THE RETIREMENT REVIEW

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Responses to Recent Market Questions

With the circus-like news flow over the past few quarters, it is a good time to pause and gain some perspective by addressing the top three questions clients have recently asked related to U.S. stock valuations, the outlook for bonds, and the potential for a sustainable rally in foreign stocks. We will approach each from a high-level, fundamental vantage point with the goal of helping our clients make better-informed decisions. However, to ensure that we do not waste the time of those who are looking for short-term predictions, keep in mind that we avoid market-timing statements in newsletters since there are too many variables at play to predict short-term market movement with a respectable level of ongoing accuracy.

Has the U.S. stock market gotten ahead of itself since the election?

Stock prices ultimately follow the path of underlying corporate values, and a primary contributor to the value of a business is its current and expected earnings (profits). After the election, a fairly large portion of the investor community believed the Trump administration would lead an effort to cut corporate taxes and reduce the regulatory hoops businesses must jump through to operate. Politics aside, both measures would have a positive impact on corporate earnings, so the stock market responded accordingly. This was on the heels of positive returns leading up to the election and greater than 275% gains from the market bottom in March, 2009 as represented by the Russell 3000 Index.

Overall, political decisions have less impact on long-term market performance than most realize. The global economy is a massive engine with many influences beyond politics. However, government decisions do have an impact, especially in the short to medium term, and a strong example can be found in the period following the 2016 election. Market valuations were near "full value" at that time, but the potential for tax and regulatory reform meant that corporate profits could be better than expected, and this justified even higher stock prices.

Toward the end of this latest quarter, the short-term rally ended when the administration struggled and ultimately failed to pass its proposed healthcare legislation. The potential for lower corporate taxes and less regulation was not the "slam dunk" many believed it would be. Of course, this meant that stock prices based on these expectations were too high, so some form of correction needed to occur for prices to more accurately reflect current valuations.

There are two general options for correcting an overpriced market: either a short-term downturn (correction) in prices to a more appropriate level or a sideways market where prices jump around, but basically go nowhere, until true business values catch up with current prices. This is often referred to as a "bunny market".

We have essentially been in a bunny market with a slight downward trajectory since the healthcare bill began to face challenges in late March. Since then, there has been little doubt the market had gotten ahead of itself given the new development. We believe the subsequent choppiness experienced is serving as a form of correction and is reflective of the high degree of uncertainty that continues to exist as a result of the political environment. In addition, the U.S. economy is in pretty good shape, which may be another reason a more rapid correction of prices has not occurred.

(Continued on page 2)

Benchmark Performance	Sector	Quarter	YTD	1-Year Average	3-Year Average	5-Year Average	10-Year Average
Index : Russell 3000 TR USD	Total US Stock	5.74	5.74	18.07	9.76	13.18	7.54
Index: S&P 500 TR USD	Large Blend	6.07	6.07	17.17	10.37	13.30	7.51
Index: Russell 2000 TR USD	Small Cap Stock	2.47	2.47	26.22	7.22	12.35	7.12
Index: MSCI ACWI Ex-US IMI NR USD	Total Foreign Stock	7.99	7.99	13.01	0.82	4.66	1.59
Index: Barclays Aggregate Bond TR USD	Bond	0.82	0.82	0.44	2.68	2.34	4.27
Index: US Treasury Bill 3-Month	Stable Value	0.15	0.15	0.42	0.19	0.14	0.60

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It is common for volatility to increase when markets reach full value, so we will make the same statement we make in every newsletter - avoid the temptation to play the short-term game! The least enjoyable and least productive part of our job is monitoring short-term market factors. Investors should only commit money to stocks they plan to retain for many years, and over that horizon, short-term factors work themselves out. 87% of 5-year periods for the S&P 500 Index have had positive returns, 95% of 10-year periods have had positive returns (with the worst 10-year period in history returning -1.38% per year), 100% of 20-year periods have been positive (with the worst period returning +3.11% per year), and of course 100% of 30-year periods have been positive (with the worst period returning +8.48%). We trust this makes the point, and remember, even a 60-year-old person can own some degree of stock exposure for 30 years. *This information is based on calendar year returns for the S&P 500 Index.*

Should U.S. bond exposure be reduced in anticipation of further interest rate increases?

