May 2017

# SOL CAPITAL MANAGEMENT COMPANY

## CLIENT INVESTMENT LETTER

### Inside this issue:



Financial markets got off to a strong start in 2017. International equities led the broad rally, delivering their best quarterly performance in five years. Domestic equities maintained their upward momentum, while U.S. bonds advanced amid stable, long-term interest rates. Also, fixed income returns were positive overseas and especially strong in emerging markets.

The period was characterized by rising optimism about the global economy. In the United States, sentiment among investors, consumers, and businesses climbed on expectations that President Trump's proposed policies would push the U.S. economy onto a faster growth trajectory. As shown on Appendix A, "soft" survey data (e.g. sentiment indicators) has soared in recent months, but there has been little movement so far in the "hard" measures of actual economic activity (e.g. growth, unemployment, inflation). Therefore, without the "hard" data to corroborate, we believe it is too early to know if the market's expectations of the new administration and Congress are justified. Nonetheless, even if legislative accomplishments fall short of the administration's goals, we believe the U.S. economy will continue to expand at a solid rate, providing a supportive backdrop for global growth and the markets.

Volatility was exceptionally low during the quarter, despite heightened geopolitical uncertainty. We would not be surprised to see volatility increase to levels more consistent with long-term averages in the coming months as instability continues in the Middle East and Asia, crucial elections are held in Europe, and the Federal Reserve continues to raise interest rates.

## Financial Markets Performance

### Equities

The S&P 500 Index and the Russell 2000 Index rose 6.1% and 2.5%, respectively, in the first quarter, buoyed by the continued post-election surge in consumer, business, and investor sentiment. After having outperformed from the election through the end of 2016, the likely beneficiaries of proposed policy changes (i.e. small-cap and financial stocks) underperformed more stable, large-cap stocks during the first

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**Exhibit 1**
**Total Return* for Selected Equity, Fixed Income, and Hedge Fund Indices**

| | **Year to Date (12/31/16 to 3/31/17)** |
|---|---|
| ***Major Equity Indices*** | **%** |
| S&P 500 Index | 6.1 |
| Russell 3000 Index (Total U.S. market) | 5.7 |
| Russell 2000 Index | 2.5 |
| MSCI All Country Ex-U.S. Index (Net) | 7.9 |
| MSCI EAFE International Index (Net) | 7.3 |
| MSCI Emerging Markets (Net) Index | 11.5 |
| MSCI ACWI Commodity Producers (Net) | (1.6) |
| *Source: Bloomberg, MSCI* | |
| ***Major Fixed Income and Hedge Fund Indices*** | |
| Bloomberg Barclays Capital U.S. Aggregate Bond Index | 0.8 |
| Bloomberg Barclays Capital U.S. Government/Credit Index | 1.0 |
| Merrill Lynch 1-3 Year U.S. Broad Market | 0.4 |
| Merrill Lynch U.S. High Yield BB-B Bond Index | 2.3 |
| JP Morgan Non-U.S. Global Bond Index (GBI) Hedged | (0.4) |
| JP Morgan EMBI Global Index in USD (Emerging Markets) | 3.9 |
| HFRX Equal Weighted Strategies Index (Hedge Funds) | 1.5 |
| *Source: Bloomberg, MSCI, PIMCO* | |

** Includes price appreciation plus dividends and/or interest.*

**"On an overall basis, companies in the S&P 500 Index reported their first year-over-year increase in earnings growth in six quarters."**

quarter. Similarly, growth stocks generated much stronger returns than value stocks across all capitalization ranges. These shifts in market leadership suggest that investors may be tempering their expectations about the extent of reforms that may be implemented.

On an overall basis, companies in the S&P 500 Index reported their first year-over-year increase in earnings growth in six quarters. Information technology gained an impressive 12.6%, making it the best-performing sector for the quarter, followed by consumer discretionary and health care, which rose 8.5% and 8.4%, respectively. Significantly, earnings of energy companies were positive for the first time since mid-2014, reflecting the stabilization in oil prices that has occurred over the past twelve months. Despite this improvement in earnings however, energy was the worst-performing sector in the S&P 500 Index during the first quarter, declining 6.7% as the recovery in oil prices slowed.

