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QUARTERLY SPOTLIGHT

Second Quarter, 2017

Economic Response & Strategic Insights

In Brief

The second quarter of 2017 still enjoyed some of the initial fervor that struck the financial markets shortly after Donald Trump was elected on November 8, 2016. The S&P 500 increased by another 3.09% during the second quarter, tacking that on top of the first quarter's 6.1%, helping to push the index to yet another new all-time high of 2,453.46 on June 19. 1Q17 saw positive returns across most financial markets, including equity, fixed income, and real assets. This bullish trend continued as a combination of improving global economic growth and the prospect of a wide range of pro-growth economic policies helped support some prices and spur others even higher. In the backdrop though of this rally was an array of economic and political news creating a variety of mixed emotions for investors.

Starting domestically, while markets continued to enjoy a toned down version of the "Trump Bump," President Trump and his administration remained mired in a political battle. They spent much of the quarter dealing with allegations of collusion with Russia, as well as, dealing with the fallout of firing FBI Director James Comey. Regardless of one's political persuasion, there was much less energy available to help push any pro-growth agenda through the legislative process. With a general policy to obstruct the President on the left and what seems a consistent reluctance to move proposals forward on the right, the current administration has found its first six months on the job frustrating.

There were of course a few things worth mentioning that happened outside the political whirlwind. S&P earnings for the first quarter were very strong, helping add fuel to the equity fire that has been burning more recently. Taking a look at some of the numbers reported: overall S&P 500 profits grew 9.7% for the first quarter. 74.1% of the S&P companies reported earnings that beat their estimates, with only 18.8% falling short. Estimates have second quarter operating profits coming in at new all-time historical highs. Inflation remains subdued, with the 12-month CPI All Items coming in at 1.6%, while unemployment hit a 16 year low of 4.3%. Both the ISM Manufacturing and Non-Manufacturing indexes continued to report the economy is in expansion mode.

Internationally, we started the quarter with a US missile strike on a Syrian airfield from which a chemical attack had been launched. North Korea was in the news shortly after the strike, taking the opportunity to test launch a missile in their efforts to build an intercontinental ballistic missile. There were also two significant elections during the quarter. The first was in France, where the centrist Emmanuel Macron beat his more conservative opponent in the Presidential race. Also significant was the UK election, where Prime Minister Theresa May suffered a setback when the conservative party lost its majority control in Parliament. All said, overall global growth continues to improve in both developed and emerging economies as central banks remain accommodative.

EQUITIES REMAIN POSITIVE DESPITE ROCKY GEO-POLITICAL ENVIRONMENT

Assuming US equity markets went sideways for the remainder of 2017, this would be the ninth consecutive year of positive stock returns, a historically significant milestone. If the trajectory during the first quarter for most equity markets was something akin to a rocket attempting to reach escape velocity from Earth, the second quarter's path looked a little more like the same rocket beginning to slow as it reached lower orbit. Year-to-date the S&P 500 has returned 9.34% with two-thirds of that return coming in Q1.

Other domestic indices showed similar results.

	Trailing Returns		
	2Q17	YTD	1 Year
Equities			
S&P 500	3.09%	9.34%	17.90%
Dow Jones Industrials	3.95%	9.35%	22.12%
Nasdaq 100	4.19%	16.78%	29.39%
Russell 1000	3.06%	9.27%	18.03%
Russell Mid Cap	2.70%	7.99%	16.48%
Russell 2000	2.46%	4.99%	24.60%
MSCI EAFE	6.37%	14.23%	20.83%
MSCI EM	6.38%	18.60%	24.17%

Source: Morningstar Direct, as of 6/30/2017

Overview

The ProEquities Investment Committee is comprised of highly specialized market strategists with 69 years of combined financial services experience. This team meets regularly to discuss markets, review portfolios, and optimize investment strategies, ultimately developing the analysis and recommendations presented here.

