Executive Summary:

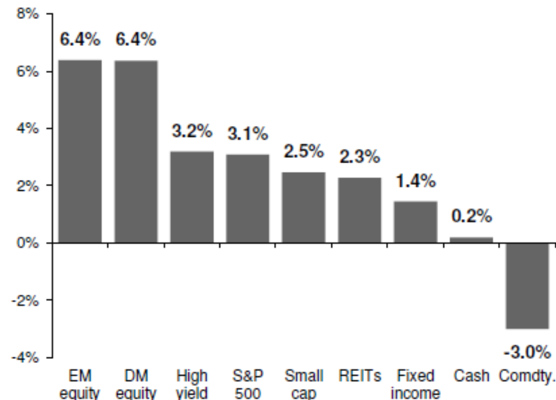
- **Let's go to the videotape!** Markets performed well in Q2 posting positive returns globally. Similar to recent quarters, the positive performance was not confined to stocks as returns were broadly strong across asset classes.
- **Normalization.** The path toward normalization of interest rates continued in the quarter with the Federal Reserve raising the federal funds rate at its most recent meeting. Ultimately, there is concern that higher interest rates will have a negative impact on a variety of asset classes, most notably equities.
- **What could go wrong?** With the unemployment rate at 4.3% the labor market is tight, suggesting an acceleration in economic activity from here could push up wages and inflation. While rising wages have yet to translate into higher inflation, the Fed may be facing an economic inflection point where accelerating growth and inflation will require a more aggressive policy response than current expectations.
- **Market timing is difficult**. There is a dramatic difference in performance over the last twenty years between being fully invested versus trying to time the market. Thoughtful asset allocation and risk management allows for longer term planning and less emotional investing.

"It's like déjà vu all over again." Yogi Berra

With summer in full swing we thought kicking off this quarter's letter with a quote from baseball great Yogi Berra was appropriate. The quote also captures what investors may be feeling about the stock market given what seems to be an inexorable move higher.

Let's go to the videotape! Markets performed well in Q2 posting positive returns globally. The S&P 500 rose 3.1% in the quarter, the tech-heavy NASDAQ was up 4.1%, the Russell 2000 showed a more modest 2.5% gain (small caps continue to lag), international developed markets were up 6.4%, and emerging markets continued their strong performance posting a 6.4% increase.

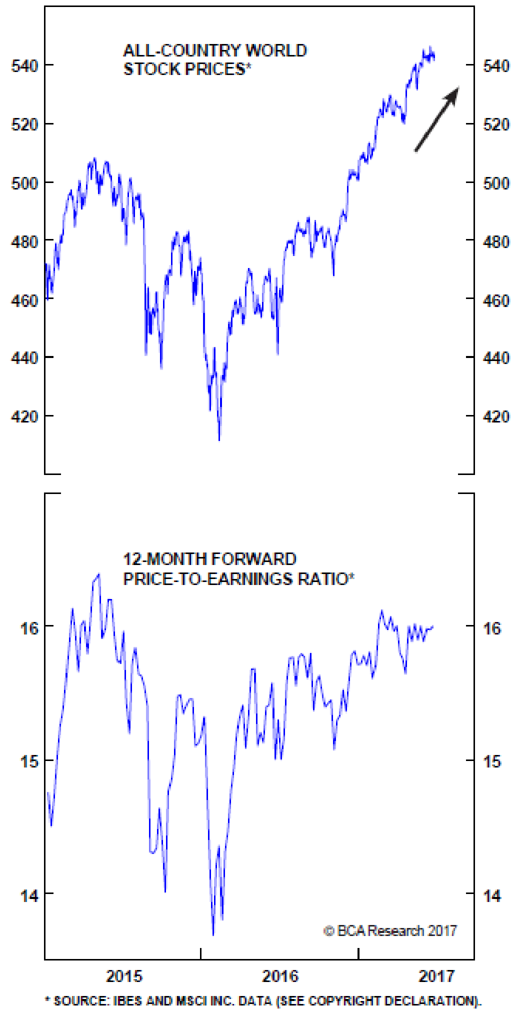
Continuing the trend of recent quarters, the positive performance was not confined to stocks. As the chart at right shows, returns were strong across asset classes. The one lagging asset class was commodities due to the ongoing supply glut of oil, which pushed prices into the low $40's per bbl. As a result, energy has been the worst performing sector in the S&P 500, down 12.6% in the first half of the year. Energy is a notable laggard in a year where thus far nine of the eleven S&P 500 sectors are higher in the first half—technology continues to lead (up 17.2% ytd) with healthcare not far behind (up 16.1% ytd).



