MSA
MAIN STREET ADVISORS, LLC
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Market Commentary – First Quarter 2017

Market Recap

Global equities greeted the new year with the same degree of élan with which they closed 2016. Emerging-market stocks led the way with a double-digit return, followed closely by developed international and U.S. stocks (Vanguard FTSE Emerging Markets ETF up 11.2%, Vanguard FTSE Developed International ETF up 8%, and Vanguard 500 Index up 6%). While investor optimism seemed to leave no contingency for downside surprises—the VIX, the markets' fear gauge, ended the quarter at historic lows—macroeconomic fundamentals were also broadly supportive.

March Benchmark Returns (Preliminary)			
	Mar	Q1	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	0.1%	6.0%	6.0%
iShares Russell 1000 ETF	0.1%	5.9%	5.9%
iShares Russell 1000 Growth ETF	1.2%	8.8%	8.8%
iShares Russell 1000 Value ETF	-1.0%	3.1%	3.1%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	0.0%	2.2%	2.2%
iShares Russell 2000 Growth ETF	1.1%	5.2%	5.2%
iShares Russell 2000 Value ETF	-0.8%	-0.3%	-0.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	3.1%	8.0%	8.0%
Vanguard FTSE Europe ETF	4.4%	8.2%	8.2%
Vanguard FTSE Emerging Markets ETF	2.8%	11.2%	11.2%
Vanguard REIT Index	-2.4%	1.0%	1.0%
Vanguard Total Bond Market Index	-0.1%	0.9%	0.9%
Vanguard Intermediate-Term Tax-Exempt	0.3%	1.4%	1.4%
BofA Merrill Lynch U.S. High Yield Cash Pay Index	-0.2%	2.7%	2.7%
S&P/LSTA Leveraged Loan Index	0.1%	1.1%	1.1%

Investors took the Federal Reserve's widely anticipated 0.25% increase in the federal funds rate in stride, treating it as another indicator of the U.S. economy's return to form. As Fed Chair Janet Yellen stated, "The simple message is the economy is doing well." On Friday, the Bureau of Economic Analysis released a revised GDP figure of 2.1% for the fourth quarter of 2016 versus an earlier estimate of 1.9%.

In Europe, stock gains also seemed to reflect a combination of bullish investor sentiment and positive economic data, including rising corporate earnings. Upward revisions to corporate earnings forecasts, GDP growth that far outstrips that of developed economies, and valuations that are still cheap compared with developed-market stocks all helped drive the strong gains in emerging-market stocks.

Defensive assets turned in a solid performance during the first quarter. Treasurys rallied after the Fed's March 15 announcement. The core bond index made up some ground in the latter half of March. That still wasn't enough to outpace the lower-quality, flexible bond funds we own including Loomis Sayles Bond, Templeton Global Bond and Osterweis Strategic Income, which returned between 1.6% and 4.6% for the quarter. High-quality bonds returned between 1% and 1.6% for the quarter (relatively good for one quarter), another sign of how "risk on" versus "risk off" works.

Moves in Treasurys and the U.S. dollar were closely tied to investor perceptions the Fed might be poised to take a more hawkish stance on interest rates in anticipation of Trump's legislative agenda boosting inflation. This view changed as the quarter drew to a close, with both the Fed and financial markets forecasting roughly two more rate hikes this year. The yield on the 10-year Treasury ended March at 2.4%, down from an intra-quarter high of 2.6%. The dollar also fell, ending 2.8% lower against a basket of currencies. Traders attributed the fall to the Fed's failure to raise its inflation expectations, which would signal a potential move to a more accelerated pace of interest rate increases.

It's too soon to know how the second quarter will play out, but we remain alert to potentially policy-driven political risk in the United States. In Europe, the outcome of upcoming elections, and related developments in France (May) and Germany (September), may have unexpected impacts on markets. While to date investors have shown a remarkable degree of staying power, that does not mean they will continue to do so.

The Investment Environment

For the first time in a while, global economic growth is in sync and improving. A quick survey of the economic landscape suggests the environment should remain supportive of stocks and other risk assets, at least over the next six to 12 months or so. As we'll discuss later, we continue to believe high current valuations will be a major headwind to U.S. stock market returns looking out longer term (i.e., the next five years). We also remain concerned about the unresolved risks stemming from the global debt build-up and unprecedented central bank policies. But for the time being at least, the global macroeconomic backdrop offers reason for optimism that many of the reflationary trends that have benefited our portfolios in recent quarters can continue.

