MARKET UPDATE

APRIL 2017

Positive economic data along with anticipation regarding Republican plans to boost economic growth have provided a tailwind for equity markets in early 2017. During the first quarter, the S & P 500 large cap index posted a solid mid-single digit return and well outperformed corporate bonds and U.S. Treasuries. Overseas markets outperformed U.S. markets last quarter (which is something that has not happened very often over the past several years), growth beat value (reversing the trend from 2016) and large capitalization stocks outperformed small capitalization stocks (again a reversal of trends seen last year).

Heading into early 2017 there was a sense of optimism regarding President Trump's plans to boost economic growth. His bold agenda that included lowering individual and corporate taxes, allowing companies to repatriate cash held overseas, reducing regulations and increasing spending on our nations' aging infrastructure was greeted positively by investors. However, along the way, President Trump hit a bit of a speed bump as his efforts to repeal Obamacare (which was one of his most high profile campaign promises) failed to attract enough votes in Congress. His first few months in office have demonstrated that passing new legislation may turn out to be more challenging than making promises on the campaign trail.

In the economy, a majority of economic data continues to be positive. For example, consumer and business confidence, employment data, corporate profits and credit spreads all remain healthy. In addition the Conference Board's Monthly Leading Economic Index (LEI) has increased for seven consecutive months and stands at an all-time high, surpassing the previous high established back in 2007. Even manufacturing data has started to show some signs of improvement. After several years of weak growth, we are also starting to see signs of improvement outside the United States as

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well. The Federal Reserve Bank's Beige Book (used at policy rate setting meetings) was released on April 19th and highlighted solid growth in employment and manufacturing activity. At least right now there are no signs of recession ahead.

However, the economic expansion is one of the longest on record, valuation levels remain high and the Federal Reserve Bank is on track to continue normalizing rates (from an historically low level). Among things that are on our radar screen, a few important sectors of the market have started to lag a bit in recent weeks. The Trump pro-growth agenda appears to have stalled temporarily, bank lending has been soft this year and geo-political events overseas are a growing risk. In addition, a lot of positive news has already been built into financial markets. While we continue to remain constructive (note: the recent election results in France appear to have removed a major source of political uncertainty in Europe), we would not be surprised to see U.S. markets somewhat range bound over the near term as investors digest first quarter earnings, keep an eye on military events overseas and try to figure out what policies will (or won't) come out of the Trump administration over the next several quarters.

The Quarter in Review

Unlike 2016, when U.S. small capitalization value stocks led the market, large cap growth stocks have posted the strongest returns year-to-date. Within the market, the technology, healthcare and consumer discretionary sectors posted the strongest returns last quarter while the energy, telecom and financial (after a strong start to the year) sectors lagged. Overseas, foreign markets (which have significantly underperformed U.S. markets over the past several years) posted robust gains during the first quarter (more on this later on).

Due to fund manager selection and the performance of specific investment choices by RDM, last quarter a majority of our investment models posted solid returns and for the most part either met or exceeded their benchmark indexes. Unlike last year, the more dynamic RDM growth oriented portfolio has outperformed the more value oriented RDM income model portfolio so far this year (and is significantly outperforming the S & P 500 as of April 24, 2017).

Globally, all of the investment holdings in RDM client managed accounts represent a mixture of approximately 55% in equities and 45% in fixed income.

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As of this writing (April 24, 2017), I am pleased to report that “globally” our performance is solidly ahead of the appropriate equity and fixed income benchmarks (represented by 55% in the S & P 500 and 45% in the Bloomberg Barclays U.S. Bond Index). We achieved this performance even though our equity risk is statistically lower than the S & P 500 and our average bond maturity is shorter than the Barclays Aggregate Bond Index.

Focusing on our widely held large moderate portfolio (which is our most conservative and risk averse of the RDM equity models) we are pleased to report that the average pure RDM Large Moderate portfolio (which has been with us for a full year and where clients own all of the model investments) almost matched the return of the S & P 500 during the first quarter and outperformed the S & P 500 through April 24, 2017. We would always like to see our portfolios outperform their benchmark indices. However, reaching your financial goals, not beating some index, will always be our major goal.

At RDM Financial, the detailed financial planning process that we utilize helps determine the target rate of return that each client needs to meet their long financial goals. Once that is determined, we can properly advise clients, place them into the correct RDM investment model and advise them in terms of what the appropriate market allocation should be between stocks and bonds. We continue to monitor our client’s financial plans and corresponding goals over time. It’s great to beat the market, but understanding our client’s financial needs and correctly assessing the appropriate amount of risk to take is equally if not more important.

