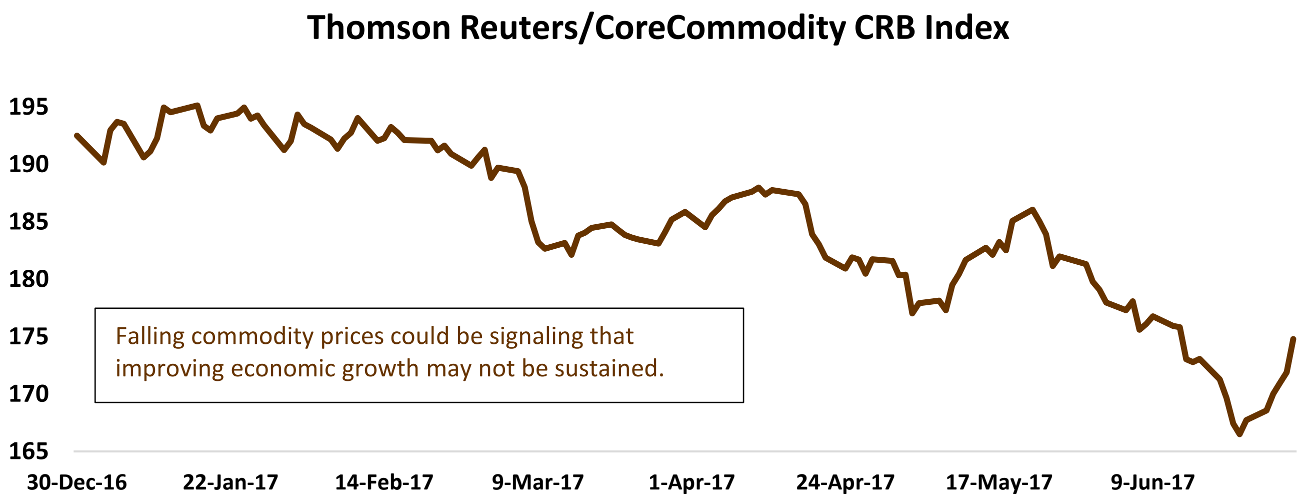
The implication: If long-term U.S. interest rates do not start rising, it may make the Fed's future plans of gradually raising short-term interest rates that much more of a challenge. It may, also, hurt banks which depend upon a widening yield curve to become more profitable when making loans.

It should be noted that, towards the end of the 2Q 2017 period, the yield curve did begin to widen as several S&P 500 companies reported very solid quarterly earnings results for their quarters ending in May.

Slumping commodity prices

In addition to the U.S. bond market signaling caution, commodity markets seem to be doing the same. Check out below how the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities, from crude oil to orange juice, declined in value over the past three months and YTD.

It should be noted that falling commodity prices are usually a sign of slowing economic activity. This is, yet, another conundrum we have observed in global financial markets this year. Stocks are suggesting full steam ahead, while the bond and commodity markets are indicating a much murkier outlook. Something has to give.



Source: Thomson Reuters

Still waiting on fiscal stimulus

Ever since Donald Trump was elected as President, the stock market has been expecting his pro-business agenda of lower taxes, less regulation and increased infrastructure spending to boost corporate profits and lift the economy. This is one of the key drivers for stock prices reaching near all-time highs. In our opinion, this is the year that the baton was to be passed from the Fed, with its easy prior U.S. monetary policy of near-zero interest rates, to the new administration's easy fiscal policy initiatives. By raising interest rates three times over the past seven months, Janet Yellen, head of the Fed, is handing over the baton to Donald Trump, but he has not yet taken it.

Related to the economy, the new administration has: taken steps to withdraw from the Trans-Pacific Partnership, informed NAFTA partners that the United States intends to renegotiate a better deal for its workers, issued a hiring freeze on all federal workers, requested that for every new Federal regulation two must be eliminated, and asked Trans-Canada to renew its permit application for the Keystone Pipeline. Aside from these changes, the rest of Trump's previously stated agenda has not yet been implemented. Additionally, some of the issues remaining may take much longer than anticipated to take effect, including the most impactful ones for the economy, such as Health Care and Tax reform and infrastructure spending.

