CAPITAL ADVISORS

Overview
Second Quarter 2017

Key Points

- Our outlook for the financial markets has not changed materially since the start of the year.
- Specifically, we believe the stock market seems capable of a double-digit return in 2017, while bonds look likely to deliver something in the low-single-digit range for the year.
- The two variables we are watching most closely to shape our outlook are interest rates and government policy.
- Global interest rates are important because today's elevated valuation multiples in the stock market may not be sustainable without the continuation of ultra-low interest rates for several years into the future.
- Washington policy matters because stock prices might already include a premium for potential tax and regulatory reform, and there is probably more upside left if business-friendly policies are enacted.
- We are hopeful these two variables might partially offset one another to support stability in the asset markets, at least through the end of 2017.
- For example, rising global interest rates would normally be a headwind for stocks, but if the catalyst for higher rates is a brighter outlook for the global economy, stocks might endure higher yields up to a point.
- On the other hand, continued dysfunction in Washington would probably darken the outlook for the economy, but it might also keep interest rates lower for longer to partially offset the negative impact of a policy failure.
- For investors, we continue to believe that a balanced approach is appropriate for even the most aggressive risk seekers.

A Strong Start to the Year Supported by Solid Fundamentals

It is not particularly bold to forecast a double-digit return for stocks in 2017 when many market benchmarks are already there. However, this outlook reflects our sense that stocks can probably hang on to their recent gains, and maybe add a little more during the second half of the year.

Asset Market Returns[1]
12/31/16 to 06/30/17

S&P 500 Index	9.34%
MSCI World Index	10.66%
Morningstar Dividend Yield Focus Index	2.91%
Bloomberg Barclays Interm. US Gov't/Credit	1.73%
Bloomberg Barclays US Aggregate Bond	2.27%

It is not possible to invest directly in the index
Past performance may not be indicative of future results

It is important to note that recent strength in the stock market has been well supported by fundamentals. Corporate earnings growth has been surging throughout the world following two consecutive years of stagnation from sinking commodity prices and a downturn in the manufacturing sector. The recent rebound in corporate profits has been driven by stronger sales growth and expanding profit margins in the U.S., the Eurozone and Japan. For now this trend seems sustainable, as 75% of S&P industry groups are still experiencing rising earnings estimates from analysts.[2]

Most major economic indicators have been encouraging as well, not only in the U.S., but also throughout the Eurozone and Japan. Key monthly data for industrial production, retail sales and capital goods orders have been healthy, with no more than the usual variance across different geographies and measurement periods.

Keep an Eye on Interest Rates

The behavior of interest rates has an enormous impact on every other asset market… stocks, commodities, real estate, you name it. This is because the valuation equation for all assets begins with the risk-free rate of interest implied by government bond yields throughout the world.

Low interest rates support higher prices for all other asset markets, and vice versa. With government bond yields anchored to zero (or less) in recent years, it is not surprising that current valuation multiples in many asset markets look stretched relative to their long-term historical average.

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[1] Source: Standard & Poor's; MSCI; Bloomberg
[2] Source: BCA Research

The Difference between Full Value and Over-Valued

The U.S. stock market looks particularly expensive relative to its historical average. For example, the normalized price-to-earnings ratio, or "CAPE ratio" of the domestic stock market has only been higher than its current reading in 3.5% of all monthly observations dating back to 1881.[3]

We believe today's elevated CAPE ratio for U.S. the stock market demands caution from investors. However, we also recognize that the risk-free interest rate reflected in historical comparisons was much higher than today. If the risk-free rate had been anchored to zero throughout much of history, instead of the actual average of about 4.0%,[4] the recent valuation multiple of the stock market would look quite normal by comparison. The same can be said about other asset markets like real estate or private equity.

The main point we wish to highlight is that the recent price of most asset markets can probably be justified by current fundamentals *as long as interest rates don't rise too far, too fast.* Many asset markets, including the U.S. stock market, look *fully* valued relative to ultra-low interest rates, but they are probably not *over*-valued as long as interest rates behave.

For now, we see little reason to expect an unsettling rise in interest rates. Central bankers are well aware of the relationship between interest rates and asset values, and they have been exceedingly transparent about their intention to normalize monetary policy *very* gradually.

