Ginsburg Financial Advisors, Inc.
Personal Financial Planning & Investment Management
Larry P. Ginsburg, CFP® **Adele Ostomel, CFP®**

phone: **(510) 339-3933**
fax: (510) 339-1611
LGinsburg@GinsburgAdvisors.com
AOstomel@GinsburgAdvisors.com

SECOND QUARTER 2017 MARKET RECAP

After Six Straight Months of U.S. Stock Gains, What Lies Ahead?

Onward and Upward!

The financial markets have continued to experience good results here in the U.S. Patience with the new administration and its inability to deliver results may wane if Congress is unable to pass legislation as expected. Foreign (International) and Emerging Markets ("EM") stocks have also done well, but the strong focus on the U.S. financial markets may not have allowed investors to notice the good results in these sectors.

"Home Cooking" Still Tastes Good

The Standard & Poor's 500 Index (S&P 500) advanced +3.09% during second quarter 2017 and +9.34% year-to-date (through June 30), representing its best first-half results since 2013. U.S. stocks have remained largely resilient despite several headwinds, including increasing valuation concerns, a U.S. Federal Reserve ("Fed") interest rate hike on June 14 (its second one quarter of one percent increase this year), falling oil prices, and heightened geopolitical concerns (e.g. North Korea saber rattling and European election results). The lack of progress on President

Trump's key fiscal policy promises, namely healthcare reform, tax reform, and infrastructure spending, has also not prevented the S&P 500 from posting its sixth straight monthly gain. While President Trump has yet to deliver on any aspect of his fiscal "trifecta," generally positive U.S. economic trends, improving corporate earnings, and continued low inflation expectations have helped to buoy U.S. investor sentiment.

Within the S&P 500, Healthcare (+7.10%) and Industrials (+4.73%) led all sectors over the second quarter while Telecom (-7.05%) and Energy (-6.36%) fell the most. Large cap stocks, as measured by the S&P 500, outpaced mid and small-cap stocks, which were up 2.70% and 2.46% respectively. Similar to last year, U.S. economic growth, while positive, has been more anemic in 2017, which has led to continued outperformance of growth-oriented stocks over value stocks.

Foreign Stocks Delivered Even Better Returns

Overseas, the MSCI EAFE Index ("Europe, Australia-Asia, and Far East" or everywhere other than the U.S.), which measures developed international market stock returns outside the U.S. and Canada, rose 6.12% during the quarter and is up 13.81% year-to-date. Investor sentiment continues to strengthen in the developed markets spurred on by an improving economic environment, more reasonable valuations, and abating populist trends. Emerging market stocks, as measured by the MSCI Emerging Markets Index, continued their rally this year, increased 6.27% during second quarter 2017, and are up 18.43% year-to-date. Improving economic trends in the U.S. and other developed markets, stabilization in Chinese economic growth and commodity prices, and relatively cheap valuations continue to support demand for emerging market stocks.

What Should We Expect From Stocks Going Forward?

The deep philosophical divides within the Grand Old Party ("GOP") over the government's role in healthcare as well as the House's widely unpopular measure to dramatically scale back Medicaid funding, which could negatively impact Republican mid-term election races next year, have delayed the formation of the Senate's bill to reform the Affordable Care Act ("Obamacare"). This in turn has pushed out the timing of the President's tax reform initiative since the Administration wants to know the impact a "repeal and replace" of Obamacare will have on government finances thus the scope of any tax reform bill. Experts we have spoken to think it is more likely that congress ultimately approves a bill that "repairs and renames" Obamacare, which would not only strengthen underlying funding mechanisms and shore up financing for state Medicaid exchanges, but expedite the pivot to tax reform. However, these experts think it is unlikely any tax proposal will be approved prior to first quarter 2018 at the earliest, and they view the approval of an infrastructure bill before 2019 as extremely unlikely.

