July 14, 2017

July and August are the months when many of our clients find time to relax, recharge their batteries and enjoy time with family and friends. We hope this will be true for you this summer.

Well, it took almost ten years, but the Federal Reserve recently approved capital plans for 34 of the largest US financial institutions, signaling a major turning point for banks after years of some of the tightest regulations and oversight in US history. Banks such as US Bancorp and Wells Fargo can now significantly increase their dividends and share buybacks to levels not seen since the financial crisis, as the latest Federal Reserve stress tests deemed the nation's biggest banks strong enough to lend to households and businesses even in times of stress. This is a major inflection point, as it concludes years of strict oversight and signals an easing of the Fed's aggressive stance towards capital requirements for insurers or banks labeled as systemically important financial institutions, or SIFIs. It is another sign of an improving economy that is supportive of the financial markets.

Second Quarter Market Review

Global equity markets rose 4.5% during the second quarter, as measured by the MSCI ACWI Index, while the Bloomberg Barclays Global Aggregate Bond Index posted a 2.6% return.[1] International markets found firmer footing alongside the US on increased manufacturing and global trade, with global economic growth expected to accelerate to 2.7% in 2017 and 2.9% in 2018-19.[2] At the same time, foreign currencies rallied against the US dollar in 2017, which boosted returns for international investments. For the first half of 2017, global stocks returned 11.8%, with international stocks up 14.5% . . . the best start to a year since 1998.

The S&P 500® Index returned 3.1% for the quarter and 9.3% year-to-date. Large-cap stocks outperformed smaller caps, with multinational companies benefiting from their broader global reach. Health Care led all sectors with a 7.1% return, with new government legislation expected to be favorable for hospitals, health insurers and drug makers. Energy stocks declined 6.4% on higher US crude inventories, as oil prices moved into "bear market" territory with prices down 20% from their recent peak. The more defensive and higher dividend sectors such as Telecom, Utilities and Consumer Staples trailed higher growth areas, including Technology.

The MSCI ACWI ex-US Index of international stocks rose 6.0% during the quarter and beat US stocks. Foreign currency appreciation was a large driver of performance, as international stocks returned 3.5% in local market terms. European stocks benefited from several developments, including growth in corporate earnings, positive readings on economic sentiment and reduced political uncertainty following the French election. The Asian region was lifted by Japan with supportive policy and lower taxes contributing to a brighter economic outlook. Emerging markets returned 6.4%, with larger gains from technology stocks in China and South Korea.

In fixed income, the Bloomberg Barclays US Aggregate Bond Index returned 1.4% during the quarter, as uncertainty around Trump pro-growth initiatives contributed to lower yields and larger gains for longer-term bonds. Corporate and high-yield bonds benefited from the favorable economic backdrop as credit spreads tightened. Lower readings on inflation hurt Treasury Inflation-Protected Securities (TIPS) - one of the few bond sectors to finish down for the quarter. International bonds rose largely due to the appreciation in the euro and British pound versus the US dollar, even as rates rose with central banks hinting at tighter monetary policy.