The first quarter saw a revival in leading economic indicators and

## Financial Markets Performance Cont.

corporate earnings growth in both international developed and emerging markets. Which, coupled with a broad strengthening in local currencies, helped non-U.S. equities (especially emerging markets) outperform in U.S. dollar terms. The MSCI EAFE Index and the MSCI Emerging Markets Index returned 7.3% and 11.5%, respectively, in U.S. dollars. European shares led the gains in international developed markets, while Latin American and Asian equities were the best-performing stocks in emerging markets. After several years of underperformance, the positive momentum in local economies and earnings has improved the outlook for international stocks versus U.S. stocks.

## Fixed Income

The Federal Reserve increased its key policy rate 0.25% on March 15 and signaled two more rate hikes by year-end, causing yields to rise on short-term U.S. Treasury securities. However, consistent with the flattening yield curve, the yield on the bellwether 10-year U.S. Treasury note decreased from 2.45% at the start of the year to 2.40% on March 31.

Yields on longer-dated Treasury issues remained stable, anchored by expectations of steady U.S. economic growth and modest inflation, as well as consistent demand from large institutional investors. The stability in long-term U.S. interest rates, combined with coupon income, contributed to a 0.8% total return in the Bloomberg Barclays U.S. Aggregate Bond Index for the first quarter. While all major sectors of the U.S. investment grade fixed income market advanced, corporate securities posted the strongest gains, particularly lower-quality issues. European and Sterling investment grade corporate bonds also generated positive returns in local currencies.

Reflecting investors' continued pursuit of yield in the low-rate environment, U.S. and European high yield bonds outperformed investment grade corporate securities, and emerging market debt rebounded from fourth quarter weakness. In addition to demand for yield, these segments of the fixed income market benefited from the improving global economic fundamentals and a rebound in corporate earnings.

**"After several years of underperformance, the positive momentum in local economies and earnings has improved the outlook for international stocks versus U.S. stocks."**

## Global Economic Outlook

> **"The world's economies are experiencing one of the most synchronized expansions in years."**

The world's economies are experiencing one of the most synchronized expansions in years. The major economies (e.g. the U.S., China, Japan, and Europe) are all expanding nicely. As shown in Appendix B, the U.K., Canada, and Australia are in the most mature stage of the business cycle. In these specific countries, we believe the housing markets (which have been buoyant) will be strong indicators of any change in their economic conditions.

China continues in recovery mode, playing a major role in the global expansion. Fueled by exceptionally accommodative monetary and fiscal policy, China pulled out of its "growth recession"[1] in 2016. Furthermore, improvement in its economy is enhancing global trade and commodity prices. Additionally, China's recovery has supported global manufacturing, which has expanded at its fastest quarterly rate in nearly six years and global growth appears poised to expand at a healthy 3.5% in 2017 (see Exhibit 2).

