Strategy Newsletter – 3rd Quarter 2017

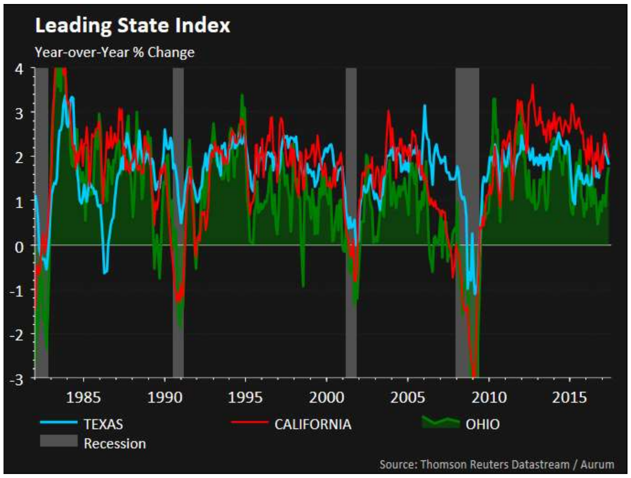
- Most states in America continue showing growth ahead, and the U.K. bounces from Brexit.
- U.S. stocks are not cheap, but are also not at the same level as the technology bubble.
- Interest rates look to be following a familiar playbook.
- TIPS might prove undervalued given the low inflation expectations today.

Economy

The United States economy is diverse, both by industry and region. It's transformed over the last century from a focus on farming to industrial and to services today. A variety of industries drive the unique economies for each state. Energy is key in Texas while technology and media propel growth in California.

Not only are industries and sectors different, so is the scale. California's economy is the size of France; if the state were a standalone country, its economy would be the sixth largest in the world.

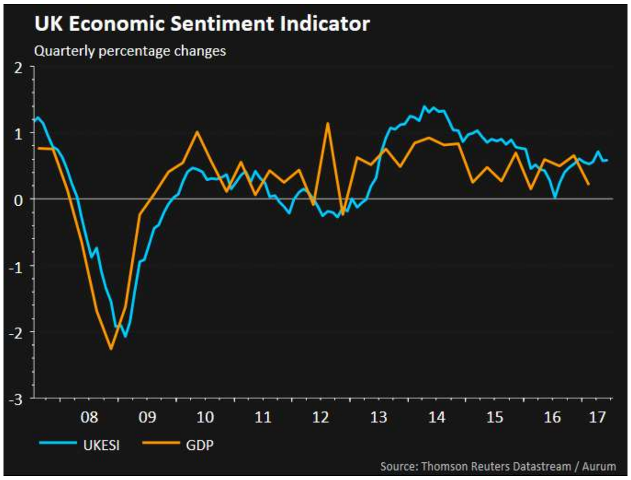
The Philadelphia Federal Reserve publishes a monthly economic index for each state. It includes data from employment, to manufacturing, and overall business activity. Below we have the 1st and 2nd largest states (Texas & California), followed by the 7th largest state economy, Ohio.



As of the latest print, 45 of 50 states experienced growth through May 2017. The five states on the negative side for this month were Delaware, Maine, Massachusetts, Montana, and Pennsylvania. These states make up about 7% of the U.S. economy, thus about 93% of state leading indices are showing growth. Those five negative states are just barely in the red for this indicator.

Despite the lack of a formal tax proposal or infrastructure plan from Washington D.C., which would provide another adrenaline shot to the economy, consumers and businesses continue to chug along.

Abroad we are seeing a similar story. Rebounds in Europe and emerging markets look solid. Even the U.K., who dealt with the Brexit election one year ago is feeling good. The FTSE 100 Index is up 25% since the election. The sentiment index for the U.K. is below, where the data tends to lead growth.

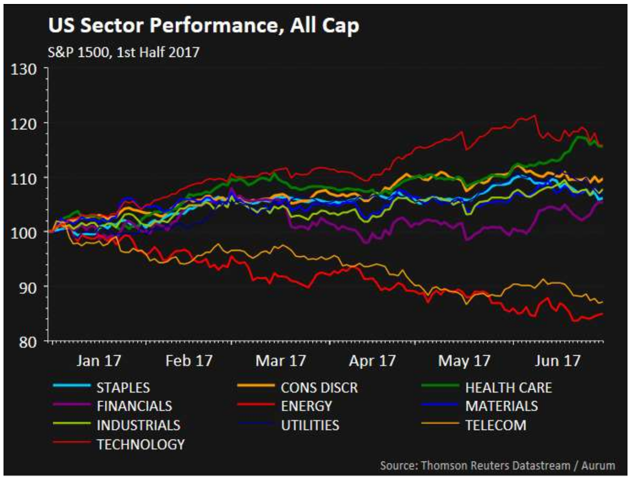


Equity

International markets followed up the first quarter with an encore performance, beating out the U.S.

