HIGHTOWER
RDM FINANCIAL GROUP

Market Update
Summer 2017

The S&P 500 has continued to advance during the first half of the year despite the fact that real GDP growth has registered around 2% and President Trump's pro-growth policies have so far failed to gain much traction. During the second quarter, equity markets posted additional gains thus extending the multi-year advance that started back in 2009. Last quarter, growth outperformed value, large capitalization stocks outperformed small capitalization stocks (similar to the first quarter of the year) and foreign stocks outperformed U.S. stocks (which is something that has not happened very often over the past several years).

In terms of the economy, corporate profits are once again rising at an attractive rate, credit spreads remain supportive, job growth continues to increase at a solid rate, the Federal Reserve Bank is raising rates at a gradual pace and both inflation and interest rates appear contained. In addition, the monthly Leading Economic Index - LEI (which historically forecasts the direction of the economy over the next 2-3 quarters) has now increased for ten consecutive months.

Overseas, we are now seeing more countries participate in the global economic recovery. For example, last month Strategas Research highlighted that all 18 countries that they monitor around the world posted a manufacturing Index above 50 (indicating expansion) for the first time in a while.

Offsetting some of the positives are the fact that the S&P 500 price to earnings ratio (P/E) currently stands at 17.4x versus an average of 14.2x dating back to 1965 (source: RBC), President Trump's pro-growth agenda seems to have at least temporarily stalled, central banks are slowly moving towards unwinding trillions in stimulus, and geo-political events around the world represent a wild card for investors. Volatility in the markets has also been very low recently, which is unusual but not unprecedented in previous bull markets. July has historically been a positive month for the stock market, but trends turn somewhat less favorable as we head into the Fall. A market pullback or correction is likely at some point but trying to time that is very hard.

At RDM Financial, we are pleased and proud to report that while financial markets had to navigate a number of real concerns over the past several quarters including Brexit, Hilary or Donald, elections in Europe, terrorism and weak corporate profits

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throughout much of 2014 / 2015, we stayed the course and remained basically fully invested. We did not run for the hills but instead took the long term view. Staying invested to our client's individual stated allocation turned out to be the correct strategy. We continued to focus on business fundamentals instead of letting emotions dictate our investment strategy. While remaining diversified, we have correctly over weighted growth across most of our portfolios this year and have started to add to foreign holdings again after largely avoiding that part of the world over the past several years. Thus we are happy to report that a majority of our investment models have performed well so far this year.

While it may not seem like it, in the U.S. we have just entered the 9th year of what is now the third longest economic expansion in the post WWII era. There have been plenty of bumps along the way that had the potential to destabilize financial markets. Equity market investors have experienced a number of 5-10% pullbacks over the past several years but this has not derailed the market's long term market advance. The S&P 500, Dow Jones Transportation Index and Russell 2000 Index (which represents small capitalization stocks) have all recently established new all-time highs. When combined with strength in the market's advance/decline line (i.e. the number of advancing versus declining stocks) this represents a positive trend regarding the current health of the market.

On the political side, the much talked about Trump agenda focusing on corporate and individual tax cuts, infrastructure spending and repatriation of corporate cash held appears to have stalled in recent weeks. It seems to us that investors have largely given up on his plans. To us, it looks like any new legislation that ultimately gets passed will likely be more of a 2018 than 2017 event.

RDM Portfolio Performance

Turning to RDM portfolio performance, we are pleased to report that a majority of our investment portfolios are off to a solid start half way through the year. Focusing on our Large Moderate, Large Equity and Large Growth Plus portfolios (through 6/30/17), the average pure 100% equity fee based portfolio (i.e. accounts that hold all of our investments and have been with us for at least a full year) have all outperformed the S&P 500 on a year-to-date basis and have also captured a majority of the returns of the more global MSCI All Country World Index (ACWI Index). Our 60 /40 Taxable and Non-Taxable models (again focusing on those 100% pure fee based accounts that hold all of our investments and have been with us for at least a full year) are also both outperforming the appropriate 60/40 U.S. benchmark and are capturing a majority of the equivalent benchmark using the ACWI Index. One portfolio that has trailed the market so far this year has been the RDM Income Model. This is do to the portfolio's value tilt. While the yield of the portfolio compares favorably versus the yield of the S & P 500, value stocks are significantly underperforming growth stocks by a wide margin this year. This won't always be the case and changes from year to tear.

