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# Strategy & Outlook
July 2017

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# Economic and Market Recap

## June 30, 2017

## U.S. Equity Market

| Index | Y-T-D | One Year |
|---|---|---|
| S&P 500 | 9.3% | 17.9% |
| Russell 3000 | 8.9% | 18.5% |
| Russell Mid Cap | 7.9% | 16.5% |
| Russell 2000 | 4.9% | 24.6% |

- June was the seventh consecutive up month for U.S. equities which helped push stocks further into positive territory.
- Despite underperformance year-to-date, small cap stocks have led the market higher over the past year.

## International Markets

| Index | Y-T-D | One Year |
|---|---|---|
| EAFE Developed | 13.9% | 20.3% |
| MSCI Emerging Mkt | 18.4% | 23.7% |
| Euro-Zone | 13.6% | 28.2% |
| China | 9.1% | 32.2% |

- International markets have outpaced U.S. equities in 2017 with emerging markets leading the surge.
- Performance in major markets of the Eurozone and China has far outpaced the U.S. over the past year. However, over longer periods the U.S. leads global markets.

## Rates, Currencies, Commodities

| Asset | 6/30/2017 | 12/31/2016 |
|---|---|---|
| 2 Year UST | 1.38% | 1.22% |
| 10 Year UST | 2.27% | 2.49% |
| "BBB" Corporate | 3.49% | 3.72% |
| Yield Spread in BPS | 122 | 123 |
| Oil (WTI) / barrel | $45.92 | $53.70 |

- The yield curve flattened in the first half of 2017 as the Fed raised short rates while long term rates have marginally declined.
- Oil prices continued to slide in June bringing its decline to over 15% for the year.

## The Economy

| Economic Data | 6/30/2017 | 12/31/2016 |
|---|---|---|
| Unemployment Rate | 4.4% | 4.7% |
| Participation Rate | 62.8% | 62.7% |
| Core CPI (YoY) | 1.92% | 2.29% |
| Leading Econ. Indicator | 126.9 | 125.1 |

- The U.S. economy continues to improve – although at a gradual pace.
- The unemployment rate remains at 15 year lows following June's employment report– and real wages have risen by 2.5% versus year ago levels.

*Sources: Russell, S&P, FactSet, Barclays, CRB, MSCI. BEA*
*Unemployment Rate as of 6/30/17, LEI as of May 31, 2017*

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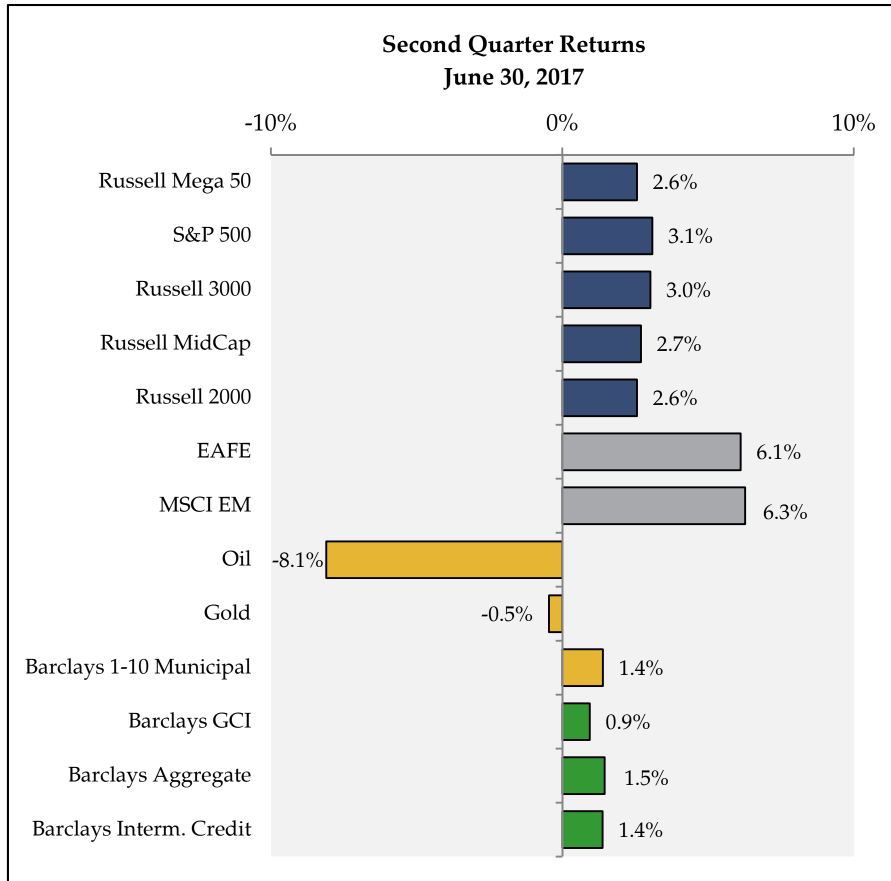
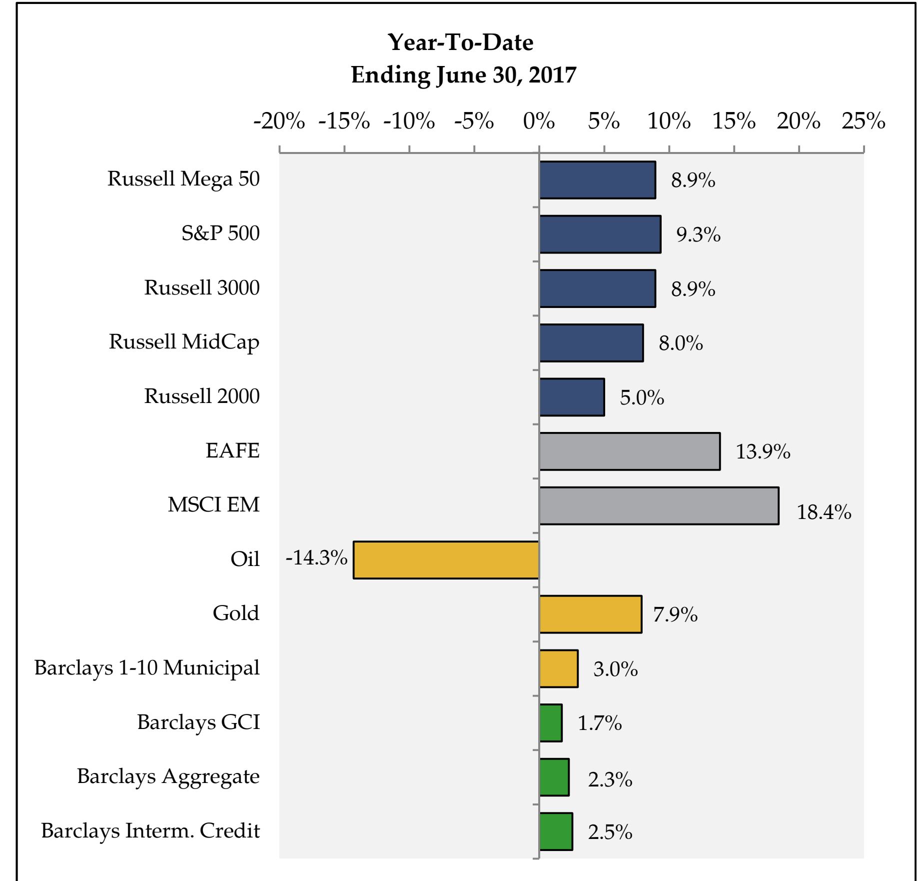
# Major Market Returns




- U.S. equity markets continued their rally throughout the second quarter pushing all major indices well into positive territory for the year. Although small caps lagged, they have significantly outperformed over the past year.
- International stocks have outperformed in 2017 – this strong relative performance comes after many years of trailing the U.S. markets.
- Despite the Fed's three rate hikes since late 2016 bond prices have performed well as intermediate and long rates have drifted lower in 2017 .