Across a wide range of measures, the global economy is in its best shape in many years. Economic growth in most countries and industries is in sync and has been accelerating, albeit modestly. Leading economic indicators suggest this trend can continue, and many of the respected economic research firms we follow agree. Capital Economics expects world GDP growth to be at least 3% this year, up from 2.5% in 2016. In its March 16 cover article titled, "On the Up: The World Economy's Surprising Rise," *The Economist* noted that across the United States, Europe, Asia, and emerging markets, "all the burners are firing at once, for the first time since a brief rebound in 2010."

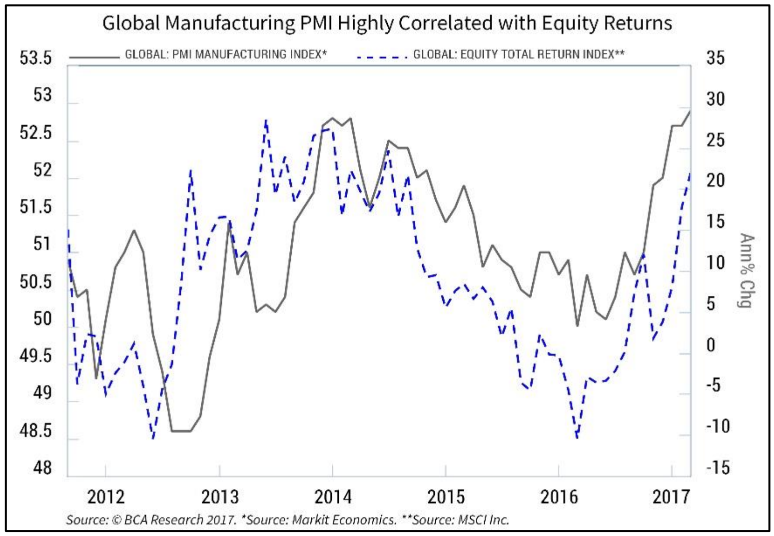
While unexpected macro shocks can occur at any time, causing at least a short-term flight from risk assets, the likelihood of an incipient U.S. or global economic recession appears low. Without a recession, history suggests a bear market in stocks is unlikely.

To highlight a few of the positive global economic indicators:

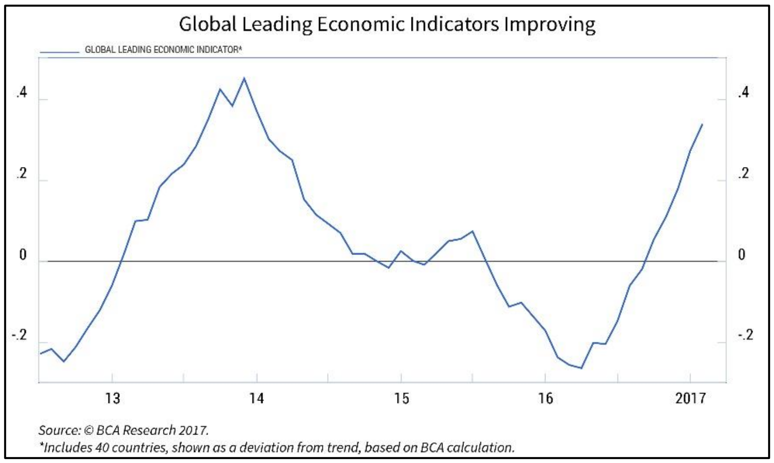
- The widely followed Global Manufacturing Purchasing Managers Index (PMI) just hit its highest level since May 2011. The Eurozone Manufacturing PMI is also at its highest level since April 2011; while China's PMI is at its highest since January 2013. As shown in the chart at the top rate from BCA, the Global Manufacturing PMI and global equity returns have been correlated over time.

- BCA's "Global Leading Economic Indicator" registered its 10th straight monthly increase and highest level since January 2014.

- Ned Davis Research's Global Recession Probability model recently dropped into the Low Recession Risk zone.