Fixed Income

Similar to the equity markets, fixed income markets started off the year on a positive note. After bottoming at 1.36% last summer, the yield of the U.S. 10 Year Treasury Bond continued to climb higher through the fall into early 2017, touching a level of 2.63% on March 13. From that point, as investors started to question Donald Trump’s ability to pass his pro-growth agenda, interest rates started to back off a bit. Events overseas in North Korea and Syria, a weaker than expected headline employment report this past month along with some uncertainty ahead of the French election likely also contributed to the recent pullback in yields.

For more than three decades interest rates in the United States have been declining. More recently over just the past several years central banks around the world (led by the U.S. Federal Reserve Bank) have taken dramatic and unprecedented steps to lower rates in order to boost economic growth. The

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chart below (source: Strategas) highlights the long term trend in U.S. interest rates over the past several decades. What stands out to us is that interest rate cycles tend to last for some time. To use a baseball analogy, the current cycle seems like it is in the later innings. With the Federal Reserve Bank starting to normalize rates and the global economy on better footing, it appears that rates are likely to start heading higher before too long.

We don't feel that any fixed income manager is smart enough to accurately forecast the direction and movement of interest rates on a regular basis. Therefore, at RDM Financial, our multi-year strategy has been to ladder individual corporate bonds (or municipal bonds where appropriate) with the majority of our fixed income allocation.

With the remainder of our fixed income assets, we have purchased a basket of multi-sector bond funds where portfolio managers have the ability to navigate what is likely to be a somewhat more volatile environment down the road. These fixed income funds represent the short end of the ladder in our client accounts. The funds provide liquidity for clients (so that we do not need to sell individual bonds at inopportune times) and represent liquidity for future investment opportunities. Over the past several quarters, our equally weighted basket of six fixed income funds has generated attractive returns compared to the benchmark Bloomberg Barclays Aggregate Bond Index. Given the uncertainty that we face in the fixed income markets going forward, we think our investment approach represents a prudent strategy for our clients.

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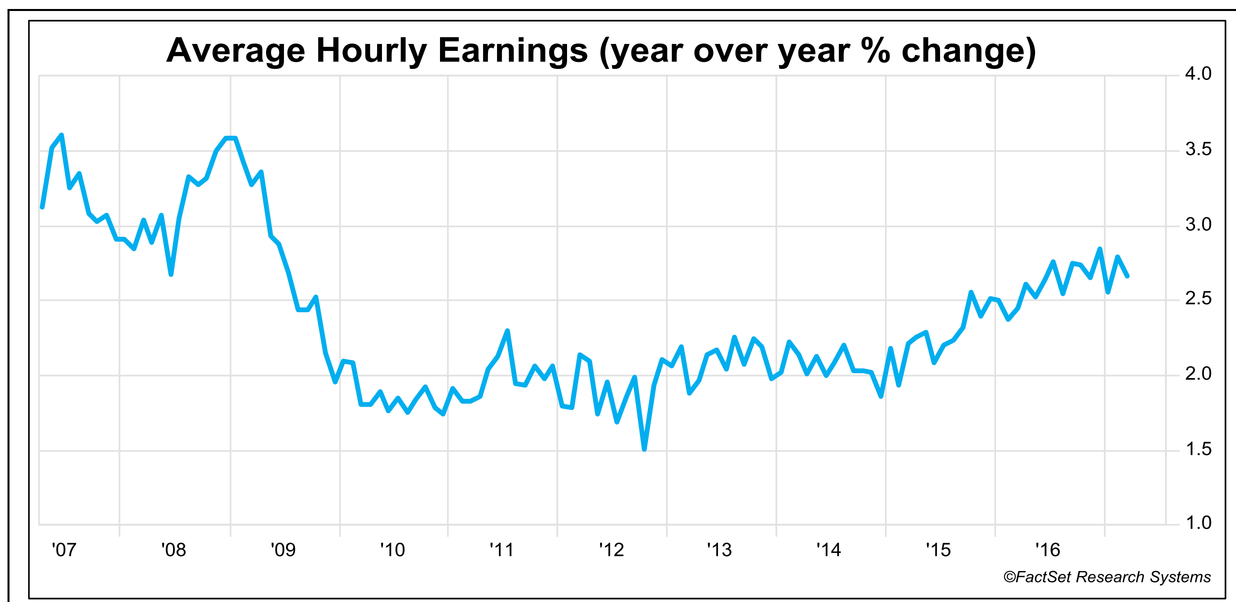
THE CONSUMER

One important area of the economy that we continue to watch is the state of the U.S. consumer. At this stage in the economic expansion, the U.S. consumer appears to be in pretty solid shape. The unemployment rate currently stands at a new cycle low of 4.5%, weekly unemployment claims remain near multi-decade lows and household net worth currently stands at record high $92.8 trillion. One issue we have noted recently is that there has been some weakness in auto and retail sales over the past few months. Given the fact that consumers appear to be in a fairly healthy position to spend right now, it is unclear why this is the case. Therefore, it is something that will just have to be watched for now.

