WEEKLY MARKET REVIEW

FEBRUARY 22, 2017

In This Edition

- *Digging deeper into the inflation report.*
- *How to position portfolios in an accelerating world.*
- *Interesting streaks within the stock market.*

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+1.48%	+5.25%	+5.25%
Domestic Large-Cap Equity[2]	+1.60%	+5.32%	+5.32%
Domestic Small-Cap Equity[3]	+0.82%	+3.27%	+3.27%
International Equity[4]	+0.87%	+5.53%	+5.53%
Developed International Equity[5]	+0.86%	+4.35%	+4.35%
Emerging Market Equity[6]	+0.97%	+8.97%	+8.97%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	-0.02%	+0.44%	+0.44%
Cash Equivalent[8]	+0.01%	+0.06%	+0.06%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	-1.39%	+0.75%	+0.75%

[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 2/17/2017

Week in Review

Markets posted healthy gains last week as stock indices continued to set all sorts of records. Inflation data was strong, and comments by a number of Federal Reserve (Fed) governors indicated the U.S. economy continues to strengthen. The S&P 500 rose 1.6%, reaching a series of new highs. Small-cap stocks and international developed markets increased 0.8%, and emerging markets climbed 0.9%. Bonds edged slightly lower on the inflation data, and commodities declined 1.4%.

While much bandwidth was spent on articles regarding the daily machinations of the Trump White House, Kraft-Heinz made big business news by offering to purchase Unilever and then withdrawing the other just a couple days later. While this takeover appears to be over for now, global investors cheered the announcement as mergers may be the mechanism for unlocking the value in European stocks.

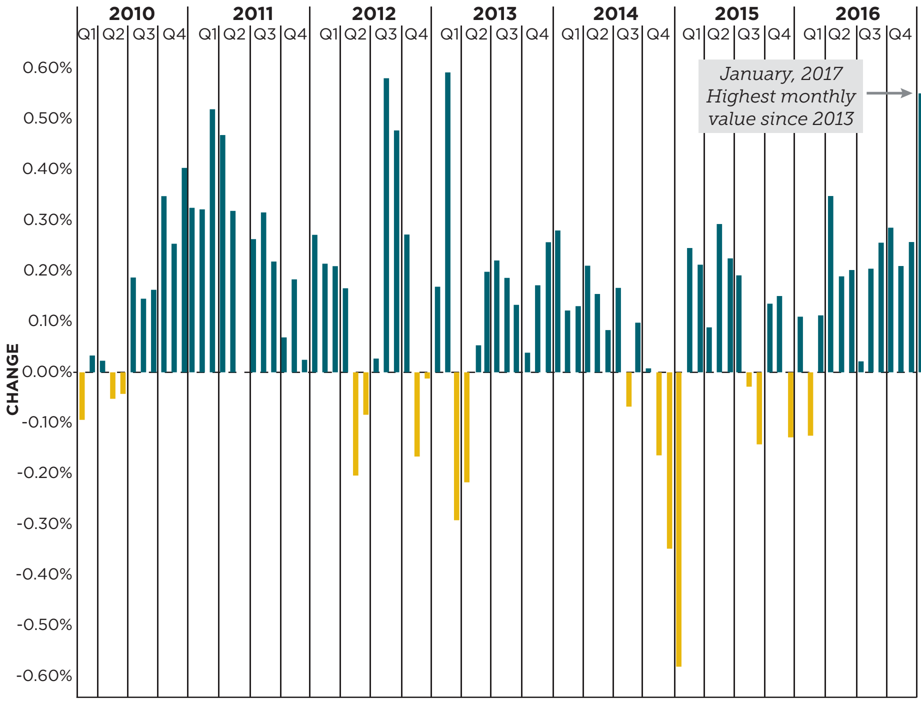
This week's market review digs deeper into the inflation report, discusses portfolio allocation in light of higher inflation and growth, and explores some of the recent records the stock markets have achieved.

Inflation shot unexpectedly higher last month. The Consumer Price Index (CPI) rose 0.6% in January compared to December. Much of the increase came from a hike in energy prices. Gasoline prices rose 7.8% last month and broader energy prices climbed 10.8% over the last 12 months. Excluding energy and food prices, which tend to be very volatile, core inflation still rose 0.3% in January.

