MARKET REVIEW & COMMENTARY

OCTOBER 2017

TELEMUS®

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MARKET REVIEW

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October was a good month as equities of all flavors continued their relentless ascent. The fixed income space witnessed a schizophrenic return set as credit was mildly positive with returns increasing with duration; all Treasuries were mildly negative and municipals were mixed with fractional ups and downs. Alternatives and real assets were broadly mixed. 'Growth' resumed its drubbing of 'value' after September's about-face although large caps continued to outperform their smaller brethren, but by a modest margin. Floaters, TIPS and high yield were up a smidgen, while emerging market and global bonds lost ground. Hedge funds increased modestly while gold and energy were down.

Specifically, the S&P500 rose +2.33% while high dividend payers gained +1.71%. Small cap value eked out a +0.13% return while small cap growth rose +1.55%. Large cap value labored up +0.73%, while large cap growth climbed a robust +3.88%. Emerging markets, one of the year's best performers, gained another +3.51%, while frontier markets also a standout this year, rose +1.23. EAFE continued to climb, gaining +1.52%, as did Europe, which was up +0.47%.

Short term paper reflected bond's asynchronous October returns. 1-3 year U.S. Treasuries were down -0.07%, 1-5 year corporate paper rose +0.08% and 1-5 year municipal paper lost -0.02%. Treasuries with maturities of 1- 20 years experienced -.07 to -.18% losses while corporates with maturities of 1-10+ years gained between +.08% and +.80%. TIPS gained +0.21% and high yield garnered a +.42% return, while world bonds lost -0.54% , and emerging market paper dropped -.13%for the month.

The HFRX Global Hedge Fund Index gained +.69%, the Bloomberg Commodity Index rose +2.14%, precious metals lost -3.67%, global natural resources were down -.05%, and world real estate was up +.79%.

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YEAR-TO-DATE

Year-to-date, U.S. equities continue their upward march but there is an ever-widening disparity of returns. The S&P500 is up +16.91% while U.S. growth stocks are up between +18.62% (small cap growth) and +25.40% (large cap growth). On the other hand, U.S. value stocks continue to lag returning +5.82% (small cap value) and +8.70% (large cap value). For the first year in several, international markets started strong, and remain strong, as we head to year-end. This just might be the year that international steals the performance baton from the U.S. Europe is up +23.37% for the year and MSCI EAFE up +21.78%. Emerging markets continue to be the best performers, up a staggering +32.26% for the year to date.

Bonds of all persuasions continue to maintain positive year-to-date returns. Taxable bond returns have almost caught up with the earlier gains in the municipal market. Short paper returns are between +0.63% and +2.54%, 5-7 year Treasury paper is up +2.21%, 1-5 year municipals are up +2.54%, and TIPS are up +1.94%. Emerging market paper (EMBI) is up 8.49% while high yield bonds are up 7.45% through October.

Alternatives and real assets have experienced varied year-to-date returns. The HFRX Global Hedge Fund Index has logged a respectable 5.15% gain while world real estate is up 10.7%, commodity metals are up +5.14%, and precious metals are up +4.84%. On the other hand, energy is down-11.41%, the Bloomberg Commodity Index is down -.79% and the dollar has given up -7.49%.

World markets remain resilient in the face of political uncertainty, reflecting ongoing global economic improvement and a rebound in corporate profits, as well as sheer momentum in most global equity markets. While corporate profits have rebounded from an earnings recession earlier in the year, historically high valuations seem to be discounting corporate profits rising faster than global growth may allow.