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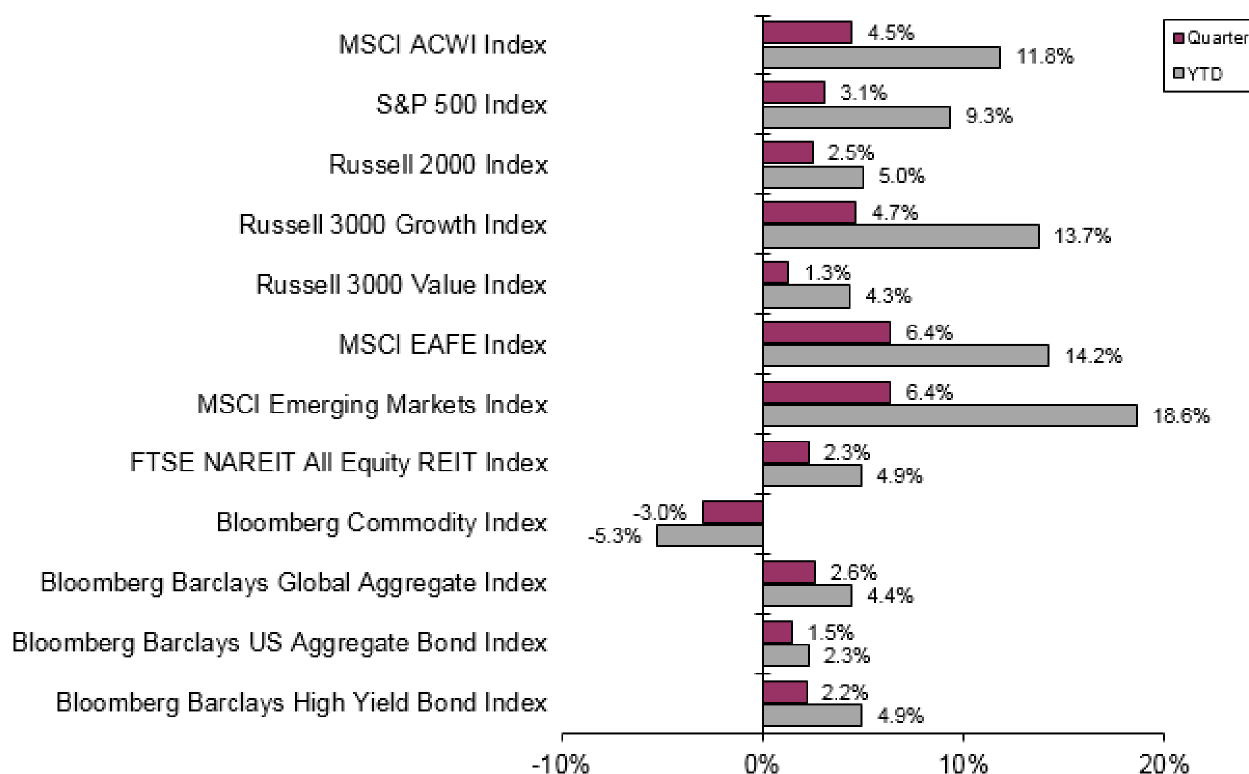

An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indices are unmanaged, with no associated expenses, and investors cannot invest directly in an index. Past performance is no guarantee of future results. All index returns shown in the table represent total return figures in US dollars, with dividends reinvested, which means the returns include not only the change in prices for the securities in the index, but any income generated by those securities. Sources: Bloomberg, Barclays, Dow Jones, Morningstar, MSCI Barra, Russell, Zephyr Associates.

Economic Highlights

The final reading on first quarter US gross domestic product (GDP) came in at 1.4% - up from earlier estimates - based on stronger exports and higher consumer spending.[1] The Federal Reserve Bank of Atlanta forecast that GDP rose 2.7% during the second quarter, even as recent estimates have been cut back due to lower auto sales. Corporate earnings are expected to grow 6.6% in the second quarter according to FactSet, led by a rebound in the energy sector. Analysts are projecting year-over-year earnings growth for nine of the eleven S&P 500 sectors, including a 10.5% increase for Technology. The Utilities and Consumer Discretionary sectors are expected to see small declines in earnings.

The Federal Reserve increased short-term rates by 0.25% to 1.00%-1.25% at the June 2017 Federal Open Market Committee meeting - the fourth increase since December 2015. The unemployment rate was 4.4% in June, below the Fed's longer-term target of 4.5%-5.0%. The Consumer Price Index (CPI) inflation rate rose 1.9% for the 12-month period through May, but has decelerated in recent months due to lower energy prices. Core inflation (excluding food and energy) increased 1.7%, which alongside other measures, was below the Fed's preferred 2% policy target.[2] Fed Chair Janet Yellen indicated that the recent decline was temporary, attributable to cheaper cell phone plans and prescription drugs.

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Wage Inflation

The labor market has significantly recovered from the effects of the financial crisis. There are more job openings than at any time since at least 2000, and unemployment is very low at 4.4% in June as noted above. Many economists view the labor market and wage growth as intimately linked; as the labor force tightens, wages should rise. However, wage growth has remained relatively stagnant since the recession while the labor market has substantially improved. Why has wage growth not increased as expected, and are we at an inflection point in wage growth, or will it continue to remain low?