*Sources: Data as of 6/30/17, Russell, S&P, Barclays, FactSet, MSCI*

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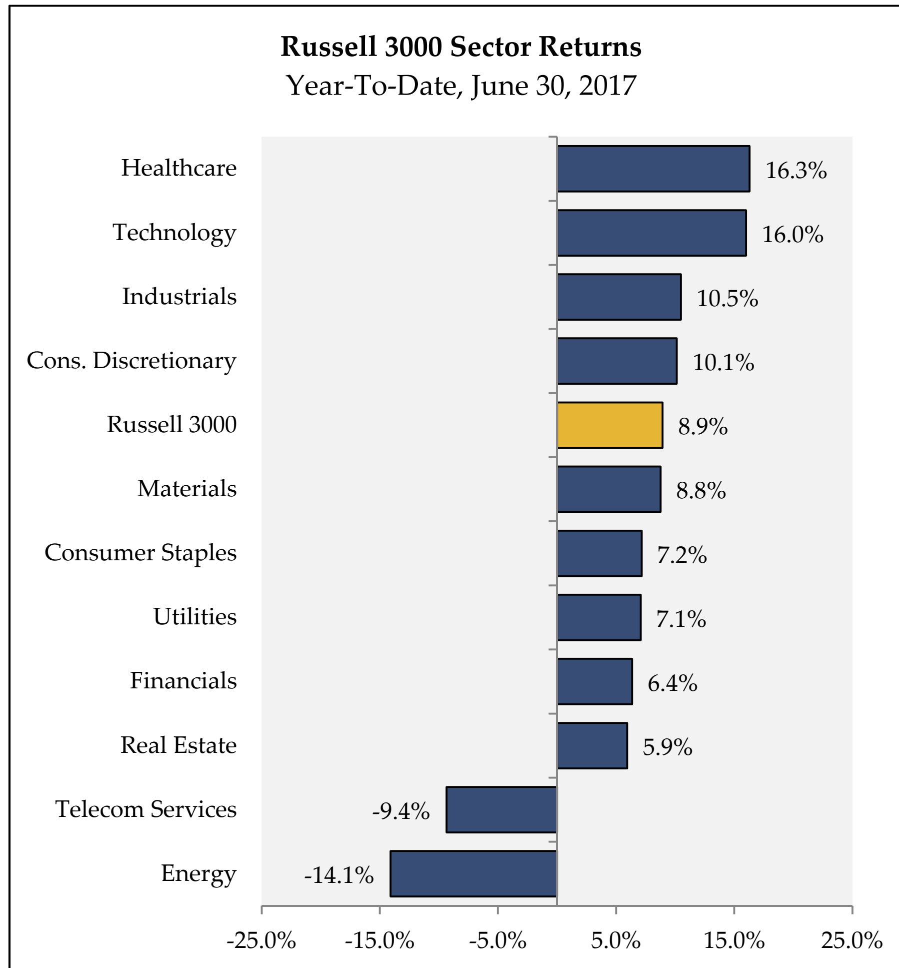
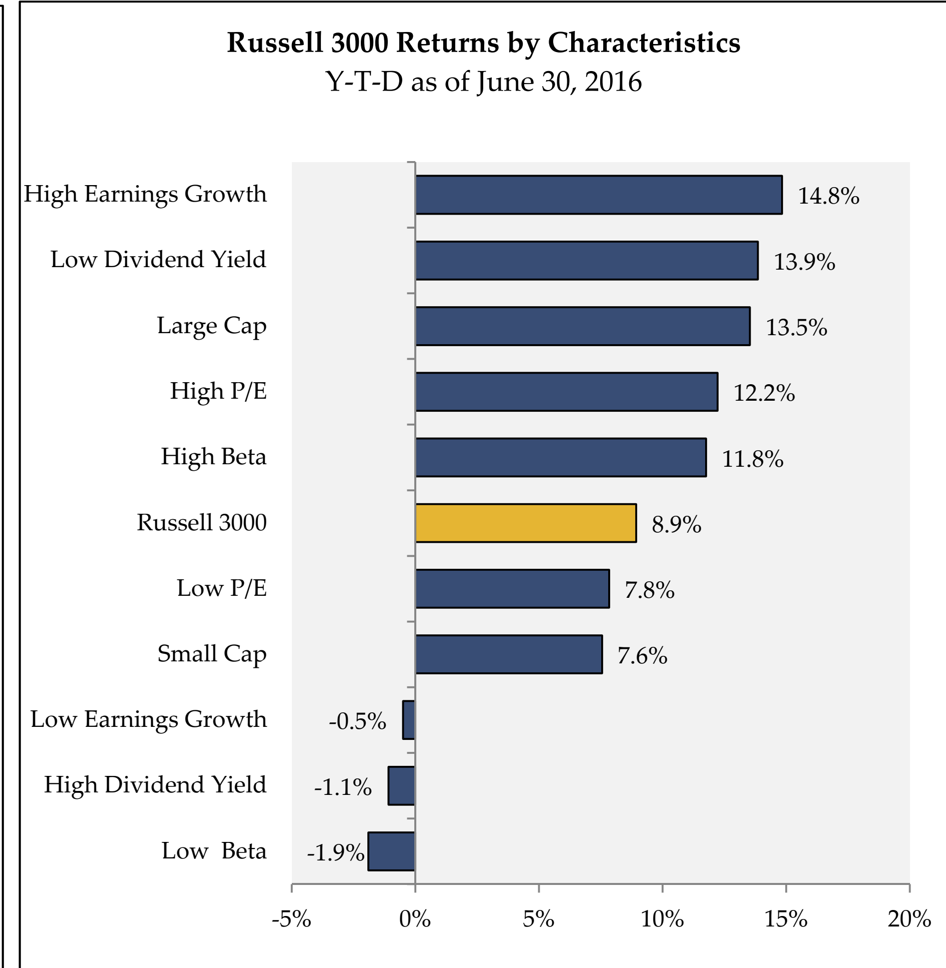
# Major Market Returns




- Leadership in the equity markets has been concentrated in companies with high earnings growth, low dividend yields, and high betas – most notably the health care and technology sectors.
- Conversely, low beta and high dividend-yielding stocks have suffered, including telecom services and REIT's. The oil-related segments of the market have been hit the hardest as oil prices have collapsed.

*Sources: Data as of 6/30/17, Russell, S&P, Barclays, FactSet, MSCI*

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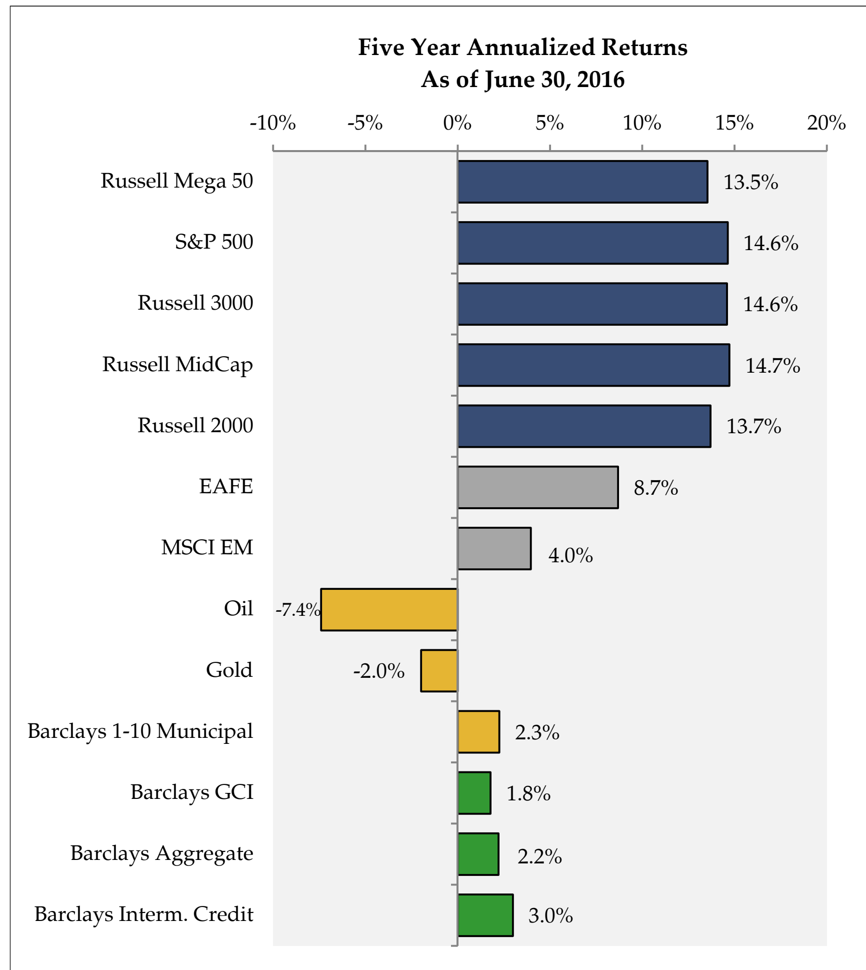
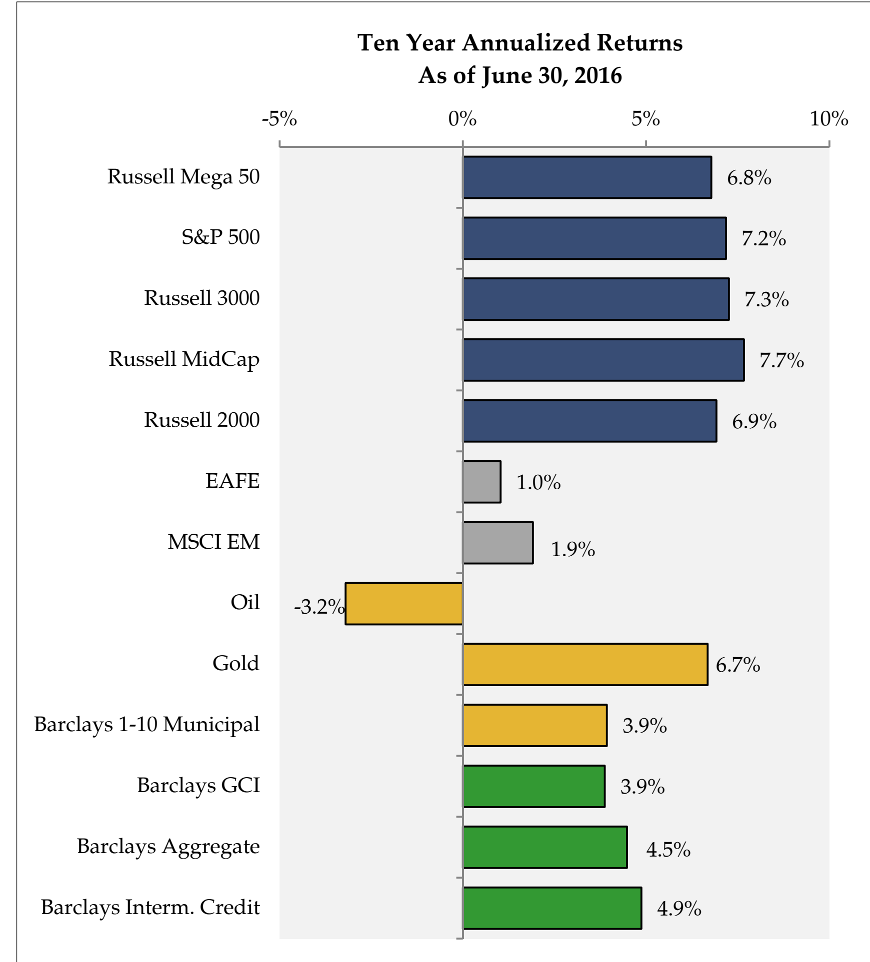
# Long Term Market Returns