### United States

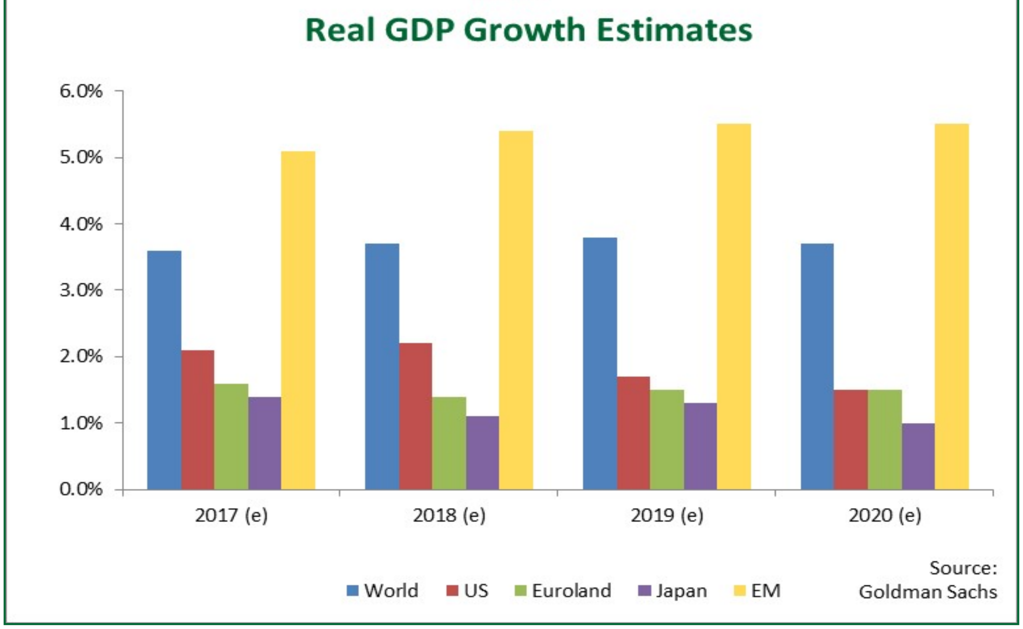
The consensus view is that the U.S. economy will grow at an annual rate slightly above 2% in both 2017 and 2018. While the current expansion is now eight years old, we do not see any indications that a recession is on the horizon. Capital spending has firmed and the industrial sector has rebounded. Housing starts are at an eight-year high, unemployment has fallen to its lowest level in nearly a decade, and consumers' balance sheets remain healthy.

At the same time, a number of headwinds are likely to keep the U.S. economy from breaking out of the 2% growth trend that has been in place since the Great Recession (2008-09). Business inventories are relatively high and the strength of the U.S. dollar is weighing on exports. Furthermore, for the U.S. economy to achieve significantly higher long-term growth, it would require a meaningful expansion in the labor force and increased capital investment in labor productivity. Both seem unlikely as the working-age population is getting older, growth rates in younger generations are slowing, and there has been little improvement in labor

*[1]A growth recession occurs when a rapidly expanding economy slows to a weaker, but still positive growth rate. This deceleration can create the same economic hardships (e.g. higher unemployment) as an actual economic contraction.*

## Global Economic Outlook Cont.

Exhibit 2




productivity in the last decade (see Appendix C).

Changes to government policies could help address these challenges. However, the new administration's priorities on immigration run counter to growth in both skilled and unskilled labor. Also, continued partisan politics, as well as the lack of consensus in the Republican Party will likely make it difficult to implement reforms.

Deregulation may be the easiest route to implement reforms that could stimulate the U.S. economy. However, we are skeptical that deregulation would spur significantly higher levels of capital spending, as companies may be unwilling to invest in long-term (e.g. 20-year) projects knowing that curtailed regulations could easily revert back under a new Congress or future administration.

As we think about what U.S. lawmakers might be able to accomplish, increases in defense and infrastructure spending seem possible, as do reductions in corporate tax rates. That said, any reduction in tax rates may not be as large as financial markets are expecting, given the level of political compromise that will be required.

It is also important to recognize the effect additional fiscal stimulus will have on federal budget deficits and the accumulated federal debt if it is not financed by spending cuts (see

**"As we think about what U.S. lawmakers might be able to accomplish, increases in defense and infrastructure spending seem possible, as do reductions in corporate tax rates."**

## Global Economic Outlook Cont.

Appendix D). Moreover, stimulus tends to be most effective when there is substantial slack in the economy, monetary policy is accommodative, and business investment is strong. None of these conditions exist today in the U.S.

> **"The European economy is expected to continue to grow at a modest rate, despite the uncertainty created by upcoming elections in several countries."**

### Europe and Japan

The European economy is expected to continue to grow at a modest rate, despite the uncertainty created by upcoming elections in several countries. Over the past two years, the region's economies have benefited from a weaker euro, lower oil prices, a recovery in global trade, and expansionary fiscal and monetary policies. Growth in both the manufacturing and services sectors has accelerated to a six-year high, unemployment continues to decline, and demand for credit remains strong (see Appendix E).

