WealthHealth
Personal Wealth Management

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Market Review

Looking back at the first half of 2017, we continued to see a steady economic climate combined with ample global monetary accommodation. These factors made for an environment very conducive to strong performance across many asset classes.

U.S. large-cap growth stocks continued to outpace International and other U.S. equity categories. Driving this strong upward move was the sustained outperformance of the so-called "FAANG" stocks—Facebook, Amazon, Apple, Netflix, and Google (aka Alphabet). Although we welcome the favorable performance, we share the now rising concerns that the market has become overly dependent on a small number of stocks.

Non-U.S. equities posted strong gains for a second quarter in a row, especially as it relates to emerging markets. Leading this move higher was a rebound in corporate earnings which finally saw growth after years of an earnings recession. However, even with this recent move higher, international equities are still seen as being cheaper than U.S. equities when using a price-to-earnings valuation.

Index Returns *Through 6/30/2017*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	3.09%	9.34%	17.90%	9.61%	14.63%
Russell 2000	2.46%	4.99%	24.60%	7.36%	13.70%
MSCI EAFE	6.12%	13.81%	20.27%	1.15%	8.69%
MSCI All Country World Index	4.26%	11.35%	19.09%	4.88%	10.76%
MSCI Emerging Markets Index	6.27%	18.43%	23.75%	1.07%	3.96%
Barclay Capital US Aggregate Bond	1.45%	2.27%	-0.31%	2.48%	2.21%
Barclay Capital Municipals	1.96%	3.57%	-0.49%	3.33%	3.26%
Bloomberg Commodity Index	-3.00%	-5.26%	-6.50%	-14.81%	-9.25%
HFRI Fund of Funds Composite Index	0.62%	3.02%	6.29%	1.49%	3.83%

Returns in the bond markets were more mixed as high quality fixed-income categories posted low single-digit positive returns while lower quality, higher risk fixed-income posted high single-digit positive returns with high grade municipals in the middle. A broadly diversified portfolio was able to capture all of these various return streams.

Broad Look

More broadly, the global economy continues to grow in 2.5% - 3% range, with most of that growth coming from emerging economies, as the developed economies are in the more mature stages of the business cycle. Underpinning this steady growth was a turnaround in manufacturing, industrial production and world trade. In addition, while corporate earnings are continuing in a positive trajectory, profit margin growth has been somewhat lackluster even as wage growth remains anemic. Lastly, as it relates to the political front, turmoil in

