Investment Commentary: 9/2017

The traditionally quiet summer months were interrupted in August by an upsurge in geopolitical risk, led by rising tensions with North Korea and terrorist attacks around the world. Despite the uptick in volatility, global stocks finished the month with positive returns. The S&P 500 returned 0.31% in August, and was supported by generally positive macroeconomic data, including an upward revision to second quarter GDP growth to 3.0% (annualized). Despite the uptick in economic growth, small-cap stocks continued to lag and were down 1.3% for the month. **Emerging markets again led the way, up 2.3%**, while developed foreign markets were essentially flat. In the fixed-income markets, core bonds had a strong month with the Barclays Aggregate Bond Index up 0.9%, while high-yield bonds were basically flat down 0.04%.

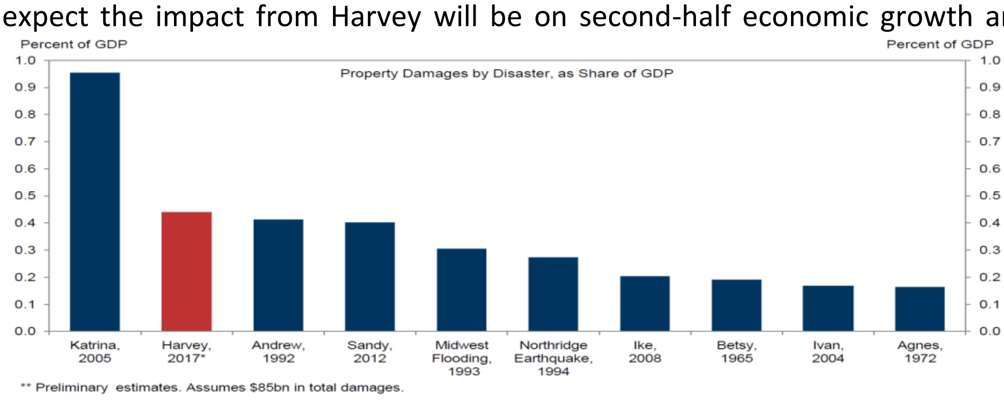
> "…..if the combination of improving economic growth and low inflation continues, it may boost the longevity of this cycle and keep investor sentiment positive on risk assets.

The global economy has been steadily improving this year, and although we wouldn't classify it as a global synchronized boom, it is the most synchronized expansion of economic activity the global economy has had since the recovery of the 2008/2009 recession. The biggest surprise is how global economic growth and inflation have been trending in opposite directions. We wouldn't expect this to continue unless productivity starts surprising upwards, something we haven't observed yet in this cycle. Experience tells us the lag from growth to inflation can take a while and varies with each cycle, so we don't expect any sudden reversals. In the meantime, if the combination of improving economic growth and low inflation continues, it may boost the longevity of this cycle and keep investor sentiment positive on risk assets.

Natural Disasters and Their Economic Impact

Hurricane Harvey is on track to become one of the costliest natural disasters in US history. Current estimates put the economic impact of Harvey second only to the hardship faced in 2005 during Hurricane Katrina. Our thoughts and prayers are with everyone impacted by Harvey and Irma.

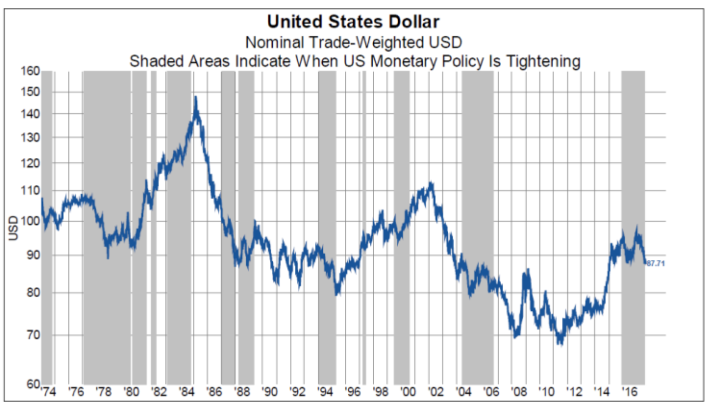
To place Harvey in historical context, its economic impact can be compared to other US natural disasters. **Recent estimates are putting the damage around $85 billion, which equates to 0.44% of GDP and would make it the second largest natural disaster since World War II, see the chart below.** At this time, it's still too early to get reliable estimates for Irma, however initial thoughts are it is likely to be in the range of Harvey or slightly higher. Evaluating past disasters and their economic impact can provide some insight on what to expect the impact from Harvey will be on second-half economic growth and inflation. **A recent study by Goldman Sachs suggests that GDP in the third quarter can be down as much as 1.4%, however economic growth should quickly rebound in the fourth quarter and into 2018.** There is a decent chance the near-term drop in GDP may keep the Fed from further increasing interest rates this

