

First Quarter 2017

QUARTER IN REVIEW

It did not take long for the post-election euphoria to wane. Ostensibly created by the expectations for growth-oriented legislative and regulatory shifts, investor enthusiasm was met with the reality that the outlook for investible markets remains a bit muddy. The world is not as safe as it has ever been, equity markets are not as inexpensive as they ever have been and central bank policy, while suggesting stability going forward, still might be cause for disruption. And yet, while the jubilation may not be as widespread, investors do not seem to have turned to dismay. Indeed, first quarter performance proved rather fruitful and there are reasons to be a bit more positive from a fundamental standpoint as we head further into 2017.

Beyond the Headlines...

Perhaps the intro read a bit too disconcerting, what with the U.S. equity market up strongly in Q1 and fixed income providing additional portfolio support. But, such was the first quarter of 2017 as news banners seem to have provided an awful lot of reasons for investor insecurity. Top of mind were a failure of the freshly charged Trump administration to secure promised health care reform, continued concerns over rising tension on the Korean Peninsula, an anxious stalemate in Syria and divisive electioneering in Europe. Even so, the prior three months proved far tamer than one might have expected, with overall equity market volatility subdued by most comparisons.

...Cause for Enthusiasm

Perhaps investors spent more time in the B Sections of the papers. Broadly positive macroeconomic trends provided a backdrop of continued slow but steady-ish growth here and abroad, with expectations generally still upbeat regarding potential corporate revenue and earnings growth.

Braced for Discomfort

But, we aren't without reason for pause. Major concerns of the first quarter have turned a bit to dread in Q2. The U.S. stepped up intervention in the Syrian crisis after a chemical attack on civilians, allegedly by the ruling Assad administration, led to a U.S. bomb strike. Russia, not surprisingly, protested the U.S. response while obfuscating the events that prompted them. Meantime, the situation in North Korea has become increasingly desperate as rhetoric on all sides has heated up in advance of additional nuclear technology tests by Supreme Leader Kim Jong-un. And though fears of a nationalist takeover of Western Europe so far have proved overdone, the resulting increase in complacency only has furthered worries that more must be done to avoid greater disruption of the European Union following the now properly initiated "Brexit" of the U.K.

Figure 1: Quarter Summary Scorecard

Overall Take			
↑	↑	Equities gained in the aggregate, with non-U.S. stocks finding particular strength. Value underperformed generally. Domestic small-cap performance fell below that of large caps, but non-U.S. small-cap stocks outperformed	
	↑	Fixed income saw reasonably positive performance, with global exposures turning in a stronger quarter than domestic bonds, amidst a backdrop of narrow movement in interest rates	
Equity			
↗	Domestic Though value and small both trailed, U.S. equities were up during the quarter		↑
		International Stocks outside of the U.S. saw steady gains, augmented by a generally weakening dollar	
Fixed Income			
↗	Domestic Expectations for continued growth offset another interest rate hike by the Federal Reserve, providing modest gains		↑
		International Global credit bonds supported modest gains in the quarter, boosted by waning dollar strength	

Macro Focus

The decision of the Federal Reserve to lift its federal funds interest rate target¹ by a quarter percentage point in March and the present consensus to maintain a pace of at least two more rate increases through year end confirms the review that broader domestic macroeconomic trends remain positive. Inflation has moved into the realm of normal and the domestic employment picture continues to improve, with job gains relatively robust and even some expansion in the labor force. This relative tightness may be showing up in the modest to moderate gains in wages and robust consumer confidence.

More recent data and commentary suggest, however, that growth may have slowed in the first quarter after having proved relatively strong for much of 2016. Weaker consumer spending is a culprit. Potentially slower growth measures, coupled with freshly softer-than-trend inflation, have cast some doubt on the Federal Reserve’s intentions. Even so, we believe the focus will remain on the broader, longer-term story, with near term shifts now seemingly much less of a focus for the Federal Reserve, the policy stance of which remains well on the accommodative side of the spectrum.

