CIO Market Update

Making Hay

ASSETMARK

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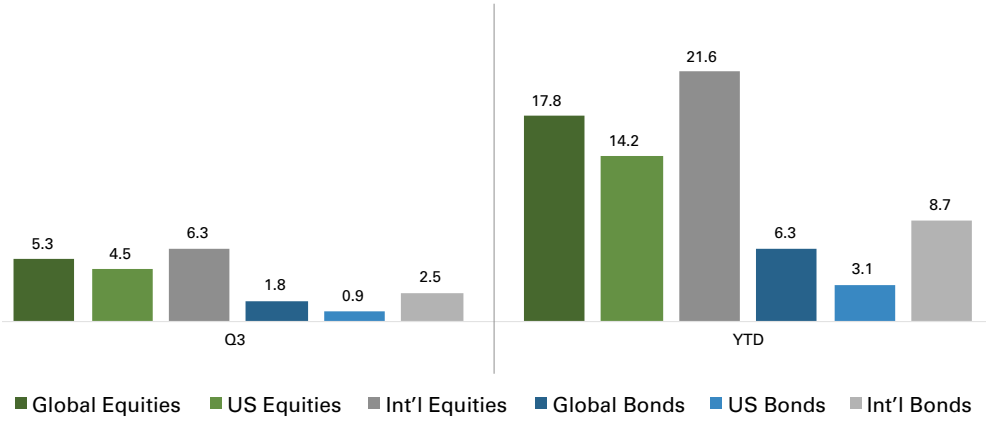
EXECUTIVE SUMMARY

1. **US stocks returned 4.5% in the third quarter of 2017** which, when added to their 9.4% return for the first half of 2017, brings their year-to-date return to 14.2%[1]. The economy continued to strengthen, earnings continued to grow, and investor sentiment remained positive.
2. **Realized volatility for the stock market during the quarter remained low**, which suggests that the market is efficiently pricing individual stocks relative to one another. Low realized volatility is also encouraging because it tends to persist, providing a high probability that volatility in the near future will remain low.
3. **Stock valuations as a function of forecasted earnings continue to be higher than their historical average, but can be rationalized given low interest rates and where we are in the economic cycle.** In addition, other valuation metrics such as price-to-book comparisons and dividend yield suggest that market valuations may still have room to rise.
4. **Bonds provided positive returns during the quarter despite the Fed's bias to a tighter monetary policy.** The Fed spelled out a plan for a very gradual and transparent unwinding of its quantitative easing in order to minimize uncertainty for the market. So far, the strategy seems to be working given that the market continued to rise within a few days of the announcement. The Fed also set expectations for a rate increase at year-end followed by three more in 2018. This is not priced into the market, suggesting bond investors are skeptical. This leaves room for bond prices to drop if investor expectations prove wrong.
5. **Global diversification benefited US investors during the quarter** thanks to the combination of a global economic expansion and the third quarter's continued weakening of the US dollar, as it did in the prior two quarters of 2017. International stocks returned 21.6%[2] year to date for US investors versus the 14.2%[1] return on US stocks.

OVERVIEW

2017 has been a surprisingly good year for investors with US equities achieving record levels. The momentum of the stock market and its low level of volatility make it appear to be moving independently of US political news and geo-political news that have mostly contained stories of danger, decline, and dysfunction. Despite the uncertainty in the world, almost all asset classes have enjoyed positive returns since the start of 2017, with the exception of Commodities which returned -2.9%[3] due to the steep drop in oil prices during the first half of 2017. Year-to-date, global equities returned 17.8%[4] with US and international stocks returning 14.2%[1] and 21.6%[2], respectively. Global bonds returned 6.3%[5] YTD with US and international bonds returning 3.1%[6] and 8.7%[7] respectively. The superior returns for US investors from international stocks and bonds (vs. US stocks and bonds) has been fueled by an 9.1%[8] decline in the value of the US dollar relative to other currencies.