One explanation is the decline of labor unions in the US. Economists state that "general economic uncertainty has helped undermine labor market reforms, making it harder for workers to form unions and demand higher wages".[2] With labor union participation rate nearly half of what it was 30 years ago, and still declining, it is no surprise that companies have less incentive to increase wages as quickly as it did pre-recession.

Most economists agree, however, that the key explanation is that productivity growth and inflation have both been very stagnant as well. Lower inflation prevents companies from increasing wages without losing profits. At the same time, low productivity growth shows that each worker has been producing little more per hour than they had in the previous year.[1] The chief economist at Wells Fargo recently stated that, "With both productivity growth and inflation continuing to prove sluggish, it is not altogether surprising that wage growth has disappointed".[3]

Why has productivity growth remained so low, keeping wage growth down? Signs point to an increasing skills mismatch in the marketplace, where companies are finding it increasingly difficult to find employees with the skills they require. One piece of evidence of this mismatch is that recruiters have had tremendous wage growth in the last year, faster than any other profession.[1] This mismatch keeps productivity growth low, which then restricts wage growth in companies. A solution to this problem is to train people more to develop new skills. However, this is a slow process and will not make a dent in the mismatch in the short-run.[1]

The question on many economists' minds is whether wage growth will continue to remain tepid or not. Diane Swonk, a veteran economist from Chicago, believes that with the tightening of the job market reaching a breaking point, we should see wage growth finally catch up soon. She stated that "this is a turning point for the overall economy".[4] Robert Johnsons, CFA and director of economic analysis for Morningstar, concluded that "wages [are] moving sharply higher" and that "wage growth may be in the process of accelerating".[5] Others argue that it is unlikely productivity growth will have any drastic change in the coming months, and with inflation remaining low and the fed increasing interest rates, all signs point to wage growth remaining low as it has in the past.[3]

Outlook

Currency moves were again a big driver of investment results during the first half of 2017. Following a strong six-year run, the US dollar declined 6.6% versus the broad basket of international currencies.[1] For US investors with exposure to international markets and foreign currencies, this provided a strong tailwind versus previous years - when foreign currency exposure detracted from investment returns. Notably, the S&P 500 outperformed international stocks every year from 2012 to 2016. Despite the cyclical trends, currencies tend to revert over longer horizons, so this year provides a good reminder to remain globally diversified.

Low volatility continued to be a key theme across multiple asset classes and supported steady gains for stocks. The frequently-referenced CBOE Volatility Index (VIX) on US stocks declined to 9.37 in early June - testing its all-time low of 9.31 achieved in December 1993. Nonetheless, the market's calm was interrupted briefly on May 17th as

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news of President Trump's potential interference in an FBI investigation drove the VIX from 10.65 to 15.59 in a single day (a move of 46%). While the market returned to its peaceful state, the move highlighted the potential for unexpected catalysts to drive swift moves across markets. However, in its mid-year outlook, Lord Abbett Investments noted that a low VIX has historically not had good predictive ability.

The strong run for stocks is now in its ninth year, dating back to March 2009. A reasonable case could be made that we are in the later stages of the bull market cycle, with the global economic recovery firmly in place and central banks indicating a shift away from accommodative policies. We continue to believe that there is room left to the upside based on our reading of current valuations and the economic growth expectations near-term. We see improvement in business and consumer sentiment potentially leading to a loosening of business pocketbooks in the form of capital expenditures and hiring. Improved fundamentals are helping global trade which has a multiplier effect for growth. Monetary policy is still accommodative despite the tightening we've seen and will continue to see ahead. We see the tightening, like the recent bank changes above, as a positive sign that the economy is on firmer footing.

Our portfolios have benefited from specific allocations to technology stocks which have been accounting for a disproportionate share of the gains in the US stock market. We continue to like technology despite a pullback in mid-late June. The Capital Economics Group notes that the cyclically-adjusted price/earnings ratio illustrates that the sector does not seem to be stretched relative to the broader market. Portfolios have also benefited by the increases made to international allocations at the beginning of the year. We believe that the global allocation will continue to be beneficial.

