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MARKET REVIEW  
SEPTEMBER 2017



### BE AWARE OF HOMETOWN BIAS

It is very tempting to stick with the familiar. Some might be disparaging and call it “falling into the same old routine,” but there certainly can be comfort taken in dining out at a favorite restaurant, vacationing at a favorite beach, or even buying the same brand of car. This preference for the familiar can be even stronger for purchases involving higher stakes. In fact, economists in the discipline of behavioral finance classify this preference as the familiarity heuristic; put more simply, the hometown bias.

#### U.S. VERSUS INTERNATIONAL EQUITIES

Often the hometown bias occurs when investors determine the allocation between domestic and international stocks. Aside from the operational challenges of buying a foreign company’s stock in that company’s home country, in its home currency and even in that country’s stock exchange, there are additional challenges to fundamental, or bottom-up, security analysis. Relative to the U.S., stocks of companies headquartered overseas can have accounting differences, varying standards for both contract law and property rights, as well as significant differences in corporate taxation. It’s no wonder some investors feel that just simply owning U.S. based multi-national conglomerates provides enough exposure to global markets.

To address the hometown bias directly it is helpful to consider the data. From an objective standpoint, comparing historical performance of domestic and international stocks would help this analysis, but as often can be the case, looking at the numbers is just a starting point. Though there is plenty of data on securities prices

for the largest stocks in the U.S., Europe and Japan, there is only limited data on domestic and international stock indexes. The two most commonly accepted and oldest indexes are the S&P500 (SP500) for domestic stocks and the Morgan Stanley Capital International Europe Australasia Far East (EAFE).

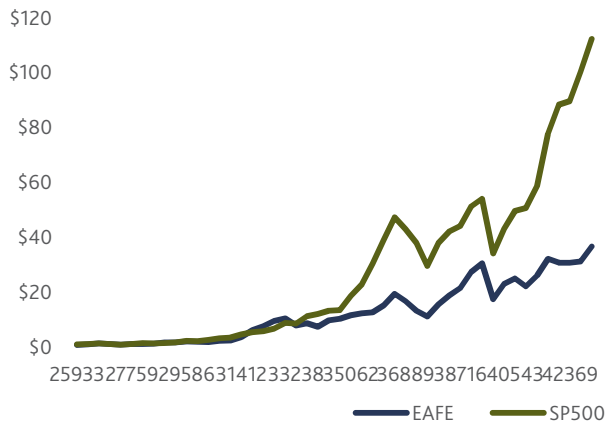
The cumulative growth of \$1 invested in each beginning with the inception date of the younger index, EAFE, and ending August, 2017 in the chart on page 3 on the top left side. In U.S. dollar terms, \$1 grew to nearly \$112 for the SP500, but only to \$37 for the EAFE. The compound annual rate for each was 10.4% and 7.8%, respectively.

#### TRENDS AND OPPORTUNITIES

With the significant outperformance of domestic versus international stocks, why not just call it for the home team? Much of the problem lies in extrapolating historical data to the future. Certain political and market events happened in the past 47 years which created unique investment situations that are unlikely to repeat. For example, in the early 1970s, U.S. stocks were held back by an embargo of imported oil from OPEC nations and suffered a recession and bear market, while foreign companies did not. In the 1980s, the U.S. and U.K. underwent pro-market government reforms like Reagan’s tax cuts and Thatcher’s unwinding of socialist policies. At the same time France was relatively more socialist and West Germany experienced political and social challenges with neighboring East Germany which led them to lag. But the 1980s also saw an economic boom in Japan, as its industrial dominance led the way to outperformance in stocks and real estate. Though the 1990’s saw stock markets surge in both the U.S. and Europe, the Japanese economy and markets were reeling from a real estate bubble that burst. In the 2000’s, low interest rates of

## GROWTH OF \$1

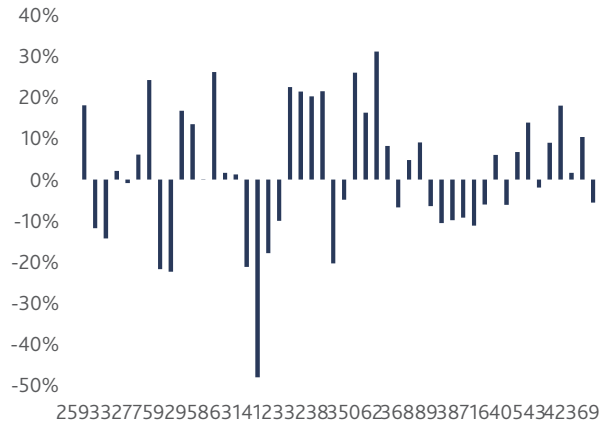
DECEMBER 31, 1970 THROUGH AUGUST 30, 2017



Source: Bloomberg. Past performance does not guarantee future results.

