A TALE OF TWO MARKETS

Half-Time 2017
Herbert Financial Group
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**Risk Considerations:** The economic forecasts set forth in this presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful. Stock investing involves risk including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.
“Bond prices reflect an economic slowdown; stock prices reflect economic growth. This is not to suggest that a major correction is looming. It is meant to highlight that too few investors seem focused on the multimarket narrative of falling bond yields and rising stock prices.

Which market is right?”
-- Barron’s, June 10, 2017
TODAY’S AGENDA

WHERE WE’VE BEEN
WHERE WE ARE
WHERE WE MAY BE GOING
WHERE WE’VE BEEN REVIEWING THE DATA

RUN FOR YOUR LIVES!!

He means, "running is good for you"
“...Data compiled within specific countries suggest that economic optimism may not have much to do with the economy at all. The Pew report finds that respondents whose preferred political party is in power tend to be more optimistic. For example, Venezuela’s GDP is expected to plummet by 7.4% in 2017; food shortages there are so severe that three-quarters of Venezuelans have lost weight involuntarily in the past year. Nonetheless, 49% of left-leaning Venezuelans – who tend to support Nicolás Maduro, the country’s president – think the economy is performing well, compared with just 11% of conservatives.”

-- The Economist, June 6, 2017
“Democrats anticipate an imminent recession, and Republicans anticipate a new era of robust economic growth...self-identified Independents, who hold more rational expectations...represent a larger share of the population (41%) than either Democrats (32%) or Republicans (27%).”

-- Richard Curtin, Director, Surveys of Consumers, University of Michigan, April 7, 2017

Source: University of Michigan Consumer Surveys
THE U.S. ECONOMY HAS BEEN GROWING SLOWLY

GROSS DOMESTIC PRODUCT (GDP) GROWTH

“The pedestrian first-quarter growth pace is, however, not a true picture of the economy's health. The labor market is near full employment and consumer confidence is near multi-year highs, suggesting that the mostly weather-induced sharp slowdown in consumer spending is probably temporary.”

-- CNBC, April 28, 2017
WHERE WE’VE BEEN

THE U.S. ECONOMY HAS BEEN GROWING SLOWLY
UNEMPLOYMENT, INFLATION, AND CONSUMER SENTIMENT

Source: Trading Economics and University of Michigan Consumer Surveys
“On one hand, intuitively, I am inclined to believe in the logic of the Phillips curve: A tight labor market should lead to competition for workers, which should lead to higher wages. Eventually, firms will have to pass some of those costs on to their customers, which should lead to higher inflation. That makes intuitive sense. That’s the faith part.

On the other hand, unfortunately, the data aren’t supporting this story, with the FOMC coming up short on its inflation target for many years in a row, and now with core inflation actually falling even as the labor market is tightening. If we base our outlook for inflation on these actual data, we shouldn’t have raised rates this week. Instead, we should have waited to see if the recent drop in inflation is transitory to ensure that we are fulfilling our inflation mandate.”

-- Neel Kashkari, President Minneapolis Federal Reserve
WHERE WE’VE BEEN

GLOBAL STOCK MARKETS
Year-to-date performance global stock markets as of June 30, 2017

Source: Financial Times
CORPORATE PROFITS HAVE IMPROVED IN THE UNITED STATES

As earnings season comes to an end, S&P 500, Nasdaq and Dow companies in aggregate have produced between 14% and 18% in year-over-year earnings per share growth for the first quarter of 2017. That’s the highest earnings growth since 2011.

Source: FactSet.com, Hedgeye
“Betting markets reckon that Mr. Trump’s chances of passing a corporate-tax cut bill this year fell from 56% to 42% by May 10th. Although stock markets remain at an all-time high, other indicators more sensitive to Mr. Trump’s promises have started to reverse course…Data from Goldman Sachs, a bank, show that when Mr. Trump was first elected, the stocks of certain companies did especially well: those paying high tax rates and those working in the construction and engineering industries outperformed the overall market index. But as the president’s chances of pushing through his policies have waned, so too have these firms’ fortunes in the market.”

-- *The Economist, June 15, 2017*
WHERE WE’VE BEEN

STILL WAITING FOR THE UPSWING IN BOND YIELDS

[Graph 1: 10-Year Treasury Constant Maturity Rate]

[Graph 2: Fed Dismissed]
“In large part, falling bond yields reflect a growing conviction that short-term interest rates are unlikely to rise quickly or soon. Central banks are fearful of cutting short the synchronized global economic upswing and, with inflation quiescent, see no real need to take the risk. They are buying lots of assets: the ECB and Bank of Japan are acquiring more; the Fed is still reinvesting. In short, little is afoot to upset the bull-market mood…”

-- The Economist, June 1, 2017
“Soft data in 2017 have so far told a much more positive story of economic growth than hard data. One reason analysts identify as a possible cause for the divergence between survey and hard economic data is consumer and business optimism after the election of Donald Trump that is not yet reflected in the hard data.”