- Despite volatility, long term rates of return for financial assets have been positive – however, commodity prices have declined.
- Annual compounded returns for equities over the trailing ten years are solidly in positive territory, despite the more than 50% market drop during the financial crisis of 2008-2009 – further supporting a focus on the long term.

*Source: FactSet, as of 6/30/2017*

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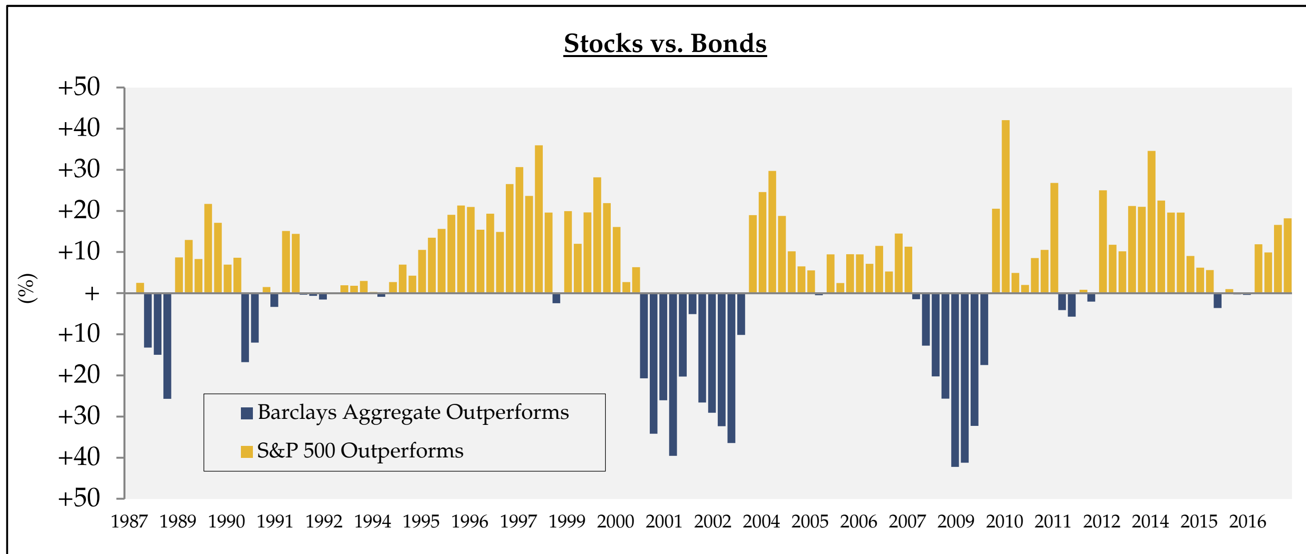
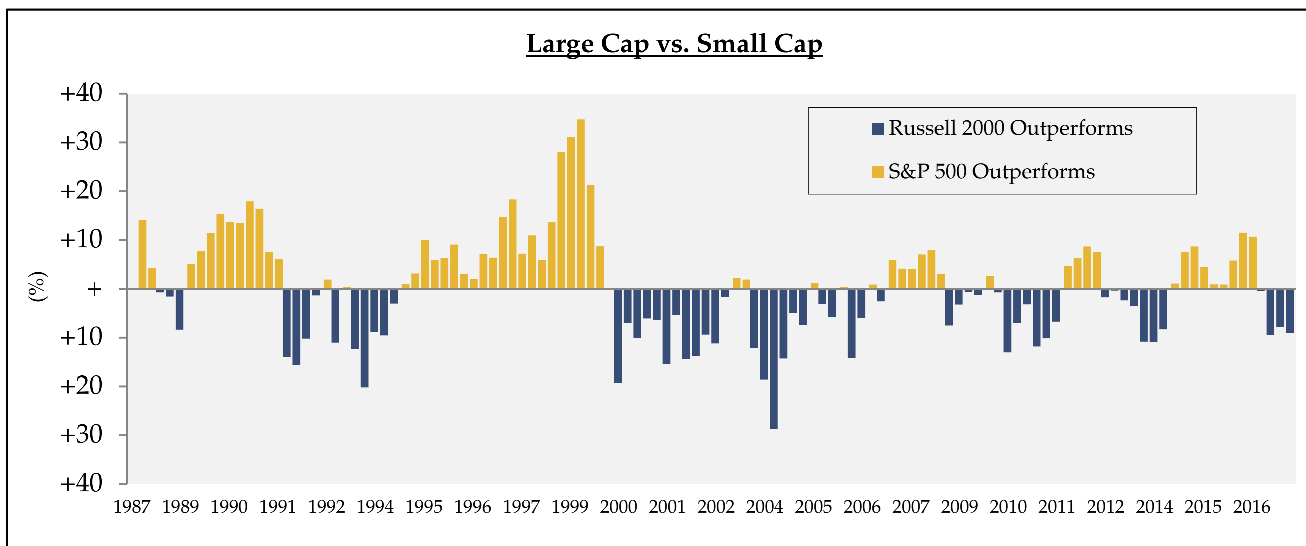
# Market Leadership: Year-Over-Year Returns




- Stock returns relative to bonds diverge dramatically over market cycles. The equity rally so far in 2017 has created significant return dispersion in stocks versus bonds on a year-over-year basis. This further supports the benefits of asset class diversification.




- There can be significant dispersion of returns within U.S. equity markets which is why we believe in equity asset class diversification. After a prolonged period of underperformance small cap stocks have begun to outperform large caps on a year-over-year basis.

*Source for both charts: eVestment Analytics as of 6/30/2017.*

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# Equity Market Volatility Over the Past Decade

**S&P 500**
*12/31/06 - 6/30/16*

2500
2300
2100
1900
1700
1500
1300
1100
900
700
500

Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12 Sep-12 Dec-12 Mar-13 Jun-13 Sep-13 Dec-13 Mar-14 Jun-14 Sep-14 Dec-14 Mar-15 Jun-15 Sep-15 Dec-15 Mar-16 Jun-16 Sep-16 Dec-16 Mar-17 Jun-17

- 57%
+286%
Unemployment rate tops 10%
-16.7%
"Flash Crash"
Japanese Earthquake
-19.3%
S&P Downgrades US Debt"
-13.4%
Greek Debt Crisis Intensifies
-11.4%
Benghazi
"Taper Tantrum"
E.U. Falls into Recession
Russia Annexes Crimea
-10.1%
China Drops Growth Rate Targets to Single Digits
-12.7%
-15.2%
Oil Hits $25/barrel
"Brexit"
U.S. Elections
Unemployment rate drops below 5%

- The past decade has been filled with economic and political challenges – however, stock prices have more than tripled from their low point in the first quarter of 2009.
- These market gains have been accompanied by extreme volatility. Although there have been seven corrections greater than 10% in the past eight years, the markets have not declined by that magnitude in over two years.

*Source: FactSet*

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# Corporate Earnings Growth

**Year-Over-Year S&P 500 Quarterly Earnings Growth**

4'Q 2012 - 4'Q2017 (*est.*)

| Quarter | Growth |
|---|---|
| Dec-12 | -0.5% |
| Mar-13 | -1.0% |
| Jun-13 | 3.5% |
| Sep-13 | 9.1% |
| Dec-13 | 14.1% |
| Mar-14 | 13.6% |
| Jun-14 | 13.4% |
| Sep-14 | 12.3% |
| Dec-14 | 2.1% |
| Mar-15 | -1.6% |
| Jun-15 | -8.0% |
| Sep-15 | -14.4% |
| Dec-15 | -15.4% |
| Mar-16 | -12.9% |
| Jun-16 | -8.4% |
| Sep-16 | -1.7% |
| Dec-16 | 4.6% |
| Mar-17 | 9.3% |
| Jun-17 | 12.4% |
| Sep-17 | 13.7% |
| Dec-17 | 14.3% |

Estimates

- Year-over-year profit growth is accelerating - driven by stronger economic growth, low interest rates, rising consumer spending, and favorable earnings comparisons.
- First quarter earnings releases exceeded analysts forecasts, and the second quarter is expected to deliver the same level of surprises. This should lead to positive earnings revisions over the next several quarters.

