3Q2017

THE INVESTOR QUARTERLY

MARKET COMMENTARY AND INVESTMENT PERSPECTIVES

The Investor Quarterly is issued in order to communicate the current state of capital markets and provide overview of economic conditions. The information contained in this publication should not be construed as investment advice. You should discuss with your financial advisor the conditions of your unique circumstances. The material prepared by Ashton Thomas Private Wealth, LLC., for use by its approved advisors.

WELCOME

Greetings,

Global capital equity markets continued their historic advance in the third calendar quarter of 2017, led once again by foreign developed, and emerging markets. Foreign developed equity markets were up +5.4% (MSCI EAFE Index) for the quarter, while their emerging market counterparts were up even more, gaining +7.9% (MSCI Emerging Markets Index) for the period [(1)]. The U.S. stock market once again lagged its foreign competitors for the quarter (S&P 500 Index was up +4.5%), though investors had to be pleased to see a bit of reacceleration in their momentum from the quarter prior, when the Index gained just +3.1% [(2)]. "Growth" stocks continued to outperform "value" stocks during the full quarter, though the month of September saw value stocks surge.

As was the case in the equity markets, foreign debt markets outperformed domestic debt markets for the quarter. The Barclays Global Aggregate Bond Ex-U.S. Index, a proxy for foreign bond markets, was up +2.5% for the quarter, extending their year-to-date (2017) returns to +8.7%. The Bloomberg Barclays Aggregate Bond Index, a proxy for the U.S. Bond markets, was up just +0.8% in the third quarter, bringing its year-to-date (2017) returns up to +3.1% [(3)].

Like the quarters that preceded it, the third quarter saw very little volatility in capital markets worldwide. Here in the U.S., the S&P 500 Index, a proxy for U.S. large-cap stocks, celebrated a rare *ninth consecutive quarter* of positive returns. In fact, the largest peak-to-trough decline in the S&P 500 Index during the third quarter was just (-2.23%), from August 8th, through August 18th, and the largest peak-to-trough decline for the entire year-to-date (2017) has been just (-2.80%), occurring from March 1st, through April 13th [(4)].

Though the year still has several months remaining in it, if a larger decline doesn't occur during the final quarter, 2017 will have the lowest level of market volatility seen since 1995.

We believe that the level of investor complacency seen today is largely explained by widely-held investor beliefs that: (1), the economy will continue to expand over the next couple of years, albeit at a modest rate of growth, and (2), the Federal Reserve Bank, and global central banks worldwide, will act quickly to any capital market decline with more monetary accommodation. The "Yellen Put", as it is referred to, is assumed to be absolute. While the Yellen Put, and before her term as Chair, the "Bernanke Put", has been an assumption that could be reasonably relied upon by investors for some time now, we're not certain market participants, particularly domestic investors, should assume there would be more Quantitative Easing to come, should markets decline at this point in the cycle. In the minutes released to the public after recent Federal Reserve Bank's FOMC Committee meetings, U.S. central bankers have made it clear that they would very much like to reduce their unprecedented ($4.5 Trillion) balance sheet's size, and to raise the Fed Funds Rate, currently at 1.00% - 1.25% [(5)], further, in anticipation of having room to lower them in the next economic recession.

European equity markets continued their robust advances last quarter, as evidence that the economic recovery there remains intact, and much of the nervous market sentiment that flooded that market earlier this year has dissipated. European stocks are up +23.4% collectively, year-to-date 2017 [(6)], with Spain (up +29.6%), France (up +27.9%), and Germany (up +25.0%) leading the region, after lagging U.S. markets for most of the previous decade.

(1) https://www.msci.com
(2) http://us.spindices.com/indices/equity/sp-500
(3) https://finance.yahoo.com/quote/AGG?p=AGG; https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf
(4) http://www.marketwatch.com/investing/index/spx
(5) https://www.federalreserve.gov/monetarypolicy/openmarket.htm
(6) https://www.msci.com/europe

WELCOME

The yield curve here in the U.S. continued to flatten in the third quarter of 2017. The "spread" between 10-Year Treasury Bonds and their 2-Year counterparts started the year at +1.23%. By the end of the second quarter, the spread between the two had narrowed to +0.93%, and by the end of the third quarter, it had tightened further, to +0.86% [7]. This "flattening" of the yield curve should be seen as a potential "danger" signal to the domestic economy, as financial institutions find it difficult to profit as the yield curve flattens.

