Market Perspectives
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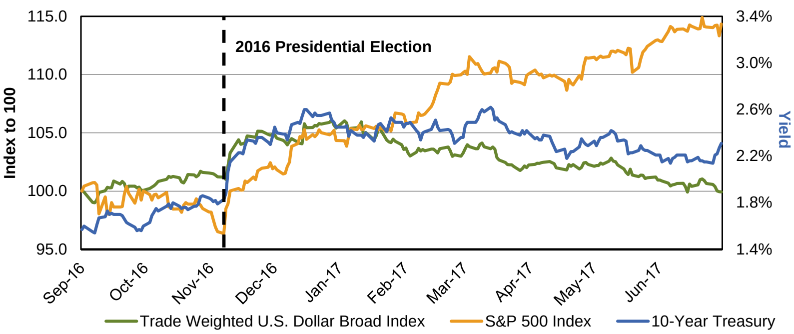
Executive Summary

- Domestic equities ended June on a positive note, with stocks making gains across all major indices.
- Emerging market stocks gained while developed international markets declined slightly last month. Year to date, however, international equities are outperforming their domestic counterparts by a significant margin.
- Bonds gave up some ground as the yield curve steepened late in the month, while lower quality bonds achieved small gains.
- In a widely expected move, the Fed raised its benchmark interest rate by 25 basis points at its June meeting. In addition, it released a plan to shrink its balance sheet, gradually reversing much of the expansion that took place as part of the former QE strategy.
- First-quarter GDP growth estimates were revised slightly upwards to 1.4%, while the outlook for the remainder of the year points to stronger growth in the coming quarters.

YIELDS AND U.S. DOLLAR STRENGTH WANE WHILE EQUITIES CONTINUE THE GRIND HIGHER



Source: PMFA, Federal Reserve Economic Data (FRED), Bloomberg

Monthly Insights

The chart on the left plots the recent trends in U.S. equities, 10-year Treasuries, and the relative strength of the dollar, looking at their performance from last September through the end of June. In the three months following the U.S. presidential election, these indices followed similar paths including a rally in equities, along with a concurrent surge in the dollar and an increase in Treasury yields.

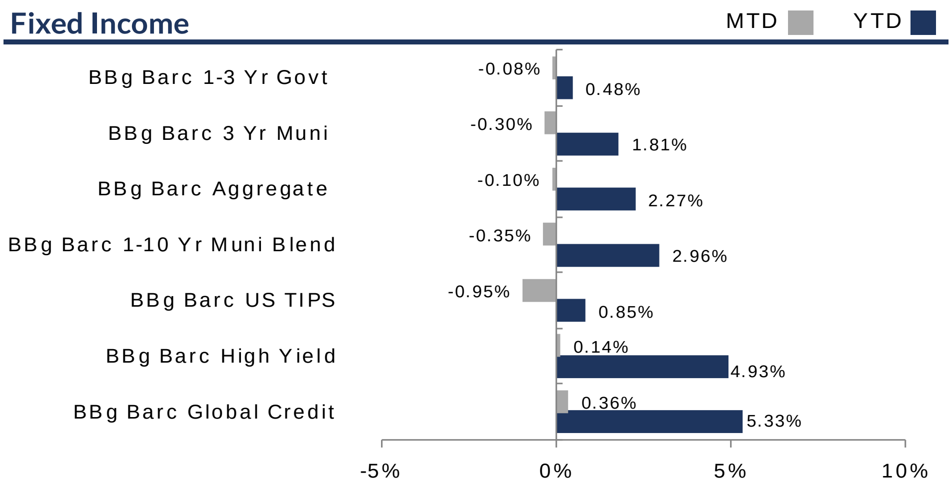
However, since February, the trends have diverged – with the strength of the dollar and Treasury yields waning, while equities have continued to rise. Greater uncertainty surrounding the timing and impact of the President's pro-growth initiatives appears to have contributed to the reversal of the post-election rally in the dollar and yields. Conversely, equities have seemingly shrugged off the shift in expectations and have continued to climb the wall of worry.

Divergent Trends

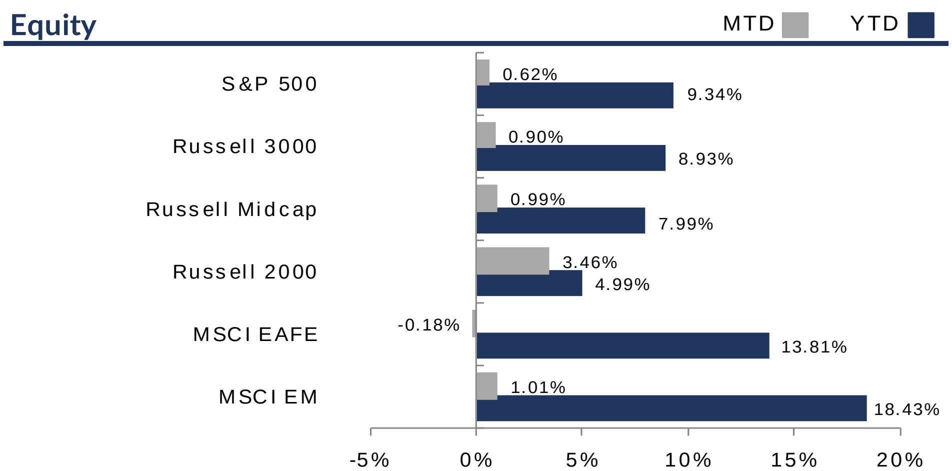
June was a positive month for stocks, as equities extended their post-November rally, even as bonds pulled back slightly. Overall, the trend since February – as noted in the Monthly Insights section above – has been one of gradual resettling towards market conditions that prevailed prior to the presidential election. However, stocks have been the exception to this rule, so far shrugging off the recalibration of expectations surrounding the pace and scope of federal policy changes at home and potential geopolitical uncertainties overseas.