*Source: As of 6/30/2017 Bloomberg and Factset*

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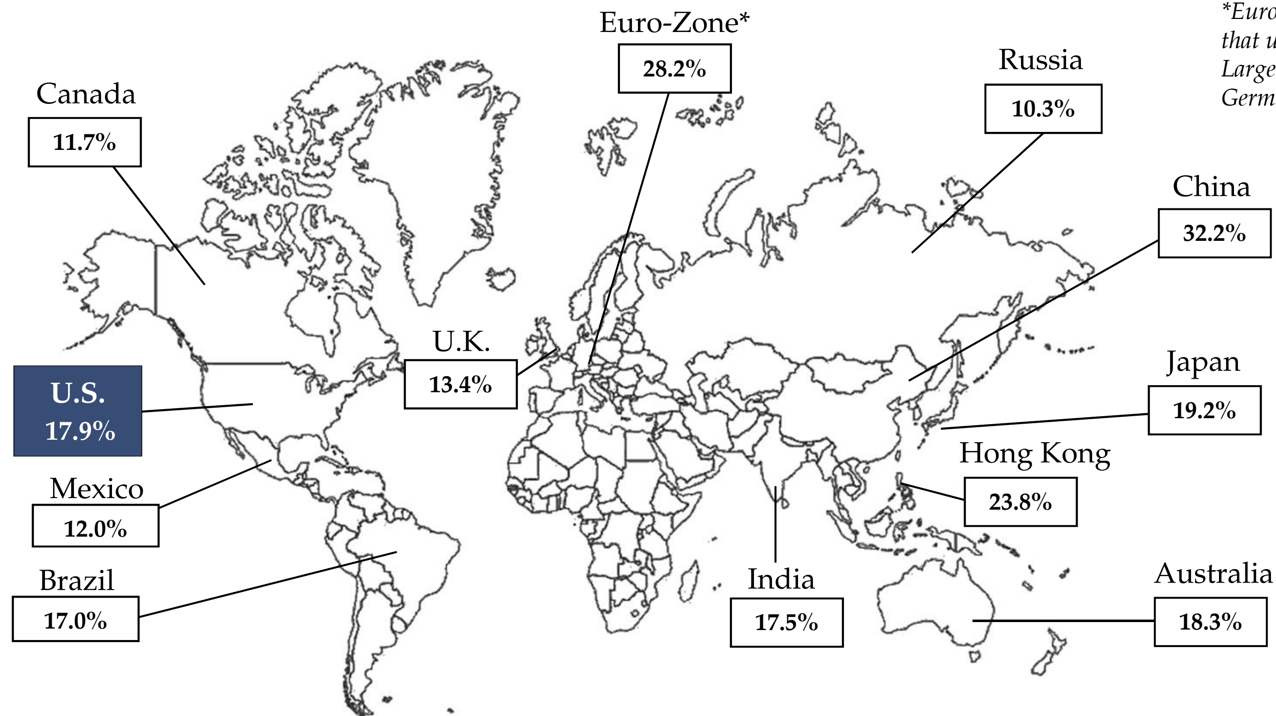
# Global Equity Market Returns

## *Trailing 12 Months Ending June 30, 2017*

**Eurozone comprised of 17 countries that use the Euro as its currency. Largest constituents include Germany, France and Italy.*




- All major markets equity markets are in positive territory over the past year – many emerging markets have surged over the past year following a prolonged period of underperformance.
- Global markets continue to confront political and economic uncertainty – this should push volatility higher.

*Source: Bloomberg*

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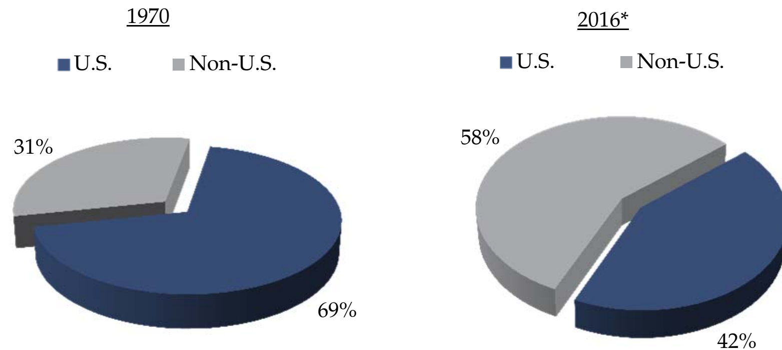
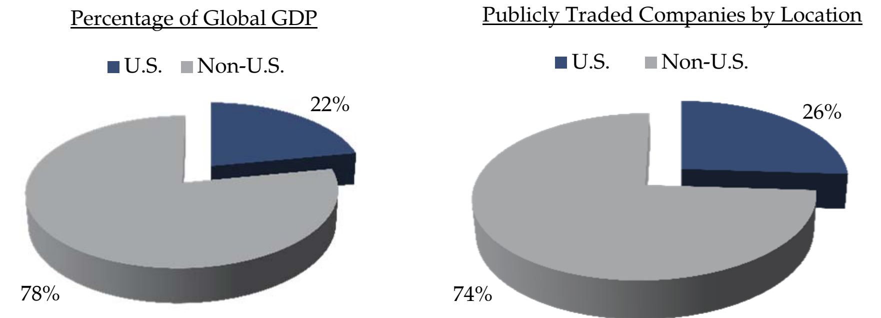
# Global Perspective

**Global Market Capitalization Breakdown (U.S. vs. Non-U.S.)**



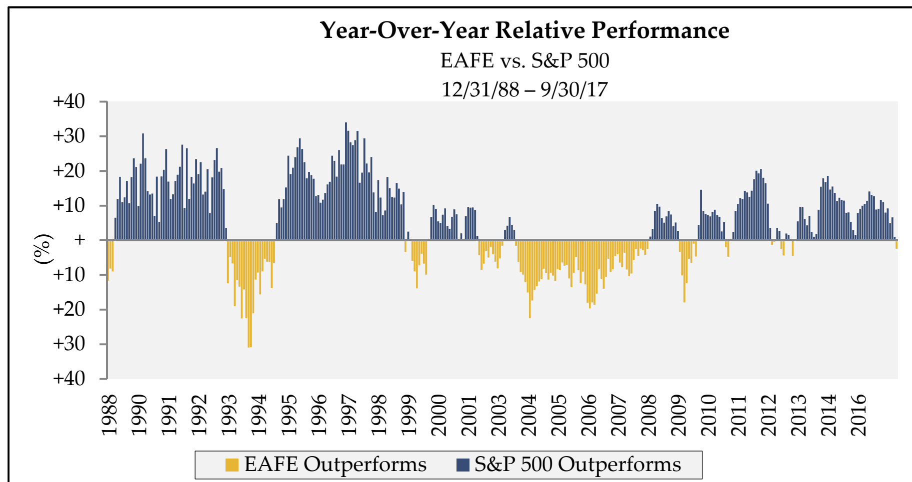

*Source: International Monetary Fund (IMF), Russell Investments*
** Preliminary*

**Global GDP and Corporate Location (U.S. vs. Non-U.S.)**



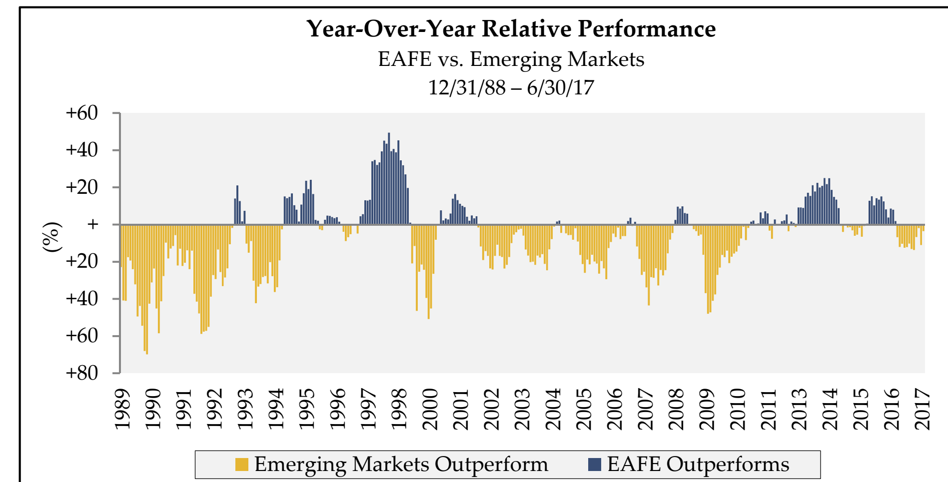

*Source: International Monetary Fund (IMF), MSCI for most recent period ending 12/31/16*

- International markets continue to grow with over half of the world's market capitalization traded outside of the U.S.
- International economies represent two-thirds of global GDP with the majority of publicly traded companies based outside of the U.S.




*Source: eVestment*

- International markets move in cycles with periods of underperformance versus U.S. markets followed by periods of outperformance.




*Source: eVestment*

- Emerging Markets have the advantage of higher growth rates – however, there are prolonged periods where developed markets generate higher returns.

