



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2017

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Executive Summary

- Global equity markets advanced nicely in Q2 with the all-country equity index returning +4.3%. A strong corporate earnings season and generally positive global economic data supported gains, while political risk eased in Europe.
- In the U.S., the overall market returned +3.0%, with larger companies outperforming smaller companies over the period and growth-oriented companies outperforming more value-oriented ones. Overall, solid earnings growth offset the increasing doubts that the Trump administration will be able to implement its fiscally expansive agenda.
- Global equities delivered another quarter of robust gains amid an upswing in global economic data and a reduction in political risk with the election of Emmanuel Macron in France. Developed equity markets returned +5.6% and emerging markets were up +3.7%.
- Fixed-income returns were more muted but positive in all segments except TIPS (Treasury inflation-protected bonds), with the Barclays U.S. Aggregate Bond Index increasing by +1.5%. Lower inflation readings and declining bond yields helped to bolster returns.
- This issue focuses on two separate themes. The first is whether the bull market is about to turn. We argue that the bull market is not yet over. The key reason is that earnings drive stock prices, and robust earnings have been the main driver of the bull market since 2009. Currently, corporate earnings are on the upswing, and most indicators are suggesting it's likely to get even better over the rest of the year. Stay invested.
- Our second theme is an introduction to sustainable investing. We briefly discuss what sustainable investing is, review some recent trends, and share with you how Artemis is approaching the opportunity.
- In terms of Artemis strategy, we continue to modestly add to our international and emerging market allocations to better capture the hoped-for (but not guaranteed) rotation away from the pricier U.S. market. We are also maintaining our focus on taking credit risk rather than interest rate risk in our fixed income allocations.

