# Trumbower Financial Advisors, LLC
# 2nd Quarter 2017
## Investment Market Commentary

### *As the World Turns*

In spite of a stumble near the end, worldwide equity markets continued their ascent during the 2nd quarter. Stronger corporate earnings and optimistic economic indicators fueled by supportive central bank policies propelled international equities ahead of domestic stocks once again. Emerging and Developed markets advanced 6.27% and 5.03%, respectively.

Back home, US Large Caps (+3.09%) beat Mid (+1.97%) and Small Cap (+2.46%) equities for the second quarter in a row. In the footsteps of an abrupt, dramatic Q1 shift, investor preference for "Growth" over "Value" persisted and the performance spread widened to over 9% within Large and Small Caps. The disparity among Mid Caps was less pronounced at 6.2%. Cyclically speaking, Value's day in the sun is long overdue. (Note that if the trend set in the first half of 2017 continues it may invalidate a point we make in our essay – beginning on page 3).

Technology (+16.9%) and Healthcare (+16.6%) were 2017's top performing sectors as of June 30th. Tech laden NASDAQ ended up 14.71% compared to the S&P 500, up 9.34%. The "FAANG" clique (Facebook, Apple, Amazon, Netflix and Google) all posted impressive first half results with returns ranging from 17.3% to 31.2%. These 5 companies comprised 26% of the NASDAQ and 11% of the S&P 500 at quarter end.

In the aggregate, commodities have fared poorly this year. Higher prices for most metals were overshadowed by declines in Iron Ore and, of course, Energy. Following suit, Energy sector equities tanked -13.7%

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***2nd Quarter Equity Market Results***

| | 2nd Qtr. % Chg. | 12-mth. % Chg. |
|---|---|---|
| S&P 500 | 3.09 | 17.90 |
| S&P 400 | 1.97 | 18.57 |
| Nasdaq | 4.16 | 28.30 |
| Russ 2000 | 2.46 | 24.60 |
| MSCI EAFE | 5.03 | 17.08 |
| MSCI Emg | 6.27 | 23.75 |

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Emerging Market equities stayed on the recovery track that started in mid-2016. The MSCI EM Index escalated 18.43% year-to-date. Poland (+33.7%) and Turkey (+33%) were top country performers but Russia, down -13.5%, remained stuck in Siberia.

Big changes are in the works for this popular measure of equity returns in lesser developed countries. Restricted access to China's country club exchanges have kept stocks denominated in yuan ("A Shares") out of the index. MSCI recently announced plans to start phasing in "On Shore" Chinese equities beginning in June 2018. The process will be gradual and full inclusion depends on China's ongoing implementation of structural reforms. Proponents say the enhanced index will offer investors greater industry diversification and exposure to segments of the Chinese economy that are currently missing. The Chinese government is looking forward to large foreign capital inflows that will inevitably occur. At full inclusion, Chinese equities may comprise over 37% of the index (currently 28%). Much of the world's economic activity turns on China. We are not sure owning more of it is necessarily a good thing - but it is a sign that China's trading platforms are inching closer to free-market exchanges and regulators are willing to consider changes to entice foreign investors.

Another theme carried forward from Q-1 is the historically low level of volatility US stocks exhibited on the way up to record highs. Invented in 1993, the VIX Index has become a widely recognized indication of implied volatility. VIX spent most of the second quarter hovering around all-time lows, but that isn't the whole story. Late June news that central bankers might consider following the Fed into tightening mode sent the VIX up 55% before it plunged back down to one of its lowest readings ever. This overreaction to "non-news" is viewed by some as evidence of anxiety lurking beneath investor confidence. Utility stocks rallied to record highs and demand for Treasury notes flattened the yield curve after the Fed's widely anticipated June 14th quarter point rate hike. These are also possible signs of wariness.

## *Municipal Melodrama*

Post-election expectations of lower tax rates and higher inflation threw municipals under the bus late last year. Despite headlines announcing Puerto Rican insolvency and the Illinois budget deadlock, capital that fled municipal funds during the last two months of 2016 has since returned. Investors have snapped up new issues – rated or not. Demand is driving down the cost of local government financing for some. At the same time, speculators are finding a treasure trove of yield amid messy municipal financial affairs. Technically, states and territories cannot seek protection from creditors' claims through bankruptcy. Congress enacted an exception for Puerto Rico with the hope that discipline imposed by an oversight board might parcel out the island's meager resources more equitably. Unfortunately Puerto Rico has been running what amounts to a Ponzi scheme for years – financing and refinancing widening deficits as its population and economy declined. Uninsured bond holders will be standing in a long line for cents on the dollar.

