MARKET COMMENTARY

July 2017

Bull Market Remains Intact

By Kevin O'Keefe, CIMA®, AIF® | Chief Investment Officer

About the Current Political Divide

Despite the financial rewards generated in the first half of the year, we would be remiss not to acknowledge widespread concern about the federal government and to consider why the rampant political discord has not had a negative impact on the stock market.

Perhaps all the rancor just hasn't had an impact yet, or could it be that there are forces supporting the stock market which overpower political divisions? Unpleasant as the political divide may be for engaged citizens, it's worth asking whether periods of bitter political partisanship have historically been bad for investors. In fact, there is evidence that suggests that stocks have performed better than average when partisan conflict has been elevated on an absolute basis and relative to the recent past.

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q2-2017	YTD	1 Year	3 Year**	5 Year**
S&P 500 Index	3.09	9.34	17.90	9.61	14.63
MSCI KLD 400 Social Index	3.17	9.17	17.01	8.32	14.08
DJIA (reinvested dividends)	3.95	9.34	22.12	11.01	13.45
S&P MidCap 400	1.97	5.99	18.57	8.53	14.92
Russell 2000 (Small Cap)	2.46	4.99	24.60	7.36	13.70
MSCI EAFE (Europe, Australasia, Far East)	6.12	13.81	20.27	1.15	8.69
MSCI Emerging Markets	6.27	18.43	23.75	1.07	3.96
Bloomberg Barclays Aggregate Bond	1.45	2.27	-0.31	2.48	2.21
Morningstar Mutual Fund Benchmarks					
U.S. Large Cap Growth	6.07	15.75	20.18	10.60	14.96
U.S. Large Cap Value	0.46	2.98	13.43	7.32	12.50
U.S. Mid Cap Growth	5.23	13.13	17.68	7.53	13.44
U.S. Mid Cap Value	0.19	3.46	19.52	8.58	17.20
U.S. Small Cap Blend	1.42	3.77	20.59	7.04	14.15
Foreign Large Blend	6.25	14.45	19.13	1.18	7.81
U.S. Real Estate	1.85	2.89	-0.61	7.25	8.49
Intermediate-term Bond	1.10	1.78	-0.07	2.58	2.41

* Sources: Morningstar

**3-Year and 5-Year returns are average annual returns for that benchmark.

Performance data presented reflects past performance. Past performance is no guarantee of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Information has been obtained from a source considered to be reliable; however, neither First Affirmative nor its agents can guarantee the accuracy of the numbers reported.

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What Does a Low VIX Say About the Stock Market?

There has been plenty of discussion in the financial media lately about the danger of investor complacency. The low VIX is often referenced as evidence that investors have become lulled into ignoring risk. But the VIX is an imperfect tool for determining whether investors are complacent; it is at best a shortcut, and its usefulness is debatable.

The VIX reflects the market's expectation for volatility over the next 30 days. It sometimes spikes following periods of calm—which is the cause of concern of complacency—however, it is more often the case that calm follows calm. Some speculators are tempted to "buy the VIX" when it's low and "sell the VIX" when it's high. But the VIX is not a stock that you can buy and hold. Most investors don't trade the VIX (which is technically the strike price of a 30-day variance swap), but many try to derive actionable meaning from it.

Despite media coverage which often implies that a low current VIX indicates future volatility featuring a sharp sell-off in stocks, the evidence shows that investors historically overestimate the 30-day forward volatility of the S&P 500. In addition, when the VIX has been low, stocks have outperformed bonds over the subsequent 12-months regardless of the change in the VIX during that time.

Conclusion: Absent other meaningful catalysts, e.g., increased geopolitical concerns, changes in central bank policies, negative economic reports, etc., there is a low probability that the currently subdued price level of the VIX in and of itself implies investor complacency or a stock market sell-off. ▪

Recap of the Financial Markets

The second quarter of 2017 closely resembled the first quarter. Global stock markets continued to move higher, with all major U.S. stock indices finishing up for the quarter and year-to-date. Small cap stocks lagged their large-stock counterparts, although they outperformed large stocks over the past 12 months. International equities performed well with both developed and emerging markets outperforming U.S. indices both for the quarter and year-to-date. Bonds held their own, despite the Fed's expected interest rate hike in June.