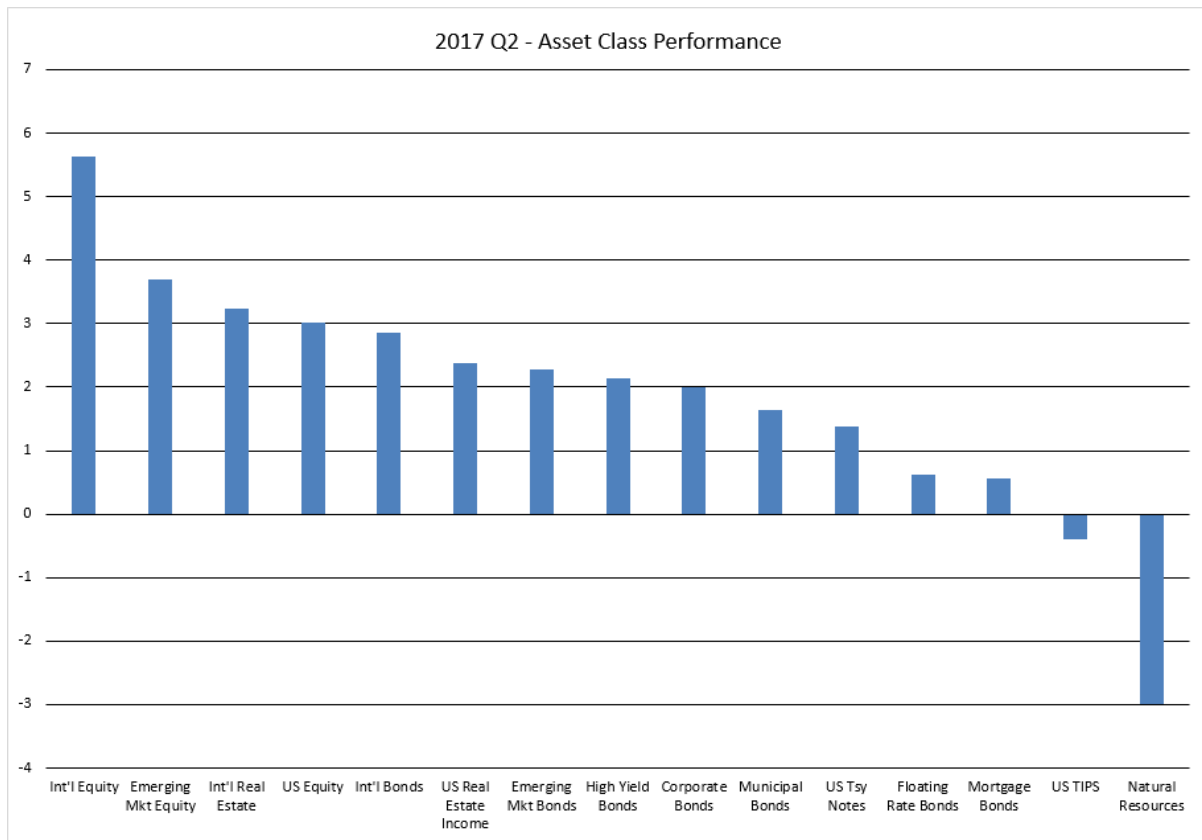


2nd Quarter in Review

Global equity markets advanced nicely in Q2 with the all-country equity index returning +4.3%. A strong corporate earnings season and generally positive global economic data supported gains, while political risk eased in Europe.

In the U.S., the overall market returned +3.0%, with larger companies outperforming smaller companies over the period (see Figure 1). Growth-oriented companies outperformed more value-oriented ones, with the so-called FANG stocks (Facebook, Amazon, Netflix and Google) accounting for more than a third of the increase in the S&P 500. A weaker dollar and strong retail spending both helped propel corporate earnings and underpinned the overall increase in the market. In sum, solid earnings growth offset the increasing doubts that the Trump administration will be able to implement its fiscally expansive agenda.

Figure 1: Market Performance by Asset Class in Q2 2017 (percentage points)



See Disclosure page for details on indices.



Equity markets abroad, both developed and emerging, outperformed the U.S. market by returning +5.6% and +3.7% percent, respectively, over the period. In Europe, we saw the election of President Emmanuel Macron in France, which helped to allay concerns over rising populist sentiment. Economic news continued to be encouraging in both Europe and Asia, suggesting a pickup in growth, and emerging markets continued to be the beneficiary of the overall supportive global backdrop.

Fixed-income markets were more muted but generally well-supported until the very end of the quarter. In the U.S., the Barclay's Aggregate Fixed Income index returned +1.5%. Once again, more credit-sensitive segments of the global bond market outperformed, with U.S. high-yield and emerging market debt leading the way. Government bonds sold off a bit at the end of the quarter, especially in Europe, likely due to comments from central bank leaders in the U.S., Europe, and the UK signaling a potentially faster trajectory of interest rate increases than the market was anticipating.

The only sector with negative returns was commodities, led by oil prices shedding almost 11% on supply concerns, with robust U.S. shale production outweighing OPEC attempts to cut output.

Is the Party Almost Over?