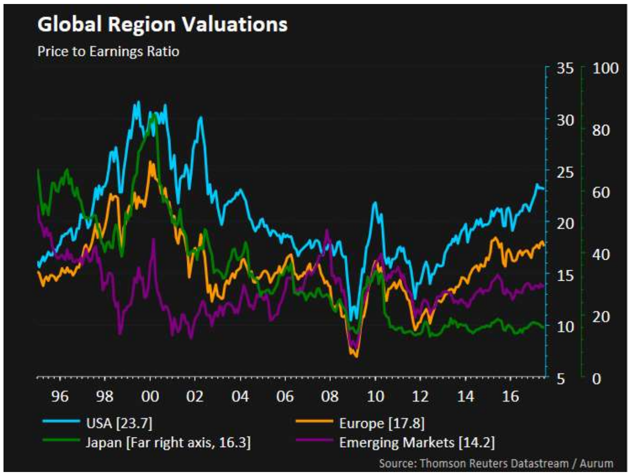
US Equity	2Q 2017
Large Cap Stock	
Dow Jones Industrial Average	3.95%
S&P 500	3.09%
Small & Mid Cap Stock	
Russell Mid Cap	2.70%
Russell 2000	2.46%
Style Indices	
Russell 3000 Value	1.29%
Russell 3000 Growth	4.65%
International Equity	**2Q 2017**
MSCI EAFE	6.37%
MSCI EAFE Value	5.07%
MSCI EAFE Growth	7.72%
MSCI Europe	7.73%
MSCI Japan	5.23%
MSCI Emerging Markets	6.38%

Some would quickly point out that growth is outperforming the value style, which is correct. Looking deeper, however, sectors are the main drivers of the returns difference. Technology and healthcare are the two largest sectors in growth and both happen to be the top sectors this year. Financials are usually the largest in value indices, and the sector lags benchmarks in 2017.



The FAANG stocks (Facebook, Amazon, Apple, NetFlix, Google) concentrated in technology are taking over market indices. Although we are nowhere close to the euphoria of the technology bubble, one cannot help but draw a few parallels. An example would be several unprofitable IPOs coming to market (Snapchat this past quarter).

Prices are certainly above fair value and it is difficult to find a single person that calls markets cheap. The reminiscing of the late 90s is deserved since the price to earnings (P/E) ratio on U.S. stocks are at the same level as 1998, coming in at 23.7x today. This metric would go on to increase by a third in just over two years at the height of the tech bubble in March 2000.



Even with Japan's excellent returns since Prime Minster Abe took over, the P/E ratio is still near a two decade low. Corporate reforms, fiscal policy, and monetary policy to back it up still makes this market look attractive to a few of our international equity managers.

We removed U.S. small caps to add to international value stocks to portfolios in the second quarter. Allocations to equities remain near the long-term strategic target. An overweight to emerging markets remains our key tactical allocation at the expense of domestic small caps.

Fixed Income

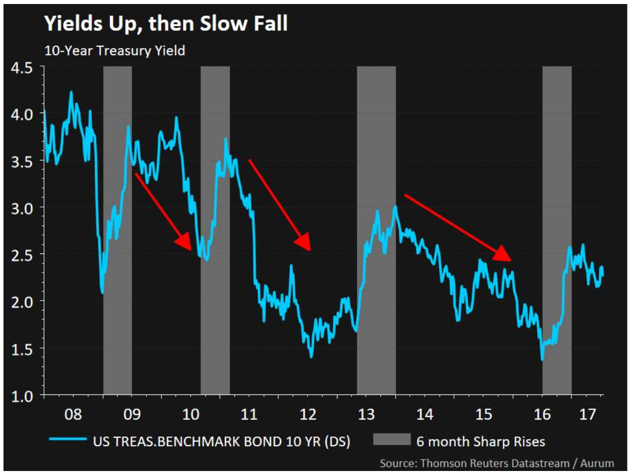
With two interest rate hikes for the first half of 2017 by the Federal Reserve, the 2-year Treasury yield ended at its highest yield of the year at 1.38%. In contrast, the ten-year Treasury yield fell from its high in March of 2.62% to as low as 2.10%, ending the quarter at 2.31%.