BROAD MARKET RETURNS



Category	Index
Global Equities	MSCI ACWI
US Equities	S&P 500
Int'l Equities	MSCI ACWI ex US
Global Bonds	Bloomberg Barclays Global Aggregate
US Bonds	Bloomberg Barclays US Aggregate
Int'l Bonds	Bloomberg Barclays Global Aggregate ex US

Source: Factset, Zephyr Style Advisor

...the combination of ... current economic growth, ... growth in corporate earnings, rising wages, positive sentiment, low volatility, and valuations that are above-average ... suggest that a recession or other long-lived drop in stock prices is not imminent.

The market's returns this year are part of what has been the second longest stock market rally in US history. Because of the longevity of this rally, some investors may be tempted to anticipate that a steep drop is around the corner. While we can expect the market will eventually experience some degree of a pull-back, the combination of the global nature of current economic growth, slow but steady growth in corporate earnings, rising wages, positive sentiment, low volatility, and valuations that are above-average— but still shy of the levels associated with late-cycle multiples— suggest that a recession or other long-lived drop in stock prices is not imminent.

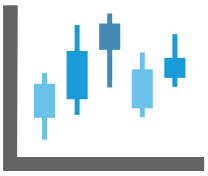
THIRD QUARTER RECAP

The third quarter of 2017 marked the eighth consecutive quarter of positive returns for the US stock market. The third quarter saw positive returns from every major asset class with US stock markets reaching record levels. Global equity markets returned 5.3%[4] for the quarter with US and international stocks returning 4.5%[1] and 6.3%[2], respectively. Global bond markets returned 1.8%[5] for the quarter with the US and international bonds returning 0.9%[6] and 2.5%[7], respectively. As in earlier quarters this year, international investments delivered premium returns for US investors due to a continued drop in the value of the US dollar relative to foreign currencies.

THE CASE FOR THE RALLY EXTENDING

Market Momentum/Sentiment

While investors are always anxious about what might happen in the markets, their expectations for the market often mirror whatever the market's recent performance has been. The current rally is in its ninth year. The S&P 500 has now delivered eight consecutive quarters with positive returns, and an even more remarkable 11 consecutive months of positive returns (the most since 1959!)[9]. The strength of the market's momentum and the remoteness of any memorable loss is likely to buoy investor confidence leading to additional investment and a continued rise in the market. Even among institutional investors, stock market momentum can lead to incremental investments in stocks, thereby extending the rally, as stock market gains enable their risk management models to increase allocations to stocks and other risk assets.



Valuation

The S&P 500 is currently priced at 18x analysts' forecast of corporate earnings for the next 12 months. While this is higher than the 16x it has averaged over the last 25 years, it is important to remember that valuations are not a particularly useful tool for forecasting market peaks or troughs because there is no single correct multiple. Price-to-earnings multiples will vary with the level of interest rates since companies can use lower borrowing costs to leverage themselves and their earnings. Multiples can also vary depending on the phase of the economic cycle. Historically, late-cycle multiples on forecasted earnings have averaged 21x and have reached as high as 24x during the dot-com bubble in early 2000. There are multiple approaches to valuation besides the price-to-earnings multiple, including the price-to-book ratio, and dividend yield. Both of these other measures are roughly equal to their 25 year average, suggesting that valuations do not yet appear to be unusually stretched.

