Strategy Newsletter

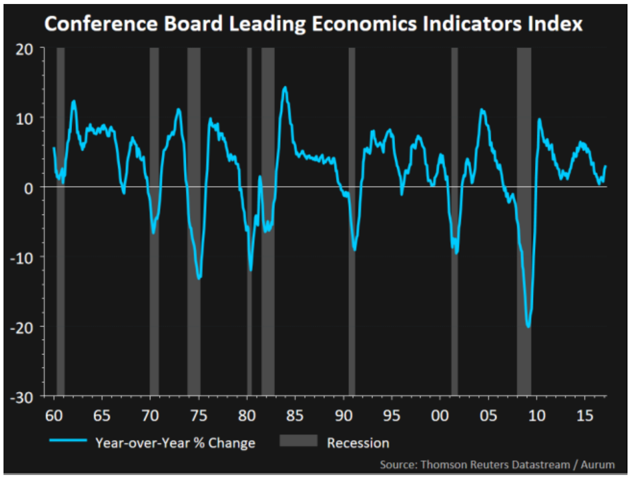
2nd Quarter 2017

- The U.S. economy looks strong with policy uncertainty ahead.
- European stocks look cheap and could be seeing a turn in earnings.
- Corporate credit spreads are on the rich side of fair value today.
- REITs still look pricey even with the pause in price due to higher interest rates.

Economy

Despite a miss in the March Jobs Report, the employment trend remains steady. The U.S. labor market is adding a couple hundred thousand new jobs each month. Households are much healthier than ten years ago, with measures of financial stress such as debt service levels at 38-year lows.

Leading indicators for the economy improved in the five months following the presidential election. This series tends to turn negative prior to recessions, which is out of range today.



The Federal Reserve increased interest rates during the first quarter, waiting only three months after the previous hike in December. The Fed waited a year between hikes previously, so the pace is likely to keep steady.

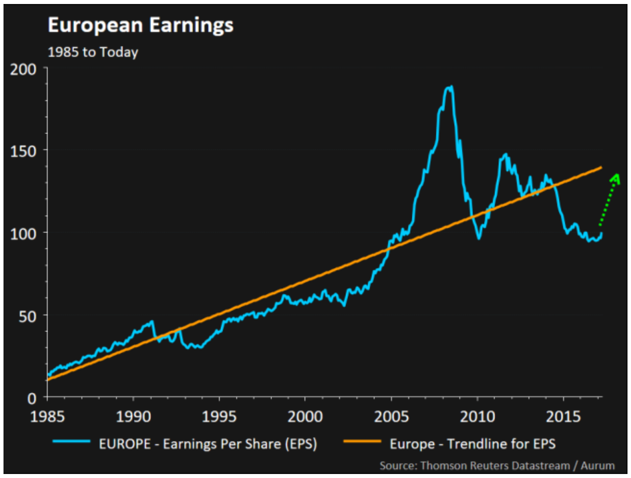
Investors are hoping to see clarity on a tax plan which would lower rates on corporations and individuals across the board. It could come with a border or reciprocal tax on imports, which most are not too excited about, considering the U.S. has essentially zero taxes on imports from countries like China and Mexico. Investors are also wondering about the trillion-dollar infrastructure plan. Inflation expectations fell since December, hinting that the plan's market impact or likelihood of passing is lower.

Equity

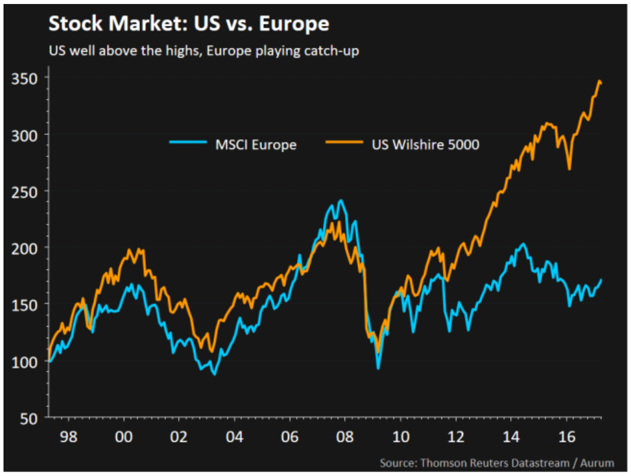
To start the year, emerging markets led the way for global equity markets. A declining dollar boosted returns on foreign investments. At home, large caps beat small caps. Growth outperformed value across the board as technology and healthcare bounced back.