PERFORMANCE OVERVIEW – AS OF 6/30/17

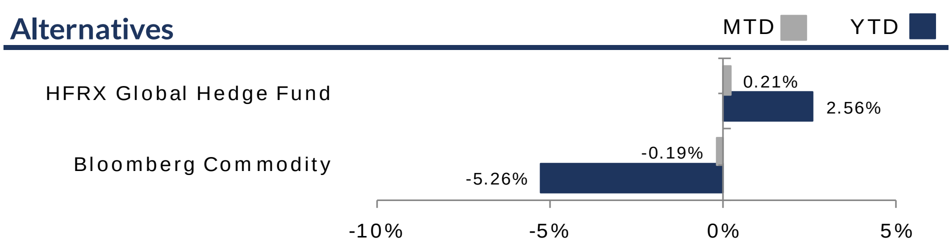
Fixed Income



Equity



Alternatives



Source: PMFA

Major developments in June included the release of the Senate's version of the health care bill, a signature piece of the Trump administration's regulatory reform agenda. This highly-anticipated legislation had a rocky reception following its unveiling, and it remains to be seen whether further progress can be expected on this front.

Other key elements of the new administration's policy agenda, which in addition to regulatory reform includes tax reform and fiscal stimulus, also appear to be stalled or progressing at a slower pace than anticipated. The reality is that even with the White House and Congress aligned on big-picture objectives, it's a difficult and time consuming process in the best of circumstances to enact significant policy changes. It is looking more likely that the work on these initiatives won't be concluded until next year.

On the international front, headlines were dominated by the results of the national elections in the U.K., in which the ruling Conservatives nearly lost their hold on power – an unexpected result that could create further uncertainty as Britain enters into Brexit negotiations with the rest of the EU.

North Korea continued to ratchet up the tensions in Asia and beyond by testing missiles that it claims are capable of reaching targets as distant as Alaska. South Korea, China, Japan, and the U.S. are scrambling to find an appropriate and effective response to de-escalate the situation in the region.

While none of these issues have had a significant impact on stock prices to date, it's important to keep in mind that such uncertainties have the potential to contribute to an increase in future market volatility.

Meanwhile, key U.S. economic indicators continue to paint a positive picture for growth in the coming quarters. A theme that extends beyond the borders of the U.S., as a synchronized global economic expansion appears to be taking hold – a positive backdrop for diversified equity investors in the second half of the year.

The U.S. economy grew slightly faster in the first quarter than previously thought, according to the latest revision to GDP estimates, but at 1.4% that figure by itself is still uninspiring. At this point, however, attention is focused on data that supports an expected pickup in growth in the second quarter, as a combination of strong labor market conditions, growing income, and consumer activity should support stronger growth.

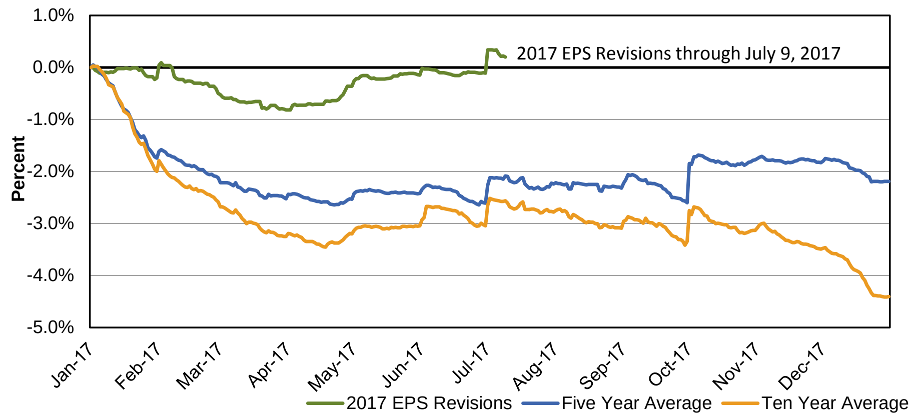
In particular, consumer spending – which dipped in the first quarter and accounted for much of the slowdown – is expected to rebound. Sentiment has dipped slightly from recent highs, but overall consumer sentiment and confidence remain at comparatively high levels, which should be supportive of expansion.