Normalization. The path toward normalization of interest rates continued in the quarter with the Federal Reserve raising the federal funds rate at its most recent meeting. That makes three interest rate increases since late last year occurring simultaneous with the aforementioned strength in asset class performance. Ultimately, there is concern that higher interest rates will have a negative impact on a variety of asset classes, most notably equities.

Historically, however, when the ten-year Treasury yield has been below 5% (around 2.3% currently) rising interest rates have been associated with *rising* stock prices, and the lower the yield the higher the correlation with positive returns. We believe the distinction is important between the current period where the Federal Reserve is moving from emergency accommodation, which it was forced to undertake during the financial crisis, and historic periods of monetary tightening.

Earnings Have Been The Main Driver Of The Global Equity Bull Market



* SOURCE: IBES AND MSCI INC. DATA (SEE COPYRIGHT DECLARATION).

Economic strength domestically is being mirrored by robust improvement abroad. The global manufacturing recession has ended, and industrial production is on the rise. Earnings globally have improved and are forecast to show double-digit growth through 2018—up 17% this year and 11% next year.

Earnings improvement is fueling the rise across markets, but after such strong gains in recent quarters it stands to reason that valuations might be getting a bit frothy. Interestingly, our colleagues at BCA Research point out that since February the global forward P/E multiple has *declined* despite an almost 4% rise in equity prices.

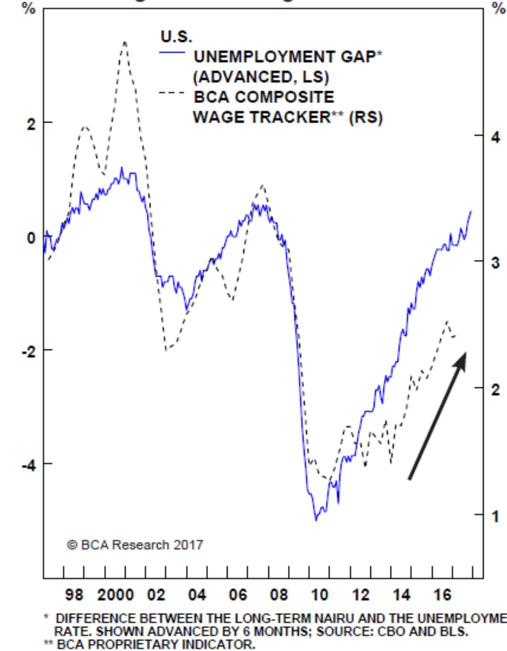
Among the major equity markets, valuations are highest in the U.S. The P/E multiple on the S&P 500 stands at 17.5x, which is slightly above the 25-year average of 16.0x, but below levels typically associated with periods of significant valuation risk. When viewed through the lens of a cyclically-adjusted P/E ratio, which normalizes earnings over a trailing ten-year period, the market appears more expensive, selling for 30.1x versus an average of 26.2x.

Importantly, we believe earnings will remain on a positive trajectory. First, U.S. GDP growth should improve from a lackluster 1.4% in Q1. Second, many U.S. domiciled companies have meaningful sales exposure to markets overseas where growth is accelerating. Third, corporate tax reform remains a wildcard that could result in a boost to earnings.

Given these factors, we remain positive on the outlook for equities albeit with more muted return expectations for domestic stocks. In a period of rising earnings, historically low interest rates and no definitive areas of excess in the economy, equities remain the asset class of choice. Despite a long bull market, we would argue stocks are best described as fairly valued.

What could go wrong? With the unemployment rate at 4.3% the labor market is tight - economic acceleration from here could push up wages and inflation. While wages have trended up in recent years, as the chart below shows, this is a bit misleading as most of the increase is a recovery from the depths of the financial crisis.