Inflation is an even more important driver of interest rates, particularly the longer-term rates that matter most to the economy and the asset markets. Here again, the outlook seems benign. Core inflation measures throughout the developed world remain stuck below 2.0%. Even in the U.S., where the unemployment rate is already very low, core inflation has struggled to breach the 2.0% threshold for most of the past 10 years.[5]

A fully valued stock market suggests future long-term returns may be lackluster from today's starting point. However, we do *not* believe stocks are so wildly over-valued that a disaster is looming. As long as the global risk-free interest rate remains unusually low (relative to its historical average), valuation multiples in the stock market can remain abnormally high. This is our baseline expectation.

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[3] Source: Robert Shiller http://www.econ.yale.edu/~shiller/ ; CAPE ratio measures the price of the S&P 500 Index divided by the trailing 10-year average earnings per share for the index, adjusted for inflation.
[4] Source: Morningstar Ibbotson
[5] Source: Bureau of Labor Statistics (BLS) https://data.bls.gov

Government Policy May be a Two-Edged Sword

The behavior of global equity markets since the November elections seems to suggest that investors want action from Washington. Developments that are interpreted to be favorable for the prospect of tax reform or regulatory relief are usually greeted with higher stock prices, while developments that diminish hope for these policies send stocks lower.

Research analysts have also begun to incorporate the prospects for tax reform into their valuation models for stocks. We have seen multiple examples of analysts raising their "fair value" estimate for stocks by adding a probability-weighted premium for the possible uplift to profit margins from tax reform. This suggests to us that markets have already discounted some of the potential benefits of tax reform into current stock prices, and therefore, a policy failure here would likely trigger a selloff.

Importantly, the bond market has tended to move in the opposite direction of the stock market on this issue. When the administration's growth-friendly agenda scores a political win, interest rates tend to rise (i.e. bond prices fall), and vice versa whenever the administration's policy agenda falters.

This dynamic may promote stability in the asset markets for the remainder of the year. Rising interest rates would normally pose a significant threat to the stock market with valuation multiples at recent levels, however, if the reason for higher rates is the passage of growth-friendly tax or regulatory policies, stocks might be more resilient.

Similar logic might apply if the opposite were to happen. If investors conclude that nothing productive is likely to come out of Washington, it would be negative for the outlook for growth, but it might also promote an expectation for interest rates to remain lower for longer.

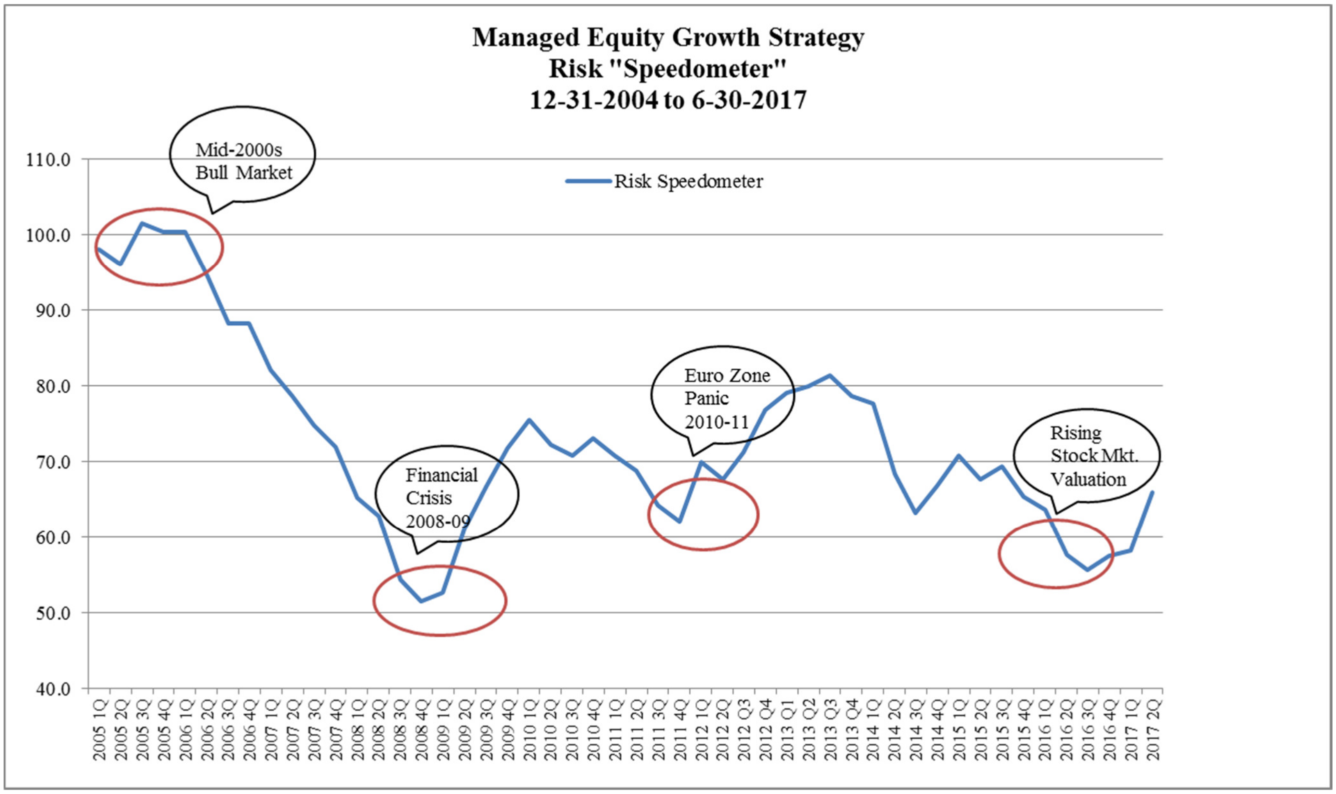
Current Design of Our Investment Strategies[6]