Like Puerto Rico, Illinois' ills are rooted in massive underfunded government pensions. The current crisis is, however, more political than structural. Population is waning but the state still has a wealthy tax base. After two and half years a budget has finally been enacted to pay debts with a $5 billion tax increase. The fate of the state's credit rating was still undetermined at this writing.

While relatively rare, municipal bonds do default, especially those issued to finance special projects that will be repaid with related revenues. In fact, there are markets for distressed debt that come with some prospects for settlement. Thorough, skilled analysis and diversification are essential to success in this high risk neighborhood.

If you own a Puerto Rico or Illinois municipal in a laddered portfolio under our supervision, rest assured that interest and principal will be paid with US Government securities held in escrow by legitimate, regulated institutions. The bond funds we recommend have minimal exposure to troubled issuers. Experienced managers are able to take advantage of situations like this by loading up on "guilty-by-association" bargains. We do our best to keep our clients out of the "soap operas."

## *Keeping it Global*

Readers with portfolios under TFA's supervision may have noticed a familiar refrain among quarterly performance comments: "Inception-to-date total return for your portfolio is X% - ahead of the EAFE by Y%." That is not to say performance is universally stellar – but for some time broadly diversified portfolios have put international equities to shame. During the past ten years (ending 5/31/17), Developed Foreign stocks delivered a measly 1.06%, annualized, and Emerging Markets just over 2%. Results are diminished across the board by this measurement period as it began near the pre-financial crisis peak. Still, Large, Mid and Small Cap US equities served up 6.9%, 8% and 7.9%, respectively over the last decade.

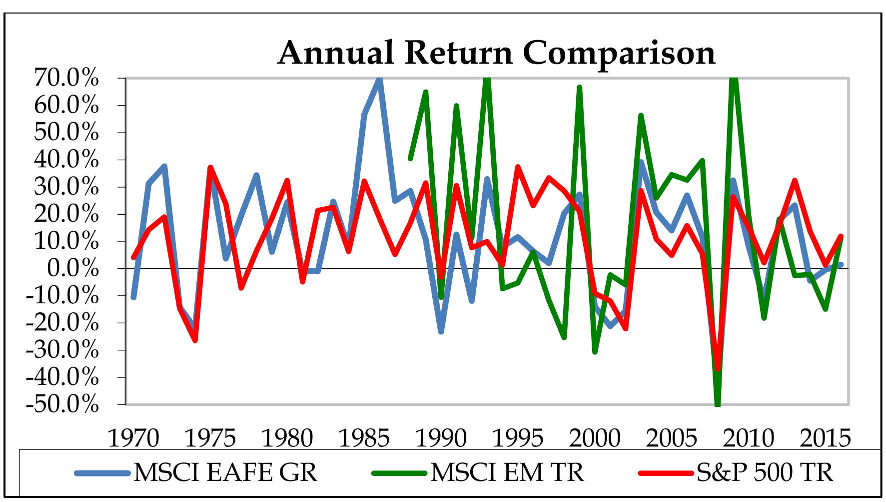
As US equities converge on record highs, we have harvested profits and, when appropriate, added to battered overseas investments. In view of the landscape we just painted, some may ask "Why bother?" In a recent *Bloomberg* article, Jack Bogle, the illustrious founder of the first Vanguard index fund, revealed that his equity portfolio sits exclusively in US stocks citing the superiority of the S&P 500's 400% rise since 1993.

International equities in the aggregate have disappointed for quite a long stretch. By definition, however, cycles don't last forever. For example, during the 6 ¾ years leading up to October, 2007 a diversified portfolio of equities that included 20% Developed and 5% Emerging international outpaced a similar US-only portfolio by almost 1.7%, annualized, with lower overall and significantly less downside volatility.

Developed Foreign stocks have displayed about as much volatility as US Small Caps but lower correlation to US equities enhanced diversification. A simple graphic comparison of major indices reveals that correlation seems to be on the rise. The peaks and valleys differ in magnitude but less divergence is evident in the pattern of annual returns since 2000. This undoubtedly reflects evolving economic globalization. Fluctuation in the value of foreign currencies is another factor that often weakens the correlation between US stocks and those that trade in local tender. The dollar's prolonged dominance over other currencies has eroded this attribute of an unhedged International portfolio component.

