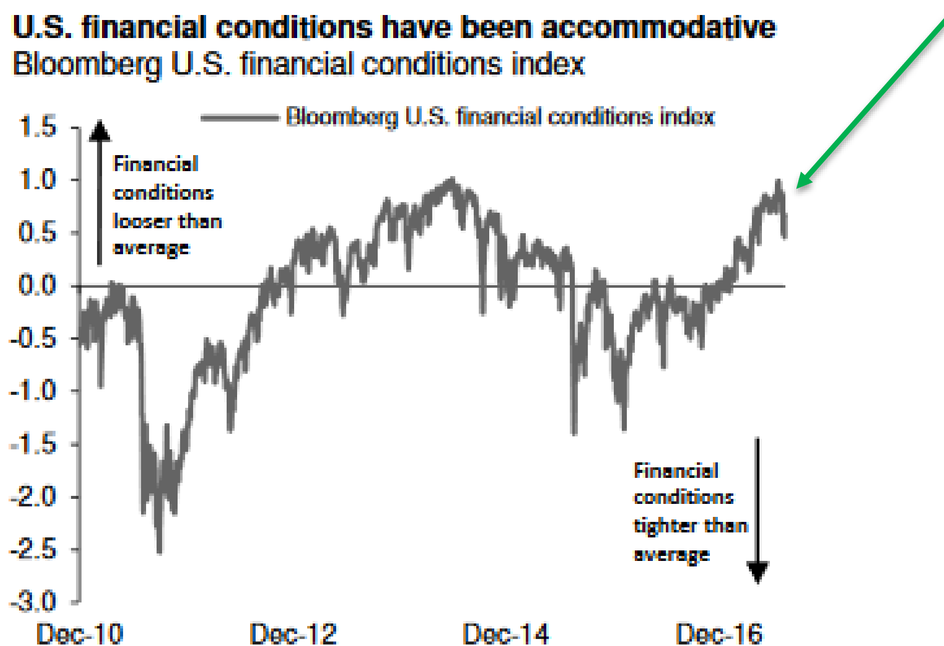
—New Albany—
Investment Management

August 22, 2017

Market Insight: Summer Consolidation; Fundamentals Remain Solid; Wide Performance Gap

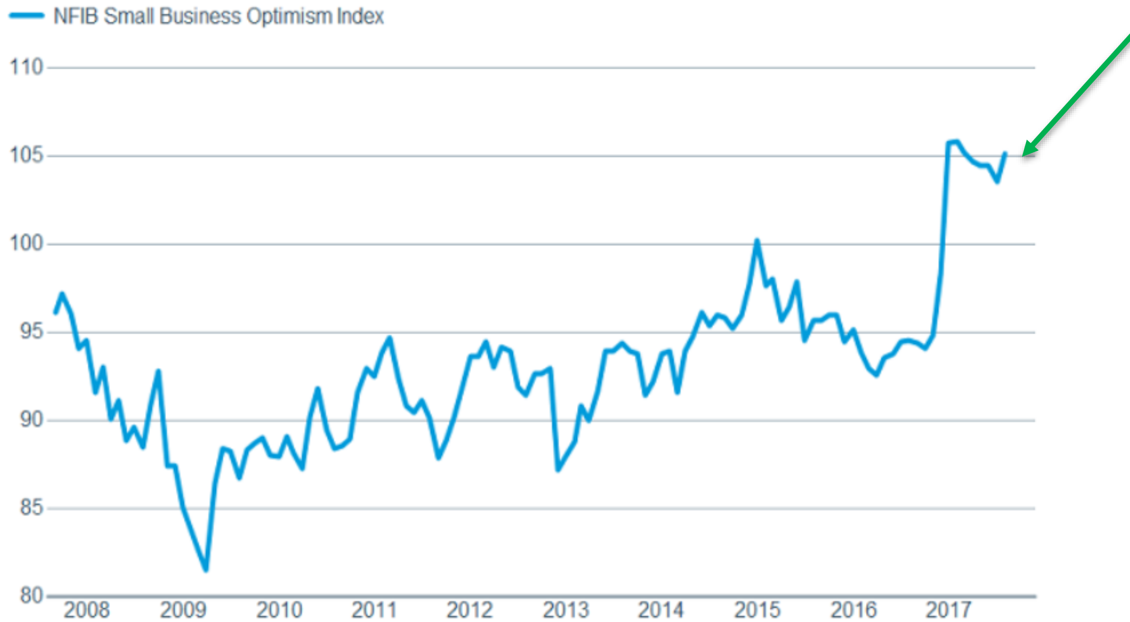
The summer doldrums are here once again and for the financial markets it means light volume trading and bouts of volatility. Earlier this month some of the Large Cap Indicies made new highs but quickly retreated as news of rising geopolitical risks in Asia and US domestic tensions intensified. At the same time, turmoil in Washington has put a damper on hopes for tax reform and has pushed Small cap stocks in the red for the the year. It is a very mixed market terrain and unlikely to get better in the near future. August and September are labled as typically the 'worst trading' months of the year which means the markets could be in a choppy trading range through the end of the quarter. But despite the current sour mood, the fundamentals remain intack: the US ecomony is quite solid; earnings season was positive; and international growth continues to accelerate. As investors, it is important to keep the big picture in focus because ultimately it is the fundamentals, not headlines, that will guide the markets. Below are a few charts that give a snapshot of some of the key fundamentals of the economy and a very interesting sector performance chart.

