Market Observations – May 2017 Recap

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At the end of May US equity markets hovered around historic highs. At the same time equity valuations, while not at bubble levels, were at above average levels. Better than expected first quarter earnings as well as the continued improvement in economic data both in the US and overseas provided strong support to continue the market rally. Volatility levels as measured by VIX were at extreme low levels during the month despite political turmoil both in the US, Europe and Latin America. A low VIX is typically interpreted by investors as a sign of complacency. When volatility eventually does increase, it usually coincides with a drawdown in equity markets in our opinion. An example is the brief VIX spike we saw in mid May when the Trump firing of the FBI Director caused a political firestorm that sent the US equity markets down close to 2%. Subsequently the market bounced back and volatility retreated.

The S&P 500 finished the month with a return of 1.4%, led by technology stocks which as a sector returned 4.4%. International equities outperformed US equities as the MSCI EAFE index returned 3.7% for the month, driven by strong fund flows, improving economic data and the defeat of the populist movement in France by the election win of Emmanuel Macron. Emerging markets returned 3.0% for the month of May despite the reemergence of political turmoil in Brazil.

The US bond markets provided strong returns in the month of May. US Treasuries posted positive performance across the curve, which was somewhat surprising as the equity market is near record highs. In our opinion, if the US market had confidence in the economy's growth, bond yields should be rising. A lack of success by the Trump administration in implementing its agenda could be the factor creating this dynamic. During the month the 10-year US Treasuries fell from 2.282% at the end of April to 2.198% at the end of May. Credit markets continued their rally in the month of May with lower quality outperforming higher quality. Non-US bond markets also posted positive performance during the month helped by currency appreciation and a broad decline in rates across Europe.

US Equity Summary:

- The S&P 500 was up 1.4% for the month. Growth outperformed value across the market cap spectrum for the 5th consecutive month.
- Information Technology, Utilities and Consumer Staples were the top three performing sectors. The Energy, Financials, Telecom and Materials sectors were down for the month.
- Large-cap stocks outperformed mid and small-cap stocks for the month. Small-cap stocks were down -2.0% as per the Russell 2000 index.
- Apple, NVIDIA, Amazon and Alphabet were the top contributing stocks within the S&P 500 for the month. Information Technology as a sector contributed over half of the index's return.
- Based on JPMorgan factors Momentum and Growth were the dominant factors while Value and Yield were the weakest performing factors.

Developed and Emerging Market Equity Summary:

- The MSCI EAFE Index was up 3.7% for the month, while the MSCI EM Index returned 3.0%. Small-cap stocks performed in line with large-cap stocks in developed markets while large-cap outperformed small-cap within emerging markets.
- Momentum and Quality were the best performing factors in developed markets with Value being the weakest. Within emerging markets Size (large cap over small cap) was the strongest performing factor while Value was the weakest.
- The European region was the best performing region within the developed markets, followed by the Far East. The Pacific region was the weakest developed market region. Emerging Asia was the best performing region within emerging markets, while Eastern Europe and Latin America were the weakest. Frontier markets outperformed the broad emerging markets for the month, as the MSCI Frontier Emerging Markets index posted a May return of 4.2%.
- Utilities, Telecom and Consumer Staples were strong performing sectors within developed markets while Financials, Industrials and Energy were the weakest. Real Estate, Consumer Discretionary and Information Technology were top performing sectors within emerging markets. Energy and Utilities were the weakest performing sectors.

Fixed Income Summary:

- All major bond segments were up for the month. Long-dated Treasuries and municipal bonds were the best performing segments with the with the Barclays US Treasury 20+ index returning 1.6% and Barclays Municipal Bond index returning 1.4% for the month.
- The Treasury curve flattened modestly at the long end during the month resulting in longer duration outperforming shorter duration.
- High yield credit continued its strong run with the BofA ML US High Yield index returning 0.9% for the month. The lower quality segments within high yield (CCC) performed better than broad high yield.
- Global bonds outperformed most U.S. segments on the back of strong foreign currency appreciation and a broad decline in rates across core Europe. As a result, local developed market bonds returned 2.2% for the month, per the JPMorgan GBI Global ex-US Index. Emerging market returns were more muted following substantial declines in oil prices, renewed political scandals in Brazil, and ongoing concerns over Chinese growth. The JPMorgan EMBI Global Diversified Index returned 0.9% for the month.

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.

The opinions expressed herein can change anytime without notice.

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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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