SIGNATUREFD

Fall 2017

MARKET SENSE:
Fundamentals Fuel Global Growth

A sage investor once said that the stock market is designed to disappoint the largest number of investors as possible at any given time. Paradoxically, in 2017, this disappointment has manifested as a multitude of investors and market analysts being wrong in predicting a stock market correction, typically defined as a drop of 10% or more. Our sense is that many professionals have been caught flat-footed this year and are hoping for a pull-back so they can put money to work. Ironically, it is this pent-up demand that has thus far prevented markets from getting ahead of themselves and causing a sizable drop.

In any given calendar year, the stock market has about a 60% probability of declining by at least 10% at some point. However, the biggest pull-back in 2017 is just 3% and the market hasn't suffered even a 5% correction in five quarters, the fifth longest streak in market history. Volatility measures in the stock and bond market are all close to record lows. How can an investor reconcile geopolitical fears in North Korea, historic storms and flooding, and political turbulence in Washington with a largely benign market environment? Simply put, the fundamentals have overwhelmed these low probability (but significant) events that haven't yet created negative impact on the economy. In fact, the global economy has been undergoing a synchronized period of growth, which is feeding into corporate earnings. At the same time, access to capital remains abundant and the potential for fiscal and tax stimulus are more fuel to sustain the recovery. In this quarter's letter we will touch on the subtle, but real, changes happening at the Federal Reserve and other central banks, as well as our views on opportunities and risks ahead. Before delving further into these, we would highlight the table below which provides data on broad measures of market performance in recent periods.

	2nd Quarter	52 Weeks
S&P 500	4.48	18.61
Dow Jones Industrial Average	5.58	25.45
MSCI EAFE (Developed International)	5.40	19.10
MSCI EM (Emerging Markets)	7.89	22.46
Bloomberg Commodity Index	2.52	-0.29
Barclays Global Aggregate Bond Index (Global Bonds)	1.76	-1.26
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	0.85	0.07
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	0.68	1.14
HFRI Fund of Funds Composite Index	2.24	6.42

GLOBAL ECONOMIC REVIEW

As mentioned above, the global economy has entered a period of sustained and synchronized global growth. Aside from the initial burst higher after the Great Recession, the data is the strongest of the current cycle which started in 2009. Ned Davis Research, one of our primary research providers, expects global GDP growth to accelerate to 3.4% for 2017. Moreover, with inflation and interest rates remaining low, investors are forecasting that this "Goldilocks" set up can continue for some time. With investor fears low, they are willing to pay up for equities and other growth-oriented assets when compared to relatively unattractive return potential from bonds and cash.

Actual growth in the form of GDP and leading indicators in the four most important economic regions – United States, Europe, Japan, and China – are all rising and arguably even running ahead of potential. This last point is important because growth above potential eventually becomes unsustainable. Economists cannot agree on the precise levels, but it is widely believed that potential growth is lower than it was 20 years ago, because of aging demographics, high debt levels, and lower labor productivity. However, inflation is the regulator for knowing when the remaining slack in the economy has been utilized. Thus far, the lack of inflation would indicate that in much of the world, including the U.S., the slack created in the Great Recession has yet to be absorbed. But, inflation often lags behind other data and it is impossible to project when this actual level is reached.

Recent data continue to show a global recovery that is remarkably resilient for this stage of recovery. Major indexes of manufacturing data continue to show solid growth. More subjective indicators, such as consumer and business surveys also remain near highs registered last fall. Importantly, these soft data points are starting to show some spill-over into capital spending. For example, a model by one of our research partners, BCA Research, forecasts that global capital spending is set to hit its highest level in more than six years over the next 12 months. Such spending would be indicative of an economy that has used up most spare capacity and needs to expand to meet future expected demand.

The improving hard data is yet to transmit into wage growth – the missing component in the inflation mystery. But, it seems just a matter of time until employers are forced to raise wages. For example, recent data from the National Federation of Small Business shows that nearly one in five companies cite finding qualified employees as their biggest challenge. With some economists projecting that the unemployment rate could drop to as little as 3.5% next year (a 50-year low), it could be workers who see the biggest improvement in situation over the coming quarters. Research by BCA also point to the classic "Phillips Curve," which measures the relationship between unemployment and wage growth, being nonlinear, where wage inflation does not begin to meaningfully accelerate until the economy reaches the natural rate of unemployment. Worth noting, the U.S. economy just recently reached this level and as such, we would expect wage growth to begin to accelerate.

GLOBAL CAPITAL SPENDING IS SET TO HIT ITS HIGHEST LEVEL IN MORE THAN SIX YEARS OVER THE NEXT 12 MONTHS.

SHIFTING CENTRAL BANK POLICY

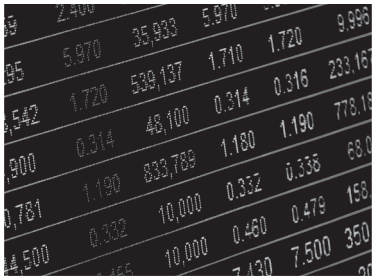
The Fed has recently stated that they feel they have largely met their goal of maximizing employment, yet remain somewhat below target with regard to inflation (which they target at 2%). But they have also reiterated that they believe the current period of low inflation is transitory and that inflation will be at their target in the next year. Given this apparent confidence, they have recently taken on a more hawkish tone (investors define hawkish as a Fed that is less supportive of asset prices).