S&P 500 VALUATION MEASURES

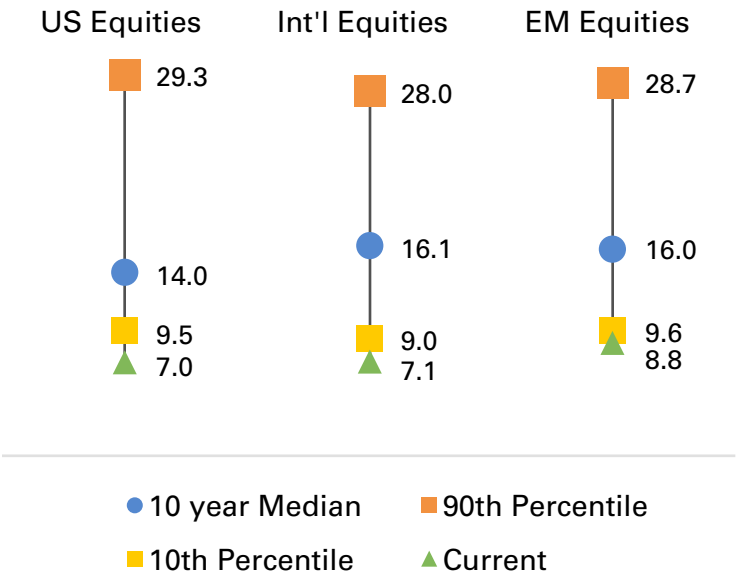
Valuation Measure	Description	Latest	25 Year Average
P/E	**Forward P/E**	17.7x	16.0x
CAPE	**Shiller's P/E**	30.7	26.3
Div. Yield	**Dividend yield**	2.1%	2.0%
P/B	**Price to book**	2.9	2.9
P/CF	**Price to cash flow**	12.4	10.7
Earnings Yield Spread	**EY minus Baa yield**	1.3%	-0.3%

Source: J.P.Morgan Asset Management – Guide to the Markets | US | 4Q 2017
* P/CF is a 20 year average due to cash flow data availability

LOW VOLATILITY

Given that valuations are not helpful in determining whether a correction is imminent, short-term realized volatility may be more useful and is currently extremely low. While realized volatility is mean-reverting, it is also persistent—which is to say it moves slowly and usually provides a reliable forecast of volatility for the week or month ahead. One interpretation of the market's current low volatility is that the market's price discovery mechanism is working efficiently. Price movements in different stocks in different industries are moving independently of one another with minimum distortion from investor emotions. That can lead to irrational pricing.

90 DAY REALIZED ANNUALIZED STANDARD DEVIATION (%)



Source: State Street Global Advisors SPDR® ETFs Chart Park, October 2017

ECONOMIC FUNDAMENTALS

Unlike a few years ago, the US economy is not alone as the sole driver of global growth. The current economic expansion is global in nature and leading economic indicators are broadly positive, including the Purchasing Managers' Index in the U.S. Domestically, we have seen consistent growth in corporate earnings but also a pick-up in wages, after an extended period of stagnation, and at a pace unseen for at least 15 years.

BREADTH OF THE RALLY

For the first two months of Q3, the types of stocks driving the bulk of the market's return were the same as those observed in the first half of 2017 - a handful of large-cap growth stocks were the biggest winners. As of the end of August, three stocks (Facebook, Microsoft and Apple) accounted for 40% of the QTD performance of the S&P 500. This changed by the end of September, as value stocks and small-cap stocks surged to catch up. On the one hand, this can be interpreted as a resurgence of the "Trump trade" as Washington began to discuss tax reform that favors cyclicals, commodities, and stocks with a domestic orientation. On the other hand, prior winners did not go down as these new stocks rose, rather the market's gains were simply less concentrated as participation in the rally broadened, which can be promising both for how much life may be left in the current rally as well as for the potential for active managers to add value through security selection.

