Market Observations – February 2017 Recap

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The S&P 500 was up 4.0% in the month of February, bringing its year-to-date return to 5.9%. Not a bad start to the year. The continuation of the rally that began after the presidential election seemed to be due to optimism regarding the plans of the Trump administration for tax cuts on corporations and individuals, increased infrastructure spending, and relaxed regulations. Whether or not the rally is overdone depends on the timeline of when those plans get implemented in our opinion. If progress is made sooner rather than later then these gains may be sustainable. However, if it takes longer than expected and investors become impatient, it would not be surprising to see a pullback. Another factor that has been supporting the rally has been improved corporate earnings and the continued reporting of good economic data. If this continues it is likely that the next Fed rate increase is on the horizon.

In the meantime, exuberance in the equity market has not translated to the Treasury market. Bond yields have fallen across the Treasury yield curve as bond investors seem to have doubts about the reflation trade, buying bonds after the 10-year Treasury reached 2.45% at the end of January. During the month of February the 10-year Treasury declined to 2.36%. The result was bonds posting positive returns across the curve with the long-end posting the best returns. Credit and municipal bonds posted strong returns as spreads continue to tighten.

There were attractive returns overseas during the month as well. The MSCI EAFE index returned 1.4% (4.4% for the year-to-date) driven by the Pacific ex Japan region which outperformed the Far East and Europe. Emerging markets posted a return of 3.1% for the month (10.1% for the year-to-date) as per the MSCI EM index. BRIC countries ex Russia (Brazil, India and China) led the way with double digit returns.

US Equity Summary:

- The S&P 500 was up 4.0% for the month. Growth outperformed value across the market cap spectrum for the 2nd consecutive month which was a reversal from what we saw in the fourth quarter of 2016.
- Health Care, Utilities and Financials were the top three performing sectors. The Telecom and Energy sectors were down for the month.
- Large-cap outperformed mid-cap and small-cap as the energy sector was hit particularly hard within mid-cap and small-cap.
- Apple, Facebook and Amazon continue as top contributing stocks within the S&P 500. Information Technology as a sector, contributed approximately 200 basis points to the index's return coming primarily from software and services companies.
- Based on JPMorgan factors Size, Yield and Quality were the dominant factors.

Developed and Emerging Market Equity Summary:

- The MSCI EAFE Index was up 1.4% for the month, while the MSCI EM Index returned 3.1%. Large-cap stocks underperformed small-cap stocks in both developed and emerging markets, contrary to what occurred in the US.
- Factor performance in developed and emerging markets was dominated by Value and Quality factors.
- The Pacific region ex Japan was the best performing region within the developed markets, followed by the Far East. Europe was the weakest developed market region. Asia and Latin America were the best performing region within emerging markets, while Emerging Europe and Eastern Europe were the weakest. Frontier markets outperformed the broad emerging markets for the month, as the MSCI Frontier Emerging Markets index was slightly down in February.
- Health Care, Consumer Staples, and Utilities were strong performing sectors within developed markets while Consumer Discretionary, Financials and Industrials were the strongest within emerging markets. The bottom performing sectors in both developed and emerging markets were Energy, Materials and Telecom.

Fixed Income Summary:

- All major bond segments were up for the month. High yield was the best performing segment with the BofA ML US High Yield index returning 1.6% for the month. The lowest quality segment within high yield was the best performing.
- The Treasury curve flattened modestly during the month resulting in longer duration outperforming shorter duration.
- The municipal bond market continued to recover some of what had been lost in a difficult fourth quarter with the Barclays Muni Bond index up 0.7%. The Barclays High Yield Municipal Bond index was up 2.4% for the month.
- Global bond performance in February was largely driven by strength in Emerging Markets, as sovereign yields declined and the USD depreciated against most major developing currencies. Both EM sovereign and corporate bonds outperformed developed markets, returning 2.0% and 1.6% respectively. On the other hand, widening interest rate spreads between the US and much of the developing world resulted in only a modest return for the Citigroup non-USD WGBI Index of 0.2%.

Disclosures

Indices are unmanaged and presented for comparison purposes only. Please note that the returns displayed for indices do not take into account any of the costs associated with buying and selling individual securities. Individuals cannot invest directly in an index.