The benign environment for interest rates, particularly beyond five-years in maturity, ended profitably for the major bond market indices.

Fixed Income	2Q 2017
Barclays U.S. Aggregate Bond	1.45%
Barclays Corporate Inv. Grade	2.54%
Barclays High Yield Bond	2.17%
Barclays Global ex. U.S. Tres.	2.65%
Barclays Municipal Bond	1.58%

In a quarter in which credit outperformed, investment grade surprisingly beat out high yield. This is evidence of the lack upside in riskier bonds given today's prices. We mentioned in the previous quarter that many of our managers continue to upgrade credit quality for this very reason. Global bonds and high yield corporate bonds (below investment grade) led the way. Municipals turned in a nice quarter after a sharply negative fourth quarter, when interest rates jumped higher.

Looking ahead, an old saying is that 'markets take the elevator down and the stairs up.' Meaning, prices fall fast, then slowly start to climb and recover. Bond yields are the inverse of bond prices. So rising yields means that prices are falling. And vice versa, falling yields means rising prices.



Three times in this cycle, the yield on the ten-year bond climbed 1% in just six months (see the previous chart). This is definition of bonds falling fast. Subsequently, yields fell over 1% during the following 15 months period. Following the "Taper Tantrum" in 2013, yields fell for a total of 30 months. Each time, the low in yields was below the previous low level.

"Past performance is not a guarantee of future results" is the warning on all investments, but this pattern is three for three in this cycle.

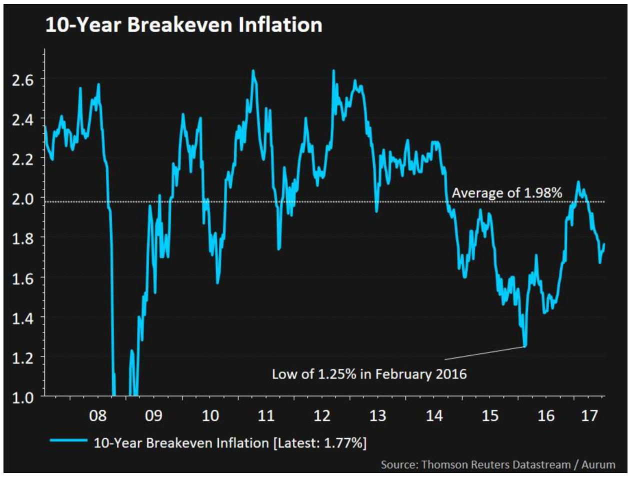
Our portfolios continue to be allocated to cash flowing bonds with underlying assets as collateral. We also view our managers with allocations to foreign currencies as favorable in this environment of the U.S. dollar declining. We remain equal weight fixed income overall in the Asset Allocation Frameworks.

Alternative Investments

REITs and hedge fund both turned in a positive second quarter.

Alternative Assets	2Q 2017
HFRI Fund of Funds Index	0.20%
Dow Jones Global Select REIT	1.55%
Barclays U.S. TIPS	-0.40%

Falling inflation expectations hurt TIPS, leading to a loss for the benchmark. Breakeven inflation is the rate of inflation implied by the bond market.



Breakeven inflation is defined as the difference between nominal treasuries and treasury inflation-protected securities.

Coming into 2017, inflation expectations were up because of the incoming Presidential administration's plans for infrastructure and lower taxes. As the likelihood of the policies being enacted faded, so did inflation expectations.

Within alternatives, we do not own TIPS today. The area is becoming more attractive as the market prices in low levels of inflation ahead, making this a nice option to capture returns if inflation ends up higher. We still own private real estate and alternative strategies. Portfolios continue to be underweight alternative investments within the Asset Allocation Frameworks.

Conclusion

As markets enter a seasonally weak calendar period, a price correction in equities or credit would be par for the course. Expecting this as a given, however, is difficult with the positive price and economic momentum. Portfolios have a small amount of above average cash levels due to the underweight to alternative assets today. We continue to believe investors expressing a home bias will look back and wish they owned more foreign denominated assets, given the lower valuations and expectations.

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%	40%	50%	56%	70%	76%
U.S. Equity	0%	0%	12%	10%	20%	16%	30%	24%	42%	36%
Int'l - Develop. Markets	0%	0%	6%	8%	12%	15%	16%	20%	21%	24%
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.

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