Starting last fall and then following Trump's election, consumer confidence moved solidly higher. The last time consumer confidence levels were this high was during the late 1990's (source: Conference Board). If President Trump can implement his tax and spending proposals, that should help boost economic growth and the consumer along with it. If his plans get delayed or do not pass at all, consumer confidence would likely suffer a setback as we head through the next few quarters.

Despite sustained growth in the labor markets over the past several years, one area that has been disappointing is that wage gains have been slow to improve over the past several quarters. At a year over year growth rate of 2.7% as of March, 2017 (see chart below – source: Factset), the growth rate of average hourly earnings rate remains below prior peaks of around 4%. As the labor markets continue to grow, further wage gains appear likely in 2017.



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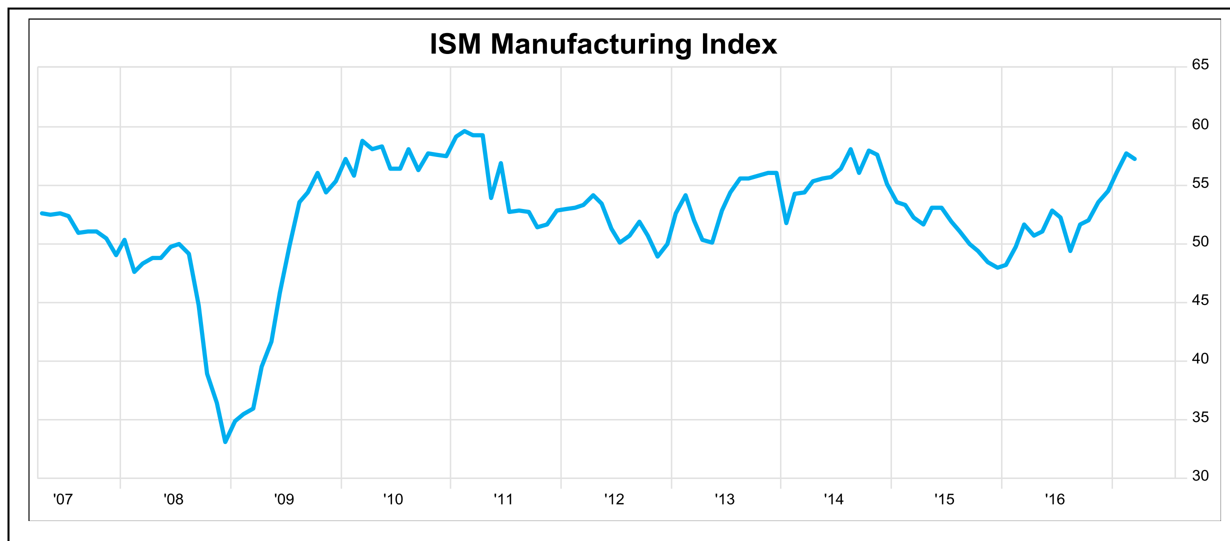
The housing market which represented the center of the economic recession back in 2008-2009, continues to slowly recover. A number of measures including new homes sales, existing home sales, the NAHB Wells Fargo Home Builders survey and monthly housing starts indicated that the housing market appears to be on solid footing. For reference, the S & P / Case Shiller 20 city home price index is currently rising at a 5.9% year over year rate. Over the past three years, this index has increased at a rate of between 4 and 6% per year.

Manufacturing Sector

As a result of strength in the U.S. dollar, weak growth overseas and falling commodity prices, U.S. manufacturing activity posted negative growth in parts of 2015 and 2016. This rarely happens outside of recessions and was a cause for concern. However, manufacturing activity has shown signs of improvement in recent months. The ISM Manufacturing Index (see chart below – source: Factset) now stands at a reading of 57.2 versus a six month average of 53.5, monthly manufacturing activity (released by the Federal Reserve Bank) each month has been positive in six of the past seven months and manufacturing employment has increased for four consecutive months. Donald Trump has focused a lot of energy and attention on boosting U.S. manufacturing activity and bringing back manufacturing jobs lost over the past several years. It's hard to say how successful he will be throughout his administration. However, at least for now, recent manufacturing data appear somewhat encouraging.