We generally recommend reducing exposure to U.S. stocks as expectations for President Trump pushing through one or more components of his fiscal "trifecta" this year begin to fade. There has also been no serious progress on a budget despite looming fall deadlines to extend spending authorization and to raise the debt ceiling. Since U.S. stocks are currently trading in line with or slightly above historical levels on a number of valuation metrics, there is little-to-no embedded discount for the possibility of increased political uncertainty that could roil confidence in both the U.S. economy and financial markets, particularly if lawmakers flirt with defaulting on the debt ceiling limit. We will look for opportunities to shift weightings to U.S. stocks back towards their long-term targets if a market correction occurs.

At this time, we have a more favorable view on international stocks and advocate shifting some U.S. stock exposure to both developed international markets and emerging market stocks. Developed international market stocks are not only cheaper relative to the U.S., but key economies, such as the Euro Area, are earlier in their business cycle and continue to benefit from supportive Central Bank monetary policy. The victory of centrist candidate Emmanuel Macron in France, coming on the heels of pro-European Union political party victories in Austria and the Netherlands, has effectively marked the peak of the populist movement in Europe and has improved economic sentiment within the region. With the exception of the Federal election in Germany to be held on September 24, abating populist-driven political noise has also improved investor sentiment towards developed international market stocks. The trailing average annual compounded rate of return in this sector was -0.02% over the past ten years, below the long term historical average for value stocks (ones that pay a dividend) of about 10% per year.

Like developed international markets, emerging markets are cheaper relative to the U.S., but the long-term growth potential of emerging market economies is much more attractive as compared to the U.S. and developed international markets. Not only are emerging market economies in the earlier stages of their economic recovery, but the underlying fundamentals continue to strengthen due to improving government finances, broad strengthening in emerging market currencies, stabilization of commodity prices, and China's continued shift to a self-sufficient, consumer-based economy. The number of Chinese consumers is expected to grow from approximately 225-250 million currently to 350-400 million over the next decade. This dynamic combined with an expanding middle class throughout the emerging markets supports the view that approximately 70% of the world's GDP growth over the next five years is expected to come from emerging market economies.

We generally recommend holding a higher-than-normal concentration of alternative and tactical assets. This is as an appropriate strategy to diversify away from traditional stocks. Alternative assets provide the opportunity to enhance portfolio diversification through lower correlated returns and differentiated volatility patterns compared to traditional stocks and bonds. Examples of alternative assets include mid-stream energy master limited partnerships ("MLPs") and assets that can employ "long" and "short" strategies to minimize downward volatility. Commodities and other hard assets are other alternative assets that can be owned, especially if there is a reason to minimize the impact of rising inflation expectations. Right now, there is no evidence of increasing inflation expectations to warrant an investment allocation in this sector. President Trump's inability to pass any of his fiscal policy measures further suppresses the risk of a rise in inflation expectations near-term. Should this change, we may find commodities appropriate to own if inflation begins to rise.

Tactical assets reflect sectors or industries that are expected to outperform the broader equity markets. Tactical asset opportunities we currently emphasize include sector investments in financials, healthcare, and information technology. As the U.S. economy enters the later phase of its economic cycle, however, new tactical opportunities may present themselves. Such opportunities may tend to disproportionately benefit from late-cycle growth dynamics relative to other stock industries or asset classes.

Investment Grade Bonds – Slow and Steady

U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Government Bond Index, gained 1.17% in the second quarter and were up 1.86% year-to-date. Investment grade bonds of all types, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, were up 1.45% in the second quarter and gained 2.27% year-to-date. The positive results in investment grade bonds were helped by strong gains in higher-rated corporate bonds, which returned 2.54% in the second quarter, as measured by the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index. Stronger-than-expected first quarter earnings and continued robust demand for yield supported U.S. investment grade credit markets during the quarter and year-to-date.