*Source: As of 6/30/2017 Factset*

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# Global Perspective

**S&P 500 vs. EAFE and Emerging Markets**
Periods Ending June 30, 2017

| | 2nd Quarter | Y-T-D | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|
| S&P 500 | 3.1% | 9.3% | 17.9% | 9.6% | 14.6% | 7.2% |
| MSCI EAFE | 6.1% | 13.9% | 20.3% | 1.2% | 8.7% | 1.0% |
| MSCI Emerging Markets | 6.3% | 18.4% | 23.7% | 1.1% | 4.0% | 1.9% |

Annual Rates of Return (3-Year, 5-Year, 10-Year)

- ➢ Recent returns have favored international markets over U.S. equities; however, the long term gap in returns suggest that international stocks have plenty of room to move higher relative to domestic stocks.

*Source: As of 6/30/2017 Factset*

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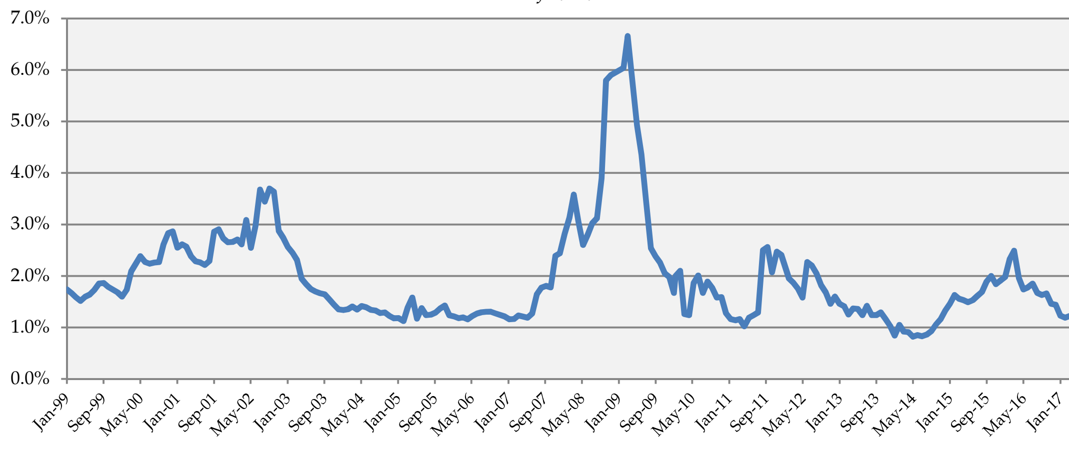
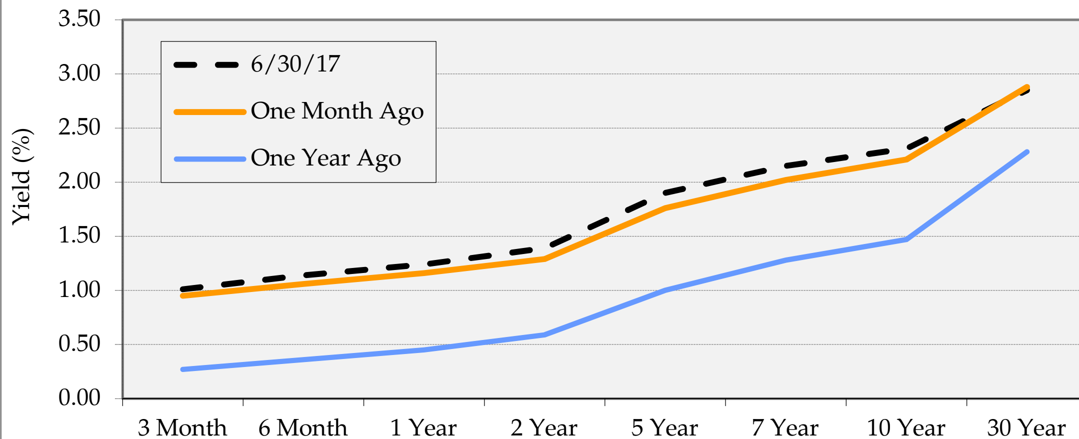
# Fixed Income Markets: Trailing 12 Months




*Source: Bloomberg; Barclays Capital*



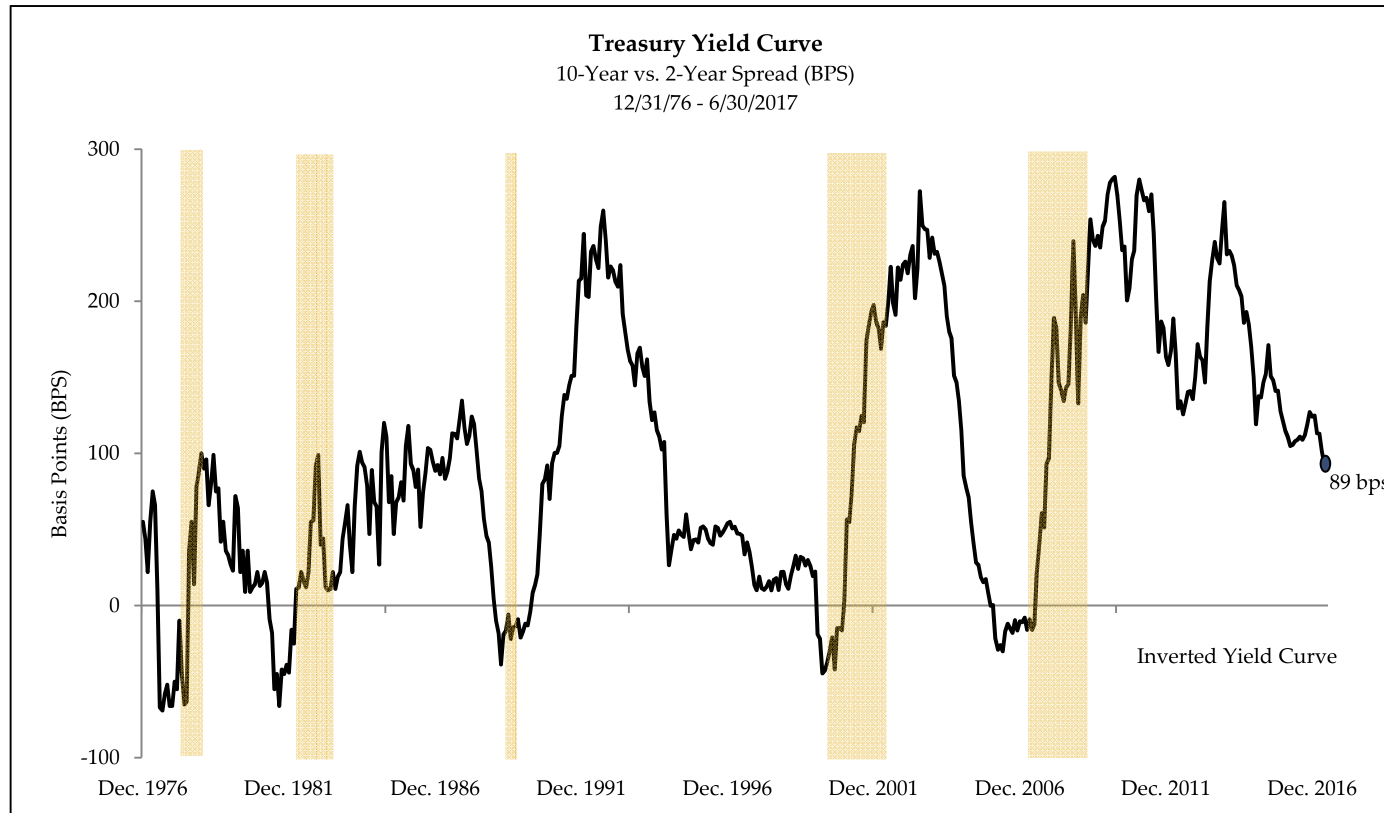

*Source: FactSet*

- In June, the BBB-rated corporate yield versus Treasuries remained unchanged versus early January at 122 basis points. However, the spread is well below last summer's level of 210 basis points.

- The yield curve has flattened in 2017 as short term rates have moved higher while long term rates have declined.

- The 10 year Treasury note yield closed June at 2.27% - up dramatically from last summer's record low of 1.40%, but lower than the year end 2016 level of 2.50%

# Fixed Income Markets: Trailing 12 Months




- The yield curve has flattened in recent quarters as short rates have risen while intermediate and long rates have drifted lower. The yield spread between 10-year and 2-year Treasuries is at levels last seen in 2007.

- A flat yield curve signals a slowdown in economic growth while an "inverted" yield curve indicates a recession on the horizon. The yield curve has inverted five times in the past forty years, all of which were followed by a recession.

- Recent flattening in the yield curve is not cause for alarm; however, it is important to pay close attention to where it moves from its current level.

*Source: As of 6/30/2017 Factset*

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# Our Current Market View and Strategy

## U.S. Equity Markets

### Strengths

- Economic growth is expected to be positive with possible upside to expectations with the new administration's policies.
- Valuations are historically high – but not at historic extremes, and earnings growth is improving.
- Corporate balance sheets are very strong – high cash and low debt levels should add stability and confidence.
- U.S. markets continue to be viewed globally as a safe haven with strong fundamentals.
- Long term rolling returns are below historic norms.

