CHIEF INVESTMENT OFFICE

The Weekly Letter

AUGUST 15, 2017

- **Two paths we can go by:** We see a confluence of factors as potential triggers of stock market volatility in the autumn, and possibly of a modest market correction. In this environment we see two main paths that could develop in the markets, one involving a small correction, the other continuing upward movement. We see both paths, however, leading to an upward trajectory over the next six to 12 months.
- **Markets in Review:** Equities declined last week. The S&P 500 shed 1.4% and international equities, as measured by the MSCI EAFE Index, were down 1.5%. Bond prices rose. The 10-year Treasury yield fell 7 basis points to 2.19% from 2.26% on Friday of the prior week. Commodities as measured by the Bloomberg Commodity Index added 0.5%, led by gold, which gained 2.4% to settle at $1,289.31 per ounce. WTI weighed on the index, having lost 1.5% to $48.82 per barrel.
- **Looking Ahead:** In the U.S. this week, investors will digest leading indicators of economic activity and the release of minutes from the July meeting of the Federal Open Market Committee. In the Eurozone, investors will await release of the preliminary second-quarter gross domestic product.

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Recent Publications

Weekly Letter
Europe and Japan rally
Income Diversity
With earnings, it's "global first"
Lessons at Midyear–Part II

Monthly Letter
The Tortoise and the Hare Cycle

ISC Viewpoint
The Tortoise and the Hare Cycle

Two paths we can go by

We see a confluence of factors as potential triggers of stock market volatility in the autumn, and possibly of a modest market correction. These factors include, but are not limited to, the recent concerns around North Korea.

First, we're entering what's historically the weakest and most volatile period of the year for equities and we're doing so with equities at premium valuations, though not ones we'd call excessive, and volatility at record lows. Add to that geopolitical tension over developments in North Korea and elsewhere, the Federal Reserve's gradual tightening of monetary policy and expectations for legislative action in Washington on items such as the debt ceiling, the budget and tax reform.

However, we're still in a healthy, synchronized global economic expansion. The latest reading for BofA Merrill Lynch (BofAML) Global Research's Global Wave was flat following 14 consecutive months of increases, and the organization's Nigel Tupper believes it could resume that trend since evidence of a peak is not there yet. Any success on tax reform and/or higher profit growth could further lift sentiment and the market.

Potentially a Small, not Large Correction: Top Reasons Why We Believe This is The Case When All Is Said and Done

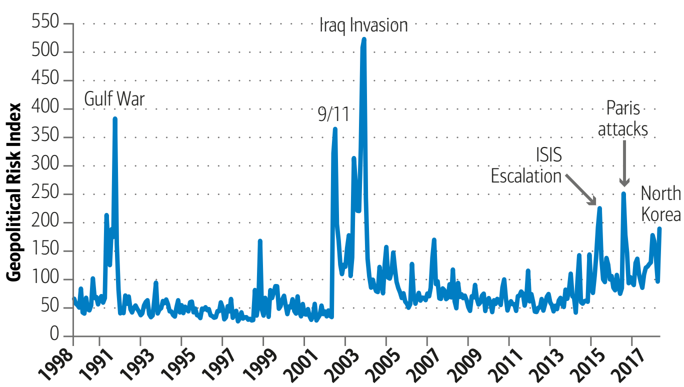
A. Fundamental Reasons: Healthy Growth, Reasonable Valuations

- Global and U.S. GDP growth still grinding toward trend, albeit slowly (strong job opening survey; accelerating copper, iron ore and global leading economic indicators)
- U.S. profit growth is still in double digits through the first half of the year and expected to remain healthy; despite tougher comparisons, more companies—about 48%—beat both their top- and bottom-line growth expectations than at any time in the last 13 years
- U.S. Equity Valuations have become more reasonable given the strong earnings rise (year ahead P/E could now move closer to 17 times, which is supported by expectations of a 1.00-1.50% risk free rate)

B. Strategic Reasons: Attractive Long Term Sentiment, Financial Conditions and Liquidity

- Financial conditions still easy (credit spreads not widening significantly, dollar weakness trend still holding, monetary policy is gradual not a sharp switch)
- Global liquidity still excessive ($trillions still earning close to 0 percent around the world)
- Global consumers have significant pent up demand given strong demographics and healthy debt to income ratios and boom in global employment
- Business and consumer confidence remains healthy; investor sentiment recently shows more bond flows than equity flows; hedge fund positioning shows low net exposure