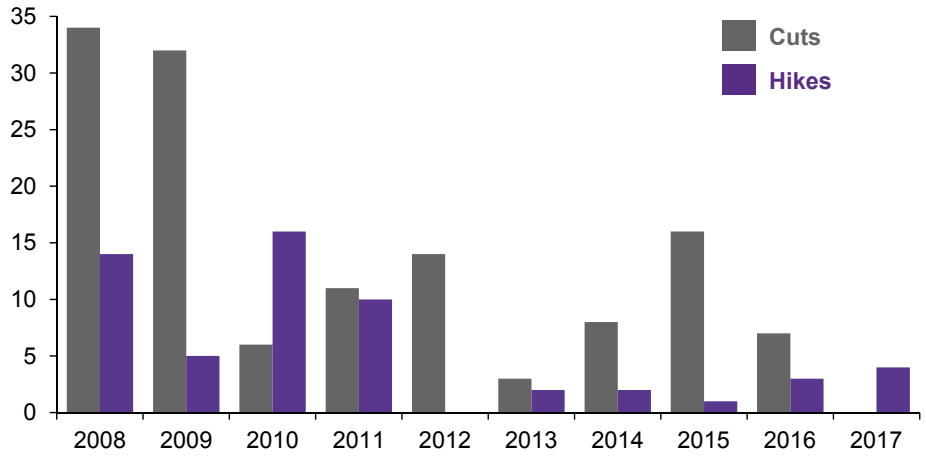
The fact that not all stocks are moving in unison reflects an efficient market but it also has the potential to confuse the assessment by investors of strategies in their portfolios. Dividend stocks are a good example of this. Dividend stocks returned a mere 9.0%[10] YTD in 2017 compared to the 14.2%[1] return on the S&P 500 for the same period. Investors may forget that in some sense the S&P 500, which returned 12%[1] in 2016, is simply beginning to catch up with dividend stocks, whose return in 2016 was almost 20.7%[10]. Similarly, investors with value-oriented managers may feel frustrated by performance relative to blended indices and need to remember that these same value managers did markedly better than the blended index in 2016.

BONDS, MONETARY POLICY, AND FISCAL STIMULUS

In its September comments announcing that it would begin to reverse quantitative easing and reduce its $4.2 trillion portfolio of US Treasury and mortgage-backed debt, the Fed was careful to communicate that this tightening would be gradual and predictable, specifying a schedule that would reduce its balance sheet by $10 billion (divided 60/40 between Treasuries and mortgage bonds) per month for Q4 and increasing this amount by $10 billion each quarter thereafter. This transparency was an effort to remove uncertainty that might frighten the markets. In fact, the market's response was fairly muted in terms of a short-lived decline in stocks. It is important to note that the stock market continued to reach new levels even after the Fed communicated that it still planned to raise rates one more time this year, suggesting that there may finally be enough strength in the economic recovery that fiscal stimulus can be slowly withdrawn without crashing markets.

The Fed set expectations for a rate hike towards year end as well as three additional rate hikes in 2018. This does not appear to be reflected in the yield curve which suggests that traders are skeptical. As a result, despite the Fed's efforts to set expectations for rising rates, the market may still be surprised, creating the potential for a sell-off in bonds.

NUMBER OF RATE CHANGES BY TOP-10 DM CENTRAL BANKS**



Source: J.P.Morgan Asset Management – Guide to the Markets | US | 4Q 2017
** Includes US, Eurozone, Japan, UK, Canada, Australia, Sweden, Norway, Denmark and Switzerland