The Fed, for its part, is continuing to execute its plans to bring about a gradual restoration of monetary policies more in line with historical norms. At its June meeting the FOMC raised the benchmark interest rate by 25 basis points, a move that was thoroughly telegraphed and so widely expected that it was a non-event for the markets.

In addition, for the first time, the Fed outlined its plans to reduce its balance sheet. Although the program of quantitative easing (QE) ended some time ago, the Fed's balance sheet grew substantially as it turned to QE as a response to the 2008 financial crisis and it remains at high levels today.

Very broadly the plan includes separate paths for shrinking the Fed's holdings in Treasuries and mortgage-backed, government-guaranteed bonds by gradually curtailing the current practice of reinvesting the proceeds from mature bonds back into the market. Initially, the Fed will impose a cap on the value of securities it allows to roll off its balance sheet, although over time it envisions raising the caps.

EARNINGS EXPECTATIONS SUPPORT STOCK MARKET



Source: PMFA, Bloomberg

Some questions remain about the details of the plan and its impact on elements of the market, and to some extent this is uncharted territory. Still, the Fed has communicated its objectives, and has indicated that it will move gradually and transparently. While the timing has yet to be determined, it is bound to be a slow process, and there should be room for policy makers to assess their progress and make course-corrections as necessary.

Looking at how the markets performed in June, domestic equities ended the month on a positive note with stocks making gains across all major indices. The small-cap Russell 2000 had a particularly strong return in that period, gaining 3.5%, while mid-caps added 1.0% and the large-cap S&P 500 edged up 0.6%. Year to date, however, it's the large-caps that are holding onto the strongest gains, up 9.3%, while mid-caps have added 8.0% and small-caps trail the group holding onto 5.0% gains.

While international equities had somewhat mixed results in June, the major theme is how well they have performed since the start of 2017, outperforming their domestic counterparts by a significant margin.

Returns for developed market stocks are up 13.8% year to date, while emerging market stocks have added an impressive 18.4%.

As long-term investors, we look at market fundamentals that will play out over a period of years – not weeks or months. Our portfolio maintains a slight overweight to international equities, because we believe that they offer the greatest growth potential based on relative valuations and the positive outlook for global economic expansion.

Turning to fixed income, bonds gave up some ground as the yield curve steepened late in the month, while lower quality bonds achieved small gains. On the downside, municipal bonds (represented by the Bloomberg Barclays 1-10 Year Muni Blend index) dropped 0.4%, while the Bloomberg Barclays Aggregate lost 0.1%. Meanwhile the Bloomberg Barclays Global Credit Index gained 0.4% and high-yield bonds added 0.1% for the month.

Year to date, all the major benchmarks remain in positive territory. Interestingly, municipal bonds have outperformed their taxable counterparts so far this year. The Bloomberg Barclays 1-10 Year Muni Blend Index is up 3.0% compared to a 2.3% gain for the Bloomberg Barclays Aggregate – the return differential becomes even more compelling on a tax adjusted basis for clients in higher tax brackets.

Now, as we consider the diverging trends in the markets in recent months, the question remains, why have equities stayed buoyant, even in the face of growing uncertainties and relatively high valuations while other factors have reversed much of their post-election jump? There are many factors that go into what sustains (or changes the momentum of) a rally, but one consideration is likely the outlook for corporate earnings.

After an extended period of decline, corporate profits are expected to show healthy growth this year, which could help ease concerns about elevated price-to-earnings ratios. In addition, unlike many previous years, earnings estimates have remained consistently high, which can boost investor confidence. To get a sense of how much recent revisions have compared to historical averages, the chart on page 3 tracks the extent to which earnings forecasts have been revised over the course of a year. As is evident from the 5 and 10-year average lines, corporate earnings estimates tend to be revised heavily downward over the course of the year. Yet, so far in 2017, this hasn't happened – providing some hard-data to support investors' positive expectations.

While diverging trends in market conditions may extend for some time, it's impossible to reliably know when the winds of change will eventually shift and in what direction. As such, we believe the best way for investors to be prepared for the inevitable shifts and take advantage of new opportunities is to adhere to a sound investment strategy focused on long-term goals and implemented in a manner that is consistent with their risk tolerance and liquidity needs.

Blog

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Gratuitously Unnecessary Fact of the Month

Flight of fancy?

In the market for a car, but not quite finding what you're looking for in the showrooms? The makers of "the world's first vertical-takeoff-and-landing" flying car are auctioning their first working prototype on eBay for a starting bid: $1 million.

The M400 Skycar was developed by Moller International in 2001 as part of the company's initiative to build flying cars that are as safe, efficient, affordable and easy to use as traditional cars. Moller promises to deliver the winning bidder a fully-operational Skycar, in its original form and flight condition.

One minor hitch, the M400 never received FAA (or DMV) approval, so in order to operate the vehicle, the new owners would have to get a few regulatory details cleared up first. Alternatively, the Skycar would make an impressive conversation piece for any living room.

Sources: eBay, Forbes