

# WINSLOW DRAKE

## 1st Half Indexes

S&P 500	8.2%
Dow Industrials	8.0%
NASDAQ	14.1%
Euro 600	5.0%
NIKKEI 225	4.8%
10 Year Treasury	2.3%

## Style Returns

Large Cap Value	5.6%
Large Cap Blend	8.6%
Large Cap Growth	14.1%
Mid Cap Value	4.6%
Mid Cap Blend	6.2%
Mid Cap Growth	12.4%
Small Cap Value	0.5%
Small Cap Blend	3.2%
Small Cap Growth	10.2%

Growth-oriented stocks have outperformed value-oriented stocks in 2017 while larger companies outpaced their smaller counterparts. This shift is a return to historic patterns.

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## *Reading the Tea Leaves*

During the first half of 2017, the S&P 500 and NASDAQ posted their best results since 2013. Meanwhile, bond markets saw a flattening of the yield curve meaning that short-term rates rose while long-term rates remained flat (*see Chart 1, page 3 for illustration*). Traditionally, strong stock market gains signal a better economic environment in 12 to 18 months while a flattening yield curve for interest rates signals a weakening economic environment in 12 to 18 months.

Which signal is right?

Let's first look at the stock markets which saw strong rallies following November's elections when the GOP took control of Congress, the Senate and the Presidency. Stock market pundits felt that GOP control would lead to the repatriation of trillions of corporate dollars that are held offshore by corporations. This money would be used to buy other companies, company stock and invest in capital expenditures - all activities that increase stock values. Additionally, the GOP were going to cut taxes on corporations which was expected to spur additional economic activity. Other actions expected were the repeal and replacement of Obamacare and massive investments in infrastructure projects like bridges, roads, airports and the energy grid.

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## 1st Half Bond Returns

The Federal Reserve has increased rates twice over the last two quarters and given indications that two more rate hikes can be expected this year. So far, bond markets have taken these increases in stride causing the total return on long-term bonds to decline at a measured rate.

In the near term, hold fewer long-term and high yield bonds positions while rates are increasing. Keep bond exposure short focusing on short-term and inflation protected holdings. Use corporate and world bonds to increase yield in the 3rd quarter relative to other options.

Fixed Income Type	1H17	1Q17
Ultra Short Bond	0.7%	0.4%
Short-Term Bond	1.2%	1.7%
Medium Term Bond	2.5%	1.7%
Medium Term Govt	1.2%	-0.6%
Corporate Bonds	3.7%	1.4%
World Bond	4.4%	2.3%
High Yield Bonds	4.1%	2.3%
Long-Term Bond	5.7%	1.9%
Preferred Stock	7.2%	3.8%
Inflation Protected	0.7%	1.2%



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1st Half Sector Returns	1H17	1Q17
Technology	19.0%	12.4%
Healthcare	18.2%	10.8%
Consumer Discretionary	9.5%	6.4%
Utilities	8.7%	6.4%
Industrials	8.4%	4.3%
Consumer Staples	7.3%	5.7%
Basic Materials	5.8%	1.2%
Financials	5.6%	2.0%
Real Estate	2.9%	1.0%
Energy	-17.0%	-5.9%

The technology and health care segments continued to returns that are twice the market averages in 2017. Technology benefitted from a quickening move across most businesses segments toward greater efficiencies driven by technological advances. Health care rebounded from 2016 as investors realized that any reforms out of Washington DC will minimally affect industry profitability.

Utilities remained surprising strong and appear overvalued. As people look toward dividend stocks to replace the income that they cannot make on fixed income, valuations on stocks in the Utilities and Real Estate sectors do not reflect the inherent value of many of these companies. Investors should be careful in these sectors moving forward.

Energy valuations remain challenged as oil prices seem capped as frackers increase productions whenever prices increase.