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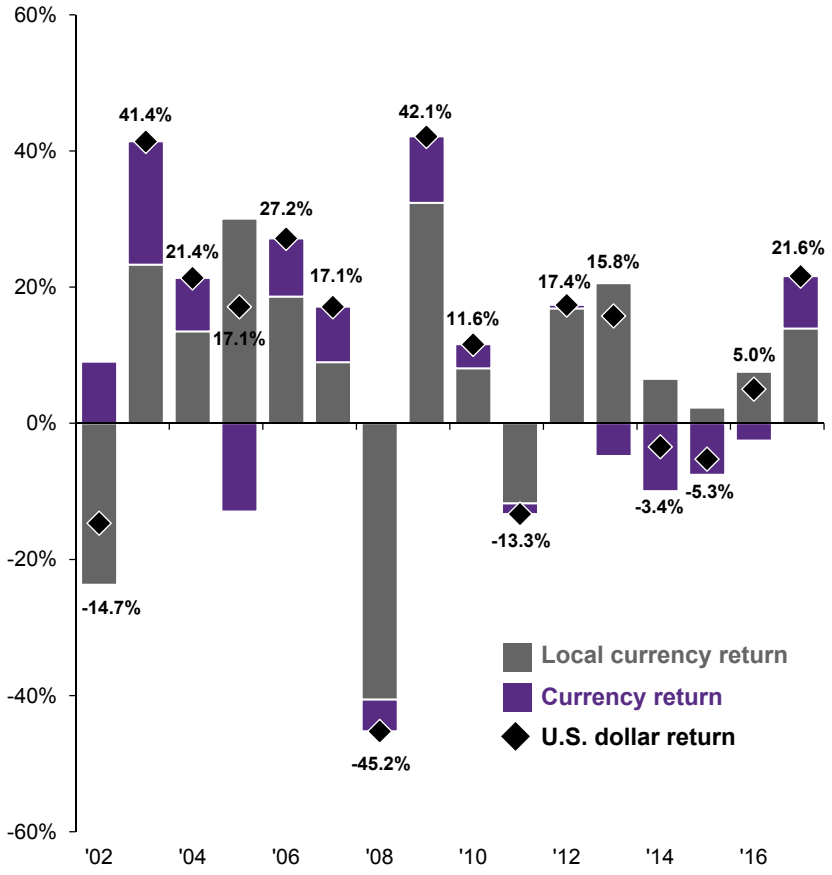
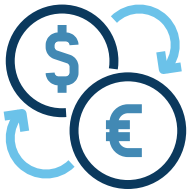
GLOBAL DIVERSIFICATION

US investors saw their international equity holdings return 21.6% YTD but local investors experienced a return for the same period that was only 13.9%[2], which was slightly less than the 14.2% return for the US stock market. Clearly international stock performance for US investors was fueled by the 9% drop in the value of the US dollar. At the end of the quarter, the dollar reversed some of the decline it experienced earlier in the quarter. This may be a reversion to the "Trump trade" anticipating that corporate tax cuts and infrastructure spending will fuel incremental growth in US corporate earnings.

CURRENCY IMPACT ON INTERNATIONAL RETURNS
MSCI ALL COUNTRY EX-U.S. INDEX, TOTAL RETURN



Source: J.P.Morgan Asset Management – Guide to the Markets | US | 4Q 2017



Purchasing power parity (PPP) is an economic theory that argues the same item for sale in two different countries should cost the same amount after adjusting for the exchange rate between the currencies. PPP is a theoretical value and currencies can remain over-valued or under-valued relative to the PPP exchange rate for extended periods of time. So why did the US dollar begin to weaken in January of this year when arguably it was over-valued for some time before? One possibility is that international growth prospects improved more than those in the U.S. Another possibility may be that, notwithstanding Brexit, fear of the euro zone breaking apart has receded.

If tax reform and infrastructure spending in the U.S. begin to look more likely, we may see the dollar start to strengthen based on expectations they would drive incremental economic growth in the U.S. Conversely if tax reform and infrastructure spending begin to look unlikely, we will probably see the value of the dollar continue to slide.

This uncertainty argues for global diversification in stock portfolios. Global diversification in bond portfolios, however, is a more complicated question since the volatility associated with exchange rates dwarfs that of the bonds themselves. As a result, unhedged international bond positions create a diversifying, but speculative, bet on currencies that many strategists feel is inconsistent with the volatility-dampening role of a portfolio's fixed income allocation. It is therefore common for global strategists to either overweight US bonds or hedge all or some of the currency risk associated with their foreign bond holdings. For these reasons, investors should not be surprised if a strategy lags its global benchmark when the dollar is falling, because the strategist has likely made a decision to forego the return associated with a declining US dollar in order to minimize the risk associated with the possibility of a rising US dollar. This dynamic will be important for investors to understand global portfolio performance this year, given that an unhedged international bond index would have returned 8.7%[7] for US investors compared to the 3.1%[6] return provided by US bonds.

OUTLOOK

As outlined above, based on technical, fundamental, and macro-economic factors, we feel we are in a positive environment for risk-taking.