European rates saw an increase in the "spread" between their 2-Year and 10-Year bonds in the first half of 2017, a trend that continued in the third quarter. The 2-Year average European sovereign bond yield started the year at a (-0.80%), and rose to a slightly less negative yield of (-0.586%) by June 30th, before finishing the third quarter at a slightly lower, but still *negative* yield of (-0.70%). The average 10-Year sovereign bond yield started the year 2017 at +0.258%, rose to +0.541% by June 30th, and fell slightly to +0.516% on September 30th [8]. Unlike the U.S. Treasury yields, the Eurozone yield curve "spread" has *widened* throughout the year 2017. The 10-year/2-Year Eurozone bond yield spread was +1.05% at year-end 2016, and widened to +1.127% on June 30th, widening further in the third quarter, to +1.216%.

As we've stated in earlier issues of this publication, we continue to see equities as extremely "expensive" at current levels, especially domestic equities. The advance in U.S. stock prices this year has been led almost exclusively by growth stocks, with Information Technology stocks being the largest contributor by far, up +26.02% through September 30th, followed by Health Care stocks, up +18.75%, and lastly, Material stocks, up +14.09%. Those three sectors are the only three (of ten) to outperform the Index' aggregate return through September 30th of +12.53%. Energy stocks, down (-8.62%) year-to-date, and Telecommunication Services, down (-8.07%) year-to-date, have been the laggards in 2017 [9]. The top 50 stocks in the S&P 500 Index today represent 50% of the entire Index' market capitalization, and the four largest (Apple, Microsoft, Facebook and Amazon) represent more than 10% of the Index' value [10]. As one would expect, they are, by far, the largest contributors to the Index' performance. The concentration and "narrowing" of gains, with fewer and fewer stocks carrying the Index' advance, is often a precursor to a market decline. Despite the seemingly inexorable rise in the Index itself, we remain extremely defensive at current levels.

We continue to manage risk with tactically defensive money managers navigating the "traditional" (stocks and bonds) markets. We surround them with non-correlated "satellite" managers and funds in markets that will provide protection from stock and bond market declines, and deliver incremental returns and "dry powder" to opportunistically re-enter those traditional capital markets, post correction.

Thank you for your continued support.

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(7) https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2017
(8) https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_area_yield_curves/html/index.en.html
(9) https://us.spindices.com/indices/equity/sp-500
(10) https://www.slickcharts.com/sp500

THE MARKET AT A GLANCE

U.S. EQUITIES:

Equities continue to be the "driver" of capital markets, and earnings improvements have been at least partly responsible. Though less than 5% of the companies that make up the Index have reported their earnings for the third quarter of 2017, consensus expectations are that Operating Earnings for the constituent companies comprising the S&P 500 Index will jump +7.96% quarter over quarter, while "As Reported" Earnings for those companies are expected to jump +10.33%. That said, consensus earnings estimates have proven wildly over-optimistic in recent years, often falling (-2.5%) to (-5%) "per Index Share" as the quarter passes, and earnings reports are actually delivered. The four quarter ("trailing") "As Reported" Earnings P/E Ratio peaked in Q3 2016 (24.34 x earnings), and assuming earnings estimates for Q3 2017 are realized, the trailing Index P/E Ratio should shrink slightly, to 23.54 x "As Reported" Earnings [11]. The 50-year average (trailing) four-quarter "As Reported" P/E Ratio (1967 – 2016) has been 18.58 x, meaning the current 23.54 P/E Ratio is (approx.) 27% higher than average. And if you eliminate the three "outlier" years during the period (i.e. 2001, 2002, 2008) where earnings virtually disappeared, the average P/E Ratio drops to 16.61 x As Reported Earnings, making the current P/E Ratio 42% higher than average [12].

Large-Cap Growth Stocks (Russell 1000 Growth Index) were the domestic market leaders once again last quarter, up +5.9%, versus a more modest gain of +3.1% for their Large-Cap Value counterparts (Russell 1000 Value Index). Mid-Cap Stocks (Russell Mid-Cap Index) lagged for the quarter, rising +3.5%, and Small-Cap Stocks (Russell 2000 Index) gained +5.7% for the period [13].