We continue to advocate holding a meaningful portion of client portfolios in investment grade bonds, both domestic and international. These assets have experienced substantially lower price fluctuations compared to stocks. This helps to stabilize portfolio returns and enables portfolios to compound returns more efficiently over time by reducing the frequency and breadth of negative portfolio fluctuations during “down” stock market cycles. While the primary goal for fixed income investments remains portfolio protection, we continue to evaluate opportunities to increase returns of bond assets. Adding direct exposure to emerging market bonds can be one way to attain such benefits. Emerging market bonds not only have a much lower default rate compared to global corporate high yield bonds, but improving economic fundamentals and stabilization in emerging market currencies have the potential to generate higher total returns without a meaningful increase in portfolio volatility.

Near-Term Risk of a U.S. Economic Recession Remains Low

The Fed continued to “normalize” monetary policy by raising its target range for the federal funds rate by 25 basis points (one-quarter of one percent) to 1.00-1.25%. The federal funds rate is the overnight rate depository institutions (e.g. banks and credit unions) lend their reserves to each other. Even though this pushed short-term rates higher, thereby causing short-term bond prices to fall, the yield on the benchmark 10-year Treasury note ended the quarter at 2.31%, down 9 basis points compared to the end of the first quarter. This “flattening” of the U.S. Treasury interest rate yield curve, where short-term rates rise faster than longer-term rates, reflects the bond market’s view that future Fed rate hikes will be less frequent. The current shape of the yield curve also infers diminished prospects for growth-enhancing fiscal policy over the near-term. Normally a flattening yield curve is an indicator of economic pessimism, but longer-term rates remain artificially depressed due to heightened demand for U.S. bonds. This is in part due to international developed market bonds that have yields near or below 0% and continued low inflationary pressures. For these reasons, strategists we regularly speak with suggest that the risk of a recession over the next twelve months remains low. They also expect Congress will ultimately pass a tax reform “lite” bill (i.e. temporary tax cuts versus true tax reform) and possibly an infrastructure “lite” bill (i.e. an infrastructure package that is much smaller in size and scope) sometime in 2018 or beyond. This is further supported by generally positive trends in key economic indicators, such as the unemployment rate and housing sales, and the Conference Board Leading Economic Index for the U.S.

Fed Balance Sheet "Unwind" Appears Manageable … For Now

In addition to raising its target for the Federal Funds rate at its latest Federal Open Market Committee ("FOMC") meeting in June, the Fed also announced detailed plans for reducing (i.e. unwinding) the size of its balance sheet from a current level of $4.5 trillion. Specifically, the Fed plans to "roll off" its agency mortgage back securities ("MBS") and Treasury holdings starting in the fourth quarter, beginning with $6 billion per month of securities and increasing this amount to $30 billion per month over time. This means when bonds mature and the U.S. government receives its principal, it will not use this money to buy new bonds. The market strategists we speak with think the bond markets can accommodate this systematic decrease in demand for government bonds given the visibility provided by the Fed, the long runway the Fed intends to use to reduce its holdings, and the fact that the Fed will continue to reinvest the interest and principal payments of bonds that have either not matured or are not earmarked to be "rolled off" upon maturity. The one caveat, however, depends on the stability of Fed philosophy, which could change should President Trump decide to replace Fed Chair Janet Yellen or if Ms. Yellen decides to step down upon expiration of her 4-year term as Fed Chair on February 3, 2018. We will continue to evaluate this situation and will look to adjust the makeup of fixed income investments if there is increasing evidence of a material change in the Fed's strategy to reduce its bond holdings and the implications this may have on the bond market.

Our View About the Financial Markets Remains Cautious

We do not currently recommend any significant deviations from a long-term stock and bond allocation. We expect U.S. stocks to underperform relative to historical averages going forward as expectations over fiscal stimulus continue to wane and political uncertainty increases. We want to reduce the potential for portfolio volatility. We also continue to advocate holding predominately investment grade bonds to further minimize volatility. In this phase of the market cycle, we continue to prefer managers with flexible investment styles that provide discretion to move nimbly within their mandates when faced with changing circumstances.

As always, please contact us if you have any questions or concerns about your investment portfolio.