-- Federal Reserve Blog, April 27, 2017
“In other words, investors are managing to be simultaneously bullish and skittish. By a large majority, fund managers expect global growth and corporate profits to be strong over the next 12 months; but they also know such expectations are already fully reflected in share prices. All will be well provided there are no shocks. But history suggests shocks have a nasty habit of occurring.”

-- The Economist, May 6, 2017

Source: Hedgeye
FINANCIAL MARKET PERFORMANCE

DEVELOPED COUNTRIES’ STOCK MARKETS ARE UP
(As of June 30, 2017)

- U.S. stocks (Standard & Poor’s 500 Index)
- International stocks (Dow Jones Global ex-U.S.)
- Emerging markets (MSCI Emerging Markets Index)
- Gold (per ounce)
- Commodities (Bloomberg Commodity Index)
- REITs (DJ Equity All REIT Total Return Index)

Source: Yahoo! Finance, Barron’s, DJIndexes.com, Google Finance, London Bullion Market Association
"After years of underperformance versus developed markets, emerging market equities and debt in 2017 are repeating their strong 2016 performance. The last several months have included a reversal of the sharp, brief “Trump tantrum” of losses and outflows following the U.S. election, and a wider recognition that emerging markets may have turned a corner.” - Goldman Sachs, May 2017

Sources: MSCI, Fidelity, Goldman Sachs
IN THE UNITED STATES, MARKET VALUATIONS ARE HIGH

“The conventional threats to the equity market are twofold: a sharp rise in interest rates, which would hit indebted individuals and companies; or a decline into recession, which would dent profits. Neither looks imminent at the moment, which helps explain why Wall Street keeps hitting record highs.”

-- The Economist, May 6, 2017

This doesn't mean all of the companies in the S&P 500 Index are pricey. Specific companies may offer attractive valuations.

Source: FactSet
“[The U.S. stock market] hasn’t been this overvalued except for a couple of times in history – around 1929, around 2000…If you go back to 1998, you’ll find the CAPE ratio was about the same as now and it kept going up for two more years. It got up to something like 45 in the year 2000. We could go back up there.”

-- Professor Robert Shiller, CNBC, April 2017

Sources: Multpl.com
INFORMATION TECHNOLOGY HAS OUTPERFORMED
“Over 100 years, then, over 50 years and over 20 years, history suggests that a value strategy works. Over the last 10 years, however, there has unarguably been a better game in town and its name is quality growth. So does that mean – dread words – this time it’s different? Here on The Value Perspective, we do not believe so because we do not believe humans beings have stopped being human.”

-- Schroder’s Global, July 2016
INVESTORS ARE CALM. ARE THEY TOO CALM?

WHERE WE ARE

THE VIX INDEX HAS CLOSED BELOW 10 | 16 TIMES SINCE 1993

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Source: CBOE.com
NO SHORTAGE OF GEOPOLITICAL SHOCKS
LOW VOLATILITY COULD BE A GOOD SIGN, OVER THE SHORT TERM
(BUT THERE’S NOT MUCH DATA)

| Performance of MSCI World Index after extreme lows in volatility expectations |
|------------------|--------|--------|--------|
| | 1 Mo. | 3 Mos. | 10 Mos. |
| U.S. VIX <10 |      |       |        |
| Average (4 events since 2006) | 1.7%  | 2.0%  | 7.5%  |

Source: Charles Schwab
WHERE WE MAY BE HEADED
INTO THE FUTURE
WHERE WE MAY BE HEADED

INTO THE LATER STAGES OF A BUSINESS CYCLE

Business cycle framework

Source: Fidelity
CONTINUED GLOBAL ECONOMIC GROWTH

WHERE WE MAY BE HEADED

A. Global growth

A. Regional growth (weighted average)

A. GDP growth

Sources: Bloomberg, World Bank
Estimated earnings growth of the S&P 500 Index (as of June 9, 2017)

Source: FactSet.com
“Our global team of investment strategists warn that investor expectations have run ahead of market fundamentals in the global equity markets. They maintain a call for caution as inflated expectations for global growth and U.S. fiscal policy drive markets higher, despite looming global economic headwinds.