## S&P 500 LESS EAFE ANNUAL RETURN GAP

1970 THROUGH YTD 2017



Source: Bloomberg. Past performance does not guarantee future results.

the Greenspan era and a China-driven commodity boom led to dollar weakness and stronger overseas results. The current decade has seen U.S. stocks outperform as other countries were much slower in their response to the 2008 global financial crisis.

The point here is that streaks happen. These are shown in the chart, above on the right, which illustrates relative annual stock market performance by subtracting the results of the EAFE from the SP500. When the result is positive, the SP500 has outperformed; when negative, EAFE outperforms. Arguably, trends of domestic or international stock outperformance do happen, most commonly in periods of 4-7 years. Some of these stretches of outperformance have averaged 20% per year. The bar furthest to the right on the x-axis indicates outperformance of the EAFE by about 6% year-to-date in 2017.

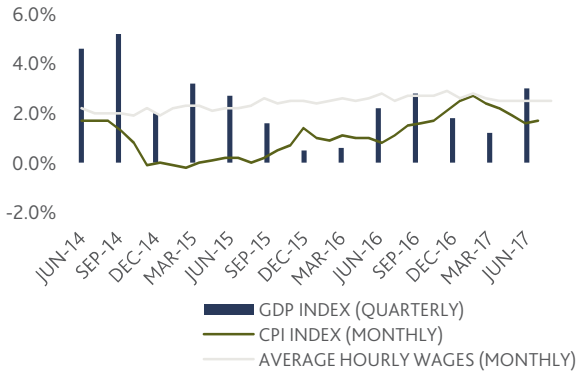
### CONCLUSION AND INVESTMENT IMPLICATIONS

Over the last 47 years, in U.S. dollar terms, the average annual returns of the S&P500 and EAFE have been 11.7% and 9.7%. Standard deviations of this return, a convenient measure of risk, have been 16.9% and 21.2%. It may seem counterproductive to consider international stocks especially when they are less rewarding and riskier than domestic ones. Pointing out that medium-term streaks of outperformance exist, lasting between four and seven years on average, does not imply that timing between these two is a viable strategy. Rather, these streaks of performance serve to demonstrate periods of low correlation between these two asset classes and alert readers to periods where often overlooked international stocks outperformed their U.S. counterparts.

The intent of this discussion is observational, rather than motivational. Relative market efficiency between domestic and international stocks should create opportunities. Intermediate-term trends in relative performance will tempt investors to time entry and exit into overseas markets. A better solution could be to consider mean reversion and relative valuation to determine targets and ranges. Relative performance of portfolios blended with domestic and international securities may be ahead or behind global stock indexes from time to time, but the savviest of investors weigh the importance of making their investment goals with as much care as they consider relative performance. Our efforts to provide a high quality investment experience, one that earns a competitive return for an acceptable risk level, requires awareness that sometimes investing in the unfamiliar can be rewarding.

# ECONOMY

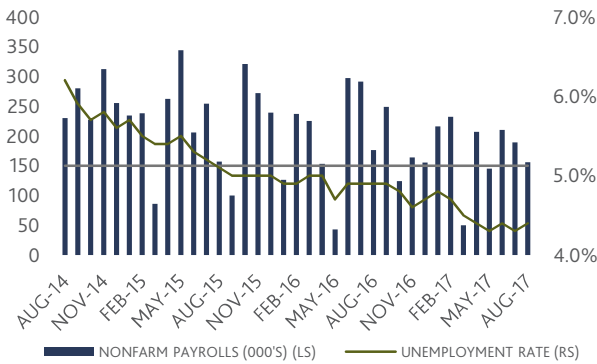
## GDP, CONSUMER PRICES AND WAGE INFLATION JUNE 2014 THROUGH JUNE 2017



Source: Bloomberg

- The U.S. economy grew faster than initially thought in the second quarter. GDP was revised to 3.0% up from the initial reading of 2.6%. Personal consumption, the largest contributor to economic growth, was revised up to 3.3% from 2.8%.
- The core Personal Consumption Expenditure (PCE) price index rose 0.1% in July. The YoY reading for Core PCE fell to 1.4% below the Fed's 2.0% target.
- Core CPI, which excludes volatile food and energy costs, rose by 0.1%, compared with expectations for 0.2%. Core CPI held steady at an annualized rate of 1.7% for July.

