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SECOND QUARTER 2017
MARKET REVIEW

Major stock indexes posted another good quarter of returns, reaching record territory during the period. Volatility remains extremely low as underlying economic data has been mostly positive for stocks, with low inflation and moderate growth. Earnings growth continued to support stocks in the second quarter, as the rebound from weak energy prices and a strong dollar continues. Healthcare stocks led the way as expectations for healthcare reform faded on disagreement among house Republicans on a replacement plan.

We did see a "sector rotation" through the quarter, as good economic data helped "pro-cyclical" stocks in industries such as industrials, technology, financial services, and consumer cyclicals. The energy sector posted losses on falling oil prices, and utilities had a difficult quarter in the face of rising interest rates. While value stocks outperformed the overall market in 2016, growth stocks have been the winner this year as the Russell 1000 index of growth stocks has returned 14.0% through the first half of the year, versus only 4.7% return for the Russell 1000 Value index. Typically, growth stocks outperform in a strong economy as investors feel better about paying more for a stock that has a strong growth profile, even though it may be several years until the company grows into its high stock valuation. International stocks posted another quarter of solid returns on the heels of accelerating global growth, attractive valuations, and stabilizing currency.

Major Stock & Bond Indexes (Total Return)			*Lipper Mutual Fund Indexes (Total Return)*		
	2Q17	YTD		2Q17	YTD
S&P 500 Index	3.1%	9.3%	Large-Cap Core Funds	3.0%	8.7%
Russell 1000 Growth	4.7%	14.0%	Large-Cap Growth Funds	5.5%	15.3%
Russell 1000 Value	1.3%	4.7%	Large-Cap Value Funds	1.9%	5.6%
Russell Midcap Index	2.7%	8.0%	Mid-Cap Core Funds	1.8%	7.4%
Russell 2000	2.5%	5.0%	Small-Cap Core Funds	1.6%	3.5%
MSCI ACWI Ex USA NR (USD)	5.8%	14.1%	International Large-Cap Core	6.2%	14.3%
MSCI EM (USD Gross)	6.3%	18.4%	Emerging Markets	5.8%	17.8%
S&P U.S. REIT TR	2.0%	3.7%	Core Bond	1.4%	2.4%
Barclays US Agg. Bond (3-5yr)	1.5%	2.3%	Intermediate Municipal Debt	1.6%	3.0%

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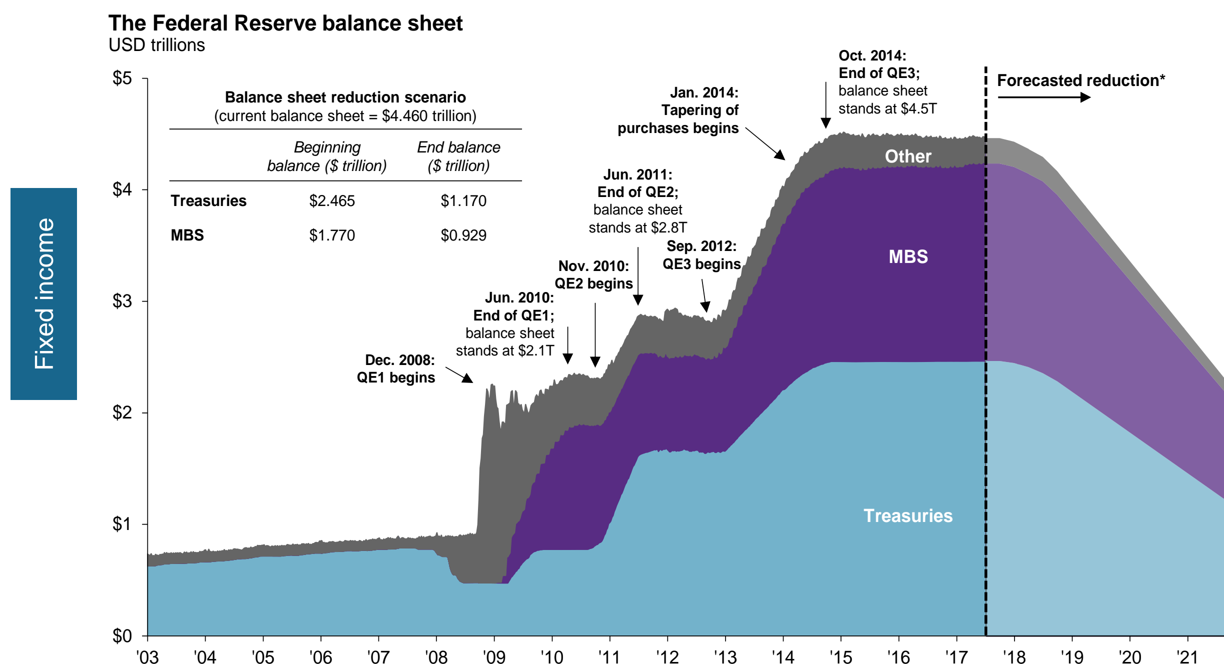
THE U.S. ECONOMY:

