CLS's WEEKLY 3

What You Need To Know About the Markets

JANUARY 30, 2018

1. Will the U.S. dollar be able to bounce back after a terrible 2017?
2. Why CLS continues to believe globally diversified portfolios are key.
3. Three important lessons investors learned in 2017.

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+2.03%	+7.12%	+7.12%
Domestic Large-Cap Equity[2]	+2.23%	+7.55%	+7.55%
Domestic Small-Cap Equity[3]	+0.66%	+4.76%	+4.76%
International Equity[4]	+1.86%	+7.09%	+7.09%
Developed International Equity[5]	+1.50%	+6.54%	+6.54%
Emerging Market Equity[6]	+3.29%	+9.93%	+9.93%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.02%	-0.95%	-0.95%
Cash Equivalent[8]	+0.03%	+0.09%	+0.09%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+2.58%	+3.10%	+3.10%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity Index

As of 1/26/2018

Week in Review

As we neared the end of the first full month of trading in 2018, all stocks enjoyed a strong week.

This may be sounding like a broken record, but once again emerging market stocks led the week, up over 3%. Large-cap U.S. stocks performed better than small-cap, growth was better than value, and developed international posted a 1.5% gain on the week. Bonds were barely negative for the week, and are down about 1% for the year. Lastly, commodities enjoyed a strong week up over 2.5%.

We followed several interesting news stories last week. The government shutdown finally ended on Monday, January 22, 2018 with an agreed-upon deal to fund the government until February 8. GDP came in at 2.6% in the fourth quarter, lower than the expected 2.9%. The market shrugged this off and advanced higher. Increases in imports held back growth. Finally, the U.S. dollar ended the week lower after U.S. Treasury Secretary Steven Mnuchin, while attending the World Economic Forum in Davos, Switzerland, said a weaker dollar is beneficial for the nation. This, after the U.S. dollar had one its worst years in 2017.

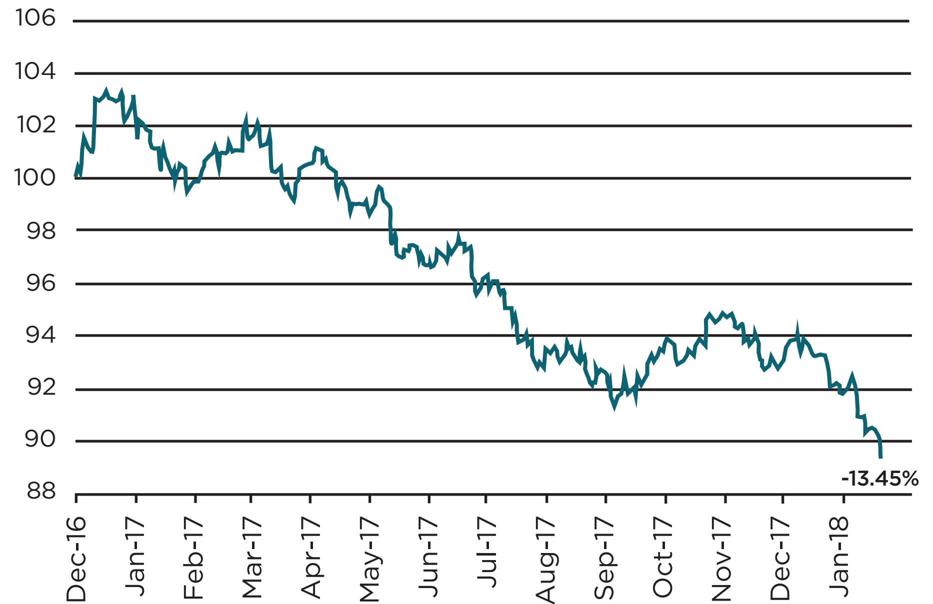
BONUS: Remember Bitcoin? Popularity increased late in 2017 as euphoria pushed its stock price to $20,000. Well, the cryptocurrency is currently trading at about $11,500. This should not be surprising as wild swings are ever apparent in the cryptocurrency markets.

The U.S. dollar continued its slide last week. The Trump administration has publicly noted several times the dollar is valued too high. In fact, the dollar peaked in December 2016 and has fallen about 13.5% since then, as illustrated in the top chart to the right.