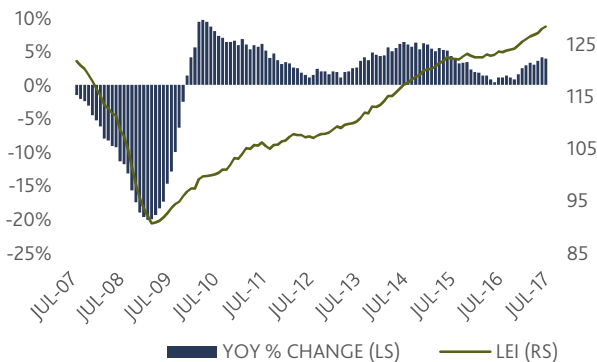
## LABOR MARKET AUGUST 2014 THROUGH AUGUST 2017



Source: Bloomberg

- U.S. nonfarm payroll employment increased in August, adding 159,000 new jobs, and coming in below consensus estimates. However, June's payroll was revised down to 210,000 from 231,000 and July's payroll was revised down to 189,000 from 209,000. After taking these revisions into, job gains have averaged 185,000 for the past 3 months.
- The July unemployment rate increased 10 basis points to 4.4%. Since the decline that took place in the beginning of 2017 the unemployment rate has remained stable at 4.3% or 4.4% since April.
- In August, the average hourly earnings increased 0.1% for an annualized rate of 2.5% while the average work week declined by 0.1 hour to 34.4 hours.

## LEADING ECONOMIC INDICATORS JULY 2014 THROUGH JULY 2017

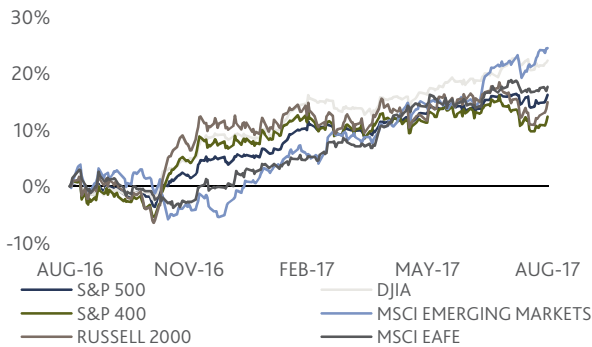


Source: Bloomberg

- The LEI Index, published by the Conference Board, is comprised of ten economic components, and is considered a helpful gauge for estimating economic activity for the subsequent three to six months. The LEI Index increased 0.3% in July to 128.3, building on gains of 0.3% and 0.6% in May and June, respectively.
- With the LEI experiencing widespread gains, building permits were the sole blemish in the month of July, detracting 0.1% from the index.
- The LEI Index increased 2.3% for the six-month period ending July 2017, compared to the 1.5% growth experienced in the previous six months.

# EQUITY

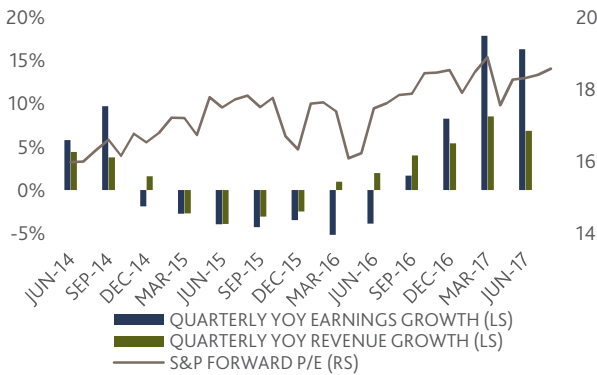
## TRAILING 12-MONTH EQUITY RETURNS PRICE APPRECIATION, AUGUST 2016 THROUGH AUGUST 2017



Source: Bloomberg

- U.S. and foreign developed equities struggled in August as investors sought out safe haven assets amid rising tensions between the U.S. and North Korea. Hurricane Harvey also weighed on domestic stocks. U.S. mid cap and small cap were the worst performing equity asset classes last month. The S&P 400 and Russell 2000 fell 1.5% and 1.3%, respectively.
- Emerging markets rose for a tenth consecutive month in August with a gain of 2.3%. Russia, Brazil, and China led emerging markets with monthly returns of 8.1%, 6.3%, and 4.2%, respectively. Russian equities jumped in response to second quarter economic growth of 2.5%, its highest growth since 2012. Russia recently recovered from a recession that lasted most of 2015 and 2016. Brazilian and Chinese equities were supported by encouraging economic data.