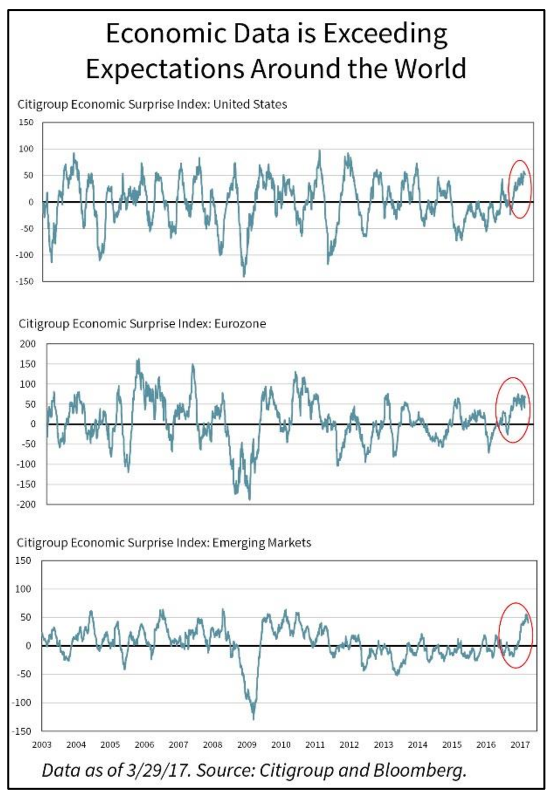


Source: © BCA Research 2017. *Source: Markit Economics. **Source: MSCI Inc.



Source: © BCA Research 2017.
*Includes 40 countries, shown as a deviation from trend, based on BCA calculation.

Macroeconomic fundamentals appear reasonably solid and are improving from cyclically depressed levels in many regions outside the United States. But financial markets respond to *new* data, information, and events that differ from the consensus expectations already discounted in prices. In other words, markets react to surprises. The Citi Economic Surprise Indexes are meant to capture whether and to what extent new economic data points are exceeding or disappointing consensus expectations. As the chart to the right shows, these indexes have also rebounded sharply over the past year. In fact, the Surprise indexes for Europe and emerging markets both recently hit seven-year highs.



Data as of 3/29/17. Source: Citigroup and Bloomberg.

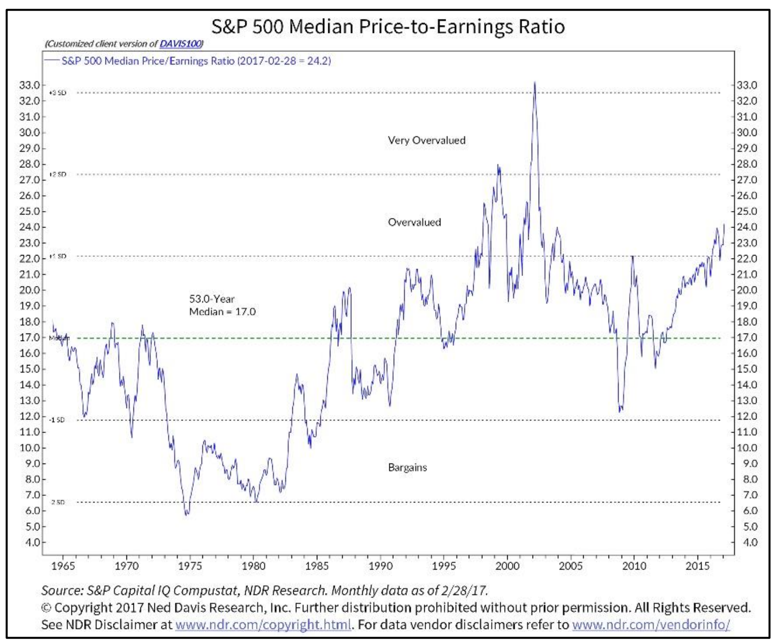
Portfolio Positioning and Outlook

U.S. Stocks

In our 2016 year-end commentary, we noted that on the heels of a fourth straight year of underperformance for foreign stocks versus U.S. stocks, the consensus view was for more of the same this year. The consensus was also for the U.S. dollar to appreciate, driven by divergent central bank policies—with the U.S. raising rates while other major central banks continued monetary stimulus—as well as President Trump's expected fiscal and trade policies. Both these consensus views have been wrong so far this year. International and emerging-market stocks have beaten U.S. stocks, and the dollar has declined by about 3%, retracing much of its post-election gain. (The dollar still looks overvalued based on longer-term fundamentals.) These counter consensus reversals were neutral to our portfolios in the first quarter, given our even weighting to non-U.S. stocks. Investors who have reduced or even quit foreign stocks in recent years perhaps failed to notice their lower pricing versus the U.S.

Over the longer term, our analysis continues to indicate the U.S. stock market is broadly overvalued. Specifically, our estimate of the expected annualized total return for U.S. stocks (including dividends) in our base case scenario is in the low single digits over the next five years. For U.S. stocks to be priced in what we consider to be a "fair value" range, that is, to at a minimum compensate investors for the risks they incur owning public equities, their expected return would be at least in the upper single digits. Since we are well below that hurdle rate in our base case scenario, we remain less than fully invested in U.S. stocks.

