AMB Newsletter
4th Quarter 2017

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3rd Quarter Review 2017

Global equity markets added another solid quarter for 2017. The old adage of “sell in May and go away” did not ring true this year. U.S. markets measured by the S&P 500 returned a strong 4.49% for the quarter and 14.25% for the year, which was more than we anticipated for 2017. Even with this return, AMB remains bullish for the long term and remains fully invested., a stance that paid off in the third quarter. As we mentioned before bull markets do not end when investors feel cautious/unsure, rather when investors feel euphoria/greed, and we believe that we have yet to hit that part of the cycle.

Current global growth and inflation numbers did increase in the 3rd quarter but longer-term projections were once again lowered in the U.S. Global growth has outpaced most expectations for 2017, and AMB expects that to continue. We must also remember that even though growth projections in the U.S. have decreased, we are still seeing growth. With global yields at historic lows and inflation rather benign, AMB believes this growth will continue to push equity markets higher. This brings us back to our point made earlier this year, that corporate earnings seemingly bottomed in the summer of 2016. Earnings are continuing to show signs of strength, which we believe will be the driver of the market going forward.

International equity markets once again outperformed U.S. equities. Measured by the MSCI EAFE, international markets posted a return of 5.03% for the third quarter, putting the index up 20% YTD. After years of continued underperformance, international markets seem to be on a strong run which can be attributed to an increase in growth along with compelling valuations compared to their U.S. counterparts.

We did see a shift away from some of the growth stocks in the third quarter, but overall it was a broad rally. All sectors aside from consumer staples were positive for the quarter with information technology leading the way with a return of 8%. AMB does believe there will be a shift in favor of value in the fourth quarter, and then soon after we will see sector leadership change to sectors we feel are undervalued, such as Energy and Financials.

U.S. central bankers spoke of reducing monetary policy and continuing on their path to rate normalization throughout the third quarter. The Federal Reserve left rates unchanged in September, which was widely anticipated, but it has now brought the normalization of the Fed’s balance sheet into play. This move will keep U.S. monetary policy going in the opposite direction of most of the world’s other central banks, as the U.S. continues to tighten. AMB anticipates that if the Fed continues on this aggressive tightening path, it will hinder growth and bring a domestic recession into play.

Interest rate volatility was abundant in the third quarter as the U.S. faced numerous issues from natural disasters to talks of nuclear war. Fixed income markets, measured by the 10-year Treasury, ended the quarter at 2.328%, reaching yields as low as 2.03% during the quarter. AMB’s target of 1.8% – 2.7% remains the same from the beginning of 2017. Fixed income portfolios experienced another positive quarter with the market measured by the Barclays Intermediate Government Credit index returning 0.60% for the quarter and 2.34% for the year. AMB believes the intermediate to longer end of the curve continues to be the place where investors need to position themselves.

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<u>Economy</u>

Mixed economic data reports in the U.S. seem to be the theme since 2009. A promising report is received only to be followed up later with a report that is downright putrid. For example, revised 2^{nd} quarter GDP came in slightly above 3%, which is in-line with the 3% target set by the administration. This shows that the economy is moving in the right direction after the slow start to the year. On the other hand, the latest personal income and spending report shows that inflation is still moving in the wrong direction. The bad news stems from inflation readings, as the core PCE price index, which is the Federal Reserve's central inflation gauge, inched only 0.1% ahead while the year-on-year rate reversed, down one-tenth to 1.3% for the weakest result since November 2015. Getting a small boost from a Harvey-related spike in gasoline prices, overall prices rose 0.2% with this yearly rate; however, also reversing, down one-tenth to 1.5%. This report demonstrates U.S. inflation is still tracking well below the Fed's mandated 2% inflation target, which could slow down the pace of future rate increases. Currently, AMB still expects the Fed to raise rates once again in December.

AMB closely tracks wages as it is our key indicator for growth and inflation domestically. Thus far, what we wrote last quarter still rings true.