Looking at the top five mutual funds across all of the different RDM portfolios, last quarter four out of five fund holdings outperformed their perspective benchmarks. At RDM we believe there is a place for

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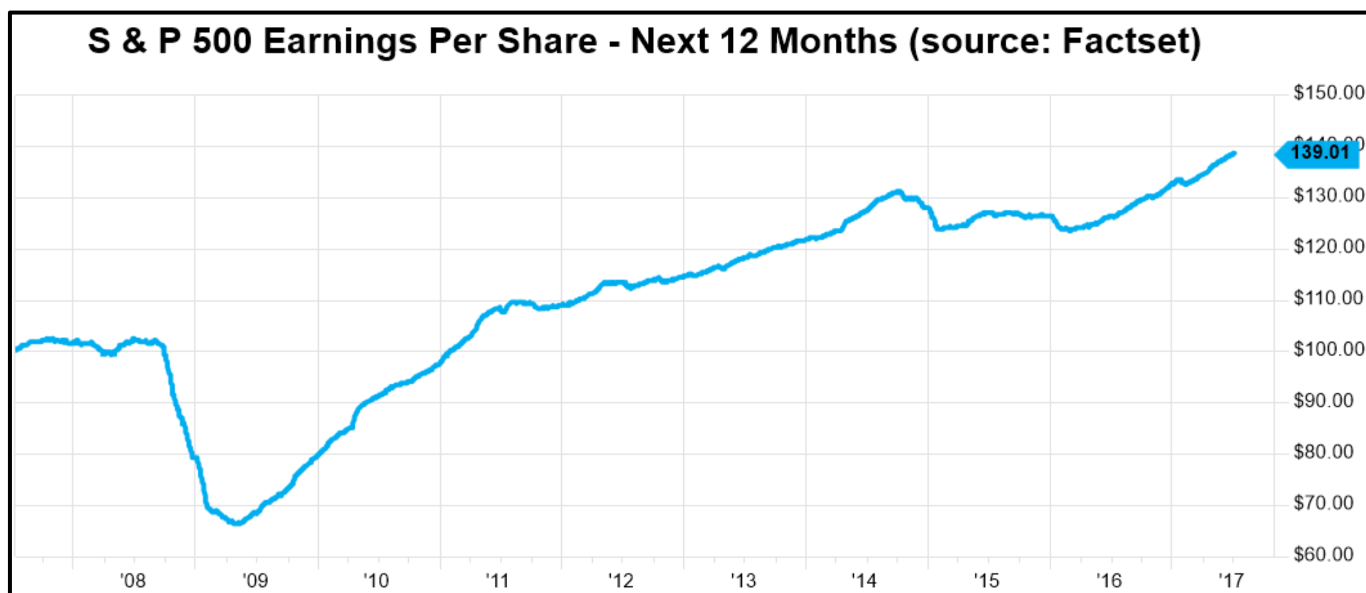
both active and passive investments. As most of you have probably noticed by now, we have added a significant number of low cost ETF's to virtually all of our portfolios over the past several quarters. In terms of our portfolios, we have made a number of strategic changes in our portfolios during the first half of the year.

After having largely avoided foreign markets over the past several years, we added some foreign exposure to most of our investment models during the first half of the year. We plan to add additional exposure over time as we believe we may now be in the early innings of a change where foreign markets perform better following several years of weak economic and market performance. Among other changes made over the past few months, we added a mutual fund to the RDM Moderate Risk investment model to help provide a bit more downside protection, we added a small position in emerging markets in the more dynamic RDM Growth Plus Model and made some portfolio adjustments to help reposition the RDM Income Model. In addition, we tilted our exposure away from more interest rate sensitive parts of the market and reduced our Master Limited Partnership (MLP) exposure by a small amount. For reference, we continue to maintain exposure to MLP's which represent a part of the energy market that provides stable, largely tax-advantaged dividend yields in the 7% range.

THE ECONOMY

Turning to the U.S. economy, economic growth has averaged a little over 2% during the current economic recovery. This compares with an historical average of just over 3%. Despite the sub-par recovery, most economic data on balance continues to look fairly healthy. Weekly jobless claims remain at multi-decade lows, consumer and business confidence is currently at high levels, credit spreads remain low, and inflation and interest rates remain under control.