The U.S. Dollar continued to weaken against most major global currencies. Gold fell slightly in Q2 but is still up nearly 8% YTD. Oil fell hard in Q2, settling at just over $46 per barrel. The VIX (known as the "fear gauge") continued its decline, spending much of the quarter near all-time lows.

Perspective

With so much uncertainty and with stocks trading at new highs, many investors may have stepped away from stocks, if only in part, at the beginning of the year. To the extent they did so, they may regret not recognizing the third longest economic expansion since 1850 or the second longest bull market since 1926 (the beginning of modern capital market history). Global stocks just turned in one of the strongest half-years in a long time, thanks chiefly to improving economies globally, central bank support, improving consumer sentiment in the eurozone, strong corporate earnings growth, and the booming technology sector in the U.S. and China.

Economists generally agree that the economy continues to improve. There is low unemployment, steady job growth, and subdued inflation. The Fed's interest rate policy remains on a path that will allow capital markets to return to normal, albeit slowly. At the June meeting, they announced another 0.25% increase in short-term interest rates and early steps toward reducing the $4.5 trillion debt.

News from the eurozone has been positive. The French presidential election result was a welcome relief from recent populist trends elsewhere and also signaled that European politics should continue to be cooperative and productive. There is increasing consensus that Mario Draghi's (President of the European Central Bank) stimulus program is getting positive results.

News out of China was largely positive as well. Starting next year, the widely followed MSCI Emerging Market Index will begin to include mainland Chinese stocks as a small portion of the index. Although the initial investment impact of this is minor, it is indicative of the improving legitimacy of Chinese capital markets. In addition, new capital controls have become effective and the volatility of the Chinese yuan has diminished.

And the drumbeat of good news has also extended to Japan. The effort to temper bond-buying stimulus in favor of allowing markets to function more normally appears to be working. Despite headwinds there are signs that the government is aware of the challenges and is working to address them.

Outlook

First quarter earnings season was exceptional: S&P 500 profits rose far higher than expected and guidance for the remainder of the year was also

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positive. As investors increasingly believe that the economy will be able to expand without significant monetary policy support, business fundamentals should replace central bank actions as the primary driver of stock market gains. For this reason, we think stocks are likely to post additional gains in the second half of 2017.

Corporate profits will become more important through the end of the year and into 2018, and we believe that the results will be good. Over the last three years, operating earnings for the S&P 500 have stalled at roughly $118 per share. Strong stock returns during this period have been primarily a function of price-earnings ratio expansion. 2017 is on track for meaningful improvement in corporate profits, thanks largely to economic growth and a stable U.S. dollar.

If S&P 500 earnings grow by 10% this year, which is probably attainable even if there is no material impact from fiscal policy changes, that would put earnings for the index in the vicinity of $130 per share.

More Positives

If any meaningful clarity on corporate tax reform arrives in the coming months, it will help provide further guidance as to 2018 earnings growth and, as a result, may justify further P/E multiple expansion. Obviously, this assumes the Administration and Congress can agree on a bill that can garner sufficient votes to pass the House and Senate.

...And a Few Potential Negatives

Political upheaval and additional Fed rate hikes could lead to bouts of stock market volatility and may upend positive market indicators. It is hard to know whether corporate tax reform has already been priced into stocks. Although investors should be cautious given the difficulty Congress has had concerning health care, corporate tax reform may be a less contentious issue. We believe that the probability of action on corporate tax reform is better than 50:50.

