Goodman Financial
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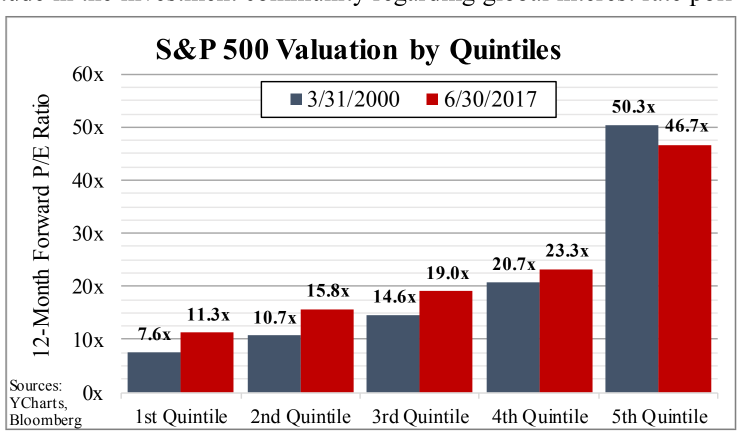
SECOND QUARTER 2017 MARKET & ECONOMIC REVIEW

Major Equity Market Indices

Index	Description	3/31/17	High	Low	6/30/17	QTD Return*
S&P 500	A market-capitalization weighted index of 500 large U.S. companies.	2,362.72	2,453.82	2,328.95	2,423.41	2.57%
DJIA	Dow Jones Industrial Average or "The Dow"; A price-weighted average of 30 major U.S. companies.	20,663.22	21,535.03	18,603.14	21,349.63	3.32%
Nasdaq Composite Index	A market-capitalization weighted index comprised of over 3,000 companies, mostly in the technology and biotech industries.	5,911.74	6,341.70	5,805.15	6,140.42	3.87%
NIKKEI 225	A price-weighted index comprised of Japan's top 225 most established companies.	18,909.26	20,318.11	18,224.68	20,033.43	5.95%
MSCI Emerging Markets	An index comprised of 23 MSCI indices from emerging economies including Brazil, China, India, Mexico, Russia, South Africa, and the UAE.	958.37	1,019.11	952.92	1,010.80	5.47%
Stoxx Europe 600	An index comprised of 600 companies based in one of 18 EU countries including Austria, Belgium, Denmark, France, Germany, Ireland, Spain, and the United Kingdom.	381.14	396.55	376.23	379.37	-0.46%

* Excludes effects of dividends — Sources: YCharts, Wall Street Journal

- Political speculation led the S&P 500 on something of a rollercoaster during the second quarter, with former FBI Director James Comey's Senate hearing and the prospect of legislative activity ebbing and flowing. The sell-off of mega-cap technology stocks towards the end of the quarter caused the index to swing downward, though it finished up for the quarter overall.
- The large-cap dominated Dow outperformed the S&P 500, perhaps because of its concentration in multinational companies which benefitted more from the weakening U.S. dollar than did more domestic-focused smaller companies.
- The **NASDAQ had a good quarter** but a weak June. The pullback of the so-called FANG stocks, a proxy for mega-cap technology stocks, resulted from a Goldman Sachs analyst note voicing concerns about their relative profitability and low volatility.
- Japan, represented here by the NIKKEI 225, experienced a generally positive quarter. The Bank of Japan raised its GDP growth estimates 10 bps to 1.6%, brisk by Japanese standards. Concerns exist regarding the aggression of nearby North Korea, but the Japanese economy continues to grow.
- **Emerging markets continued the upward climb** that started at the beginning of 2017. During the quarter, Eastern European and East Asian countries led the emerging markets. Mineral-dependent Russia, Brazil, Qatar, and Pakistan lagged behind their peers.
- **European markets had a mixed quarter** with major Western European markets (e.g., the United Kingdom, Germany, and France) experiencing sharp declines at the end of June due to comments from central banks suggesting rising rates.
- The growth of passive index investing and a wait-and-see attitude in the investment community regarding global interest rate policy has caused a wide-spread expansion of valuation multiples among U.S. stocks.
- The graph on the right shows the S&P 500 divided into five groups based on 12-month forward price-to-earnings and compares the average forward P/E at the end of the second quarter of 2017 versus the end of the first quarter of 2000, the eve of the Dot Com bust.
- While valuations on the whole have risen, the expansion is broad-based. Bubbles typically exhibit a concentration, as was the case in early 2000 with highly valued internet stocks.
- **We do not find that the bursting of any bubble is imminent**, but we did find that high valuations limited investment opportunities in equities during the second quarter.



