Market Review and Outlook—October 4, 2017

Everyone's A Winner! The chart below shows gains for every category for the past quarter and the past year. All roads led to profits for investors recently. Foreign stocks have caught up to US stocks, as both have one-year gains in the high teens. Stock sectors have a wide range, with real estate posting anemic gains, natural resources doing well, and technology stocks on fire, gaining 27% in the past year. Stocks have done so well that bonds' low gains, of under 1%, have not prevented an investor with 60% stocks from gaining over 10% in the past year.

US Economy—In 2015 and 2016 low oil prices led to losses for US energy companies, and these losses dragged down the earnings of the overall US stock market. The rest of the US economy has been solid—technology, financials, health care, consumer discretionary, industrials, etc. With consistent, recovered oil prices this year, the final sector is back in the fold, US earnings have recovered and have begun setting new highs. Furthermore, the US dollar has fallen over the past year, which helps US companies sell more goods and services overseas (43% of sales of S&P 500 companies are foreign). Real estate has limped along this year, but has solid longer-term results. Healthcare has gained a bit over 16% in the past year, technology 27%, and financials 30%.

Not to be Outdone—Foreign economies are also growing, often at a better pace than in the US. US investors get a double-delight, as the foreign stock gains are boosted by the currency change of recently declining US dollar. Although they fell slightly in September, emerging market stocks have been very strong this quarter and year (up 7⅜% and 20%, respectively). Foreign smaller stocks have also had a nice quarter and year, gaining 7% and 22⅜%, respectively.

New Normal for Bonds—The Fed has begun to paint their process for gradually reducing their mammoth inventory of bonds, which they bought to prop up the US economy. This will serve as a drag on returns for bond investors for five years or more. Thus, annual bond yields could continue their below-three-percent level for years. Our opportunity bonds, however, are chosen to deliver better returns in this environment, and they returned over 3½% during the past year.

The table below was easy to construct—it requires gathering data from the past. The more important table will have future returns. The next page will address what we see ahead of us.

Category	**3 Months**	**12 Months**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.18%	+0.40%	+0.16%	+0.10%	+0.52%
Intermediate Term Bond	+0.87%	+0.84%	+2.52%	+2.14%	+4.31%
Intermediate Muni Bond	+0.99%	+0.47%	+2.52%	+2.36%	+3.72%
Large-Cap Stock	+4.20%	+17.63%	+9.04%	+12.87%	+6.59%
Mid-Cap Stock	+3.67%	+16.02%	+8.15%	+12.86%	+6.88%
Small-Cap Stock	+5.08%	+18.88%	+10.01%	+12.84%	+7.22%
Foreign Large-Cap Stock	+5.30%	+17.98%	+5.11%	+7.78%	+1.28%
Natural Resources	+8.52%	+15.23%	-0.46%	+1.85%	+0.43%
Real Estate	+0.72%	+1.55%	+8.73%	+8.73%	+5.13%
Technology	+8.15%	+27.06%	+16.12%	+17.79%	+9.64%
Moderate Allocation (60% stocks)	+3.01%	+10.54%	+5.40%	+7.54%	+5.10%

The data in this table comes from Morningstar and is as of September 30, 2017.
Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect, transactions in securities, or the rendering of personalized investment advice for compensation.

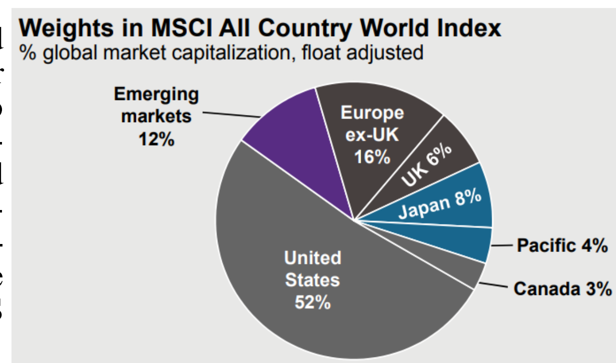
The US Economic Future Looks Bright, For Now—There are many reasons, but the US economy is expected to remain strong for the next few quarters, and the data supporting this view is convincing. Oil prices have been pretty stable at a level where solid profits can be enjoyed. The US dollar is expected to continue to weaken, which helps US companies boost their sales. The federal government is considering cutting corporate income tax rates, which could single-handedly provide a boost to companies' profits. The crystal ball for the US economy, however, is very murky further than twelve months off.

The Future is Brighter Beyond—The US' economic recovery is near record levels, already beyond eight years. The recoveries in Europe and other foreign economies are younger, with much more room to grow. But foreign economies don't only have better potential, they are experiencing real growth, finally. Furthermore, the growth is not in a few pockets—it is nearly universal. Even Greece's economy is growing!

But What Does It Cost? While it is nice that there are growing economies, are those stocks overpriced? Some are. Stocks are pretty expensive in the US, partially due to the growth discussed earlier. As has been the case for years, stocks deserve to be more expensive than normal, due to how low bond yields are compared with their history (another way to say that bonds are much more expensive than US stocks). Stocks are reasonably priced beyond the US, and now that there is clear underlying growth, the upside is very attractive.

Sectors—We continue to maintain a small extra dose of financial, health care, and technology sector exposure. We also maintain a 4% allocation to real estate, as a long-term inflation hedge and diversifier. We are cutting our natural resource allocation from 4 to 2% for now, selling into recent strength and thus sealing in some nice profits. Our 'normal' holdings already maintain exposure to natural resources, so we are working to eliminate our special allocation as it's advantageous, but it will take a bit longer.

Stock Strategy—We are leaving our primary dial unchanged at 102%, so clients with a 50% long-term allocation target for stocks will get 51% of stocks. The change we are making is to shift a further 2% from US to foreign stocks, so that our balance will be 52/48%. This reflects the balance of the broad MSCI All Country World Index. It captures the fact that foreign growth is greater than US growth, that foreign stock prices are less expensive than US stock prices, and that the upside for foreign stocks markets appears much greater than in the US where the stock market recovery has continued for so long.



Bond Strategy—We are not changing much for bonds. We continue to maintain our solid base of 65% quality bonds, primarily high quality corporate bonds. We split them evenly between short and intermediate-term bonds, to reduce the risk of loss should interest rates suddenly rise sharply . We also maintain a small 3% position in inflation-linked bonds, as protection in case inflation spikes. This piece has done little, as inflation has remained very tame for quite a while.

We also are maintaining our 35% allocation to opportunity bonds, split among the following sectors: high-yield bonds, bank loan bonds, multisector bonds, and emerging market bonds. These are more aggressive than our quality bonds, and this provides the potential for higher returns while the economy is chugging along. When we see greater risk for the US economy slowing down, we will look to cut back our 35% allocation, since opportunity bonds perform poorly in weakening economies.

Caution—The US recovery is much longer than most. It will end, and US stocks will fall from their current record levels. The problem, of course, is we don't know when. This problem is compounded by the abysmal returns from cash and bonds at this time. We are therefore proceeding with more caution than normal, yet we are accepting the risk from stocks, due to the strong economic support global stocks currently enjoy.

Rebalance—With one-year returns ranging from ½% to 27%, there are great opportunities to seal in some profits and buy some investments cheap, through a portfolio rebalance. This also reduces the risk that builds up when you let your portfolio drift. Commit to rebalance, and consider doing so now, while returns are high.