WEEKLY MARKET REVIEW

FEBRUARY 14, 2017

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CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+0.88%	+3.71%	+3.71%
Domestic Large-Cap Equity[2]	+0.87%	+3.66%	+3.66%
Domestic Small-Cap Equity[3]	+0.83%	+2.43%	+2.43%
International Equity[4]	+0.34%	+4.62%	+4.62%
Developed International Equity[5]	-0.02%	+3.46%	+3.46%
Emerging Market Equity[6]	+1.24%	+7.92%	+7.92%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	+0.44%	+0.46%	+0.46%
Cash Equivalent[8]	+0.01%	+0.05%	+0.05%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	+1.62%	+2.17%	+2.17%

[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

As of 2/10/2017

Week in Review

Last week was mostly positive for the markets. In the U.S., the major indices hit all-time highs as stocks returned 0.88% with large-caps narrowly outperforming small-caps. International stocks returned 0.34%, despite slightly negative performance from developed nations. Emerging stocks were the top performers, up 1.24%. The 10-year Treasury bond rallied early in the week with the yield falling as low as 2.33%. Ultimately, the yield ended the week unchanged at 2.41%. Commodities were the top performing broad asset class for the week. Energy prices were helped by a new Energy Information Agency (EIA) report that showed strong compliance by Organization for Oil Exporting Countries (OPEC) related to production cuts.

It was a quiet week for economic data releases. Jobless claims continued to hover around the lowest level in more than 40 years, wholesale inventories met expectations with a 1.0% increase, and the University of Michigan sentiment survey came in lower than expected.

A Mismatch in Concerns

As we move further into 2017, it seems uncertainty is becoming a major theme. However, this is nothing new, the world is simply an uncertain place. Turn on the financial media for a few minutes and you are sure to hear about uncertainty related to the new presidential administration, fiscal policy, and monetary policy. As we've noted in our 91 Reasons piece, there is usually a multitude of issues to be concerned about, but seldom should the news flow impact your portfolio decision making. More often than not, it's just noise.

How the future will unfold is unknowable. Even if you could predict the outcome with precision, there is no guarantee you could use that information to your advantage within your portfolio. A great example is the recent presidential election. The market consensus was Hillary Clinton would be good for the stock market, Donald Trump would be bad, and Clinton would be elected. We all know what happened next. Trump won, and we now have Trump-rallied our way to all-time highs on all of the major U.S. stock indices.

CLS does not manage money by news flow, and we do not try to predict the unpredictable. We stick to our disciplined risk management approach (Risk Budgeting), and maintain a value orientation. This does not mean there is nothing in the markets we are concerned about. In fact, each month we publish our top concerns as part of our Monthly Perspectives.

Valuations have a strong and direct impact on future returns, so when the market looks expensive it is cause for concern. One way to measure this is by using the cyclically adjusted price-to-earnings ratio (CAPE ratio) developed by Robert Shiller. The CAPE ratio is similar to the traditional price-to-earnings (P/E) ratio, but uses the average inflation-adjusted earnings of the last 10 years rather than 12 months of trailing or forward earnings. Currently, the valuation on the S&P 500 Index as represented by the CAPE ratio is 28, which is higher than the average of 25. This may not sound like a large deviation, but what does it mean for the market?

The table below illustrates the S&P 500's past performance following a period where the CAPE ratio was at the current level or higher ("High CAPE"). It also shows the market's performance following a period where the CAPE ratio was an equal distance below its average ("Low CAPE").

To establish a baseline for comparison purposes, we calculated the average one-year rolling return during the full period being analyzed. On average, the market returned 10.9%, and experienced a negative one-year rolling return about 17.8% of the time. It is evident that the starting valuation has a significant impact on returns moving forward. In High CAPE periods, returns were still positive on average, but they were materially lower than 10.9%. The frequency of negative returns was also substantially higher. During Low CAPE periods, returns were much higher than the baseline, and the frequency of negative returns almost dropped off completely. Based on this evidence, investors must temper their return expectations moving forward.

While high valuations in the U.S. market have CLS concerned, this is not a recommendation to go to cash. Our expectation for the U.S. stock market is for positive, but below-average returns, which is consistent with High CAPE periods. Fortunately for us, there are still attractive opportunities in equities (they're just outside of the U.S.). CLS Portfolio Manager, Kostya Etus, CFA, wrote more on this topic in last week's Market Review. Given the higher propensity for negative returns, it's also worth pointing out that high-quality bonds are a great diversifier for equity risk.

S&P's Past Performance

		High CAPE			Low CAPE		
	Average 1Yr Return	Avg 1Yr Forward Return	Avg 3Yr Forward Return (Annlzd)	Avg 5Yr Forward Return (Annlzd)	Avg 1Yr Forward Return	Avg 3Yr Forward Return (Annlzd)	Avg 5Yr Forward Return (Annlzd)
Number of Periods	337	62	62	62	115	115	81
Average Return	10.90%	3.87%	0.73%	0.93%	17.09%	15.80%	16.91%
Frequency of Negative Returns	17.80%	45.16%	50.00%	53.23%	6.09%	0.00%	0.00%

Period 1/31/1988 - 1/31/2017. Source: Bloomberg & http://www.econ.yale.edu/~shiller/data.com