The US dollar ended 2016 at its highest level versus major trading partners in 14 years. After bottoming in August 2011 it ascended 35%. Although it has wavered a little year-to-date, the dollar remains less than 5% below its recent high and near its 44-year average. Continued strengthening from this perch is not unprecedented but rare. It is worth noting that the dollar tends to anticipate Fed Funds rate hikes and expectations may be priced in.

Over the past 8 years, the dollar's formidable strength has clearly taken a toll on US investors holding foreign stocks. Like every other financial phenomenon, exchange rates move in cycles. Since 1973, fluctuating currencies have negatively affected the EAFE's calendar year returns just about as often as they have helped. On average, the EAFE tends to underperform in 5-year phases and a



## *Keeping It Global*

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shift is now overdue. Counterbalancing conversion losses, strong dollars should positively impact export-oriented economies like Europe and Japan. Worries about Emerging Markets burdened with dollar debt could be overblown. Exposure is well below levels prevailing during the 1990s and current account balances among lesser developed countries are improved making it less likely that an obstinate dollar will trigger an Emerging Market meltdown.

US stock valuations and resuscitated attraction to Value management style may tip the scale in favor of foreign stocks. In late 2015 Value rebounded from its hiatus and outperformed Growth in 2016 by the widest margin in over a decade. Cycles during which Value reigns supreme have averaged around 7 years (although the first half of 2017 could signal another "about face"). There is a strong historical relationship between investor preference for Value and non-US equities. Contrarian Value seekers can't help but view the US market's extreme and sustained supremacy over European equities as an opportunity to scoop up under-appreciated stocks. Several metrics indicate that US stocks might be relatively expensive and appreciation potential might be dwarfed by Internationals.

Fundamentals, especially in Europe, are starting to show signs of a mid-cycle economic expansion. There are outliers, but unemployment rates in the Eurozone have declined from a peak of 12.1% to 9.5%. Deflationary pressures have subsided and business sentiment is more positive within the largest countries in the Zone. Revenue and earnings per share growth rates have finally bounced into the black. Eurozone credit demand is rising. Growth in manufacturing activity outside the US has exceeded the domestic Purchasing Manager's Index ("PMI"). Japan reported real growth in GDP and record high profit margins while the yen reversed its upward trend activating a surge in exports.

Potentially spooky events still loom on the Eurozone horizon not the least of which is the outcome of the "Brexit" process. Angela Merkel, a pillar of consistency in European leadership over the last decade, faces a political challenge this fall. Australia comprises ~7% of EAFE. Its biggest trading partner, China, remains a source of concern but the Aussie economy has reinvented itself since the 1980s. Central bank reforms and free floating exchange rates contributed to diversification and have spared Australia from recession for 25 years.

Despite achievements over the past 18-months, broad Emerging Market indices need another 5.9% to reach pre-2007 peaks. Valuations are just below long-term average (14.5 vs 15.2) and GDP growth expectations are roughly twice that of Developed Markets. Currencies are trading at lows not seen since the late 1990's Asian financial crisis while banking institutions are much sturdier. So far China hasn't landed hard. If you can believe them, the world's second largest economy continued to plug along just below its planned 7% growth rate. China's new 5-year target of 6.5% is enviable by developed standards. Misgivings abound but the potential for continued improvement in the discretionary incomes of millions of middle class consumers is compelling. Rivaled in population only by China, India elected a reform-minded Prime Minister in 2014. Its stock market took off erasing losses experienced during the previous three years. After a rough 2015 Indian stocks are again moving in the right direction.

Emerging Market index performance over the past 2-years was marred by deep recession in Brazil and Russia. Markets in both countries have rebounded off lows but are far from recovered. Some savvy active fund managers avoided these troubled regions and selective participation in the asset class may be the way to go.

International equities sandbagged performance for the last 10 years. From a cyclical perspective change is long overdue. Fundamentals are not universally encouraging but there are indications that economies outside the US are finally digging out from under the rubble of the global financial crisis. At this writing US stock markets show no signs of toppling, but the longer expansionary fiscal policies remain stalled the more likely we are to see some of the euphoria dissipate. A meaningful international portfolio component might juice things up or soften the blow of a US equity market correction.

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