US Equity	1Q 2017
Large Cap Stock	
Dow Jones Industrial Average	5.19%
S&P 500	6.07%
Small & Mid Cap Stock	
Russell Mid Cap	5.15%
Russell 2000	2.47%
Style Indices	
Russell 3000 Value	2.99%
Russell 3000 Growth	8.63%
International Equity	**1Q 2017**
MSCI EAFE	7.39%
MSCI EAFE Value	6.21%
MSCI EAFE Growth	8.64%
MSCI Europe	7.61%
MSCI Japan	4.64%
MSCI Emerging Markets	11.49%

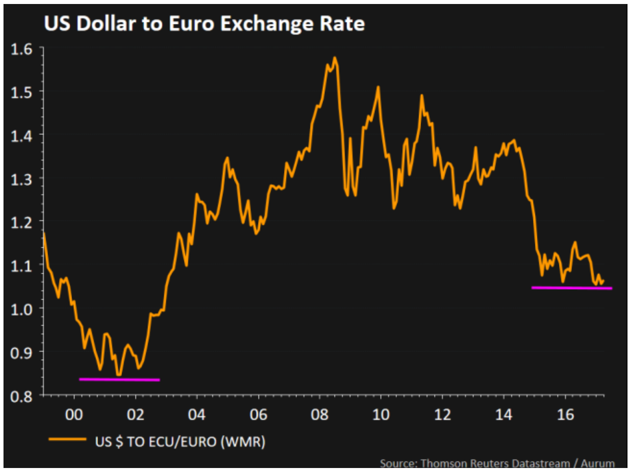
Last quarter we discussed the earnings turnaround in emerging market regions. The growth from the trough in 2016 is over 30%. Also, earnings in Europe are beginning to look positive. Over the last quarter, the growth rate of earnings in Europe was the fastest since 2010. Earnings tend to grow over time, oscillating around the long-term trend line (below in orange). If this is the end of the earnings recession in Europe, there is quite a bit of upside for companies to get back to trend.



Over the last ten years, European stocks underperformed the U.S. market. Instead of stimulating the economy with fiscal spending like the U.S., the Eurozone chose austerity. This was partly out of necessity and clearly a mistake. The good news is that the fiscal balance sheets are stronger, though the periphery countries like Greece suffered the last 7 years to get to this point.



Importantly, the Euro has stabilized over the past year between the 1.05 and 1.10 level. This looks like the 2000 to 2002 period when the Euro halted its price decline from the previous years and traded between 0.85 and 0.90. This led to stability for the Eurozone economies and appreciation in the currency over the next several years.



We recently sold U.S. small caps in favor of adding to international equities. Portfolios remain near the overall equity targets with equal weights for U.S. large caps and developed international equities. Portfolios are also overweight emerging markets with an underweight to U.S. small caps.

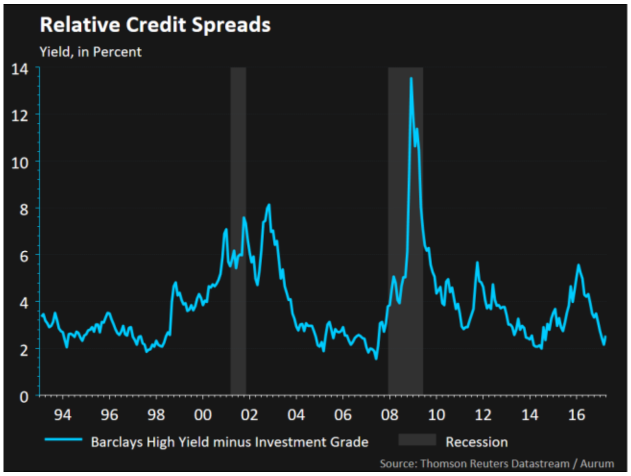
Fixed Income

The ten-year Treasury yield ended 2016 at 2.45% and by the end of March fell to 2.40%. It traded in a range from 2.3% to 2.6%. The relatively stable yield environment was profitable for bond indices.