Global central bank monetary stimulus

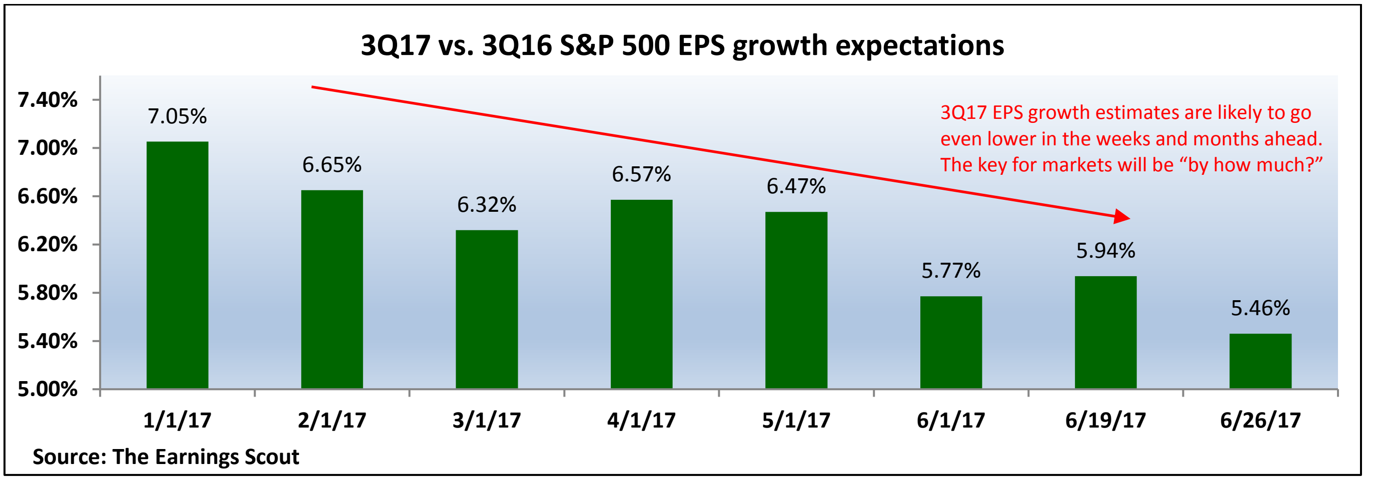
While we are still waiting on expected fiscal stimulus and the Fed is raising interest rates, outside of the U.S., central banks are pumping record levels of liquidity into their economies via QE (Quantitative Easing) bond purchases. To us, this is the biggest reason global stock prices are rising to record highs. This belief is further supported by the fact that international stock markets are, collectively, having a better year than U.S. markets.

Is it ending? Towards the end of the 2Q 2017, Mario Draghi, the head of the European Central Bank (ECB) gave a speech in Portugal where he discussed many positive economic indicators, new jobs being created and 16 quarters of growth. During the speech, many began to interpret his statements to indicate that the ECB would be scaling back on its bond purchases, which stimulate the European economy. Draghi later had to tell markets there were actually no immediate plans to stop.

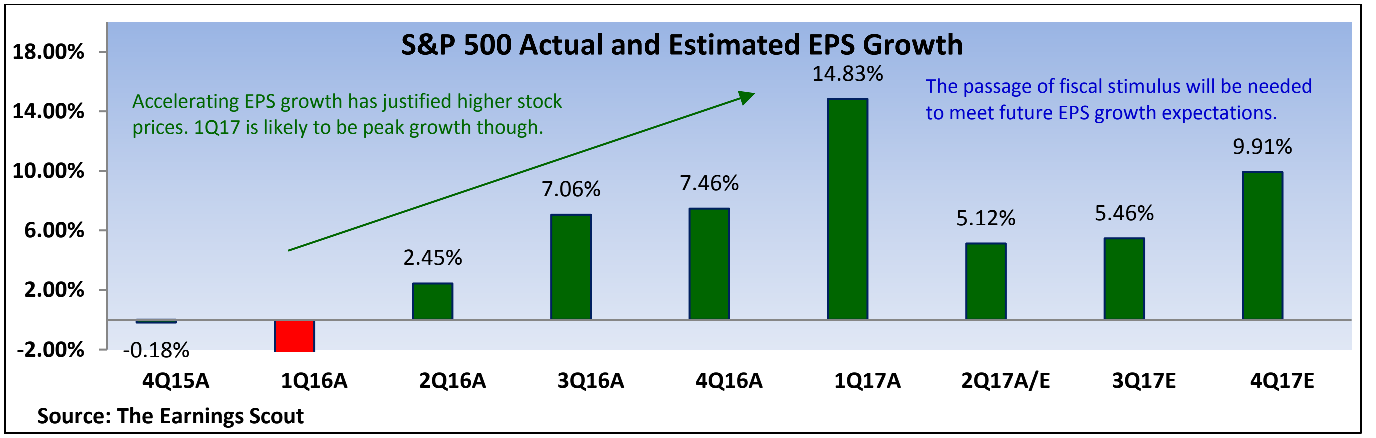
One of the most noteworthy observations of this year's global stock market rally has been just how calmly markets have risen. While we do not anticipate global central banks to take the punch bowl away anytime soon, in the event they shock markets and do, it would likely lead to a sharp rise in overall market volatility. In fact, ever since the speech made by Draghi in Portugal, global bonds have been selling off sending their yields higher.

