AMB Newsletter
3rd Quarter 2017

Table of Contents

2nd Quarter Review

3rd Quarter Outlook

Economy

Equity Markets

Fixed Income

Conclusion

2nd Quarter 2017 Review

After aggressively pushing to new all-time highs in the first quarter, the markets began to calm slightly in the second quarter but still performed quite well. Measured by the S&P 500, the market had a positive return of 3.09%; however, it seems these returns continue to be met by overly cautious investors waiting for a significant pullback. Bull markets do not end when investors feel cautious, rather when investors feel euphoria. AMB believes the market will continue its upward projection given investors' current mentality remains.

Many investors ask how or why the market continues to move higher despite the economies at home and abroad growing at a slower than projected pace. First, one must remember that the stock market and the economy are two different things. In the short run, the market and actual economic conditions do not have to correlate with one another. Secondly, while economies abroad are not growing fast, they are still growing all while inflation remains low, in addition to global yields at historic lows. Moreover, while corporate earnings bottomed in the summer of 2016, they have been showing signs of growth this year as outlooks continue to be upgraded.

International equity markets had a positive quarter while outperforming U.S. equities. Measured by the MSCI EAFE, international markets posted a return of 6.37% for the second quarter putting the index up 20% over the past twelve months ending June 30. After years of continued underperformance, international markets seem to be on a solid run which can be attributed to an uptick in growth and compelling valuations compared to their U.S. counterparts.

Growth stocks continue to dominate the market with the two leading sectors of the S&P 500 being Information Technology and Health Care once again. This shift in favor of value to growth is one of the most significant divergence in growth and value stocks in recent memory as growth stocks are returning more than 10% over value stocks. Year to date, the energy sector remains the biggest detractor in performance with the telecom sector being a close second.

The Federal Reserve hiked rates in June as expected. This takes the Fed Funds rate to 1.00-1.25%, which keeps them on track to normalize rates, though AMB continues to believe it is well below what some market participants are expecting. Reducing the balance sheet that the Fed accumulated during the quantitative easing programs is now also a priority; however, in recent testimony from the Fed Chair, policy may become more accommodative once again.

Fixed income markets measured by the 10-year Treasury finished the quarter at 2.29% after reaching yields as low as 2.12% during the quarter. AMB's target of 1.8 – 2.7% remains the same as it was the beginning of the year. Fixed income portfolios experienced another positive quarter with the market measured by the Barclays Intermediate Government Credit index returning .94% for the quarter and 1.75% for the year. The intermediate to longer end of the curve continues to be the place in which investors need to position themselves.

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AMB Newsletter
3rd Quarter 2017

3rd Quarter 2017 Outlook

Economy— Revised first quarter GDP came in slightly above 1%, which is below the 3% target set by the administration. Inflation data that picked up toward the end of 2016 and beginning of 2017 has reversed course. June data continued to confirm that trend in one of the weakest four month stretches over the past couple decades, core consumer prices could manage only a 0.1% increase in June. Producer prices, another gauge of inflation, edged up 0.1% higher in June as did the less food & energy reading with year-on-year rates moving down noticeably. It seems the Fed mandated 2% target may now be in jeopardy, which is why AMB believes Yellen and the Fed Presidents toned down their hawkish stance and moved to a more dovish tone over the last few weeks.

The employment situation in the U.S. continued to improve in 2017; however, AMB's most favored indicator, wage growth, is still not improving at our desired pace. The difference in hiring demand and paid wages continues to grow. In a service driven economy, wages drive growth and inflation, and without this push in growth, the economy will continue to post slow growth results. The June employment report showed a significant improvement in payroll growth but a flat line earnings. Since 2009, AMB has continually expressed the type of jobs being added to the economy are part-time, low paying jobs, which are not the type that would drive significant spending going forward.

Looking ahead, AMB continues to believe the positive driver for the US economy must come in the form of fiscal policy, as we believe the Fed has exhausted monetary policy. Based on the new administration's campaign promise, we hope to see fixed business investment increase, which has been absent since the financial crisis. If the burden companies face from ACA, tax rates, and other regulations lightens as we move forward, AMB believes companies will begin to invest more domestically. In AMB's view, capital expenditures have to be a major driver for future growth and with the amount of cash on company balance sheets, it could push the U.S. economy out of the malaise we have endured since 2009.

