AMB Newsletter
3rd Quarter 2016

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3rd Quarter Overview

At the end of the second quarter, the markets were hit with the shock of the UK referendum (Brexit), in which the UK voted to leave the European Union. This took the market by surprise and led to a steep sell-off in risk assets. However, as we expected, this was short lived and the markets recovered. Domestic equities measured by the Russell 3000 were up 4% for the quarter and 15% over the last twelve months, a nice return considering the call for a crash market pundits have been pushing over the last year. Heading into the 4th quarter, which is historically the strongest quarter of the year, it looks like 2016 is going to wind up being a strong year for global markets.

Diving deeper into the breakdown of equity market returns, small-cap stocks outperformed for the third quarter gaining over 9%. This now puts them up over 15% for the last twelve months, but are still trailing Large-Caps by an annualized 3% over the last three years. Large-Cap stocks, as measured by the S&P 500, were up a 3.86% for the quarter and now stand at a positive 15.45% over the last twelve months. Over the last five years, the S&P 500 is up an annualized 16.37%. The equity markets are definitely where investors wanted to be since the financial crisis.

International markets had a very good quarter as well. The developed international markets as measured by the MSCI EAFE (Europe, Australia, and Far East) finished the quarter up 6% while Emerging Markets gained approximately 9%. Though the past quarter was good for international markets, they still trail domestic equities by a large margin over an extended time period. AMB believes based on current market valuations, International markets will out perform domestic equities in the foreseeable future. International equities appear fundamentally cheaper and AMB expects some outperformance abroad if growth does turn around in the rest of the developed world.

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The bond market, measured by the Barclays Aggregate Index, ended the quarter in positive territory. This puts the bond market up over 5% for the year, with an annualized five year return of approximately 3%. Fixed income has not been knocking it out of the park, but it has definitely been a nice complement to the equity performance investors have been enjoying as of late. AMB continues to believe there is a place for fixed income's predictability and stability in investor's portfolio, even with rates at all-time lows.

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Economic Overview – US Economic growth continues to improve albeit at a very sluggish pace. According to our policymakers, growth in the second half of 2016 is improving over the slow start seen in the first two quarters of the year, which were very weak. The most recent Federal Reserve statement, policymakers stated growth of economic activity has increased from the modest pace seen in the first half of 2016. This verbiage was an improvement over what was stated in the first two meetings of 2016. However, despite their optimistic view, the 3rd and 4th quarter growth projections were downgraded to 2.26% and 1.22% respectively.

AMB believes US growth and inflation prospects will continue to track wages and business spending. As we have said many times, our firm believes wage growth will continue to be essential, due to 70% of the US economy being made up of consumer spending. Until we see a steady improvement in wage inflation and fixed business investment, we believe US growth will remain subdued. The current problem facing the US economy is not the quantity of jobs being added in the economy but rather the quality. Low quality jobs have comprised a major portion of job additions since the financial crisis, which will not fuel additional economic growth. Most of the higher quality jobs added since 2009 came in the oil patch and with the recent carnage seen in the oil sector, many of these higher paying jobs have been lost. Until we see a change in the current trend of job additions, AMB believes economic growth in the US will continue to be sluggish.

Federal Reserve – The Federal Reserve has dominated headlines since the Financial Crisis, due to the deployment of unconventional monetary policy tools used to help spur economic growth. The accommodative policies seen over the past few years have included Quantitative Easing (outright buying of bonds) and ZIRP (Zero Interest Rate Policy). These programs have moved rates lower and driven money out of fixed income investments into risky assets. The reason market participants hang on the Feds every word is they believe if the punch bowl is removed the markets will experience a meltdown.

Taking a look at what the Fed has done recently, it is hard to believe pundits are calling them hawkish. Even though the Fed has stopped its expansion of the QE program, they have continued to maintain the same size balance sheet, which means a bond is replaced as it matures. The Fed is not currently shrinking the size of the balance sheet which is still considered an accommodative policy. Last December, the Fed Governors ended ZIRP and conducted the first rate hike in over a decade. They proceeded to talk up the possibility of multiple rate hikes this year, sending shockwaves through the market. As mentioned in our last letter, this was part of the reason 2016 had the worst start for the stock market historically. While they talked about multiple rate hikes, AMB felt if a rate hike occurred this year, it would only happen once, occurring after the presidential election.

