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Investment Management

Market Review

Second Quarter 2017

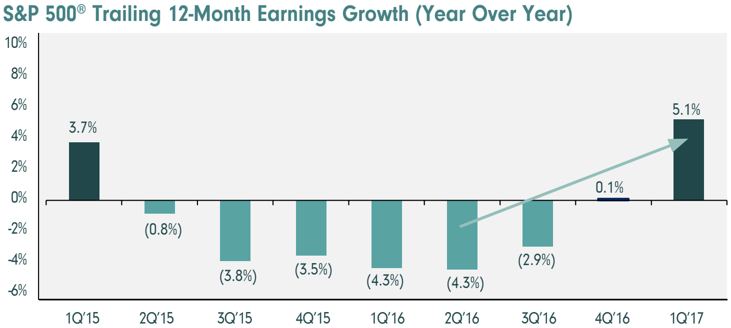
Has Trump Been Dumped?

First-Half Performance

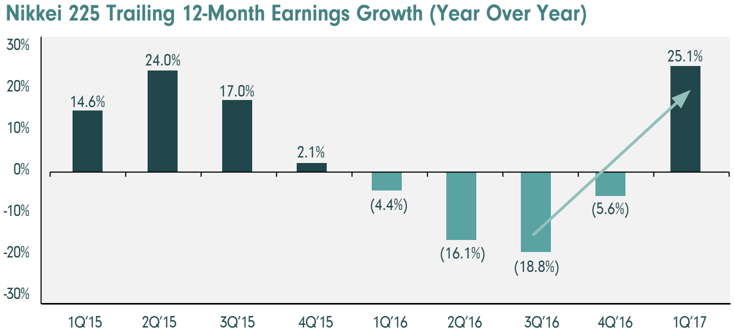
As we closed the first half of the year, stocks continued their steady march forward. For example, U.S. large-capitalization equities, as measured by the S&P 500 Index, advanced +9.34%, year-to-date through June 30; international stocks, as measured by the MSCI EAFE Index, were up 13.81%; and emerging market stocks, as measured by the MSCI Emerging Markets Index, were up even stronger, gaining 18.43%. Growth stocks and large-cap stocks continued to outpace value and small-cap stocks in the first half of this year—the exact opposite of what occurred in 2016. The Russell 1000 Growth Index was up 13.99%, year-to-date, versus the Russell 1000 Value Index, which was up only 4.66%. Small-cap stocks, as measured by the Russell 2000 Index, were up 4.99%—about half the return of the S&P 500 year-to-date. As usual, corporate earnings were a key factor driving stock returns. First quarter 2017 results were up double-digit and earnings-per-share growth is improving, globally, for the first time in years (See charts: *Global Earnings Growth*).

Global Earnings Growth

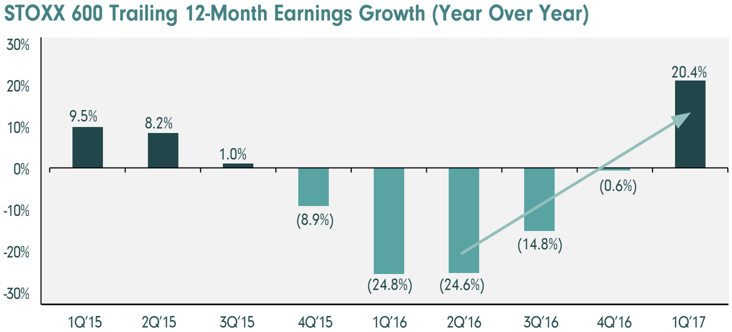
S&P 500® Trailing 12-Month Earnings Growth (Year Over Year)



Nikkei 225 Trailing 12-Month Earnings Growth (Year Over Year)



STOXX 600 Trailing 12-Month Earnings Growth (Year Over Year)



Data is obtained from Strategas and Bloomberg and is assumed to be reliable. Past performance is no guarantee of future results.

Bonds continued to perform well, with the Bloomberg Barclays U.S. Aggregate Bond Index up 2.27%. California municipal bonds advanced 3.64%; high yield bonds, as measured by the Bank of America Merrill Lynch U.S. High Yield Bond Index, returned 4.91%; and emerging market debt, as measured by the JPMorgan Emerging Markets Bond Index Global, was up 6.20% for the first half of the year. Credit spreads continued to tighten overall in the second quarter. The 10-Year U.S. Treasury yield fell from 2.44% at the start of the year to 2.30% as of June 30. The 30-Year U.S. Treasury also fell from 3.07% to 2.83% at the end of the quarter. The decline in longer-term rates occurred despite the fact that the U.S. Federal Reserve continued to raise short-term interest rates for the second time this year. Given that the yield curve has continued to flatten, we believe this will make any further short-term rate increases more difficult to achieve. Inflation is also still below the Fed's target, which is positively impacting long-term rates.

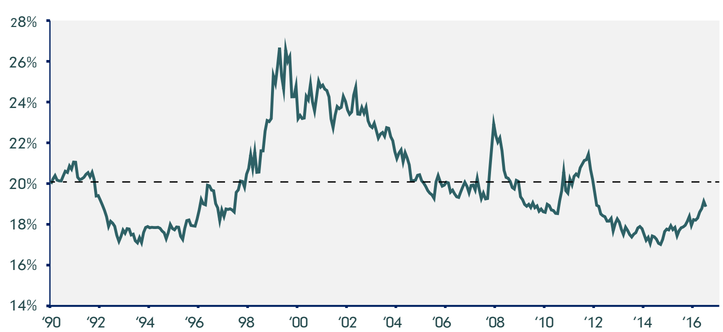
Low Volatility?