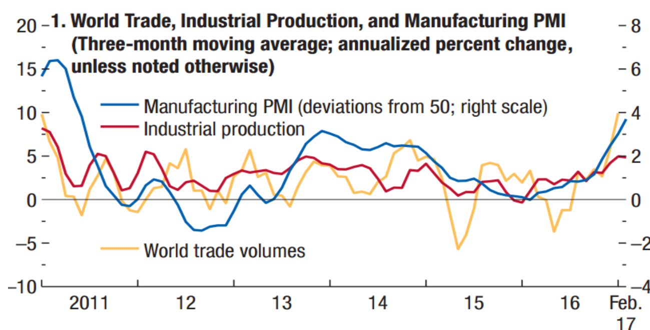

image source: IMF

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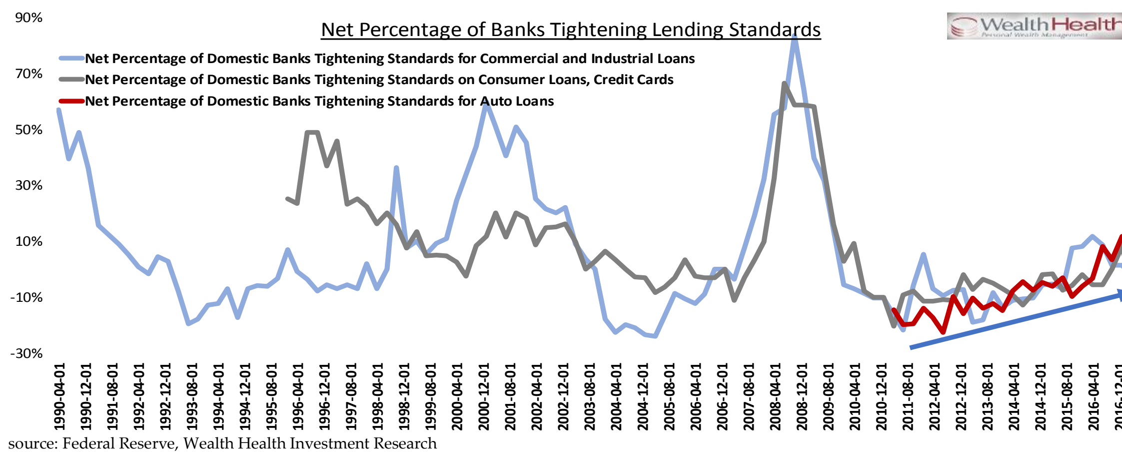
Congress and the White House puts into question the "Trumpflation" trade and the high expectations that were built into the equity markets. Until there is some semblance of cohesion or the even slightest amount of bipartisanship, the likelihood of implementing President Trumps' "pro-growth" agenda remains in question.

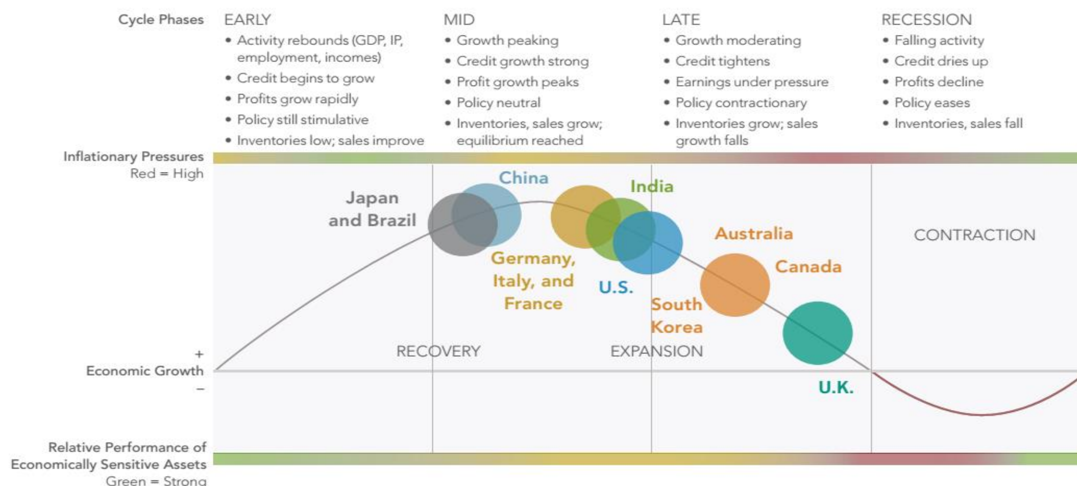
Looking Ahead

As the U.S. economy is in the later stages of the business cycle, there are mixed signals that are starting to develop. While global demand growth did boost manufacturing activity, potentially rising wages may hamper profitability. In addition, banks are starting to tighten their lending standards making future loans harder to obtain. A reduction in available credit will put further pressure on an already mature business cycle.



source: Federal Reserve, Wealth Health Investment Research

Going forward, inflation may be muted as a flurry of housing construction supply enters the market and constrains shelter cost growth. Concurrently, global demand for oil may see some difficulty offsetting global supply. And as Fidelity notes, "late cycles have the most mixed performance of any business-cycle phase, with more limited overall upside than mid-cycle phases. There is less confidence in equity performance, though stocks have typically outperformed bonds".