Financial conditions have been more accomodative since the start of 2017. A good gauge of financial health is the National Financial Conditions Index (*NFCI*) which measures risk, liquidity, and leverage conditions in the money markets, debt and equity markets. The chart below shows the NFCI over the last six years and the recent rise since December 2016, indicating improving financial conditions for both borrowers and investors.



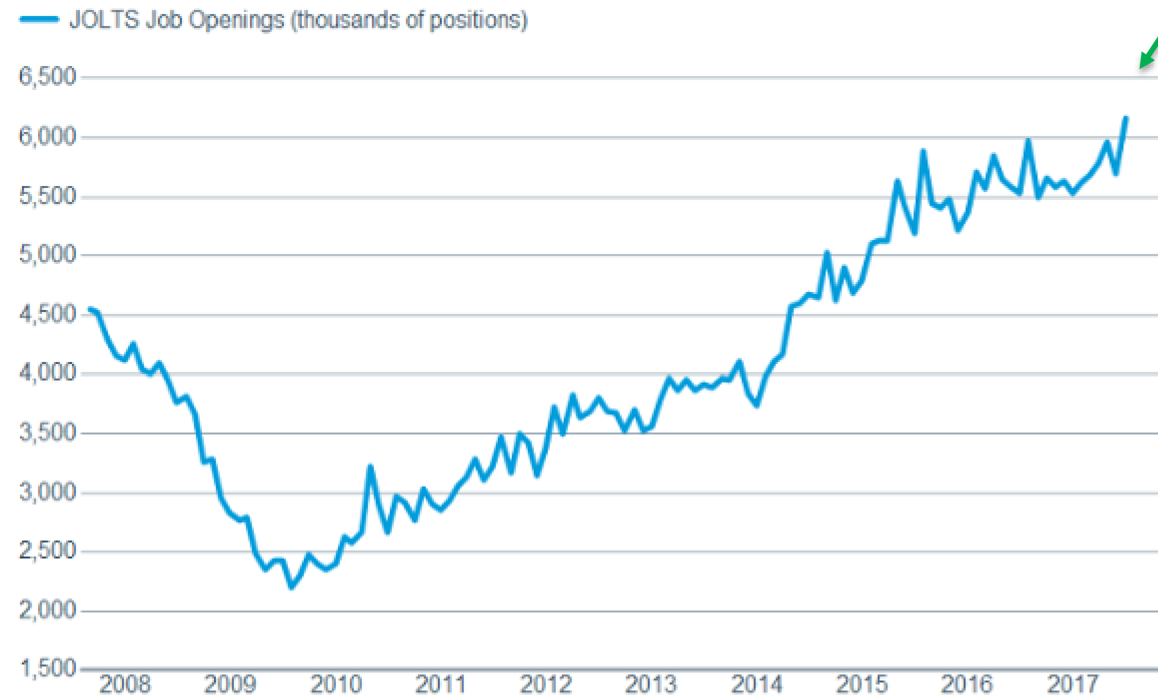
This improvement is mainly due to two factors: Falling longer term interest rates and rising stock prices. Despite the Fed raising short term rates, longer term rates, which determine both consumer and corporate borrowing cost, are actually lower than the start of the year. Lower rates make consumer credit cheaper (spending more affordable) and corporate borrowing easier. At the same time, solid earnings growth has supported stock prices which has created a wealth effect for investors and corporations. This is good news for the economy, but it also gives the Fed a green light to continue on its path to raising rates and to begin unwinding its bond purchase program.

Small Business Optimism Still Strong: Despite the gridlock in Washington on progress for healthcare and tax reform, Small business optimism remainds quite high and this should lead to more growth through job creation.



Source: FactSet, Natl. Federation of Independent Business. As of Aug. 14, 2017.

