BFS Wealth Management
A FOCUS FINANCIAL PARTNER

PERSPECTIVES

JULY 2017

Market Recap

It has been a very good year for investors so far - even somewhat better than expected. At the beginning of the year we thought U.S. stock markets might generate returns of 5-7% for the calendar year. The S&P 500[1] is now up 8.2% year-to-date.

We thought international stock markets would outperform U.S. markets in 2017, and they have done so. The MSCI EAFE index[2] for developed international stock markets is up nearly 12% year-to-date. The MSCI Emerging Markets index[3], which is an index for emerging markets, is up 17.2%.

We expected that we would be in a rising interest rate environment this year, thus creating a headwind for U.S. bonds (interest rates and bond prices move in opposite directions). The Federal Reserve Open Market Committee (FOMC) is on schedule with a .25% increase in both March and June. However, the surprise is that U.S. bonds have done well in spite of these rate increases, with interest rates on 10 year U.S. Treasuries actually declining year-to-date, and their prices rising. We believe a lot of the fall in long-term yields is due to the shortage of high-quality assets caused by global quantitative easing (QE) and demand for those assets. Only when QE has been reversed, will long-term rates have the opportunity to rise. Central banks around the globe are talking about reducing QE, and we expect interest rate volatility through the remainder of this year.

However, as usual, not all of the stock and bond market sectors performed in a similar fashion. For example, U.S. large-cap growth stocks are up 3x as much as U.S. large-cap value stocks. U.S. small-cap value returns are barely positive year-to-date![4] In U.S. bond markets, long U.S. Treasuries are up almost 5x as much as intermediate-term Treasuries.[5] Where you park your money makes a difference.

Commodities have performed poorly this year with overall inflation stubbornly staying just below 2% - about half of the 50 year average.[6] Commodity supply has generally exceeded worldwide demand this year, which has put downward pressure on prices.

Forecast

We are looking to add to our already good portfolio returns over the balance of the year. However, some analysts expect the U.S. stock market to be flat between now and the end of the year, and bonds to actually give back some returns as interest rates rise. Those analysts may turn out to be correct if no progress is made on corporate and personal tax reform, if the march towards less oppressive business regulation stalls, or if China commits a major economic policy blunder. We believe that the U.S. economy will continue to strengthen, that inflation could easily march back towards 2% (which can be good for corporate earnings), that rising interest rates will add to bank earnings, that unemployment will remain low, and consumer spending will stay steady. All in all, we think good corporate earnings growth will continue to lift U.S. equity markets.

Roughly a third of our equity exposure is in international markets, and we have been adding to positions over the past few years. Our patience has begun to pay off over the past couple of quarters. We expect international equities to continue to outperform as the global growth recovery continues. It makes sense to diversify internationally, particularly when valuations are relatively more attractive than in the U.S.

Inflation remains stubbornly low at less than 2%, and as a result, some analysts believe the FOMC will increase interest rates just one more time this year. With an unemployment rate at a relatively low 4.3% and an economy that is motoring along pretty well, we would normally expect to see some upward pressure on inflation building as wage rates start to rise.[7] However, productivity increases are somewhat dampening the demand for certain types of workers and keeping production costs in check. We continue to maintain exposure to commodities, real assets such as real estate and infrastructure and inflation-linked bonds to protect purchasing power. Not only do these assets provide inflation protection, but they can also potentially reduce volatility in a diversified portfolio.

Portfolio Management

2017 is so far playing out just about like we expected. We are very happy with our current asset allocations, given our expectations for markets the balance of this year.

In Q2 we did an exhaustive analysis of U.S. mid-cap equity mutual funds. We use some very robust software to analyze and drill down on literally hundreds of mid-cap mutual funds, applying criteria that we uniquely specify. We quantitatively rank funds versus a custom peer group (we screen out mutual funds with commissions and funds with less than 3 years of returns), and funds get scored based on trailing and rolling net returns over various time-periods, statistical risk and style measurements, and most important, fund expenses. That process helps us to identify funds with a top ranking based on our evaluation methodology.

Having done this preliminary analysis to narrow the scope of our search, we then go to work to study and examine each of these specific funds, including conference calls directly with portfolio managers of the fund. We consider several qualitative aspects when reviewing the funds, such as the management team, manager tenure, firm structure, process and philosophy. Finally, as a committee, Pat, Mike and Lisa select the fund that they believe will serve our clients best. As a result of this research, we have been adding the U.S. mid-cap fund that we selected to most of our client's portfolios, as individual portfolio circumstances permit. If you are interested in finding out more about our mutual fund evaluation methodology, please don't hesitate to reach out to us.

