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WEALTH MANAGEMENT SERVICES

Midyear Update 2017
Goldilocks' Recipe for Just Right Stock Returns

By Charles Mathews, CFA
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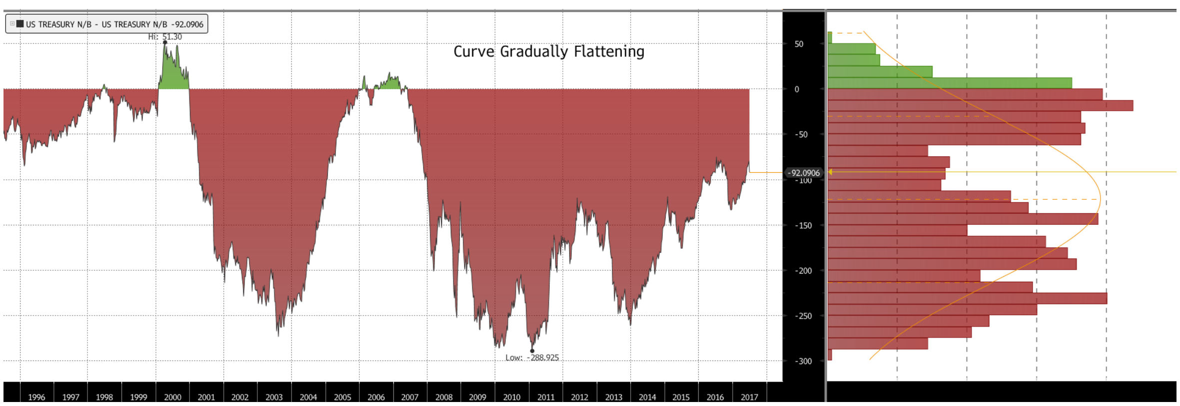
Who knew as we ushered in the new year six months ago that we would have so much political volatility and so little market volatility during the first half? Even if anyone could have predicted all of the political gyrations thus far in 2017, they would have likewise predicted more volatile markets to go along with it. Luckily for investors, markets will look beyond some of the gymnastics that happen in Washington provided that the economic climate suggests that they should and that is precisely what we have seen this year. We came into the year feeling pretty good about the potential for earnings growth and have yet to be disappointed in that regard as the flow of economic data suggests a continuation of the modest growth trajectory that has persisted for some time. Our biggest fear as the year began was that a fiscal stimulus package from a new administration with a like minded Congress might fan the flames of inflation causing the Fed to more aggressively pursue raising interest rates. However, this was at least delayed as the administration got bogged down on other fronts and the usual catalysts for inflation never really got out of the barn. What we ended up with was decent job growth with not much wage pressure, a pick up in global manufacturing activity absent any major movement in capital investment, and consumers that were heartened by low interest rates and low energy prices. It was a "not too hot, not too cold" recipe that allowed the Fed to continue along the path of rate normalization, but in such a measured fashion as to not impede the wheels of economic progress.

It was a solid environment for large cap U.S. stocks with the S&P 500 up +9.34% year to date, supportive for mid caps as the S&P 400 Midcap Index rose +5.99%, and outstanding for international stocks as the MSCI EAFE Index increased +14.21% to the midyear point driven by increases in manufacturing activity and some signs of stabilization for the European banks. Two important themes emerged as ingredients for success in the equity market. The first was large cap growth leadership in the US with the tech sector being a leading contributor to performance. The second was the leadership of global stocks in the wake of a decade where they have mostly underperformed their domestic counterparts. Similar to their colleagues at the Federal Reserve, global central bankers are finally seeing some results from the unprecedented accommodative policies of recent years. In turn, investors have begun to see the attractiveness of more reasonable global stock valuations in an asset class that is under owned by U.S. institutional managers due to the long standing nature of its underperformance. As we look toward other market segments, there wasn't a lot of performance to be found as the Bloomberg Barclays Intermediate Govt/Corp Bond Index gained +1.73%, the Dow Jones Commodity Index was down –2.18% and the Lipper Market Neutral Hedge Fund Index rose a modest +0.81%. It is not lost on us that the lackluster performance in these other asset classes may also have contributed to the positive flow of funds that we have seen heading toward equities.