We look forward to feedback and questions at: PESolutions@proequities.com

About ProEquities

ProEquities is a an independent RIA with a broker/dealer helping advisors maximize their effective-ness and optimize business growth. Founded in 1985, this wholly owned subsidiary of Protective Life Insurance Company supports more than 750 independent financial advisors nationwide with headquarters in Birmingham, Ala.

The Nasdaq 100 was up 16.78% for the first six months of 2017, of which 4.2% was produced during second quarter. The Russell Mid Cap benchmark was up 7.99% for the first six months with just 2.70% being produced for the second.

International markets were able to outpace most domestic stocks in 2Q17 with the EAFE and Emerging Market indices both returning more than 6%. Both markets have also had very strong returns year-to-date as improving economic growth, favorable interest rate environments, and relative valuation advantages helped incentivize investors to seek globally exposed investments. The MSCI Emerging Market's 18.60% return is the strongest return year-to-date for the indexes we most closely track, although the technology filled Nasdaq 100 remains a close second. Volatility has remained subdued during 2017, other than two brief attempts at moving higher, first in April then in May. The lows reached during 4Q16 (11.27 index value) and 1Q17 (10.58) were again beaten during 2Q17 as the index reach the 9.75 level on June 2.

The current environment is an interesting one, as volatility in equity markets continues to fall, indicating to some that there is possibly less fear in the markets and more confidence with investors about the future. On the flip side, this confidence could evolve into a particular complacency by investors which creates its own set of risks.

BONDS: YIELD CURVE CONTINUES TO FLATTEN AS FED STICKS TO PLAN

Bond markets continued to show strength during the second quarter, a trend that has endured since the beginning of the year. Some might use the term "Goldilocks Environment" to denote a situation where everything is just about right. For the past two quarters, we could safely use this reference for the bond markets. Shorter-term interest rates are moving higher, not because of speculation, but because the Fed is using its legal power to control lending rates in order to make them go higher. In response, the yield curve is flattening, essentially twisting on a central fulcrum point, right between the 3- and 5-year yields.

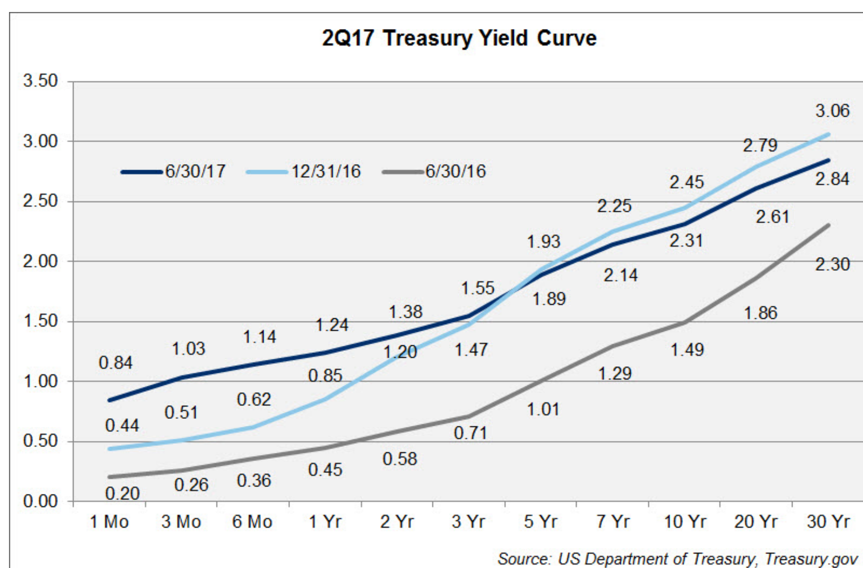
The Fed's actions have caused short-term bond yields to move higher relatively quickly, with the 3- and 6-month yields moving the greatest distance, 52 basis points year-to-date, aligned with the two rate hikes this year. On the other end of the Treasury yield curve, interest rates have actually fallen for the past two quarters, with the 10-, 20-, and 30-year yields moving 12, 12, and 15 basis points lower respectively. The 10-year yield finished the second quarter at 2.31%.