Stronger Labor Market Is Leading To Faster Wage Growth

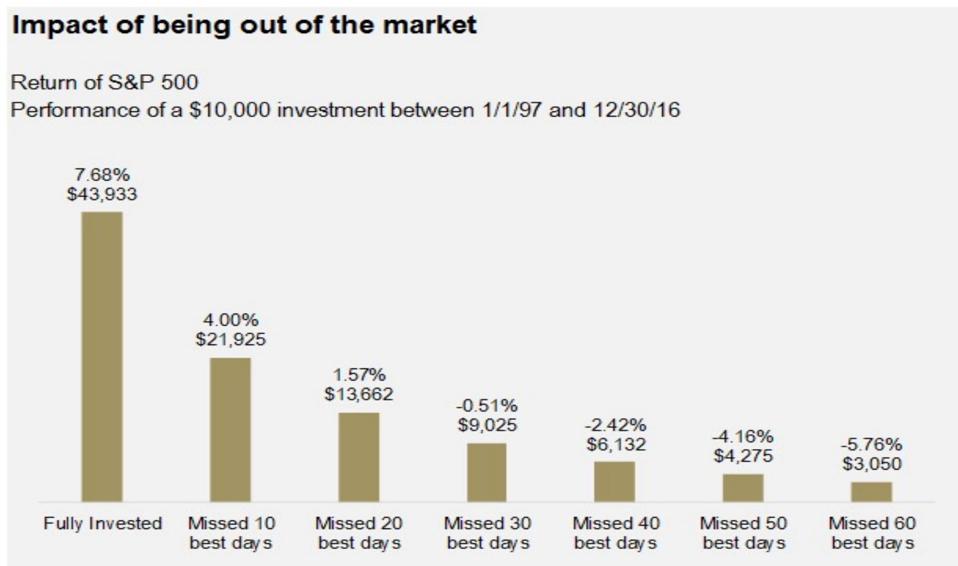


* DIFFERENCE BETWEEN THE LONG-TERM NAIRU AND THE UNEMPLOYMENT RATE. SHOWN ADVANCED BY 6 MONTHS; SOURCE: CBO AND BLS.
** BCA PROPRIETARY INDICATOR.

Thus far, there has not been a push on inflation from rising wages. The most recent readings of inflation remain around 1.5%, and this is happening with an unemployment rate near 4%, which by historical standards is also quite low. The deflationary effects of technology are clearly impacting current inflation readings. The question for the economy and financial markets is whether we are reaching an inflection where wages break out due to the tight labor market and the Fed finds itself in a position where it must combat wage inflation by more aggressively raising interest rates. This is the scenario where the economic growth is choked off.

For now, a variety of readings on the economy remain strong. The Purchasing Manager's Index for June was 57.8, up almost three points from May. Consumer confidence is now comfortably above its long-term average, and household net worth is at an all-time high.

June was the 96th month of the current economic expansion, the second longest on record. Every cycle has a signature. This one has been marked by tepid economic growth, an easy Fed, a strong stock market, but a lack of apparent excesses. That the expansion has lasted this long is not terribly surprising, but some of the signature elements of the recent economy are changing. Perhaps most importantly, the Federal Reserve has already started to tighten. With little slack left in the labor market the worrisome issue is—as our partners at BCA point out—that recessions become more likely when the labor market begins to overheat.



Source: JP Morgan

Market timing is difficult. Duration alone is not a good predictor for determining when the circumstances for the economy and the stock market might change. The length of the current bull market and economic expansion does, however, have investors looking over their collective shoulders.

Using history as our guide, the evidence suggests that investor attempts to time markets have been broadly unsuccessful, and we would urge caution in becoming overly focused on the short term. The chart above shows the difference in performance over twenty years ended last December of being fully invested the entire period versus trying to time the market. The reality is that trying to time the market usually translates into selling stocks near lows when emotions take over while remaining out of the market during the ensuing days when stocks turn positive. Six of the ten best days for stocks occurred within two weeks of the ten worst days. (The best day of 2015 was August 26, which was only *two days* after the worst day of that year.

The more important planning decisions are around risk management rather than fretting over whether stocks are near a peak. Asset allocation decisions that match one's risk tolerance and time horizon combined with long

term investing that tamps down tax liabilities has proven to be the winning strategy.

In closing, we want to reiterate our appreciation for the trust our clients have bestowed upon us. As we move forward, we are committed to retaining your confidence and serving your specific needs.

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