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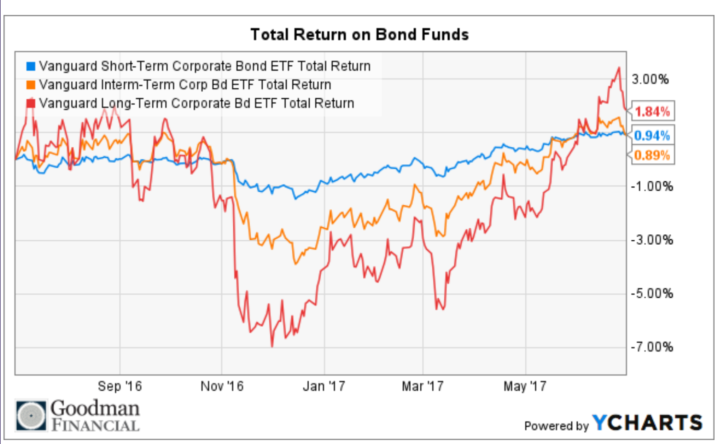
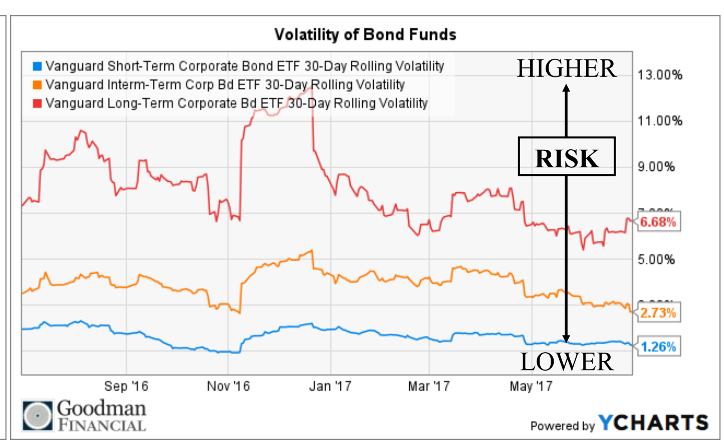
Fixed Income

Description	3/31/17	6/30/17	QTD Change in Basis Points*	Description	6/30/17	52-Week Range Low	52-Week Range High
90 Day Treasury Bill	0.76%	1.03%	↑ 27	Federal Funds Rate Target	1.00%-1.25%	0.25%-0.50%	1.00%-1.25%
10 Yr. Treasury Note	2.40%	2.31%	↓ -9	Prime Rate (U.S.)	4.25%	3.50%	4.25%
30 Yr. Treasury Bond	3.02%	2.84%	↓ -18	LIBOR (3-Month)	1.30%	0.65%	1.30%
15 Yr. Mortgage Rate	3.33%	3.21%	↓ -12	5-Year CD	1.39%	1.17%	1.39%
30 Yr. Mortgage Rate	4.13%	4.02%	↓ -11	HELOC ($30,000)	5.12%	4.57%	5.12%

* One basis point is equal to 1/100th of 1%, or 0.01% Sources: YCharts, Wall Street Journal

- The **Federal Reserve's Federal Open Markets Committee (FOMC) voted to raise the Fed Funds target range** by 25 bps to 1.00% - 1.25%. The June FOMC meeting minutes revealed the Fed will begin to gradually wind down its balance sheet at some point in the near future. The Fed will unwind its balance sheet by choosing to not reinvest maturing bonds, starting with $10 billion per month and working up to $50 billion per month. At the suggested pace, the Fed will need approximately 7 years to sell all assets. Whether or not the Fed plans on completely eliminating its holdings is unclear.
- Even though the Fed has said how it will unwind its balance sheet, **long-term rates continue to stay low**, as the U.S. Treasury yield curve continues to flatten. A reasonable explanation of the yield curve's stubbornness is investor pessimism about the prospect of passing legislation in Washington coupled with stubbornly low inflation rates.
- The prime rate, the rate that banks charge their highest-quality customers, ticked up 25 bps since last quarter in response to the Fed Funds rate hike. Fortunately for banks, the 5-year CD rate increased only 10 bps over the same period. The widening of the spread between lending rates and borrowing rates is a positive for banks, giving their margins some breathing room.
- With the difference between short- and long-term bond yields being as minimal as it is, designing a bond portfolio that balances the need for yield with managing interest rate risks has led GFC to **focus on bonds with near-term maturities**.
- GFC has decided to weight our clients' bond portfolios towards the short-term in an effort to better capitalize on higher rates when they begin to materialize. Additionally, **shorter-term bonds exhibit less volatility** (i.e., less risk) than longer-term bonds.
- The graphs below compare bond funds with different maturity objectives over the past year. Versus the long-term fund (red), the short-term fund (blue) underperformed but took on considerably less risk as illustrated by lower volatility. **GFC is preparing bond portfolios for rising rates.** As rates rise, it is likely we will extend our clients' bond ladders, but right now we feel the risk-reward trade-off favors short-term bonds.