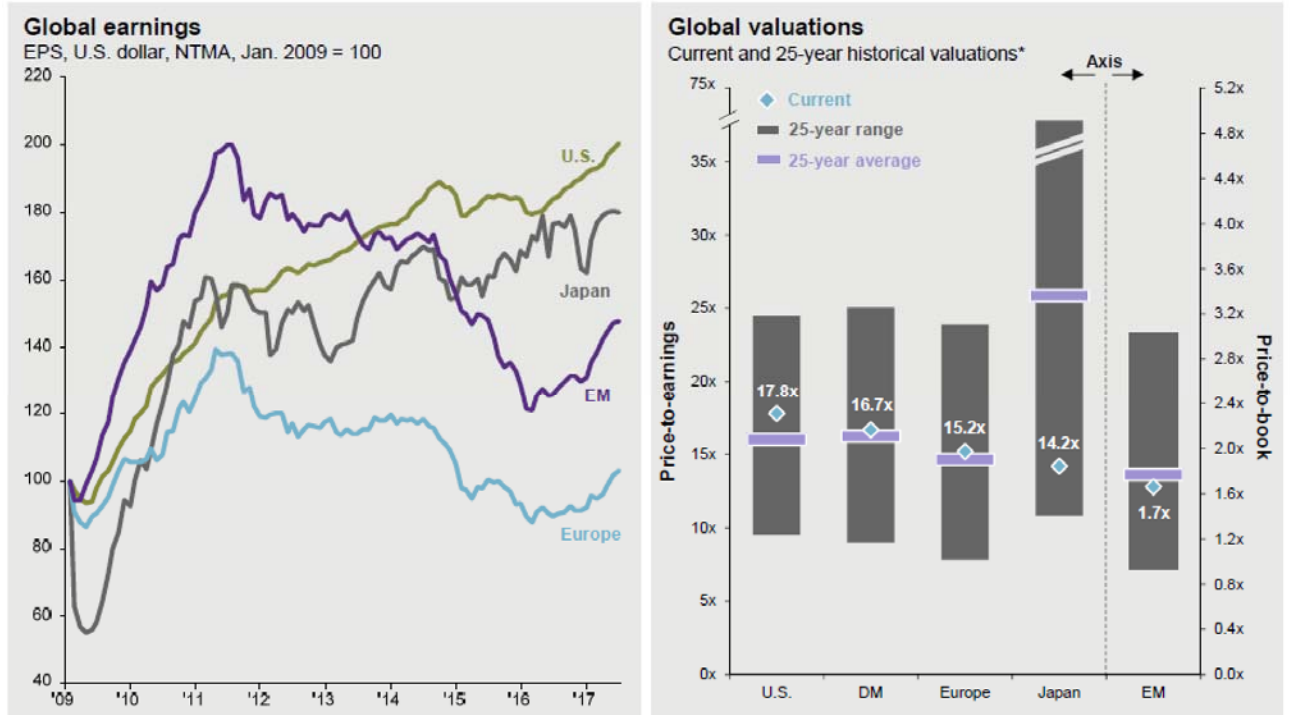
The question on everyone's mind these days it seems is whether the bull market that all of us have enjoyed for over eight years now is about to end, and potentially very badly. In my view, the answer is No, and if you read no further, then remember this: **Earnings drive stock prices, and robust earnings have been the main driver of the global equity bull market since 2009.** If we see decent global growth continue over the next year – and there are many reasons to be optimistic – corporate earnings growth will continue to provide positive momentum to the markets.

As shown in Figure 2 on the next page (left-hand side), U.S. corporate earnings have been increasing almost without a pause since the end of the recession. The only slow period was in 2015 when energy prices collapsed and the dollar strengthened. What's even more important is that because earnings have increased, the U.S. stock market has not become "horribly overvalued" as some pundits argue. In fact, as shown on the right-hand side of the chart, the forward price-earnings ratio for the U.S. stock market is only slightly above its 25-year average. The market is not cheap, but it is definitely not crazy expensive either.

The same chart reveals more good news. Not only are U.S. corporate earnings currently increasing at a fairly good clip, so too are earnings across the rest of the world.



Figure 2. Global Corporate Earnings and Valuations



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
*Valuations refer to NTMA P/E for Europe, U.S., Japan and Developed Markets and P/B for emerging markets. Valuation and earnings charts use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates, which may differ from earnings estimates used elsewhere in the book.

This synchronized global recovery is why stock prices are increasing across all major regions.

Why is this happening? As one analyst pointed out, while the collapse in oil prices in late 2014 was the main reason for the deterioration in global growth in 2015, it is also the principal cause for the subsequent rebound that got underway in the middle of 2016. The reason is that while falling oil prices tend to be bad for global growth, low oil prices are good for it. Low oil prices are a windfall to consumers, all energy-consuming industries, and all oil-importing countries. In 2016, this low-price environment came after a fairly prolonged period of monetary easing (i.e., central banks reducing interest rates to stimulate borrowing and economic activity) that aided economic growth. This is where we are today.