Though single-country elections are likely to remain top-of-mind for investors, European economies also are finding stronger growth footing despite the political uncertainty. Helps that much of the rest of the world, including Japan and some long-struggling emerging economies, are collectively supporting and being supported by a global economy on the slow mend.

¹ The fed funds rate is the rate at which banks loan each other funds overnight. The Federal Reserve establishes a target for this rate, seeking to modulate macroeconomic activity. A very helpful primer on the workings of the Federal Reserve can be found here: <https://www.stlouisfed.org/in-plain-english>

Altogether, we can color the macroeconomic backdrop as constructive for our portfolios on a going-forward basis. Far from a nothing-to-see-here mentality, however, we will continue to be on watch from diversions from trend and shifts in geopolitical risks for potential impact on portfolio stability and return.

Equity Market Review

After a mixed final quarter of 2016, equity markets in the first quarter built upon gains following the U.S. election to turn in a very solid first quarter. Though our favored Value exposures underperformed their Growth peers, and while U.S. small-cap stock performance fell below that of larger-company stocks, international diversification boosted overall portfolio return in Q1. Emerging markets topped developed markets as a group, while non-U.S. small-cap stocks turned in notable outperformance as well. We detail broader-market equity performance in Figure 2. Performance for the value components of the broad-market indexes can be found the middle section of Figure 2 and we show their relative performance (Value minus the broad market), versus their respective broader markets, in that figure's final section.

Figure 2: Trailing Broad Equity-Market Performance

Broad Equity-Market Indexes							
	3 months	1 Year	3 Year	5 Year	10 Year	Inception	
Global	6.91	15.04	5.08	8.37	4.00	4.00	
World ex. U.S.	7.86	13.13	0.56	4.36	1.35	1.35	
World ex. U.S. Small-Cap	8.78	12.26	2.46	6.68	3.05	3.05	
U.S.	5.74	18.07	9.76	13.18	7.54	7.54	
U.S. Large-Cap	6.07	17.17	10.37	13.30	7.51	7.51	
U.S. Small-Cap	2.47	26.22	7.22	12.35	7.12	7.12	
Developed Markets	7.25	11.67	0.50	5.83	1.05	1.05	
Emerging Markets	11.44	17.22	1.18	0.81	2.72	2.72	

Value Component of Equity Indexes							
	3 months	1 Year	3 Year	5 Year	10 Year	Inception	
Global	4.86	17.12	3.81	7.82	2.83	2.83	
World ex. U.S.	6.68	16.68	-0.51	3.81	0.68	0.68	
World ex. U.S. Small-Cap	8.55	15.64	2.24	6.83	NA	NA	
U.S.	2.99	19.97	8.58	13.08	5.94	5.94	
U.S. Large-Cap	3.29	18.66	8.88	12.66	5.70	5.70	
U.S. Small-Cap	-0.13	29.37	7.62	12.54	6.09	6.09	
Developed Markets	6.05	15.98	-0.61	5.56	0.05	0.05	
Emerging Markets	10.16	17.43	-0.10	-1.01	2.67	2.67	

Value Component, vs. Aggregate Equity Indexes							
	3 months	1 Year	3 Year	5 Year	10 Year	Inception	
Global	-2.05	2.08	-1.27	-0.56	-1.17	-1.17	
World ex. U.S.	-1.18	3.54	-1.08	-0.55	-0.68	-0.68	
World ex. U.S. Small-Cap	-0.22	3.38	-0.22	0.14	NA	NA	
U.S.	-2.75	1.90	-1.18	-0.10	-1.60	-1.60	
U.S. Large-Cap	-2.77	1.49	-1.49	-0.64	-1.81	-1.81	
U.S. Small-Cap	-2.60	3.15	0.41	0.19	-1.03	-1.03	
Developed Markets	-1.20	4.31	-1.11	-0.27	-1.00	-1.00	
Emerging Markets	-1.29	0.21	-1.28	-1.81	-0.05	-0.05	

From 03.31.07 to 03.31.17. Total return data for broad market categories are annualized for periods greater than 1 year. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