Both the overall inflation rate and the core rate increased more than forecasted. Economists had predicted overall inflation would rise 0.3% and the core rate would increase 0.2%. Fed governors reacted to the new data and ongoing economic strength by reinforcing the likelihood of three rate hikes, and there were even some vague hints of four hikes. Fed Chair Janet Yellen, in her testimony to Congress, said it could be appropriate to raise rates "at our upcoming meetings."

The outsized reaction by the Fed suggests increasing concern about inflation. As the chart above shows, the increase was the largest since February 2013. During 2013, inflation was extremely volatile. The large increase in February that year was followed by two months of declining inflation. The other two strong months were in the third quarter of 2012, and followed a period of very weak inflation. Because current trends show a more stable inflation environment, increases likely have more staying power.

U.S. Inflation



Source: *https://data.bls.gov/cgi-bin/dsrv and CLS internal calculations.*

Economists also compare inflation for the past 12 months to previous periods in order to remove some of the volatility. This data also showed increasing inflation. Year over year, the index rose 2.5%, which is the largest annual increase since March 2012.

The unemployment rate has also fallen since 2013, reflecting less slack in the economy. As the unemployment rate declines, businesses may look to offset increasing wages by passing the costs onto the consumer. During the earlier periods when inflation spiked, there remained more people seeking work who could fill the positions at current wages, lessening the need to increase wages.

CLS does not expect inflation to continue at last month's pace. As noted earlier, gasoline and other energy prices accounted for much of the increased inflation. These gains are extremely unlikely to continue. Energy prices were reacting to announced production cuts by key international producers, and it is unlikely additional cuts will be announced.

Still, the higher core rate bears watching because it affects asset classes differently. The next section explores how CLS views the current economic environment affecting portfolio positioning.

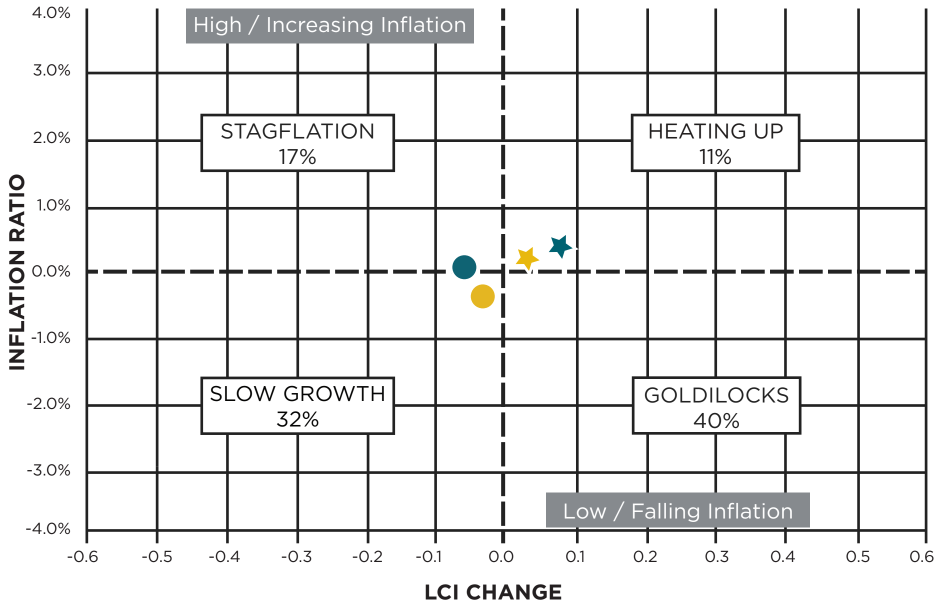
Portfolio Positioning in an Accelerating World

Economic analysis is one of the five key areas CLS uses to evaluate markets. As discussed in the previous section, economic growth continues to be steady and the global economy is moving closer to normal growth. Economic trends prior to the most recent inflation data show this transition is already in motion.

One of our economic analysis tools compares the inflation trend to the change in leading composite indicators (LCI). Leading indicators are used by economists to predict the direction of economic growth. Research originally done by MSCI, and updated by CLS, separates economic regimes into the four quadrants seen in the chart to the right. The chart shows the global economy has moved from the slow-growth quadrant to the heating-up quadrant. The heating-up quadrant is associated with stronger economic growth and increasing inflation.