As the valuation chart to the right indicates, the U.S. stock market is as expensive as it has *ever* been in the past 50 years, with one exception: the dot-com stock market bubble of the late 1990s, from which the S&P 500 Index plunged nearly 50%. We don't believe this time is different. We do believe valuation matters. When stock market valuations are high, the odds are your *future* market returns will be low. So we remain underweight to U.S. equities in favor of (1) foreign stocks with much better return prospects and (2) bonds and a small amount of precious metals.



Source: S&P Capital IQ Compustat, NDR Research. Monthly data as of 2/28/17.

European Stocks

Our portfolios have meaningful exposure to developed international markets, with a focus on European stocks. These positions added value to our portfolios in the first quarter, and we continue to be confident European stocks will outperform their U.S. counterparts over the next several years. Remember, much of the EU/ Brexit/ other concerns are priced into these markets.

Primarily due to the onset of a regional debt crisis in 2011, European corporate earnings have barely grown since the 2008–2009 financial crisis. Fiscal and monetary policies have not been stimulative enough to offset this. Meanwhile, U.S. company earnings have grown strongly, exceeding prior cyclical highs due to historically high profit margins, stock buybacks, and low interest expenses. This divergence in earnings trends is the key reason we view European stocks as more attractive looking forward.

We estimate that over the next five years European companies will likely grow earnings at a much faster rate than their U.S. counterparts; this would lead to outperformance by European stocks. Simply stated, we believe European earnings are cyclically depressed, while U.S. earnings are near cyclical highs. Further, we do not believe this condition is adequately reflected in their respective valuations. We don't know the precise timing or exactly what catalyst will lead investors to close the gap. This is especially true now, when political uncertainty in Europe is high. Yet, there are reasons for optimism the market will finally start to take notice.

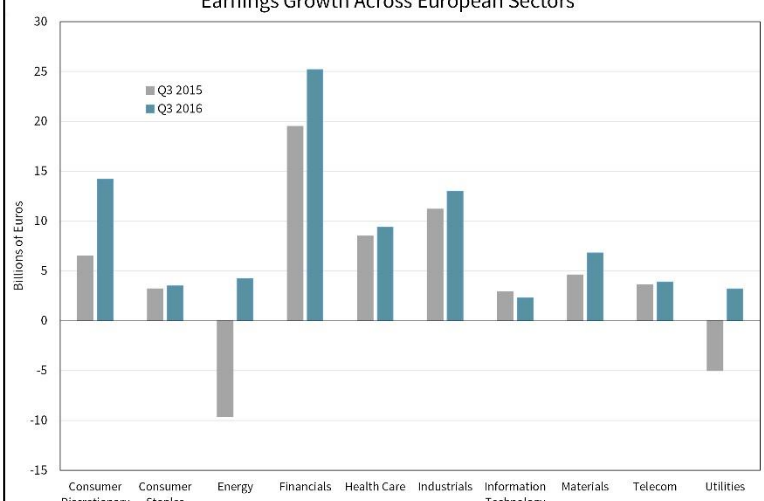
Last year, for the first time since the 2008–2009 financial crisis, Europe's economy grew faster than that of the United States. Improving economic growth is a good sign as it ultimately leads to better sales growth and gets consumers and corporations to borrow and spend, furthering the growth cycle. According to the Bank Credit Analyst, private sector credit growth in Europe is up at the fastest rate since the financial crisis.

Private Sector Credit Growth is Accelerating in Europe

Data as of 2/28/17. Source: European Central Bank.

Unsurprisingly, the European Central Bank is expressing greater confidence in its economic outlook, and has revised upward both its inflation and growth projections for 2017–2018. We are also finally seeing better earnings from European companies. Looking at the sector level, according to NDR, the most beaten down sectors, such as financials and energy, are seeing the fastest earnings growth year over year in local-currency terms. Europe has a relatively large exposure to these sectors and any improvement there will reflect positively in index-level earnings growth.

Earnings Growth Across European Sectors



Source: NDR. Data as of 9/30/16.

Last but not least, our active equity managers own many global business franchises that while domiciled in Europe are geared toward growth outside the continent. Even if Europe's growth were to disappoint, these businesses would benefit from emerging markets' growth and/or improvement in the United States' economy.