Logically speaking, if a rise in interest rates has a negative impact on the price of outstanding bonds, and the Federal Reserve is in a tightening cycle, why does it make sense to own bonds? The answer is not as simple as it may seem. First, predicting the direction of interest rates is not a perfect science. For example, the Fed raised rates in December of 2015, and most investors thought rates would steadily climb in 2016. However, a few economic surprises early in 2016 caused the Fed to pause, and interest rates actually declined in the 1st half of the year. As a result, bonds did quite well and those who played the prediction game were wrong.

It is also important to recognize that the pace of the increase in rates is very important. Remember, there are two components of bond returns, price movement and coupon (the interest earned on the bond). If an investor is earning 4% per year on a bond, it would require a price hit of 4%+ within a year to create a negative return. The Fed raised rates mid-March 2017 and they predict in their forecast that two more hikes will occur this calendar year. However, what should calm investors is how clear the Fed is being about their intentions (less surprise factor for rates) and the fact that they are committed to a "gradual" process based on economic results - not an abrupt, steep path of change. A gradual process of normalizing rates will increase the likelihood that the price impact for bonds may be less significant, which may allow coupons to offset a portion or more of the price hit.

An additional consideration for those who gain their bond exposure through actively managed bond funds is that savvy management teams can take steps to reduce the impact of rising U.S. interest rates. We could write an entire newsletter on this (and yes, you would need an extra serving of caffeine to read it), but in general, teams can reduce interest rate sensitivity by buying shorter-term bonds, adjusting their sector exposure to increase their holdings in less sensitive areas, and diversifying their portfolio to include foreign bonds that are in a different cycle with interest rates.

Remember, investors typically own bonds for income and protection, but protection should be the primary goal. No one likes to earn -1.0% in a year, but this is an appealing alternative when the stock market loses -30.0%. If you feel the urge to reduce your exposure to bonds due to the interest rate environment, be careful shifting those allocations to stocks unless you are committed to doing so for a very long time. Stocks are not an alternative for protection!

When will foreign stocks experience a sustainable rally?

As of 3/31/2017, the 10-year average return for U.S. stocks as represented by the Russell 3000 Index was 7.54% and the 10-year average for foreign stocks as represented by the MSCI ACWI ex-U.S. IM Index was 1.59%. Interestingly, this gap was almost entirely caused by a divergence of returns that began in 2011, as displayed in Chart 1 on page 3.

The information on the left side of Chart 2, which was provided by J.P. Morgan, clearly illustrates that corporate earnings were a primary culprit. The obvious question is what caused the disparity in corporate performance from 2011 forward. Of course, numerous factors played a role in this. However, we believe a root cause is the significant difference in the level of stimulus that was implemented by global central banks during the challenging quarters of the Financial Crisis.

The U.S. Federal Reserve was viewed by its international counterparts as being aggressive during that time. However, our leaders felt that it was important to stop the exponential growth of our problems with quick, decisive action, instead of a more conventional "Band-Aid" approach. It will be decades from now before we will know if our Fed's more aggressive measures were prudent, but it is worth noting that foreign central banks have been forced to further increase their stimulative efforts in recent years due to continued struggles in their economies.

A more sustainable recovery in the relative performance of foreign stocks will obviously require a sustainable economic recovery in foreign economies. The good news is that the increased stimulus from foreign central banks in recent years appears to be having a positive impact across a number of key economic factors like earnings and unemployment. The uptick in earnings is illustrated on the left side of Chart 2.