INDEX RETURNS AS OF 10/31/2017

BASIC INDEX RETURNS

	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
BALANCED INDEX (25% ACWI, 60% US Gov. Cr 1-5, 5% HFRX, 5% commodity, 5% bill)	0.64%	0.64%	5.85%	7.54%	16.11%	27.96%
HFRX GLOBAL HEDGE FUND INDEX	0.69%	0.69%	5.15%	3.42%	11.44%	-6.97%
CPI - SEASONALLY ADJUSTED	0.00%	0.00%	1.46%	3.63%	6.37%	17.78%
S&P 500 COMPOSITE	2.33%	2.33%	16.91%	35.92%	100.51%	111.75%
LIPPER LARGE - CAP CORE	1.88%	1.88%	15.87%	31.80%	90.98%	94.15%
WISDOM TREE LARGE CAP DIVIDEND	1.71%	1.71%	13.08%	32.69%	88.31%	103.67%
MSCI ALL COUNTRY WORLD INDEX NET	2.08%	2.08%	19.69%	25.68%	65.60%	46.82%
MSCI EAFE NET	1.52%	1.52%	21.78%	19.37%	49.64%	13.67%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	-0.03%	-0.03%	3.84%	5.68%	9.94%	44.34%
BLOOMBERG BARCLAYS US AGGREGATE	0.06%	0.06%	3.20%	7.37%	10.75%	49.67%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.09%	0.09%	0.66%	1.04%	1.17%	4.47%

EXTENDED INDEX RETURNS

	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
RUSSELL 1000 GROWTH	3.88%	3.88%	25.40%	44.85%	114.84%	143.45%
RUSSELL 1000 VALUE	0.73%	0.73%	8.70%	25.94%	86.05%	85.31%
RUSSELL MIDCAP GROWTH	2.80%	2.80%	20.57%	33.00%	100.49%	124.22%
RUSSELL MIDCAP VALUE	0.81%	0.81%	8.30%	26.89%	93.51%	120.19%
RUSSELL SMALL CAP COMP GROWTH	2.60%	2.60%	22.40%	35.78%	109.59%	137.25%
RUSSELL SMALL CAP COMP VALUE	0.60%	0.60%	7.56%	27.56%	83.75%	108.36%
MSCI EM (EMERGING MARKETS) NET	3.51%	3.51%	32.26%	18.09%	26.06%	8.37%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.09%	0.09%	0.79%	1.74%	2.08%	8.13%
BLOOMBERG BARCLAYS US AGENCY	0.01%	0.01%	2.08%	5.10%	6.97%	35.02%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	-0.13%	-0.13%	8.49%	17.52%	20.89%	93.68%
CITI GROUP WORLD GOVERNMENT BOND	-0.54%	-0.54%	5.81%	2.38%	-1.91%	30.11%
BLOOMBERG COMMODITY	2.14%	2.14%	-0.79%	-25.96%	-39.02%	-51.44%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	-4.08%	-4.08%	2.97%	25.15%	-56.60%	-56.72%
LIPPER GLOBL NAT RES	-0.05%	-0.05%	-0.20%	-6.95%	-0.46%	-25.53%
LIPPER PRECIOUS METAL FUND	-3.67%	-3.67%	4.84%	24.80%	-49.27%	-40.92%
MSCI WORLD REAL ESTATE	0.79%	0.79%	10.70%	14.58%	39.28%	21.56%
LIPPER REAL ESTATE FUND	-0.15%	-0.15%	4.09%	18.99%	44.62%	40.66%

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Over the past month there have been a number of headline news items, some that represent little change from the status quo and others that may be longer lasting and have more meaningful impact. Below is a sampling of both:

A New Fed Chair - Jerome Powell was nominated to replace Janet Yellen as the Chair of the Federal Reserve Board. This announcement turned out to be a non-event given that Powell is the functional equivalent of Yellen, both in his voting record on the Fed and his outlook for Fed action going forward. The more important issue is how the markets will react to the unwinding of central bank balance sheets that have become bloated by quantitative easing over the past eight years.