This shift creates opportunities for the patient investor by tilting the portfolio towards three broad opportunities that are likely to benefit from a moderate increase in core inflation. First, our portfolios generally lean toward value stocks, which do better when the economy is "heating up." Value stocks tend to be associated with sectors that do well when interest rates are normal (financials) and sectors that benefit from higher inflation (energy). Excluding 2016, the nearby chart shows value stocks have struggled against growth stocks. We believe the economic trend is just one reason to move toward value.

Economic Environment



	● Q4-16 (Global)	★ Q1-17 (Global)	● Q4-16 (U.S.)	★ Q1-17 (U.S.)
Inflation Ratio	-0.36%	0.02%	0.05%	0.20%
LCI Change	-0.03	0.04	-0.07	0.08

Source: *Current data as of 10/31/16. Figures under quadrant titles represent percent of time Global has spent in each quadrant since 1976. LCI Diff - Leading Composite Indicators difference – measured month over month change. Inflation Ratio - ratio of 3 month average inflation divided by 36 month average. Economic data obtained from OECD (https://data.oecd.org/) Q3 and Q4 figures are CLS's outlook.*

Scott Kubie, CFA

Chief Investment Strategist

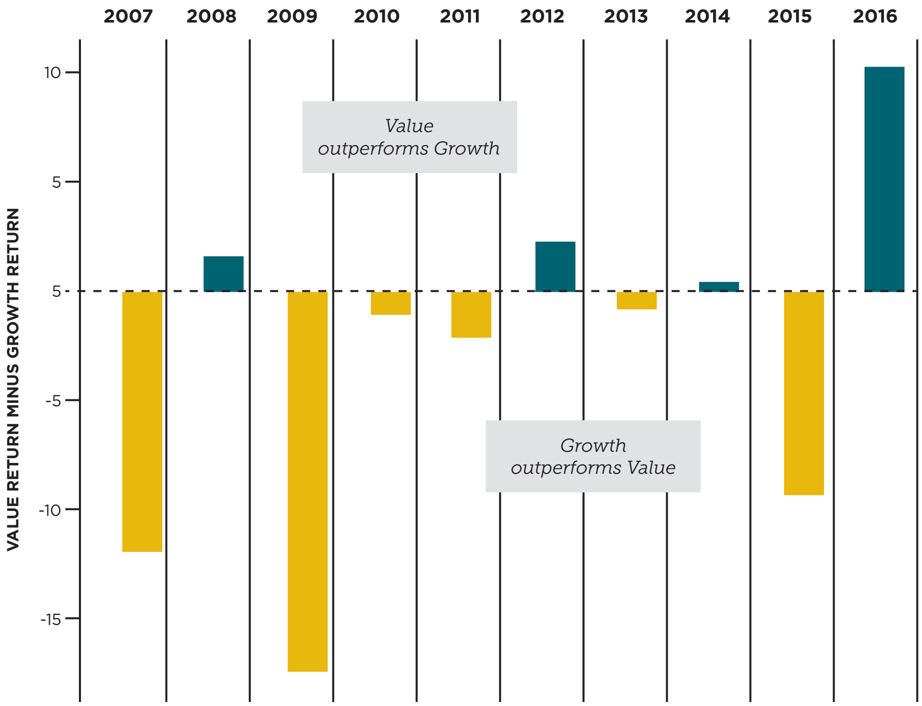
Scott Kubie joined CLS as a Portfolio Manager in November 1995. In March of 2002, he was given additional responsibilities as the Director of Research. In response to rapid asset growth at CLS, Mr. Kubie moved to the role of Chief Strategist in June 2005.

Mr. Kubie holds a Bachelor of Arts degree in Business and Economics from Trinity University in San Antonio, Texas, and a Master of Business Administration from the University of Nebraska at Omaha (UNO). He holds Series 6 and Series 65 securities registrations as well as the Chartered Financial Analyst (CFA) designation.

Second, our portfolios emphasize short-term bonds, which are less sensitive to inflation and increasing rates. While tilting a portfolio toward the short-term can benefit results, my colleague Josh Jenkins, CFA wrote an excellent piece in last week's Market Review about how bonds bounce back quickly from declines and any tilt to the short-term shouldn't be overdone.

Third, some CLS portfolios have access to alternative investments and bonds that offer inflation or interest rate protection. When good choices are available, we mix in a small allocation to commodities, bonds whose face value increases with inflation, and bonds whose interest rates change if rates move higher. While the exact mix of these choices will vary based on the quality of options available, CLS has tools available to reduce the negative consequences of higher inflation.

