Financial Services Advisory
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The Dog Days of Summer

June Market Review—July 9, 2017

As temperatures heat up across the country at this time of year, the pace of life often slows down as we seek to stay cool and savor the long days and mild evenings. Many families vacation at the beach or in the mountains or visit other places around the country. Stocks also seem to take time off during this time of year. According to BTN Research, stock market returns over the summer months (June-July-August) have been essentially flat (-0.1%) for the past 25 years (1992-2016). During 14 of those years the S&P index had positive returns, and for 11 of those years, the return was negative.

Early this summer, returns seemed on pace to do much better than the 25-year average. A late sell-off in stocks, however, pushed the S&P to modest returns for the month of June, and the Nasdaq index—a strong performer for the year overall—finished in the red (down 1%). Foreign stocks have continued to perform well even though they also slid by the month's end.

Bonds have performed a bit better than expected, especially given that the Federal Reserve Board is on track to raise short-term interest rates. The 20-year Treasury bond has increased about 5% for the year while the more diversified and shorter-term Barclays Aggregate Bond index is up roughly 2%. Considering that the yield on a 10-year Treasury note is just over 2%, a total return of 2% for just six months is pretty good.

Given this encouraging environment, FSA accounts continue to have very low money market allocations. With both equity and high yield bond trends moving in the right direction (i.e., up), we are content to leave the portfolios heavily invested. Technology and health care stocks led the way for the first half of 2017; the more aggressive FSA strategies (Core Equity and Tactical Growth) reflect that tilt. Additionally, foreign stocks have continued to be a bright spot in the equities universe, posting strong second quarter returns. Foreign stocks have lagged for the past several years so we are hopeful that this trend will continue for some time.

Outlook for the Second Half

Because the return for the first half of the year has already achieved roughly the long-term yearly average for the S&P 500 index, should investors expect more gains in the second half of the year? History suggests that's likely. Stocks are influenced by momentum, so if stocks are going up in the short run they often keep going in the same direction. Before getting too comfortable with that sanguine forecast, we'll point to 1987 as a notable exception. Perhaps

you recall that extraordinary year in which stocks started out with explosive growth, rising 30% by August, then suffered a one-day crash of 23% in October. When stock returns generate unusually strong excitement among investors it generally means a major correction is due.

Another notable characteristic of the first half of this year was the lack of volatility. The steepest drop for the S&P index in the first six months of this year was only 2.5%. Does a calm first half of the year portend a rougher ride in the second half of the year? It might seem reasonable to assume so.

However, in a study that offers some historical perspective on the probabilities, Bespoke Investment Group looked at the years since 1928 that had the smallest pullbacks. There were 16 years with market declines of 5 percent or less in the first half. In those same years, the second half generally had smaller-than-average pullbacks as well. The study also found that returns in the second half of the year tended to be better than the average gain for that time period.

So, there you have it. If history repeats itself, volatility should remain reasonably muted in the second half, with returns a little better than average.

We would remind our readers that even though historical perspective is helpful in showing how markets have behaved in various situations, we should not lose sight of the specific circumstances that mark the current investment climate. These factors, not historical averages, will determine the path of stock and bond returns for the rest of the year.

Some of the positive attributes of this market are:

- Overall upward market trends
- Solid corporate earnings
- Low interest rates
- Positive (albeit modest) economic growth

Among the negative attributes are:

- Now in ninth year of a bull market (average is six to seven years)
- Growing complacency among investors
- Federal Reserve on a path to increase short-term interest rates
- Political dysfunction in Washington at all-time high

As we digest these cross-currents, we continue to keep the portfolios fully invested while realizing that even the slightest developments could kick stocks (and bonds) out of their recent comfort zone. For those of you who have gotten complacent with your own investments (outside of FSA), now would be a good time to bring them back into your focus. The dog days of summer don’t last forever.

Portfolio Review

Below, we review first quarter results in FSA's six broad investment strategies. Keep in mind that because we manage clients' portfolios individually, the results for your particular account may differ somewhat from the averages.

Income (Strategy 1)

The Income strategy continues to be an attractive alternative to the low returns offered by CDs and money market accounts. Even though the Federal Reserve has begun to increase short-term interest rates, we have been able to find bond funds that have increased in value. During the quarter, we eliminated the floating rate funds (which were lagging) while increasing the allocation to high quality bonds and high yield municipal bonds. The portfolio remains fully invested, with a money market allocation below 5%.

Income & Growth (Strategy 2)

Even though Income & Growth is a balanced strategy (with both stocks and bonds), we manage this strategy with a focus on "absolute" returns, that is, to generate returns while taking as little risk as possible, with an objective of posting positive returns in all but the most difficult market environments. During the quarter, we added some global funds to the portfolios, including both a bond fund and a stock fund. We also eliminated the floating rate funds, as they were languishing. These portfolios remain at their maximum of 50% in equities, with a money market allocation below 5%.

Conservative Growth (Strategy 3)

We have continued to push the Conservative Growth accounts more heavily into equities as the rally has continued. During the quarter, we eliminated the small-cap funds, as those stocks have lagged, and added money to foreign stocks, which are marching steadily higher. We also reduced the allocation to floating rate funds. The equity portion now stands at 65%, with the money market allocation below 5%.

Core Equity (Strategy 4)

Core Equity portfolio allocations will remain fully invested as long as the overall stock market maintains its upward trend. During the quarter we exited the remaining small-cap funds, as well as the gold fund, while adding to international stocks and technology-oriented sectors (e.g., internet, Nasdaq). Health care and international funds provided the best lift to the portfolios. For the second half of the year we will be on the lookout for a shift in market leadership from technology-oriented sectors to financial sectors.

Tactical Growth (Strategy 5)

The portfolios in this strategy continue to hold an eclectic mix of aggressive stock funds (technology, emerging markets, gold mining), along with high yield bond funds. In some of the accounts we recently added a fund that tracks volatility (VIX), which will act as a hedge in case the market environment becomes more difficult. We also added an ETF that invests in REITs (real estate investment trusts). Finally, we increased the allocation to the biotechnology fund

up to 10%, as this area finally broke out of its trading range. The money market allocation is below 5%.

Sector Rotation (Strategy 6)
With a focus on so-called growth sectors for much of the second quarter (including technology, health care, and leisure), this strategy posted solid gains for the quarter, as well as for the year. In the most recent rotation, there has been a decrease in the technology concentration (from three funds to one fund), along with a pickup in the financial sector (which made a strong rebound in June). The portfolio now consists of a mix of investments in biotechnology, health care, internet, leisure, transportation, and financials.

Please remember to inform us of any changes in your life that could affect your investment objectives.

FSA Investment Team

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