In the medium-term, they are not bearish…”

-- *Russell Investment Outlook Q2 2017*
“Goldilocks appears to have arrived – low interest rates, improving earnings, a strong labor market, calm inflation, and still-accommodative monetary policy…But, as always, there are clouds on the horizon and pullbacks are possible at any time so it's important for investors to remain vigilant in keeping a diversified portfolio with appropriate risk exposure. In keeping with the Goldilocks theme, we’ll point out three potential pitfalls, or bears, worth watching:

- An economic slowdown,
- A domestic political implosion, or
- A geopolitical blowup.

None appear to be imminent, but either of the latter two could appear suddenly.”

-- Schwab Market Perspective, June 9, 2017
A SUBSTANTIAL DECLINE

“From the standpoint of downside risk over the completion of the current cycle, merely touching historically run-of-the-mill valuations in the next few years would presently require a decline in the S&P 500 on the order of 57-62%....Suffice it to say that a 50-60% loss in the S&P 500 over the completion of the current market cycle would not be a “worst case” scenario, but instead a run-of-the-mill outcome.”

-- Dr. John P. Hussman, Chairman, Hussman Strategic Advisors, June 2017
A 20-YEAR LIMPING REGRESSION

“... if you are expecting a quick or explosive market decline in the S&P 500 that will return us to pre-1997 ratios (perhaps because that is the kind of thing that happened in the past), then you should at least be prepared to be frustrated for some considerable further time: until you can feel the process of the real interest rate structure moving back up toward its old level. All in all, from the many possibilities, I prefer my suggestion...of a 20-year limping regression that takes us two-thirds of the way back to the good old days pre-1997. What I fear is that if I am wrong, it is less likely to be because regression is more dramatic as some die-hard value managers believe (and I would dearly, dearly love to see!) than it is to be even slower.”

-- Jeremy Grantham, Co-Founder of GMO
WHERE WE MAY BE HEADED

WE’LL BE WATCHING POLITICAL AND ECONOMIC EVENTS
WHERE WE MAY BE HEADED

WE’LL BE WATCHING CONSUMER SENTIMENT

Source: University of Michigan Consumer Sentiment Survey
“Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

-- Sir John Templeton

Source: American Association of Individual Investors
“While I don’t believe QE succeeded in spurring stronger economic growth, it probably did succeed in depressing long-term interest rates and an aggressive path of reverse QE, particularly when accompanied by steady increases in the federal funds rate and less easy central banks overseas will very likely push long-term interest rates higher over the next few years. While still low inflation should limit the back-up in yields, it will likely feel a little worse than “paint drying” for investors heavily allocated to the long end of the Treasury market.”

-- David Kelly, Chief Global Strategist, J.P. Morgan Funds, cited by Barron’s, June 19, 2017
WHERE WE MAY BE HEADED

Time For Change

WHAT’S NEW FOR YOU?
HALF-TIME 2017

THANK YOU FOR YOUR CONTINUED SUPPORT!
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Important Information:
- The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.
- The Dow Jones Equity All REIT Total Return Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust industry.
- The Standard & Poor’s 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
- The Cyclically Adjusted Price-to-Earnings (CAPE) ratio is a valuation measure usually applied to the U.S. S&P 500 equity market and is defined as price divided by the average of 10 years of earnings (moving average) adjusted for inflation.
- The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) shows the market’s expectation of 30-day volatility and is constructed using the implied volatilities of a wide range of S&P 500 Index options.
- The MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 Developed Markets (DM) countries.
- The Bloomberg Commodity Index is a broadly diversified commodity price index distribution by Bloomberg Indexes, rebalanced annually, and is calculated on an excess return basis and reflects commodity futures price movements.
- The Nikkei 225 Index is a price-weighted index comprised of Japan’s top 225 blue-chip companies traded on the Tokyo Stock Exchange. It is equivalent to the Dow Jones Industrial Average Index in the United States.
- STOXX Europe 600 is a series of market indexes that are representative of the European and global markets. These indexes cover a wide range of market segments including the broad market, blue chips, individual sectors, and global indexes.
- The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. This index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arms-length transactions. This index is named for its creators, Karl Case and Robert Shiller.
- The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
- The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, targeted towards goods and services consumed by individuals. CPI is released monthly by the Bureau of Economic Analysis (BEA).
- Quantitative Easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. QE increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.
- The Price-to-Earning (P/E) ratio is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means investors are paying more for each unit of net income, thus, the stock is more expensive compared to one with a lower P/E ratio.
- International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings.