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CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

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From RiverPoint Capital Management

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September Sound Bites on the Market and Economy

We hope you enjoyed our recent "Mid-Year Review and Market Outlook" webinar which we sent out to everyone. As its highly creative title implied, the webinar focused on our take on the first half of 2017 and our outlook for the remainder of the year. We appreciate the opportunity to follow-up via this final Sound Bites issue of the summer and highlight several points of interest as you head into the long Labor Day Weekend. The Labor Day holiday was established as a national holiday in 1894 by President Grover Cleveland after 30 states had already begun to recognize it independently. According to Wikipedia, Labor Day "honors the American Laborer and the contribution workers have made to the strength, prosperity, laws and well-being of the country" Amen! While everything may not be picture perfect on the employment front at present, we have much to be thankful for in this country with regard to the American worker…the 4.3% unemployment rate is at a 16 year low, unemployment claims are at lower levels than we have seen in decades, payroll growth is averaging roughly 200,000 new jobs per month over the last quarter (a very robust pace for this late in the cycle), and consumer confidence is at the highest level since 2000. The economy and investors have much to celebrate these last nine years…many thanks to the American worker/consumer! In fact, many observe this does not feel like a lazy 2% economy with these types of 2017 statistics. And maybe it's not. The well-respected Atlanta Fed is looking for GDP to rise by 3.7% in Q3 2017, so perhaps the trend is stronger than we recognize right now.

In This Issue:

Since we are heading into what is perceived as a seasonally challenging time for the market during September and October we thought we would comment on odds of some type of pullback from current price levels and how we would anticipate reacting to that potential occurrence. Given that we have seen a recent spike in volatility, largely due to geopolitical events such as North Korean threats to ramp-up their nuclear missile program and elevated concerns that the White House and Congress simply are unable to lead effectively, we wanted to share data on how the market does behave around and in the aftermath of global conflict and geopolitical challenge…oddly, the historical data on this is confidence building.

Corrections and Market Tops are as Different as Night and Day

…As are the events that precede them and how you should react to them. We have stated time and again recently that we fully expect a 5-15% correction. Why?--simply because these types of SHORT LIVED pullbacks are absolutely normal and generally occur EVERY year. We've shown you the chart on

continued on next page

this many times. Market returns have just been too smooth this year. It's analogous to taking a coast to coast flight with ZERO turbulence…it happens, but it's rare. The turbulence doesn't mean the flight isn't going to land safely; it is just some normal discomfort we have to bear on an otherwise very efficient, comfortable trip. With regard to the lack of normal turbulence in stocks so far this year, we've only experienced a 3% maximum sell-off in the S&P 500 on a year to date basis and have only seen a couple of days where the market has wiggled more than 1% up or down in a given day. This compares to the normal 60 or so such days in the average calendar year. That just can't continue. In fact, in the past 60 years, there have only been 5 calendar years where the market hasn't seen at least a 5% intra year sell-off of some kind. Doesn't mean 2017 couldn't mark the 6th time out of 61 years…but as you can see that would be rare. The last double digit swoon in the S&P 500 was in January of 2016. We had an 11% pullback then before what (and this is the point)? ...Before the market went on to post a very satisfactory 12% return last year. And that's just typical behavior in stock land when the fundamentals are attractive, valuation is reasonable and technical price trends are healthy-- like they are today. This is the definition of a correction…a temporary cleansing before moving on to another high.

One other note as to why a temporary pullback in the near term could be in the offering. While long term price charts remain in nice uptrends, momentum in the market has stalled of late and advancing stocks appear to be in the more defensive areas of the market. Specifically, the S&P 500 has only gained 1.2% since March and it's been the more "safe haven" sectors like utilities and staples that have outperformed over the last 30 days. We look for such divergences that can telegraph market pauses. This can be coupled with the fact that despite a very strong S&P 500 earnings season and an associated above average number of stocks beating expectations, stocks that have beaten these anticipated consensus EPS figures in Q2 have on average sold off 0.3% in the ensuing 4 days after their earnings releases versus typical average price gains of 1.4% for positive earnings surprises in this time period historically. Again, this doesn't portend a bear market, it just portrays a sense that the market wants to take a short breather

Corrections are unpredictable, don't last long and therefore are not actionable. If anything, smart investors hold positions they like, invest any modest excess cash they have tucked away for opportunities or upgrade positions a bit by swapping into attractive stocks that have been overly punished in the pullback. **That's what we do at RiverPoint in CORRECTIONS when the underlying economic trends and market underpinnings remain favorable.**

This is clearly different than market tops that generally mark or are accompanied by economic recessions. You DO want to pivot and reduce risk at these moments. Now, we know that sirens don't go off when these tops and recessions are approaching or of higher probability. But **there are good indicators that are signals of rising risk that we watch carefully.** What are they? Well things like massive purchases or flows into US mutual funds and ETF's (suggest investors are just too euphoric if that happens); very high M&A and IPO activity; rising inflation from fairly high levels; rising short term rates from high levels that lead to an inverted yield curve; expanding spreads on corporate bond yields versus safer government bond yields, decelerating growth in earnings; decelerating job growth; weakening manufacturing and service level activity; and a narrowing in the number of stocks advancing in the market. Most of these signals enumerated here WERE PRESENT prior to the 2000 and 2007 nasty bear markets. **Virtually none are apparent today.** In fact, Q2 earnings were far better than expected –up 11% versus the anticipated 6% growth going into the earnings reporting season and the 5% revenue growth was impressive. Market tops just don't typically occur in the midst of rising payrolls and earnings growth. This is a key reason why we see further advancement in the market over the next twelve months. Again, we monitor this data obsessively.

