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Performance Reports

# SPECTRUM
STRATEGIC CAPITAL MANAGEMENT, LLC

Q3 2016 Newsletter By: Jeff Griggs

## On the Fridge

### Commodities

Commodities were the top performing asset class in the quarter as oil prices rose 32%.

### Pfizer

Pfizer (PFE) was the top performing name in the Dow during the second quarter, rising 18.3%.

### Value

Value handily outperformed growth this quarter, as yield hungry investors were once again rewarded by lower interest rates.

## In the Dog House

### Apple

Apple was the worst performing Dow component, falling –12.6% in the second quarter.

### Non-US Developed

Non-US Developed equities were the worst asset class in the quarter. After briefly outperforming the S&P 500, Brexit fears took over and left the MSCI EAFE down -1.2% in the quarter.

### Information Technology

Led largely by its largest constituent, Apple, the tech sector finished the quarter down –2.84% trailing all other sectors (Energy took the top spot with an 11.6% gain).



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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.

## Big Picture — Review

The second quarter was defined by its final week. In a display of collective naivety, Brexit came as a shock to capital markets despite polls indicating the vote would be very close. At this point I won't pontificate on the impact of the Brexit referendum. The truth is Brexit is a big question mark, whether the move ends up being positive or negative for UK, European, or global economic growth is completely to-be-determined. The only thing for certain is that it creates uncertainty, and in capital markets, that means volatility.

Brexit aside, and despite what either presidential campaign might have you believe, things in the US economy are looking just fine. Despite showing a bit of temporary weakness towards the end of the quarter, the job market remains strong. In April, Consumer Spending posted the largest monthly jump since 2009, wages rose, and the savings rate dipped (although it remains healthy). Home prices continue their climb. Overall the US economy continues its slow and steady pace. Until economic indicators begin to show sustained evidence of a trend shift, we expect the extended bull market to march on.

## Looking Ahead — Outlook

We maintain our expectation for periods of heightened volatility, at least over the short-term. With several potential disrupters out there (Brexit, election, terrorism, etc.) investors should be prepared for the mini-panics and rallies of the first half 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.

In equity markets, above average multiples remain justified when earnings yield is considered relative to bond yields. The yield-to-worst on the Barclays Investment Grade Corporate Bond Index is 2.48%, while the duration is 7.53yrs. Duration is a measure of interest rate sensitivity, it should be interpreted as the percent change in the price of a bond for a 1% movement in interest rates. This means even if interest rates don't rise at all over the next several years, the reward for taking on interest rate risk is extremely low. If interest rates rise 0.33% or more, you risk a zero to negative return on your bond portfolio. Meanwhile, the S&P 500 finished the quarter with a 2.18% dividend yield, and remains valued just above its historical average, at a 16.71 forward P/E ratio (or 6% earnings yield).

Within US equities, the US consumer looks strong. The household debt service ratio is at its lowest in at least 35 years. Household net worth is at all-time highs. The consumer balance sheet shows a very healthy ratio of assets to liabilities of over 7x. Housing starts, and home prices

## Links and Articles

- **Exploring Labor Particpation**
  Brookings Fellow, Scott Winship, dispels a few of the myths and fears regarding the Labor Participation Rate.
- **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.
- **How Do People Really Feel About the Economy?**
  Ben Bernanke explores the bifurcation in American consumer sentiment.
- **Identifying Sources of Mutual Fund Outperformance**
  This article explores three potential indicators of mutual fund outperformance.

Outlook

## Looking Ahead cont.

continue their 7-year climb from recession lows, while average mortgage rates continue to fall and the housing affordability index remains just off its all-time lows (suggesting housing is highly affordable). The average FICO score remains above historical average at 745, most likely reflecting both higher lending standards and, to some extent, an increase in the countries average credit score as recession related foreclosures and bankruptcies are rolling off of people's credit reports. Wages continue to grow, albeit at a slow, but accelerating, pace. Cyclical unemployment is nearly nonexistent, as the already low 4.8% unemployment rate is almost entirely explained by demographic and other factors. Lastly, the US dollar remains strong and gas remains cheap. When I say the US economy is just fine, these are some of the things I'm talking about. All things considered, we expect wages to continue to rise thanks to a tight labor market and Americans to begin to spend as they grow more comfortable with the economic improvement we've experienced since 2008. However, Presidential campaigns tend to paint a morbid picture of current conditions (and promise incredible improvements if you'll just vote for them). Depending on how negative the two parties get with their campaigning, the election may put a damper on consumer confidence for the rest of the year.

With all of that said, we continue to prefer companies that are consumer oriented, domestic revenue driven, housing related, or of course, secular growers. Our sector preferences remain unchanged. We prefer tech, consumer discretionary, health care, and we remain selective within financials and staples. We remain focused on building portfolios with a mix of secular growers and total yield plays (dividend, buyback, and earnings/free cash flow), refusing to overpay for large dividends in a market that is starved for yield.

Performance

## Performance

The quarterly performance for each asset class is shown below. Commodities led the way as oil rallied over 30% during the quarter. High yield bonds performed second best, rising 5.5% as energy related names recovered particularly well. Helping both high yield and investment grade bonds, the yield on the 10yr treasury fell about 17% to 1.47%, contributing to a 3.6% gain in corporates and a 2.0% return from government bonds. In equities, value outperformed growth across the board for the second straight quarter. High yield stocks (utilities, telecoms, etc.) tend to exhibit positive duration and perform well when rates fall, they also tend to fall into the value style. Value's outperformance occurred mostly throughout the first half of the quarter, indicating a positive relationship with falling rates, more than a flight-to-safety effect from the Brexit referendum or any other cause of fear.

| Segments | Benchmark | Return |
|---|---|---|
| Cash | Barclays US Treasury Bill 1-3 Month | 0.1% |
| Government | Barclays US Aggregate Government | 2.0% |
| Inflation Protected | Barclays US Treasury US TIPS | 1.7% |
| Corporate | Barclays US Corporate Investment Grade | 3.6% |
| High Yield Corporate | Barclays US Corporate High Yield | 5.5% |
| Non-US Fixed Income | Barclays Global Aggregate Hedged USD | 2.5% |
| Large Cap Growth | S&P 500 Growth | 1.0% |
| Large Cap Value | S&P 500 Value | 4.0% |
| Mid Cap Growth | Russell Midcap Growth | 1.6% |
| Mid Cap Value | Russell Midcap Value | 4.8% |
| Small Cap Growth | Russell 2000 Growth | 3.2% |
| Small Cap Value | Russell 2000 Value | 4.3% |
| Non-US Developed | MSCI EAFE | -1.2% |
| Emerging Markets | MSCI Emerging Markets | 0.8% |
| Real Estate | DJ US Select REIT | 5.4% |
| Commodities | Bloomberg Commodity | 12.8% |
| Alternatives | Credit Suisse Liquid Alternative Beta I | 1.2% |

*Total returns provided by Morningstar for the period 4/1/2016 through 6/30/2016.

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| Benchmark | Description |
|---|---|
| **Barclays US Treasury Bill 1-3 Month** | 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 Treasury 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 Corp. Investment Grade** | Measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. |
| **Barclays US Corporate High Yield** | 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 Agg Hedged USD** | 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. |
| **Credit Suisse Liquid Alternative Beta** | Reflects the return of a dynamic basket of liquid, investable market factors selected and weighted ina ccordance with an algorithm that aims to approximate the aggregate returns of the universe of hedge fund managers as represented by the Credit Suisse Hedge Fund Index. |
| **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. |