Over time we believe that stock prices tend to follow the direction of earnings per share (EPS). After experiencing a shallow profits decline during



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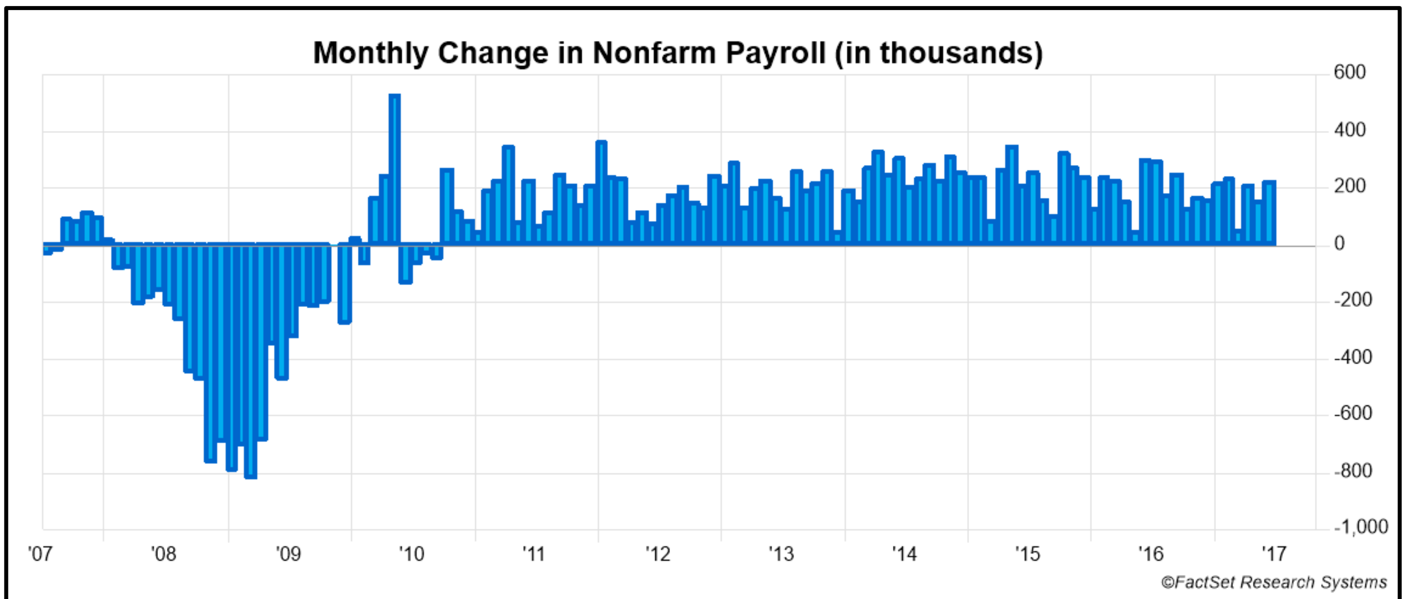
2014/2015, EPS rebounded and advanced 13.9% year over year last quarter. Looking ahead, earnings per share for the S&P 500 are currently forecast to rise 9.8% in 2017 followed by a gain of 11.6% in 2018. The graph (page 3) is a line chart that tracks analyst estimates for S&P 500 EPS over the next 12 months (source: Factset). As you can see, after treading water for parts of 2014/2015, EPS have once again turned higher and now stand at all-time highs. If this trend were to continue, we believe it would represent a positive tailwind for equity markets in the quarters ahead.

The U.S. consumer, which is responsible for almost 70% of the U.S. economy, currently appears in pretty solid shape. On July 8, 2017 the June monthly employment report was released and jobs increased 222,000 (see chart below). Over the past 1 and 3 years, employment has increased at a rate of 187,000 and 209,000 jobs per month respectively. The prior two months were also revised higher by 47,000. Last month's report compares with a three month average of 194,000 and a 12 month average of 187,000. Among various details within the report, manufacturing jobs rose 1,000, construction increased 16,000, professional and business services rose 35,000, temp jobs increased 13,000 and education and health rose 35,000.

In other parts of the employment report, the diffusion index (i.e. the % of industries hiring workers) rose from 55.2% the prior month to 59.6% in June and average weekly hours worked increased from 34.4 to 34.5 hours. During past economic expansions, wage growth typically peaked around 4%. This time around it has had trouble rising above 2.5% - 2.6%. While this month's employment report was encouraging, future job growth is likely to slow somewhat as the economy moves closer to full employment. One issue that a number of companies have cited over the past few quarters is a lack of skilled and qualified workers. This may continue to be a challenge as the unemployment rate continues to fall. Wage growth, on the other hand, should rise further as the labor markets continue to tighten.



