JOHN D. DOVICH & ASSOCIATES, LLC

Market Update — Second Quarter 2017

Financial markets continued their rally with all major asset classes posting positive results for the second quarter and the first half of the year. While the passing of health care and corporate tax reform, deregulation and an infrastructure spending plan has stalled, the US economy continues to steadily grow and interest rates remain low. US corporate profits as measured by S&P 500 companies are expected to post over 7% growth collectively. Without fiscal stimulus, investors turned their focus back to economic data and decided the economy remains healthy. The following table highlights total returns during the second quarter.

Index	2nd Qtr 6/30	YTD
S&P 500 (large cap US stocks)	3.1%	9.3%
Russell Mid Cap	2.7%	8.0%
Russell 2000 (small cap US stocks)	2.5%	5.0%
MSCI EAFE (large cap foreign)	6.1%	13.8%
MSCI Emerging Markets	6.3%	18.4%
MSCI ACWI All Cap (global stocks)	4.3%	11.4%
Barclays US Aggregate Bond	1.5%	2.3%

Second Quarter 2017 Review

Investors continued to reward growth stocks with Information Technology and Healthcare stocks repeating their outperformance for a second straight quarter. New outperforming sectors during the quarter included Financials, Industrials and Materials. These latter sectors indicate investors are hopeful economic growth continues to expand. However, with the Fed raising interest rates again in June, their fourth time since December 2015, the US economy may need an assist from fiscal policy to extend the current economic expansion.

What may be surprising to some investors is economic growth outside the US is improving, translating to strong stock performance by international stocks. The MSCI EAFE Index doubled up on the S&P 500 performance by gaining 6.1%. For the first six months, international stocks have returned 13.8%, relative to 9.3% for the S&P 500. While foreign countries are experiencing slow economic growth much like the US, their monetary policies remain more accommodative that the US. This suggests to us foreign stocks may continue to outperform US stocks. A recent chart from J.P. Morgan arrives at this same conclusion.

As you will see detailed below, US stocks and international stocks tend to move in the same direction, but exhibit cycles that can lead to diverging performances. For example, since the beginning of 2009 when the current bull market started, US stocks have risen 258%, while international stocks have risen 106%.

International

MSCI All Country World ex-U.S. and S&P 500 Index

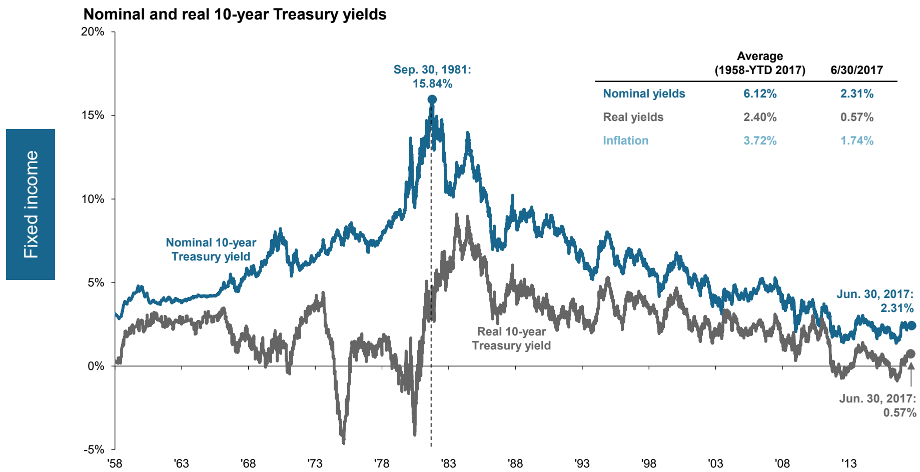
Dec. 1996 = 100, U.S. dollar, price return

Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next twelve months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns. Dividend yield is calculated as consensus estimates of dividends for the next twelve months, divided by most recent price, as provided by FactSet Market Aggregates.
Guide to the Markets – U.S. Data are as of June 30, 2017.

In the table, international stocks (ACWI ex-US) have a lower valuation of a 14.1X P/E compared to US stocks (S&P 500) of 17.5X P/E. Additionally, dividend yields for international stocks are higher at 3.2% vs. 2.1% for US stocks. While this may take several years to materialize, we expect international stocks to gradually converge with the performance of US stocks. We believe international stocks are attractively valued and plan to gradually increase positions as we see opportunities.

The Federal Reserve

In our last commentary, we stated that while the Trump administration has dominated headline news, Fed Chairperson Yellen remains one of the most powerful figures in the global economy, for now. Her term is currently set to expire in early February 2018. The Federal Reserve plays a significant role in setting monetary policy to bring the US out of recessions, like the ones that occurred in 2000 and 2008. However, the Federal Reserve has received criticism in contributing to these recessions by aggressively raising interest rates during economic expansions. There has been much discussion in the financial community over the past few years about the need to normalize interest rates since concern remains that low interest rates could lead to high inflation. The following chart provides nearly a 60-year history of nominal and real (Treasury yield less core CPI inflation) 10-year Treasury yields that shows how low interest rates have remained over the past ten years.



Source: BLS, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for June 2017, where real yields are calculated by subtracting out May 2017 year-over-year core inflation.
Guide to the Markets – U.S. Data are as of June 30, 2017.

With three interest rate hikes in the past six months and the Fed's stated intention to begin shedding its $4.5 trillion balance sheet that expanded over $3.5 trillion since the financial crisis, the Fed is attempting to return to a normal monetary policy. We believe one of the greatest risks to the financial markets, besides any unforeseen geopolitical risk, is how the Fed handles normalizing monetary policy. The Fed is ideally looking for a 'Goldilocks economy,' one that is not too hot to cause inflation and one that is not so cold that it causes a recession. The current low unemployment rate, rising asset prices for stocks and bonds, low interest rates, steady GDP growth and low inflation is a near 'Goldilocks' environment. Therefore, while the Fed may not be in the headlines daily, its effect on the US economy cannot be understated.

Investment Process

With stocks and bonds near all-time highs, valuations for stocks are above average and high for bonds, which could hinder performance in the short-term. To add value in this scenario, we plan to proactively manage investment allocations as divergences emerge. In the bond space, we continue to invest in bond funds with managers that can actively manage these assets in a challenging interest rate environment. For both stock and bond funds, we focus on managers that have a strong and deep research process with a demonstrated track record over long periods of time. It is important to invest in funds with strong management teams that have had success in a variety of investment environments.

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Concluding Remarks

The first half of 2017 has delivered strong investment results. While it is unlikely these results will repeat in the second half, we remain cautiously optimistic about the US economy and financial markets. From time to time, short-term volatility in the markets may occur. However, it is important to remain focused on your long-term financial goals.

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Definitions

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell Midcap® Index: The Russell Midcap Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the mid-cap segment of the U.S. equity universe.

Russell 2000® Index: The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

MSCI EAFE Index (Europe, Australasia, Far East): The MSCI EAFE Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed international markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI ACWI All Cap Index: The MSCI ACWI All Cap Index is a free float-adjusted index that is designed to measure the equity market performance of the global equity markets representing over 14,000 securities including large, mid, small and micro-cap segments of developed markets together with large, mid and small cap segments of emerging markets.

Barclays Capital U.S. Aggregate Bond Index: The Barclays Capital U.S. Aggregate Bond Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, taxable bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

P/E: The price-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

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Index and sector performance information in the Market Commentary sourced from Morningstar.

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