Investment Insights: May Review

June 14, 2017

Asset Allocation & Market Strategy
(Theresa) May Gray and June Gloom

Both stock and bond markets pushed stubbornly higher in May even as adverse political news in the U.S. and the U.K. dominated headlines. Global stock markets climbed ever-higher during the month, gaining 2.28 percent according to the MSCI ACWI Index, as economic data reinforced optimism and investors saw a dip in the market as a buying opportunity. Turmoil hit markets in the middle of the month as political events roiled the Trump administration. The ongoing probe into the Trump team’s ties with Russian officials during the election and onwards have been widely publicized alongside the testimony of James Comey, ex-head of the FBI, and sitting U.S. Attorney General, Jeff Sessions. Investors may have seen this as a threat to the Trump rally and the president’s pro-growth agenda as global stocks tumbled almost 1.50 percent before recovering in the latter part of May.

Global bonds seemed to take notice of the geopolitical volatility, performing well during the month as evidenced by the 1.28 percent gain in a global-aggregate bond index maintained by Bloomberg. Comparable gains were made in U.S. bond markets as the mid-month stock slide pushed money toward safe-haven assets. On the monetary policy side, the Federal Reserve has continued to mull over the idea of unraveling the ballooned balance sheet. Fed officials are very likely to raise rates during their June meeting this week, implied probabilities aggregated by Bloomberg show a 93.5 percent chance of a hike. Within other government sectors, a plan was recently released by the U.S. Treasury Department which proposed changes to current regulations and legislation in an effort to reduce restrictions on banks. These changes could have wide-reaching implications for financial institutions, investors, as well as for consumers. In addition to releasing the sweeping plan, the Treasury has also been keeping the federal government afloat via “extraordinary measures” accounting since hitting the debt limit in March.

U.K. Prime Minister Theresa May faced a spectacular backfire after calling for a snap election in early June. An election was not due until 2020, but May organized the surprise election in an effort to boost her party’s majority in Parliament and strengthen her hand going into Brexit negotiations. That plan failed tremendously as the Conservative party lost their majority. The divorce deal between the U.K. and the EU was already incredibly complex, but this vote may have thrown yet another wrench in the works. Based on the stances of the U.K. and EU administrations, it looks like we are headed for a hard Brexit as both sides attempt to hardball discussions. There are countless facets to Brexit, each of which is a momentous task, and finding an agreement to each one within the two-year deadline will be challenging. If no deal can be reached and without an extension of negotiations, which would require all EU member states to approve, the U.K.’s terms would default to the harshest outcome. President of the European Council Donald Tusk had a concise response to the U.K. stating they were used to having their cake and eating it too, “There will be no cakes on the table, for anyone. There will be only salt and vinegar.”

Equities
International Stocks Take the Reins

U.S. stocks trailed international markets as the U.S. administration came under fire and investors began to question if Trump would be able to follow through with his proposals. The S&P 500 Index gained 1.41 percent for the month while international developed stocks and emerging market stocks gained 3.76 percent and 2.97 percent, respectively, according to MSCI data. Although geopolitical risk continues to rise and fall due to new developments regarding Brexit and Eurozone elections, economic data has continued to show a long-awaited improvement in Europe. According to Eurostat, the EU grew by 2.4 percent from a year ago in the first quarter, unemployment has trended steadily downward, inflation hit 2 percent in April, and the European Commission’s
Economic Sentiment indicator is at levels not seen since before the 2008 financial crisis. Even Japan, which has endured a stagnating economy for years, has seen some improvement due to ultra-accommodative policies; the MSCI Japan gained 2.14 percent compared to the MSCI Europe’s 1.65 percent in May.

Despite being behind the pack for this month and even more so for 2017, the U.S. may still have some room to run. The most recent earnings season came to an end in mid-May and the complete results are finally in – and they are strong. While sales and earnings numbers beat Wall Street consensus estimates by a fairly “typical” amount, the actual growth numbers are a welcome change. From last quarter, sales grew 7.8 percent and earnings climbed almost 15 percent. That is a whopping improvement from last quarter and the negative sales and earnings in the middle of last year. The substantial progress seems to be largely due to advances in the technology, financials, and materials sectors; however, energy was a dark horse this quarter and added a lot to the mix after stabilizing from weakening oil prices.

Markets seem to be on a fairly unstoppable charge higher despite regionally rich valuations and apparent unresolved geopolitical risks. The Global Investment Management team believes we are well positioned for the current environment and over the short term, but may make some adjustments as events unfold. We continue to review international markets as a greater opportunity than domestic markets, but political changes, specifically around infrastructure spending or tax reform, could be the tailwind needed for the U.S. to regain the lead in the global stock market race.

Fixed Income
All Up to Yellen

International bonds pushed higher as the global economy improved and domestic bonds were along for the ride. While international bonds led the charge, similar to stock markets, U.S. bonds gained 77 basis points during the month, according to the Barclays U.S. Universal Bond Index. The 10-year Treasury yield jumped to over 2.40 percent before the Trump turmoil pressured yields lower, with the benchmark rate ending the month at 2.20 percent. Lower-rated bonds, which have been a recent top performer, finally slowed their advance. High yield bonds gained 83 basis points in May, according to Bloomberg, compared to almost double that in three of the last four months prior. Corporate bonds, which are rated investment grade, gained 1.19 percent in May bringing their year-to-date gain to 3.52 percent based on similar data.