Exhibit 1: Geopolitical Risk Index has been on the rise



Source: Dario Caldara and Matteo Iacoviello, Federal Reserve Board. As of August 10, 2017. (See Dr. Iacoviello's webpage: www2.bc.edu/matteo-iacoviello/gpr.htm)

In this environment we see two main paths that could develop in the markets—a small correction based on tightening monetary policy and rising geopolitical risk, or continuing upward movement as earnings keep bringing positive surprises and tax reform lifts spirits. Both paths, in our view, ultimately lead to an upward trajectory over six to 12 months, when all is said and done.

One way the first scenario could play out: After second-quarter earnings announcements are done, a consolidation phase brings a correction of some 5% driven by increased geopolitical worries and renewed focus on monetary policy adjustments, which could lower market multiples somewhat. After this correction and prior to third-quarter earnings announcements, we trade back toward the most recent highs for the S&P 500 of around 2500 before we close the year. This move back up would be in anticipation of continuing good earnings announcements, which we expect.

In the second case, we could see a small consolidation phase (a move less than 5% lower) through September but consistent passive investment flows that overwhelm the wall of worry regarding monetary policy and geopolitics and move the S&P 500 toward new highs of around 2600.

Geopolitics: Focus on North Korea

The situation in North Korea keeps escalating, and risks of military action seem to have been rising. The United Nations approved additional sanctions in response to North Korea's missile launches. U.S. intelligence agencies say North Korea has nuclear warheads ready to mount on missiles. Belligerent rhetoric has begun to include direct and specific threats of attack.

While these developments are driving geopolitical risks higher (see Exhibit 1), markets have been following the historical pattern of a relatively muted response. Despite the escalation of tensions, and a modest selloff on higher volatility last week, they still seem to be pricing in a diplomatic resolution. South Korean equities (as measured by the KOSPI index) are near historical highs. In addition, volatility in global equities, including those of South Korea, has risen modestly and prices have declined.

Back to School for Washington

An interesting legislative season is upon us. The nation's debt limit must be raised by September 29 to prevent default, endangering the government's credit rating, and a budget resolution for the 2017-2018 fiscal year must be agreed on by September 30 to stave off a government shutdown. In a vacuum, either issue could be quite contentious; taken together in the context of extreme partisanship, the way forward looks anything but smooth. Setbacks may prove destabilizing for the financial markets.

Budget Brinksmanship

If the federal government's 12 appropriation bills do not pass both chambers of Congress and gain presidential approval, the budget agreement could fail, federal funding could lapse, and the government could shut down on October 1 with non-essential activities coming to a halt. Without completed appropriation bills, legislators may pursue a "continuing resolution," which temporarily funds discretionary programs. The implications of a shutdown are mixed; investors may become discouraged that Washington seems unable to legislate effectively. However, when the U.S. last faced a government shutdown in 2013, spanning 16 days and eroding the favorability ratings of both political parties, the S&P 500 advanced nearly 2.4%.

Deciding how to spend $1.065 trillion

At this point President Trump has delivered his budget proposal and the House Budget Committee has approved a resolution, although the Senate will not take up budget legislation until after its August recess. This year's budget process features added intrigue due to the prospect of budget reconciliation as a means of enacting tax reform. BofAML Global Research's David Woo notes that the threat of a shutdown and/or default remain two of President Trump's most powerful levers to influence his policy priority of tax reform. The details of the budget resolution and reconciliation instructions will be of critical importance to the size, scale, tenure and likelihood of tax reform. Ethan Harris, the Global Economist for BofAML Global Research, believes that the most likely outcome remains a last-minute continuing resolution.

Stay the course!: Since any volatility or correction would be difficult to time, we maintain the view that the best course of action for investors is to stay the course, overweighting equities in portfolios with a preference for international over domestic ones, and to be prepared for the volatility that's typical of the season and could be amplified by the aforementioned factors, individually or in combination. We also advise investors to consider taking advantage of market dips as entry points or buying opportunities.