But how about the outlook? In my view, there are many more reasons to be optimistic than to be worried. Let me list some of them:



1. Continued strong employment growth in the U.S. and now even in Europe. The latest employment report in the U.S. just came out a few weeks ago, and the number of new jobs created was well over 200,000 in June, surpassing expectations. Companies don't hire at this rate if earnings are under threat.
2. Rising employment is spurring increased consumer spending. While the press is focusing on the tough times for department stores and other brick-and-mortar retail chains, overall consumer spending is doing very well.
3. More consumption growth should spur increased capital expenditures, although we have yet to see this in the data. However, very recent surveys show that the share of U.S. firms planning to increase capital expenditures has risen to a post-recession high, in part because they see consumers willing to spend.
4. Indices tracking new orders by both manufacturing and non-manufacturing sectors in the U.S. are almost off the chart, suggesting that companies will see some nice top-line revenue growth.
5. Europe seems to be growing once again – corporate balance sheets in the euro area are improving and credit growth is accelerating. In addition, unemployment is falling, which creates a virtuous circle of spurring more consumption and business investment.
6. Even Japan is growing nicely. Its exports are recovering, and manufacturing indices are at near-record levels.
7. China is still chugging along, based on real-time measures of activity such as electricity production and railway freight traffic. Even lending is accelerating.
8. We are also not seeing an increase in inflation that would indicate an overheated economy. As a result, central bankers are not rushing to take away the punch bowl (i.e., tighten monetary policy).
9. Finally, we are not experiencing any of the imbalances that typically trigger a recession, such as a technology or housing bubble, or a huge spike in oil prices (remember the lovely 1970s).

In summary, while the 'Trump bump' that helped stock prices in the days and months after the election may be dissipating due to an increasing consensus that the current administration will not get its growth-stimulating agenda through Congress, the so-called fundamentals of the global economy are doing well and actually improving. I believe this is the key reason we have not seen any kind of a market correction thus far. Also, I believe there is room to run.



Sustainable Investing at Artemis: An Introduction

Artemis has recently introduced sustainable investing as an option for interested clients. Below is a brief review of the concept, a discussion of some recent trends, and an explanation about how we are approaching the opportunity.

Sustainable investing is not new.¹ Indeed, many individual clients and institutions have long expressed their values in one way or another via their investment decisions. Traditionally, this has taken the form of eliminating any investment in specific sectors (e.g., gambling, stem-cell research) or specific companies deemed to be inconsistent with one's values.

The problem with this approach is twofold. First, what's against one person's values (e.g., contraceptives) may well be a godsend to another, so adopting an "exclusionary" type approach has required some amount of customization, which makes it expensive to implement. Second, research indicates that investors who have reflected their values in their investment choices by excluding certain industries often pay a price in terms of investment performance.

A good example of this is Norway's \$870 billion Government Pension Fund, which has long had a socially responsible mandate. The fund excludes two types of companies from its investment portfolio: "product-based" exclusions include weapons, thermal coal and tobacco producers and suppliers; and "conduct-based" exclusions include companies with a track record of human rights violations, severe environmental damage and corruption. According to a newly released study by the fund's managers this year, the fund has missed out on 1.1 percentage points of gain annually on average over the last 11 years. Other studies have found similar or mixed results (at best) for similar exclusionary-type approaches.

More recently, sustainable investing has moved beyond a purely exclusionary approach to one that is more inclusionary; i.e., one that considers environmental, social and governance (ESG) criteria in addition to traditional financial metrics, but does not necessarily screen out entire industries. (See Figure 3 on the next page.) With this approach, investors seek companies that are deemed to perform better than their peers on the subset of ESG criteria

¹ Sustainable investing is also referred to as socially-responsive investing (SRI), environmental, social and governance investing (ESG), green investing and impact investing. Each term has come to mean something a little different in the literature. Here we using the term sustainable investing as an umbrella term for all approaches.

that apply to their industry. As such, ESG screens only exclude (or minimize) those companies within an industry that score poorly on ESG criteria.