Corporate Earnings – Corporate earnings improved for the second consecutive month and the market continued to reward earnings growth with valuations that extrapolate the current rate of growth well into the future. According to FactSet 81% of the companies in the S&P 500 have reported actual results for Q3, 74% of companies have reported positive EPS surprises and 66% have reported positive sales surprises. The blended earnings growth rate for the S&P 500 is 5.9%. As for Q4 2017, 51 S&P 500 companies have issued negative EPS guidance, while 26 have issued positive EPS guidance. The forward 12-month P/E ratio for the S&P 500 is 18.0, assuming a $143 of S&P 500 earnings over the next 12 months, which we believe will be difficult to attain.

Budget Resolution - The budget resolution that was passed narrowly by both the Senate and the House included reconciliation instructions, which allow Congress to later reconcile government spending and revenue. It's kind of a resolution to resolve things later, better known as kicking the can down the road. As such, it requires only a simple majority for approval in the Senate as opposed to the higher bipartisan hurdle of 60 votes. A number of GOP legislators had misgivings about the resolution with one (Bob Corker) referring to it as a sham "passed only so lawmakers could move on to tax legislation." And so they have. The current version of the tax bill is highly controversial, not only with Democrats, but with GOP fiscal conservatives that want any tax legislation to be "revenue-neutral." The initial proposals include tax cuts costing $5.5 trillion over the next decade, only $1.5 trillion of which is offset in the 2018 budget resolution. Without "payfors" this $4 trillion gap leaves the revenue-neutral crowd screaming at the top of their lungs. Moreover, "payfors" such as rolling back the 401(k) deduction and the elimination of the SALT (state and local tax, including property taxes) deductions will be fought hammer and tongs by large and powerful lobbies. The very real fact is that reconciling budgets by rolling back long-embedded benefits to powerful constituencies is a

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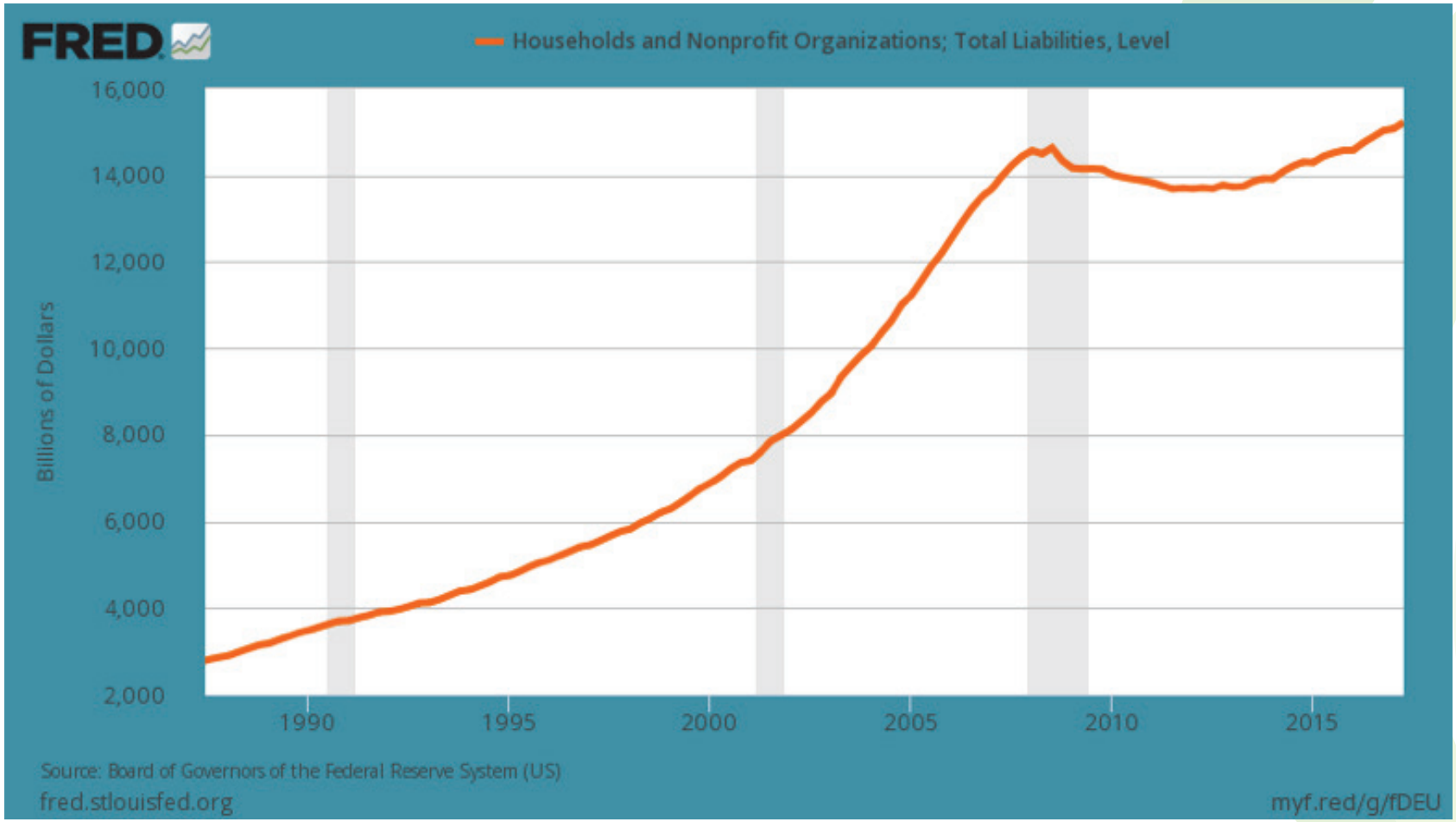
complex and multivariable equation, the solution to which is being worked on by legislators still perfecting primary arithmetic skills. Accordingly, we assign a relatively healthy discount to any tax legislation in 2017, especially considering the Thanksgiving and Christmas holidays leave only about 21 legislative days remaining in the year.

