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STRATEGIC CAPITAL MANAGEMENT, LLC

Q2 2016 Newsletter **By: Jeff Griggs**

On the Fridge

Emerging Markets

As oil and commodities appeared to stabilize, Emerging Markets were the second best asset class in the quarter, returning 5.8%

Verizon

Verizon was the top performing Dow component in the first quarter, rising over 18%. Outpacing the overall sector which rose 16.6% in the quarter.

Utilities

Displaying both their duration risk, and safe-haven nature, utilities were the second best sector in the quarter rising 15.5%.

In the Dog House

Goldman Sachs

Goldman Sachs (GS), was the worst performing Dow component in the first quarter, falling –12.5%.

Small Cap Growth

Small Cap Growth stocks were the worst asset class in the quarter, falling –4.7%. Their underperformance was primarily related to the overweight in the health care sector in the Russell 2000 Growth index (25% vs. 14% in Rusell 3000).

Health Care

Health Care was the worst performing sector in the quarter, falling –5.5%, as Biotech fell –26.36%.

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Review

Big Picture

Coming off a strong end to 2015, the market took a violent turn to start the new year, falling about -10% in the first three weeks. Global growth fears and widening credit spreads (especially surrounding energy related high-yield debt) caused a bit of a panic. 10yr treasury yields fell over 25% down to 1.66%, and the Leading Economic Indicators (LEI) posted a second straight monthly decline in January. At the time, we wrote that the fear wasn't confirmed by economic data and recommended standing pat. The market reversed over the second half of the quarter and finished up 1.3%.

Earnings estimates for the entire year have fallen to just 2.2%, from 7.6% at the beginning of the year. While there isn't much to suggest an economic turnaround, there isn't a lot of positive momentum (beyond the rebound in stock prices) for bulls to cling to. This stagnation of momentum will set the stage for increased volatility. Investors should be prepared to endure further panic induced dips, fear mongering, and recession calls. But for now, we believe the economy remains healthy and should continue to improve steadily. It is important that investors mentally prepare now for continued volatility and stick to their investment strategy at times of market turbulence. Until we see a real change in economic conditions we continue to expect moderate returns from equities and plan to take advantage of any buying opportunities the market presents.

Outlook

Looking Ahead

Going forward, we expect increased volatility, and periods of mini-panics that may mimic, or surpass, what we saw to start the year. Overall, however, we maintain our preference for equities over fixed income, and further our preference for large vs. small, growth vs. value, domestic revenue vs. exports, and consumer oriented (discretionary, tech, and certain staples) and/or housing related stocks. We expect slow economic growth, and thus prefer companies and industries with the ability to grow their businesses despite the macro background. It may be a scary year to be an investor, but once the noise is filtered through time, we expect moderate returns amongst a healthy, if boring, macroeconomic backdrop.

Bonds rallied over the first quarter as interest rates fell, but our 3-5yr return expectations remain largely unchanged. We expect future rate hikes to initially have a flattening effect, and expect intermediate and long term rates to rise gradually over time. As of now, the market is still pricing in a 61% chance of at least one more rate hike this year. We maintain our broadly negative stance on Fixed Income and favor credit risk to duration risk, preferring to move down in credit quality rather than out in time-to-maturity.

Our intermediate return expectation for US equities remains unchanged at a lower than historical

Links and Articles

- **The Great Recession Scare of 2016**
  Guggenheim's CIO, Scott Minerd offers his thoughts on the market.
- **Do Elections Impact the Market?**
  A broad source for the research that has been done on the Presidential election cycle's impact on the stock market.
- **When Interest Rates Rise**
  The best guide to understanding what's going on with interest rates.
- **Identifying Sources of Mutual Fund Outperformance**
  This article explores three potential indicators of mutual fund outperformance.

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Looking Ahead cont.

Outlook

level of about 6% annually. However, at least over the short-term, we expect increased volatility. Investors should be prepared for the mini-panics and rallies of the first quarter to repeat throughout the rest of the year. This is a natural result of lackluster economic improvement and a mature bull market. As upside confidence wanes, the bears become more convincing, allowing small fears and events to cause substantial disruptions.

Above average multiples remain justified when earnings yield is considered relative to bond yields. However, rising rates and lower return expectations provide downward pressure on multiples. Last quarter we wrote that we could see multiple contraction outpace earnings growth (leading to negative returns on stocks), "even if earnings meet their healthy estimates," which were above 7% at the time. Since then, they've fallen to just 2.2% for 2016, significantly increasing the chance of a down year for the markets. However, the rebound in the second half of the first quarter showed there are still buyers out there, and the 1.35% return for the quarter puts us roughly on track for our 6% estimate. The market should be keeping a close eye on actual first quarter earnings as companies begin to report. With macro data providing a mixed picture, and analysts drastically revising estimates, actual earnings could be a dominant driver of equity returns, and perhaps the best indicator of the state of the economy this year.

