The Retirement Review

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Midyear Market Review and Outlook

Stock Market Review

- U.S. stocks extended their advance against the backdrop of rising corporate earnings, steady improvement in overall economic conditions and continued hope for an even stronger business environment. For the semiannual period, the Russell 3000 Index (total U.S. market) rose 8.9%.
- In a mirror reversal from 2016, growth stocks trounced value stocks in the first 6 months of 2017. To illustrate the degree to which this occurred, consider the fact that the Russell 3000 Growth Index outperformed its value counterpart by 9.4%.
- Regarding market capitalization (company size), performance was weaker down the market cap spectrum (*i.e.* large caps performed better than mid caps, mid caps better than small caps, and small caps better than micro caps).
- There was a meaningful difference in sector returns as Technology, Healthcare, and Consumer Cyclical stocks led the U.S. market with strong double-digit gains. On the opposite end, Energy was the only sector that posted a loss, and it was a fairly significant one on the heels of a declining oil market.
- After a multi-year stretch of underperformance relative to domestic stocks, foreign equities outperformed by a wide margin. The MSCI ACWI ex-U.S. IM Index (broad foreign index) gained 14.3%, besting the Russell 3000 Index by 5.4%.
- Within the foreign equity market, Emerging Market stocks outperformed developed market stocks. China and India were some of the best performing regions with gains in excess of 23%.

Bond Market Review

- The Federal Reserve (Fed) voted to increase short-term interest rates by 0.25% twice in the 1st half of 2017, illustrating that they have enough confidence in the expansion to tighten monetary policy. Moving forward, it is anticipated that one more rate hike will occur this year - unless the Fed's targets for inflation, unemployment, and overall economic health are not met.
- Despite action from the Fed, interest rates declined steadily throughout the 1st half. The 10-year Treasury bond began the year at 2.45% and ended the semiannual period at 2.31%.
- As a result of the decline in interest rates, overall performance for the U.S. bond market was positive with a 2.3% gain for the semiannual period (as measured by the Bloomberg Barclays U.S. Aggregate Bond Index). All bond market sectors posted gains, led by riskier fare such as Emerging Market and High-Yield Bonds. Among the weakest-performing sectors were U.S. Treasury Inflation Protected Securities (TIPS), Mortgage Backed Securities (MBS), and U.S. Treasuries.
- Across the quality and maturity spectrum, longer maturities and lower quality bonds outperformed. As expected given the rate environment, longer maturities experienced greater price increases as yields fell, and low interest rates continue to positively impact the demand for lower quality bonds.
- In response to improving economic conditions internationally, foreign bonds were a bright spot among the global landscape. The Bloomberg Barclays Global Aggregate ex-U.S. Bond Index gained 6.1%, outperforming domestic bonds by 3.9%.

Stock Market Synopsis - For the first time in a number of years, economic momentum was building on a global scale in the 1st half of 2017. Manufacturing, employment, and rising corporate earnings (both realized and anticipated) were on a positive trend, and this provided a foundation for healthy gains in the broader equity markets domestically and internationally. With this said, several factors related to valuation and currency (weaker U.S. dollar) helped international stocks outperform domestic stocks by a meaningful margin (a stark reversal from recent years). The U.S. market's continued gains have stretched valuations further, and this is based on anticipated improvement in the business environment (as it relates to profitability). The degree of speculation priced into the U.S. market obviously increases risk for investors, but fund management teams continue to be encouraged by economic performance and they state that selective opportunities remain.

Bond Market Synopsis - After a volatile period in fixed income in the later stages of 2016, bond performance steadily improved in the 1st half of 2017. Multiple rate hikes by the Federal Reserve moved short term rates slightly higher, but softer than expected inflation data put downward pressure on longer term rates and they declined throughout the semiannual period. This resulted in broad gains, albeit modest, within fixed income. Bright spots continued to be High-Yield and Emerging Market debt as the low interest rate environment has enticed investors to seek greater potential return in these sectors. In addition, foreign bonds reversed course and outperformed domestic bonds as commodity prices were relatively stable and currency factors served as a tailwind. Overall, it was a favorable period for fixed income investors.

Market Outlook

Positive Stock Influences

- The U.S. economy has been in recovery mode for more than 8 years, and this marks the third longest economic expansion in history. However, what sets this particular expansion apart from others is the modest pace in which growth has occurred. While most investors would have preferred a more significant pace of growth, the modest trajectory leaves many economists with hope the expansion has more room to run.
- The market is anticipating some degree of improvement in the business environment as a result of the administration's efforts to reduce regulations and corporate tax rates. An agreement on corporate tax reform would obviously have a positive impact on net profits.
- U.S. corporate earnings momentum has been increasing recently. While share buybacks and cost cutting are having a positive impact, a large portion of this momentum has been driven by fundamentals as U.S. sales growth is at its strongest level in 6 years.
- Foreign economic conditions are improving, and after years of investor pessimism, sentiment is gradually shifting to cautious optimism. Falling unemployment, improving credit demand, and an increase in manufacturing are all driving the advance.

