Market Perspectives

Since the end of the 2008-09 recession, the strongest market returns came from large cap domestic equities. The S&P 500, a proxy for large cap U.S. equity, has returned 14.63% annually for the past five years. Diversification, generally regarded as a protector of portfolios, has recently been a detractor from portfolios due to the massive outperformance of large cap domestic stocks. This is evidenced by the MSCI EAFE, which represents international large cap equity in "developed markets" trailing the S&P 500 by 5.94% over the past five years, and the MSCI EM which represents "emerging markets" such as China, Brazil, India, and South Korea trailing by 10.67% over the same period. However, 2017 seems to have marked the end of this streak.

Since the November 2016 elections, markets switched from being a one-trick pony, to having significantly varied returns across asset classes. Many investment categories that struggled between 2009 and 2016 came roaring back to life in 2017. In the second quarter of 2017, the S&P 500 returned 3.09% while the MSCI EAFE and MSCI EM returned 6.12% and 6.27% respectively. The year-to-date numbers display an even greater disparity. The S&P 500 is up 9.34% since January 1 while the MSCI EAFE and MSCI EM are up 13.81% and 18.43% respectively. The power of diversification finally has resurfaced.

We continue to believe that diversification across asset classes and regions will benefit portfolios by reducing volatility and improving long-term return potential. Historically speaking, the domestic stock market is trading at elevated prices. The S&P 500's price to earnings ratio (P/E ratio) is sitting at 23.87[1]. This compares with a long-term historical average of 15.66 and a fifteen-year average of 17.50[2]. While this does not mean that a crash is imminent, it provides evidence that broadening portfolio allocations to include securities that are not trading at such elevated valuations could provide some protection in an equity market downturn.

It should also be noted that interest rates on bonds are very low. Because bonds compete with stocks for investor dollars, this does provide one reason for equities to trade at above-average prices. Developed international and emerging market equities trade at significantly lower valuations than those in the U.S. We have confidence that utilizing allocations with these types of securities will continue to benefit portfolios over the next few years.

So far in 2017, fixed income markets performed strongly as low interest rates drifted mostly lower. This was the same for both domestic and international markets. Since bond prices move inversely to their yield, all major fixed income asset classes had positive returns (This is only true for international fixed income after converting back to U.S. Dollars.)[3]. Top performers were emerging market debt, followed by high yield debt, and then corporate debt. While high yield has performed well, we continue to keep limited allocations to the asset class as the yield spread between high yield and investment grade is near the 2014 lows[4].

Over the second quarter of 2017, individual sectors within the domestic stock market had vast discrepancies in their returns. This is another reason that it can be beneficial to diversify an investment portfolio. For example, the worst sector for the quarter was telecommunications (-7.05%). This was followed by energy (-6.36%). The top performing sector was healthcare (7.1%), and the next best sector was industrials (4.73%). Technology, which had been the top sector in the first quarter of 2017, had another strong quarter with a 4.14% return[5].

Commodities, which have not had a significant place in our portfolios for some time, continue to lag other types of securities. The Goldman Sachs Commodity index lost 4.08% over the quarter. This was pushed down by a very poor quarter for oil (-10.48%). Metals were somewhat mixed. Gold had a small loss of 0.31%, while silver dropped by 8.89%. Other commodities, which are a smaller part of the index, were up. These include timber (8.24%) and natural gas (19.52%). In spite of the large gain for natural gas in the second quarter, it

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1 *Wall Street Journal, Market Data Center, June 30, 2017*
2 *ValueWalk, FactSet, August 12, 2016*
3 *JPMorgan Asset Management, Q3 Guide to Markets 2017, June 30, 2017*
4 *InvestmentNews, A Caution Light for High Yield Bonds, John Waggoner, March 2, 2017*
5 *Morningstar, June 30, 2017*
6 *CME Group, FedWatch Tool, June 30, 2017*

is still down 18.48% on the year[5].

In general, allocation and tactical funds performed as one would expect. Returns for U.S. Allocation, World Allocation, and Tactical Allocation were 2.35%, 2.83% and 1.8% respectively[5].

Economic trends in the U.S. are mixed. Since the 2008-09 recession, real GDP growth has been significantly below trend for a recovery, indicators such as vehicle sales and housing starts have come in below expectation, and capital goods orders have been on a decline. However, household debt service (average interest cost/disposable income) and household net worth are both at their all-time high[3]. Although unemployment is near historical lows, wage growth remains muted and the labor force participation rate is near its lowest level since the 1970s. This remains true even after accounting for our aging population entering retirement.

In our opinion, all of these factors add up to the need to remain invested across a broad assortment of asset classes and to look for market opportunities to take advantage of as they arise. As the interest rate hike cycle continues on its (currently) upward trajectory[6], there could be pressure on both fixed income and equity securities. With that in mind, we believe that diversification, particularly across global markets, should continue to pay off as it has so far in 2017.

5 Morningstar, June 30, 2017
6 CME Group, FedWatch Tool, June 30, 2017

Economic Perspectives

Economic Growth & Profits

- Real gross domestic product growth (GDP) for the first quarter of 2017 was revised up to 1.4% from 1.2% according to the most recent estimate. This was due to consumer spending coming in at 1.1% vs. the previous reading at 0.6%. Consumer spending still lagged 2016's fourth quarter which came in at 2.4%[7].
- 2016 GDP for the year came in at 1.6%, so the economy is running at a slightly slower pace so far. Estimates for Q2 GDP will be released just prior to the end of July 2017[7].

Interest Rates

- The Federal Open Market Committee (FOMC) has again raised the range for the federal funds rate to 1.00-1.25% in June[8].
- The committee's press release was slightly less hawkish than that of March. Still, the Federal Reserve Board members' "dot-plot" (estimates of future rates) remain significantly above market-based predictions[9].