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The Federal Reserve Bank

As widely anticipated, on March 15, 2017 the Federal Reserve Bank increased short term rates for the third time this cycle. Looking ahead, Federal Reserve Bank officials have indicated that the central bank is likely to raise rates two more times this year as they continue to slowly normalize interest rates. In past cycles, the central bank has raised rates to slow the economy, prevent excesses from developing and keep a lid on inflation.

This time around (at least so far), Fed chairwoman Janet Yellen has indicated that the Federal Reserve Bank is going to take a go slow approach to raising rates. Looking back at past cycles, the current expansion is one of the longest in the post WWII period. The Federal Reserve Bank's go slow approach likely means that the current economic expansion has more time to go before running into trouble. As we head through the year, we are likely to hear more talk about the Federal Reserve Bank reducing the size of its $4.5 trillion dollar balance which it built up through quantitative easing over the past several years. As we get closer and more details are announced, this could generate some short term instability for financial markets.

Corporate Profits

After a period that lasted several quarters from early 2015 into the middle of 2016, corporate profits have started to grow once again. According to the latest data from Factset, earnings per share (EPS) for the S & P 500 are currently forecast to rise 9.2% during the first quarter of 2017 (note: this would be the largest year over year increase since Q4, 2011), increase 9.7% for all of 2017 and rise an additional 12% in 2018. A lot can change between now and 2018 so take this number with a grain of salt.

Revenues for companies in the S & P 500 are currently forecast to increase 5.3% in 2017 followed by an increase of 4.7% next year. One chart that helps us monitor the outlook for corporate profits is to look at EPS for companies in the S & P 500 over the next 12 months. As you can see in the chart on page 8 (source: Factset), after stagnating for a few quarters, the forward looking trend for EPS (over the next 12 months) has once again turned higher and currently stands at a record high. Over time, we believe that stocks tend to follow the direction of corporate profits. While not the only factor that helps determine the direction of stock prices, we find the current trend in profits encouraging.

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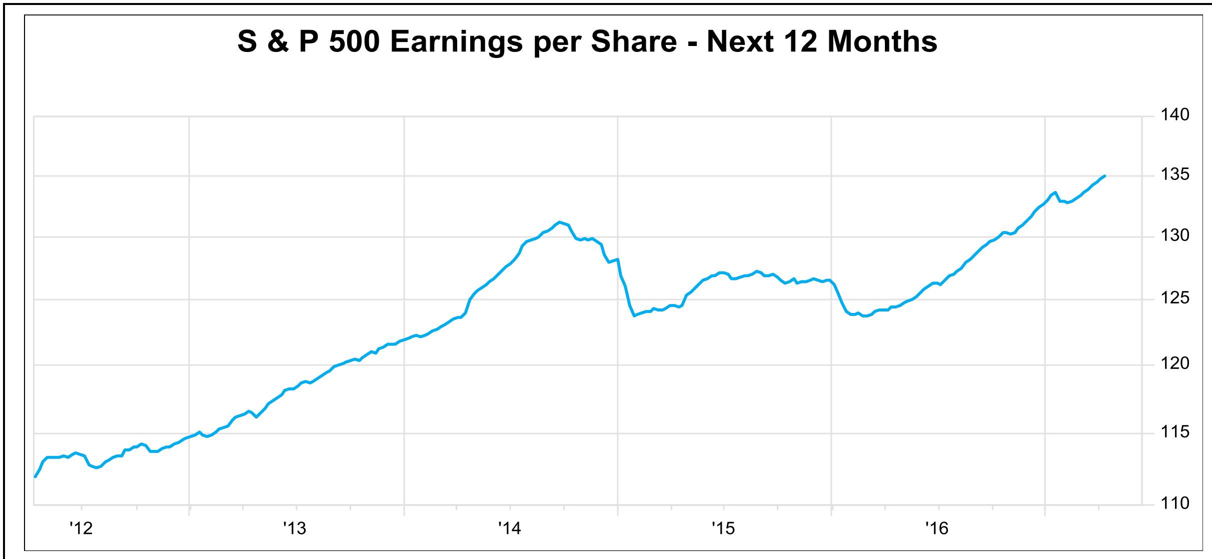