Given the absence of market volatility in the last several months, it is hard not to allow for the possibility of an equity market correction heading into the third quarter. At the same time, as we consider the underlying economic fundamentals, it is difficult to see the onset of a bear market at least in the near term. This conundrum leaves us taking some profits where stock allocations have been pushed above strategic levels by market action, but not yet ready to become defensive toward stocks. While we expect volatility to increase during the second half, we believe that the economy has enough momentum to continue to overcome event driven headline risks as they inevitably crop up from time to time.

One of the biggest challenges for investors during this business cycle has been the unusual length of the post financial crisis expansion dating from 2009. This is rooted in the duration of Fed policy that has consisted of three waves of unprecedented easing from 2009 to 2014 followed by three years of relative patience in raising rates due to the lack of inflationary pressure in the system. For the most part, we think that the Fed has gotten it right when you consider where we've been and where we are today though debate will continue on as to whether they were too accommodative earlier on or overly restrictive in beginning to raise rates without more evidence of inflation. While there are other issues such as trade policy that present risks to the expansion, we are most focused on how the credit markets respond to the Fed in the weeks and months ahead. The reason for this is that each of the last three major bear markets (1990, 2000-2003, and 2007-2009) came on the heels of Fed tightening cycles where the yield curve ultimately flattened or inverted in response to the Fed's actions. When the curve gets flat, it typically is the result of the Fed pushing the short end up and investors bringing the long end down as they see less inflation forward in time. Less inflation is usually associated with lower growth and there is the rub for earnings and the stock market. Our concern is that as the Fed tightens in the absence of inflation, the economy starts to slow in response. What we hope to see is a yield curve that continues to maintain some steepness as a function of improving demand. This would confirm that the Fed hasn't overdone it and that there is still some potential for stocks to work higher. It would also allow the Fed to begin normalizing its balance sheet without being overly disruptive to markets.



Credit Ratings: Why do they matter? Ask Illinois or Puerto Rico bond investors.

By Robert Magan, CFA

Ratings firms rank debt according to how safe an investment they believe it is. The 12 safest tiers are considered "investment grade," meaning investors have what S&P terms "adequate" protection against the risk of default. Below that, bonds are considered junk, or "speculative grade," meaning they face "large uncertainties" or "major exposure to adverse conditions," according to S&P. Investors who buy junk may earn greater profits if the bonds perform well but they also face greater danger of losses.

Sortable Table Key	Moody's	Fitch	S&P
Highest grade credit	Aaa	AAA	AAA
Very high grade credit	Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-
High grade credit	A1, A2, A3	A+, A, A-	A+, A, A-
Good credit grade	Baa1, Baa2, Baa3, Baa4	BBB+, BBB, BBB-	BBB+, BBB, BBB-
Speculative grade credit	Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-
Very speculative credit	B1, B2, B3	B+, B, B-	B+, B, B-
Substantial risks - In default	Caa1, Caa2, Caa3, Ca	CCC, CC, C, RD, D	CCC+, CCC, CCC-, CC, C, D

Background on State of Illinois

In the first half of 2017 a significant event occurred for the State of Illinois. On June 1 S&P downgraded Illinois to BBB- from BBB and Moody's followed on June 7 with their own downgrade to Baa3 from Baa2, both moving Illinois to the last tier of "Investment Grade" ratings and with continued negative outlook, which means they could be downgraded to "Junk" status if things do not improve.

The Legislature and the governor have been locked in a political stalemate as they have been without a budget for over 700 days. Illinois could become the first U.S. state to have its debt downgraded to junk status. S&P and Moody's both threatened a downgrade if the parties can't agree on a package of spending and taxes by the start of their next fiscal year, July 1st.