Fixed Income Returns

	Trailing Returns		
	2Q17	YTD	1 Year
Fixed Income[1]			
Short Gov't / Credit	0.31%	0.72%	0.35%
U.S. Aggregate Bond	1.45%	2.27%	(0.31%)
High Yield	2.17%	4.93%	12.70%
Global Aggregate Bond	0.98%	1.43%	(0.41%)
Emerging Markets	1.77%	5.11%	5.57%

Source: Morningstar Direct, as of 6/30/2017

In this environment, the proxy measure of the broader bond market, the Bloomberg Barclays Aggregate Bond Index, was higher by 1.45% during the second quarter, almost doubling the 0.82% return experienced in the first. High Yield bonds were again one of the stronger performing sectors for the quarter, along with both Developed and Emerging Market bond markets. Lower interest rates on the long-end, improving economic conditions, and relative valuations helped drive these groups higher.



Looking across the vast array of bond indices, both domestic and foreign, we find the majority of them were all higher for the first six months of 2017, in spite of the Fed apparently sticking to its planned attack on interest rates. With a rate hike at the end of 2016 and two so far this year, the Fed Funds Rate now sits at a target range of 1.00-1.25%. Our Goldilocks reference above is that even though interest rates are moving higher, most, if not all, bond prices are higher for 2017. Investors understand the Fed is serious for now as short term rates move higher, but longer term they feel the economy will require them to slow down or even stop the rate hikes. This, in part, explains why the yield curve is flattening.

Janet Yellen and the Fed have made two of their three planned rate hikes this year and more recently have proposed a multi-year, multi-trillion dollar unwinding of their balance sheet, which will serve to take additional liquidity out of the US financial system.

REAL ASSETS: REAL ESTATE BUILDING CONSISTENCY WHILE OIL CONTINUES ITS DECLINE

Real estate was positive on the whole in 2016, but has struggled during the last two quarters. The sector has shown positive returns to date, though at a muted pace when compared to most other equity sectors. Negative performance last year was due in part to interest rates moving higher. With longer term rates moving back down during both the first and second quarters, real estate has had a chance to catch its breath.

Alternatives Returns

	Trailing Returns		
	2Q17	YTD	1 Year
Real Assets			
MSCI US REIT	1.65%	2.66%	(1.82%)
S&P NA Natural Res	(7.09%)	(11.04%)	(2.62%)
Oil (WTI)	(8.94%)	(14.38%)	(4.66%)
Gold	0.12%	7.26%	(5.60%)

Source: Morningstar Direct, as of 6/30/2017

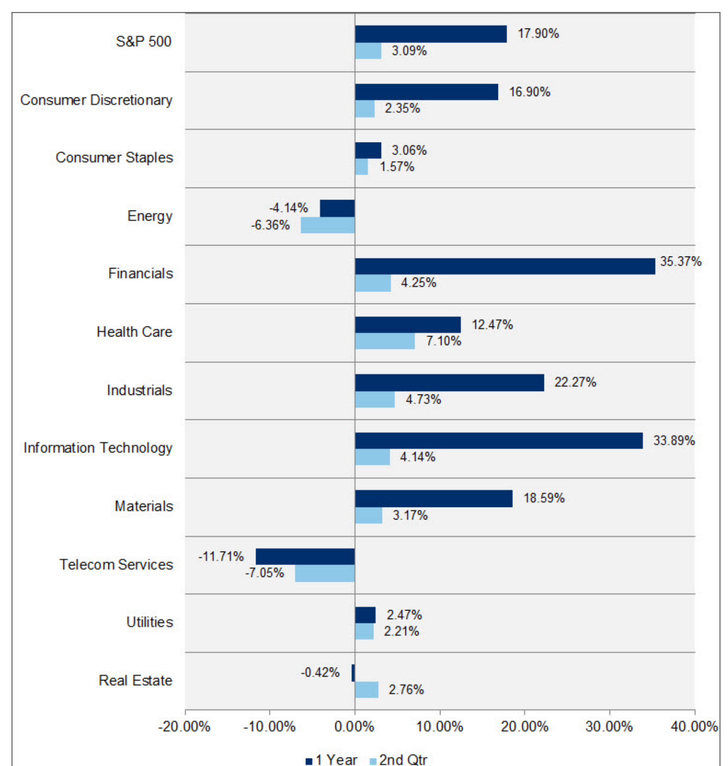
Commodity benchmarks have struggled during 2017, mostly because of their large exposures to the Energy sector with some of them allocating 65% and more to these stocks. Energy-related investments have steadily declined year-to-date though accelerating during the second quarter, as oil prices have also moved solidly lower. We started the year with oil prices at $53.72/barrel and watched it ebb and flow to finally rest at $46.04. While there is sometimes a loose inverse correlation between oil prices and the dollar, in the current environment this relationship has broken down as the dollar has been falling in price during 2017. It appears we are in a good, old fashioned supply/demand dynamic with additional supply helping to soften oil prices. This is the result of a combination of growing oil production coming online from US frackers and the inability of OPEC and other major oil producing countries to manage any meaningful production cuts.