The U.S. economic expansion celebrated its eighth birthday during the quarter, making it the second longest in history, although still two years short of the record ten-year expansion through the 1990's. All expansions must eventually end; however, there are no indications of a recession on the near-term horizon. The unemployment rate of 4.3% is the lowest in 17 years, and job openings are the highest ever recorded in the 17-year history that they have been tracked. The monthly jobs report is starting to show a slowing in job creation, with all indications that this is due to a lack of qualified workers to fill the positions, rather than a slowdown in the willingness of businesses to hire. The falling labor force participation rate is largely due to Baby Boomers reaching 65 years old when they are eligible for Medicare and Social Security, and unfortunately, a growing drug abuse problem in the country, particularly in areas hardest hit by a falling number of manufacturing jobs. Slowing housing starts and new vehicle sales could be areas for concern down the road, but for now, there are no major red flags that would indicate a recession in 2017 or even into early 2018. Historically, economic expansions don't die from old age, they die from overheating, which doesn't appear to be a current risk. In previous expansions the economy has grown to an average of 125% of its prior peak, and is currently only at 112% of its prior peak, meaning we still have more to grow in order to reach the average recovery.

The Federal Reserve is likely to steal the spotlight from politics, and should garner much of the market's attention for the rest of the year. The Fed appears intently focused on "normalizing" interest rates after a prolonged period of low rates following the 2008 financial crisis. Rather than waiting for inflation data to move rates higher, the standard now appears to be that as long as the economy does not appear to be at risk, short-term rates will go higher. It is possible that in this business cycle, we do not get the typical acceleration in inflation towards the end of the expansion as highly compensated Baby Boomers are retiring in large numbers and being replaced in the workforce by younger Millennials, keeping wage inflation low. Many economists believe that the Fed waited too long to normalize rates, possibly due to the presidential election, and are now trying to catch up by raising aggressively rather than waiting for inflation.

In addition to raising short-term interest rates, the Fed has indicated it would like to reduce the size of its balance sheet later this year. In order to help stimulate the economy in 2008, the Federal Reserve started buying longer dated debt instruments, including Treasury bonds and mortgage backed securities, which was intended to reduce long-term interest rates and spur business activity. Although the Federal Reserve does usually hold a nominal amount of Treasuries on its balance sheet, these purchases or "quantitative easing" as it became known as, added about $4 trillion in bonds to its balance, bringing total holdings to $4.5 trillion by the end of 2014 when it ended the program. This bond purchase program has never been attempted before, so the impact of unwinding this massive amount of bond holdings is not known. Many economists feel that the data shows bond purchases by the Federal Reserve from 2008 to 2014 had very little actual impact on interest rates, and therefore, selling the positions back to the market will not meaningfully increase rates. Other economists believe that the Federal Reserve will coordinate with other global central banks on selling debt instruments, creating havoc on global markets. Though we are not overly concerned about the unwinding of the Fed balance sheet as adjustments can be made along the way, the combination of traditional tightening and unwinding of the balance sheet make the Fed one of the bigger risks to economic expansion.