At some point this will inevitably change, but at the moment, the risk of recession appears remote. If Washington starts to make progress on tax reform, this would be considered stimulative for the economy and investors may anticipate accelerated earnings growth and inject fresh energy into the current rally.

The time to make hay is when the sun is shining, but it is also important to include strategies that are on the lookout for a change in the weather.

PORTFOLIO IMPLICATIONS

While market rallies generally breed investor confidence, we are hearing from advisors that a surprising number of clients want to discuss when this bull market will end and whether they should exit stocks in order to avoid the inevitable "crash". Given the age of this bull market, and investors' memory of 2008-2009's sell-off (-56%) coming roughly seven years after the dot-com bust (-44%)[1], perhaps this should not be surprising.

While we are generally skeptical of the ability of investors to time markets based solely on returns, we think the temptation to do so is particularly dangerous now, as the biggest run-ups in a rally are usually towards the beginning and the end. Given that it has been documented that investors anticipate a correction far more frequently than they actually occur, advisors may help anxious investors to stay invested by pointing out to clients the decision to include strategies like managed futures in portfolios to provide offsetting value in markets with downward trends, and volatility strategies that free investors from worrying about when to de-risk or re-risk portfolios because you've included in the portfolio a specialized strategist focused on exactly that challenge. Because these strategists are focused and disciplined, they are much more likely to get the market exposure decision right than anyone trying to make these calls in a less disciplined manner.

If an investor regrets that they weren't overweight technology[11] or large-cap growth[12] or emerging markets[13] which have returned more than 20%[11] this year, then they may want to consider substituting some portion of their core strategy with a tactical enhanced return strategy designed to rotate among relatively concentrated sector exposures with the goal of adding value relative to a more broadly diversified US or global index. One of the most important sources of an advisor's value is the opportunity cost avoided by leaving clients left to their own emotions and faulty perceptions of risk and return patterns. It's important to stay invested but trying to time markets without focus and the required tools is a fool's errand that we should not indulge or enable. The risk of recession next quarter seems remote as does the risk of an extended drawdown. Given this, we would encourage investors to stay invested in order to participate in a likely extension of the current rally. The time to make hay is when the sun is shining, but it is also important to include strategies that are on the lookout for a change in the weather.

Source for all data is Morningstar, unless otherwise noted. All data as of September 30, 2017 unless otherwise noted.

[1] S&P 500®: A cap-weighted index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the U.S. Market capitalizations are generally above $5 billion representing approximately 80% of available market capitalization.

[2] MSCI ACWI ex USA: The Morgan Stanley Capital International (MSCI) World ex USA Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the US.

[3] Bloomberg Commodity Index: The index is composed of futures contracts of 19 physical commodities traded on U.S. exchanges, except aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The component weightings are also determined by several rules designed to insure diversified commodity exposure.

[4] MSCI ACWI: A free float-adjusted capitalization weighted index that is designed to measure the equity performance of countries considered to represent both developed and emerging markets.

[5] Bloomberg Barclays Global Aggregate: A measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

[6] Bloomberg Barclays US Aggregate: The index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and DMBS sectors. US Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to the US Aggregate Index on April 1, 2007.

[7] Bloomberg Barclays Global Aggregate ex US Bond: Designed to be a broad based measure of the global investment grade, fixed rate, fixed income corporate markets outside of the United States.

[8] The U.S. Dollar Index: An index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. Source: Ned Davis Research

[9] Source: Ned Davis Research

[10] S&P High Yield Dividend Aristocrats® index is designed to measure the performance of companies within the S&P Composite 1500® that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 years

[11] Sectors represented by sub-indices of the S&P 500 Index: S&P 500® Information Technology Index

[12] Russell 1000 Growth: The index measures the performance of the large capitalization growth sector of the U.S. equity market.

[13] MSCI Emerging Markets: The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 839 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Investment Terms

Core Market strategies are broad market exposures, mainly in stocks and bonds.

Tactical Enhanced Return strategies attempt to beat an index, typically equities.

Standard Deviation is a measure of the dispersion of a set of data from its average.

Important Information

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