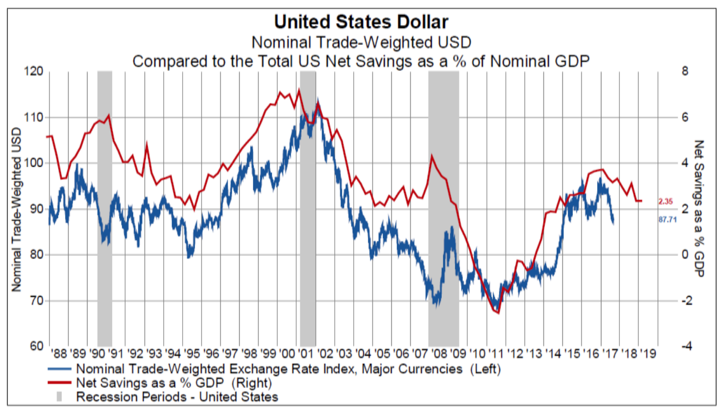


Source: National Hurricane Center, Goldman Sachs Global Investment Research year, which would likely be perceived as a positive by financial markets.

Watching the USD for Inflection Points

The common perception in that the US Dollar (USD) should appreciate when the Federal Reserve is increasing interest rates. However, the first chart below shows how the Dollar often falls during monetary tightening cycles. More accurately, it is the business cycle that drives the US Dollar. When the combined savings of the business, household and government declines, the USD Falls (Chart 2). Experienced asset allocators know, the trend in the Dollar has important implications for the performance of various asset classes. Since 2008, the USD has been in a clear bull market. However, recently it has been trending down and recently broke below some key technical levels. **It is too early to declare a secular bear market for the USD, however it's possible and worth watching closely.** Especially since it may help determine the future performance of several asset classes. **During the last USD bear market from 2001-2008 late cycle sectors (energy and materials) out-performed by a wide margin while technology, healthcare and consumer discretion lagged. Regionally, the emerging market and foreign developed markets outperformed US stocks, as did gold.** We will be watching the trends in the USD closely to gain insights on the future direction of sectors and asset classes.