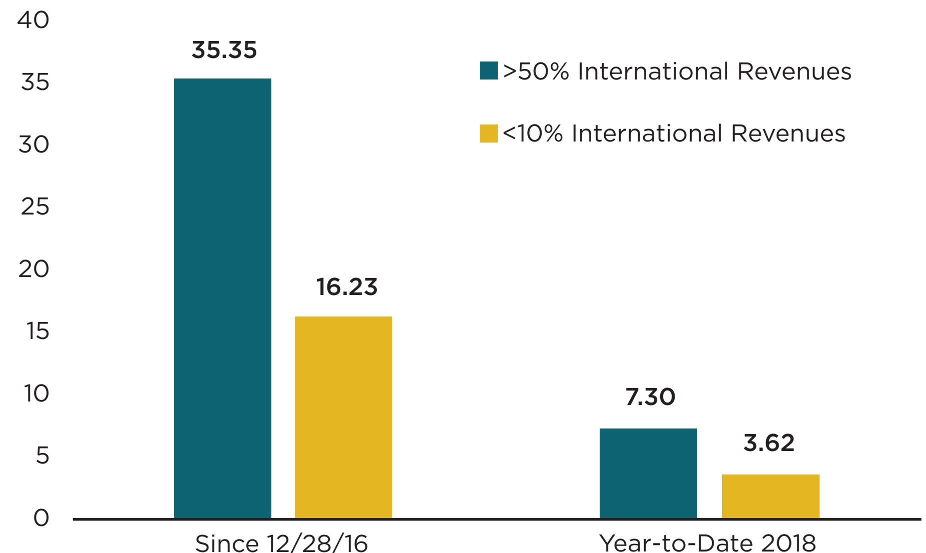
Some readers may be thinking this cannot possibly be good for the U.S. market, our largest companies, or even the global stock market as a whole. But, so far, all three have moved higher since the dollar's peak.

Unless you've been living under a rock (often not a bad thing), you have noticed soaring prices and low volatility in the stock market. Additionally, U.S.-based multinational corporations that derive most of their revenues overseas have enjoyed blockbuster returns (see bottom chart to the right). The general narrative behind this is lower currency prices make our goods and services more attractive to export.

It's important to note when U.S. investors buy an international stock or basket of stocks domiciled abroad, they are not just buying the market, but the currency, too. When those currencies appreciate against the dollar, they can expect an incremental boost in performance.



Source: Bespoke, as of January 24, 2018



Source: Bespoke, as of January 24, 2018

It's unclear whether this trend can continue. Measuring valuation on the basis of purchasing power parity (PPP), the dollar is still overvalued (yes, still). Meanwhile, technical patterns show bearish signals and sentiment is neutral.

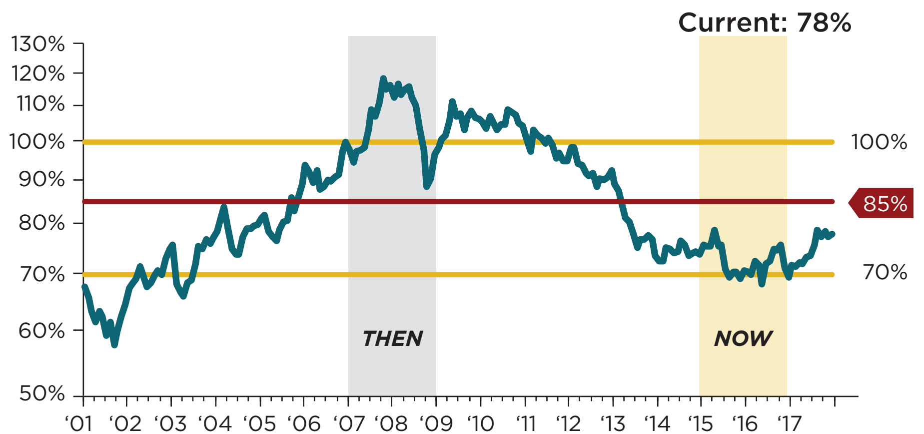
CLS maintains a strong conviction to international stocks and, more importantly, non-hedged positions with international currency market exposure that are expected to benefit if the dollar continues to move lower.