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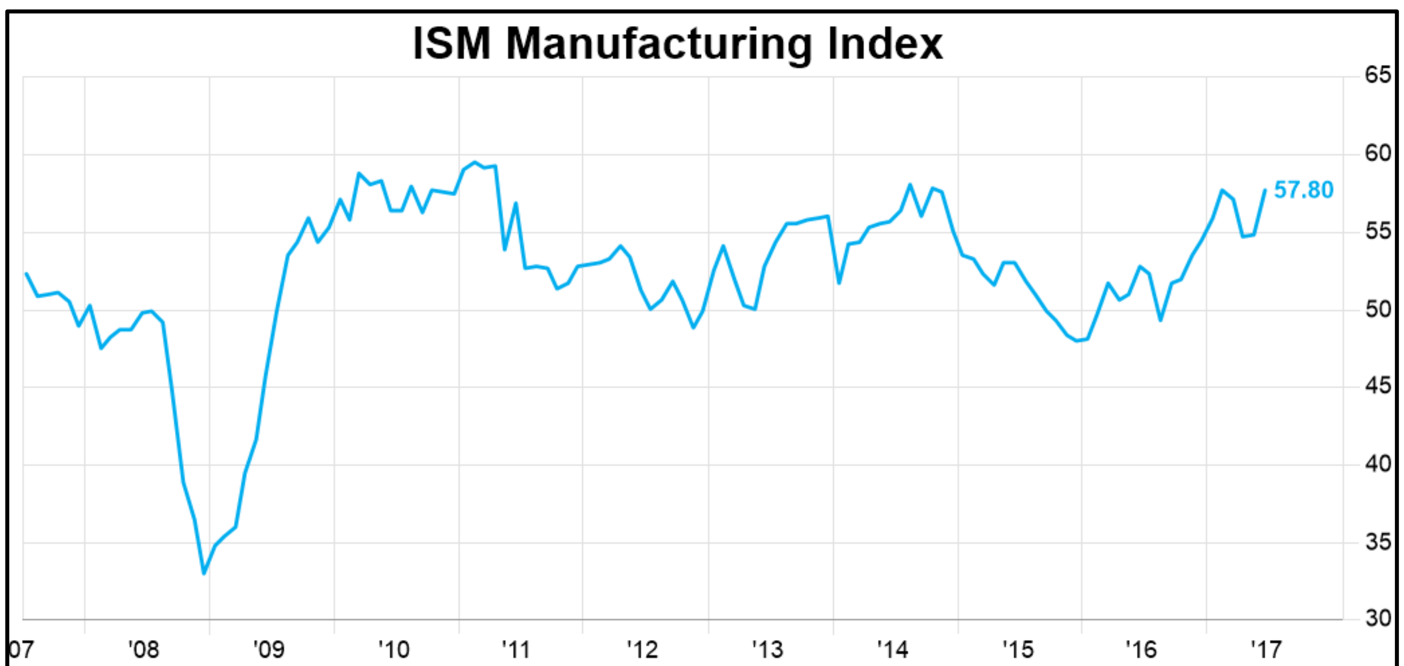
A few modest negatives in last month's jobs report are: 1) that the unemployment rate edged 0.1% higher (although that is mainly because more workers re-entered the workforce); 2) average hourly earnings (i.e. wages) increased just 0.2% or 2.5% on a year over year basis; 3) the percent of workers unemployed for 27 weeks or longer rose to a 5 month high and individuals working multiple jobs have now increased 5.2% over the past 12 months. Separately, while retail sales data have been pretty steady over the past few quarters, retail sales have declined in three of the past five months. This is a trend that we will keep an eye on.

Manufacturing activity (which suffered through a sharp down turn during parts of 2014 and in 2015) appears to be on relatively solid footing in 2017. Last month the ISM Manufacturing Index rose to a level of 57.8 versus 54.9 the prior month and a 12 month average of 54.3 (see chart below – source: Factset). As a reminder a reading above 50 indicates expansion while a number below 50 indicates contraction. Importantly, new orders, production and employment (which represent the three most important components within the report) all rose solidly last month. Reduced regulation, a decline in the dollar and a pickup in growth overseas have all helped provide a better foundation for manufacturing growth.