Some examples: **Fresenius Medical**, a German company, generates 70% of its revenues from the United States and has a leading market share here. **Valeo** used to be primarily focused on France, its home base, but in the past several years it has transformed itself into a truly global auto-components company.

Emerging-Market Stocks
Our analysis continues to indicate that emerging-market stocks are attractive compared to U.S. stocks. Emerging-market company earnings are *cyclically* depressed relative to earnings of U.S. companies, yet investors are essentially pricing that in as a *permanent* condition. Using what we believe are very conservative normalized earnings estimates, our analysis indicates emerging-market stocks in aggregate are trading at a price-to-earnings multiple well below their historical averages. Using Robert Shiller's valuation methodology—another way of normalizing earnings, or smoothing out their cycles—emerging-market stocks are trading at around half the multiple of their U.S. counterparts**.** As emerging-market earnings growth comes through, we expect investors to bid up their prices and valuations, generating low double-digit annualized returns.

Of course, there are risks investing in emerging markets. Among the new worries investors have is President Trump's protectionist stance on international trade. There remains considerable uncertainty as to whether his stated policies on border taxes, import tariffs, etc., will actually be implemented in the manner he has proposed. There is a good chance they may not be. Even assuming they will be, while they would be a near-term negative for some emerging-market countries, we argue they may actually be worse for larger U.S. companies. That is because, among other things, Trump's protectionist policies would likely disrupt global supply chains for U.S. multinationals. This ability to conduct sourcing on a global basis has driven down multinationals' operating costs and has been important in pushing U.S. corporate margins higher for the past decade-plus.

Emerging markets are better positioned today to weather protectionism, higher U.S. interest rates, and a rising dollar than they were a few years ago. Many countries are implementing reforms and undergoing political change that could be positive longer term. For example, Michael Kass, portfolio manager of Baron Emerging Markets, cites the approval of a "national sales tax" in India that's aimed at creating a single unified market and reducing bureaucracy there. In Latin America, Kass is optimistic recent political regime shifts and renewed fiscal constraint in Brazil and Argentina could increase foreign capital and investment, helping the region recover from its economic stagnation. In China, much needed supply-side reforms seem to finally be occurring. For example, in a recent report by Artisan International, we learned China is shutting down low-return-on-capital fertilizer plants and helping affected workers by creating a social fund. (The reduction in supply is generating stock-specific opportunities in the fertilizer space for this manager.)

The above developments are not sufficient in and of themselves to drive growth and outperformance in emerging markets. But when we start to see such actions occur at a time when earnings are historically depressed *and* valuations are attractive, we think there are good reasons to be optimistic about investing in emerging markets.

Fixed-Income

For the quarter as a whole, all but one of our active fixed-income funds outperformed the core benchmark, continuing the trend from 2016. (Vanguard Intermediate-Term Corporate "just missed".) Our fixed-income exposure encompasses what we believe is a prudent amount of credit risk and modest interest-rate risk (duration). It also offers a meaningful yield and expected-return advantage versus the core bond index. We have been correct in maintaining – and especially not sharply reducing as some investors have – our belief in fixed income (bonds). Now, we do believe that over the next several years the most likely direction for U.S. interest rates *is* higher, although it will likely be a *bumpy* path and upwards moves may periodically stall. That would be consistent with the evidence of global economic reflation as discussed above. In such a scenario, core bond index annualized returns will be relatively low (and potentially negative over a 12-month period). In contrast, we believe our actively managed flexible and lower-quality bond funds can generate mid-single-digit-type annualized returns.

Gold & Precious Metals/ Managed Futures

As with the asset classes profiled above, diversification is the primary tool we are using in our global diversified portfolios. We reduced or eliminated managed futures and merger arbitrage from most of our client portfolios, although we are believers in the long-term benefits of owning alternative strategies in our portfolios. We may go back to them in the future, but for now we believe the Trump presidency is causing expectations to rise in traditional stock and bond markets; as you've seen, we added to primarily equities but also bonds with the proceeds of the alternative sales. We still maintain a gold bullion in most portfolios, and gold has had a strong year thus far.

Putting it All Together

Despite a high level of volatility emanating from U.S. politics in recent months, U.S. stock market volatility has remained very low. That is unlikely to last. Our portfolios are prepared for more oscillations, particularly downside risk to U.S. stocks. We remain confident in our positioning and in our investment process, both of which allow us to look past periods of uncertainty and keep our focus where it should be: on prudently managing our diversified portfolios to achieve long-term, risk-adjusted returns.

—Main Street Advisors, LLC/ Litman Gregory Research Team (April 17, 2017)