# 2017 Capital Markets Review

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## Conflict Resolution

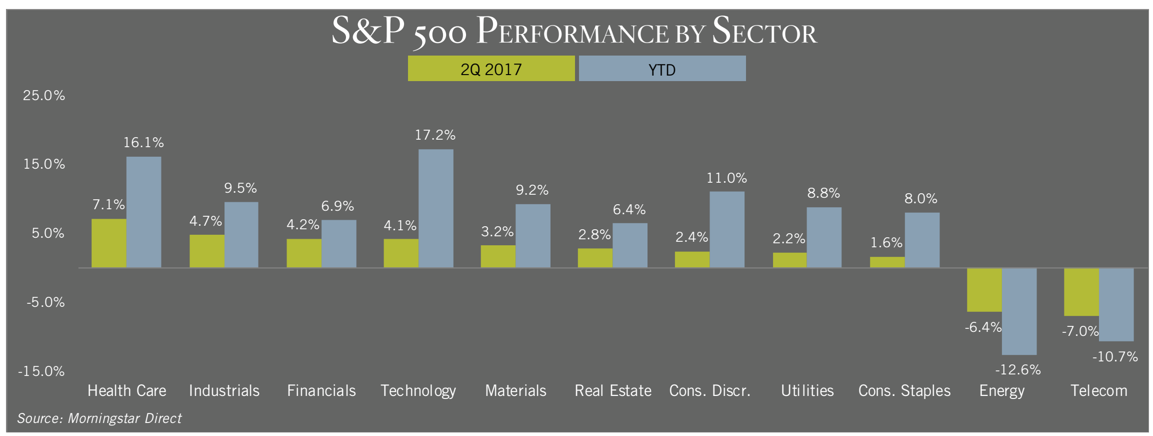
Investors trying to navigate the markets are likely scratching their heads trying to reconcile conflicting messages being sent across the investment landscape. U.S. economic growth remains positive but anemic, as the expectation of accelerating growth following the U.S. Presidential Election continues to disappoint. According to the Bureau of Economic Analysis, the final GDP growth tally for Q1 was a sluggish 1.4% while projections for full-year 2017 are falling fast.

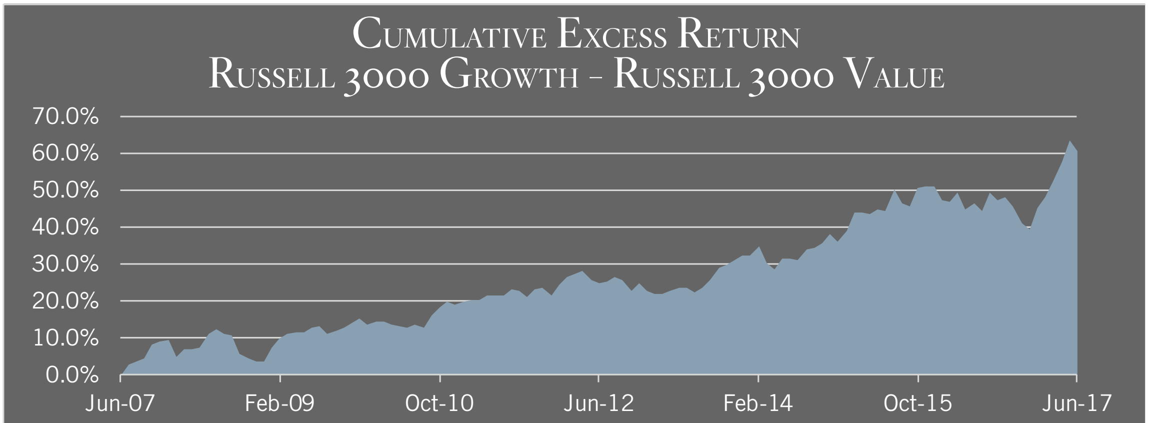
Despite the top-line economic headwinds, corporations have delivered robust bottom-line earnings growth over the first half of 2017. According to FactSet, S&P 500 earnings growth during the first quarter was 13.9%, the highest level since Q3 2011, with expectations for continued strength during the second quarter. Contributing to the robust year-over-year earnings growth has been an earnings recovery within the Energy sector, bouncing off the dismal lows from early 2016. Potentially more enduring is an improving global environment, particularly across Europe and emerging markets. According to Factset, S&P 500 companies with more than 50% of their revenue coming from outside the U.S. experienced 20%+ earnings growth to start 2017.

### Equity Market Review

Against this backdrop, equity investors were clearly focused on the strong bottom-line, pushing equity markets higher. Within the U.S., the S&P 500 ended the second quarter up 3.1%, bringing its mid-year result to 9.3%. Reviewing sector returns, nine out of eleven S&P sectors gained ground during the second quarter, led by the Health Care sector's 7.1% advance. Despite uncertainty related to the future of the Affordable Care Act, strong balance sheet fundamentals and relatively attractive valuations continued to support the sector. On the opposite end of the spectrum, the Energy and Telecom sectors have lost value in both quarters to start 2017. Investors have looked beyond the transitory improvement in energy earnings and focused on excess supply concerns, weighing heavily on the Energy sector's performance, while the Telecom sector is the only area projected to report a year-over-year decline in revenues.