We welcomed the turn of fortune for non-domestic equities, surmising that the longer-term underperformance of non-U.S. equities has weakened investor enthusiasm for exposures outside the U.S. and otherwise has increased the temptation to attempt to time individual country and region investments. We lately often have found ourselves defending a global approach to investing and will look to review the merits of investing outside the U.S. in an upcoming commentary. The gist is that international diversification can benefit portfolios both on the risk and return sides of the performance equation. Those potential benefits are not always achieved after the fact, but market history broadly supports an externally tilted stance. We therefore will continue to balance the potential benefit to risk-relative return with the observation that clients generally seem to feel more comfortable with more familiar (read: domestic) exposures in their portfolios.

Fixed Income Market Review

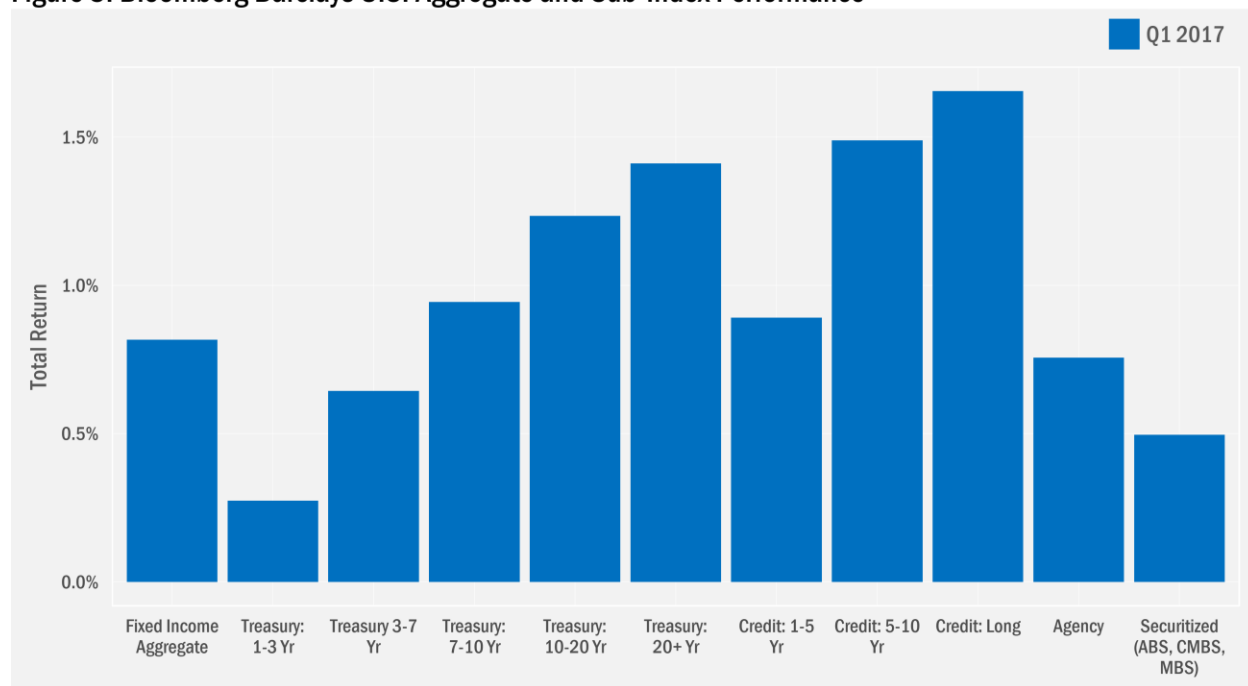
With broader levels of interest rates still very low by historical comparison, it remains easy for rate volatility to obscure fixed income market performance. After the Fed's decision to lift its fed funds target by a quarter percentage point in December, interest rates maintained a relatively narrow range through the Fed's latest rate hike last month (the third such decision since the financial crisis). The March 15th move put the target range for the overnight lending rate at between 0.75% and 1.00%.