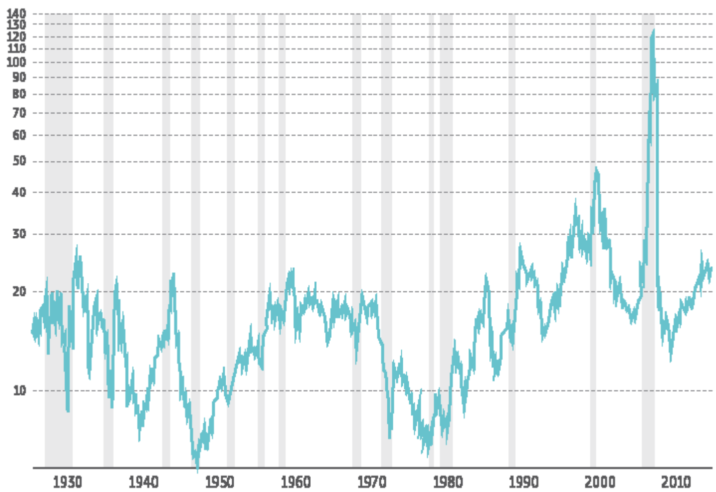
Summary

It has been a great first half for investors. The economy is expected to accelerate and for this reason the aging bull market is likely to keep on chugging. Tax policy may not help much this year and further Fed tightening could contribute to a pick-up in market volatility. Stocks historically have tended to underperform in the summer months and then kick into gear in the fourth quarter. We would not be surprised if 2017 holds true to form. ▪

A Word About Bubbles

At about 20-25 times trailing S&P 500 earnings, stocks are expensive compared to their long-term historical average. However, P/E multiples should be considered in the context of interest rates and inflation, which are still near all-time lows. In this context, current valuations are not unreasonable. And, if earnings accelerate, support is there not only for current multiples but potentially even higher multiples. Taken out of context, above-average valuations have been poor predictors of near-term stock market performance. If and when multiples expand to the levels we saw in 1999-2000, then talk of bubbles will be justified.

S&P 500 Trailing 12 month P/E Ratio



(Note: The extreme P/E ratios in 2008-2009 was a result of many companies posting losses in the wake of the financial crisis. In 2000 there was a stock market bubble; in 2008-2009 there was a financial crisis and bear market.) ▪

Municipal Bond Market Commentary

By Harris May

The second quarter municipal bond market was driven by economic uncertainties and a supply-demand imbalance. As a result, the market posted a 1.96% return for the quarter and a solid 3.57% for year-to-date performance, according to the Bloomberg Barclays Municipal Bond Index.

Bloomberg Barclays Municipal Bond Index

Maturity	2nd Quarter 2017	YTD 6/30/17
1-Year	0.26%	0.96%
3-Year	0.54%	1.81%
5-Year	1.25%	3.17%
7-Year	1.93%	3.92%
10-Year	2.35%	4.18%
20-Year	2.49%	4.02%
Long Bond (22+)	2.75%	4.54%
Total Return	**1.96%**	**3.57%**

Strong Performance Despite Uncertainty

This strong performance came as a surprise to investors who anticipated that the Trump administration's agenda would lead to an uptick in economic growth, lower tax rates and higher inflation. However, while tax reform and infrastructure spending continue to be discussed, there are no foreseeable outcomes.

Lack of Supply

Although many of the states and municipalities have recovered from the Great Recession, they face uncertainties on "federal taxes, trade, and health insurance," according to The Pew Charitable Trusts. These issues, plus state pension funding gaps, have made states and municipalities reluctant to issue debt for new infrastructure spending.

Credit Spreads Tighten

The lack of supply has caused credit spreads to tighten. Investors are therefore not being compensated for taking credit risks.

Flattening Yield Curve

The yield curve of general obligation bonds rated triple-A flattened during the quarter, according to Hutchinson, Schockey, Erley & Co. The spread between the 1-year and 10-year stood at 1.18% at the end of June, versus 1.35% at the end of March. Some of the flattening can be attributed to investors moving further out on the curve in search of higher income.

Puerto Rico, Connecticut and Illinois continued to make headlines during the second quarter.

The Commonwealth of Puerto Rico and its Sales Tax Corporation bonds were placed under court restructuring. The filing was the largest municipal bond bankruptcy in U.S. History.

The State of Connecticut, the nation's wealthiest state, was downgraded to single A by all three rating agencies. And the State of Illinois may face its third fiscal year without a balanced budget. Its debt burden and unfunded pension obligations are among the highest in the country.

In spite of these headlines, the demand for municipal bonds remains strong.

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