The Federal Reserve will meet this week to decide whether economic data is strong enough to warrant a second hike for this year. Markets currently expect the Fed will raise the federal funds rate another quarter point this month with a third hike likely later this year. The timing of the third move will likely be dependent upon the unraveling of part of the Fed’s $4.5 trillion balance sheet starting next year. While a rotation from monetary policy to fiscal policy was expected for the U.S., it seems we have hit a snag. Markets seem to be sobering to the fact that some, if not all, of Trump’s proposed deals may not pass as promised. Investors are still anxiously awaiting the infrastructure spending bill and tax reform that could add substantial fuel to the economy. If the administration is unable to push these measures through a Congress dominated by their own political party, it may be up to Yellen and the Federal Reserve to keep their foot on the gas.

We maintain a slight underweight to duration in our strategies, while continuing to watch for more attractive opportunities to add to high yield and international debt. We are reviewing allocations to floating rate bonds, which remain attractive in rising interest rate environments. For now, we are keeping a watchful eye on longer-term rates as investors push cash into safe-haven assets, lowering yields and pushing valuations higher.
Alternatives

Bacons Back on the Menu

As no surprise, commodities churned during the month as energy-related constituents and some soft components dragged on the overall Bloomberg Commodity Index; the gauge ended down 1.41 percent in May. Global real estate rose 1.76 percent during the month, according to the MSCI World Real Estate Index, as economic data firmed, particularly in foreign markets, and accommodative monetary policy remained in major developed countries. Hedge funds which focused on emerging markets experienced the largest gains for the period, while equity hedged and event-driven strategies followed suit. Overall, hedge funds gained just 24 basis points in May based on the HFRX Global Hedge Fund Index. The hedge fund industry continues to struggle amid investors’ distaste for high fees and diminished relative returns due in part to low volatility and increased correlations.

Commodities have been in a difficult position for the past few years. While most indices are dominated by crude oil, each commodity can have its own supply or demand oscillations, not to mention their relationship with inflation. While oil has been one of the major detriments to performance, other commodities have contributed to the over 5 percent loss just this year. This month natural gas was the worst performer, losing 8.30 percent as mild summer weather kept storage levels above a five-year average. Hog and pork markets saw a notable jump in May as pork production fell drastically during the month; lean hogs gained over 12 percent.

Our strategies remain heavily underweight to broad commodities and favor a gold-specific investment in an effort to stabilize the portfolio and capitalize on potential volatility in financial markets. Our main focus continues to be absolute return strategies that share very little correlation with overall stock and bond markets, particularly insurance-linked products and investment vehicles that employ hedge fund-type mandates such as market neutral strategies.
Alternative investments are investments that are not one of the three traditional asset types (stocks, bonds and cash).

Barclays U.S. Universal Bond Index is an unmanaged index comprising US dollar-denominated, taxable bonds that are rated investment grade or below investment grade.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Brexit is an abbreviation of “British exit”, which refers to the June 23, 2016 referendum by British voters to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.

Bureau of Labor Statistics is the arm of the U.S. Department of Labor that researches and publishes a range of data, from inflation and consumer spending to employment, productivity and wages, as well as other economic measures.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Sometimes referred to as “headline inflation.”

Corporate bonds are debt obligations issued by corporations. An investment in corporate bonds is subject to a variety of risks including credit and default risk, market risk, event risk, call risk, interest rate risk, foreign risk, and sector risk.

Emerging Market countries have economies that are progressing towards becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU’s goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Eurostat is the agency within the European Union charged with providing statistical information for the continent, as well as to ensure that member countries are using acceptable methods to track and report statistics within their borders.

Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.

Federal Open Market Committee (FOMC) is a committee that sets interest rate and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities.

Federal Reserve (Fed) is the federal banking authority in the U.S. that performs the functions of a central bank and is used to implement the country’s monetary policy, providing a national system of reserve cash available to banks.

Frontier Markets are less advanced capital markets from the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. They are also known as “pre-emerging markets”.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period, though GDP is usually calculated on an annual basis. Real Gross Domestic Product is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices. Often referred to as “constant-price,” “inflation-corrected” GDP or “constant dollar GDP”. Real GDP can account for changes in the price level, and provide a more accurate figure.

High yield bonds are high paying bonds with a lower credit rating than investment-grade corporate bonds. Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below “BBB” from S&P, and below “Baa” from Moody’s. Bonds with ratings at or above these levels are considered investment grade. Credit ratings can be as low as “D” (currently in default), and most bonds with “C” ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Investment-grade (IG) is typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor’s ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgement of the rating agency, are projected to have relatively low default risk.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red chips and P chips. With 145 constituents, the index covers about 85% of this China equity universe.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Municipal bonds are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects. The interest income from municipal bonds is generally exempt from federal taxes and may be exempt from state and local taxes. Municipal bonds are subject to a number of risks such as interest rate risk, call risk, inflation risk, credit and default risk, and tax risks.

Price-Earnings Ratio (P/E Ratio) is a valuation ratio of a company’s current share price compared to its per-share earnings.

Russell 2500 Index features 2,500 stocks that cover the small and mid cap market capitalizations. The Russell 2500 is a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities. The index is designed to be broad and unbiased in its inclusion criteria, and is recomposed annually to account for the inevitable changes that occur as stocks rise and fall in value.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

Treasuries are debt obligations issued and backed by the full faith and credit of the U.S. government. Treasuries are subject to interest rate risk, call risk, and inflation risk. As Treasuries are backed by the full faith and credit of the federal government, they have low credit or default risk. As a result they generally offer lower yields relative to other bonds.

One cannot invest directly in an index.
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Investing involves risk, including the possible loss of principal and fluctuation in value.

Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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