The remainder of this report addresses the current positioning of each of our investment strategies. Please also note that we have a new strategy that is composed entirely of international stocks. It's called the **International Focus** strategy, and it is reviewed below.

[6] The portfolio strategy discussions in this section are supplemental to a compliant presentation. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

Managed Equity Growth

The *Managed Equity Growth* strategy serves as a core allocation to the domestic equity asset class to achieve long-term capital appreciation. The graph below has been updated since the last *Overview* to reflect the recent risk profile of the portfolio model.



Source: Capital Advisors

The graph reflects the strategy's relatively cautious approach since the financial crisis. After taking the risk level higher during the recovery years of 2010-13, we began a downward shift in the risk level in the second half of 2013 in response to higher valuation multiples in the stock market following a strong advance that year.

More recently the risk profile has edged higher as we have positioned the portfolio to participate in the upward bias we expect from the stock market in 2017. Despite this uptick, the strategy model still includes a cash reserve of approximately 10%, and stocks representing our most conservative risk category – Stable Earners – comprise the largest weighting within the model. We are comfortable with the current position of the portfolio, but suspect the next change in the risk profile is more likely to be downward than further upward.

Managed Equity Dividend

The *Managed Equity Dividend* strategy is designed to complement the equity and fixed income allocations of a diversified portfolio. For the equity portion of a portfolio this strategy provides a value tilt due to its emphasis on mature companies with relatively stable cash flows. For the fixed income portion of a portfolio this strategy diversifies the sources of cash flow to include dividend income in addition to interest from bonds.

We like the outlook for high-dividend stocks in 2017 because we believe the worst of the adjustment to higher interest rates may be over for now. Assuming the Fed follows through on its current forecast to raise the Fed Funds Rate one more time in 2017, it would not be surprising if interest rates drifted a bit higher by year-end. However, we suspect longer-term interest rates may have already priced in another rate hike, and long-term rates provide the greatest competition for high dividend stocks in the marketplace.

Meanwhile, the weighted average dividend yield for the *Managed Equity Dividend* strategy model was approximately 4.6% (Source: *Orion*) as of June 30, 2017. With interest rates near historic lows, and the valuation multiple of the stock market near a high, we suspect the cash yield from this strategy may provide a competitive return compared to other major asset markets for the foreseeable future.

Tactical Dynamic Allocation

The *Tactical Dynamic Allocation* strategy is designed to be highly responsive to changing market conditions. By systematically responding to a quantitative indicator called a "moving average," this strategy is likely to be mostly exposed to risk assets when the recent trend in global markets has been positive, and mostly out of risk markets when the recent trend has been negative.

We use this strategy to complement a diversified portfolio of equity and fixed income assets because the variable portfolio mix within this strategy allows the overall risk exposure of a balanced portfolio to react to changing market conditions un-emotionally. This strategy may be a particularly good match for the current stage of the market cycle because it is specifically designed to reduce risk whenever market conditions deteriorate. As of June 30, the strategy model included 89% exposure to risk markets and 11% in fixed income and cash reserves. The only un-invested risk market as of quarter-end was natural resources.

International Focus (NEW!)

The *International Focus* strategy delivers broad exposure to the global equity markets, excluding the United States. The strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined exposure to three market factors that have demonstrated a long-term history of producing attractive risk-reward characteristics – value, momentum and low market capitalization.