Corporate CEO and small business confidence levels have also increased in recent months reflecting greater confidence in the outlook for the economy. Following the election of Donald Trump last Fall, the NFIB Small Business Index (which tracks the outlook for small businesses across the country) rose from a level of 94.1 in October, 2016 to a high of 105.9 in January, 2017. The Conference Board's quarterly survey of corporate CEO's currently stands at the highest level since 2004. Rising confidence among corporate executives and small business leaders is a bullish sign that could lead to a pickup in business activity in the months ahead. One last comment on the topic is that the NFIB Small Business Index has started to move a bit lower over the past month or two (although it remains at historically high levels).



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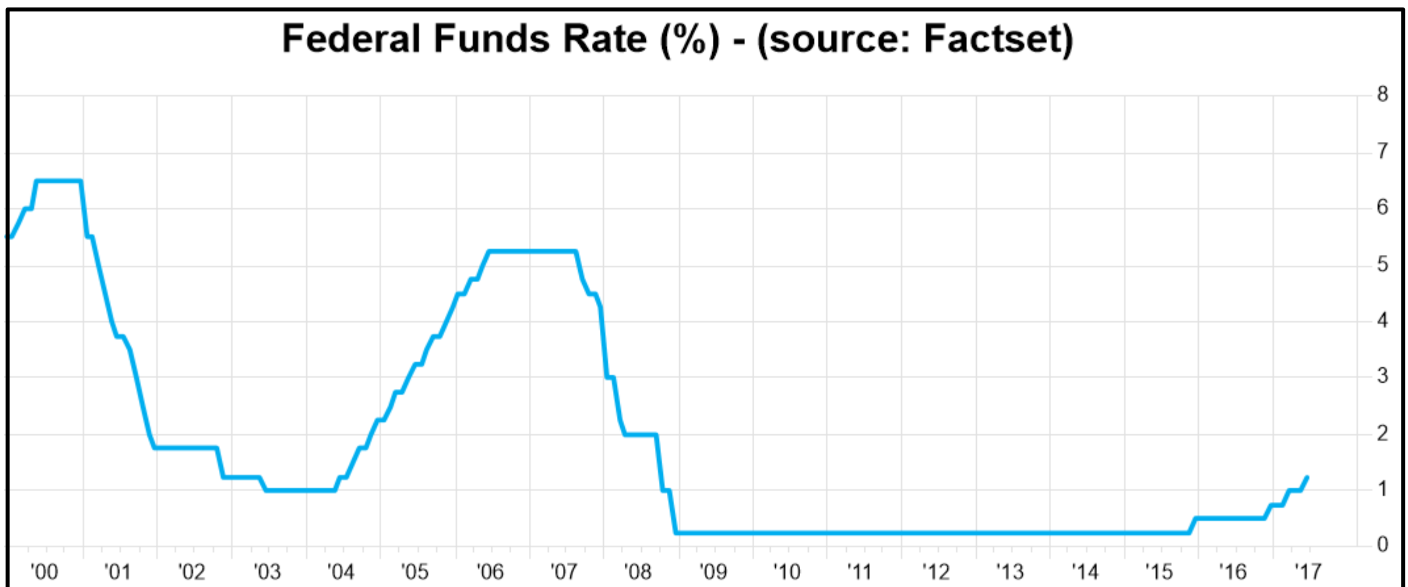
If Washington fails to deliver on its pro-growth policy initiatives, business spending and confidence levels could fall back to pre-election day levels over the next several months.

Federal Reserve and Central Bank Policy

The Federal Reserve Bank has raised short term rates four times so far since starting its current rate cycle back in late 2015 (see chart below). Looking forward, the FOMC (the rate setting committee for The Federal Reserve Bank) projects that it will ultimately raise short term rates to a level of around 3% over the next few years as it continues to normalize rates following the last economic downturn. Financial market participants are somewhat less optimistic and see fewer rate hikes over the next 12-24 months. For reference, the likelihood of another rate hike later this year now stands at less than 50% (based on Eurodollar futures contracts). Time will tell. In addition to raising its short term Fed Funds rate, the FOMC has indicated that it will likely (as soon as September, 2017) start reducing the size of its balance sheet which now stands at $4.5 trillion.