Figure 3. Environmental, Social and Governance Criteria

Environmental	Social	Governance
Climate change and carbon emissions	Gender and diversity policies	Board composition
Air and water pollution	Human rights	Executive compensation
Energy efficiency	Labor standards	Audit committee structure
Waste management	Employee engagement	Bribery and corruption policies
Water scarcity	Customer satisfaction	Lobbying activities
Biodiversity and deforestation	Community relations	Political contributions

Source: Morningstar

The premise with this more inclusionary approach is that **directing capital toward companies that are dealing effectively with sustainability and governance issues will enhance the transition to a more sustainable global economy and lead to better investment performance.** The latter is posited because those companies that are effectively addressing ESG issues have been shown to perform better on a whole variety of financial metrics.²

Even so, many challenges remain. While there are several new ratings schemes to help investment managers and financial advisors understand which companies rate highly on ESG criteria, much less is known about how to identify the relatively small subset of the ESG data that is truly material and value-relevant for each industry. Another challenge is the still relatively low quality of the underlying ESG data being reported by companies. No

² One of the more comprehensive reviews examined more than 100 academic studies of sustainability investing around the world and found that ESG factors are strongly correlated with superior risk-adjusted returns at a securities level. The study also confirmed that corporations with high ratings for ESG factors have a lower cost of capital in terms of debt and equity and most exhibit market-based outperformance. See Deutsche Bank Climate Change Advisors, *Sustainable Investing: Establish Long-term Value and Performance*, June 2012.



consistent standard or reporting methods exist as of yet and, as a result, it is still difficult for investors and the rating agencies to compare companies across ESG metrics.

So the question becomes, do you wait to invest using ESG criteria until the data and rating methodologies are as good as traditional financial data? My view has evolved on this point, in part due to the recent introduction of wider variety of low-cost indexed-based mutual funds and ETFs (Exchange Traded Funds) that do a fairly good job of tracking traditional market benchmarks. They do so by keeping sector weights close to benchmark weights while still emphasizing companies with high ESG scores and minimizing those with lower scores. These newer products enable us to fairly easily substitute our conventional equity fund choices for ESG funds without having to change or compromise the overarching asset allocation strategy.³

My view has also evolved because I am increasingly finding it very intuitively appealing to send a signal to companies that issues such as energy efficiency, carbon emissions, workplace safety, and employee relations matter to investors and that investors are willing to reward those who implement good or best practices. (For example, the delete Uber movement is having an impact.) In time, the hope is that investor interest will lead to more and better reporting standards, more precise ESG ratings, and a more sustainable and just world.

The choice to introduce ESG criteria into the investment decision is an individual one. Artemis will continue to utilize conventional index-based funds in the absence of a proactive request from a client. Indeed, after 8+ years of a bull market, the capital gains costs of switching to a fully allocated ESG portfolio would be prohibitive for many current clients in any event. Please get in touch if you would like to learn more.

Artemis Investment Strategy

Our portfolios are lagging their benchmarks this year because the asset classes we favor relative to the benchmarks we use are smaller companies and more value-oriented ones. Both of these segments of the market outperformed strongly last year and seem to be

³ Note that this approach precludes the ability to screen out entire industries such as gambling, tobacco, etc. In addition, the available ESG fund choices for fixed income are still extremely limited precluding applying ESG criteria to the fixed income portion of the portfolio. If either of the above considerations are paramount, one would need to hire an advisor that builds highly customized individual stock and bond portfolios. Such advisors do exist but typically have fairly high minimums due to the work involved.



‘reverting to the mean’ so far this year. See Figure 4. In addition, while we have been taking a bit of profit in our U.S. equity allocation and investing more internationally, our portfolios do not match the benchmark’s U.S. / developed international equity split, as shown in Figure 5 on the next page. As such, they are always going to lag a bit when developed international markets are outperforming. But remember, while Europe is doing well currently, the region is no longer a screaming buy. Moreover, as you may recall from my report last quarter, both Europe and developed countries in Asia face very serious long-term structural problems so I am not rushing to add more exposure than I already have.