## Looking forward

As stated last quarter, given that the GOP is having trouble implementing their agenda, expect greater volatility in the second half of 2017. Use market declines as a chance to invest in previously overvalued stocks.

Where domestic stocks outperformed their international brethren in recent years, it appears that many domestic stocks are fully or overvalued at present with small cap stocks bearing more of the downside risk.

World economies appear to be back in growth mode and are generally undervalued relative to their U.S. counterparts. As such, consider increasing international exposure selectively. Countries and companies with too much debt can be expected to underperform peers.

## Reading the Tea Leaves

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Somewhere along the way, the GOP found that they could not get their own caucuses to work together and pass these sweeping changes. As a result, the market has slowly come to the conclusion that any change will be far more muted than originally expected. Nevertheless, the stock values continued to march higher based on stronger earnings from companies due to increased consumer demand.

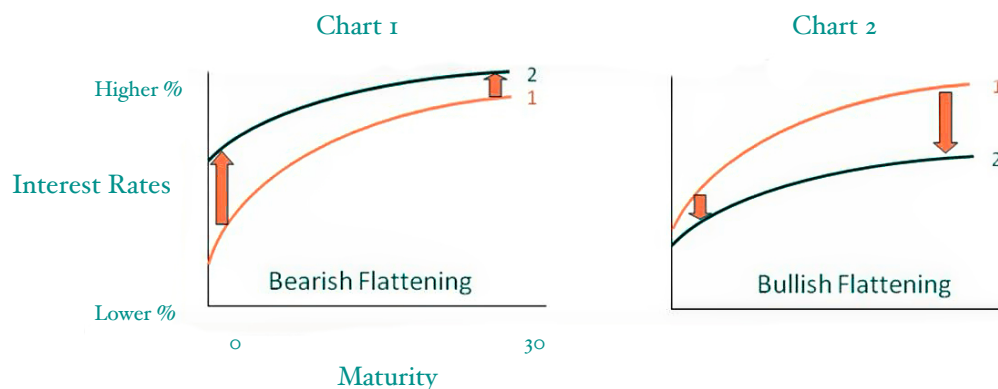
Improved economic results have helped the Federal Reserve and other Central Banks around the world to gain comfort in raising short-term interest rates from historic lows maintained since the Great Recession. While interest rates remain well below historic norms, rates have begun to increase globally.

The odd thing is that short term rates are increasing while long-term are remaining flat. This flattening of the yield curve has typically been a signal of economic weakness in the future (see Chart 1).

The difference this time is that the Central Banks of the world hold one-third of all global debt. Massive government intervention like this distorts markets. As an example, real estate prices that have dropped home affordability to the lowest levels in 25 years. Commercial real estate prices are also high enough that they are helping to fuel moves by businesses toward internet-based sales as the cost of physical locations and staffing are increasingly uncompetitive.

As stated by Peter Wallison, the former General Counsel to the U.S. Treasury, excessive government intervention ultimately leads to disruptive corrections. For an example, we need look no further than the financial crisis of nearly a decade ago. When the government sponsored organizations like Fannie Mae and Freddie Mac who buy most home loans in the United States reduced underwriting standards, lenders responded by creating mortgage types that allowed people to buy homes without the financial wherewithal to make payments. This led to massive mortgage foreclosures and the near collapse of economies around the world.

What happens when the Central Banks of the world stop buying up debt as they have over the last decade? Interest rates will increase. What if those same Central Banks unwind their massive positions and sell those bonds back into the market? Interest rates will increase more causing many bond values to decline. Anyone trying to sell a bond prior to maturity has a higher likelihood of losses. Bond Mutual Funds and Exchange Traded Funds are at a greater risk of principal values declines that outpace income increases. Higher rates will cause companies with sizable debt levels to decline in value as well.



What this suggests is that we can expect better economic times before we can expect worse economic times. When you add the rapid pace of disruptive changes caused by technological advances, the economy is headed toward a brave new world unlike anything that we have experienced in recent history.

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