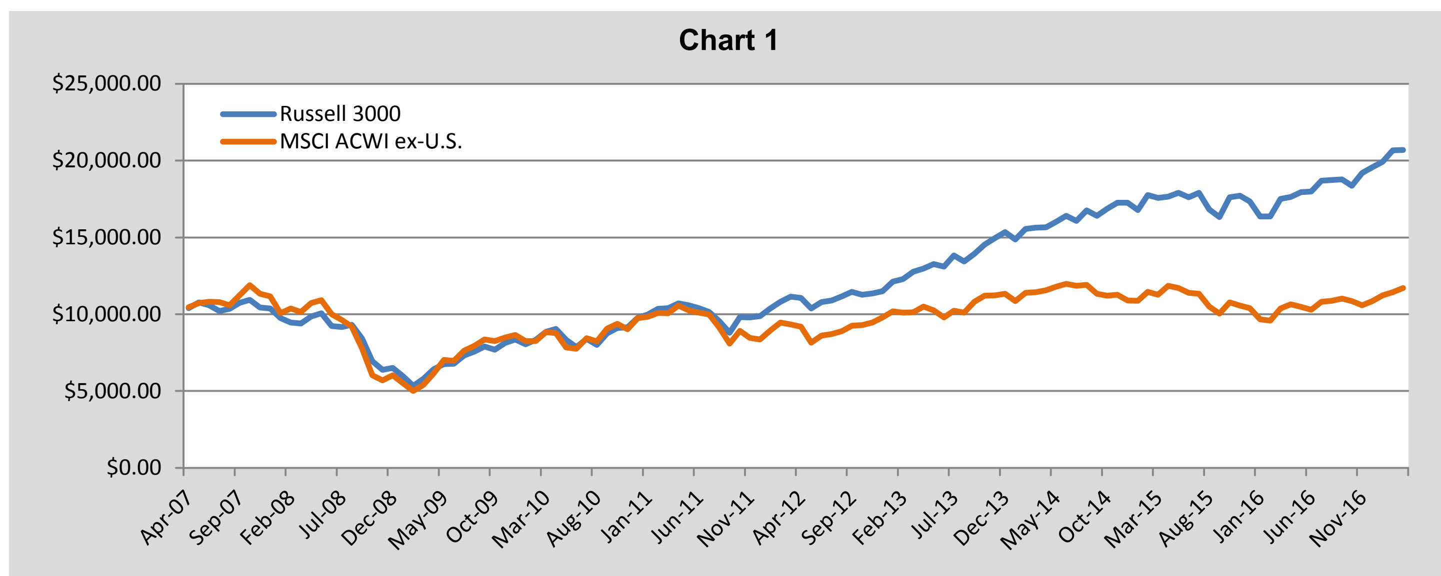
Regarding the information on the right side of Chart 2, which indicates that valuations are full for foreign markets, keep in mind that price metrics have a divisor that also impacts the calculation (*e.g.* price to earnings or price to book). Therefore, these metrics can become more attractive, even as prices rise, as long as earnings or book values increase at a faster pace than prices (which can occur in economic recoveries).

After such a sustained period of U.S. outperformance, it is important to remain cognizant of the fact that domestic and foreign markets tend to have similar returns over the long term. Therefore, it is likely that a sustained rally in foreign

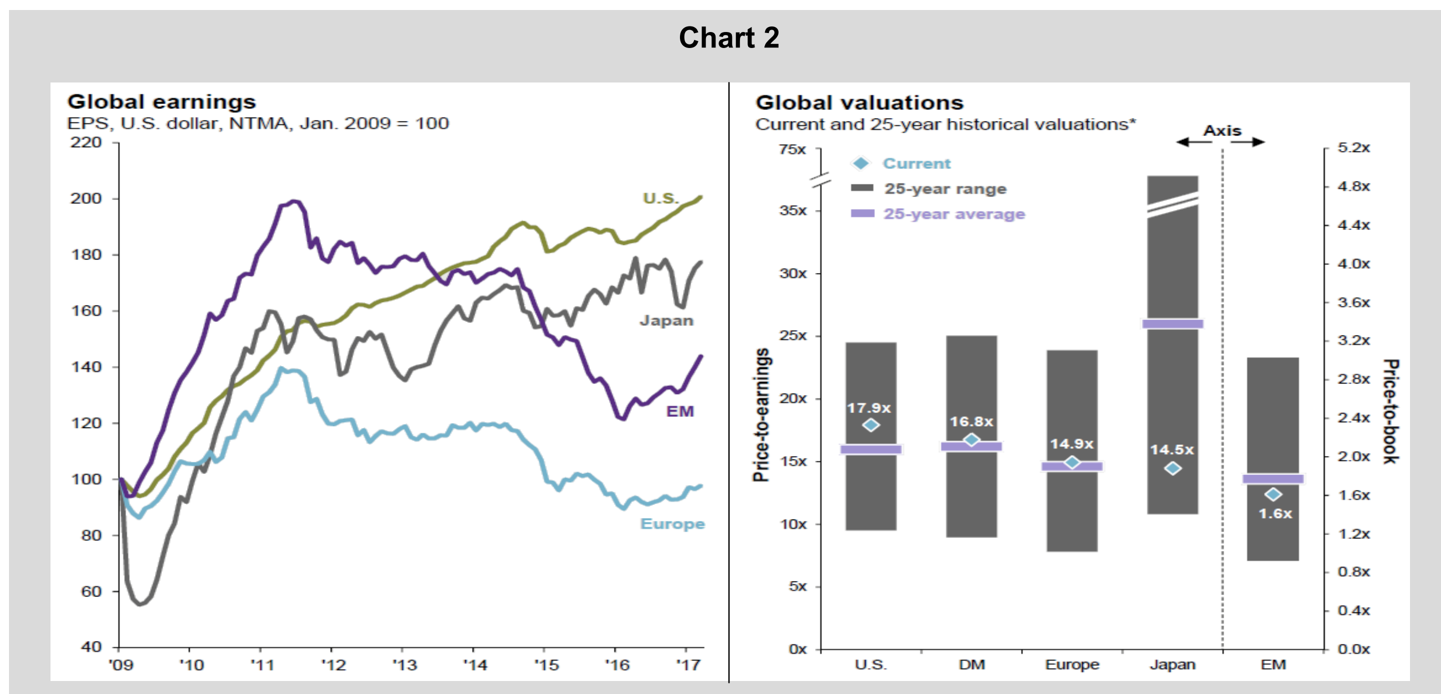
stocks will happen at some point to close the current gap. In fact, there is a chance that it started this year as foreign stocks outperformed domestic stocks in the 1st quarter by 2.25%.