> *"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 wages paid continues to grow. As we have mentioned many times in a service driven economy, wages drive growth and inflation. 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. AMB has continued to express the fact since 2009, 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."*

When trying to pinpoint the driver of future domestic growth, it still falls squarely on fiscal policy in AMB's view. Monetary policy measures have been exhausted, and they are now being scaled back in favor of measures of tightening. Moving into the end of the year and looking ahead into 2018, reforms on the Affordable Care Act, taxes, and other burdensome regulations, will be key for domestic growth.

<u>Equity Market</u>

The first and second quarter of 2017 were dominated by U.S. large cap growth stocks. The disparity between growth and value was at the widest level witnessed in decades, which brought us to the conclusion that the rest of the market would play "catch up" going into the end of the year. Growth stocks still performed well for the third quarter, but the performance from the market was broad based and allowed our accounts to rally in the third quarter. Information Technology still took the lead, but all sectors aside from consumer staples were higher for the quarter. Our key points in our last letter are still very relevant this quarter as we continue to receive similar questions.

> *"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 that these types of questions are being asked. Bull markets do not end during times of cautious mentality but rather during times of extreme euphoria." We continue to believe that we are in a bull market that has shifted from being driven by interest rates and low inflation to being driven by higher earnings. Earnings seemed to have bottomed in the summer of 2016 and that has been reinforced by 1^{st} and 2^{nd} quarter earnings in 2017.*

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Equity Market

Entering the fourth quarter, AMB remains optimistic on individual stocks in the market. We feel the overall market may not move much higher during the fourth quarter, but we feel there will be opportunities. The growth stocks that drove the first half of the year are going to give way to value stocks in our view. AMB is consistently observing the markets to see what sectors could lead the markets going forward. In our view, that will be Financials, Cyclicals, and Energy as we wrap up the year. AMB has recently taken an overweighting in two of the three. We are neutral on information technology, health care, materials, telecom and staples. We are underweight or void utilities and REITS.

Non-U.S. equity assets have continued to perform well in 2017. A weakening dollar pushed emerging country assets higher as evidenced by emerging market (measured by the MSCI EM Index) returns of 7.89% for the quarter and 27% YTD. International developed markets (as measured by the MSCI EAFE Index) also posted strong returns with 5.03% for the quarter and 20% YTD. International equities were well positioned for a good year based on relative valuations. Fundamentally, developed international equities remain undervalued compared to their U.S. counterparts, and in our view, they are in the early stages of recovery.

Fixed Income

For the lack of volatility in the equity markets, it has been compensated in the fixed income markets. During the quarter, rates measured by the 10-year U.S. Treasury went back and forth from as low as 2.03% to 2.328% where it closed for the quarter. This volatility has been driven by a number of things, such as the geopolitical tensions between the U.S. and North Korea as well as extremely week inflation data over the summer. The consensus going into 2017 was that interest rates would continue to move higher, being pushed by growth-stimulating policies from the new administration; however, we continue to feel that rates will remain low throughout the rest of the year and into 2018.

AMB maintains this outlook for a number of reasons. Even with the Federal Reserve continuing their tightening cycle, we maintain this will only affect the front end of the curve as the main driver for intermediate to longer dated maturities is economic growth and inflation. We believe that growth in the U.S. and around the world will remain subdued through the end of the year. U.S. growth continues to be hampered by overregulation and burdensome policies, and growth will not take off unless that changes. Inflation will remain benign as wage growth continues to flounder. In our view, wages remain the largest driver of inflation in the U.S. as 70% of the economy is made up of consumer spending. Until higher paying jobs make up more of the jobs being added, expect to see poor inflation numbers. Rates around the world remain below their U.S. counterparts, which we believe will continue to drive foreign capital into our debt markets, which in turn will put a cap on rates. For these reasons, we maintain our 1.7% - 2.7% U.S. 10-year Treasury range.

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

As we wind down 2017, market returns have continued an upward trajectory that now seems undeterred by most geopolitical events. While the administration has tried and failed with healthcare reform, perhaps a move by Congress to amend the tax code could bring about some meaningful change that is needed in order to stimulate more domestic growth.