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SPECTRUM
STRATEGIC CAPITAL MANAGEMENT, LLC

Q4 2016 Newsletter By: Jeff Griggs

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.

On the Fridge

Emerging Markets

EM rose 9.2% in Q3, buoyed by commodity and currency strength, and a global hunt for yield.

Nordstrom, Inc. (JWN)

Nordstrom was the top performing consumer discretionary stock in the S&P 500, rising 37% in Q3.

Information Technology

The tech sector handily outperformed all others in the third quarter, rising 12.86%,

In the Dog House

Bristol-Myers (BMY)

Bristol-Myers Squibb (BMY) was the worst performer in the S&P 500 falling –26.9% in Q3 over news of their lung cancer drug failing FDA trials.

Treasuries

As an example of the risk of holding low-yield, high duration assets, our benchmark for Government bonds was one of only three asset classes to fall in the third quarter, finishing down –0.3%.

Utilities, Telecoms

While the S&P 500 rose almost 4%, two sectors were down more than –5%. Utilities and Telecoms fell –5.91% and –5.6%, respectively, as interest rates rose and high-yield assets sold off.

Big Picture — Review

The third quarter began with the fallout of the Brexit referendum, whose bark has thus far been worse than its bite. In fact, British equities have handily outperformed their US counterparts since the vote. While the details, in terms of trade and immigration agreements, are yet to be hashed out, Theresa May has announced she would invoke Article 50 and thus officially trigger the Brexit process, by the end of March 2017.

A relatively boring quarter was overshadowed by the hijinks of the presidential race. All in all, the slow-and-steady trend remains intact. The Fed failed to move, although a rate hike is widely expected in December. The third quarter did little to change our economic perspective. We continue to expect steady GDP growth, a strong consumer, and low returns from risk assets. Although we will continue to keep a close eye on earnings reports as many companies have warned performance in the coming quarters may be weaker than expected.

Looking Ahead — Outlook

The main drivers of capital markets over the coming quarters are likely to be the Federal Reserve, the US Presidential election, and corporate earnings. The market is currently giving it about a 70% chance that the Fed raises rates in December. If this doesn't occur, it likely means bonds and other high income investments continue to do well. If it does, it likely won't come as a shock, but should continue the rising (and flattening) of the yield curve and weigh on income driven investments.

On the second point, Hillary has all but been sworn in with nearly every real analysis giving her over an 80% chance of winning the White House. This too should not be a shock to capital markets as she is widely viewed as "more of the same" as far as they are concerned. As the outcome becomes more certain it should support asset prices, as some investors may have hedged the risk of a "wild card" Trump presidency, but the impact of the election should remain as minimal as ever.

Earnings are the real worry at this point. Third quarter earnings are coming in fairly decent with about 78% of S&P 500 companies reporting earnings above estimate, the estimated earnings decline for Q3 has gone from -2% at the end of the quarter to just -0.3% today. 10 S&P 500 companies have issued negative guidance, but 7 have issued positive guidance. There is a narrative that this quarter's earnings are going poorly not for the actual results, but negative sentiment expressed about future results. I'm not sure that is entirely warranted, as of Sept. 28, according to the FactSet

Links and Articles

- **What's Up with Wage Growth?**
  The Fed Reserve bank of San Francisco presents an alternative narrative to stagnant wages.
- **Why Emerging Market Stocks are Surging**
  Oppenheimer's take on the latest outperformance
- **Why is the Economy Growing So Slowly?**
  Vox speculates on a number of theories behind the stagnant growth in America.
- **Create your Own Electoral Map**
  Realclearpolitics.com provides a fun, interactive tool to stress test various election outcomes.

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Outlook

Looking Ahead cont.

Guidance Monthly report, 80 companies had issued negative guidance for the third quarter, but that figure is below the 5-year average. While the percentage of companies reporting positive guidance was above average. The tech sector actually recorded the highest number of companies issuing positive EPS guidance since Q1 2012. What is undeniable though, is that the market has been harshly punishing companies reporting weak guidance and stingy about rewarding any positive news. This is an indication of poor investor sentiment, and may lead to increased volatility, or market pull backs in the coming quarters.

As far as equities are concerned, we continue to expect below historical returns of around 6%, and maintain our expectation for heightened volatility over the short-term. Investors should be prepared for periods of mini-panics, pullbacks, and rallies that we view as a natural result of a mature bull market. With that said, we have yet to see any evidence of the long-term slow-and-steady trend being disrupted. We continue to believe that above-average multiples remain justified when earnings yield is considered relative to bond yields. We are not worried about the level of stock prices at this time, and until we see a distinct disruption of the economic trend, we remain overweight US equities with a preference towards consumer facing and growth oriented companies.

In terms of fixed income, We expect the 10yr to float back towards its 2yr average of 2.10%. Again, the market seems confident, with a 70% probability, that the Fed will raise rates in December. We are not so sure as we've seen the Fed delay too many times to be certain of anything. However, when/if the Fed does act, we expect rate hikes to have an initially flattening effect with intermediate and long term rates rising gradually over time. We view this situation as inevitable, eventually, and are not impressed with the yields currently offered in the fixed income space. For that reason, we maintain our broadly negative stance and continue to favor credit risk to interest rate (duration) risk where fixed income assets must be purchased.

Performance

Performance

The quarterly performance for each asset class is shown below. Emerging markets and small cap stocks led the pack, while high yield debt and developed market equities performed well. Commodities fared the worst, while REITs and Government bonds were the only other asset classes to fall in the third quarter. Part of the strength in Emerging Markets is no doubt due to commodity prices. Many, including oil, are off their bottom and appear to have established some stability. Some strength is due to currencies as many emerging currencies like the Brazilian Real (+21%), South African Rand (+11.3%), and Korean Won (+7%) all gained on the dollar through three quarters. However, another significant source of strength for many emerging markets may be their yield. Like a shift from investment grade to high yield, investors are looking beyond blue-chip US stocks and finding dividend yield in Emerging Markets.

Segments	Benchmark	Return
Cash	Barclays US Treasury Bill 1-3 Month	0.1%
Government	Barclays US Aggregate Government	-0.3%
Inflation Protected	Barclays US Treasury US TIPS	1.0%
Corporate	Barclays US Corporate Investment Grade	1.4%
High Yield Corporate	Barclays US Corporate High Yield	5.6%
Non-US Fixed Income	Barclays Global Agg ex-USD Hdg USD	0.5%
Large Cap Growth	S&P 500 Growth	4.8%
Large Cap Value	S&P 500 Value	2.9%
Mid Cap Growth	Russell Midcap Growth	4.6%
Mid Cap Value	Russell Midcap Value	4.4%
Small Cap Growth	Russell 2000 Growth	9.2%
Small Cap Value	Russell 2000 Value	8.9%
Non-US Developed	MSCI EAFE	6.5%
Emerging Markets	MSCI Emerging Markets	9.2%
Real Estate	DJ US Select REIT	-1.2%
Commodities	Bloomberg Commodity	-3.9%
Alternatives	Credit Suisse Liquid Alternative Beta I	2.5%

*Total returns provided by Morningstar for the period 7/1/2016 through 9/30/2016.

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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.