Bull Market Top Checklist

	2000	2007	Current	Comments
1. Blow-off top	✓	✓	x	No signs of panic buying or speculative excess in public equity markets.
2. Heavy inflows into equity market funds	✓	✓	x	Net inflows into domestic equity mutual funds and ETFs has only recently started to rise. Inflows into bond funds remains robust.
3. Big pick-up in M&A activity	✓	✓	x	While M&A activity picked up meaningfully in 2015, both deal volume and deal value faded in 2016. Deal volume remains far from robust this year.
4. IPO activity	✓	✓	x	Despite some high-profile new issues thus far in 2017, deal volume and assets raised remain far below the pace exhibited in 2015.
5. Rising real interest rates	✓	✓	x	5yr-5yr breakeven expectations have turned lower over the last 3 months.
6. Weakening upward earnings revisions	✓	✓	x	Upward earnings have been trending upward recently.
7. Erosion in number of stocks making new highs	✓	✓	x	The market's breadth is far healthier today than it was during the period of consolidation between 2014 and early 2016.
8. Shift towards defensive leadership	✓	✓	x	Since the February low, cyclical shares have outperformed.
9. Widening credit spreads	✓	✓	x	High-yield and investment grade credits spreads remain tight.

Market Behavior Around Global Conflict and Geopolitical Events

So, if we think the economy and earnings are on sound footing, why do we think a pullback is likely? In other words what would spark it? Other than we "are due" for one, our view is driven by the abundant headline risk out there to heighten emotions and create moments of over-reaction. Currently the list on that front would indeed include things like: anxieties around the North Korean nuclear missile capabilities; looming September/October Congressional debates on raising the debt ceiling and passing budget resolutions; speculation about additional Trump Administration staff departures etc. Any one of these items is capable of igniting the temporary setback. Do these sound familiar to last year's wall of worry items such as concerns over Brexit and the US Presidential Election? Related mild sell-offs around these concerns proved to be opportunities. Why did the market shrug off these headlines last year and why did we stay steadfast in our growth positioning? In examining the facts and the data, it became abundantly clear the economy was improving and earnings were accelerating. That is what truly drives stocks. Paraphrasing Bill Clinton, "It's the Fundamentals, Stupid". We see a similar and continued positive fundamental backdrop today. In fact the attached chart illustrates how the market has responded around and after a number of various events that have involved global conflict or geopolitical challenge. The table includes some pretty fascinating periods in our history, like the Cuban Missile Crisis, Watergate, the US Government Debt Downgrade, Brexit etc. This table demonstrates that while many such events spark initial negative reaction that can lead to double digit sell-offs in the immediate months following these events, the market has well more than absorbed the temporary corrections and advanced to new highs 6 and 12 months out.

continued on next page

Event	Date	Day of	+ 20 Days	3 Months	6 Months	12 Months
Pearl Harbor	12/7/1941	-3.8%	0.3%	-10.5%	-5.6%	3.7%
Cuban Missile Crisis	10/16/1962	-0.3%	2.2%	13.2%	21.1%	27.8%
JFK Assassinated	11/22/1963	-2.8%	6.3%	11.8%	15.7%	23.9%
Pres. Nixon Resigns	8/9/1974	-0.9%	-13.8%	-7.1%	-2.8%	6.7%
1987 Stock Market Crash	10/19/1987	-20.5%	9.7%	8.1%	15.3%	22.4%
Iraq Invades Kuwait	8/2/1990	-1.1%	-9.3%	-11.3%	-3.0%	10.0%
First World Trade Center Bombing	2/26/1993	0.2%	1.0%	2.4%	3.8%	6.3%
Asian Financial Crisis	10/8/1997	-0.9%	-3.2%	-3.6%	13.1%	1.1%
9/11 Terror Attacks	9/11/2001	-4.9%	4.9%	10.0%	12.2%	-14.3%
Iraq War	3/20/2003	0.2%	2.0%	12.1%	17.2%	28.3%
Lehman Brothers Collapse	9/15/2008	-4.7%	-15.9%	-23.4%	-36.8%	-12.6%
U.S. Government Debt Downgrade	8/5/2011	-0.1%	-3.3%	4.5%	12.1%	16.3%
BREXIT	6/24/2016	-3.6%	6.4%	6.0%	11.2%	19.5%
Average		**-3.3%**	**-1.0%**	**0.9%**	**5.7%**	**10.7%**

We'll close by wishing you and family the best as we transition from summer to beautiful Fall weather and the family gatherings to come at year end. We'll keep an eye on the data, and, as always stand ready to make adjustments when the facts change.

Thanks for your confidence and ongoing support. All the Best from all of us at RiverPoint!

Thanks,
RiverPoint Capital Management

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