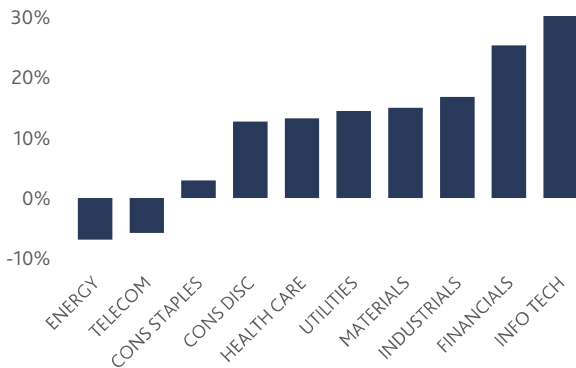
## S&P 500 YOY EARNINGS & REVENUE GROWTH BY QUARTER, JUNE 2014 THROUGH JUNE 2017



Source: Bloomberg

- The second quarter earnings reporting season is almost complete with results reported from 99% of S&P 500 companies. Trailing twelve month earnings are on pace to grow 9.6%, compared to analysts' consensus estimate of 8.4% at the start of the quarter.
- Outside of energy, technology and financials had the highest earnings growth rates of 15.7% and 9.5%, respectively. Energy experienced abnormally high earnings growth of 209.9% due to the slump in earnings a year ago driven by low oil prices. The Utilities sector was the only sector to report negative earnings growth.
- Trailing twelve month sales growth is on pace for 5.3%, which is in line with analysts' consensus estimate of 5.7%. Excluding energy, technology had the highest sales growth of 9.2%.

## S&P 500 SECTORS 12-MONTH RETURNS (PRICE) AUGUST 2016 THROUGH AUGUST 2017

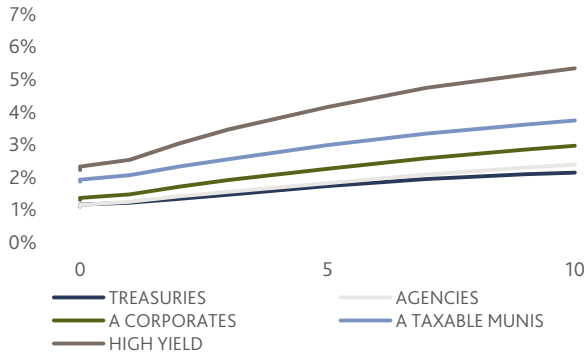


Source: Bloomberg

- Energy was the worst performing sector in August with a decline of 5.2%, marking the sector's largest monthly decline since December 2015. Hurricane Harvey disrupted energy markets by forcing almost a quarter of U.S. oil refiners to close.
- The storm also weighed on shares of insurance companies. The S&P 500 insurance industry index fell 3.4% in the month. Analysts estimate the economic cost from flood and wind damage could be tens of billions of dollars, making Hurricane Harvey one of the most costly natural disasters in U.S. history.
- Technology was the best performing sector for a second straight month in August. The technology sector's performance was supported by strong revenue and earnings growth.

# FIXED INCOME

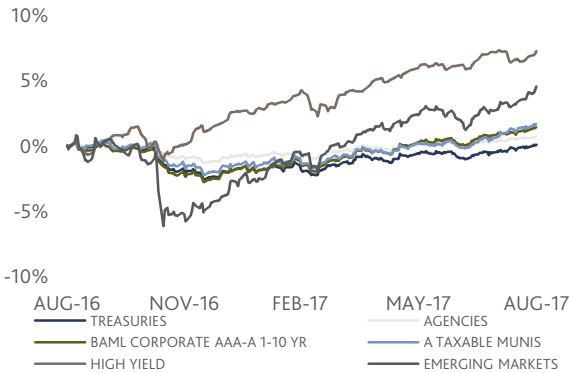
## CURRENT YIELD CURVES YIELD CURVES AS OF AUGUST 2017



Source: Bloomberg

- The U.S. Treasury yield curve flattened 12 basis points in August as geopolitical risks fed a rally in longer dated notes and bonds.
- Even as the Citi U.S. Economic Surprise Index continued to recover from its mid-June trough, the yield on the 10-year U.S. Treasury note declined by roughly 14bps, with much of the decline coming in the latter half of August as North Korea provocations escalated and central bankers discussed financial stability concerns at Jackson Hole.
- The part of the Treasury curve that is inverted has shifted with the announcement of what amounts to a 3-month extension of the debt ceiling. T-bills maturing at the end of 2017 now offer more yield than those maturing in the first month of 2018.

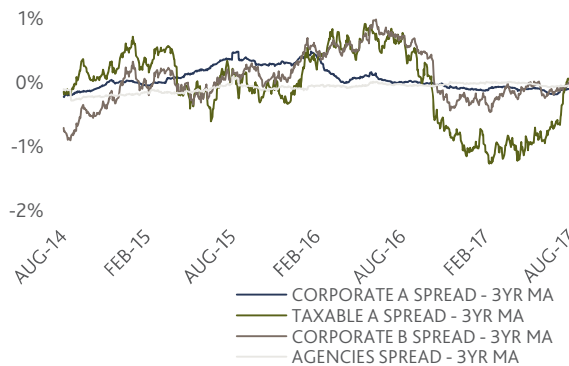
## 12-MONTH RETURNS, TAXABLE BOND SEGMENTS AUGUST 2016 THROUGH AUGUST 2017



Source: Bloomberg

- High yield and emerging market bonds continue to maintain their strength over the rest of the market, with EM again marginally outperforming high yield on a one-month basis, but still significantly trailing high yield for the best performing fixed income asset class over the last 12 months.
- Following a post-election sell off in emerging market and high yield bonds, income-seeking investors have since driven spreads to well below historical average levels
- Among the more risk-averse asset classes, taxable municipal bonds have surpassed corporate bonds for third highest twelve-month total return.

## SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE AUGUST 2014 THROUGH AUGUST 2017

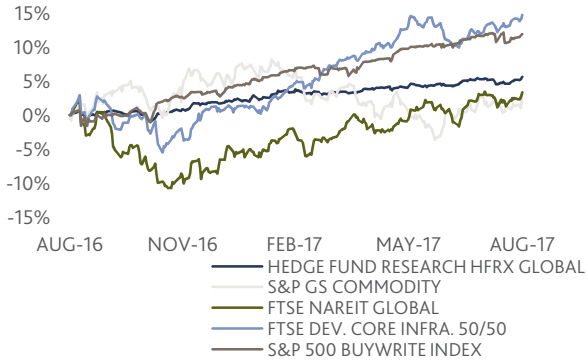


Source: Bloomberg

- Most asset class spreads remain at tighter-than-average levels to U.S. Treasuries, though taxable municipal bond yields are finally breaking above recent levels.
- Tight spreads, particularly in riskier asset classes, tend to signal turning points in the credit cycle. While spreads did widen slightly this month, defaults remain below their historical norms, meaning this cycle may still have legs.
- While other sectors have gotten slightly cheaper relative to their historical averages, investment grade corporates have remained tight, indicating they may be at fair value or even expensive at this point.

# ALTERNATIVES

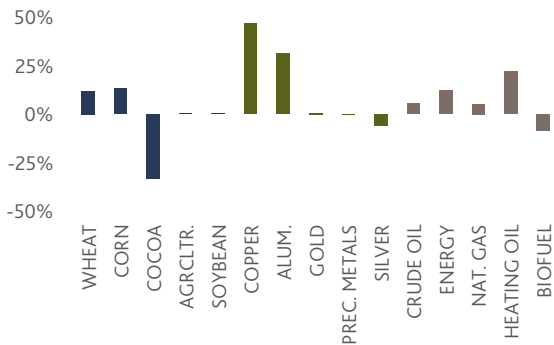
ALTERNATIVES, 12-MONTH RETURNS  
AUGUST 2016 THROUGH AUGUST 2017



Source: Bloomberg

- The global developed market infrastructure asset class extended its year-to-date gains into August, boosted by strong monthly performance of key European toll road and U.S. utility stocks.
- August was one of the most volatile months of 2017 for U.S. equity investors; four of the eight days thus far this year in which the S&P 500 Index saw a 1.0% move in either direction occurred in August. Against this backdrop, four of the five alternative strategy indexes shown on the left matched or exceeded the S&P 500's 0.3% return for the month with less daily volatility.
- Further declines in U.S. interest rates in August combined with an improving global economic outlook continue to support global real estate price levels.

COMMODITIES, 12-MONTH SPOT RETURNS  
AUGUST 2016 THROUGH AUGUST 2017



Source: Bloomberg

- Hurricane Harvey's landfall in southeast Texas and subsequent regional flooding in the final week of August temporarily knocked out about 30% of U.S. crude oil refining capacity. This drove gasoline prices to two-year highs, while crude oil prices fell several percent. The Houston ship channel is the largest refining and petrochemical complex in the world.
- Escalating tensions on the Korean peninsula and tame inflation data in the U.S. have seemed to put a bid under gold prices in the last six weeks, as the precious metal rallied nearly \$100/oz., or 8.0% from July 13 to August 31. Gold, along with U.S. Treasury bonds, the Swiss franc and the Japanese yen are generally considered the most prominent so-called safe haven assets.



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