### Concerns

- Uncertainty over the impact of new trade and tax policies anticipated by the new administration.
- Uncertainty over the timing and pace of the Fed's shift in monetary policy in 2017.
- Delays in pro-business policy implementation from the new administration.
- Geopolitical risk - especially with recent developments in the Middle East and North Korea, and continuation of uncertainty in Russian Mid East policy.

We are positive on the long-term outlook for U.S. equities. We expect positive earnings growth, low inflation, and strong corporate balance sheets will help stocks move higher over the next several years. In addition, the U.S.'s position as a global economic leader should continue to attract capital. The pro-business shift in Washington following the election adds opportunity for a boost in growth – however, uncertainty over timing and pace of change will persist. We expect significant volatility as issues are resolved around fiscal and monetary policy – and global growth expectations.

## International Equity Markets

### Strengths

- Unique investment opportunities in various regions exist as non-U.S. markets now represent over 50% of global capitalization – our emphasis is currently on developed markets vs. emerging markets.
- Expect higher than U.S. growth in many non-U.S. economies – primarily emerging markets - over the next three to five years.
- Recent positive performance versus the U.S. has been driven by improving fundamentals – which should allow this trend to continue.

### Concerns

- Despite recent positive relative returns, emerging market growth expectations have slowed in recent quarters causing investor concerns and increased volatility in their equity markets.
- Geopolitical, economic, social, and military unrest and uncertainty in Europe , as well as the Middle East and North Korea.

Our view towards international equities has turned more positive. Valuation and improving fundamentals are encouraging. We want to have an active exposure to these markets in the current environment. We believe global economic and financial markets continue to be a cornerstone of a diversified portfolio. Our current bias is towards developed markets versus emerging markets.

## Fixed Income Markets

### Strengths

- Changes to monetary policy through the Fed's interest rate policies is expected to be gradual over the next year.
- Corporate credit fundamentals are strong and improving.
- Growing pressure to reduce government debt and spending.
- Continued low inflationary pressures.

### Concerns

- Fed's successful execution of rate hikes over the next year.
- Rising concerns over a possible uptick in inflation driven by improving economic conditions.
- Risk associated with emerging market debt, China and India economic growth concerns, and pervasive geopolitical unrest.

We are positioning our portfolios more defensively by maintaining short to neutral maturity positions relative to benchmarks and focusing on higher coupon bonds. We believe the improving economy is expected to eventually put upward pressure on long term rates. We favor overweighting high quality corporate bonds relative to Treasury and Agency securities. Our high quality bias is expected to provide enhanced liquidity during this transition period. Municipal bonds have been attractively priced relative to taxable securities for the past several years – however, recently that relationship has become more normalized.

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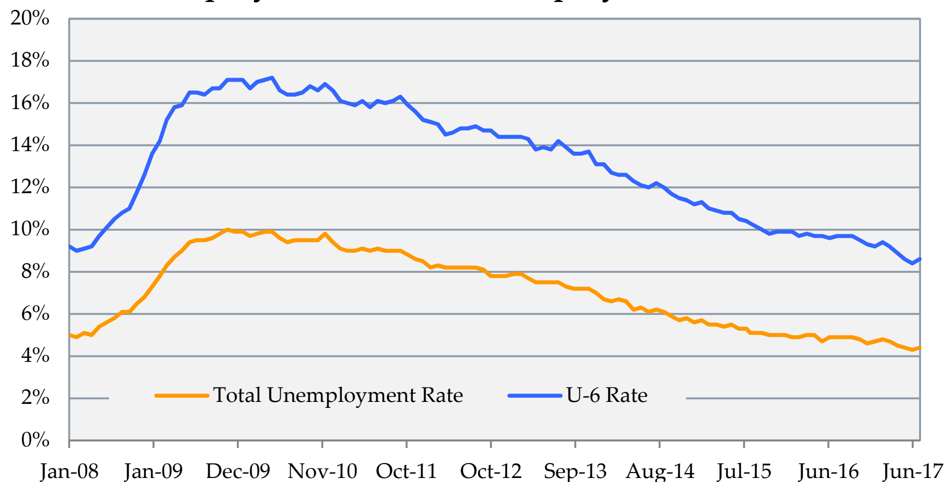
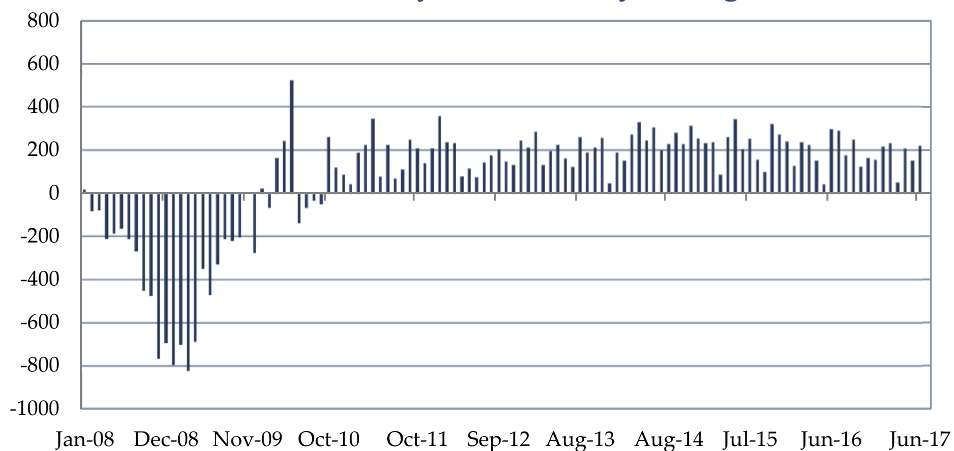
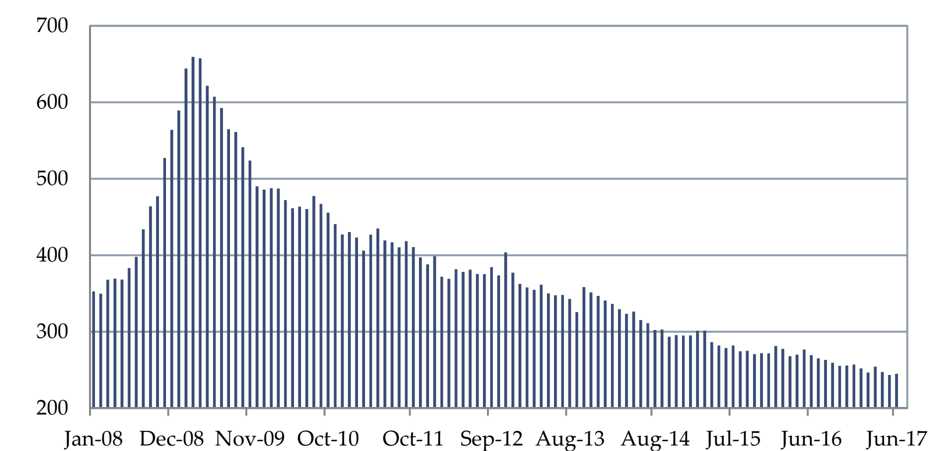
# Yellen's Dashboard of Labor Market Indicators

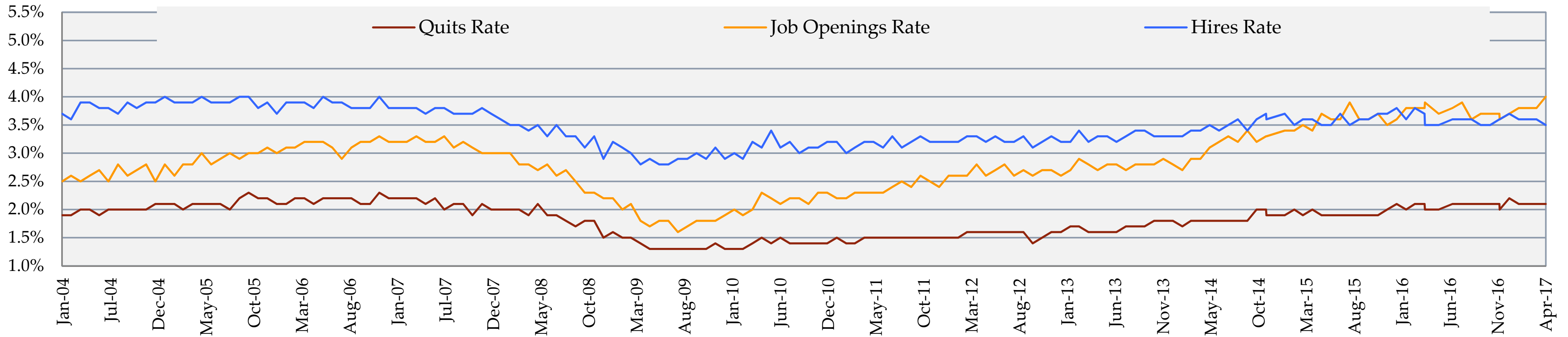





*Data as of 06.30.2017. Sources: Bureau of Labor Statistics, Department of Labor.*