As we've repeatedly stated in prior missives to clients, we see remain cautiously underweight domestic equities, expecting the second longest equity market expansion in U.S. history, largely fueled by the Federal Reserve Board's unprecedented monetary accommodation, to end in the coming quarters.

INTERNATIONAL DEVELOPED MARKETS:

For the third consecutive quarter, the MSCI E.A.F.E. ("Europe, Australia, Far East") Index, a proxy for foreign (ex.-U.S.) developed equity markets, outpaced the S&P 500 Index returns, gaining +5.4% in Q3 2017. The best performing region was the Eurozone, up +6.5% for the quarter, followed by Japan, up +4.1%, and by the rest of the Pacific Rim countries (ex-Japan), which were up +3.7% for the quarter. In contrast to the domestic equity markets, foreign "Value" oriented stocks outpaced their "Growth" stock brethren. Small-Cap stocks were the best performers, rising +7.5% for the period, followed by Mid-Caps, up +6.1%, and finally, Large-Caps, which were up +5.2% for the period [14]. For U.S. investors deploying capital to foreign developed equity markets, the U.S. Dollar's strength has been a headwind to returns for most of the past decade. But despite the impact of higher interest rates in the U.S. than the Eurozone or Asian economies, the U.S. Dollar Index ("DXY") has retreated (-5.81%) from year-end 2016, through the end of the third calendar quarter, providing a tailwind to the larger equity advances seen overseas [15].

(11) https://us.spindices.com/indices/equity/sp-500
(12) http://www.multpl.com/table
(13) https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf
(14) https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf
(15) http://www.marketwatch.com/investing/index/dxy

THE MARKET AT A GLANCE

The European Central Bank ("ECB") continues its accommodative monetary policy. The ECB's Deposit Facility Rate, the Eurozone's equivalent to the U.S. Federal Reserve Bank's Fed Funds Rate, remains negative, at (-0.40%), where it was set in March of this year. The ECB's Balance Sheet, at $5.2 Trillion (USD), is the largest in the developed world. Japan's Central Bank, the Bank of Japan ("BOJ"), also maintains a slightly negative "Overnight Call Rate", at (-0.10%), and holds $4.7 Trillion (USD) on its books. There has been speculation that the ECB and BOJ will follow the Fed's lead at some point, raising overnight lending rates and unwinding its balance sheets, but they've taken no concrete steps to begin implementing those changes (16). Given their more reasonable valuation levels, until they do, we believe foreign developed equity markets are better positioned for continued advancement than here in the U.S.

EMERGING MARKETS:

The Emerging Markets' equity markets continued their torrid advance in the third quarter of 2017, with the MSCI Emerging Markets Equity Index gaining +7.9% for the period, increasing their year-to-date 2017 gains to +27.8%. The "BRIC" (Brazil, Russia, India, China) countries led the way in the group, with the MSCI BRIC Index up +13.9% for the quarter, and +33.2% for the year-to-date (17). Despite the outsized gains year-to-date, the MSCI Emerging Markets Index trades at a very reasonable 15.27 x trailing four quarters' earnings, and 12.48 x forward estimated earnings (18). Emerging markets equities have finally regained their momentum, after the Index delivered *negative returns* for four of the six calendar years leading up to 2017. Information Technology companies represent six of the largest ten stocks in the Index, and is the largest segment of these markets with a 27.59% industry "weight", followed by Financials (23.40%) and Consumer Discretionary (10.29%). China, the world's second largest economy, continues to increase its weighting in the Index at 29.55% of the Index' market capitalization.

Risks to the continued expansion in emerging markets equities include (1), the potential that the U.S. Federal Reserve might hike interest rates rapidly, something seen as relatively unlikely, (2), the potential that a Trump administration might pursue trade protectionist policies, and perhaps most likely, (3), a surprise devaluation of the renminbi, something that could be announced as soon as China's 19th National Congress of the Communist Party of China, set to begin October 18th in Beijing. We have little exposure to the Emerging Markets currently, though we are considering adding those stocks to our clients' portfolios.