Since last fall's election, equity indexes have appeared very calm relative to history. However, underneath the broad stock indexes has been a lot of rotation and change in individual industries and stocks. A recent example of this has been Amazon's announced purchase of Whole Foods. Amazon has already disrupted many retailers' business models and now seems poised to potentially disrupt the traditional grocery business. Retail and grocery stock prices have been negatively impacted due to this threat. So despite very calm macroeconomic and index performance, there continues to be significant disruption, innovation and change at the industry and stock level. This is providing excellent opportunities for fundamentally based active stock pickers to add value.

Market Breadth?

Many market participants have observed that much of this year's stock returns have been driven by a select few mega-cap technology stocks. While these stocks have certainly outperformed in the first half of this year, this focus fails to acknowledge that many of these mega-cap tech stocks performed poorly last year (particularly after President Trump's surprise election). This poor stock performance occurred despite the fact that these companies' cash flow and earnings grew very robustly in 2016. This concentration of returns among the top 10 mega caps does not appear to be too unusual by historical standards (See chart: *Combined Weight of 10 Largest S&P 500© Stocks*). We would argue the strong first-half performance of these stocks simply reflects catch up for their strong corporate performance that was not rewarded in 2016.

Combined Weight of 10 Largest S&P 500® Stocks



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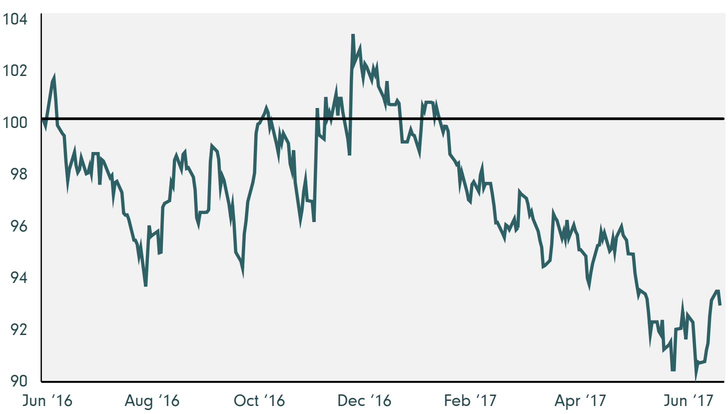
Trump Bump?

In looking at the data, the stock market does not believe any of President Trump's agenda will be passed into law, as the sectors which benefited the most last fall from his election have all materially lagged the market this year. Energy, financials, materials and many industrials have performed poorly so far this year, causing the value indexes to lag the growth indexes by a wide margin. Given the inability to pass any health care legislation thus far, investors are understandably skeptical about the ability to pass other meaningful legislation. The good news is that stocks are priced for no tax reform (See chart: *High Tax Portfolio Relative to Low Tax Portfolio*). Therefore, if tax reform ever really does occur, it could represent further upside for the stock market. A fair amount of merger and acquisition activity is being deferred in many industries as corporate boards await further clarity on the tax reform plan.

High Tax Portfolio Relative to Low Tax Portfolio

(100 = 06/01/2016)



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Second-Half Outlook

Even in a mediocre GDP outlook environment, corporate earnings continue to look very solid over the next 6-12 months. As a result, stocks should continue to generate positive returns (although we may experience a correction along the way) for the foreseeable future. Despite the yield curve flattening materially, it is still not inverted and the Fed may feel less pressure to continue with another rate increase in the second half of the year. A meaningful increase in the price of crude oil, or major progress by the Trump Administration on tax reform and/or an infrastructure bill could cause longer-term bond yields to rise over the next 6-12 months. This would give the Fed more wiggle room with short-term interest rates than what is currently available. The key takeaway for clients in this environment is to remember to focus on their real, longer-term objectives and to not get caught up in the day-to-day vagaries of the stock market. Time can be our strongest ally in achieving our positive return goals (See chart: *Rolling Performance for the S&P 500® Index*).

Rolling Performance for the S&P 500® Index

(1926-2016)

	Positive	Negative
Daily	54%	46%
Monthly	62%	38%
Quarterly	68%	32%
6 Months	74%	26%
1 Year	79%	21%
5 Years	88%	12%
10 Years	94%	6%
20 Years	100%	0%

Data is obtained from Peterlazaroff.com and is assumed to be reliable. Past performance is no guarantee of future results.

Douglas S. Foreman, CFA

Chief Investment Officer

Douglas S. Foreman, CFA is Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 31 years of investment experience.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. The MSCI® Emerging Markets (EM) Index is a free-float adjusted market capitalization index tracking the equity performance of global emerging markets. The Russell 1000® Growth Index is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Value Index is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Bloomberg Barclays U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The Bloomberg Barclays California Municipal Bond Index is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more. The Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The JPMorgan Emerging Markets Bond Index Global is a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements. The Nikkei 225 is a price-weighted equity index, which consists of 225 stocks in the 1st section of the Tokyo Stock Exchange. The STOXX Europe 600 Index, covering the 600 largest companies in Europe, is divided into 19 Supersectors according to the ICB industry classification and reflects the exposure to a certain sector in terms of free-float market capitalization.

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