Corporate earnings expectations

Throughout the 2Q 2017 period, expected corporate earnings have been going lower mostly because fiscal stimulus initiatives keep getting pushed out further into the future. While it sounds bad that earnings expectations are going lower, this is a fairly routine game that is played by Wall Street analysts, who make the estimates, and corporations, who provide guidance to the analysts. The good news on the earnings front is that the rate at which overall corporate earnings expectations are currently being cut is less severe than in prior periods. The bad news is that the EPS estimates are still going lower as stock prices are rising, making stocks more and more expensive.



Source: The Earnings Scout



Source: The Earnings Scout

Paying even more for less

As stock prices have risen on the mounting hope(s) the economy picks up more steam, the hard economic data (i.e. real EPS estimate revision data) is not showing as much improvement in macroeconomic expectations. This has caused P/E multiples on the market to rise. The P/E multiple is a valuation metric that represents just how much you pay for every dollar of expected earnings.

One year ago, you had to pay a multiple of 16.45x for every dollar of future earnings. Since price has risen as EPS estimates have fallen, today you have to pay 18.46x. As such, stocks have become modestly expensive as investors have to pay a little more for a little less in 2017.

Date	*S&P 500P/E ratio based EPS Estimate over the next 12 months
6/30/2016	16.45x
1/1/2017	16.86x
3/31/2017	18.09x
6/30/2017	18.46x

As a rule of thumb, the higher the P/E ratio, the more expensive the overall stock market. The long-term historical P/E ratio for the S&P 500 (i.e. the market) is

Source: The Earnings Scout

Global stock market performance

Country	Stock Index	2Q 2017 Return	2017 YTD Return	Post U.S. election
Greece	ASE	23.67%	27.98%	41.49%
Turkey	BIST 30	13.11%	29.12%	32.08%
South Korea	KOSPI	10.72%	18.03%	19.39%
Vietnam	Ho Chi Minh	7.50%	16.79%	14.78%
Philippines	PSEi	7.27%	14.66%	7.33%
Hong Kong	Hang Seng	6.86%	17.11%	12.46%
Taiwan	TSE	5.95%	12.34%	12.78%
Japan	Nikkei 225	5.95%	4.81%	16.67%
Indonesia	JSE Composite	4.70%	10.06%	6.56%
India	SENSEX	4.39%	16.13%	12.07%
Portugal	PSI	2.90%	10.12%	12.95%
Mexico	Bolsa IPC	2.71%	9.23%	2.86%
U.S. Large Cap	S&P 500	2.57%	8.24%	13.27%
Ireland	ISE	2.54%	4.76%	12.17%
U.S. Small Cap	Russell 2000 Index	2.12%	4.29%	18.43%
Italy	MIB	0.45%	7.02%	22.40%
Germany	DAX	0.10%	7.35%	17.58%
Thailand	SET Index	-0.02%	2.06%	4.30%
France	CAC	-0.04%	5.31%	14.38%
U.K.	FTSE	-0.14%	2.38%	6.86%
Spain	IBEX	-0.18%	11.68%	16.87%
South Africa	FTSE/JSE All Share	-0.85%	1.89%	1.80%
China	Shanghai Composite	-0.93%	2.86%	1.41%
Canada	TSX Composite	-2.35%	-0.69%	3.58%
Brazil	Ibovespa	-3.21%	4.44%	-1.96%
Russia	MICEX	-5.83%	-15.82%	-4.49%

Source: Bloomberg

Conclusion

After a very strong first half of the year for stocks, our overall view on financial markets, as we enter the 3Q 2017 period, is relatively unchanged from the beginning of the year. During the last quarter, though, we did shift our views to become more optimistic on the prospects for international companies. We are concerned very low market volatility could soon come to an end when the positive effects from central bank policies start to fade or are completely removed.

The U.S. Fed has taken steps to do so with its three rate hikes over the past seven months. What happens if the ECB follows suit? At some point, the market will also need the new administration to push through lower taxes, less regulation and increased infrastructure spending. If those all get passed, stocks could easily see another leg up. Unfortunately, many of those policies may not impact corporate bottom lines for years to come.

We will not speculate and just hope everything all works out fine. To become more constructive on stocks, we need to measure significant improvement in expected macroeconomic data to justify a sustained stock rally. Our biggest concern with the post-Trump rally has been that Wall Street has had to justify current stock prices by discounting earnings three to five years into the future (i.e. when some of Trump's policies could kick in). In doing so, the market has become much more speculative in nature. For that reason, we are hoping for the best, but maintaining a slightly more cautious stance than we had one year ago.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Scott Hohman, CFP®, AIF®

Mark Klopfenstein, AIF®

Nick Raich, CFA®

Erin Zylka, MBA

---

[i] Small cap stocks are measured by the Russell 2000 Index
[ii] Large cap stocks are measured by the S&P 500 Index
[iii] Developed International Markets are measured by the iShares MSCI EAFE Index Fund
[iv] Emerging Markets are measured by the iShares MSCI Emerging Markets Index Fund
[v] Interest rate data related to U.S. Treasuries obtained from the U.S. Treasury Department