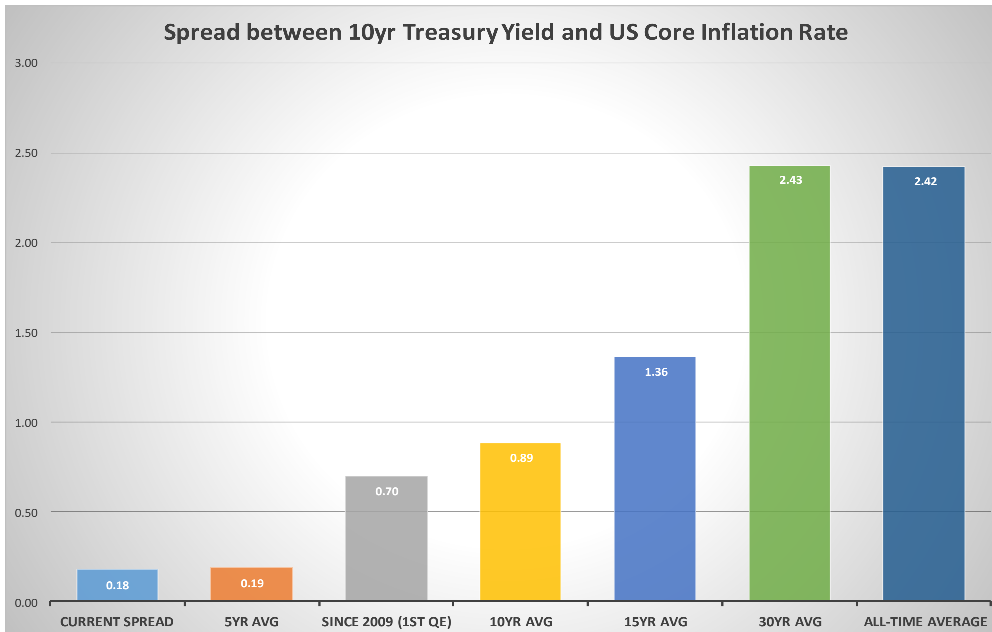
GBA Financial

Monthly Newsletter

March 2017

Commentary

Quantitative easing from central banks around the world has held interest rates far below their historical average. From a different vantage point, the chart below looks at the difference between the 10-year Treasury yields and US Core Consumer Price Index (Core CPI). Core CPI is a index that measures inflation but eliminates energy and food sectors as they tend to be volatile in the shorter-term, and the 10-year Treasury yield is what the U.S. government pays to borrow money for a 10-year loan and is regarded as the safest loan in the world. From historical standards the 10-year Treasury yield averages slightly more than 2.4% above what the US Core Inflation is year-over-year. All things equal, if you invest in a 10-year Treasury and inflation rate stays the same, you would generate a 2.4% return over inflation. Referring to the chart, you can see why investing in Treasury doesn't look attractive. The current spread (as of 1/31/17) and the 5-year average are under 20 bps! Put another way, if you bought $10,000 worth of 10-year Treasury bonds, you would have a return under $20 after inflation. Something's got to give. We expect to see some sort of revision to the mean, but how do we get there? The Federal Reserve has two mandates: maximizing employment and stabilizing prices, with a target of two percent for inflation over time for stabilizing prices. Core inflation came in at 2.3% year-over-year for January, so the math says if we were at historical spreads the 10-year should be at 4.7%. Obviously that is not happening soon, but what about a spread of 50 bps or 75 bps over the next year? It's not impossible. However this plays out, we believe the 10-year will move higher and a short duration fixed income portfolio should benefit. The Fed has an extremely hard job ahead, balancing out inflation by tightening monetary policies but not so much that it kills the economic recovery. Can the politicians in Washington come together and bring some fiscal stimuli to help offset the monetary tightening and help out the Fed? It sure seems like a good idea.



(cont. on reverse)

Economic Highlights

S&P 500	2,363.64
DJIA	20,812.24
NASDAQ	5,825.44
Oil	$54.01/barrel
Gold	$1,253.90/ounce
10 Year Treasury Yield	2.36%
Unemployment	4.8%
GDP	1.9%
Consumer Price Index (CPI)	+0.6% 12 month change: +2.5%
Core CPI	+0.3% 12 month change: +2.3%

Consumer Confidence - Since after the US election, consumer confidence grown; February didn't change that as a consumer survey report showed another new high. We haven't seen this confidence spill over to spending from consumers or businesses, but we believe it will start to show up in 2017.

GDP - After very strong third quarter GDP numbers, the second revision to fourth quarter numbers were on the low side again. The consensus range was 2.0% to 3.1% and GDP coming in at 1.9% annualized.

Europe - All signs are pointing to the U.K. leaving the European Union's single market and negotiating individual topics as it seeks the best possible outcome on each. These negotiations could greatly affect growth in Europe. Does the EU play hardball?

(cont.)

February continued the slow upward trend in the stock market as we have reached day 95 where the S&P 500 hasn't recorded a day down 1%. Volatility (measured by the VIX futures) in the stock market is at extremely low levels. The Federal Open Market Committee (FOMC) will be meeting March 14-15 and will be making their announcement on the 15th. The market has priced in a greater than 75% chance of a 25 bps rate increase. Nonfarm payrolls beat consensus and participation rate jumped 0.2% to 62.9%. Average hourly earnings and average workweek hours were a little weak, but the report was solid.

Many economic and technical indicators point to a bullish economy and stock market. US large cap stocks have been performing well the last two years and we expect this to continue but also believe that small- and mid-caps are positioned to take the lead as risk appetite increases. That said, we are currently watching markets to increase the exposure to small-caps and reduce exposure to large-caps. We feel a shift into small-caps should benefit the portfolio over the next three to five years. An improving economy and strong balance sheets for US consumers and businesses should continue to drive the economy forward. One negative feature of a strong economy is a strong dollar, which can cause headwind for large multinational companies. This is another reason we see small-cap companies as well-positioned, as they tend to be less affected by a strong dollar.

Sector-wise, we are bullish on Technology, Industrials, and Financials, but are cautious in Utilities, Health Care, and Consumer Staples. Brexit still looms over the international developed markets and we are maintaining our defensive approach with our product selection in international developed markets, and are in wait-and-see mode for more news and information before we make additional changes. We expect there to be a opportunity in international developed markets with Quantitative Easing improving balance sheets for consumers and businesses (similar to the US), but the risk of Brexit negotiation versus the reward is not tilted in the reward's favor enough to be very aggressive. Emerging Markets valuations look very attractive, and we do believe there will be an opportunity to benefit from these valuations, but again we are in a wait-and-see mode regarding Trump and his policies on trade agreements. Our fixed income positions have been weighted towards low duration, which historically tend to do better in a rising interest rate environment; we believe this is still the best positioning, as we think rates have more room to go. We continue to be tactically underweight to government bonds and overweight to corporate, high yield, floating rate, and global bonds. With our daily monitoring we'll continue to rebalance models when they fall outside their target threshold.

Economic Highlights

Index	3 Mo	1 Yr	3 Yr	5 Yr
S&P 500	8.04	24.98	10.63	14.01
MSCI EAFE	7.98	16.31	-0.71	5.63
BarCap Agg Bond	1.01	1.42	2.64	2.24

Data as of 2/28/2017. Investments cannot be made directly into an index.

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Additional risks are associated with international investing, such as currency fluctuations, Political and economic stability and differences in accounting standards.

The stocks of small companies are more volatile than the stocks of larger, more established companies.