

Market Review and Outlook—July 6, 2017

Foreigners Welcome Foreign-stock investors were finally rewarded for their patience, as foreign stock markets did very well in the past quarter, and these gains were magnified for US investors as the US dollar fell 3%. The three types of foreign stocks that we follow all did well—foreign large stocks, foreign smaller stocks, and emerging market stocks, with gains of about 6-8%. All major areas—Europe, Japan, Asia—posted solid results.

While Back at Home US stocks posted fine results, just nothing special, with gains of 1½ to 3%. Sectors were mixed, with Health up 7%, Technology up almost 6%, Real Estate less than 2%, and Natural Resources down 4.4% from a 10% decline in the price of oil. With strength in Health and Tech, growth stocks outpaced value.

What About Bonds? Bonds gained between 1½ and 2% during the quarter. That includes intermediate-term taxable bonds, intermediate municipals, high-yield bonds, and multi-sector bonds.

Texas Tea As mentioned earlier, oil prices fell 10% during the quarter, but appears to be holding within a \$40-\$60 per barrel range. Critically, the oil sector is now making a meaningful contribution to the earnings of the S&P 500, and this is expected to continue, even with the lower current prices.

Money, Money, Money The US dollar fell 3% during the quarter, but is up about 2¾% during the past year. Like oil, the US dollar appears to be in a ‘trading range.’ Many investors would prefer that the dollar just hold ground, so that we don’t have to project where it will go next.

Interested? Interest rates did not move much during the quarter, and are quite ‘flat.’ At the end of 2013, 30-year Treasuries yielded 3.9% more than a one-year Treasury. That gap is now less than half that, only 1.6%. 30-year Treasuries yield only 0.7% more than a 7-year Treasury. High-yield default rates are beginning to climb, and their yields are not compelling. The 3- and 5-year trailing returns for bonds have been pretty low.

Rebalance With fairly modest 3-month gains, rebalancing required at this time should be modest. Some investors, however, have shunned foreign stocks for years, awaiting signs of life. The past quarter and year may convince them to venture back with substantial purchases, rebuilding their foreign stocks to more normal levels.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.12%	+0.25%	+0.10%	+0.06%	+0.63%
Intermediate Term Bond	+1.48%	+0.95%	+2.23%	+2.47%	+4.34%
Intermediate Muni Bond	+1.68%	-0.83%	+2.53%	+2.54%	+3.67%
Large-Cap Stock	+2.89%	+17.17%	+7.57%	+13.34%	+6.21%
Mid-Cap Stock	+1.92%	+17.41%	+5.45%	+12.99%	+6.10%
Small-Cap Stock	+1.51%	+20.94%	+5.69%	+12.73%	+6.14%
Foreign Large-Cap Stock	+6.26%	+19.13%	+1.21%	+7.83%	+0.99%
Natural Resources	-4.44%	+6.88%	-8.25%	+0.36%	-1.35%
Real Estate	+1.84%	-0.63%	+7.25%	+8.48%	+5.18%
Technology	+5.91%	+33.99%	+13.43%	+16.86%	+9.32%
Moderate Allocation (60% stocks)	+2.35%	+10.70%	+4.03%	+8.02%	+4.90%

The data in this table comes from Morningstar and is as of June 30, 2017.

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Global economic growth continues to look solid. Of 23 countries and regions, 22 post positive manufacturing outlooks, with Indonesia the only holdout. Even Greece has a positive outlook. Very significantly, non-US economies, overall, have brighter outlooks than the US, for the first time since 2011. The European region has exceptionally strong prospects. The US economy does not appear at risk of a collapse; however, it is expected to merely continue at its familiar, anemic growth rate. One reason for higher expectations in Europe is that its unemployment rate, while falling, remains much higher than that of the US. As such, Europe is seeing regular progress in reducing their unemployment rate, and has room for this to continue for a few years. This has the double benefit of steady increase in the number of consumers, and in economic production.

Are Stocks Expensive? Stocks are beginning to look expensive in the US. Their saving grace is that many alternatives (cash, bonds, commodities) are more expensive/unattractive. We don't see a crash coming, however we are seeing better opportunities beyond US stocks, specifically with foreign stocks. Stock prices are often quoted as the product of the earnings-per-share and a multiple, the **P/E ratio** (price divided by earnings). US stocks are trading with a P/E of 17.8 while foreign stocks have a P/E of about 16.7. While that difference seems, and is, pretty small, it is a notable difference. US stock earnings have more than doubled from their 2008-2009 crash levels; European stock earnings are only about 5% higher than crash levels. For stock investors to make money, they need 1) earnings to grow while the P/E levels are stable, 2) P/E levels to rise, and/or 3) dividends to be paid. Foreign stocks will have an easier time than US stocks to provide all three profit engines (foreign stocks pay dividends of 3% while US stocks pay only 2%, overall). That is three strikes.

Emerging market stock prices are cheaper than US or foreign large stocks. They have recovered more than European stocks, but still have much room for profit growth. We feel that emerging market stocks deserve a supporting role for investors' foreign stocks, with potential for occasional, very strong results.

The Great Unwinding Last month, the **Federal Reserve Bank** prepared its game plan to sell most of the \$4.5 trillion in bonds it purchased since 2008 to stabilize the US economy. Within a year, it plans to be selling \$50B of bonds per month. (Yes, this pace could take close to a decade; however, it took about eight years to build this collection.) This process will serve as a headwind for bond investors for a long time, and could spell the long-overdue death of the 37-year-old bond bull market. Critically, this unwinding is unlikely to cause a crash, due to it being well-publicized and gradual; it involves the sale of only about 1½% of US bonds per year. Given this unwinding headwind, and given our expectation that the US economic growth, while very low, is unlikely to reverse, we continue our use of opportunity bonds to complement quality bonds. Many foreign central banks also have sharply boosted their balance sheets, but their unwindings are likely years away.

Investment Committee We met today to finalize our strategy for client portfolios. We prefer stocks to bonds more than normal, and continue to set stock targets to 102% of their long-term target levels. Due to strengthening outlook for foreign stocks, and overvaluation for US stocks, we have changed our US/foreign stock balance from 56/44% to 54/46%, the first such change in years. We are maintaining our 70/20/10 split of large/mid/small-cap stocks, and are continuing to neither favor growth nor value stocks at this time. We have a small lean to tech, health-care, and financial stocks. We continue a 4% allocation to real estate and another 4% to natural resources. Among foreign stocks we are boosting our emerging-market stocks level to 22%, cutting our smaller stocks in larger countries level to 15%, while maintaining 20% for Europe specifically, and 43% for foreign-based multi-national large companies.

For bonds, we still have a 65/35% quality/opportunity balance, with quality invested 2/30/30/3% cash/short-term/intermediate-term/inflation-linked bonds. Opportunity bonds for lower-tax bracket clients is 5/15/15% high-yield/multi-sector/bank loan, while higher bracket clients get 20/5/10 high-yield/multi-sector/bank loan. We have had several changes for bond allocations, but overall they were small.

2017 is shaping up quite well for investors; we are focusing on fairly small changes at this time.