As always, we will remain diligent in identifying and controlling portfolio risk, responding to new economic developments, and navigating the global capital markets on your behalf. If you have any questions, concerns, or would like to address your specific financial situation, please don't hesitate to get in touch. Thank you for your continued trust and support.

Performance

Performance

The quarterly performance for each asset class is shown below. Small Cap Growth stocks performed the worst, falling about -5% in the quarter. In fact, Growth severely underperformed value across the board. Interestingly, the S&P 500 value outperformed its growth counterpart both in the downturn (1/1 through 2/11) and in the recovery (2/11 to 3/31). The outperformance at the beginning of the year was a relative flight to safety. As stocks and interest rates fell, investors moved into safer sectors such as telecoms and utilities. In the second half of the quarter, value was, in large part, bolstered by a rebound in the Energy sector which returned 9.3% in March and 4% overall in the quarter. Oil prices seemed to stabilize throughout the quarter, even spending some time above $40/barrel in March.

Segments	Benchmark	Return
Cash	Barclays 3 Month T-Bill	0.1%
Government	Barclays US Aggregate Government	3.1%
Inflation Protected	Barclays US TIPS	4.5%
Corporate	Barclays US Aggregate Credit	3.9%
High Yield Corporate	Barclays High Yield - Corporate	3.4%
Non-US Fixed Income	Barclays Global Bond excl. US	8.3%
Large Cap Growth	S&P 500 Growth	0.5%
Large Cap Value	S&P 500 Value	2.2%
Mid Cap Growth	Russell Midcap Growth	0.6%
Mid Cap Value	Russell Midcap Value	3.9%
Small Cap Growth	Russell 2000 Growth	-4.7%
Small Cap Value	Russell 2000 Value	1.7%
Non-US Developed	MSCI EAFE	-2.9%
Emerging Markets	MSCI Emerging Markets	5.8%
Real Estate	DJ US Select REIT	5.1%
Commodities	Bloomberg Commodity Index	0.4%

*Total returns provided by FactSet for the period 12/31/2015 through 3/31/2016.

Bonds in general performed well as interest rates fell. The 10yr treasury fell over 25% from 2.27% at the beginning of the year to a low of 1.66% on February 11th, finishing the quarter at 1.77%. Non-US bonds performed particularly well, leading all other asset classes, as the dollar fell over -4% in the quarter.

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Benchmark	Description
Barclays 3 Month T-Bill	Measures the performance of government bonds issued by the US Treasury. The index includes only those bonds near to their original term. Maturities between 30 and 90 days.
Barclays US Aggregate Government	Comprised of U.S. Treasury and U.S. Agency indices. The index includes treasuries and U.S. agency debentures.
Barclays US TIPS	Measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible. The US TIPS Index was launched in March 1997.
Barclays US Aggregate Credit	Measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. Comprised of US Corporate Index and a non-corporate component that includes foreign agencies , sovereigns, supranationals and local authorities.
Barclays High Yield - Corporate	Measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Issuers with an emerging markets country of risk are excluded.
Barclays Global Bond excl. US	Measure of global investment grade debt from twenty-three different local currency markets. This multi-currency benchmark includes fixed-rate treasury, government-related, corporate and securitized bonds from both developed and emerging markets issuers.
S&P 500	Market-cap weighted index. Includes 500 leading US companies and captures approximately 80% coverage of available US market capitalization.
S&P 500 Growth	Growth segment of S&P 500. Measures growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum.
S&P 500 Value	Value segment of S&P 500. Measures value stocks using three factors: the ratios of book value, earnings and sales to price.
Russell Midcap Growth	Measures performance of the mid-cap growth segment of the U.S. equity universe. Growth is defined as those companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap Value	Measures performance of the mid-cap value segment of the U.S. equity universe. Value is defined as those companies with lower price-to-book ratios and lower forecasted growth values.
Russell 2000 Growth	Measures performance of the small-cap growth segment of the U.S. equity universe. Includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values.
Russell 2000 Value	Measures performance of the small-cap value segment of the U.S. equity universe. Includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.
STOXX 600	Derived from the STOXX Europe Total Market Index, this index has a fixed number of 600 components representing large, mid and small cap companies across 18 countries of the European region.
MSCI EAFE	Equity index that captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada.
MSCI Emerging Markets	Captures large and mid cap representation across 23 Emerging Markets countries. Contains 836 constituents and covers approximately 85% of the free float-adjusted market cap in each country.
DJ US Select REIT	A subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities. Excluding mortgage REITs, net-lease REITs, timber REITs, and others.
Bloomberg Commodity Index	Made of 22 exchange-traded futures on physical commodities. Represents 20 commodities that are weighted to account for economic significance and market liquidity.
ICE Dollar Index	A fixed weight basket of 6 foreign currency values in relation to the US dollar. Includes Euro, Yen, British Pound, Canadian Dollar, Swedish Krona, and Swiss Franc.