China – The 19th National Congress of the Communist Party of China was held the third week of October during which a new guiding ideology was offered by Xi Jinping, marking the first time since Mao that the party's constitution adopted an ideology named after a living party leader. The importance of this event cannot be underestimated. To wit, 18 months prior to the 19th Congress the PBOC expanded credit in an effort to bolster the Chinese economy, which was beginning to slow as excessive debt weighed heavy. The injection of credit did its job over the short run stabilizing economic growth and raising sentiment among the population, while the Yuan strengthened and the equity market rose. As the 19th Congress drew closer signs were seen throughout the country encouraging support for the Chinese equity market until the October 18th meeting. However, concurrent with such encouragement, PBOC officials were beginning to warn that Chinese corporate debt was too high and began arguing for less financial leverage and new fiscal reforms to constrain local government borrowing. Interestingly, with Mr. Xi's "coronation" as the new Mao safely in place, Chinese bond yields have risen sharply to three-year highs and its yield curve has sunk into negative territory for the longest period on record.

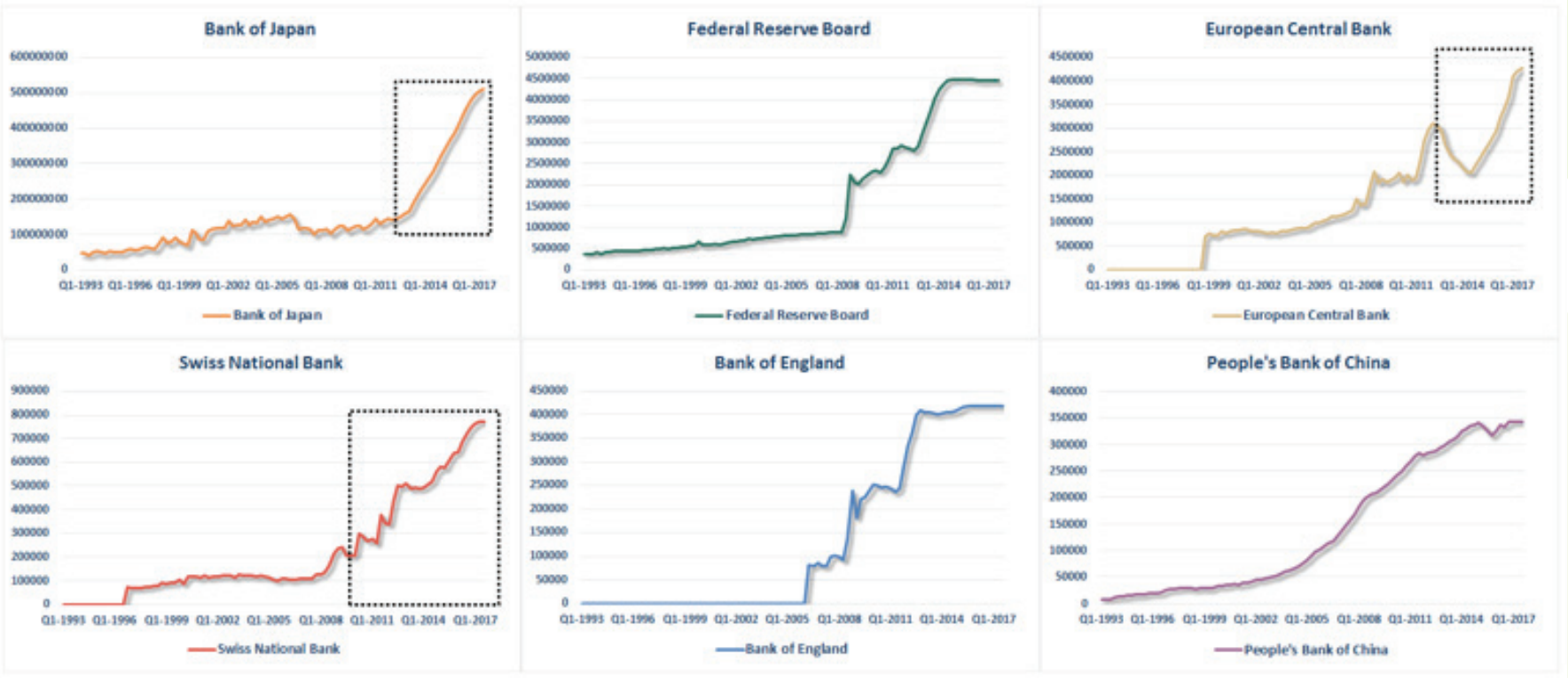
While capitalism is operational within the Chinese economy, no one should doubt that China is a command economy where production, investment, prices and incomes are determined centrally by Mr. Xi and the PBOC. With five years to go before the 20th Congress, the PBOC is likely to follow through with credit reform and resetting expectations for economic growth over the short and intermediate term, before adding stimulus again in a few years just in time for the next Party Congress. We are watching these events carefully as global growth is linked closely to the Chinese economy. A ratcheting down of credit in China and the resultant slowing of their economic growth would ripple through the global economy and impact meaningfully the equity markets that are discounting continued global economic growth.

The triple bull markets in credit, equities and real estate now represent the second longest period of economic recovery in history, so we remain cautious. However, the unprecedented monetary policy of the past eight years has left the current economy in uncharted waters, which makes difficult an assessment of the near term direction of monetary policy, interest rates, and equity market valuations. Accordingly, our fears of excessive global debt and historically high equity market valuations may not be realized for some extended period of time, especially if economic weakness is met with a new round of quantitative easing. Nevertheless, we continue to rebalance accounts in a disciplined way by reducing stocks to targets and reinvesting gains in shorter term bonds and alternative investment strategies that should maintain value better in case of a market decline.

Household debt is now back above 2008 high.