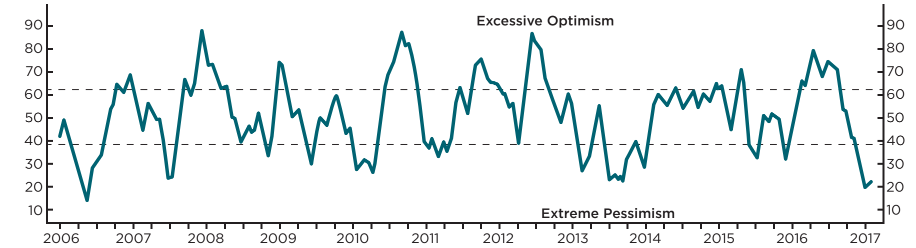
Creative Diversification in Action

Creative Diversification is my favorite investment theme. You may ask: "Josh, doesn't it seem convenient for a bond manager to prefer the theme most directly related to bonds?" Well, I guess. OK, I'm definitely biased. There is a good reason Creative Diversification has been around for awhile and is still going strong. CLS is a risk management shop. Creative Diversification allows us to manage risk in equity-dominated portfolios while still seeking to maximize return. The investment themes component of our Monthly Perspectives piece articulates a few ways we go about doing this, including actively managing our duration, credit, and sector exposures. Below is a recent example of this in action.

In early 2016, the high-yield bond market was under intense pressure. Commodity prices were in free fall causing investors to question the financial strength of energy and mining firms that issue high-yield debt. Before long, that fear spread to the rest of high-yield market, including industries with limited exposure to commodity prices. At the peak, the spread between Treasury and high-yield bond yields reached 887 basis points, compared to 476 basis points the prior year. The spread measures how much compensation investors receive to take on credit risk not found in Treasuries. It can also be thought of as a valuation metric, where a high spread equates to a low valuation (bargain price).

With this backdrop, high-yield bonds represented an attractive

NDR Daily Bond Sentiment Composite (02/07/2017 = 21.82)



T-Bond Futures Performance *Full History: 06/06/1984 - 02/07/2017*		
NDR Daily Bond Sentiment Composite Is	% Gain/ Annum	% of Time
Above 62.0	-4.82	22.03
38.0-62.0	4.58	54.38
Below 38.0	8.81	23.59
Buy/Hold = 3.40% Gain/Annum		

T-Bond Futures Performance *Chart History: 01/03/1984 - 02/07/2017*		
NDR Daily Bond Sentiment Composite Is	% Gain/ Annum	% of Time
Above 62.0	-1.20	25.91
38.0-62.0	0.25	50.65
Below 38.0	12.27	23.44
Buy/Hold = 2.56% Gain/Annum		

***Source:** Ned Davis Research, Inc.; Commodity Systems, Inc. (CSI) www.csidata.com*

opportunity and CLS portfolios added exposure early last year. Eventually, commodity prices stabilized and fears subsided. High-yield bonds ended up outperforming the S&P 500 during 2016.

After such a strong run, high-yield bonds are no longer priced at a bargain. In fact, they are trading at the most expensive levels in two and a half years. Time to move on. But, where to? Spreads in other sectors are also pretty compressed. Well, if you are not getting paid much to take on credit risk, reduce the credit risk. That's exactly what we have been doing. CLS portfolios are increasing their allocations to higher-quality bonds.

In addition to the expensive price tag on lower quality, high-quality bonds are attractive here for a few other reasons. In a Weekly Market Review from last December, I highlighted the fact that the bond market tends to do well following extreme sell-offs, like the one we saw during November. Bond returns have in fact been positive since then.

Similarly, when sentiment in the bond market hits extremely pessimistic levels (as it is now), bonds tend to do well. High-quality bonds are superior diversifiers for a stock portfolio than low-quality bonds. Since the probability of negative stock performance has increased with valuation levels, adding high-quality bonds will help mitigate that risk.

Finally, high-yield bonds and other low-quality bond sectors require a larger risk allocation. Shifting this exposure to lower-risk, high-quality bonds allows us to redeploy cash to other areas of the market that look attractively valued, such as international equities.

Expectations for Interest Rates

The market and the Federal Open Market Committee (FOMC)'s anticipated paths of interest rates are currently at odds with one another. The former is pricing in two hikes for 2017, despite the latter publishing its forecast of three hikes for the year at the conclusion of its December 2016 meeting. Our view is for fewer than three hikes. But, if the broad expectation is for higher rates, what can investors expect from their bond portfolios?

To answer this question, CLS conducted an analysis of bond returns going back more than 50 years. We specifically looked at how the bond market has performed during periods when monetary policy was tightening as well as when longer-term rates were rising. The results of our analysis will be published in a new white paper in the near future. The paper should provide a historical perspective and help to anchor expectations moving forward. Ultimately, higher interest rates are positive for long-term investors. Stay tuned to see how.

Josh Jenkns, CFA
Portfolio Manager on Growth, Flexible Income, and Milestone Treasury Obligations

Joshua Jenkins joined CLS in March 2013, and serves as a Portfolio Manager. He is the lead manager of an income-focused separately-managed account strategy and also functions as the lead analyst for the CLS Growth and Income Fund, CLS Flexible Income Fund, and the Milestone Treasury Obligations Fund. In these roles, Mr. Jenkins utilizes fundamental and technical analysis to assist portfolio managers in asset allocation decisions. In addition, due to his extensive knowledge of Exchange Traded Products, he drives CLS's implementation process and is integral in selecting the appropriate ETPs to gain desired exposure within CLS portfolios.

Prior to joining CLS, Mr. Jenkins worked as an Analyst on the private equity desk at Auriga USA, LLC, a small broker-dealer headquartered in New York City.

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 composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The MSCI EAFE Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI Emerging Markets Index is a composite index which tracks performance of large and mid-cap firms across 21 countries classified as emerging market countries. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's 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 22 exchange-traded futures on physical commodities and represents 20 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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