COMMODITIES:

Commodity prices continue to be a mixed bag. Industrial and Precious Metals continue to advance with Aluminum (up +21.9%), and Copper (up +16.1%) leading the way year-to-date, followed by Gold (up +10.7%) and Silver (up +3.2%) year-to-date. Agricultural commodity prices are largely down, with Corn (down -7.9%), Soybeans (down -5.7%), and Wheat (down -4.7%) year-to-date. The lone exception among Agricultural commodities is Livestock, which is up +3.0% this year. Energy prices are the worst performers in the sector, with a (-27.9%) decline in Natural Gas prices in 2017. Unleaded Gasoline (-9.6%) and Crude Oil (-9.4%) have also been big losers this year-to-date. (19)

(16) https://www.yardeni.com/pub/peacockfedecbassets.pdf
(17) https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf
(18) https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111
(19) https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf

THE MARKET AT A GLANCE

The U.S. Dollar is a major factor when it comes to commodity prices, as it tends to have an inverse value relationship with raw material prices. As mentioned earlier in this Report, the U.S. Dollar Index declined another (-2.66%) in the third quarter, bringing the year-to-date decline in the U.S. Dollar to (-9.19%), from the highest levels since 2002 [(20)]. Continued U.S. Dollar weakness would be a tailwind to Commodity prices going forward.

That said, we remain very cautious toward allocations into Commodities. While Crude Oil prices seem to have stabilized, we see very little in the way of inflation in the near-term, despite global Central Banks' efforts to manufacture it, and inflation is necessary to a sustained advance in Commodity prices.

REAL ESTATE:

The S&P United States REIT Index, a proxy for the 160 publicly-traded REIT stocks, rose +0.84% during the third quarter of 2017, bringing its year-to-date returns (including dividends) to +2.93% [(21)]. The performance varied widely by real estate sub-sector, as it has all year. The best performing REITs year-to-date continue to be the Data Center REIT's (up +27.95%), followed by Infrastructure REIT's (up +24.39%) and Manufactured Home REIT's (up +17.03). On the other end of the spectrum are Shopping Center REIT's (down -15.23%), and Regional Malls (down -11.74%) year-to-date.

Macroeconomic and demographic shifts in consumer behaviors make sector selection more important than ever in the Real Estate markets. Broad diversification, such as buying the REIT Index through a fund or an ETF would be unwise as it would force exposure to the poorest performing real-estate sub-sectors. With a (trailing) P/E Ratio of 33.25 x earnings, REIT's are even more "expensive" than the broad stock market in general, and in 2008, the last time the domestic equity market declined more than (-20%), the Index declined (-38.33%), so we believe caution is warranted here [(22)].

FIXED INCOME:

Like their equity counterparts, foreign (non-U.S. issues) bonds outperformed their domestic (U.S. issuers) counterparts, continuing a trend that began in January. The Bloomberg Barclays Global Bond (ex – U.S.) Index, a proxy for developed foreign countries' issuance, was up, +2.5% for the third quarter of 2017, bringing year-to-date returns for that Index up to +8.7%. In contrast to those gains, the Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for the broad, U.S. bond markets in general, was up +0.8%, and +3.1% for the third quarter, and year-to-date 2017, respectfully. The Bloomberg Barclays Municipal Bond Index, a proxy for U.S. Municipal Bonds, was up +1.1%, and +4.7%, for the third quarter and year-to-date 2017, respectfully.

With a "flattening" yield curve, and longer-term interest rates holding steady, and declining slightly during the quarter (and year-to-date 2017), longer-dated maturities continued to outperform their intermediate and shorter-term maturity issuers. Higher yielding, lower credit quality issuance (below Baa) have been the best performing credits, delivering +2.0%, and +7.0%, for the third quarter and year-to-date 2017, respectively.

(20) https://seekingalpha.com/article/4110889-commodities-3rd-quarter-overview-outlook-q4
(21) https://us.spindices.com/indices/equity/sp-united-states-reit-us-dollar
(22) https://www.reit.com/sites/default/files/returns/prop.pdf

THE MARKET AT A GLANCE

High yield "spreads", the excess yield paid to bond holders for accepting the credit risk associated with lower credit rated bonds, started the third quarter at +3.81% (381 bps), and ended it at +3.47% (347 bps) on September 30th, 2017 [(23)]. We remain very tactically defensive in our allocations to domestic debt, as the Bloomberg Barclays Aggregate Bond Index has delivered just one year (2013) of negative returns in the last ten [(24)]. Such streaks are difficult to maintain, especially as the Federal Reserve Bank makes clear their intentions to raise interest rates, at least on the short end of the yield curve.

