HalpernFinancial

1st Quarter 2017 – Investment Commentary

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Market and Portfolio Performance:

Summary:

- **Outlook for stocks remains positive,** even as the market is near recent all-time highs (remember the Dow Jones Industrial Average hit 20,000 in January, and 21,000 in the middle of March?) Major policy announcements and strengthening economic data are potential catalysts for further market gains. The rally to end the month of March should be a positive signal heading into the second quarter.
- **Remember the markets are not the economy and vice versa.** While returns were excellent for domestic equities this past quarter, our expectations for the future are tempered by low GDP numbers showing that the U.S. economy continues to grow at a sluggish pace. We have not seen U.S. GDP increase more than 2.6% per year since 2006. For 2017, first quarter GDP growth is expected to be in the 1% to 1.5% range. Compare that to 4.25%, the average annual GDP growth since 1950!
- **Bonds adjusted to Fed rate hikes.** The Fed raised rates right near the end of 2016, which did result in some price and yield adjustment. Yet when the Fed raised rates again in March, bond markets basically ignored it. Rising rates now appear to be somewhat "baked in" to bond markets. Because the Fed is being so transparent and predictable about when they will adjust rates, bond markets are absorbing these changes in stride.

U.S. Equities:

- **Fantastic quarter for large-cap domestic equities, with funds up 3% to 8%, depending on type.** Domestic equities did well in January and even better in February. They were flat or slightly negative in March depending on the asset class – influenced in March by a 'wait and see' mentality around the Fed meeting, and the failure to pass health-care reform. Growth stocks outperformed value stocks, helped by recent all-time highs in Apple, Microsoft, Alphabet and Facebook—all companies that make up the top holdings in growth stock indexes.
- **Mid- and small-caps underperformed their larger counterparts**. Returns were still solidly in positive territory, but in a rising rate environment, investor appetite for companies with higher debt loads (often the case for small- and mid-cap companies) is diminished.

International Equities:

- **Developed international stocks outperformed most U.S. equity asset classes despite Brexit concerns.** Remember, the U.K. and Europe are just two of many developed foreign markets—the index funds we use also have exposure to Japan, Australia, and other developed-economy countries to diversify risk.
- **Emerging Markets (EM) up double digits, rebounding from prior lagging performance.** As a high-risk, high-return asset class, you can expect EM stocks to react strongly to global developments. Economic reforms and improving corporate fundamentals have helped emerging market stocks. This is wonderful in positive stretches like right now, but this is also why we limit exposure for our clients who own these funds. Recent strength in EM is also due to strength in precious metals, which can have a significant effect on the economies of countries like South Africa that have a huge exposure to mining.

Alternatives:

- **Strong risk-adjusted returns beat the index.** Your REIT fund saw very little movement in January, healthy gains for February, and stayed flat in March—overall amounting to strong quarterly performance, especially compared to its benchmark index. The Dow Jones Wilshire Real Estate index suffered a -2% loss in March, compared to your fund's minor dip of just -0.02%. This is what we mean when we talk about the benefit of

risk-adjusted returns. When you invest in assets with a good balance of risk and return, you are often able to avoid extreme downturns, so there is less of a hole to dig out of to provide for strong overall returns.

U.S. Bonds:

- **Bond performance followed expected patterns.** In a quarter where bonds delivered decent returns, bonds with higher risk-return potential (long-term bonds and high-yield bonds) outperformed short- and intermediate-term bonds. In a relatively steady market, the higher levels of income delivered by longer-term and high-yield bonds were able to outperform shorter-term, and investment grade counterparts. Keep in mind when we talk about "high risk" within the bond space, the levels of risk here are still lower risk than stocks.

International Bonds:

- **Emerging market bonds providing strong, equity-like numbers.** Again, this is a story of higher risk levels, and higher return! In fact the emerging market bond fund we favor has a current yield of 5.41%. We are also pleased to report that the credit quality of emerging market bonds has improved, with more than 60% of the market rated investment grade, compared with less than 40% in 2000.

Expectations and Perceptions for the Future:

Equities:

- **U.S. strike on Syria could impact commodities and emerging market holdings.** Although the strike did not occur in Q1, we feel we must comment on the potential market impact of this news. Oil leaped to a one-month high the day after the strike, while domestic stocks reacted initially, then settled to end the day flat. It is possible that reactionary traders will flock to "safe haven" investments (fixed income, large, dividend-paying stocks) upon further developments. We are watching how this unfolds, but know that your portfolio is designed to weather any potential shocks in a defensive manner while still poised to take advantage of further growth.
- **The triggering of the Brexit process and key elections in France and Germany will shape developed markets.** As expected, Prime Minister Theresa May triggered Article 50 on March 29, starting the process to formally exit the E.U. This process will not be complete until 2019 and will surely change trade in the region. The outcome of the French presidential election on April 23 and the German election on September 24 may also impact developed market stocks.
- **Tax reform and lessened business regulation upcoming, but when?** Both of these factors are positives for investors, but details on timing and implementation are still unclear.

Alternatives:

- **Fundamental demand for real estate remains high, despite challenges.** A rising-rate environment means less favorable lending rates for real estate investors, but commercial real estate property supply is still below historical averages while demand remains high. Positive supply-demand figures should help support this asset class through a rising rate environment. Real estate remains an attractive option to hedge against equity volatility, and to capture higher yields in a still low rate climate.

Bonds:

- **The Fed expects to raise the Fed Funds rate to 1.5% by the end of 2017, in the form of two more 0.25% hikes.** Currently the Fed Funds rate is 0.75% to 1.0%. While the plans of the Federal Reserve are never set in stone, markets are expecting two more small increases throughout the year. Slow progression takes away the scariness and volatility around rate hikes. History has shown that when the Fed is more

transparent and measured with their rate-increase approach, bonds absorb these increases in far better fashion.

- **Do municipal bonds still make sense in a rising rate environment? Yes.** Even if you are in a low tax-bracket, the tax-equivalent yield is extremely attractive when you compare this to taxable alternatives in the same asset class. In fact some of these actually have even higher yields than their taxable counterparts! Plus you have the relative stability, and diversification of added in income from municipalities which are historically of better credit quality (less risk), than corporate bonds of the same asset class.
- **Diversified exposure to different bond maturities is beneficial in a rising rate environment.** When the Fed changes rates, it affects short-term bonds first because they roll over first. Meanwhile, longer-term bonds have higher yields that help offset moves in prices (as they did in Q1). A strategy incorporating short-, intermediate-, and long-term bond exposure prepares you for a multitude of situations.

Please feel free to reach out with any questions about your investments in the current market environment. We are always happy to talk to you, and we wish you a very pleasant start to Spring!

Commentary Disclosure

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