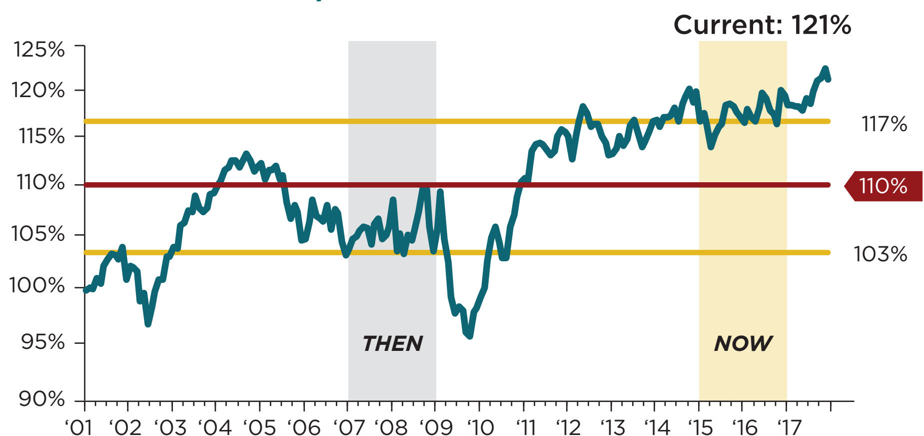
Invested in Emerging Markets? Don't Worry, Enjoy Diversification

If investors had exposure to emerging markets in the past year, they have no doubt loved this diverse asset class. But some investors, and CLS clients I hear from, are wondering whether we moved too far too fast and it's time to trim positions. I completely understand why investors may be concerned: recency bias is inherent in all of us. Not only do we all still freshly remember the 2008 global financial crisis, we also remember how hard emerging market stocks were hit in that bear market downturn. How does minus 50% sound? That's right. In 2008, emerging market stocks (including currencies) lost half their value, more than the U.S. market.

With recent market valuations high across the world, clients are wondering if (and when) we see a downturn or, worse, a bear market, will emerging market stocks be cut in half again? Actually, most clients aren't asking this, they are *expecting* it!

Let's take a step back and try to ease some tensions. The charts to the right are taken from CLS's own Chart Pack (global valuations are shown in full on page 8). The gray shaded area in the top chart shows emerging market valuations in the years around the financial crisis. Valuations are evidently high. The U.S. at that time was not terribly expensive, but it was not cheap either. With the benefit of hindsight, we can see higher starting valuations may lead to deeper declines.





— long-term average relative valuation
— one standard deviation away from the average

Source: Morningstar, as of 12/31/2017

But, that's not the current question. The question is, "When a drawdown happens, will emerging market stocks lose half their value again?" The charts above show where we are now. Emerging market stocks are still relatively cheap and U.S. stocks are expensive.

Statistics don't always paint the full picture, but based on this data, we can expect emerging market stocks to continue to enjoy their recent run. In a prolonged selloff, emerging markets may hold up better, and it could be our own markets that suffer deeper declines.

3 Lessons Investors Learned in 2017

2017 was a glorious year, and it proved a couple things: no one can predict the future, and some of the biggest bets and predicted narratives seldom come true. Here are a few more lessons from 2017:

1. Diversification works, eventually.

In every diversified, multi-asset portfolio, there will be something an investor hates. It could be a single stock, bonds, commodities, a country, region, or even the other half of the global stock market. In 2017, all major markets moved higher. International outpaced U.S. stocks, which ended a long stretch of underperformance. Whenever a position lags for a long time in a diversified portfolio, there is a temptation to get out of it. But the point of diversification is to admit we don't know what will happen. 2017 proved globally diversifying portfolios is always a prudent move.

My advice: Don't fall victim to narrow framing in your portfolio. In other words, once you put a well-diversified portfolio in place, don't focus too heavily on one position.

2. Rate hikes may not mean negative bond markets.

The expectations coming into 2017 were interest rates would continue to rise and the Federal Reserve (Fed) would continue to hike. Both happened, but that is a broad statement. Yes, rates rose, but only on the short end of the curve. Short-term rates rose with the Fed 's rate hiking activity, but long-term rates fell modestly, thus flattening the curve. So, what happened to broad bonds? They went up! The U.S. bond market was up about 3.5%.

My advice: Don't make major portfolio decisions based on consensus narratives.

3. Political volatility does not equal stock market volatility.

The global political landscape was one source of volatility in 2017. In today's 24-hour news cycle, constant social media streaming, and smart phone notifications, we have our work cut out for us as fiduciaries coaching clients. There is no shortage of outlets for news stories to be hyped each second of the day. But news is not what drives long-term market gains. Fundamentals and valuations do. I admit, I was surprised the political environment did not create more stock market volatility in 2017, but we are often surprised when predictions do not come true.