SECTOR PERFORMANCE: FINANCIALS LEAD THE WAY WITH TECH ON ITS TAIL

What a difference a couple of quarters can make for a sector's wellbeing. When we look across the US equity sector landscape back in 2016, eight sectors had positive double digit returns and three of them had returns over 20%. **Energy** was the top sector in 2016, returning 27.4%, followed closely by **Telecom** which put up a 23.5% return. Where have those two sectors been in 2017? Energy now has the worst performance of the eleven sector group, falling 12.61% for the first six months of the year, and 6.4% of that occurred in Q2. To no one's surprise, the slow and steady decline of oil prices this year has been the primary culprit. Telecom seemed like it was still following Energy around like last year, falling in total 10.74% to date. In addition to the ever increasing competition in the group, falling profits and growing debt burdens are weighing on the group. The other nine sectors managed positive returns during the second quarter and year-to-date.

The best performance so far has been from the **Technology** sector, tacking on another 17.2%. This puts the trailing one-year performance at 33.9%. While the "Trump Rally" started unexpectedly and moved some sectors quickly through the end of 2016, Technology was actually not one of those, returning only 1.2% during the 4Q16. Much of their good fortune this year is due to strong earnings results and the outlook for the remainder of 2017. Looking at first quarter S&P earnings results, 31 of the 36 Technology firms that reported beat their first quarter estimates.

The second strongest year-to-date performance came from the **Health Care** sector, returning 16.07% with returns fairly evenly distributed across the first and second quarters. This is a significant turnaround from both the fourth quarter and year as a whole in 2016, where the sector fell 2.69%. While the defensive nature of the sector appears to have impacted last year's returns to some degree, the surge this year has been the result of the proposed health care reforms. **Financials** are currently sitting at the top of the sector heap in terms of trailing 12-month performance with a return of 35.37% ending 6/30/17. The bulk of this return was produced during the 21.1% fourth quarter run up last year, and the bulk of that quarter's return was actually produced after the Trump election. The initial surge was in response to the prospect of higher interest rates, pro-growth policies, and potential deregulation of the industry. The sector has slowed down somewhat year-to-date, producing 6.88% as investors are very wary about what, if any, pro-growth policies will roll out this year.



Source[2]: Morningstar Direct, as of 6/30/2017

STYLE PERFORMANCE: GROWTH CONTINUES TO RULE OVER VALUE

The pendulum that began its swing during the first quarter back from Small and Value to Large and Growth continued to have that same momentum throughout Q2. **Large** caps again were able to outpace their smaller cap counterparts, and **Growth** stocks again were the dominant play, driven forward still by strength in corporate earnings, signs of continued job growth, and most importantly, the prospect of nearer-term pro-growth policies.