If the FOMC continues to raise rates 3-4 times per year and reduces the size of its balance sheet at the same time, this may ultimately lead to increased volatility in financial markets later this year. This rate cycle is already very different than past cycles. Looking ahead, we believe that The Federal Reserve Bank is likely to remain cautious as it attempts to normalize rates without causing the economy to slow significantly or fall into another recession.

Importantly, higher rates by themselves are not necessarily a bad thing for the economy and financial markets. The reason the Federal Reserve Bank is raising rates in the first place is that the economy is doing better and no longer needs the kind of lower for longer emergency rates that were necessary during the last economic downturn. It's only when the central bank overshoots and raises rates too aggressively that we need to worry. With real rates (i.e. the short term Federal Funds rate minus inflation) still negative, monetary policy still looks quite accommodative.



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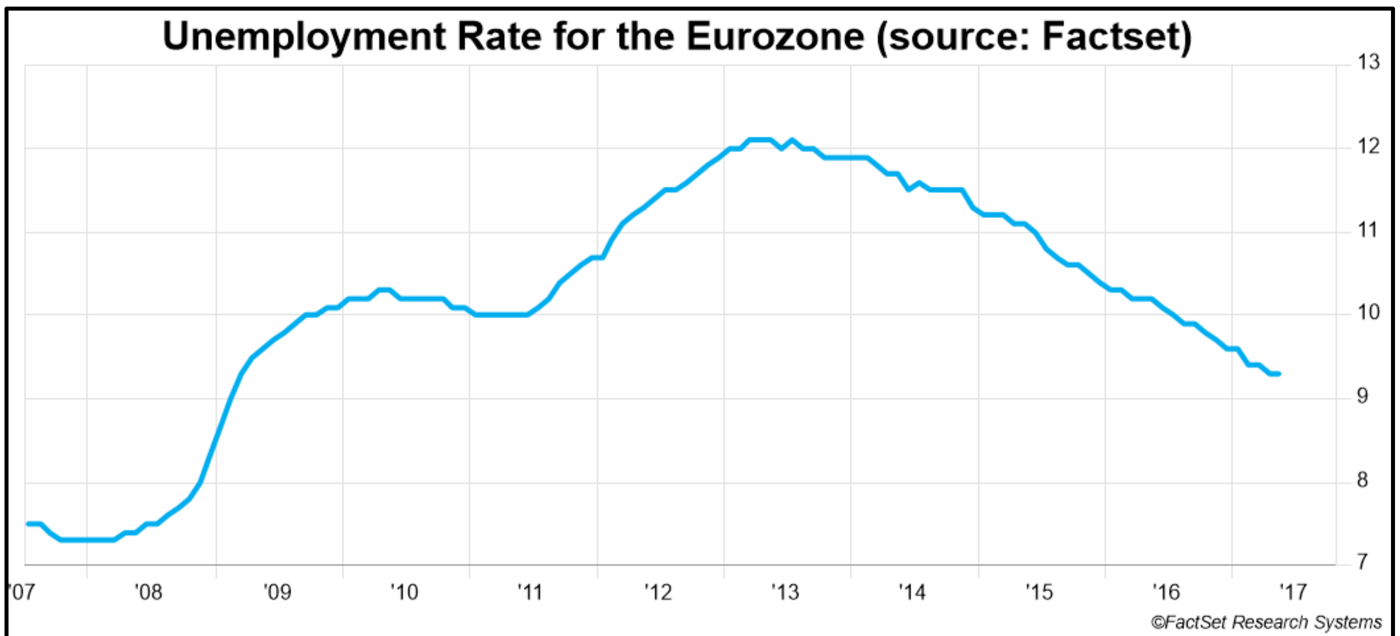
The European Central Bank (the ECB) has recently provided comments that they are getting closer to reducing some of the stimulus they have provided over the past couple of years. When the head of the European Central Bank (ECB), Mario Draghi, hinted that ECB stimulus might be waning, bond investors reacted quickly and German Bund yields (i.e. 10 year German bonds) rose to new cycle highs. This is something to keep an eye on. At least for now, the Bank of England and the Bank of Japan are keeping the status quo.

OVERSEAS

Overseas growth has rebounded across a wide range of countries. According to Morgan Stanley, global growth has averaged 3.1% over the past three years, below the historical average of 3.5%. Going forward, they forecast that global growth should reach 3.6% this year followed by 3.7% in 2018. Looking specifically at Europe, growth has rebounded in recent months after several years of weak and uneven economic performance.