The portfolio model is strategically diversified across five ETFs that provide broad exposure to international stocks and emerging markets. Two of the five ETFs use a quantitative discipline to overweight securities that exhibit characteristics of value such as low price-to-book, low price-to-earnings or low price-to-sales. Two ETFs apply a quantitative process to overweight securities that demonstrate recent price momentum. The fifth ETF focuses on small-cap and mid-cap companies outside the United States.

The *International Focus* strategy participates in the long-term growth of the global equity markets. It can be used as a complement to domestic portfolio strategies to enhance the diversification of a portfolio's risk market exposure. Since the systematic adjustments that maintain the strategy's factor tilts occur within each ETF, rather than at the portfolio level, the strategy may be relatively tax efficient.

Tactical Global Strategies

The *Tactical Global Growth* and *Tactical Global Income* strategies participate in the long-term growth of the global equity markets. A discipline of systematically tilting the sector weightings toward relative strength incorporates a momentum effect into both portfolios. These strategies can serve as a core position for investors seeking global diversification within the equity portion of their portfolio.

Both strategies spread investments among 10 broad sectors of the global asset markets using exchange traded funds (ETFs) for each market sector. We believe the global diversification inherent in these strategies may be helpful over the next several years because international equity markets might offer higher potential returns than the domestic stock market from today's starting point. Broadly speaking, the international equity markets trade at a lower price-to-earnings multiple, and a higher dividend yield relative to domestic market benchmarks.

Fixed Income

Our Fixed Income strategies are customized according to three broad priorities – Liquidity, Income or Aggregate. A Liquidity portfolio invests exclusively in high credit quality securities and short-term maturities to ensure stability of principal and ready access to capital. An Income portfolio extends further out on the yield curve and includes a broader range of credit quality to generate a higher level of income. The Aggregate approach incorporates elements of both designs for a "core" exposure to the fixed income asset class.

Our fixed income portfolios are currently structured to withstand a possible increase in short-term interest rates associated with a gradual monetary tightening process from the Fed. It seems reasonable to expect some upward pressure on interest rates as the Fed tightens policy, however, we don't expect a substantial increase from here because rates already moved a lot in the second half of last year, and interest rates throughout much of Europe and Asia remain well below domestic levels.

By structuring our bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the overall sensitivity to rising interest rates should be moderate unless rates rise much further and faster than we currently expect. Even then, a laddered bond portfolio provides opportunities to take advantage of higher rates by shifting near-term maturities further out on the yield curve.

We continue to emphasize "defined maturity" ETFs in our fixed income model portfolios. These funds include all of the features of a traditional fixed income ETF with one important difference: a specific maturity date. These funds are populated with bonds that all mature in the same calendar year. At the end of that year, the ETF terminates, and the fund's net assets are distributed to shareholders as cash, similar to what happens when an individual bond matures.

Most alternative fixed income strategies look relatively expensive to us, but we see potential opportunities in floating-rate bank loans, along with variable rate and trust preferred securities. In all cases we will not reach for yield unless the merits of the underlying strategy prove worthwhile relative to the risk.

July 5, 2017

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The **S&P 500 Index** is a stock market index based on the market capitalizations of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.
The **MSCI World Index** is a stock market index of 1,650 global stocks, and is used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI.
The **Morningstar® Dividend Yield Focus Index** is designed to track high-yielding, qualified dividend paying, U.S.-based securities screened for companies with superior quality and financial health. The Index represents the top 75 high yielding stocks that meet the screening requirements.
The **Bloomberg Barclays Intermediate Government/Credit Bond Index** seeks to track the investment results of U.S. dollar-denominated government, government-related and investment-grade U.S. corporate bonds with remaining maturities between one and ten years.
The **Bloomberg Barclays Aggregate Bond Index** is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States.

Estimated portfolio yield represents the 12-month run-rate of interest and/or dividend payments in a strategy divided by the market value of the securities and cash reserves invested in the strategy. Estimated interest/dividend payments and market values are calculated by a portfolio accounting system from *Orion* using a single client portfolio that Capital Advisors believes to be representative of clients' portfolios invested in the same strategy. The actual portfolio yield for any single client portfolio may be lower or higher than the yield quoted. The underlying holdings of any presented portfolio are not federally or FDIC-insured and are not deposits or obligations of, or guaranteed by, any financial institution.

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The information provided is supplemental to a fully compliant presentation. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested.

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