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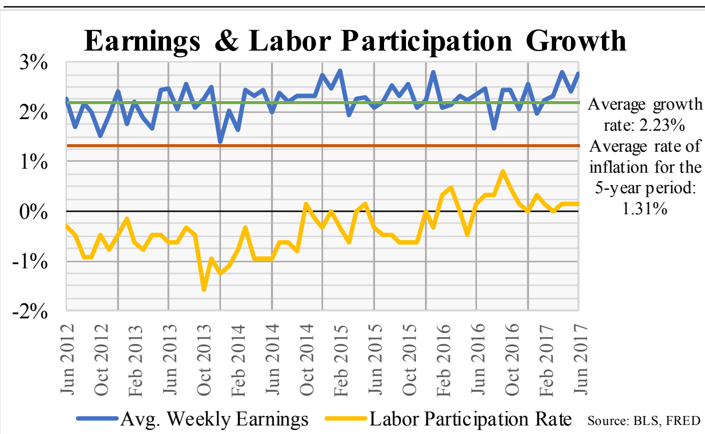
Economic Indicators

Indicator	Description	3/31/17	6/30/17	QTD Change
Average Weekly Initial Claims for Unemployment Insurance	The number of new filings for unemployment insurance benefits. **The number of claims increased but remains below the 300,000 level.** *Most economists believe claims below 300,000 indicate a healthy labor market environment.*	235,000	248,000	↑ 5.53%
Unemployment Rate	The percentage of total labor force that is unemployed but actively seeking employment. **The unemployment rate remains below 5%.** *The U.S. Federal Reserve targets a long-run unemployment rate of between 4.5% and 5%.*	4.5%	4.4%	↓ -10 bps
Average Weekly Earnings	The average weekly salary earned by private, nonfarm employees. **Average weekly earnings slightly increased. This suggests more disposable income for consumers and could be the result of a tightening labor market.**	$896.26	$905.63	↑ 1.05%
Index of Consumer Sentiment	This index reflects consumer attitudes towards the state of the economy. **Consumer confidence dipped but remains near its post-recession high of 98.5.**	96.90	95.10	↓ -1.86%
Manufacturers' New Orders for Consumer Goods and Materials (Millions) *	The number of new orders placed for consumer goods. **New orders increased, indicating higher demand for U.S.-produced consumer goods and validating high consumer confidence and lower unemployment.**	$194,019	$194,577	↑ 0.29%
Manufacturers' New Orders for Nondefense Capital Goods, Excluding Aircraft (Millions) *	This index is the producer's counterpart of new orders of consumer goods and materials. **New orders for nondefense capital goods increased during the quarter, suggesting increased business confidence in the economy.**	$62,850	$63,139	↑ 0.46%
US Capacity Utilization: Manufacturing *	The ratio of production capacity being used to produce finished products compared to the total capacity available. **Capacity utilization increased slightly, in line with increased new orders and confidence.**	75.5%	76.0%	↑ 48 bps

*These items are as of 5/31/17, the date of the most recently published statistics

Sources: YCharts, Federal Reserve Bank of St. Louis, The University of Michigan, U.S. Census Bureau, U.S Department of Labor

U.S. Economic Health



The U.S. economy has observed generally good news in the labor market for some time now. Unemployment has been within the Fed's target range, weekly earnings are trending upwards, and consumer sentiment remains high. So why are we not seeing more explosive growth or inflation?

The answer may lie in the fact that so many Americans left the labor force as a result of the Great Recession. The effect is that headline unemployment drops because people no longer count towards that calculation once they have stopped looking for work. It also means that there are plenty of workers on the sidelines waiting for wages to improve. It's this last point that leads to the graph on the left.

The graph depicts the year-over-year change in average weekly earnings and in the labor force participation rate (i.e., the percentage of able-bodied, working age Americans that are in the workforce). The graph also depicts the 5-year average rate of inflation. There are two key takeaways: 1) **wage growth has on average outpaced inflation**, meaning people are experiencing so-called "real" wage growth, and 2) the growth in wages is contributing to an **increase in the labor participation rate**. The flip side is that as those people get pulled into the workforce, wage growth is somewhat impeded as supply catches us with demand.

While **unemployment has reached and maintained a desirable level**, inflation has not. It may not be intuitive, but **modest inflation is good for the economy**. Modest inflation incentivizes consumers and businesses to spend in the near-term, boosting economic output. Without inflation, consumers and businesses may postpone spending in the hopes of a better deal later. This presents a chicken-and-egg dilemma: for the economy to grow more money needs to be spent, but for more money to be spent people need to believe the economy is growing. A sign of growth is inflation. Whether the chicken or egg will budge first is difficult to predict. Thankfully, economic indicators point to limited downside. While slow growth is agonizing and tedious, it surely beats no growth.