1 Year numbers show **Small** caps still dominating all other groups. Looking to the year-to-date numbers, we find that **Large Growth** returns have well outpaced all other market segments, returning 14.0% in the first six months of the year. **Mid** and **Small Growth** have dominated their respective market cap-weighted peer groups as well with 11.4% and 10.0% returns respectively. **Small Value**, which dominated the 2016 US equity markets with its blistering 31.7% return, has suffered the fate of the all too familiar "mean reversion," able only to muster a 0.5% return so far this year.

2Q17	Value	Blend	Growth
Large	1.3%	3.1%	4.7%
Mid	1.4%	2.7%	4.21%
Small	0.7%	2.5%	4.4%

1 Year	Value	Blend	Growth
Large	15.5%	18.0%	20.4%
Mid	15.9%	16.5%	17.1%
Small	24.9%	24.6%	24.4%

Source: Morningstar Direct, as of 3/31/2017

FUND FLOWS: REALLOCATION TO BONDS CONTINUES

Looking this quarter at how investment dollars have flowed in terms of high-level asset category, we see that the large reallocation from equity investments to bonds continues at full strength. Looking at the table below, 2016 shows us that the top two categories in terms of positive asset flows (combining both ETFs and Mutual Funds) were Taxable Bonds with $200.5 billion in new assets, and Municipal Bonds with $33.6 billion. The next closest positive groups were Commodities with $13.9 billion and International Equity with $10.8 billion, while Domestic Equities were pretty much break even between mutual fund outflows and ETF inflows. This trend has continued and even accelerated during the first six months of 2017, as $203.6 and $17.9 billion have rolled into Taxable and Municipal Bond funds respectively, almost matching all of last year's bond net inflows.

Asset Flows (in billions)	2Q17		YTD		2016	
	ETF	MF	ETF	MF	ETF	MF
US Equity	$16.1	($23.0)	$59.7	($23.9)	$143.1	($143.8)
Sector Equity	($0.0)	($3.6)	$19.1	$8.1	$27.1	($27.2)
International Equity	$57.0	$29.7	$90.6	$46.4	$11.1	($0.3)
Allocation	$0.6	($4.9)	$0.8	($9.5)	$1.0	($49.9)
Taxable Bond	$33.7	$62.4	$67.6	$136.0	$86.4	$114.1
Municipal Bond	$1.5	$8.7	$2.2	$15.7	$6.3	$27.3
Alternative	$1.8	($0.7)	$3.4	($2.2)	$3.4	($2.8)
Commodities	$0.9	$0.0	$1.9	$0.3	$10.4	$3.8
Totals	**$111.5**	**$68.5**	**$245.3**	**$154.7**	**$288.9**	**($78.9)**

Source: Morningstar Direct, as of 6/30/2017

The dramatic net outflows from equity funds last year has changed course so far in 2017, swinging from a $171.3 billion net outflow to a $31.5 billion net inflow. That being said, ETFs continue to win the asset gathering battle of mutual funds — $245.3 billion flowing into ETFs to date across all asset categories, versus Mutual Funds' $154.7 billion. At the end of the second quarter, Total Net Assets for mutual funds sat at $13.62 trillion versus $2.98 trillion for ETFs.

Other than the overriding move away from actively managed mutual funds to passively managed ETFs, there were two other notable asset flow trends. The first is the recent uptick in International Equity flows since the beginning of the year. With investor concerns growing over domestic stock valuations and US economic growth, there has been a shift to move assets abroad where relative valuations seem more favorable. Secondly, as previously mentioned, the tremendous shift in asset flows from equities to fixed income is worth mentioning twice. From 2013 to 2015 equity mutual funds and ETFs outgrew their fixed income counterparts by $856.5 billion! Since the beginning of 2016, bonds have managed to tack on approximately $174.7 billion more in assets than equities.

LOOK AHEAD: WHICH OF THE MARKETS IS TELLING THE CORRECT STORY?