Fixed Income	1Q 2017
Barclays U.S. Aggregate Bond	0.82%
Barclays Corporate Inv. Grade	1.22%
Barclays High Yield Bond	2.70%
Barclays Global ex. U.S. Tres.	2.65%
Barclays Municipal Bond	1.58%

Global bonds and high yield (below investment grade) corporate bonds led the way. Municipals turned in a nice quarter after a sharply negative fourth quarter, when interest rates jumped higher.

The difference for increasing the credit risk of a bond portfolio is quite low compared to history. For a 2.5% gain in extra yield, one must move down to below investment grade corporate bonds. This spread was as low as 2.0% in 2014, and a few other times such as, 1994, 1998, and the mid-2000s. In early 2016, the spread was as high as 5.6%.



Forecasting a negative credit cycle with high defaults would mean a recession. Yet none of our managers are forecasting one at this time. Thus, instead of taking a defensive stance, managers are upgrading the credit quality of bond portfolios.

We continue to like bonds backed by assets such as houses, railcars, or franchising fees. In this way, our bonds enjoy a nice spread over treasuries without downgrading credit quality. Portfolios still own some high yield and emerging market bonds, in specific cases where the portfolio managers see value. We remain equal weight fixed income overall in the Asset Allocation Frameworks.

Alternative Investments

Hedge funds were the top performing alternative during the first quarter. The tailwind of positive equity markets helped propel long/short and event driven managers higher.

Alternative Assets	1Q 2017
HFRI Fund of Funds Index	2.03%
Dow Jones Global Select REIT	0.66%
Barclays U.S. TIPS	1.26%

It is difficult to get comfortable with the public Real Estate Investment Trusts market today. The Price-to-EBITDA (a proxy for operating cash flow), is still near the highs of the last 13 years. These levels happen to coincide with the same level as the 2007 bubble prices. Of course interest rates and leverage ratios are much lower today. In addition, the loan underwriting process is more stringent today.

Still, certain areas of real estate are struggling, such as retail – which faces competition from online retailers. Other areas are winning such as industrial, benefiting from the need for greater distribution by e-commerce.

We are investing with select private real estate managers while avoiding the public markets today, though we would be buyers if the valuation levels come down. We continue to be underweight alternative investments within the Asset Allocation Frameworks.

Conclusion

The new administration has high hopes to keep up the economic momentum. Passing a tax plan that slashes rates for corporations and individuals would provide a boost. There are many obstacles, but as one political strategist said, the plan would make the U.S. a tax haven, providing a huge economic boost for years to come. That being said, tax reform, along with multiple other aspects of the administration's objectives, must be passed.

Asset prices are high and investors are positioned aggressively, so expected future returns should be moderated. We like the opportunities in certain areas of the fixed income market. In addition, foreign equities have been in a stealth bear market for seven years now. We have been increasing exposure to regions that offer up better values while trimming domestic securities that may have gotten ahead of themselves.

Aurum Asset Allocation Frameworks

	Income		Conservative		Balanced		Moderate		Growth	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	24%	35%	41%	50%	56%	70%	77%
U.S. Equity	0%	0%	12%	12%	20%	20%	30%	28%	42%	40%
Int'l - Develop. Markets	0%	0%	6%	6%	12%	12%	16%	16%	21%	21%
Int'l - Emerg. Markets	0%	0%	2%	6%	3%	9%	4%	12%	7%	16%
Fixed Income	65%	65%	45%	47%	30%	33%	17%	22%	10%	10%
U.S. Fixed Income	56%	62%	39%	41%	26%	29%	15%	18%	7%	9%
Global Fixed Income	9%	7%	6%	6%	4%	4%	2%	4%	3%	1%
Alternative Invest.	25%	23%	28%	19%	30%	19%	30%	19%	19%	13%
Diversified Strategies	19%	23%	22%	19%	24%	19%	24%	19%	15%	13%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	12%	7%	10%	5%	7%	3%	3%	1%	0%
U.S. Dollar	10%	12%	7%	10%	5%	7%	3%	3%	1%	0%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.