In April, the European Central Bank (ECB) began tapering the amount of its monthly bond purchases from €80 billion to €60 billion, a scheduled reduction that was announced last December. We see the potential for additional tightening in the future, either in response to higher rates of growth or inflation, or because the ECB has reached the limits of its bond-buying program.

Japan is poised for continued expansion, supported by growth in the manufacturing sector, low unemployment, and modestly improving wage growth. Nonetheless, unfavorable demographics will likely contain annual GDP growth to approximately 1% over the next few years. Japan's population is both aging and shrinking, while social norms and government policies stymy immigration that could support the contracting labor force. These trends negatively affect economic output and household spending, and further strain the country's pension system.

### Emerging Markets

The growth outlook for emerging markets is strong, led by Asia where pro-growth policies and tight labor markets are causing domestic demand to accelerate across much of the region. In China, employers created a record number of jobs in 2016, the housing sector has rebounded, and industrial activity is strengthening (see Appendix F). Chinese policymakers are now shifting to a less-accommodative stance in efforts to control credit growth, despite continued excess production capacity.

India's economy slowed mildly in the fourth quarter following the government's decision to take the country's largest denominations of currency notes out of circulation.

## Global Economic Outlook Cont.

However, GDP growth is expected to rebound relatively quickly as Indian consumers and businesses adjust to the change.

On the heels of deep recessions, Brazil and Russia appear poised for modest grow in 2017, aided by the stabilization in commodity prices that began early last year. Firming commodity prices are also benefiting other countries that export raw materials, such as Colombia and Peru.

## Investment Strategy

### Equities

We believe the U.S. stock market is fully valued and corporate earnings growth appears to be peaking. Furthermore, if wage growth continues to increase (as anticipated), it may make it more difficult for companies to maintain already-elevated profit margins, thereby tempering expected returns. That said, fuller valuations and the potential for slower earnings growth do not necessarily mean that domestic equities cannot continue to advance. These conditions simply suggest that further near-term gains may occur at a more measured pace than the gains we have witnessed since February of last year. Moreover, regardless of the direction the broad indices may take, we continue to identify areas within the equity market that look attractively valued relative to fundamentals. Additional shifts in market leadership and a resurgence in volatility may also create opportunities in the U.S. stock market.

Valuations continue to be more attractive overseas, even after the strong first quarter rally of foreign equities. Furthermore, local currencies remain relatively weak against the U.S. dollar. Both of these factors bode well for international equity returns, and we continue to maintain exposure to non-U.S. stocks, where appropriate. We believe the most compelling long-term opportunities reside in emerging markets, where valuations are below their 25-year historical average, corporate earnings-per-share forecasts are trending higher, economic growth is generally strong, and demographics are favorable.

### Fixed Income

We continue to underweight fixed income, where appropriate, as we believe the asset class remains overvalued. While default rates are low and there are no signs of recession, yield premiums on non-government bonds (relative to government

**"We believe the most compelling long-term opportunities reside in emerging markets, where valuations are below their 25-year historical average..."**

## Investment Strategy Cont.

> **"Despite the headwinds facing fixed income markets, an allocation to bonds remains a core component of a well-diversified portfolio, lowering risk and providing income."**

bonds) have narrowed to levels not seen since mid-2014.

In addition, we expect the Fed to follow through on its plans to continue raising short-term interest rates, barring any major setbacks in the U.S. economy. The Fed's actions will likely ripple through the bond market, although the effects on longer-term bonds may be more muted, due to steady demand for long-term securities from insurance companies and other large institutional buyers. It is also possible that in 2017 or early 2018, the Fed will begin reducing the size of its balance sheet by unwinding the Treasury and mortgage-backed securities (MBS) it acquired under its various quantitative easing programs. If the Fed decides to unwind its assets, the increased supply of Treasury bonds and MBS in the market may have a negative impact on the returns of U.S. fixed income. However, we believe the Fed would be thoughtful in its implementation to minimize strains on the market.

Despite the headwinds facing fixed income markets, an allocation to bonds remains a core component of a well-diversified portfolio, lowering risk and providing income. To minimize downside risk and volatility, we continue to emphasize high-quality, shorter-duration bond funds, as well as unconstrained fixed income strategies, both of which are less exposed to movements in interest rates. Furthermore, unconstrained approaches have the flexibility to avoid overvalued areas of the markets and pursue more attractively valued areas, such as emerging market sovereign and corporate debt.