Conclusion

There is content in this newsletter that could cause investors to focus on short-term factors. Therefore, we feel compelled to state that the overall economic and market picture remains balanced with key factors that could meaningfully impact results (in either direction) moving forward. For this reason, as well as the fact that accurately predicting the markets on an ongoing basis is nearly impossible, we continue to urge our clients to avoid the temptation to make short-term market-timing decisions. The prudent way to invest throughout your life is to base allocation decisions on fundamental factors related to your personal financial goals and objectives.



Source: Morningstar Direct. The performance for domestic stocks is represented by the Russell 3000 Index (total U.S. market) while the performance for foreign stocks is represented by the MSCI ACWI ex-U.S. IM Index (total foreign market) for the most recent 10-year period ending 3/31/2017.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. *Valuations refer to NTMA P/E for Europe, U.S., Japan and Developed Markets and P/B for emerging markets. Valuation and earnings charts use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates, which may differ from earnings estimates used elsewhere in the book. Guide to the Markets – U.S. Data are as of March 31, 2017.

Market Comments

U.S. stocks rallied to new all-time highs in the 1st quarter as investors continued to focus on the potential for policy changes from the new administration that would be supportive of further growth in corporate profits. In addition, current economic statistics related to consumer confidence, employment and rising corporate earnings (with current policies) are generally providing evidence of a sound economy. Toward the end of the quarter, the administration's inability to pass healthcare reform ended the euphoric rally and stocks treaded water (additional detail is provided in the newsletter content on page 1). Within the U.S. market, growth significantly outperformed value and larger cap stocks outperformed smaller cap stocks.

Foreign stocks outperformed domestic stocks in the quarter as statistics clearly indicate there is improvement in the global economy. A bright spot was Emerging Markets as growth fears for China temporarily subsided and the country's economic results were ahead of expectations. These factors overshadowed upcoming geopolitical events as 1) key elections are set to take place in Europe over the coming months and 2) the U.K. officially began the two year process of unwinding from the European Union.

In fixed income, bond returns were muted as the Federal Reserve continued their path of interest rate normalization. The Fed voted to increase short-term rates by 0.25% in March, citing favorable economic, employment and inflation data. While many bond investors focused on the rate increase, there was actually a market-driven decline in interest rates, which helped bonds post modest gains during the quarter. A few sectors stood out such as Emerging Market and High-Yield bonds, indicating that investors are still in a "risk-on" mindset as they search for yield in a historically low rate environment. Given the "risk-on" mindset, it is unsurprising that U.S. Treasuries were among the worst-performing bond sectors in the 1st quarter.

Data Source: Morningstar, March 31, 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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