Overseas Growth

We have been very underweight foreign markets over the past several years (correctly so). Following the last economic downturn, U.S. markets have significantly outperformed most of the world's major equity markets over the past several years. For example, since 3/9/09 when the S & P 500 Index bottomed, the U.S. market has advanced at a 19% compound annualized growth rate (CAGR) while the MSCI EAFE Index (Europe, Australia and the Far East) rose 12.9% per year and the MSCI Emerging Markets Index advanced 12.2% per year (see chart below – source: Factset). The main reason U.S. markets outperformed foreign markets is because the U.S. economy provided investors with greater stability and our economy outperformed its counterparts overseas. Looking back, the U.S. Federal Reserve Bank was more aggressive in lowering rates, recapitalizing our banks and providing liquidity for the economy. In addition, the U.S. did not suffer from many of the problems that affected economic growth in the European Union and other countries in emerging markets.

The first round of the presidential election in France created some uncertainty but election results generated few surprises. Looking ahead (while no election poll is safe these days), it appears that the pro-Euro Zone centrist candidate Emmanuel Macron is likely to become the next president of France at the upcoming May 7th election. In terms of the economy, we have finally witnessed signs that growth overseas is starting to improve. The unemployment rate in Europe is starting to come down after peaking at more than 12%,

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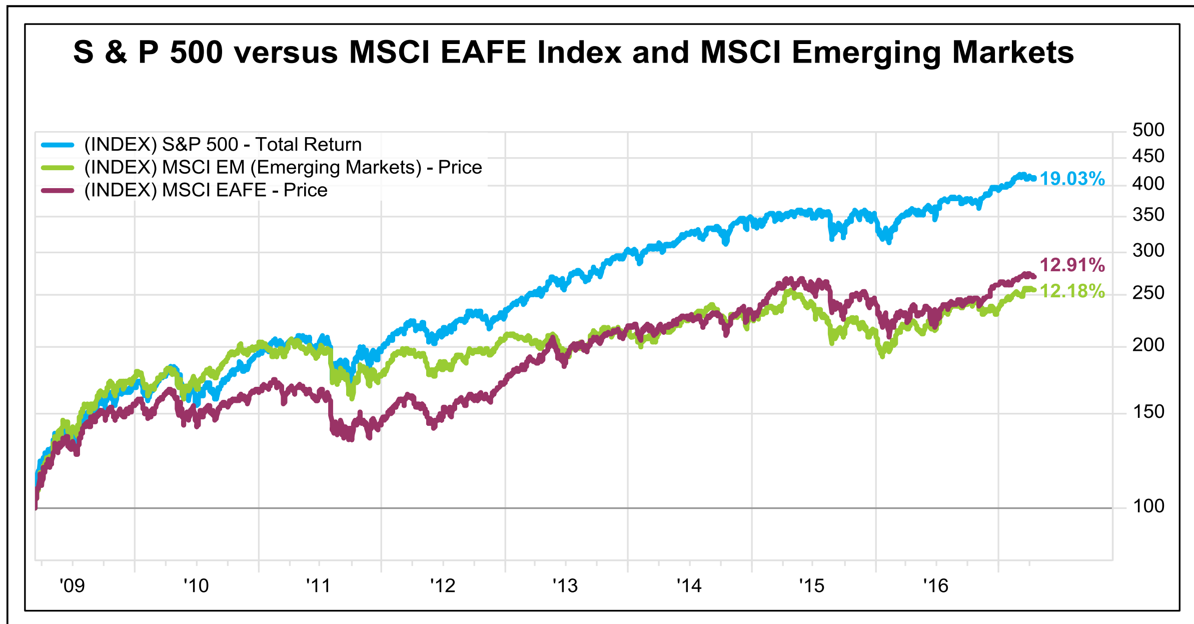

manufacturing data is starting to recover and even Europe's hard hit banking sector is starting to show signs of life. In China GDP growth in the first quarter came in above the consensus forecast and registered a gain of 6.9%, representing the highest level since the third quarter of 2015. While debt levels remain high in a number of emerging markets, several countries are starting to benefit from a moderate recovery in various commodity prices (including iron ore, copper and oil) and global trade.

As a result of the fact that overseas markets have trailed the performance of U.S. markets significantly over the past several years combined with more attractive valuation levels and improving fundamentals, we are starting to add a bit more exposure to foreign markets.