Employment

- Total non-farm payroll employment increased by 222,000 in June. The unemployment rates ticked up from 4.3% to 4.4% which is still significantly down from 4.7% reported this past February[10].
- The labor force participation rate (the share of working-age people in the labor force) fell slightly to 62.8% vs. 63.0% during the Q1 reading[10].
- In June, average hourly earnings for all employees on private non-farm payrolls rose to $26.25. This compares favorably to $26.09 recorded in February 2017. Additionally, the average weekly number of hours worked rose 0.1 to 34.5[10].
- The broader U-6 measurement of unemployment (includes those "marginally attached to labor force" and part-time workers) rose to 8.6% in June vs. 8.4% in May. This is still better than the 9.2% reading from this past February. It is also a full percentage point better than last year at this time[10].

Inflation

- The Consumer Price Index for All Urban Consumers (CPI-U) decreased 0.1% in May on a seasonally-adjusted basis[11].
- The cumulative one-year change is 1.9%, a bit under the Federal Reserve's inflation target of 2.0%[11].
- The Core-CPI, which removes volatile energy and food prices from the CPI, rose 0.1%[11]. Because the energy index fell 2.7%, the Core-CPI came in above the CPI-U.

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7 U.S. Department of Commerce: Bureau of Economic Analysis - Gross Domestic Product: Q1 2017 Third Estimate, June 29, 2017
8 U.S. Federal Reserve - Federal Reserve Issues FOMC Statement, June 14, 2017
9 CME Group - CME FedWatch Tool, July 7, 2017
10 U.S. Department of Labor - Bureau of Labor Statistics - The Employment Situation, July 7, 2017
11 U.S. Department of Labor: Bureau of Labor Statistics - Consumer Price Index, May 2017, released June 14, 2017

Risks

- Interest rate risk due to the expectation of a continued rise in rates
- Uncertainty caused by the U.S. government's legislative agenda
  1. Healthcare reform
     - Could be either positive or negative for markets
  2. Tax reform
     - If anything happens, will likely be beneficial to markets
- Trade policy uncertainty
- Oil prices: Currently low, but can be volatile
- Geopolitical risk
  1. Middle East
     - Syria- ISIS/Assad
     - Iran
     - Qatari relations with rest of Sunni Middle East
  2. East Asia
     - North Korea - Ballistic missile program, nuclear weapons program
- Concerns about a slowing China
  1. Chinese GDP continues to slow and may fall under 6.5% in 2017
  2. This could cause internal issues which, due to China's large foreign currency reserves, could have ripple effects around the globe

Index Returns Table

Index	Total Return (%) 3 Mo (Mo-End) USD	Total Return (%) YTD (Mo-End) USD	Total Return (%) 1 Yr (Mo-End) USD	Total Return (%) Annualized 3 Yr (Mo-End) USD	Total Return (%) Annualized 5 Yr (Mo-End) USD
DJ Industrial Average TR USD	3.95	9.35	22.12	11.01	13.45
S&P 500 TR USD	3.09	9.34	17.90	9.61	14.63
S&P 400 Mid Cap TR USD	1.97	5.99	18.57	8.53	14.92
S&P 600 Small Cap TR USD	1.71	2.79	22.47	9.32	15.47
MSCI KLD 400 Social GR USD	3.31	17.68	9.47	8.98	14.78
MSCI EAFE NR USD	6.12	13.81	20.27	1.15	8.69
MSCI EM NR USD	6.27	18.43	23.75	1.07	3.96
Barclays U.S. Agg Bond TR USD	1.45	2.27	-0.31	2.48	2.21
Barclays Global Agg Bond TR USD	2.60	4.41	-2.18	-0.35	0.78
S&P GSCI Spot	-4.08	-6.49	-0.44	-17.31	-9.08
S&P Target Risk Cons. TR USD	2.40	5.19	5.50	3.05	4.68
S&P Target Risk Mod. TR USD	2.72	6.18	7.45	3.55	6.02
S&P Target Risk Aggr. TR USD	3.95	10.05	15.37	5.53	10.43

Source: Morningstar® as of June 30, 2017

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI U.S. Broad Market Index is comprised of nearly 100% of the total market capitalization of U.S. stocks traded on the NYSE and the NASDAQ. The S&P 500 Index is a market capitalization free-float adjusted index of the prices of 500 large capitalization common stocks traded in the United States. The S&P 400 Mid Cap Index serves as a barometer for the U.S. mid-cap equities sector and includes stocks with total market capitalization that ranges from roughly $750 million to $3 billion. The S&P 600 Small Cap Index covers a broad range of U.S. small cap stocks and is weighted according to market capitalization covering about 3-4% of the total market for U.S. equities. The MSCI KLD 400 Social Index is a free float-adjusted market capitalization index designed to target U.S. companies that have positive environmental, social, and governance (ESG) characteristics. The MSCI EAFE Index is a market capitalization weighted index and is designed to measure the equity market performance of developed markets (Europe, Australasia, and Far East) excluding the U.S. and Canada. The MSCI EM NR USD Index is a free-float adjusted market capitalization index that is designed to measure the equity market performance in the global emerging markets. The Barclays Aggregate Bond Index is a market-capitalization weighted index that is considered to be representative of U.S. traded investment grade bonds. The Barclays Global Aggregate Bond Index includes government securities, mortgage-backed securities, asset-based securities and corporate securities to simulate the universe of bonds in the market. The S&P GSCI Spot is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures. The S&P Target Risk series of indices comprise multi asset class indices that correspond to a particular risk tolerance with varying levels of exposure to equities and fixed income intended to represent stock and bond allocations across a risk spectrum. The market indices referenced are unmanaged. You cannot invest directly in an index.