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (AART), as of May 31, 2017.

image source: Fidelity Investments

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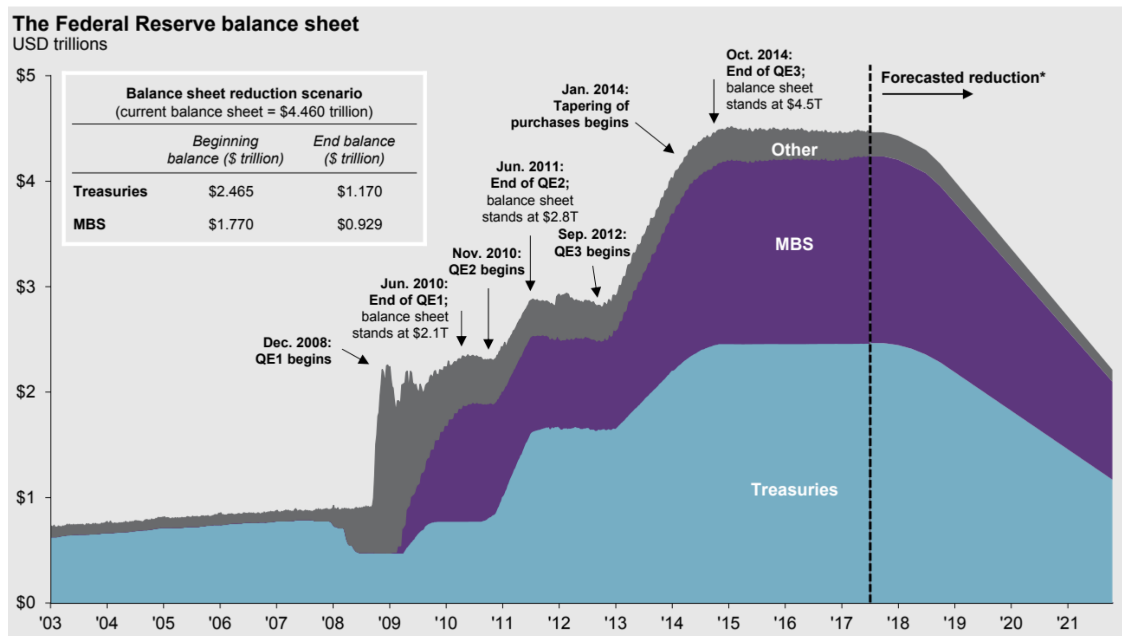
Further compounding uncertainty is that as this business cycle matures, the main underlying force in global market stability may start to recede. Balance sheets of the four major central banks—the U.S. Federal Reserve (Fed), European Central Bank, Bank of Japan, and Bank of England—have more than quadrupled since the global financial crisis due to trillions of dollars of asset purchases. This business cycle will be quite different from any other as it will also involve reducing the size of these balance sheets.

Although inflation and global growth have picked up over the last year, giving the Fed confidence to continue gradually hiking it's Federal Funds Rate, both are weaker than during prior tightenig periods. Following in the Fed's footsteps, Europe's progress toward higher rates may occur sooner than markets anticipate as they continue to grapple with negative yields (Swiss banks paid out $1 billion to their central bank for the privelage of holding their money with them). Increasing U.S. and global growth, stable inflation, and relatively stable global conditions, should allow the Fed to continue with their planned balance sheet reduction and trajectory towards higher rates.



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.
*Balance sheet reduction assumes reduction from current level, beginning October 2017 and lasting four years, concluding in October 2021. Reduction of Treasuries and MBS is per FOMC guidelines from the June 2017 meeting minutes: Treasury securities will be reduced $6 billion per month initially and reduction rate will increase in steps of $6 billion at three-month intervals over 12 months until reaching $30 billion per month; MBS will be reduced $4 billion per month initially and reduction rate will increase in steps of $4 billion at three-month intervals over 12 months until reaching $20 billion per month; Other assets are reduced in proportion. Forecasts do not take into account months where maturing assets do not exceed the stated cap nor do they consider the reinvestment of principal or interest repayment in excess of the stated cap.
Guide to the Markets – U.S. Data are as of June 30, 2017.

image source: JPMorgan Chase

In Summary

Overall, recession risks remain low globally, although less accommodative policy may constrain upside to growth going forward. Undoubtedly, the biggest unknown is how markets will react to the unwinding of trillions in assets by world central banks. However, we don't see any reason to worry yet as there has been ample guidance by the central banks. It would seem this guidance has resonated with investors, since risk complacency is at all-time highs even as the business cycle matures, rates rise and central banks divest. We are aware of all these moving parts and factor them into our analysis and into how we manage your assets. As always, we weigh the possibilities by their probabilities and act accordingly.