Equity Market – Themes from the first quarter definitely carried over into the second quarter as large cap growth stocks once again dominated market returns. This trend has continued from 2016, where the best performers the previous year have been the worst performers the current year. Of the eleven sectors of the S&P 500, all sectors posted positive returns for the quarter with the exception of energy (-6.4%) and telecom (-7.0%). Coming into 2017, AMB predicted information technology and healthcare were two places that we saw value, and our predication has come to fruition . Even with the run we have seen in these two sectors, AMB believes there are places within these sectors that still offer value.

Recently, the current market valuations are the questions most frequently asked by clients. Are stocks overpriced? Is the market in a bubble? When can we expect a correction? These are pertinent, important questions; however, in AMB's view, one of the most bullish signs for the equity markets is the fact these types of questions are being asked by investors. Bull markets do not end during times of cautious mentality but rather during times of extreme euphoria. This also supports AMB's notion that earnings bottomed in the summer of 2016. In addition, AMB sees the market has shifting from a low interest rate, Central Bank driven bull market to an earnings driven bull market. First quarter earnings seemed to reinforce this thought, with the markets having the best earnings season since 2011.

Looking to the second half of the year, AMB is still optimistic on equity markets even with its nearly 10% return year to date. Furthermore, AMB is consistently observing the markets to see which sectors could lead the market going forward. AMB expects to see a shift from growth to value before the end of 2017. The dramatic divergence in the two styles should lead to a convergence with money flowing into more value style stocks. For the latter half of the year, AMB is favoring the financial, consumer discretionary, and healthcare sectors. Non-U.S. equity assets have continued to perform well in 2017. Emerging markets (measured by the MSCI EM Index) posted returns of 6.2% for the quarter, now up over 18% year to date. International developed markets (as measured by the MSCI EAFE Index) also posted strong returns with 6.1% for the quarter and 13.8% year to date. Coming into 2017, AMB felt international equities were positioned for a good year based on relative valuations. Fundamentally, developed international equities remain undervalued compared to their U.S. counterparts; however, performance going forward will depend on policy set by the European Central Bank and Bank of Japan in the coming months.

3rd Quarter 2017

Fixed Income – The consensus going into 2017 was interest rates would continue moving higher, being pushed by growth-simulative policies from the new administration. Once again, AMB took the opposite side of most pundits, as we felt rates would remain low. AMB felt growth in the U.S. would remain slow and inflation would remain benign, which would continue to keep rates low. Even with the Federal Reserve continuing to hike short term rates, the intermediate/longer end of the curve would continue to be anchored by these macro factors.

Looking forward, AMB maintains this outlook: we expect short rates to continue moving higher, while longer dated maturities stay relatively stable. AMB believes there are a few factors keeping rates anchored, first being the upcoming debt ceiling concerns. The extension for the debt ceiling expired on March 15th of this year, and to avoid defaulting on its obligations, extraordinary measures were undertaken, though they will expire in November. With the current political situation in Washington, AMB believes there could be a repeat of 2011, when the U.S. credit rating was downgraded. Additionally, we expect wage growth to remain absent, in effect continuing the slower paced domestic growth while inflation remains subdued.

We also need to remember why we invest in fixed income. It is not the growth engine of our portfolios, but it is what brings stability and predictability to them. Using a buy and hold strategy, interest rate movements are irrelevant, as we are investing for a stream of cash flows, and the safety of principal, which will be repaid upon maturity as long as the bond is credit worthy. Pundits that speak to fixed income being riskier than the stock market are making a generalized blanket statement that we feel is not accurate.

Conclusion— With the first half of the year over, the second quarter was somewhat similar to the first quarter in several ways: the Fed tightened interest rates, the markets reached all-time highs, and corporate earnings and outlooks were largely positive. Overall, 2017 has been a good year so far for investors, and the markets appear to be continuing this positive trend. Despite the political gridlock in Washington, the unknown fate of the Affordable Care Act, or the state of the American healthcare system, the markets have remained strong, effectively tuning out the negative press in the media. With this in mind, it's important to recall that politics do not often influence market trends and investors should stay focused on their long-term goals and strategies.