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Equity Commentary

July, 2017

While the gains were not as broad, equities continued their ascent during the 2nd quarter, and it has come without much of a fuss. According to the WSJ, "The S&P 500 hasn't had a 5% dip since the post-Brexit vote drop, only the third time since the mid-1960s it has managed more than a year without such a pullback." [1] While this has been an up year in equities, it has not been a pro-cyclical or risk-on up market; however, it is important to remember that this scenario has generally been the case for most of this cycle. Stocks that exhibit the more risk-averse factors such as quality, profitability, larger size, growth, and earnings stability have outperformed this year and during most of the 2nd quarter, the exact opposite of what defined the up-market of 2016. Year-to-date, this has been a favorable backdrop for our portfolio holdings, as we have fared well versus the benchmarks.

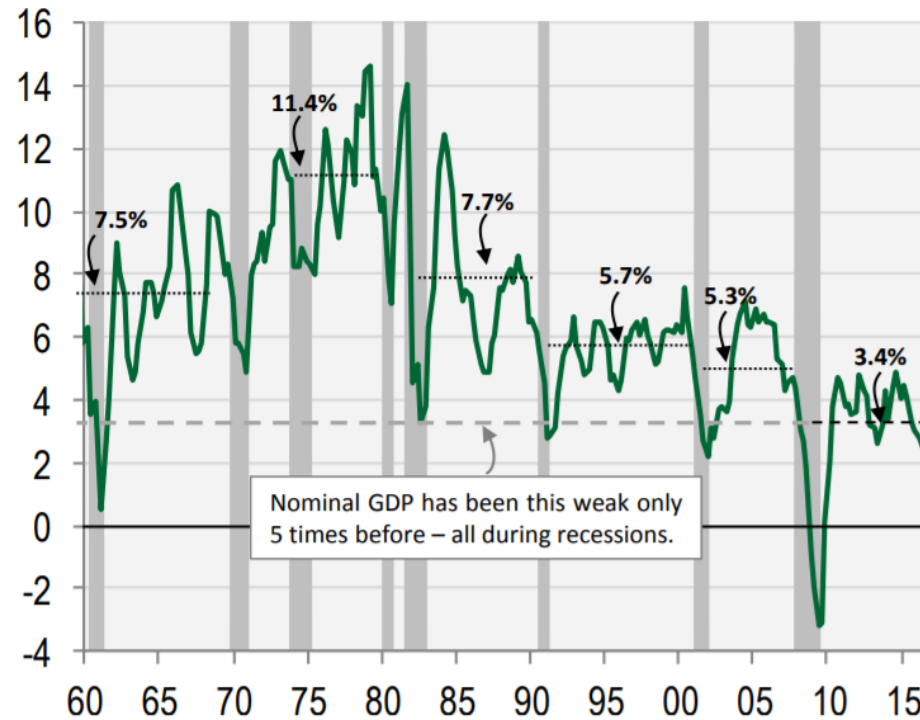
To be clear, we have been concerned about the market since late last year. We have certainly wrestled with the issue of elevated valuations, but our bigger concern has been that after expectations rose in 2016, we did not believe that the pace of growth would reset to a sustainably higher level, and there was risk that the post-election excitement would fade. Halfway through the year, we believe we have been correct with this call. One of the better ways to depict this is with the Citigroup Economic Surprise Index, which is designed to track how well economic data is doing in comparison with expectations. After climbing higher through most of 2016, and hitting a three year high in March, the index has rather suddenly fallen to its lowest level in more than five years. This index is naturally mean-reverting, but it has a decent and logical correlation with asset prices. To connect the dots, while the broader economic data has not been bad, it has disappointed expectations. This dynamic tends to coincide with a preference for less risky assets such as US Treasury bonds and the less cyclical and higher quality equities, which have in fact been the market leaders here in 2017.

While being more conservatively positioned within the portfolio has worked, we have been surprised by the continued strength of the market in absolute terms. Absent an event driven shock to the market, we do see how the current goldilocks scenario could continue. While the economy is not growing at the pace of previous expansions, the mild real growth and low inflation that are playing out again have essentially kept this cycle from burning itself out, and is a primary reason why this business cycle has been one of the longest on record. Low inflation keeps rates low, and lessens the need for aggressive central bank tightening, which is good for our consumption-driven economy and consistent with higher equity valuations. Additionally, if the administration and Congress were to regain traction, this might provide a boost to sentiment similar to the bounce we saw last fall. Corporate tax cuts would help drive earnings higher, tax reform is needed and might incent greater business investment and a constructive healthcare solution is needed. Unfortunately, their initiatives seem to be stuck in the mud. According to the June NFIB Small Business Optimism Report, "Progress is being made, but poorly communicated, and the biggest issues, healthcare and tax reform remain stuck in the bowels of Washington politics."[2] While these two scenarios are possible, we believe that we are clearly in the later innings of this cycle. Job gains and broader measures of corporate profits are positive but have been slowing, and banks are not as easy with their lending as they were a few years ago. Asset prices are high, financial stress is low and the unemployment rate is low, so the Fed is not easing like they were, and the yield curve is flattening. To summarize our current view, we continue to believe that this is not the time to position the portfolios aggressively, and we continue to focus on stocks that do not require help from a cyclical acceleration.

Large Cap Value 2Q17 Performance Comments

Our Large Cap Value Strategy slightly trailed the Russell 1000 Value Index during the quarter, but maintained its year-to-date lead over the index. Our top performing stock in the quarter, Delta Airlines (DAL), benefited from the recent drop in oil prices, which has coincided with a firmer industry pricing environment and another 50% dividend raise. Broadcom (AVGO) and ThermoFisher (TMO) both continued their strong performance with steady results and rising estimates. In terms of sector positioning, our relative underweight in energy continued to be the biggest positive driver to our performance during the 2nd quarter. These positives were offset by

a few individual holdings that ran into trouble during the quarter. Stiffer competition and a lack of pricing power pushed our supermarket operator, Kroger (KR), to lower their earnings guidance, and then news broke that Amazon (AMZN) offered to acquire Whole Foods (WFM). This announcement sent shockwaves throughout the market and comes at a time when retail stocks have been struggling, and it weighed on our relatively new holding, Dollar Tree (DLTR). We viewed this retailer as uniquely healthy and less at risk from online buying given their smaller ticket size and the more spur-of-the-moment nature of their shopper.



Tyler Pullen, CFA

Portfolio Manager

Past performance does not guarantee future results. Market conditions can vary widely over time and can result in a loss of portfolio value. In accordance with the rules of the Securities and Exchange Commission, we notify you that a copy of our ADV, Part II filing with the SEC is available to you upon request.

[1] Wall Street Journal, "Everything is Awesome! Now is the Time to Sell", James Mackintosh, 7/6/17

[2] June 2017 Report: Small Business Optimism Index