What's been interesting is the bond market activity since then. While rates have held rather firm on the short end of the yield curve² (one year to maturity and less), rates have fallen for Treasury bonds with maturities greater than two years since the March decision. There are several observed rationales for this trend. First is that inflation expectations have waned. The presumed motivation for declining expectations is the fact that the Trump administration has yet to follow through with headline policy initiatives that might engender faster growth. Second, as we noted earlier, the short-term shift in focus to domestic politics after the election lasted only until Kim Jong-un rattled his nuclear sabers and another horrific chemical weapons attack in Syria prompted a military response from the U.S. that arguably has brought U.S.-Russian relations to Putin-era (perhaps even post-Cold War) low.

The late-in-the-quarter slide in longer-term rates saw the Bloomberg Barclays U.S. Aggregate Bond Index gain a bit more than a percentage point from mid-March, leaving the quarter's gain at 0.82%. Domestic bond market performance also was supported by a further narrowing of credit spreads, meaning that investors demanded less in terms of extra yield for corporate bonds to compensate for the additional potential for default (a risk that U.S. Treasuries do not present). Outside the U.S., similarly favorable rate trends, coupled with the aforementioned slide in U.S. dollar strength, boosted performance of international fixed income for U.S. investors.

² A yield curve is a plot of the rates offered by bonds of the same credit quality, but with various terms until maturity.

Figure 3: Bloomberg Barclays U.S. Aggregate and Sub-Index Performance



From 12.31.15 to 04.15.17. SOURCE: SRCM using data from Bloomberg

In Praise of Nuance

Our hope with all our letters is to present a view that balances potential upside with potential risk. Indeed, we believe we regularly must remind our clients that, even as investing can prove disconcerting in the short run, a properly positioned portfolio can boost one’s chances of achieving our long-term financial goals. Thus, if we seem intent on highlighting the negatives of potential ill consequence to investible markets, we seek merely to persuade readers to remain cognizant of possible risks to near- and medium-term investment scenarios; this especially after a period of demonstrably tame equity market movement.

Of course, favorable year-to-date gains are the very spice of investing that justifies the wait and worry of periods like the earlier part of 2016. Thus, balancing the prospects of both return and risk, we will continue to promote the sensibility of global diversification as core to a risk-targeting approach to investing. To that end, we invite readers to reach out to your Advisors for an assessment of financial and emotional tolerance for market risk with the intention to ensure portfolio allocations are in line with historical gauges of potential market volatility and downside.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Asset classes and their respective indexes mentioned in this report include the following:

International (global non-U.S. dollar-denominated) fixed income: The Bloomberg Barclays Global Aggregate Index is a multi-currency benchmark that measures global investment grade debt and includes fixed-rate treasury, government-related, corporate and securitized bonds from developed and emerging markets issuers while excluding U.S. dollar-denominated debt.

Domestic (U.S.) fixed income (Fixed Income Aggregate): The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds.

Global equity: The MSCI ACWI Index captures large- and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set.

International equity: The MSCI ACWI ex. USA Index captures large- and mid-cap representation across 22 Developed Markets countries and 23 Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.

International small-cap equity: The MSCI ACWI ex. USA Small Cap Index captures small cap representation across 22 Developed Markets countries (excluding the U.S.) and 23 Emerging Markets countries. The index covers approximately 14% of the global equity opportunity set outside the U.S.

International value equity: The MSCI ACWI ex. USA Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 22 Developed and 23 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The index targets 50% coverage of the free float-adjusted market capitalization of the MSCI ACWI ex. USA Index.

International small-cap value equity: The MSCI ACWI ex. USA Small Cap Value Index captures small-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 23 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The index targets 14% coverage of the free float-adjusted market capitalization in each country.

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

Domestic (U.S.) equity: The Russell 3000 Index represents approximately 98% of the investable U.S. equity market. The Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Domestic (U.S.) large-cap equity: The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization. The S&P 500 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P 500 Index.

Domestic (U.S.) small-cap equity: The Russell 2000 Index tracks the performance of U.S. small-capitalization stocks and is comprised of the smallest 2000 companies in the Russell 3000 Index. The Russell 2000 Value Index measures the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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