Geopolitical events will undoubtedly surface and cause consternation. So far, the markets have looked past these events and put a focus on fundamentals. We believe that long-term investors should do so as well.

PRW Wealth Management News

Elliot and Chris recently attended an all-day investment conference hosted by Charles Schwab and moderated by Ron Insana from CNBC. A number of national investment managers were represented and generally provided an optimistic albeit measured outlook.

Bill and Janice had an article published in the June issue of the well-respected Trusts & Estates Magazine entitled, "Busting Some Life Insurance Myths". A copy of the article can be accessed on our website, by clicking here:

http://prwwealthmanagement.com/wp-content/uploads/2017/07/Trusts-Estates-PRW-Article-2.pdf.

In June, Bill and Rick attended a two day - "Trusted Advisors Conference" in Las Vegas. The conference focused on impactful tax strategies for clients and a forward perspective on the economy and capital markets.

Janice was also quoted by Insurance News Net in an article entitled, "Too Busy to Die".

Chris assumed the Chair of the Networking Committee for the Boston Estate Planning Council.

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Enjoy the summer. Please contact us if there have been any changes to your financial situation, your investment objectives or your instructions concerning your account.

We look forward to seeing and working with you in the months ahead. Thank you.

Sincerely,

William A. Payne Richard A. Renwick Elliot B. Herman

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For any questions, please contact William Payne, Richard Renwick or Elliot Herman at 617-745-0900.

Benchmark Definitions

Bloomberg Barclays High Yield Bond Index: measures market of US $-denominated, non-investment grade, fixed-rate, taxable corporate bonds.
Bloomberg Barclays US Aggregate Bond Index: is a broad base index measuring investment grade, US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related & corporate Securities, MBS (agency fixed-rate & hybrid ARM pass-through), ABSs & CMBs.
Bloomberg Barclays Global Aggregate Index: is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States.
Bloomberg Commodity Index: The index is made up of 22 exchange-traded futures on physical commodities. The index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity. Weighting restrictions on individual commodities and commodity groups promote diversification.
FTSE NAREIT All Equity REIT Index: The index measures the performance of all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. A REIT is a company that owns, and in most cases, operates income-producing real estate.
MSCI ACWI Index: The index measures the performance of the large and mid-cap segments of all country markets. It is free float adjusted market-capitalization weighted.
MSCI ACWI ex-US Index: Measures the performance of the large and mid-cap segments of the particular regions, excluding USA equity securities, including developed and emerging market. It is free float-adjusted market-capitalization weighted.
MSCI EAFE Index (Europe, Australasia, and Far East): a free-float-adjusted, market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding US & Canada.
MSCI Emerging Markets Index: free-float-adjusted, market-capitalization-weighted index designed to measure equity performance of emerging markets.
Russell 2000 Index: a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.

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Russell 3000 Growth Index: a market capitalization weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above average growth. The index is used to provide a gauge of the performance of growth stocks in the U.S.
Russell 3000 Value Index: A market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform.
S&P500® Index: an index of 500 leading companies in leading industries of the US economy, capturing 75% coverage of US equities.

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Endnotes

Section 1: Second Quarter Market Review; Page 1

[1] Unless otherwise indicated, all index returns are from FactSet

[2] Source: The World Bank. "Global Economic Prospects: A Fragile Recovery (June 2017)"

Section 2: Economic Highlights; Page 2

[1] Source: Bureau of Economic Analysis

[2] Bureau of Labor Statistics

Section 3: Wage Inflation ; Page 3

[1] AQR Macro Wrap-Up - "The Skills to Pay the Bills" by: AQR Capital Management

[2] Forbes - "Four Reasons Wage Growth is Lagging Behind the Jobs Recovery" by: Erik Dolan-Del Vecchio

[3] Wall Street Journal - "U.S. Jobs Growth Picks Up, but Wage Gains Lag Behind" by: Jeffrey Sparshott

[4] New York Times - "Recovery Finally Yields Big Gains for Average Worker's Pay" by: Nelson Schwartz

[5] Morningstar - "Rays of Hope in This Week's Economic News" by: Robert Johnson

Section 4: Outlook, Page 4

[5] Bloomberg, US Dollar Spot Index

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