Growth and Value 2007-2016



Source: Morningstar

Are Streaks Meant to Be Broken?

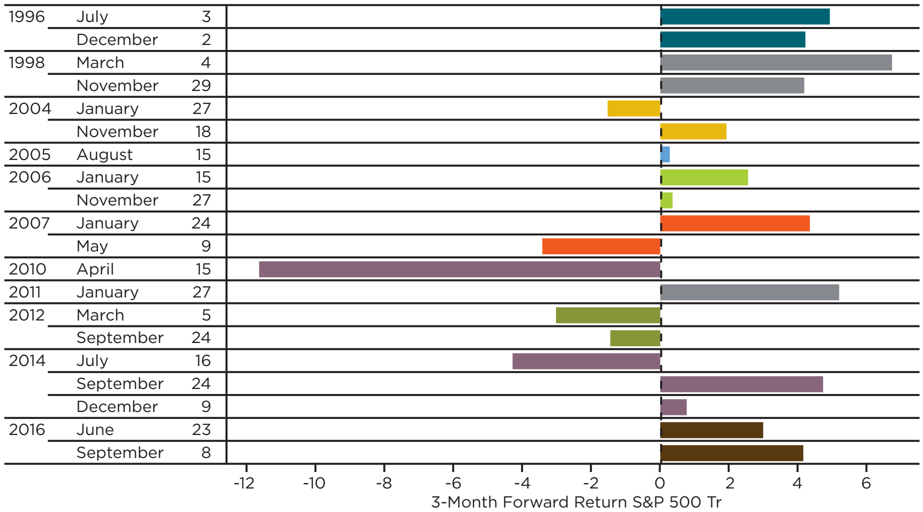
The common adage is streaks are meant to be broken. At least most people not associated with University of Connecticut women's basketball team seem to think so. Despite Tulane's best efforts last week, the UConn women have won an incredible 101 consecutive basketball games. This stretch includes two national championships and is a reminder to us all that streaks can go on for a long time.

Recent market performance has created a number of interesting streaks that make some investors believe they are too good to be true. The first streak was actually broken last Thursday. The S&P 500 had increased the previous seven trading days. While this streak seems short, at least by UConn standards, it is the longest winning streak since 2013. It could have easily been 10 days instead. The S&P 500 only declined 0.08% on Thursday, and then rallied on Friday to reach a record high.

Record highs are a second trend that can get investors worried. Underlying the concern about record highs is the idea that investing in stocks is akin to gambling. But, stock investing and gambling are very different. First, the odds favor the investor and generally don't favor the gambler. Stocks go up more than they go down, and the historical odds of losing money go down the more we invest. The longer we play roulette wheels, slot machines, and lottery tickets the more likely we are to lose.

Second, stock investors aren't investing in the outcome of a little ball or a computerized machine;

Bad Luck Investing



Source: Morningstar Direct and CLS Investments, LLC

they are investing in companies with valuable economic assets and tangible cash flows. Stocks reaching new highs is an indication that the value of the underlying businesses will continue to grow. While not true for every stock or every period, markets hitting new highs is a natural part of the process.

The current streak I find most interesting is the number of consecutive trading days since the S&P 500 declined by more than 1%. The current streak of 87 is the second longest since 1996, and only six days away from the 93-day streak in the second half of 2006.

The above chart, "Bad Luck Investing," shows how a "bad luck" investor would have fared if he or she had invested right at the close of the last day of the streak and held for three months.

Even with the limited sample, the chart provides a number of insights:

- The markets were higher 70% of the time.
- 45% of the time markets increased at an annualized rate of greater than 12%.
- Only one negative return occurred prior to mid-2007, or after mid-2014.
- Only 25% of the periods produced an annualized return between 0% and 12%.
- Eight years had multiple long streaks, three years had one, and 10 years had none of the top 20 streaks.

What these results show is investing with particularly bad luck has often produced some pretty good returns. It also shows that low-volatility periods can produce frequent long streaks. More importantly, those periods of low volatility can restart quickly, or end at any time. Risk Budgeting works because it assumes volatility and risk are always lurking. Investors should align their portfolios with Risk Budgets that allow them to stay the course during the eventual correction.

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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