# Yellen's Dashboard of Labor Market Indicators



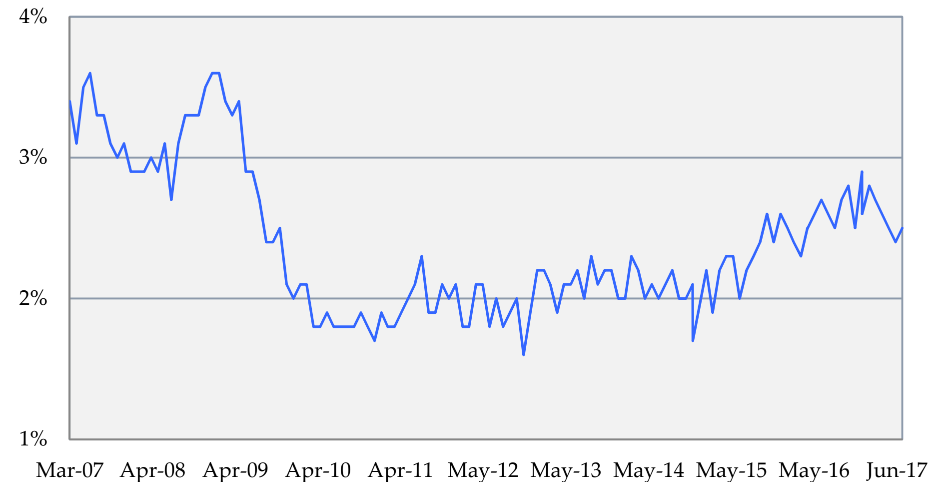



*Chart: Labor Market Indicators data as of 04.30.2017. Charts: Labor Force Participation Rate and Average Hourly Earnings Growth YoY data as of 06.30.2017. Source: Bureau of Labor Statistics.*

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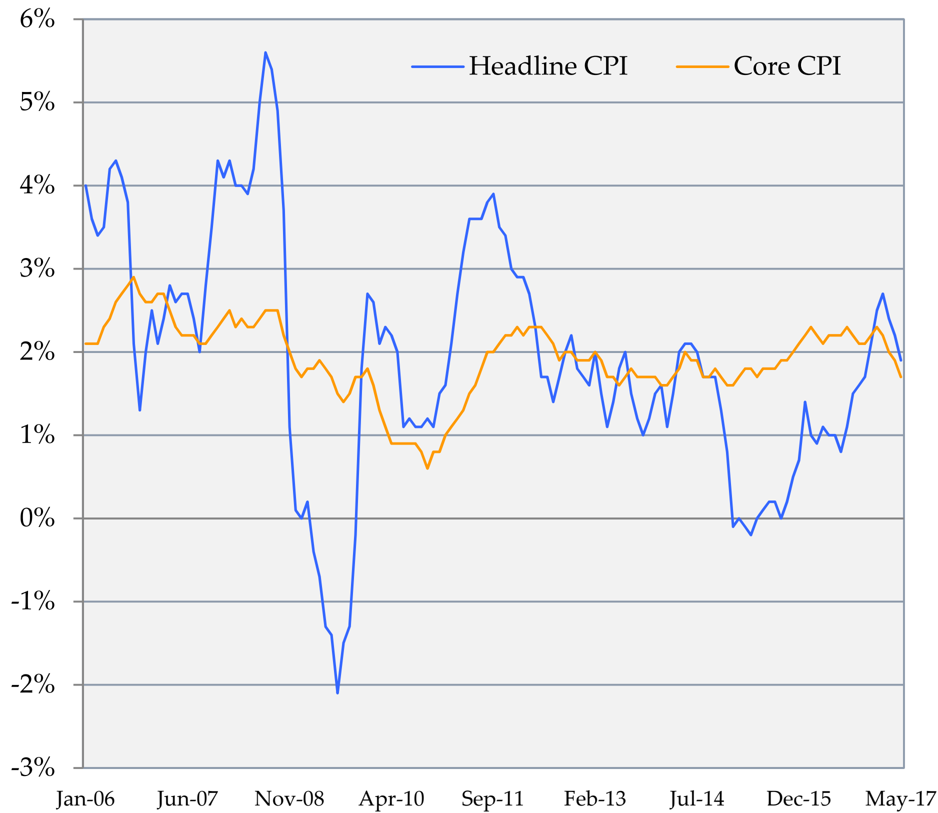
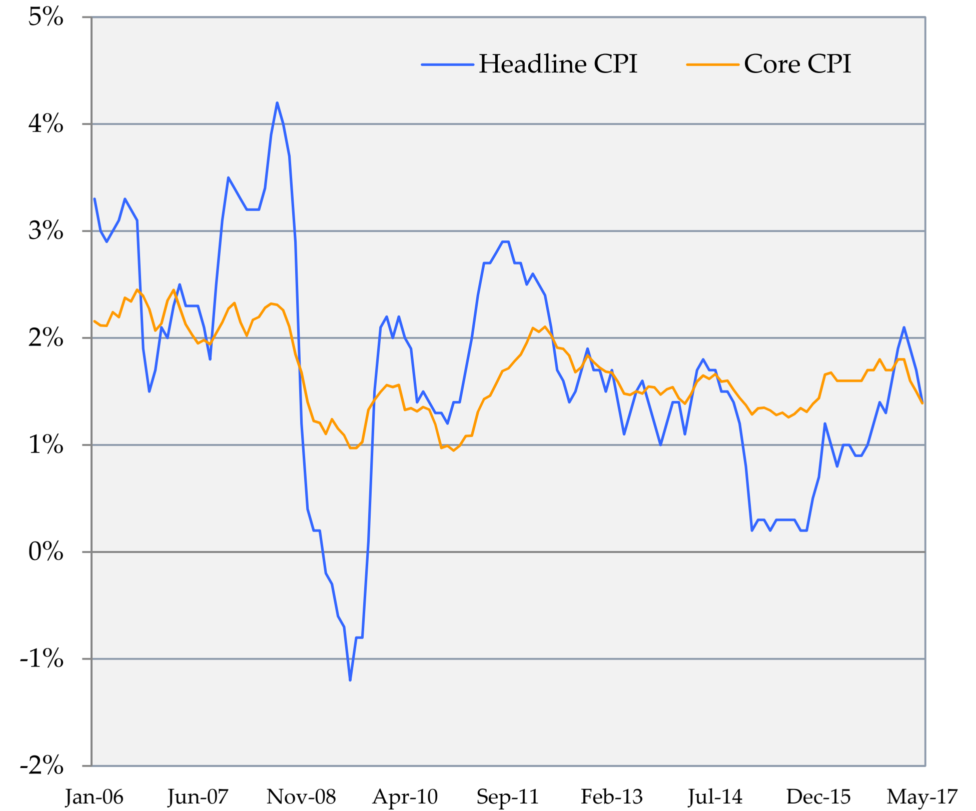
# Inflation Outlook

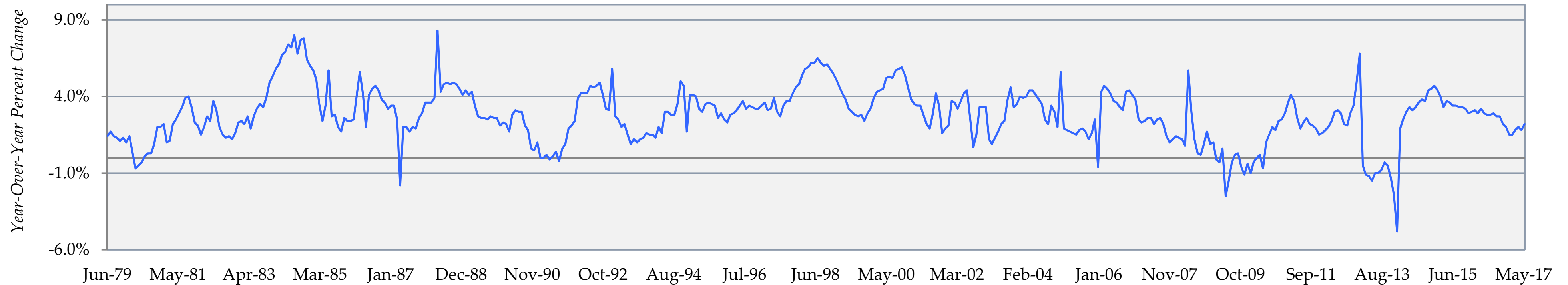


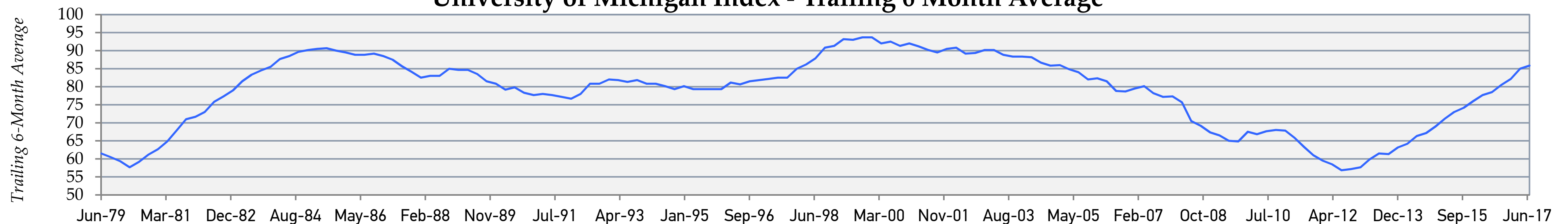




- Inflation measures have dropped recently, in part driven by declines in energy prices.