Negative Stock Influences

- Weak labor force participation (increasingly stemming from an aging population) and weak business investment are factors preventing a breakout in U.S. economic growth. While there is a higher probability of improvement in business investment, weak demographics are a longer-term issue for the economy.
- Broadly speaking, it appears that U.S. equity prices are moderately higher than underlying business values. This stems from a level of anticipation on the part of investors that the business environment will improve, and this is priced into the market. Tighter valuations are always a headwind for future performance, and any challenges the administration faces with their pro-business agenda will likely be met with increased volatility.
- Unexpected policy shifts such as unfavorable trade negotiations or external shocks such as a China slowdown or political uncertainty could also trigger volatility.
- Though economic conditions are improving in foreign economies, they are coming off of low to distressed levels (depending on the region) and structural problems still exist. In addition, foreign economies have proven to be quite sensitive to both inside and outside forces around the globe.

Positive Bond Influences

- The Federal Reserve increased rates twice in 2017 as the recovery in employment continued, inflation remained within an acceptable range, and Fed members were comfortable with the gradual economic recovery in foreign economies. With this in mind, the Fed has stressed a gradual approach to further rate increases, which may lower the degree of interest rate risk and uncertainty moving forward.
- An increasingly large aging population in the U.S. will likely continue to have a positive impact on bond demand as older investors seek the protective and income generating traits that fixed income typically provides.
- While bond prices may be negatively impacted in the near term when rates rise, the outlook for long-term bond investors can be seen in a positive light as income within bond mutual funds is reinvested at higher yields.
- Active managers have the opportunity to improve the risk/reward profile of their portfolios given the growing divergence of monetary policies around the globe and their ability to select from various regions, sectors, and maturities.

Negative Bond Influences

- While market pressures have kept medium to long-term rates in check, it is expected that rates will rise if economic conditions continue to improve. As a result, the near-term outlook for bond returns is more subdued since rising interest rates typically have a negative impact on outstanding bond prices.
- We are in uncharted territory given the massive amount of stimulus that has been injected into the economy through Quantitative Easing (QE) programs. While the Fed has shown caution in normalizing monetary policy, there may be unforeseen risks moving forward if they become more aggressive raising rates and shrinking their massive $4.5 trillion balance sheet.
- Interest rates around the globe are low, and this has forced yield-seeking investors to pursue opportunities in higher yielding, riskier sectors. In these environments, it is common for investors to lose sight of the credit risk and potential volatility of lower quality bonds. This could lead to abnormally high losses for aggressive investors if an economic hiccup causes a change in demand that favors higher quality bonds.

Due to the difficulty of accurately predicting the investment markets, investors should continue to make prudent allocation decisions based on their goals, time horizon and risk tolerance.

Stock Outlook - Stock performance has been fairly one-sided, and as a result, equity valuations (most notably in the U.S.) appear to be slightly above fair value. However, the degree of concern this should cause hinges on whether investor anticipation of an even stronger business environment plays out. If corporate earnings continue to rise and some of the "pro-growth" policies set forth in the form of lighter regulation and tax cuts are implemented, stock performance may continue to be positive over the short to medium term. Of course, if expectations do not play out in a period where prices are above fair value, volatility would likely ensue. With regard to foreign economies, it is evident (in hindsight) that the cautiousness of foreign central banks during and after The Financial Crisis created a gap in economic growth and stock performance with the U.S. Since the market bottom in March 2009, U.S. stocks have outperformed foreign stocks by an astounding 166.7%. With this said, now that foreign central banks have increased their stimulative efforts, economic improvements are materializing and international fund managers are cautiously optimistic that the recovery in foreign stocks has begun.

Bond Outlook - The decline in U.S. interest rates makes the short-term outlook for bonds more challenging, since it only widens the gap between current rates and potentially higher rates down the road. However, the news is not all bad for investors. A key positive for bonds is the gradual nature in which the Fed is taking action and the clarity they are providing with their short and medium-term intentions. A gradual increase in rates reduces the impact of higher rates on bond prices, which helps bond mutual funds better offset price declines with interest earned. In addition, bond management teams can better rotate in a gradual environment to securities that are paying a higher degree of interest. With all of this said, the surprising nature of interest rate movement over the past few years has proven how difficult it is to accurately predict the market's impact on rates over the short term. Investors should pay less attention to the what-ifs of the short term and remain focused on the primary reason for buying bonds in the first place - protection. If the stock market experiences a 20% loss and bonds lose 2%, investors will love their bonds!

