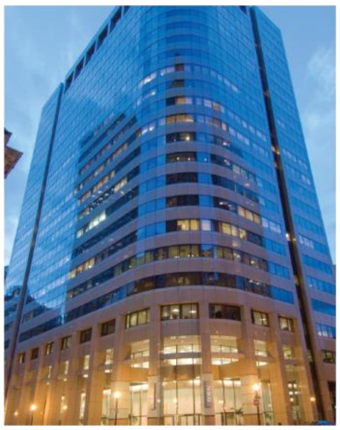
TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
AUGUST 23, 2016

OUR VIEW



Market Rally and Money Market Fund Changes

U.S. Stock Markets Reach New Highs in August

"What a long, strange trip it's been."

I don't usually quote songs from the Grateful Dead in client letters, but the quotation seems appropriate for this market update. The three major U.S. stock market indexes--S&P 500, Dow Jones Industrial Average and NASDAQ--closed at new highs on Thursday, August 11. The three indexes last reached synchronized highs on December 31, 1999. Synchronized highs weren't a novelty in 1999--between 1986 and 1999 the indexes closed at synchronized highs 131 times!

The U.S. is in the 8th year of a bull market that represents the second-longest bull market in history. However, this may be the least-loved bull market in history, understandable given recent memories of the technology bubble and the global financial crisis. Economic momentum is positive but uninspiring, with slow growth in the U.S. and even slower growth in Europe and Japan. Political developments dominate the headlines, providing mostly discouraging sound and fury for investors.

To be sure, 2016 has been an unusual year in the markets, starting with an abrupt correction in January that was reversed by a rapid relief rally in February and March. Last quarter ended with disruption caused by the Brexit vote in the U.K., but most markets have subsequently recovered their post-Brexit losses. Value indexes have generally been stronger performers than growth indexes, a development TFC welcomes after several years of growth leadership! However, performance within the value indexes has not been uniformly positive and bears a closer look.

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Value Stocks: A Rising Tide Hasn't Lifted All Boats

The continuation of expansionary (and extraordinary) monetary policies has had a far-reaching impact on value stocks. Financial stocks, a major component of value indexes, have lagged the market this year as low (or negative) interest rates hinder bank and insurance company earnings. In contrast, stocks that pay above-market dividends have been big winners, given the lack of yield available through traditional fixed income investments.

U.S. large cap value indexes have benefited from the strong performance of telecommunications, utility and energy stocks. For much of the year, high-yielding utility and telecommunications stocks benefited from the quest for yield and for the perceived safety of industries that historically have been less volatile than the broad market. Energy stocks also contributed to value performance, recovering some ground lost in the collapse of energy prices in 2014 and 2015.

U.S. small cap value indexes also benefited from the strength of utilities and the comeback of energy stocks. REITs, which represent a significant weighting within the small cap value universe, also were significant beneficiaries of the low interest rate environment and the quest for yield. REITs will become a standalone sector in September, after years of being a "square peg within a round hole" as part of the financial services sector.

The rising value "tide" hasn't lifted all boats, as we review fund performance for the first seven months of the year. Managers define "value" in different ways, choosing to emphasize or deemphasize certain industries. Managers may also use different definitions of value, using different metrics to determine whether a company is a value stock or not. Some value managers avoid or limit their exposure to utilities, based on the regulated nature of the business. Utilities stocks now trade at an eyebrow-raising 17 times next year's earnings--a high price-to-earnings ratio relative to the market and to the sector historically. We are wary of the long-term prospects for utilities, considering utilities a slow-growth, highly regulated sector potentially threatened by the growth of renewable energy sources and energy conservation. The dividend payout that is so valued by investors is not, in many cases, covered by current cash flows. TFC has enough exposure to utilities to benefit from their surge, but not so much as to make us meaningfully vulnerable in a downturn.

REITs are another investment category that doesn't always fit neatly into value portfolios. Some consider REITs a distinct asset class, and consequently avoid or limit their exposure in value equity portfolios. Other value investors are uncomfortable with the high leverage found in REITs, and while they include REITs in their investment opportunity set, they'll tend to have below-benchmark exposure. TFC is enthusiastic about the long-term prospects for REITs, but less so in the near-term given current valuations and recent stock market success. Our REIT exposure is approximately equivalent to market-weight.

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Different definitions used to create value portfolios can have a subtle influence over performance. Frank Russell, the sponsor of commonly cited value and growth indexes, uses a combination of book to price and expected earnings growth. Russell also uses three categories to divide the investment universe--pure value, pure growth, and companies with elements of both that are included in value and growth indexes at partial weights. Dimensional Fund Advisors (DFA) defines value as book/price, using the classic metric from the academic research that inspires their investment process. Another approach is that of AQR, a well-respected firm with an academically focused approach similar to that of DFA. AQR uses an equally weighted blend of five different measures of value.

An important part of the TFC investment process is in understanding the approach taken by each fund, so that we have insight into investment style, process and portfolio design. That insight helps us develop realistic expectations about performance and risk at the fund level, and is an important part of how we build a comprehensive portfolio of mutual funds that each serve a defined role for our clients.

Our Outlook

We're optimistic that today's bull market won't end with the tears experienced when the technology bubble burst in 2000 or the financial crisis emerged in 2008. Although U.S. valuations are above long-term trends, they are nowhere near the excesses of 1999. Nor do we see meaningful parallels to 2007 and 2008, when over-leveraged consumers, imprudent financial institutions, and a proliferation of complex derivatives created a global crisis.

We remain optimistic about the long-term prospects for the market, while being conscious that the length of this bull market and level of valuations in the U.S. raises the risk of a moderate correction. In this environment, we will look for opportunities to rebalance client portfolios, and will be measured in our aggressiveness at putting cash contributions to work in equities.

Money Market Fund Changes Are Coming

Extensive new rules governing money market funds take effect in mid-October, implementation of regulatory changes developed in response to money funds that "broke the buck" in 2008 by falling below a $1 share value. Although the rule changes are far-reaching, most TFC clients will be unaffected.

Under the new rules, prime institutional money funds, which cater to large institutions, will have to allow their shares to fluctuate in value. Institutional municipal money funds will be subject to the same rules. *Money market funds used by individual investors will be allowed to continue to target a stable $1 net asset value, as is the case today, though they may impose redemption fees or selling restrictions in a crisis*. Government money funds will be allowed to target a stable $1 net asset value and won't be required to impose redemption fees or restrict redemptions.

Implications for TFC clients are minor, though you are likely to see many headlines between now and October.

As always, we welcome your comments and questions.

Regards,

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