Going forward AMB believes the Fed and the Fed governors will continue to go back and forth on when and how much rates should move. We believe the longer run normal rate will be lower than in the past, and it will take much longer to get there than what the Fed is currently stating. AMB is looking for the Fed to remain accommodative, which should continue to help risky assets.

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Equity Market – After the horrific start to 2016, equity markets have made a nice turn around, setting investors up for another solid year of returns. Year to date, the equity market, measured by the S&P 500, is up approximately 7.5%. As AMB stated after the February selloff and weak first quarter, we were optimistic on the equity markets this year. We were able to use the beginning of the year as a good entry point to reduce cash in our model holdings and add positions we believed to be undervalued. Our firm will continue to employ this strategy and use downside volatility in the markets as entry points.

Last quarter, AMB stated we anticipated the second quarter earnings would be the trough. Going forward, investors could start to see returns coming from earnings growth instead of multiple expansion. With the tremendous run investors have seen since the financial crisis, our firm thinks that multiple expansion has run its course in this bull market. Earnings growth will be the only way this bull market is going to continue in our view. With pundits claiming without accommodative monetary policy and increasing rates that the market can't move higher, this is not the case. The bull market can continue. Even with multiple contraction and increasing interest rates as long as earnings growth picks up going forward.

Sector allocation and a bottom up stock selection approach, per our investment strategy, are going to be important. With rates being near zero, we have seen money move into higher yielding stocks. Select AMB models were positioned to take advantage of this. At this point, we believe this trade is crowded, and the stocks in those sectors have become overvalued. These sectors include consumer defensive, utilities, and telecom, of which we will now begin to rotate out. Going forward, AMB will start moving these funds into sectors that we deem to be undervalued, which include consumer cyclical, technology, financials, and some areas of the health care sector. AMB continues to invest in companies with stable and increasing cash flows, a catalyst for future growth prospects, and maintain a shareholder friendly management style.

Fixed Income - The bond market has put together yet another solid year thus far in 2016 with returns near 5%. AMB has said for many years that we believed that rates would continue to move lower and remain at lower levels for the foreseeable future. Our outlook has not changed heading into the 4th quarter and into 2017. AMB expects rates to remain subdued especially in the intermediate to longer term maturities. Monetary policy will continue to dictate how the short end of the curve moves, which we expect to be higher. The intermediate to longer end are dictated by growth and inflation, we see them remaining lower for longer, which is where we will be positioned.

What key drivers are going to keep rates subdued? Currently, the main driver is foreign demand. With rates around the world being not just low, but in negative territory in many circumstances, international investors are starved for higher yielding debt. This is causing money to flow into fixed income securities in the US. Where are investors going to find 2% yielding debt with the credit quality of the US? The answer is nowhere, and until that changes investors will continue to see money pour into the US, capping interest rates going forward.

Investors need to remember why invest in fixed income. It is not the growth engine of our portfolio, it brings stability and predictability to them. If investors are in a buy and hold strategy, then interest rate movements up or down are irrelevant as we are investing for a stream of cash flows. Principal will be repaid upon maturity as long as the bond is credit worthy. Pundits speak to fixed income being riskier than the stock market currently, are spreading a falsehood. AMB feels this is not accurate and quite dangerous.

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<u>2016 Election</u>— A major portion of questions we have been asked recently relate to the US presidential election and the implications of the outcome. AMB's view is quite simple, and our outlook pertains to how it will affect the markets without any partisan opinion. In our view, a Hilary Clinton election would be positive for the markets, especially in the short run. Her presidency and policies will be much the same as President Obama, which will be seen as a continuance of the current administration. On the other side, the total opposite exists with Donald Trump. If he were to be elected, we believe it could cause a major downturn in the market in the short run because his policies are an unknown, which the market and its participants do not like. Taking a short term market view, Clinton would be best for the market, but the longer run implications of either are not predictable.

Matthew J. Roach

Portfolio Manager, Assistant Vice President