At the most recent Federal Open Market Committee (FOMC) meeting, the Fed announced the beginning of their long-awaited balance sheet reduction. The U.S. Central Bank currently has a $4.5 trillion balance sheet (up from about $800 billion before the financial crisis) and plans on allowing $6 billion of Treasury and $4 billion of mortgage-backed securities (MBS) to roll off each month for the first three months beginning in October. The Fed will look to increase this amount gradually, but the balance sheet normalization will be slow and predictable according to the Fed's plan, which the Fed hopes will lower the risk of market disruptions. In its efforts to make this a market nonevent, the Fed somewhat constrained itself to any deviation of its path for future policy. Given that the normalization could take as long as five years, this may prove to be a difficult promise to keep.

The other large focus from the meeting was the likelihood of a December rate hike. Prior to the meeting, the market had implied there was a 40% chance the Fed would hike in December, though as of now, the market has readjusted this view to more than 70%. Over the next several quarters a large gap remains, however, with regard to the pace of rate increases. The market is currently forecasting only two rate increases from now through year-end 2019. The Federal Reserve members, on average, are forecasting six.

Inflation is the key determinant of whether the Fed or the market's forecast is ultimately proven correct, we believe. Economists project that interest rates on the 10-year Treasury could rise between 0.5 and 1.0% as the balance sheet normalization plays out. If six rate increases occur, this would likely occur with inflation rising to 2% or more, and investor expectations for future inflation could push rates up an additional 1%, implying a 10-year Treasury yield of close to 4%. Outside the U.S., other major central banks also appear to be hitting peak easing. The Bank of England has recently talked of raising interest rates. In Europe, the European Central Bank is likely to announce asset purchase tapering within the next few quarters. Japan's central bank will almost certainly be the last developed country's to tighten policy, but an expansion of current policy seems unlikely at present. Thus, the developed world will see the first synchronized central bank policy since 2010; however, this synchronization will be one of all banks tightening or at least slowing down support for their domestic economies.

The apparent result of this bias to tightening is that global interest rates are set to rise. However, even though our investment team believes that long-term interest rates are likely to gradually rise over time, we are not forecasting a major spike. We believe that the larger impact could come from the risks that Fed policy poses over the next few years. A Fed that either acts too slowly or too quickly could have an impact. If data or outside events keep the Fed from gradually raising rates, inflation and expectations could quickly move higher at some point, causing the market to panic that the Fed is "behind the curve." Given the Fed's own forecast for rate increases, this seems like a limited risk. The larger risk could be that they move too quickly. Fed policy impacts the economy with a significant lag.



THE MARKET IS CURRENTLY FORECASTING ONLY TWO RATE INCREASES FROM NOW THROUGH YEAR-END 2019.

It is unclear at what level interest rates will start to slow economic activity but the Fed could inadvertently push too far and cause the economy to stall before they realize it. Client portfolios are designed for this current environment of continued global growth, expanding corporate profits, and slowly rising rates and inflation. However, as the cycle continues to age, we must be on alert for subtle shifts that indicate it is time to change course.

Market Risks and Opportunities

We believe this return to a more normal market is healthy given that Fed policy has been a driving force in the economy for the past several years. However, it remains true that we are in unchartered waters. Market volatility could appear at any time, given that the Fed is now shrinking their balance sheet and raising interest rates. How quickly and forcefully this shifting policy will impact the economy is unclear.

Aside from impossible to project "black swan" economic or geopolitical events, the other primary risk we currently see is China. Risks coming from China are certainly not new, but as we forecast earlier this year, they have not materialized in advance of this month's 19th National Congress. But as we enter 2018, reform will become more aggressive. One of the key objectives of policymakers for the next five years is financial market stabilization. The party leadership aims to reduce dependence on credit growth and to shrink the size of the banking system relative to the economy. Though healthy in the long-run, it is impossible to project any near-term impact on the markets or economy.

Even though asset prices broadly remain on the high-side, opportunities for investors do still exist. As over the last several quarters we believe opportunities outside the U.S. exist. The Eurozone and Japanese areas are benefiting from an alignment of macroeconomic stars: an accelerating economy, political reforms, relatively cheaper valuations, and (especially in the case of Europe) an undervalued currency.

Within the U.S., we have recently seen a trend back toward economically sensitive reflationary sectors. This is helping our portfolios as they are geared toward this economic outcome which benefits industrials, financials, and energy, specifically. With regard to energy, we still find this the most interesting space within the U.S. Our portfolios have overweight positions in pipelines and oil field services. Data indicates that inventories are correcting at pace unseen in over 10 years. True, global inventories were very high in the 2014-16 period, but we think with global growth pushing demand higher and inventories correcting quickly, this will not be the case by year-end. Additionally, with global energy capital spending declining for four years running (the first time ever), the ability of production to quickly ramp up should be questioned. Clearly the U.S. has a good chance of capitalizing on rising prices, as our shale-based energy production is among the most efficient in the world. If they do, we believe our energy exposure will benefit.

With regard to the fixed income portion of portfolios, our outlook on interest rates filters into positioning. We remain significantly underweight in core bonds, which would be the most sensitive to interest rate increases. Our exposure remains mostly in shorter-term, higher-yielding corporate- and mortgage-related bonds – positions that have higher levels of credit risk. As long as our view of the economy holds, this risk should not be an issue.

As always, we thank you for your continued confidence in our team and welcome any questions on this letter or any other matters.