Reviewing style and capitalization benchmarks, growth companies continued their dominance over value companies across the capitalization spectrum. Year-to-date, growth companies have outpaced their value counterparts by over 9%, as measured





*Source: Morninstar Direct, Welch Hornsby, Inc.*

by the Russell 3000 Index. 2017 has continued a longer-term trend which has resulted in a 60% cumulative excess return over the last decade for growth companies.

Investment conditions outside the U.S. continued to improve. Election concerns in France subsided as Marine Le Pen's anti-euro campaign was rejected, leading Mario Draghi to state "political winds are becoming tailwinds" in Europe. Equity and bond markets across Europe climbed early, but stalled late in the quarter as Draghi questioned the need for continued European Central Bank (ECB) stimulus programs. The stabilizing economic landscape along with potential policy changes by the ECB sent European currencies sharply higher. In other major markets, the Japanese economy benefited from robust export growth; however, personal consumption and inflation continued to lag.

| Developed Market 2Q2017 Performance Contribution | Local Currency Return | Currency Impact | U.S. Dollar-Based Return |
|---|---|---|---|
| MSCI Europe Index | 2.1% | 5.6% | 7.7% |
| MSCI Japan Index | 6.1% | -0.9% | 5.2% |
| MSCI EAFE Index | 3.0% | 3.4% | 6.4% |

*Source: Morningstar Direct, Welch Hornsby, Inc.*

## Fixed Income Review

The Federal Reserve continued its rate normalization program by raising the Fed Funds rate 0.25% in June and projected a steady march higher in 2018 and 2019. Additionally, the Fed announced it would likely start reducing the size of its balance sheet "relatively soon". This backdrop would certainly be challenging for bond markets; however, bond investors discounted the Fed's future projections, focusing their scrutiny on the economy's recent top-line weakness, most notably the lack of inflation. This skeptical view of future activity actually caused longer-term yields to decline, supporting Treasury prices, and flattening the yield curve.

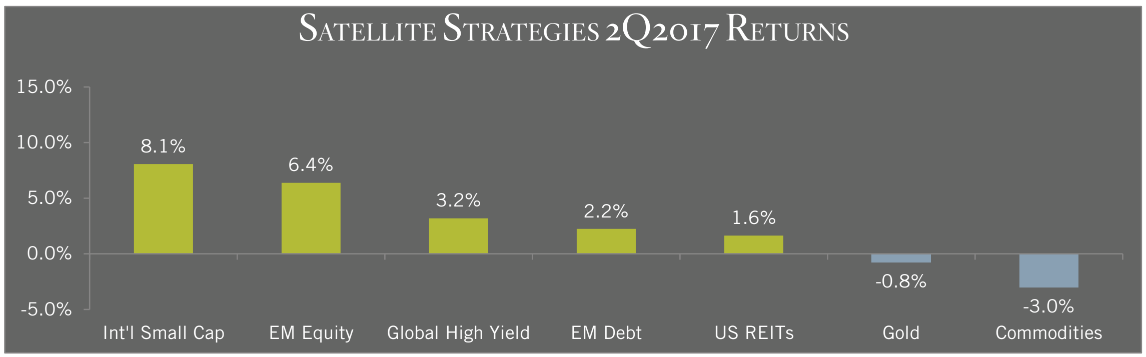
| Fed Funds Rate | June 14, 2017 | |
|---|---|---|
| | Fed Projections | Market Projections |
| June 2017 | 1.125% | |
| December 2017 | 1.375% | 1.235% |
| December 2018 | 2.125% | 1.475% |
| September 2019 | 2.938% | 1.660% |

*Source: Federal Reserve, CME Group - Fed Funds Futures 6/14/2017*

Credit sectors generally outpaced their comparable duration Treasuries, as strong corporate earnings growth caused investment-grade corporate bond spreads to contract to levels not seen since 2014. Finally, tax-exempt bonds benefited from the flattening yield curve environment. Additionally, supply and demand forces have been favorable over the first half of 2017 with new issues down 14.1% year-over-year.

## Satellite Strategies

Foreign equity markets were the top performers as the global economic outlook improved. Against this backdrop, international small cap equities and emerging market equities led the way during the quarter, gaining 8.1% and 6.4%, respectively. High yield bonds were also a solid performer, gaining 3.2% as credit spreads tightened. On the negative side, gold gave back a small portion of its first quarter gains, while falling oil prices continued to weigh heavily on the broad market Commodities benchmarks.




*Source: Morningstar Direct, Welch Hornsby, Inc. - Emerging Mkt Equity: MSCI EM Index ($); Global High Yield: Barclays Global High Yield TR ($); US REITs - DJ US Select RESI TR ($); Emerging Market Debt - JPM EMBI Global Diversified TR ($); Commodities - Bloomberg Commodity TR ($); Int'l Small Cap: S&P Developed Ex US Small TR ($); Gold - S&P GSCI Gold ($)*