Markets in Review

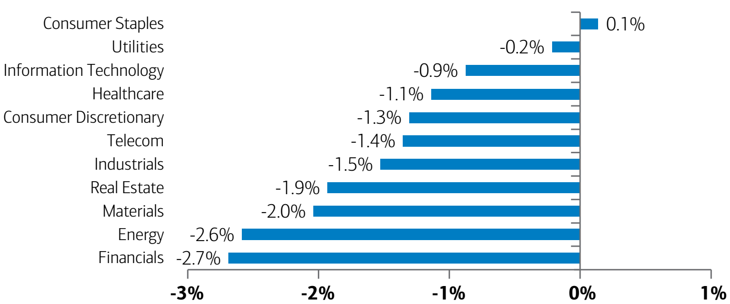
Nicholas Giorgi
Vice President

Trailing Economic Releases

- The Bureau of Labor Statistics released preliminary second-quarter nonfarm labor productivity figures. The measure rose 0.9%, surpassing the BofAML Global Research projection of 0.2%. While productivity growth has picked up in recent quarters, it remains lackluster within a historical context.
- The Bureau of Labor Statistics reported a 0.1% increase in the Consumer Price Index and Core CPI, excluding food and energy, for June, below the BofAML Global Research estimate of 0.2%. With scant inflation, the Federal Reserve may exercise caution in pursuing tighter monetary policy.
- The U.K. Office for National Statistics reported the country's Industrial Production for June rose 0.5%, exceeding the BofAML Global Research estimate of a 0.1% increase.

S&P 500 Sector Returns (as of last Friday's market close)

S&P 500 Sector Total Returns (as of last Friday's close)



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	21,858.3	-0.9	0.0	12.3
NASDAQ	6,256.6	-1.4	-1.4	17.0
S&P 500	2,441.3	-1.4	-1.1	10.4
S&P 400 Mid Cap	1,711.1	-2.3	-2.8	4.0
Russell 2000	1,374.2	-2.7	-3.5	2.0
MSCI World	1,937.7	-1.5	-1.1	12.1
MSCI EAFE	1,916.7	-1.5	-0.9	16.1
MSCI Emerging Mkts	1,042.8	-2.2	-2.1	22.8

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.40	0.3	0.5	3.3
ML 10-Year US Treasury	2.19	0.7	0.9	3.6
ML US Muni Master	2.18	0.2	0.5	4.7
ML US IG Corp Master	3.12	0.0	0.2	4.9
ML US HY Corp Master	5.80	-0.8	-0.8	5.3

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	170.1	0.5	-0.8	-3.9
WTI Crude $/Barrel[1]	48.8	-1.5	-2.7	-9.1
Gold Spot $/Ounce[1]	1,289.4	2.4	1.6	11.9
Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.18	1.18	1.18	1.05
USD/JPY	109.19	110.69	110.26	116.96

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
Past performance is no guarantee of future results.

Looking Ahead

Upcoming Economic Releases

- On Thursday, the Conference Board will report its Leading Index for July, which indicates the growth trajectory of the economy going forward. The consensus calls for 0.3% monthly growth, which would add to a string of ten months of expansion.
- On Wednesday, the Federal Reserve releases the minutes from its July 26th FOMC meeting. As measures of inflation have declined, investors will be focusing on the Fed's discussion of inputs and factors. The minutes may touch on plans for balance sheet normalization contingent on incoming data and financial conditions.
- In the Eurozone, on Wednesday Eurostat will report preliminary growth figures for seasonally adjusted second-quarter gross domestic product (GDP). BofAML Global Research forecasts 0.5% quarter-over-quarter growth, continuing a run of solid readings.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2017 E
Target	2,450
EPS	$129.00
Real Gross Domestic Product	**2017 E**
Global	3.5%
U.S.	2.1%
Euro Area	1.9%
Emerging Markets	4.6%
U.S. Interest Rates	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
Commodities	**2017 E**
Gold ($/oz-period average)	$1,276
WTI Crude Oil ($/bbl-eop)	$47.00

All data as of last Friday's close.

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Past performance is no guarantee of future results.

Asset allocation, diversification dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

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