Bloomberg Barclays US Corporate High Yield TR USD: *Bloomberg Barclays US Corporate High Yield TR USD*

Bloomberg Barclays US Treasury 1-3 Yr TR USD: *The Bloomberg Barclays Capital US Treasury Bond 1-3yr term index measures the performance of short-term government bonds issued by the US Treasury.*

Bloomberg Barclays US Treasury 10 Yr USD: The index *measures the performance of government bonds issued by the US Treasury.*

Bloomberg Barclays US Treasury 20+ Yr TR USD: *The Index is market capitalization weighted and includes all of the securities that meet the Index criteria. The index includes all publicly issued, U.S. Treasury securities that have a remaining maturity greater than 20 years, are non-convertible, are denominated in U.S. dollars, are rated investment grade (Baa3 or better) by Moody's Investors Service, are fixed rate, and have more than $150 million par outstanding. Excluded from the Index are certain special issues, such as flower bonds, targeted investor notes (TINs) and state and local government series bonds (SLGs), and coupon issues that have been stripped from assets already included.*

Bloomberg Barclays US Aggregate Bond Index: *The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The Index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety.*

MSCI EM Index: *The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country*

MSCI EAFE Index: *The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia and the Far East.*

S&P 500 Index: *The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted Index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The Index is one of the most widely used benchmarks of US Equity Large Cap performance.*

Alerian MLP Index: *The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).*

J.P. Morgan Factor Definitions

Yield: *Stocks are ranked by trailing 12 month dividend yield. Positive factor performance indicates that the highest yielding stocks outperformed the lowest yielding stocks (as well as those stocks that did not pay any dividends) in the universe.*

Size: *Stocks are ranked by their month end market cap. A negative Size factor return would indicate that smaller cap stocks generally outperformed larger cap stocks.*

Quality: *Combines ROE and Earnings Risk (inverted such that stocks with tightest forecasts are rewarded with a higher score).*

Price Momentum: *The 12 Month Price Momentum factor is calculated by ranking stocks by their total return over the previous 12 months.*

Earnings Momentum: *This factor ranks stocks by their forward earnings momentum (1Mth + 3 Mth). For each stock, the change in FY1 earnings over the last month and the last 3 months, and the change in FY2 earnings over the last month and the last 3 months are calculated. A 3-month revision number and a 1-month revision number is calculated by taking the average of the change in FY1 and FY2. A composite value as the average of the 1 month and 3 month values is then calculated.*

Book-to-Price: *Stocks are ranked by their 12 month trailing Book/Market ratio with the cheapest stocks exhibiting the lowest ratio. A positive factor return indicates that stocks with a lower book-to-price ratio outperformed higher book-to-price stocks in the universe.*

Beta: *Beta for the stock relative to its local benchmark index. Note this is a fundamental beta not a calculated Beta.*

USD: United States Dollar.
EURO: The official currency of the Eurozone.
CAD: The official currency of Canada.
AUD: The official currency of Australia.
BRL: The official currency of Brazil.
CHF: The official currency of Switzerland.
JPY: The official currency of Japan.
INR: The official currency of India.

West Texas Intermediate (WTI): *West Texas Intermediate (WTI) crude oil is the underlying commodity of the New York Mercantile Exchange's oil futures contracts. The success of an investment program may be affected by general economic and market conditions, such as interest rates, availability of credit, inflation rates, economic uncertainty, changes in laws and national and international political circumstances. These factors may affect the level and volatility of securities prices and the liquidity of a portfolio's investments. Unexpected volatility or illiquidity could result in losses.*

Investing in securities is speculative and entails risk. There can be no assurance that one's investment objectives will be achieved or that an investment strategy will be successful. Significant losses could result if a strategy involves the use leverage, short sales and derivative transactions, investment in foreign or illiquid securities, and potentially limited diversification.

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Special Risks of Foreign Securities
Investments in foreign securities are affected by risk factors generally not thought to be present in the US. The factors include, but are not limited to, the following: less public information about issuers of foreign securities and less governmental regulation and supervision over the issuance and trading of securities.

Special Risks of Master Limited Partnerships
Master limited partnerships (MLPs) are publicly listed securities that trade much like a stock, but they are taxed as partnerships. MLPs are typically concentrated investments in assets such as oil, timber, gold and real estate. The risks of MLPs include concentration risk, illiquidity, and exposure to potential volatility, tax reporting complexity, fiscal policy and market risk. MLPs are not suitable for all investors.

Special Risks of Small Market Capitalization Securities
Investments in companies with smaller market capitalization are generally riskier than investments in larger, well-established companies. Smaller companies often are more recently formed than larger companies and may have limited product lines, distribution channels and financial and managerial resources. These companies may not be well known to the investing public, may not have significant institutional ownership and may have cyclical, static or moderate growth prospects. There is often less publicly available information about these companies than there is for larger, more established issuers, making it more difficult for the Investment Manager to analyze that value of the company. The equity securities of small and mid capitalization companies are often traded over-the-counter or on regional exchanges and may not be traded in the volume typical for securities that are traded on a national securities exchange. Consequently, the Investment Manager may be required to sell these securities over a longer period of time (and potentially at less favorable prices) than would be the case for securities of larger companies. In addition, the prices of the securities of small and mid capitalization companies may be more volatile that those of larger companies.

Special Risks of Fixed Income Securities
For fixed income securities, there is a risk that the price of these securities will go down as interest rates rise. Another risk of fixed income securities is credit risk, which is the risk that an issuer of a bond will not be able to make principal and interest payments on time.

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