Fixed Market Commentary

June 30, 2017

Ho-Hum

The Federal Reserve hiked the federal funds rate in June, the second rate hike of 2017 and the third increase since December. Despite the rate hikes, stocks continue to soar. The S&P 500 was up 3.1% in Q2 and has returned 9.3% year-to-date. And, ho-hum, the S&P 500 hit a new all-time high of 2453 on June 19. As we mentioned last quarter, monetary policy remains very accommodative. The Fed continues to reinvest the proceeds of maturing bonds in their enormous $4.5 trillion portfolio. Some analysts believe the "effective" federal funds rate, taking into account the size of the Fed's balance sheet, is NEGATIVE.

In late June, ECB President Mario Draghi uttered some hawkish comments, hinting that the ECB is considering unwinding some of their extraordinary monetary policy moves. Other central bankers made similar comments in the following days, hinting at a coordinated move to alert markets that they may soon remove the "punch bowl." After rallying for much of the quarter, 10-year Treasury yields jumped in response to the hawkish rhetoric, finishing Q2 at 2.3%. The second quarter return on the Barclays Aggregate Index was 1.4%. YTD, the Aggregate is up 2.3%.

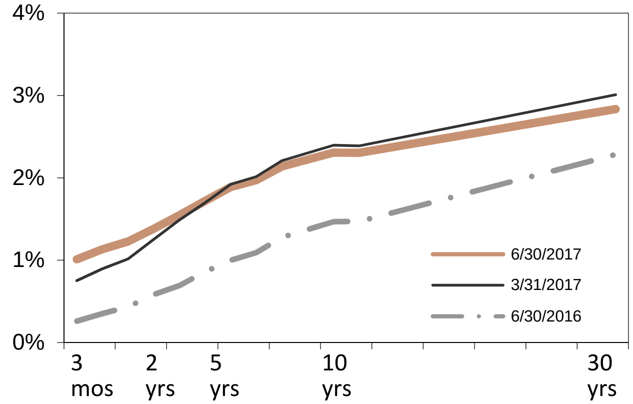
Speculation has now turned to what the Fed will do for the balance of 2017 and beyond. For the first time, Fed officials have made public comments about reducing the size of their enormous portfolio of US Treasury and mortgage-backed securities acquired over the course of their various quantitative easing programs. The consensus expectation is that the Fed will announce in September a plan to allow the "run off" of these securities from their balance sheet. This move will make monetary policy less accommodative, comparable to an increase in the funds rate. In addition to the anticipated balance sheet changes, analysts are split on whether the Fed will raise the funds rate again in 2017. Only a few weeks ago, a third rate hike in 2017 was widely anticipated. However, low inflation and lackluster economic data now have the market pricing in no additional rate hikes until March 2018.

In mid-June, following the Fed rate hike, 10-year Treasury yields plunged to 2.13%, the lowest level since early November. You might ask, "Why are long-term Treasury yields FALLING when the Fed is HIKING short-term rates?" Keep in mind that the Fed can influence short-term rates through changes in the federal funds rate. Long term yields, on the other hand, are driven by inflation expectations, largely reflecting economic strength. Some believe that the bond market is signaling a potential "policy mistake" on the part of the Fed. Plunging long term yields is a signal that traders believe the Fed is being reckless by raising the funds rate in an environment of subpar GDP growth. The current economic expansion, despite its lack of vigor, is into its 9th year and getting long in the tooth. At some point, a recession is inevitable, and the Fed may be accelerating the time table.

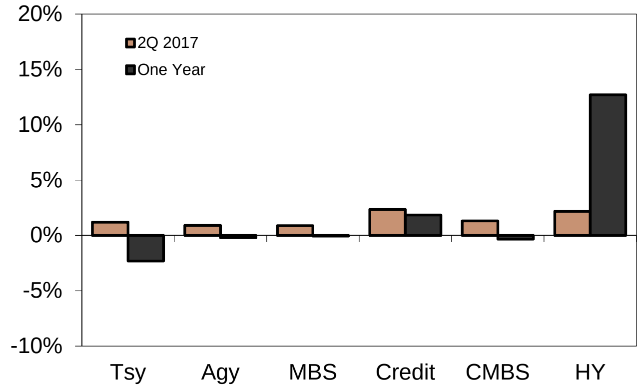
Fixed Market Commentary

June 30, 2017

US Treasury Yield Curves



Sector Index Returns



So why is the Fed hell bent on raising rates? In our view, the Fed is concerned that years of accommodative monetary policy has pushed up stock prices to unsustainable levels. The June FOMC minutes contained this warning: "In the assessment of a few participants, equity prices were high when judged against standard valuation measures." This is Fed speak for "We are worried that we may be inflating a stock market bubble." The Fed would like to see equity valuations gradually decline to a level more in line with economic fundamentals. In addition, some analysts believe the Fed is hiking now in order to, in the words of PIMCO, "regain monetary policy space." In other words, the Fed needs to raise rates now, so that they will have room to cut rates when the next recession arrives. But that's a dangerous game to play in a 2% economy.

We will tactically adjust portfolio durations to take advantage of anticipated interest rate moves. Our client portfolios are underweight government securities. US Treasuries currently offer little value, but they do provide liquidity and act as a hedge against "flight to quality" buying. We are overweight credit and slightly underweight mortgage-backed securities.

June 30, 2017

FAANG....

The bulls continue to ride the market higher with little resistance from the bears. For the quarter, the S&P 500 gained 3.1% while the average US Stock Fund increased 2.7%. After years of lackluster results, international stocks continue to bounce back with the Morgan Stanley EAFE Index climbing a robust 5.0%. Growth outperformed Value and while Large Cap stocks outperformed Small Caps, they were positive as the Russell 2000 rose a more modest 2.5%. Bonds gained ground as the Barclay's Aggregate Bond Index appreciated 1.4%.

There have been many studies recently that attempt to explain today's market advance. The reality is that roughly half of this year's gain in the S&P 500 Index has been fueled by a handful of glamorous, highly publicized "FAANG" stocks – Facebook, Apple Computer, Amazon, Netflix, and Google (Alphabet). Historically, this phenomenon of a narrow advance does not support a healthy market over the long haul. Technically speaking, this "bad breadth" is unfavorable. However, we expect an eventual transition away from these fully valued mega-cap "waterfront lots" into lesser valued broad market themes.

As the global economy has strengthened, central banks are beginning to take steps towards normalization including rate hikes and halting bond purchases. The distortions created by the zero/negative interest rate policies are receding slowly. This is an exciting period and one that is likely to result in a return to normalization for equity market trends (favoring active management) and an elongation of this current bull market.

Our research continues to favor long-term positive trends in many important sectors including technology, financials, industrials and, more recently, healthcare.

The Information Technology sector, after a near linear advance beginning around this time last year, finally took a breather during the quarter resulting in several additions to the buy list, most notably in some of the mega cap leadership names.

The uptrend for the Financial sector resumed in June. After several months consolidating gains it was encouraging to see the financial sector rebound with several buys emerging.

Healthcare surged ahead in June and is now clearly in a new uptrend. Recent improvement has been swift and powerful. We recommend using patience as most companies are too high to buy in the short-term.

In addition, after several years of relative underperformance, we are seeing a resurgence of international equity markets. We have many buys across both the developed and emergent markets. In total, the global macroeconomic landscape is highly constructive for equities and signaling a bullish second half for 2017 and beyond.