## In Closing

As we opened this letter, financial markets delivered a strong performance in the first quarter of 2017. The U.S. economy is expanding at a healthy pace, and economic activity in the eurozone has accelerated. China and other emerging Asian economies are performing well, causing a resurgence in demand for commodities, benefiting Brazil, Russia, and other commodity-exporting nations.

Despite relatively low volatility in the first quarter, we expect it to return to long-term average levels in the future. If we experience short-term spikes in volatility, it is important to remember that they are a normal part of the investment process for investors

## In Closing Cont.

seeking attractive, long-term returns. In addition, volatility often presents opportunities to buy high-quality assets at less expensive prices. History shows that markets react in different ways to Fed tightening cycles, although, on average, the S&P 500 Index has advanced during the previous five rate-hiking cycles.

As always, we are focused on maintaining broad diversification by asset class, geographic market, asset size, and investment style to protect against market volatility.

In addition, we continue to thoughtfully rebalance portfolios as we work to meet your long-term investment goals, within your risk profile, and fund your future liquidity needs.

Please call us at +1 (301) 881-3727 to make us aware of any changes in your circumstances, or if you have questions about your portfolio.

Sincerely,

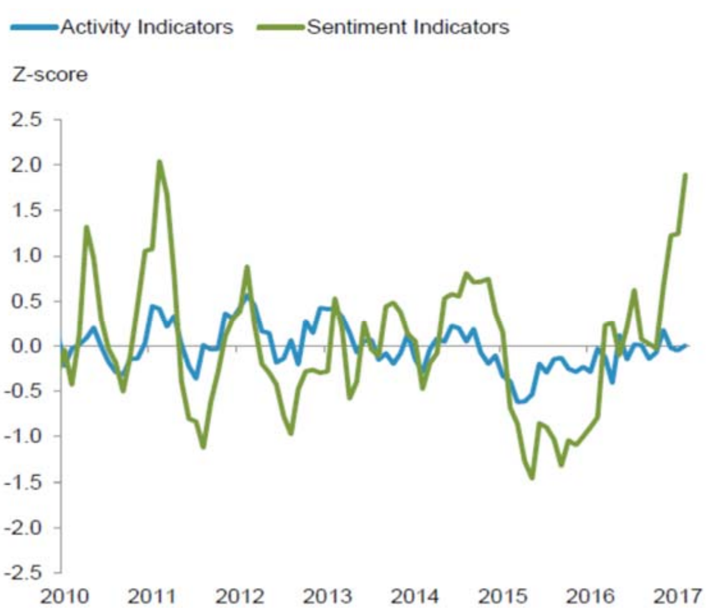
The SOL Capital Management Team

**"...we are focused on maintaining broad diversification by asset class, geographic market, asset size, and investment style to protect against market volatility."**