(23) https://content.rwbaird.com/RWB/Content/PDF/Insights/Quarterly-Market-Chart-Book.pdf

THE WORLD ECONOMY AT A GLANCE

The third calendar quarter of 2017 saw a continuation of the global economic expansion that has been in process for quite some time. Some have described economic conditions as "*Goldilocks-like*", as in, "*not too hot and not too cold, but just right*". The U.S economy, as measured by its Gross Domestic Production ("GDP") expanded at an unexpectedly robust +3.1% in the second quarter of the year, and the Atlanta Fed in its "*GDPNow forecast*" updated October 13th, projects GDP in the third quarter to come in at +2.7%, slightly below prior estimates, due to the economic disruptions caused by Hurricanes Harvey and Irma (25. Growth is expected to rebound in the following quarters however, as rebuilding efforts intensify, and consumer goods are purchased in replacement of items lost. Consensus estimates from economists we follow see U.S. GDP growth in 2018 accelerating to a healthy +3.2%.

GDP growth in the Eurozone was confirmed at 0.6% in the second quarter of 2017, following an increase of 0.5% in the first quarter. ECB President Mario Draghi boosted consumer sentiment in the region by announcing that the ECB had discussed various scenarios around potentially unwinding their quantitative easing programs, something the Federal Reserve has begun already here at home. The United Kingdom has also taken a more hawkish tone, as officials seem less concerned about the medium-term economic drag from Brexit. Growing expectations that inflation in the U.K. will likely exceed +3% in its October report, has led to speculation that monetary tightening, not expected until next year, might be imminent.

Japan has seen improving economic data as well. September industrial production was better than forecast, and there was also a jump in headline inflation, to +0.7%, the highest rate in more than seven quarters (26). Unlike its peers however, the Bank of Japan reaffirmed its accommodative policy stance despite a backdrop of strengthening economic momentum.

China, who's GDP expanded at +6.9% in the second quarter, saw a mixed bag of economic data in Q3. Leading data indicated China has embarked upon a downward economic trajectory following a robust first half of the year, as attempts to restrain credit growth across all sectors are expected to dampen economic activity. A stronger yuan partially offset those concerns, as a stronger currency will ease fears of capital outflows.

Uneven recoveries in select emerging economies like Brazil, Columbia, Russia, Ukraine and South Africa, where economic growth is still nascent, and recoveries fragile, have several central banks on an easing cycle. It's difficult to see "organic" disruptions in the globally-coordinated economic expansion, as supply and demand is in relative equilibrium in the developed world. Though this economic expansion is the third longest in U.S. history at 101 months, there is nothing in the economic data we see to indicate that it won't survive long enough to become the longest in history, surpassing the 120-month economic expansion from March 1991 to March 2001. If it were to be interrupted before achieving that milestone (in May 2019), it would more likely be a result of a geopolitical "event" or "shock" involving war, or severe political instability.

(25) https://www.frbatlanta.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf
(26) https://tradingeconomics.com/japan/inflation-cpi

THE U.S. ECONOMY IN FOCUS

GROWTH

Estimated to be +2.7% in Q3 2017. Moderate, but accelerating [27].

JOB CREATION

Q3 2017 – 274,000 new jobs. Unemployment Rate declines to +4.2% in September [29].

CORPORATE PROFITS

Expected to reach record highs in Q3 2017. Projections for year-over year growth of +20% are probably wildly overestimated, but growth of half that level would keep markets from collapsing [28] .

INFLATION

+2.2% in September. Accelerating [30].

INTEREST RATES

The Federal Reserve has indicated a likely increase in the Fed Funds Rate following its December meeting. At the same time, longer-term rates have declined slightly, causing the yield curve to "flatten".

RISK TO CONTINUED U.S. ECONOMIC GROWTH

Economic growth is steady, and approaching reasonably robust levels (> +3%). Primarily susceptible to geopolitical "shocks" (i.e. military conflicts), or domestic political dysfunction that might delay needed tax and economic reforms.

(27) https://www.frbatlanta.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.p
(28) https://us.spindices.com/indices/equity/sp-500
(29) https://www.bls.gov/ces/#news
(30) https://www.bls.gov/cpi/

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