Benchmark Information

Stock Benchmarks	Description	Quarter	Semi Annual	1-Year Avg	3-Year Avg	5-Year Avg	10-Year Avg
Russell 3000	Total US Market	3.02	8.93	18.51	9.10	14.58	7.26
Russell 3000 Growth	Growth Stocks	4.65	13.69	20.72	10.83	15.20	8.82
Russell 3000 Value	Value Stocks	1.29	4.32	16.21	7.32	13.89	5.59
S&P 500	Large Cap Stocks	3.09	9.34	17.90	9.61	14.63	7.18
Russell 2000	Small Cap Stocks	2.46	4.99	24.60	7.36	13.70	6.92
MSCI AC World ex-US	Foreign Stocks	5.85	14.30	20.43	1.14	7.58	1.38
Large Growth	Morningstar Categories *(This section represents the performance of the Morningstar categories or peer groups. The categories vary by company size and style.)*	5.01	14.14	20.02	8.80	13.87	7.51
Large Blend		2.92	8.65	17.17	7.60	13.35	6.21
Large Value		1.78	5.55	16.49	6.40	12.64	5.18
Mid Growth		4.68	12.37	18.58	6.86	12.72	6.81
Mid Value		1.03	4.58	17.26	5.74	13.37	6.17
Small Growth		4.33	10.15	23.12	6.67	12.81	7.05
Small Value		0.26	0.52	21.15	5.18	12.47	5.97
Foreign Large Blend		6.25	14.45	19.13	1.18	7.81	0.96
Foreign Small/Mid Blend		8.28	17.98	23.65	3.99	11.31	3.17
Basic Materials	Cyclical *(most sensitive)*	2.13	9.72	20.34	5.08	10.72	4.89
Consumer Cyclical		3.44	11.83	19.03	10.81	16.81	9.85
Financial Services		4.17	7.00	36.60	12.08	18.48	1.30
Real Estate		2.21	4.17	0.29	7.76	9.08	5.05
Communication Services	Economically Sensitive *(moderately sensitive)*	-1.35	1.33	8.09	9.05	14.13	7.64
Energy		-7.66	-13.68	-4.12	-12.05	1.32	2.10
Industrials		4.27	9.16	22.05	9.68	16.08	7.58
Technology		3.96	16.94	33.92	14.53	16.54	10.42
Consumer Defensive	Defensive *(least sensitive)*	1.23	6.77	2.86	10.17	12.84	10.21
Healthcare		7.34	16.61	13.37	11.09	18.13	11.12
Utilities		2.27	8.65	2.92	9.23	11.53	7.08
Fixed Income Benchmarks							
Barclays Aggregate	Aggregate Bond	1.45	2.27	-0.31	2.48	2.21	4.48
Barclays Government	US Government Bonds	1.17	1.86	-2.18	1.99	1.30	3.93
Barclays Credit	Investment Grade Corp. Bonds	2.35	3.68	1.84	3.40	3.68	5.61
Barclays High Yield Corporate	High Yield Corporate	2.17	4.93	12.70	4.48	6.89	7.67
Barclays Global Aggregate	Global Bonds	2.60	4.41	-2.18	-0.35	0.78	3.69
Morningstar Emerging Markets	Emerging Mkt. Bonds	1.90	5.42	5.50	4.36	4.97	7.17
US T-Bill 3 Month	Money Market	0.23	0.39	0.58	0.26	0.18	0.49
Short Term US Government	Morningstar Indexes *(This section represents the performance of varying maturity ranges and of Government bonds and Investment Grade Corporate bonds.)*	0.30	0.61	-0.25	0.84	0.73	2.34
Short Term Corporate		0.78	1.68	1.51	1.79	2.28	3.40
Intermediate Term US Government		0.94	1.68	-1.84	2.00	1.32	4.53
Intermediate Term Corporate		1.77	3.23	2.05	3.18	3.87	5.84
Long Term US Government		3.01	4.43	-5.68	4.69	2.49	6.68
Long Term Corporate		4.02	5.76	3.08	4.86	5.25	7.50

Data Source: Morningstar, June 30, 2017; www.Morningstar.com; fund family Web sites; direct communication with fund families. Note: Past performance does not guarantee future returns. Investment returns and principal values vary and investors may realize a gain or loss when shares are sold. Mutual fund performance shown is after the deduction of all applicable fund operational expenses and fees (net). Mutual fund returns and index returns are provided by Morningstar. The total return is calculated assuming a purchase of the fund shares at Net Asset Value (NAV). More information on funds may be obtained by visiting fund Web sites or by requesting fund prospectuses from your Plan contact.

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