Market Commentary
Second Quarter 2017

The labor market tightened further during the second quarter with the unemployment rate declining to 4.3%. Inflation remains stubbornly below the Federal Reserve Open Market Committee's (FOMC) 2% target, but a tightening labor market may eventually place upward pressure on wages. The FOMC increased its policy interest rate an additional 0.25% in June to a target of 1%-1.25%, and announced plans for additional interest rate increases. In addition, the FOMC disclosed its plan to reduce its securities portfolio acquired since the Great Recession. Portfolio balance to be unwound is in excess of *$3 trillion.*

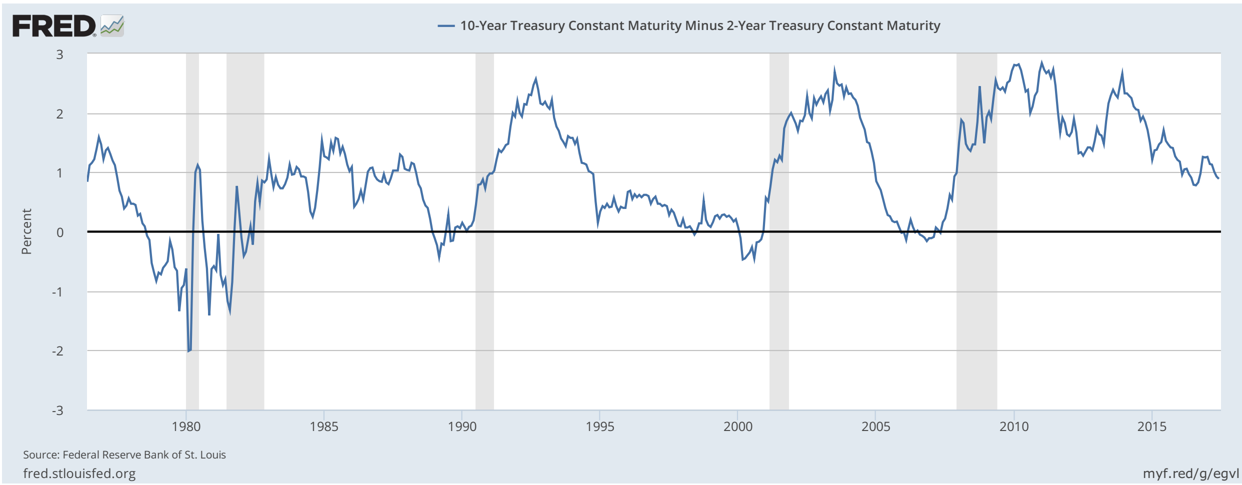
The FOMC intends to normalize its balance sheet by slowing the pace of re-investment as securities mature in the portfolio. The first step is a re-investment reduction by $10 billion per month, followed by further reductions each quarter until the portfolio is shrinking by $50 billion per month. The process is anticipated to be gradual (the most aggressive plan will take 7+ years), and the pace of shrinkage is expected to be more dependent upon economic data than the proposed calendar schedule. Regardless, once implementation begins there will be less market demand than today, which will have a modest tightening effect on the economy.

That being said, the FOMC is projecting a 3% target interest rate as early as 2019, while the fixed income futures market is reflecting about 2%. We continue to expect the FOMC will be cautious with monetary policy tightening and interest rates will remain lower longer, consistent with the fixed income futures.

The U.S. economic expansion is eight years old, making it the third longest on record, exceeded only by the expansions from 1961 to 1969 and 1991 to 2001. First quarter GDP was +1.4%, continuing the trend of slower growth than in past expansions. Without major fiscal stimulus from Congress it is unlikely GDP will do much better than 2% during the next few years.

So, how long will the expansion continue? No one knows. One of the better leading indicators of economic recessions has been the spread as measured in basis points between the 10 year and 2 year U.S. treasury bond yields. When this spread is declining, the yield curve is "flattening" and implies that economic growth is slowing. Economic recessions have typically occurred following a negative spread, e.g. 10 year yields are lower than 2 year yields. As noted in the graph below, the spread is declining, but still positive and a long way from being negative.

Previous economic recessions are noted by the gray bars. Each of these recessions was associated with the FOMC increasing interest rates too much and too late in the economic cycle. We expect the economy to continue growing at a slow, yet positive pace and do not see signs of a recession in the near term.



Foreign equities continued to outperform domestic during the second quarter. The developed international and emerging markets gained 14.2% and 18.6% year to date, respectively, while the S&P 500 gained 9.3%. The foreign equity returns were aided by the weak dollar relative to other currencies. Since the previous market lows in 2009, the S&P 500 and foreign equities have increased 258% and 106%, respectively. The price-to-earnings (P/E) multiple for the S&P 500 and foreign equities are 17.5x and 14.1x, respectively. In our view, it is likely foreign equities will continue to outperform domestic equities until valuations converge and more closely reflect their historical average multiples. Looking in the rearview mirror, the 20-year average P/E multiples for domestic and foreign equities are 16.0x and 14.7x, respectively.

U.S. growth stocks performed much better than value during the second quarter and year to date. Best and worst performing domestic sectors year to date were technology, +17.2% and energy, -12.6%, respectively.

During the second quarter, the oil market officially entered a bear market, as defined by a 20% decline in market price. Since bottoming in price June 21, oil is up about 10% and energy stocks are performing much better. Shale oil producers continue to become more efficient, and are able to respond quickly to changes in prices. Unless there is a significant supply disruption from OPEC or another large producer, we do not expect oil prices to move significantly higher any time soon.

One of the few certainties with investing is the inevitability of cycles. For this reason, it is important for long term investors to focus on portfolio diversification and goals based portfolio construction. Owning multiple asset classes will continue to smooth portfolio performance through these market cycles and reward patient investors with attractive risk adjusted returns.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio please let us know.

Respectfully,

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