My advice: Don't let others who seem to know with certainty what will happen in the market fool you into changing your well-diversified portfolio. No one knows what will happen, and those who say they do rarely put their own money on the line for fear of being made a fool.

One more note about 2017. Be on the lookout for an upcoming blog, from my colleague, Kostya Etus, which discusses the strength of returns for the amount of risk taken (Sharpe ratio) last year. *Spoiler: It was not the best, but it was right up there.*

BONUS: My New Year's Resolution

I rarely make New Year's resolutions, but here is one that I resolve to work harder on, not necessarily to make myself better, but to improve our joint clients. My goal is to work harder to help clients avoid making mistakes in their portfolios. This can mean helping them avoid selling out in an area of the market that is underperforming, chasing returns by increasing their Risk Budgets, or selling in a down market by going to cash or lowering their Risk Budgets. Honestly, this will be tough. It's so easy to hit the "easy button" and give clients what they want, but that often may be against their best interests in realizing their retirement goals.

When we have the pleasure of talking or emailing in 2018, please do not be surprised if my standard advice is: do nothing. Don't raise the Risk Budget; don't lower it; don't sell to cash; don't chase high-income securities. Stick to the well-laid-out plan.

Thanks for reading, and if you have any questions or issues you'd like to discuss, please call me at: 402-297-8545.

Case Eichenberger, CIMA®

Client Portfolio Manager

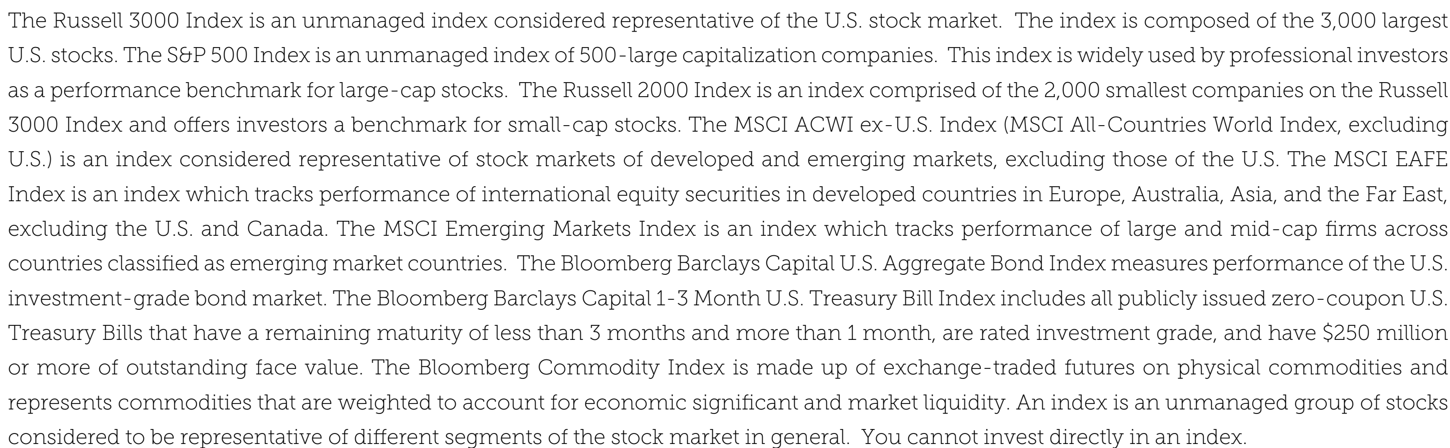
Case Eichenberger co-manages CLS's American Funds strategies, works closely with CLS's separate account strategies (Master Manager), and communicates with advisors and their clients both remotely and in-person.

Since joining CLS in 2007, Mr. Eichenberger has held various roles, including Relationship Representative and Internal Wholesaler. In 2015, he accepted the role of Client Portfolio Manager.

Mr. Eichenberger received his Bachelor of Science degree in Business Administration from Midland University. He holds the FINRA Series 6, 63, and 65 licenses and Certified Investment Management Analyst (CIMA®) designation. During the accreditation process, he attended the Wharton School of Business at the University of Pennsylvania.

Mr. Eichenberger is a member of Greater Omaha Young Professionals and a volunteer for Habitat for Humanity.

Did you know? Case comes from a long line of educators.



The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex-U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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