We started the 1Q17 Spotlight commenting about the enthusiasm the markets were feeling because of the many pro-growth policies that a Trump administration would be willing to rollout immediately. We also commented that we had witnessed the new administration's first hiccup within the first 100 days, namely the failure to get an initial vote on proposed reforms to the Affordable Care Act by the House of Representatives. Flash forward three months, and we do have a bill through the House but now the Senate is wrestling over what their version will be. If the legislation did not have such a fundamental impact on the economy and directly affect every US citizen so significantly, this would be an opportunity to simply watch an interesting phenomenon with the Republican Party. They currently control the White House, House, and Senate, yet are having difficulty moving any significant piece of legislation towards the President's desk, an individual who was elected in great part because of his promise to bring reform and growth. What generally happens to financial markets that have been trading on a particular expectation or assumption only to find those assumptions were premature or altogether wrong? That's really more of a rhetorical question.

So far in 2017 virtually every major asset class category has been moving higher, including equities (both domestic and international), fixed income (domestic and international), and real assets (real estate and most commodities EXCEPT for oil). That seems somewhat suspect, especially when you consider that many of these markets are not historically correlated which leads us to believe there is a shorter-term anomaly going on, specifically because of the structural change in Fed policy. It is structural in the sense that we have been functioning in a world with almost 0% borrowing rates on the low end of the curve for almost 10 years. There are individuals under the age of 30 who may find the idea that money market yields were in the 4% range right about the time they were starting their college career versus today when you might be lucky to get 1% on your cash. Moving interest rates back to whatever level the Fed deems “normal” is a structurally significant event. An important point to remember though, as many fret over the negative aspects of higher interest rates, is that it is more expensive to borrow.

There are also a wide range of positives that should not be discounted. Some examples include: savings, money markets, CDs, and other investments with their income stream tied directly to interest rates will go up, putting more money in the pockets of a wide array of investors, both retail and institutional. It incentivizes banks to lend, because their net interest margin, or the difference between what they charge for a loan and the cost of those funds, is able to expand thus providing greater revenues and ultimately profits. When banks can make more money on lending, they tend to lend more and help generate economic growth. In terms of home buyers, higher interest rates can also incentivize (though using the stick and not the carrot) to get off the sidelines and go ahead and make a home purchase in an effort to lock in borrowing rates.

The question is “which market is correct?” Ultimately, and possibly quite soon, one of them will be proven incorrect. If the stock market is the one that is more correct currently, then what they see is the economy remaining strong, unemployment remaining low, wages continuing to improve, and the opportunity for further expansion through capital expenditures and improving exports. And this particular scenario does not even really take into consideration Congress and the Trump Administration finally getting some form of Fiscal stimulus package implemented.

On the other hand, if the fixed income markets are correct in terms of what their behavior is telling us, then the current interest rate hikes are moving too quickly, taking away too much accommodation, and increasing borrowing costs at such a rate that will damage the current economy. Ultimately that will require the Fed to reverse course and begin bringing interest rates back down. We are at something of a crossroads with two definitive hypotheses on future outlook. The one thing we do know is that whoever is wrong is going to feel some pain.

HAVE QUESTIONS OR FEEDBACK?

Email the ProEquities Investment Committee at PESolutions@proequities.com.

DISCLOSURES

*Benchmark performance statistics for the time periods referenced are pulled from Morningstar Direct, a robust investment research and analysis tool used widely by investment professionals. The tool focuses on providing comprehensive and timely financial, statistical, and operational information on a wide range of investment products and indices.