## Appendices

**Appendix A**

### U.S. Economic Surprise Index

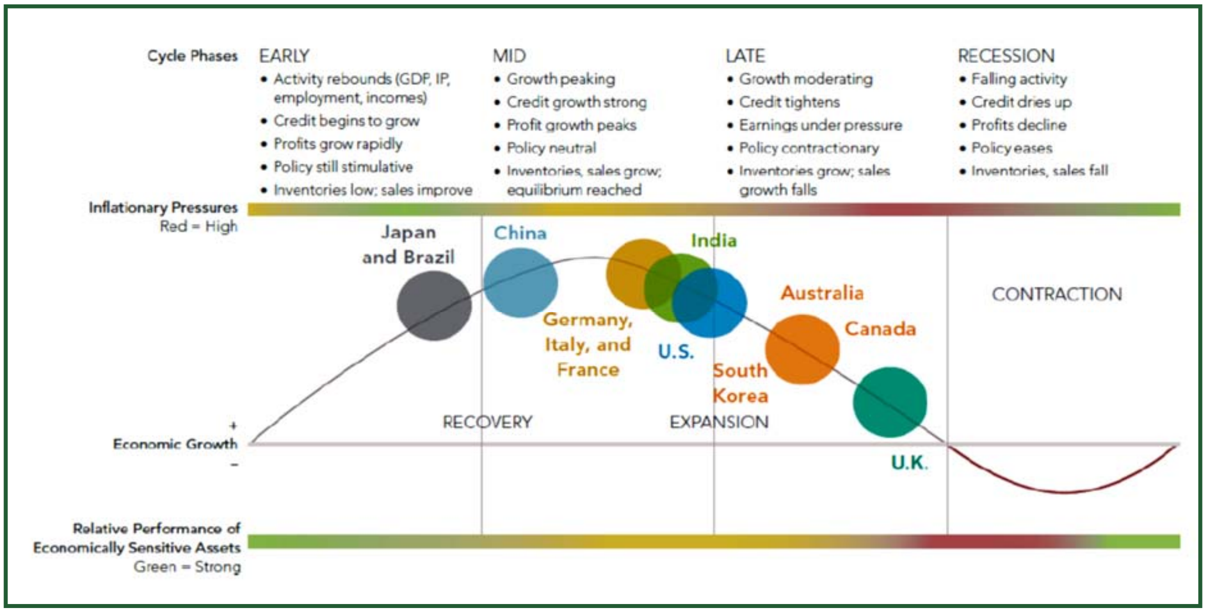



*Source: Second Quarter 2017 Quarterly Market Update, **Fidelity Investments**, page 18*

# Appendices Cont.

### Appendix B

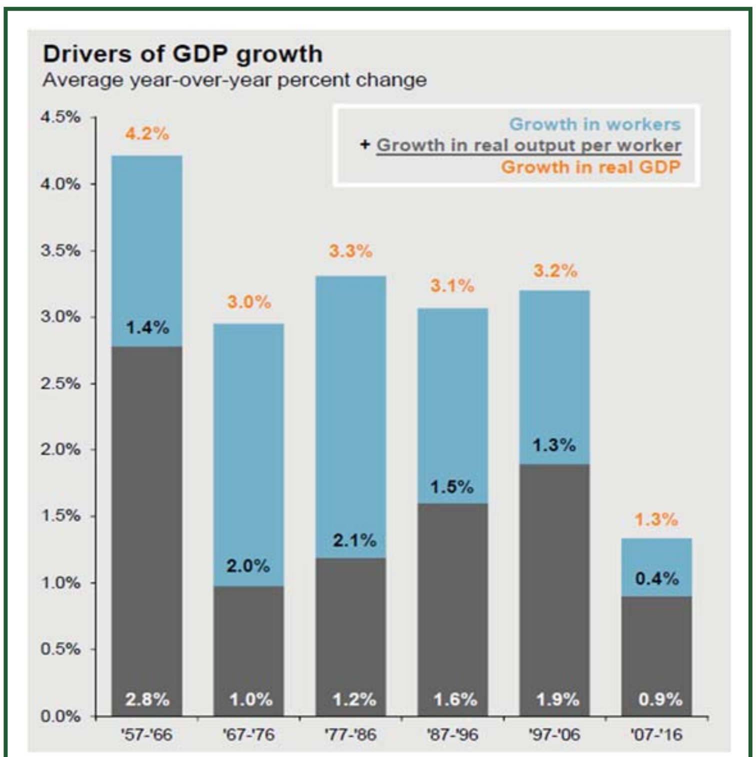
## Business Cycle Framework




*Source: Second Quarter 2017 Quarterly Market Update, **Fidelity Investments**, page 16*