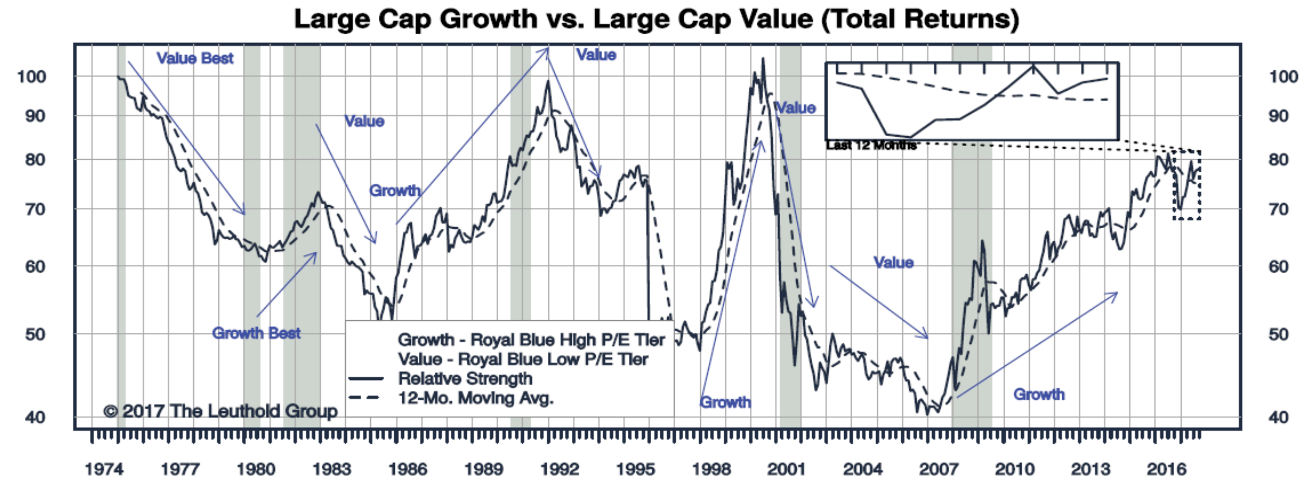


Source: GaveKal

Growth vs. Value- It's Been No Contest

The performance of growth stocks continues to trample value stocks, and is outperforming by close to 15% year-to-date. In fact, the past seven years it has been a one-way trade in favor of growth stocks, partly due to a preference for faster growing companies in a slow economy, and value stocks have several sector concentrations in retail, energy and financials, all of which have underperformed. Even within growth sectors like technology there has been a preference for new tech (FANG stocks) compared to old tech, and in healthcare biotech has trounced cheaper pharmaceutical stocks. As you can see in the chart below the cycle of relative performance between value and growth swings in cycles. Although, we think this cycle of growth out-performance is getting stretched it may continue longer than expected if the economy stays in a slow growth mode. **The chart below shows how value usually shines after recessions when the economy is growing faster and for an extended period of time. With tepid economic growth and no recession on the horizon, it may be more of the same, for now.**

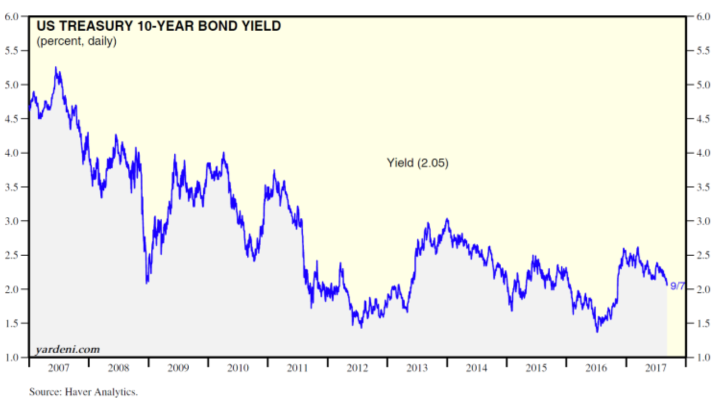
Investment Commentary: 9/2017



Treasury Bonds- As Good As It Gets?

The 10 year U.S. Treasury bond yield broke below its recent trading range of 2.15% - 2.4% bps, and is hovering around 2% in early September. It's hard to imagine, but even with the latest rally **the real return for the 10-Treasury bond over the past five years is close to zero. Keep in mind, this near zero performance happened in a very positive enviroment for government bonds, here are just some of the positives over the past five years:**

- The price of oil has fallen from the mid $80's to under $50
- *Nominal GDP* has grown at a very low 3.6%
- Commodities have fallen sharply
- Competition from foreign government bonds has basically disappeared, as yields in many leading global economies dropped to 1% or lower
- The Federal Reserve grew its balance sheet to $4.5 trillion by buying Treasury bonds and mortgages, and has yet to sell of them



Needless to say, it will be challenging for Treasury bonds to generate positive real returns with interest rates so low, unless we see another deflationary recession. **Should interest rates continue to fall we will actively look to shorten duration (interest rate risk) in portfolios, and look to add income strategies that can add value to portfolio returns.** The best reason to own Treasury bonds is for risk management, and investors should temper their expecations for future returns.

--AWM Investment Team (9/17)