Over the past few years, Europe has suffered through a number of high profile events that negatively affected financial markets and economy. These events include talk of a breakup of the EU, the possibility that Greece might have to file for bankruptcy, a banking crisis, Brexit in 2016 and more recently high profile elections across a number of different countries. As we speak today, Europe has survived these events and appears to be on more solid footing. The European Purchasing Manager's Index, for example, currently stands at a reading of 57.4 (versus 57 last month and 52.8 one year ago), the unemployment rate (while still high – see chart below) has come down from over 12% to 9.3% and corporate profits are currently forecast to rise double digits this year followed by a gain of 8% next year. In addition to increasing our foreign investment positions, we also own a number of large U.S. multi-national companies that stand to benefit from a pickup in growth overseas.



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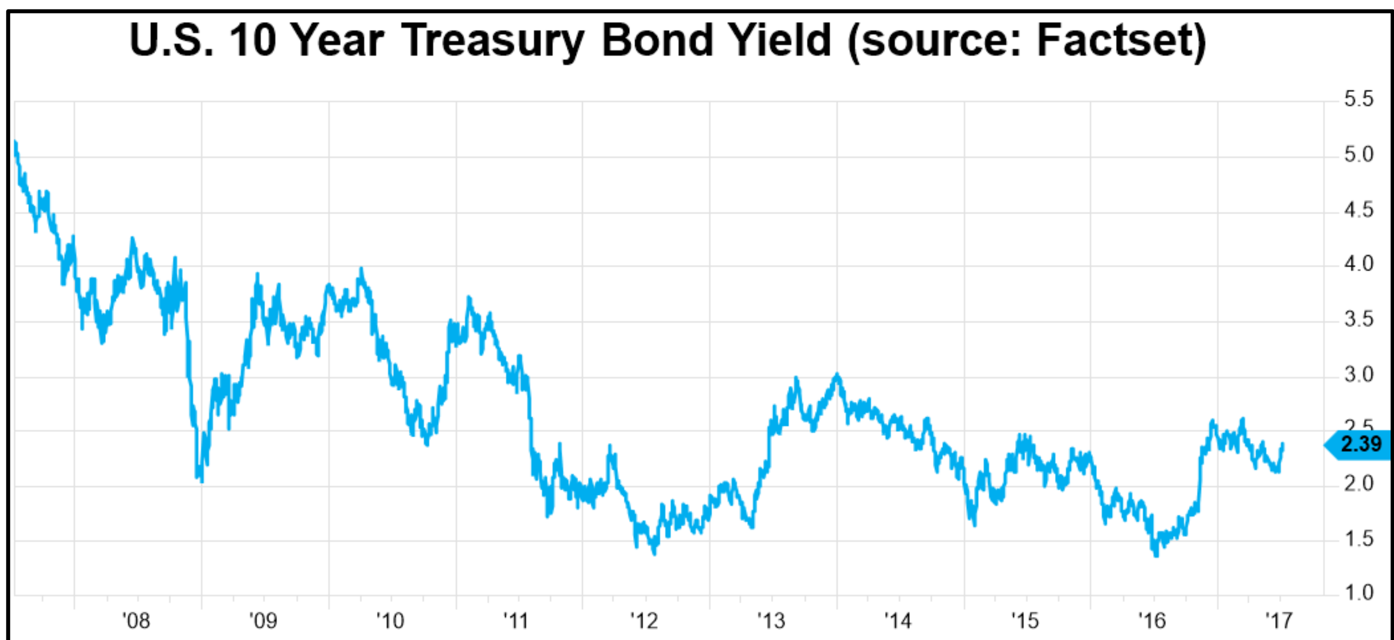
Fixed Income

On the fixed income side, U.S. 10 Year Treasury Bond Yields have been on a somewhat wild ride over the past few years (see chart below – source: Factset). After hitting a multi-decade low of 1.46% during the summer of 2012, interest rates have generally been range bound between about 3% on the high side and 1.50% on the down side. In early 2017 interest rates moved higher fueled by improving economic data combined with optimism regarding President Trump's pro-growth agenda. However, interest rates reversed course towards the end of the first quarter and headed down from there, reaching a 2017 low of 2.20% on June 27, 2017 (before rebounding somewhat over the past several weeks).