[1]The fixed income sectors referenced in this table correspond to the following benchmarks: Short Gov't/Credit = Barclays US Government / Credit 1-3 YR Index / U.S. Aggregate Bond = Barclays U.S. Aggregate Bond Index / High Yield = Barclays High Yield Corporate Bond Index/ Global Aggregate Bond = Barclays Capital Global Aggregate Bond Index / Emerging Markets = Barclays Emerging Markets Hard Currency Aggregate Index

[2]The sector performance numbers pulled from Morningstar Direct are from the **S&P 500 Sector** performance series

Benchmark Descriptions

The **S&P 500 Index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. Members are selected based on market size, liquidity, and industry group representation. The **Dow Jones Industrial Average** is calculated by summing the prices of the stocks of 30 companies and then dividing that total by an adjusted value (due to the effect of stock splits throughout the history of the index). The **Nasdaq 100 Index** includes 100 of the largest domestic and international on-financial companies listed on the Nasdaq based on market capitalization. The **Russell 1000 Index** is an index of approximately 1,000 of the largest companies in the U.S. Equity markets. It is market cap weighted meaning that the largest companies constitute the largest percentages in the index. **The Russell Mid-Cap Index** measures the performance of the mid-cap segment of the U.S. equity universe. The index is a subset of the Russell 1000 Index and is reconstituted annually. The **Russell 2500 Index** is a broad index featuring 2,500 stocks that cover the small and mid-cap market capitalization. It is market cap weighted meaning that the largest companies constitute the largest percentages in the index. The **Russell 2000 Index** is an unmanaged index consisting of approximately 2000 US small capitalization common stocks. The **MSCI EAFE Index** is an unmanaged market capitulation-weighted index that monitors the performance of stocks from Europe, Australia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI US REIT Index** is a free float-adjusted market capitalization weighted index that is comprised of equity REITs that are included in the MSCI US Investable Market 2500 Index, with the exception of specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. The index represents approximately 85% of the US REIT universe. The **S&P Developed BMI Property Index** is an index consisting of companies from developed markets whose floats are larger than $100 million and derive more than half of their revenue from property-related activities. The MSCI EAFE Index is an unmanaged market capitalization-weighted equity index comprising 20 of the 48 countries in the MSCI universe and representing the developed world outside of North America. The **S&P North American Natural Resources Index** is a capitalization weighted index considered representative of the natural resource industry. The **Barclays Capital Global Aggregate Bond Index (Unhedged)** provides a broad-based measure of the global investment-grade fixed-rate debt markets. It consists of three major components: the US Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. The **Barclays US Government / Credit 1-3 YR Index** includes all medium and larger issues of US Government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 3 years and are publicly issued. The **Barclays U.S. Government / Credit Intermediate Index** is an unmanaged index based on all publicly issued intermediate government and corporate debt securities with maturities of 1-10 years. This index represents assets types which are subject to risk, including loss of principal. The **Barclays High Yield Corporate Bond Index** includes all fixed income securities having a maximum quality rating from Moody's Investor Service of Ba1, a minimum amount outstanding of $100 million, and at least one year to maturity. The **Barclays U.S. Aggregate Bond Index** is an unmanaged index composed of securities from the **Barclays Government/Corporate Bond Index**, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation / depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization. The **Barclays Capital Global Aggregate Bond Index (Unhedged)** provides a broad-based measure of the global investment-grade fixed-rate debt markets. It consists of three major components: the U.S. Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. Bonds are denominated in local currency and subject to exchange rate risk. The **Citi World Government Bond Index** is a market capitalization weighted bond index consisting of the government bond markets of multiple countries. The index includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of US$25 million. Government securities typically exclude floating or variable rate bonds, US/Canadian savings bonds and private placements. The listed portfolio allocations are not adjusted to reflect a 3% allocation to cash as represented by the Barclays US Treasury 1-3 month index. The **Barclays Emerging Markets Hard Currency Aggregate Index** is a debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The Barclays Emerging Market Aggregate Index **Barclays US Treasury 1-3 Month Index** is the 1-3 month component of the US Treasury Bill Index and includes US Treasury Bills with a maturity from one up to twelve months.

The historical performance results of the above listed indexes do not reflect the deduction of transaction and custodial charges, or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing indicated historical performance results. The aforementioned indexes are not indexes into which an investor can directly invest. An investor cannot invest directly in an index.