*Data as of 05.31.2017. Sources: Bureau of Economic Analysis, The Federal Reserve.*

# American Consumer on Solid Footing

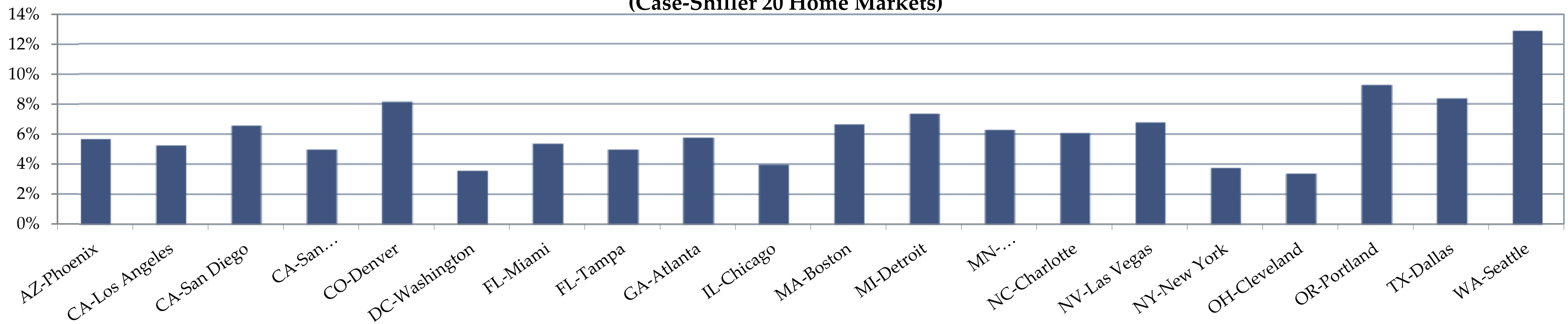


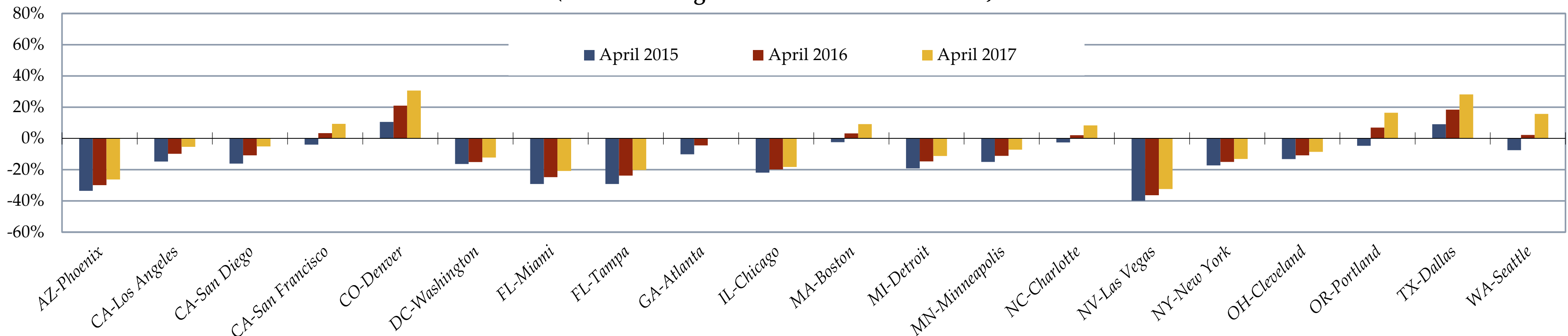




- The consumer has seen continued growth of disposable income over the last two years and remains optimistic about future income growth.

*U.S. Real Disposable Personal Income data as of 05.30.2017. U.S. Consumer Real Income Expectations data as of 06.30.2017. Source: Bureau of Economic Analysis.*

# Housing by Metropolitan Area



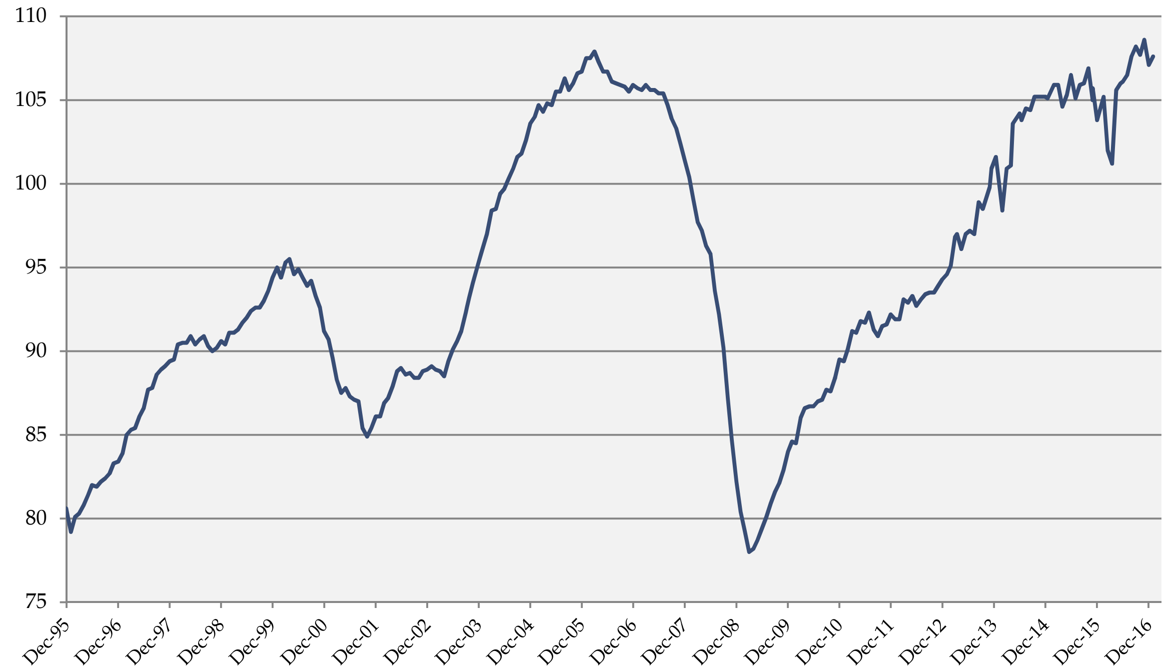

- ➢ The most recent housing data shows continued improvement in home prices; however, most major markets remain below peak levels.

*Data as of 04.30.2017. Source: Standard & Poor's.*

# Leading Economic Indicators

**Indicators**

- Week by Hours (Manufacturing)
- Jobless Claims
- Manufacturing New Orders for Consumers
- Manufacturing New Orders for Non-Defense
- Vendors Performance
- Building Permits
- S&P 500 Performance
- Money Supply (M2)
- Interest Rate Spread (10 yr Treasury vs. Fed Funds)
- Consumer Confidence




- The Leading Economic Indicators (LEI) Index is released monthly and is comprised of 10 indicators that have shown to forecast the future direction of the business cycle.
- The current LEI remains marginally below pre-recession highs; however, 7 of 10 indicators are in positive territory and the trend remains positive.

*Source: U.S. Conference Board*

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# Historical U.S. GDP

## U.S. GDP Annual Growth Rate

8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%

1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 Forecast

2.50%-2.75%

- U.S. economic growth has been positive for the past seven years; however the pace of growth has been below its long-term historic average.
- GDP expansion in 2016 generated full year growth of 2.1% - primarily due to a stronger second half of the year. We expect economic momentum to continue and pro-growth policies to ultimately be implemented. Despite a slow start in the first quarter our 2017 growth expectations are in the 2.50% - 2.75% range.

*Data as of 12.31.2016. Forecast data from Sterling Capital Management . Source: Bureau of Economic Analysis, Sterling Capital Management.*

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# Economic Outlook

## Strengths

- Signs of economic improvement continue – new "pro business" administration in Washington likely to support stronger growth through tax reforms and reduced regulation.
- Consumer confidence and manufacturing is strengthening.
- Strong corporate balance sheets continue as a positive.
- Global economies showing signs of modest improvement and stability
- Personal incomes growing and employment picture improving.
- Positive trend in leading economic indicators.

## Concerns

- Washington "quagmire" may derail new administration's policies and stall the execution of pro-business agenda.
- The Fed's pace and magnitude of interest rate increases adds monetary policy uncertainty.
- Investor complacency after a prolonged run in equity prices accompanied by low volatility.
- Global security concerns are rising with several terrorist incidences occurring and North Korea's nuclear weapons escalation.

**Outlook**

The combination of a modest improvement in housing, employment, and business spending should keep economic growth in positive territory over the next several quarters. Geopolitical concerns and uncertainty in Washington will overhang the economy, but should not derail the recovery. Improving corporate earnings, rising consumer confidence, and an uptick in capital spending should support positive future growth. However, the threat of the administration's pro-business agenda being stalled adds uncertainty. For 2017, we believe economic growth will push higher to the 2.50%-2.75% range, up from the 2.1% rate of growth in 2016.

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# Sterling Capital Disclosure

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