### Appendix C

## Labor Force and Labor Productivity

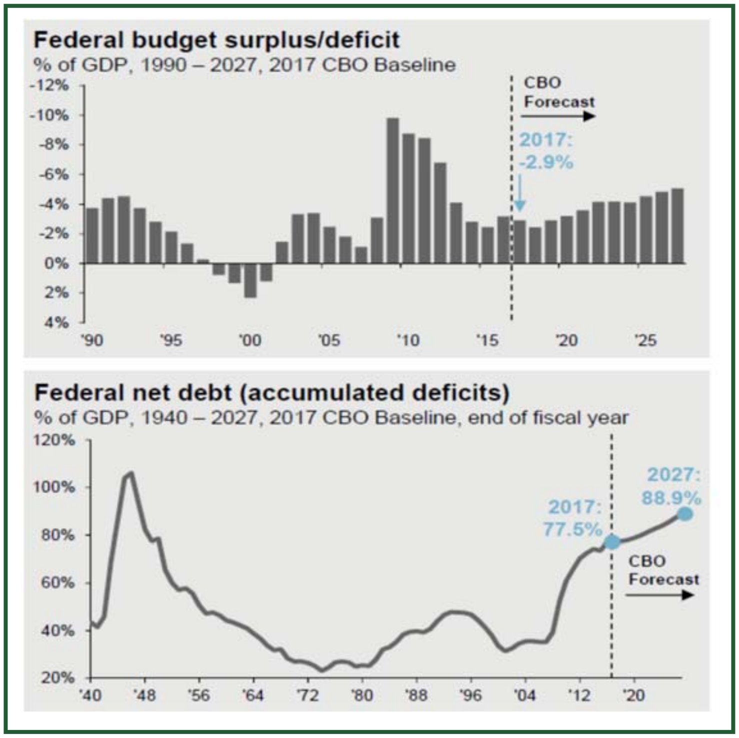



*Source: Guide to the Markets 2Q 2017, **J.P. Morgan Asset Management**, page 23*

# Appendices

**Appendix D**

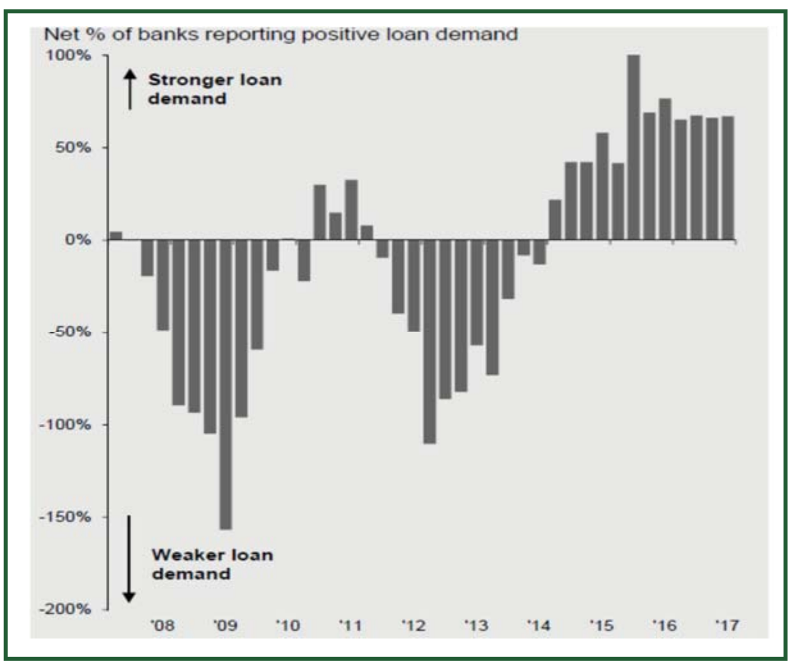
## U.S. Federal Finances




*Source: Guide to the Markets 2Q 2017 – **J.P. Morgan Asset Management,** page 24*

**Appendix E**

## Eurozone Credit Demand




*Source: Guide to the Markets 2Q 2017, **J.P. Morgan Asset Management**, page 47*

## Appendices Cont.

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**Appendix F**

### Chinese Industrial Activity


*Source: Second Quarter 2017 Quarterly Market Update, **Fidelity Investments**, page 17*

*Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by SOL Capital Management Company), made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from SOL Capital Management Company. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. SOL Capital Management Company is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the SOL Capital Management Company's current written disclosure statement discussing our advisory services and fees is available upon request. <u>If you are a SOL Capital Management Company client, please remember to contact SOL Capital Management Company, **in writing**, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services.</u>*

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