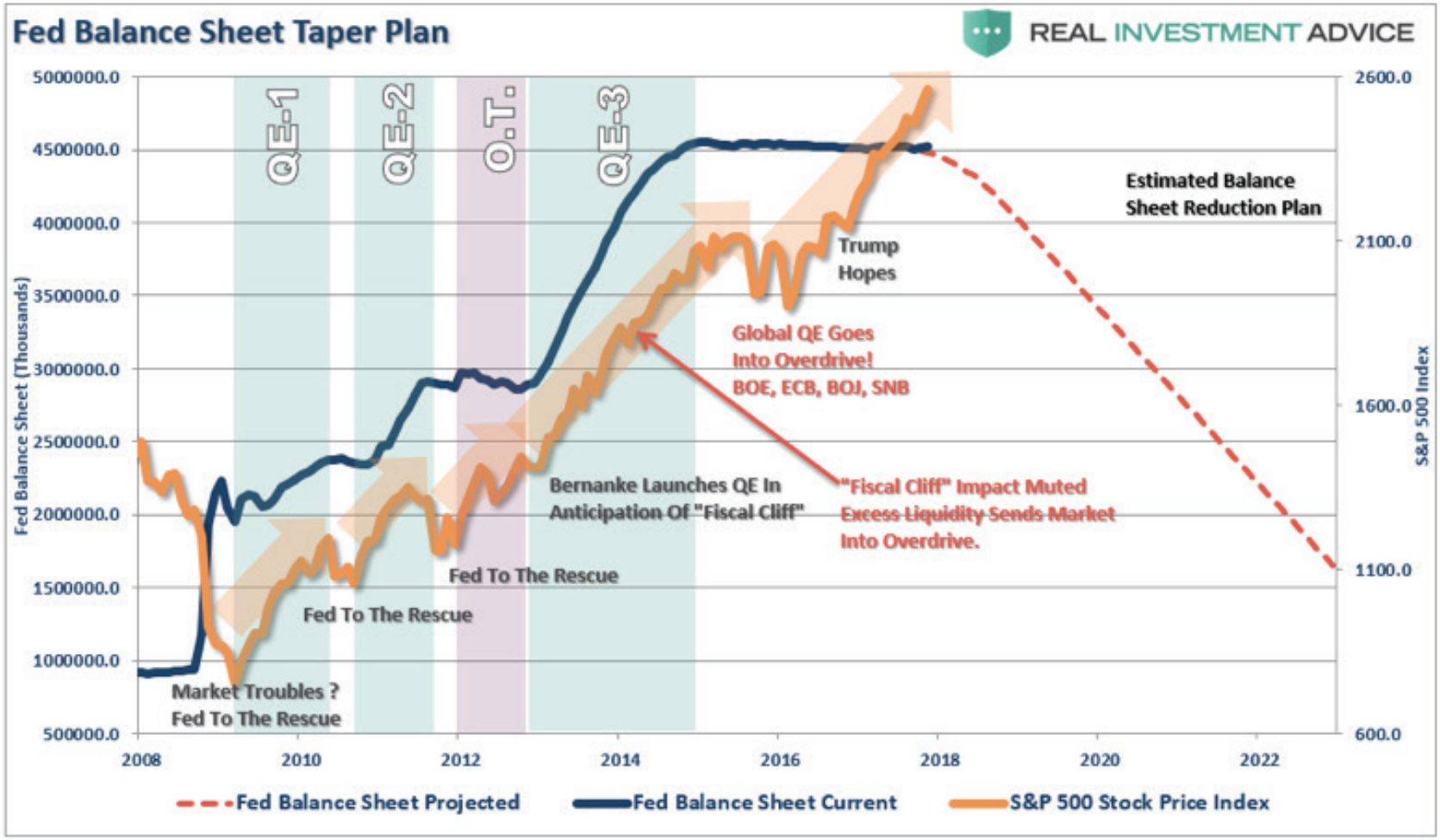


Unprecedented global central bank balance sheet expansion (Quantitative Easing).



[Source: RealInvestmentAdvice.com]

Fed balance sheet expansion created liquidity that drove the market higher. Fed balance sheet contraction will remove liquidity from the markets.



China's yield curve turns negative, historically a precursor to recession.

[Source: Bloomberg]

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