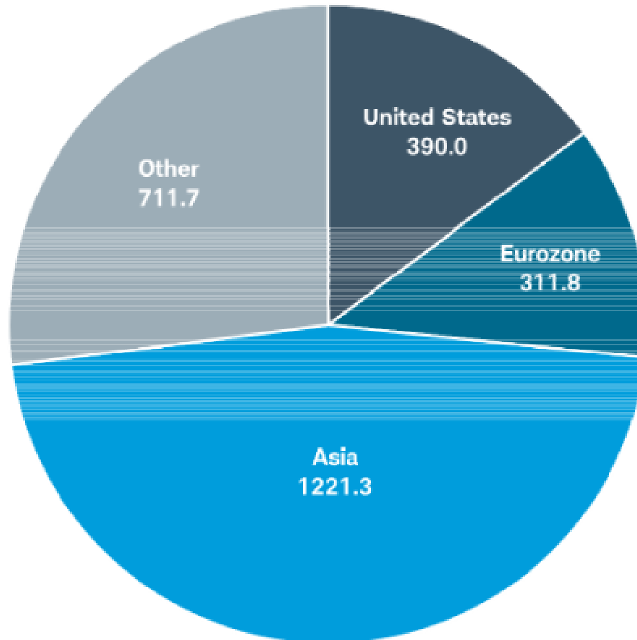
Job Openings continue to rise; Business are looking to hire: More jobs will translate into more spending, and accelerate growth.



Source: FactSet, U.S. Dept. of Labor. As of Aug. 14, 2017.

Another Source of Growth are the Asian economies which will contibute nearly half of global growth in 2017. China, Japan, and South Korea are among the three biggest economies in Asia and they each are seeing solid to improving growth. This is especially impactful on earnings growth for both local and foreign companies.

Contribution to 2017 IMF world GDP growth forecast (in billions of US dollars)



Source: Charles Schwab, International Monetary Fund data as of 8/15/2017.

Stock Sector Performance: Huge Gap in Returns. Solid economic growth around the globe has not impacted all market sectors the same. In fact, there is a huge performance dispersion in stocks across both style (Value, Blend, Growth) and size (Large, Mid, Small Cap). The chart below shows the YTD performance of each sector and shows two themes: “Large “ (L) is beating “Small” (S); and “Growth” (G) is trouncing “Value” (V) .

	V	B	G
L	3.4	9.8	15.9
M	2.9	6.4	10.8
S	-4.2	0.8	6.4

YTD

The performance differential is due to several factors:

1) Large Cap companies derive approximatley 45% of their sales and earnings outside the US and are benefiting from strengthening foreign economies.
2) A weaker US dollar has contributed to higher earnings to those compaines with sales outside the US, which is predominately large cap.
3) Tax Reform: Small caps saw a huge run up after the election, on hopes of aggressive tax reform that would benefit small businees owners. But recently, with inaction out of Washington, investors' hopes of action any time soon have soured.
4) Valuation: Small caps are the most expensive segment of an already expensive market. The S&P 500 (large cap) trades at 17.3 P/E verses small caps at 26 P/E.
5) Falling Interest Rates give large caps a boost. Dividend paying stocks are mostly "Large Cap Value" companies. As mentioned above, long term rates have fallen this year and make those dividend paying stocks more attractive for now.

Gapping sector performance signals potential risks and opportunity: Investors Beware. It is not uncommon to see a wide dispersion of returns across sectors, but eventually these dispersions converge and often reverse. The chart below shows performance by year of various asset classes. (Please ignore the solid black line for this illustration.) Notice how the Small Cap sector (Orange box) performance rises and falls from one year to the next. In 2013 Small caps were the top performer, up + 38%, but then dropped to the bottom performer by 2015 at -4.4%, before popping back up to top performer in 2016. So far for 2017, Small caps are back on the bottom.

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD
Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 18.6%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 14.2%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 9.3%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Asset Alloc. 6.8%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	High Yield 6.5%
Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	Small Cap 5.0%
EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 4.9%
DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 2.3%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Cash 0.3%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Comdty. -5.3%

Source JPMorgan: The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays US Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index.

Diversification a Must: If and when there is any inkling of positive progress in Washington, the Small cap space will quickly reignite, so exposure to this sector is still warranted. At the same time, once the Fed starts unwinding their bond purchase program, there should be pressure on long term rates to rise which will put pressure on dividend paying stocks. It is exceptionally difficult to time these events, and thus it is all the more reason to maintian a diversified portfolio.

In sum, the markets may flowder through the end of the quarter, but will likely regain positive momentum as we head into Autumn. Continued economic momentum both in the US and internationally, and strong earnings growth should provide support for the global equity markets. At the same time, political uncertainty, the unwinding of the Fed's bond purchasing program, and elevated valuations will contribute to investor caution and market volatility.

Investment Strategy: Unchanged from last month.
Stocks: Equity exposure remains broadly diversified, with some reallocation outside the US, as growth around the globe is gradually accelerating.

Bonds: Interest rates are likely to creep higher over the next year, thus duration is short with exposure to investment grade and high yield corporates, and floating rate bank loans.

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

Kind Regards,

Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139 www.newalbanyinvestment.com