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.
*Balance sheet reduction assumes reduction from current level, beginning October 2017 and lasting four years, concluding in October 2021. Reduction of Treasuries and MBS is per FOMC guidelines from the June 2017 meeting minutes: Treasury securities will be reduced $6 billion per month initially and reduction rate will increase in steps of $6 billion at three-month intervals over 12 months until reaching $30 billion per month; MBS will be reduced $4 billion per month initially and reduction rate will increase in steps of $4 billion at three-month intervals over 12 months until reaching $20 billion per month; Other assets are reduced in proportion. Forecasts do not take into account months where maturing assets do not exceed the stated cap nor do they consider the reinvestment of principal or interest repayment in excess of the stated cap.
Guide to the Markets – U.S. Data are as of June 30, 2017.

STOCK MARKETS:

U.S. stocks continued to reach new highs during the quarter, with the S&P 500 up another 3.1% during the second quarter, bringing the year-to-date return to 9.3%. Corporate profits also continue to grow, which has helped keep valuations somewhat in check. However, the S&P 500 remains about 10% to 15% overvalued on many metrics. An overvalued market is not a sign that a correction is imminent, as markets can remain expensive for an extended period of time. Investors are hopeful that corporate tax cuts will be enacted in the later part of the year, which could bring valuations back in line with historical averages. For example, if the corporate tax rate was cut from a 35% Federal rate to 25%, profits would increase by 10%, bringing valuations back in to line with average levels over the past 30 years. The failure of the President and Congress to agree on legislation to cut corporate taxes is probably the biggest risk to stocks in the second half of 2017. Although the market got a little bit of a reality check in May as healthcare reform ran into trouble, it still appears that the market is pricing in tax reform. Republicans in Congress should have an easier time agreeing on tax reform than healthcare, however the narrow majority in the Senate will still present a challenge. There is also support for corporate tax reform among many Democrats, although it is difficult to see the two parties cooperating on anything in the current environment.

International markets have been the star performers this year, with the MSCI-ACWI index, a broadly diversified index of international developed market countries, up 14.1% for the first half of the year and the emerging market index up 18.4%. Although international markets no longer appear cheap relative to their historical valuations, they do not appear overvalued either. Given that global growth is accelerating, a recovery in profits should drive stock prices higher for some

time to come. Moreover, the strong rally in the U.S. dollar over the past several years appears to be reversing and should no longer be a headwind given better international growth.

OUTLOOK:

Elevated stock valuations are not a sign of an imminent correction or bear market, although they are a reason to temper longer-term return expectations. Current valuations would imply a five-year return outlook in the mid-single digit range, versus double-digit return expectations for an undervalued market. History tells us that returns are not likely to be even, and the last few years of a bull market typically has the best returns. It does make sense to look into investments as an alternative to stocks, although challenges facing the bond market are much greater as we head into a rising rate environment following a 30-year bull market for bonds. To this end, we have moved more aggressively into international markets with better risk-to-reward profiles, and other investments that can still produce reasonably strong returns in a variety of markets.

Outside of the coming debate on tax reform, the Federal Reserve is likely to take center stage. Although the immediate impact of a Fed rate hike on stocks is usually negative, they typically recover and perform positively in overall low rate environments. Historically, rising rates signal stronger economic growth and industries such as industrials, financials and cyclical sectors do quite well. Conversely, defensive sectors such as consumer staples and health care, along with interest rate sensitive industries such as utilities and telecom services do poorly.

COMMUNICATIONS FROM HC FINANCIAL ADVISORS, INC.

We want to meet with you at least once a year to review and update any changes in your goals and objectives. We want you to understand the decisions we are making on your behalf and be comfortable with your asset allocation. Please call us with any questions or concerns.

Stephen C. Biggs, CFP®, CFA

July 11, 2017