MARKET Insights

July 2017

Halftime Report

The rally that began last fall continued in the first half of 2017. All major asset classes posted gains, with US and international equity markets up significantly. The S&P 500 gained **+9.3%**, the MSCI EAFE index of developed international markets was up **+14.2%** in dollar terms, and the MSCI Emerging Markets index gained **+18.6%** also in dollars. This was the first time since 1997 that all three measures of the global stock markets gained more than **8.0%** together in the first half of the year.

In fixed income markets, both investment grade and high yield markets posted positive results, as the Barclays US Aggregate and High Yield indexes gained **+2.3%** and **+4.9%**, respectively. Even gold gained **+7.9%**, a notable return among the losses delivered by energy and agricultural commodities this year.

ASSET CLASS	YTD 2017
Equities	
US (S&P 500)	+9.3%
International (MSCI EAFE)	+14.2%
Emerging Markets (MSCI EM)	+18.6%
Fixed Income	
Investment Grade (Barclays Agg)	+2.3%
High Yield (Barclays High Yield)	+4.9%
Commodities	
Gold (NYMEX spot)	+7.9%

Source: FactSet Indexes, June 30,2017

Our Report Card: How we've done so far

At the beginning of the year we outlined three major themes that would drive our positioning for 2017:

Theme 1: *Maintain a pro-growth investment stance, favoring stocks over bonds*
Theme 2: *Shorten duration in bond portfolios, allocate away from government debt*
Theme 3: *Diversify global equities selectively, avoiding "anti-globalization" risk*

Theme 1 has worked to our clients' advantage, as the S&P 500 has gained **+9.3%** versus a return of **+2.3%** for the Barclays US Aggregate Bond index. Equities continue to advance due to rising corporate earnings, increasing optimism about the economy, and supportive interest rate policies by all three of the major central banks – the Federal Reserve, European Central Bank and Bank of Japan.

Several items have helped propel stock prices to new heights: revenue growth continues to be strong, US manufacturing activity has improved, interest rates have actually fallen this year, and major losses in the energy and commodities industries seem to have passed. As we have written recently, we expect a normal correction in stock prices in the near term (6-12 months).

Theme 2 has been a mixed bag this year. Interest rates have fallen, as the yield on the benchmark US ten-year Treasury note declined from **2.48%** to **2.27%**, so our overall call was incorrect. However, we believe the recent declines in fixed income yields have been more of a technical move from the oversold levels that bonds exhibited shortly after the US presidential election. Economic data has come in or been revised higher than expected this year; the US dollar has actually weakened and riskier assets like stocks have risen. Moves such as these indicate that investors are not in a flight-to-safety, "risk off" mode and that the meager gains in fixed income so far this year are a small consolation for the losses over the past year, as the benchmark US Treasury ten-year note has delivered a loss of **-5.6%** since June 30, 2016.

	YTD 2017	Last 12 months
Treasury 10 Year Note	+2.3%	-5.6%
Treasury 30 Year Bond	+6.0%	-8.7%
USD vs. major currencies	-6.4%	-0.4%

Source: FactSet Indexes, June 30,2017

Theme 3 has worked for the most part in the first half of 2017. We maintained neutral positioning in Emerging Markets Equities, with a tilt toward countries that are manufacturers or commodity-importers (East Asia, India) and away from countries that are commodity exporters (Russia, Latin America). We began the year with an underweight position in International Developed Equities, and patiently have been increasing exposure to a neutral position since the second quarter of this year as the global growth outlook has improved. Global company profits are rising at a healthy pace again, with the greatest improvement in Europe, even in former stragglers such as Italy and France. We also called for increasing allocations to US small cap stocks, expecting domestically oriented companies both to profit from economic strength and to remain insulated from potential anti-trade policy. This recommendation delivered positive results, with the small cap Russell 2000 index up **+5.0%** in the first half of the year, but trailed the overall large cap gain of **+9.3%** in the S&P 500 index.

Region/Country	Index	YTD 2017	Last 12 months
Emerging markets	**MSCI EM**	+18.6%	+24.2%
Asia ex Japan	MSCI Asia ex Japan	+22.9%	+27.1%
Russia	Russia RTS	-13.1%	+7.5%
Latin America	MSCI EM Latin America	-10.3%	+15.4%
International Developed	**MSCI EAFE**	+15.9%	+21.8%
Europe	STOXX Europe	+15.8%	+21.3%
UK	FTSE 100	+4.7%	+16.9%
Japan	Nikkei 225	+9.8%	+19.7%

Source: FactSet Indexes, June 30,2017
Returns in US dollars.

