Q2 2017 MARKET RECAP

July 10, 2017

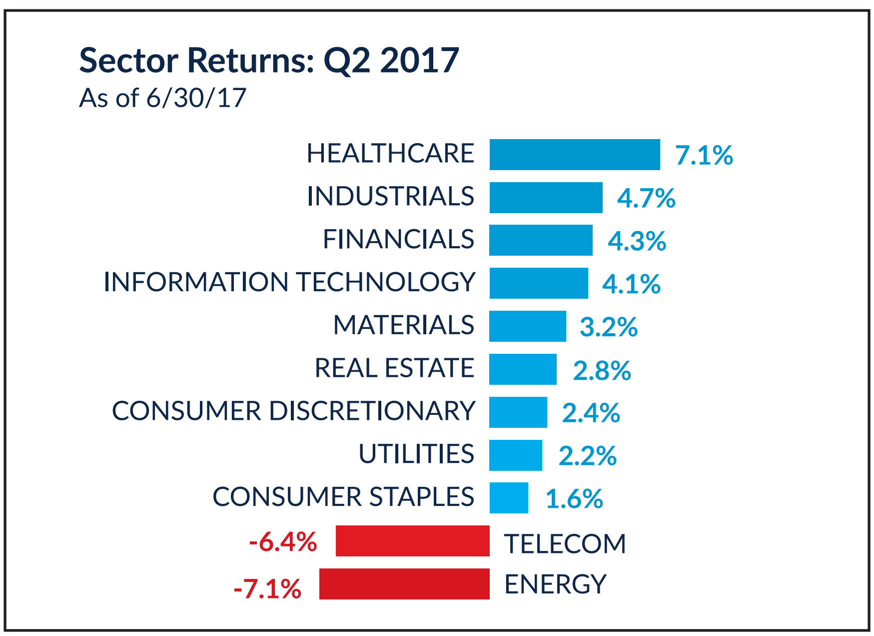
SOME HIGHS DESPITE "LOW AND SLOW" ECONOMY

The second quarter of 2017 saw markets make new highs despite lackluster economic data. The Trump administration has seen strong market performance but has been unable to get two of its main goals coming into the inauguration – healthcare and tax reform – off the ground. This lack of action caused some hesitation in the markets, and when coupled with uninspiring economic data, has resulted in a more uncertain outlook heading into the second half of the year.

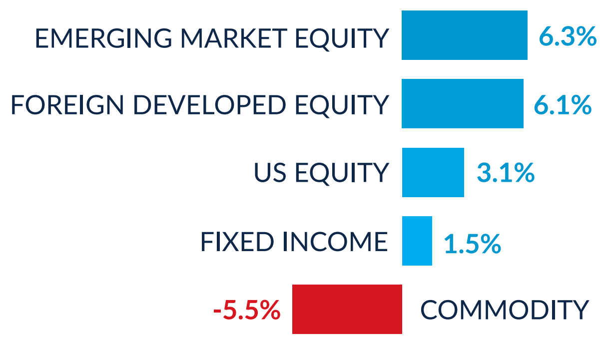
After a strong first quarter, the markets continued higher, but were unable to maintain the torrid pace. The S&P 500 closed the quarter up +3.1%, while the Dow Jones Industrial Average and Russell 2000 returned +4.0% and +2.5% respectively. The NASDAQ was the best performing index, closing up +4.2% for the second quarter. One thing we noted last quarter was that defensive stocks had closed the gap on cyclicals (which had been outperforming). In Q2, this theme continued, with cyclicals up +2.4% and defensives up +4.1%. The best performing sector was Healthcare, up +7.1%, while the worst was Energy, down -7.1%. One particular market aspect that was notable was the lack of volatility. The CBOE Volatility Index (VIX) averaged 11.7 in Q1 and managed to come in below that in Q2, averaging only 11.4.

Economic data in the US was lower than most had hoped. While we are not in danger of heading into a recession, this recovery is certainly stretching the "low and slow" characterization to its limits. The labor market remains quite tight, but there is a mismatch between skills required for the jobs that are open and the people looking for employment. Despite a low unemployment rate, the average number of monthly jobs added so far in 2017 is the lowest since 2010. GDP growth in Q1 came in at a final figure of +0.7%, the weakest since 2014. Forecasts for Q2 GDP have been steadily revised downward from 3-4% to 1.5-2%. Inflation remains subdued, as do bond yields.

The Federal Reserve Bank mostly looked past the weak data when it raised rates again in early June. This hike was



Asset Class Returns: Q2 2017
As of 6/30/17



the second so far this year and the consensus is calling for one more hike before the end of the year. However, if the economic data deteriorates over the next few months, the likelihood of that third hike will decrease considerably. It remains to be seen if the Trump administration can get the economy moving at a faster pace. Another one of its stated goals has been passing an infrastructure spending plan which would boost economic growth. But, like healthcare and tax reform, it too has been stymied by partisan conflict and lack of definition. If the administration can find a way to gather bipartisan support for tax reform and infrastructure, it would likely provide a considerable boost to the economy.

OUTSIDE OF THE US

Emerging Markets led the way in the second quarter, returning +6.3%. Frontier and broad Developed Markets were up very close behind, both up +6.1%. International markets continue to see stronger growth than the U.S. and the manufacturing PMI numbers continue to bear this out. One of the biggest international events in Q2 was the French presidential election in which Emmanuel Macron beat out Marine Le Pen. Macron's victory provided relief for markets, as Le Pen would have pushed for France's exit from the Eurozone.

Heading into the third quarter, we remain constructive. The US economy continues to grow below its potential, but it is growing. Economies across the globe should continue on their stronger trajectories. As the recovery stretches on, fears of recession will inevitably ebb and flow, but it is important to keep in mind that recoveries rarely die of old age. "Low and slow" might seem unsatisfying but it is also unlikely to burn out. The consensus view is for one more rate hike this year, but that could come into doubt if GDP and inflation weaken further.

Sincerely,

Kim David Arthur
CEO and Portfolio Manager