Figure 4. U.S. Equity Performance By Size and Style – 2016 vs. 2017 YTD

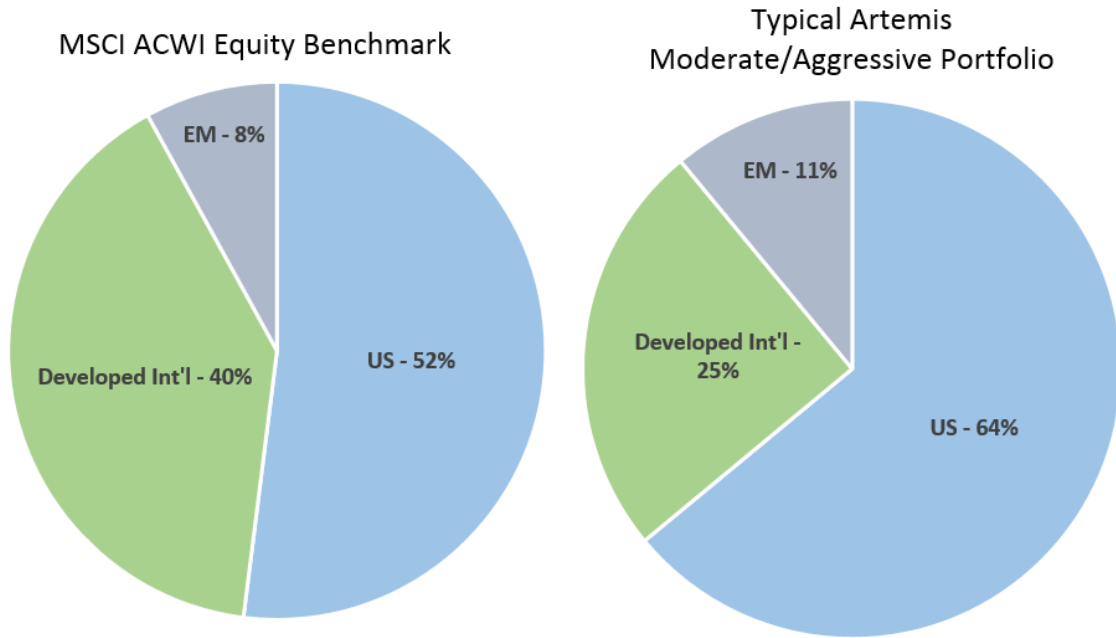
		2016			2017 YTD		
		Value	Blend	Growth	Value	Blend	Growth
Size	Large	17.3%	12.0%	7.1%	4.7%	9.3%	14.0%
	Mid	20.0%	13.8%	7.3%	5.2%	8.0%	11.4%
	Small	31.7%	21.3%	11.3%	0.5%	5.0%	10.0%

On the fixed-income side, we still favor the more credit-sensitive sectors such as high yield and emerging market debt. This has added almost a full percentage point of return to most portfolios since the beginning of this year relative to the benchmark. The only real detractor on an absolute basis has been our allocation to inflation-protected U.S. Treasuries, primarily because inflation readings have declined since the start of the year, a development that Janet Yellen of the Federal Reserve is watching quite closely.

Finally, I am starting to watch our real estate allocation, especially our domestic exposure, and may begin to pare our allocations. Rent growth is slowing, retail vacancies are increasing (anyone walked down Newbury street in Boston lately?), and overall commercial real estate prices in the U.S. currently stand 7% above pre-recession levels.



Figure 5. International Equity Exposure in Artemis Portfolios vs. the Benchmark



Market Index Descriptions

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large, mid and small capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than ten years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon GNMA mortgages, with at least of \$150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than fifteen years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.



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The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publically issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.