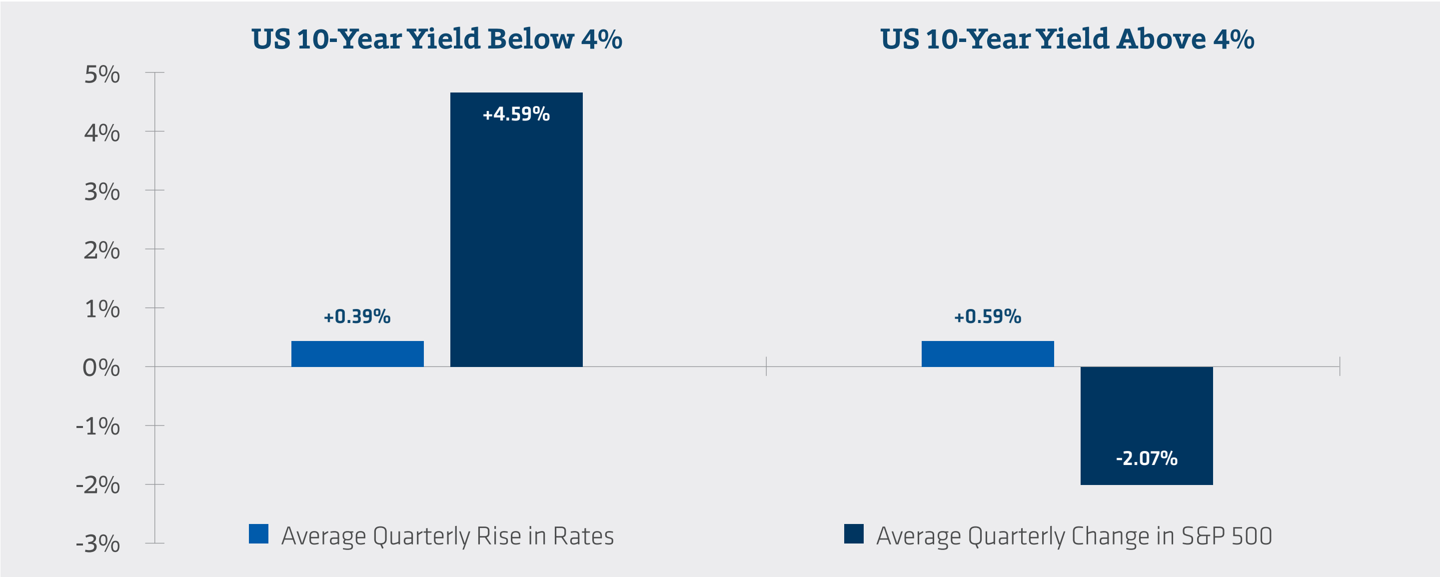
Outlook and Portfolio Positioning

We note concerns about the duration of the current bull market, especially in light of expectations for increasing interest rates this year. We would point out that the level of rates alone does not determine stock performance. Rather, interest rates reflect the underlying economic fundamentals, namely the nominal income growth of individual companies and households that make up the overall economy. If interest rates rise because real growth rises, it typically indicates improving growth prospects, which is good for corporate profits and stock prices. If interest rates rise because of price inflation, it can be a mixed bag because companies with higher variable costs will face shrinking profit margins. High interest rates result in higher corporate borrowing costs and a potentially stronger dollar that leads to lower exports and overseas profits for US companies.

During the past twenty years, stock prices actually have been positively correlated with increases in interest rates when the US ten-year Treasury yield has been below 4%. At higher levels of interest rates, stock market returns have been negatively correlated with increases in interest rates.

Current long-term interest rates are still relatively low and barely above the rate of annual price inflation. The yield on the ten-year Treasury note has remained in a tight range of 2.16% to 2.63%. At today's levels of interest rates, stocks still have some cushion before higher interest rates weigh on consumer spending, capital investment and corporate earnings.

As we wrote previously, we expect to see a correction in equity markets over the near team (within a year), and we intend to use any market weakness to rebalance client equity allocations. We continue to increase allocations to international equities, specifically in European markets. In fixed income allocations, we are targeting an overall maturity profile of five years or less. We continue to trim high yield exposure, as credit spreads have tightened, and have added to floating rate debt via funds that hold senior bank loans. Client allocations to alternative strategies are diversified across convertible arbitrage, equity buy-write and fixed income relative value strategies. We hold a small position in REITS and recommend no exposure to commodities currently.



Source: FactSet Indexes, data through June 29, 2017.

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Current Asset Allocation Recommendations

Asset Class	Sector or Geography	Recommended Positioning
Equities	US Large Cap	Overweight in financials, industrials, technology. Increasing healthcare.
Equities	US Large Cap	Underweight utilities, telecom, consumer staples and "low volatility" proxies.
Equities	International Developed	Neutral, adding exposure gradually to European markets.
Equities	Emerging Markets	Neutral, favoring Asia over LatAm, S Africa and Russia.
Fixed Income	Government Debt	Shorten duration, avoiding long maturities (10+ years).
Fixed Income	Municipal bonds	Attractive yields relative to comparable taxable credits.
Fixed Income	Bank Loans	Substitute traditional high yield bonds via floating-rate, senior secured loans.
Fixed Income	High-Yield	Reducing sizing on strength. Current relative yields less compelling.
Fixed Income	Inflation-Indexed	Moderate allocation to profit from potential increase in official inflation.
Fixed Income	Emerging Market Debt	Corporate US-dollar issuers based on attractive relative yields.
Alternatives	REITs	Underweight due to interest rate sensitivity.
Alternatives	Commodities	Negative on oil and base metals, potential Chinese demand fades in 2H 2017.
Alternatives	Absolute Return	Satellite allocations to arbitrage, buy-write and credit relative value strategies.

Summing it up – Our Mid-2017 Grades

Our decision to keep a pro-growth investment stance by overweighting stocks relative to bonds in client portfolios has proven correct thus far in 2017.

Our recommendation to shorten the maturity profile ("duration") in Fixed Income allocations and to allocate away from government debt was not the most profitable call, but it has not cost client actual dollar returns this year.

Lastly, our recommendation to begin diversifying portfolios globally has proven profitable thus far this year, as economic growth has continued to improve outside of the US. Our allocation to US small capitalization stocks has lagged US large cap stock returns in 2017, but we believe it is important for clients to have exposure to small cap stocks.

Summing up, our overall portfolio positioning for the first half of 2017 has delivered solid positive results, so we would assign ourselves a passing grade for the period. We continue to focus on process and portfolio execution so that our research efforts are reflected efficiently and fully in client portfolios, and so that we are prepared for whatever results markets deliver in the latter half of this year.

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