The Score Board

	06/30/17	YTD (Change)
Dow Jones Industrial Average*	21349.63	8.0%
S&P 500*	2423.41	8.2%
NASDAQ Composite*	6140.42	14.1%
MSCI EAFE (USD)*	1883.19	11.8%
Bloomberg Commodity Index	82.60	-5.6%
Barclays Aggregate Bond Index	1921.31	2.3%
10 Yr U.S. Treasury Bond Yield	2.31%	-14 bps
30 Yr Fixed Mortgage Rate	4.00%	-21 bps
Prime Rate	4.25%	+50 bps
Crude Oil ($/barrel)	$46.04	-14.3%
Gold ($/oz.)	$1,240.70	7.9%
U.S.$/Euro	$1.14	8.6%
Core Inflation (ex food/energy)		1.7% **
Inflation (with food/energy)		1.9% **

* Without dividends
** Unadjusted 12-mos. ended May 2017
bps (1 Basis Point = 1/100%)

UNCH (Unchanged)
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

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Talk With Us!

Goldman Sachs just recently put out a research piece on June 23rd titled "The Next Recession: Lessons From History." Their research addresses the probability, timing and likely causes of the next recession. We think it is a piece that is worth sharing with our clients.

Goldman Sachs Economic Research:

> "With the current expansion already the third longest in US history, investors have begun to look ahead to the next recession. In this week's Analyst, we ask how likely the next recession is to come soon and where it is likely to come from.
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> We start with a historical overview of the causes of recessions. Looking at 33 U.S. recessions since the 1850s, we find that many pre-WW2 recessions originated in the financial sector, many post-WW2 recessions were caused by oil shocks and monetary policy tightening, and sentiment-driven swings in borrowing and investment led to recessions in both eras. A similar International Monetary Fund study of the key contributors to 122 advanced economy recessions shows that even before 2008, financial crises were a fairly common source of modern recessions too.
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> History offers several lessons about possible sparks for the next recession. Some common contributors to past recessions look less worrisome today. Two frequent causes of modern advanced economy recessions—fiscal policy shocks and weak foreign demand—have generally not been sufficient to tip the U.S. into recession. In addition, the dominant cause of postwar U.S. recessions—rapid rate hikes in response to high inflation, often boosted by oil shocks—is less threatening today due to the anchoring of inflation expectations and the rise of shale.
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> Nonetheless, history suggests that overly rapid tightening is still a risk, as even tame tightening cycles have sometimes ended in recession. And the more timeless drivers of the business cycle—the sentiment-driven swings in both financial asset prices and borrowing and investment that are often attributed to 'animal spirits'—retain their relevance as recession risks.
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> Combining lessons from our historical study, our cross-country recession model, and research on U.S.-specific leading indicators, we develop a recession risk dashboard for the U.S. economy. The dashboard suggests that recession risk remains only moderate, highlighting the decline in spare capacity as a rising risk factor. This reinforces the message from our cross-country recession model, which now estimates a 1/4 chance of recession over the next two years, somewhat below the unconditional probability over two years of 1/3 since 1980."

While we at BFS Wealth Management also believe the next recession is most likely a few years away, we are not just sitting around and waiting for it. We are constantly discussing our asset allocation and looking at ways we can protect our clients' nest-eggs. We recently completed a scenario analysis to see how our clients' portfolios would perform in various economic environments. We looked at movements of different economic indicators like U.S. GDP growth, oil prices, inflation, interest rates, etc. and how these movements would affect portfolio returns.[8] We then review our asset allocations and will make any necessary tweaks based on the probabilities we place on the events unfolding while remaining focused on valuations. If you have any questions or concerns, **TALK WITH US!**

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
2. The MSCI EAFE index is a measure of the equity performance of developed markets, excluding the U.S. and Canada. Price return quoted.
3. The MSCI Emerging Markets index consists of 23 emerging markets country indexes. Price return quoted.
4. For style performance, large and small refer to the Russell 1000 and Russell 2000 indices, respectively. Value refers to companies with lower price-to-book ratios and lower expected growth values, and growth refers to higher price-to-book ratios and higher forecasted growth values.
5. The S&P U.S. Treasury index is a broad, comprehensive, market-value weighted index designed to measure the performance of U.S. Treasury bonds and the intermediate-term and long-term refers to the segment on the respective yield curve.
6. The Bloomberg Commodity index is a broadly diversified commodity price index.
7. Source: Bureau of Labor Statistics, May 2017.
8. A regression analysis is used to determine the historical (prior 10 year) relationship between each economic indicator and each asset in our model portfolio. The model is then run 2,500 times for each scenarios/portfolio combination similar to a Monte Carlo analysis.

Disclosures