One of the hardest things to do in investing is to purchase out of favor assets (at attractive valuation levels) that you believe are likely to outperform based on improving fundamentals. We believe this is one of those situations. While recent trends overseas are encouraging, we would not be surprised to see various headwinds arise from time to time. Therefore, we are taking a go slow approach as we evaluate economic trends and investment opportunities overseas.

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POTENTIAL REASONS FOR CONCERN

While a majority of economic and market based data has been positive in recent months, there are a few areas of concern that we are keeping an eye on:

- While the markets have behaved well in recent months and the S & P 500 advance / decline line actually hit an all-time high when the S & P 500 peaked a few weeks ago on March 1, 2017, small capitalization stocks, transportation stocks and financial stocks have started to trail the market a bit in recent weeks. So far we are not too concerned about this recent trend and think it more likely represents a pause or short term consolidation rather the start of a more worrisome market sell-off.
- Bank lending data (source: Federal Reserve Bank) has been weak in recent months. This could simply represent the fact that corporations are issuing more corporate bonds and taking out less in bank loans from banks. However, this trend bears watching.
- The yield curve (i.e. the spread between 10 year U.S. Treasury yields and 2 year U.S. Treasury yields) and inflation breakeven spreads (i.e. the outlook for inflation in financial markets) have both declined in early 2017. We would like to see this trend reverse, indicating a healthier economy and market outlook.
- Following the inability of President Trump to pass healthcare reform, there is some doubt regarding the ability of the Trump administration to pass legislation regarding corporate and individual tax reform, overseas cash repatriation, financial deregulation and infrastructure spending.
- Geo-political risk has increased in recent days in areas such as Syria and North Korea. This kind of activity is clearly unpredictable but could lead to increased volatility in financial markets.
- As a result of the long bull market, valuation levels are currently historically high. For reference, according to Goldman Sachs, the median stock in the S & P 500 currently has a price to earnings ratio (P/E) of 18.2x versus a 35 year average of 14x. However, interest rates remain historically low, the Fed is taking a go slow approach to raising rates and corporate profits are once again rising at a solid rate. To some degree these factors help mitigate the risk from high valuation levels. However, if valuation levels moved higher from here or conversely should the economy start to weaken, we would become more concerned.

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SUMMARY

So far in early, 2017, a majority of economic data both here at home (and overseas) has been positive. In the U.S. consumer and business confidence levels remain high, corporate profits are improving, a majority of housing data remains positive and after a rough patch, manufacturing data has started to improve as well. In short, the U.S. economy appears to be on fairly solid footing to start the year.

After peaking on March 1, the Trump bump, which helped boost stock prices in late 2016 and early 2017 appears to have lost a bit of forward momentum. Some realization appears to be setting in that making campaign promises to potential voters may be easier said than turning those promises into actual legislation. As a result, equity markets have experienced some modest profit taking over the past several weeks. However, from the recent highs on March 1, 2017, the S & P 500, NASDAQ and Russell 2000 Indices are down (at least so far) just 2.6%, 1.6% and 4.6% respectively as of 4/14/17 (the recent low point for the S & P 500).

Looking forward, the biggest potential headwinds for the markets this year will likely be the ability of President Trump to enact new pro-growth legislation. This story will probably have several twists and turns as we head through the year and will likely lead to a pickup in volatility at some point. Geo-political events around the world, elections overseas and actions taken by the Federal Reserve Bank to normalize rates will also play a role in the direction of the economy and financial markets this year.

For the remainder of 2017, we remain moderately constructive. However with equity markets at historically high valuation levels and positive expectations already priced into financial markets, investors may need to be somewhat more patient. The markets have experienced a period of extremely low volatility in recent quarters. As we have been saying for some time, equity markets are likely overdue for a short term pullback or correction. As a reminder, that is a normal part of investing and something that reduces the chance of the market overheating and creating larger equity market corrections down the road. Eventually the current economic expansion will fade and give way to a period of weakness, but we believe that is a story for down the road.

Respectfully,

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Managing Director & Partner

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Executive Director, Chief Investment Officer

S&P 500 – The S & P 500 is a market capitalization weighted index of 500 stocks chosen based on market size, liquidity and industry grouping, among other factors.

MSCI EAFE Index – The MSCI EAFE Index is a market cap-weighted index that tracks the performance of stocks in Europe, Australia and the Far East.

MSCI Emerging markets Index – A market cap weighted index that tracks the performance of 23 countries in emerging markets around the world.

Russell 2000 Index – The Russell 2000 Index is a small cap stock market index of the bottom 2000 stocks in the Russell 3,000 Index.

Nasdaq Composite - The Nasdaq Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.

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