It has been our opinion (which has taken longer than we have expected so far) that interest rates are ultimately in a multi-year bottoming process that will lead to higher rates down the road. Rates have been falling since about 1980 when then Federal Reserve Chairman Paul Volcker raised rates aggressively to slow the economy and choke off inflation. After two recessions within a relatively short period of time in the early 1980's, interest rates started falling and kept falling until reaching a bottom in 2012.

Due to a lack of wage pressures, inflation below the Federal Reserve Bank's 2% threshold, the spread of manufacturing around the world and low interest rates overseas, yields appear unlikely to move substantially higher any time soon. However, as the U.S. economy continues to expand, the global economy rebounds and central banks around the world become less accommodative, we believe that interest rates are likely to start heading somewhat higher over time.

There has been a considerable amount of uncertainty surrounding the timing and ultimate direction of interest rates. No one has a crystal ball. Therefore, on the fixed income side, we ladder



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individual corporate bonds for a majority of assets in client portfolios and combine that with a mix of several carefully chosen flexible bond funds. The bond funds that we own have so far done a very good job navigating changing interest rate and credit environments. We think of these fixed income bond funds as the short end of our corporate bond ladders. These funds represent liquidity and dry power for future fixed income investment opportunities. When the time is right, these funds can be sold and the proceeds can be used to add to corporate bond ladders (hopefully at higher rates in the future).

What Leads to Recessions?

Given that we are now in the 9th year of the current economic expansion, a natural question to ask is what can go wrong. After all, the economic cycle has not been refuted. In a recent report titled "The Next Recession: Lessons from History," Goldman Sachs highlighted a number of factors that have historically led to the end of bull markets and the start of market downturns. Historically these factors include a sharp increase in oil prices (in fact we have the opposite now), a sharp rise in interest rates from the Federal Reserve Bank (at present the Fed is raising rates at a gradual rate) and dislocations in various parts of the economy such as the housing or financial sectors, for example. It's encouraging that these factors are currently not present. However, that does not mean that other factors won't emerge and impact the economy in the future.

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Again, the U.S. economic expansion is now in its 9th year which is the third longest in the post WWII period. Right now the conditions that have led to prior economic and market downturns do not look like they are present in the economy and financial markets. Yes, market valuation levels are on the high side, geo-political events overseas are a constant but unknown threat and President Trump's policies represent somewhat of a wild card. Possibly the biggest threat to financial markets is the unwinding of trillions of dollars in central bank stimulus over the next several years.

For now the U.S. economy appears to be on relatively sound footing. Employment continues to rise, credit spreads remain healthy, the Federal Reserve Bank is raising rates at a gradual pace and corporate profits are rising at a solid rate once again. The economy lacks the kind of pent up demand for things like autos, housing and consumer goods to help fuel more robust economic growth. Therefore, the most likely outcome is additional growth in the 2% or so range in the U.S. Looking overseas, for the first time in several years, things seem to be looking better. There are signs developing that a global synchronous expansion (which is something that has been missing in recent years) may now be at hand. Yes there are risks (elections, terrorism, central bank actions and trade wars) that will need to be monitored – there always are.

In the U.S., a few of the main indicators that we plan to keep an eye on include the spread between short and long term rates, changes in the Conference Board's Leading Economic Index, the trend in inflation and interest rates and changes in the labor markets. Lastly, volatility has been extremely low in recent months and will almost certainly pick up at some point. We have been saying for some time that the market may be due for a short term pullback or correction. According to the research firm Investech citing data going back to 1932, "10% corrections come around about every two years (25.9 months) and 5% corrections occur more regularly – every 7.1 months." Therefore, while we don't see a recession ahead, we also would not be surprised to see another bump or two in the road before too long (within the context of a continuation of the current moderate growth environment we have experienced over the past several years).

Respectfully,

Michael Sheldon, CFA
Executive Director & CIO

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Managing Director & Partner

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DESCRIPTION

S&P 500 - The *S&P 500* is a stock market index that tracks the *500* most widely held stocks on the New York Stock Exchange or NASDAQ.

MSCI All Country World Index (ACWI) – The *MSCI ACWI* captures all sources of equity returns in 23 developed and 24 emerging markets.

Russell 2000 Index – The Russell 2000 Index is a small-cap stock-market index of the bottom 2,000 stocks within the Russell 3000 Index.

Dow Jones Transportation Index - The Dow Jones Transportation Average is a 20-stock, price-weighted index that represents the stock performance of large, well-known U.S. companies within the transportation industry.

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RDM Financial Group

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