Illinois is struggling under the weight of $130 billion in pension debt, a liability far greater than any other state's. In addition they have a burdensome backlog of nearly $15 billion in bills left over from two years without a budget which will likely leave Illinois "vulnerable to unanticipated economic stress," according to research by S&P Global Inc. And to add to the problems, a federal judge found Illinois noncompliant with its Medicaid payments, with the state owing $3 billion to health-care providers.

While a budget deal may have been passed on July 4th, ratings agencies are still concerned because the budget does not address a solution for the pension debt and it adds to the long term debt outstanding as it issues more debt to cover unpaid bills. With all of this combined we can see why Illinois is now rated Baa3/BBB- by Moody's and S&P.

The possible effects on Investors and the Municipal Bond Market

Analysts predict prices would drop only a few cents in the event of a junk downgrade to somewhere around 95 cents on the dollar. Junk bonds don't usually trade near par, but state general obligation debt is considered safer because states have broad power to tax and lack the legal ability to declare bankruptcy. A junk rating won't affect the state's ability to pay bondholders. State officials have said those payments are their No. 1 priority. A good portion of the budget that was passed by Illinois includes tax increases in an effort to right the ship.

There has been a fair amount of trading as bonds changed hands. Bondholders spooked by the state's deteriorating credit sold and high-yield investors took advantage of the opportunity to buy. Mutual funds have already sold more than $100 million in Illinois general obligation bonds since the end of 2016, according to Morningstar, and buyers have been taking advantage of temporary dips.

The most immediate and longer-term impact will be the rising costs of borrowing, making it more expensive to raise money for new projects. Because of the lower ratings and possible further downgrades investors will likely demand a higher rate of interest to buy future bonds. This could be as much as a half-percent to a percent in interest, meaning the state would pay an additional $5 million to $10 million for every $1 billion it borrows. There is a direct relationship between credit rating and cost of borrowing. In November 2016, Illinois paid yields of 4.4% for 20-year bonds they issued. In contrast, 20-year bonds issued by the state of Wisconsin (Aa2/AA) around the same time yielded 2.8%.

In comparing this event with the events in Puerto Rico we have to remember that Illinois' problems are largely political. Unlike Puerto Rico, which is in the midst of a court-supervised restructuring, Illinois has a strong underlying economy and annual revenues that are about 10 times its yearly debt service payments. Puerto Rico, on the other hand, has endured more than a decade of economic distress. There should be no concerns that Illinois will continue to be able to access the Municipal Bond Markets for funding projects going forward.

As far as this becoming any sort of a contagion that spreads to other states we should look to New Jersey (A3/A-) and Connecticut (A1/A+), among the lowest-rated states after Illinois. They may face more scrutiny from investors as analysts will begin to look more closely at the next issue that could come to fruition. Both these states are wrestling with budget problems and mounting liabilities. But New Jersey and Connecticut still have a long way to go to match Illinois' ratings dilemma. They are rated several tiers higher by S&P and Moody's Investors Service.

Bank of New Hampshire Approach to Municipal Bond Investing

At the time of purchase all bonds must have a rating of A3/A- or better by one of the three rating agencies. In practice, we focus primarily on buying General Obligation bonds because they are secured by the full faith and credit of the municipality that issues them. We prefer GOs because essential revenues from general taxation are used to pay interest and principal. We believe this to be the best place for long term investors in an ever changing environment with increased uncertainty in the future. We may at times purchase high quality Revenue Bonds which are municipal bonds that are secured by the specific income of the issuer, i.e. Airport Revenue Bonds or Turnpike Authority Bonds. Our focus would be on projects that have a history of consistent repayment.

With our approach in mind, the good news for Bank of New Hampshire clients is that we have been aware of the issues in Illinois as well as Puerto Rico. We do not own any State of Illinois GO Bonds or any Puerto Rico Bonds in our portfolios. This confirms our focus on owning higher quality municipal bonds that provide a consistent, safe and secure source of tax free income.