Investment Manager Meetings Recap Commentary

This quarter, the Strategic Income Group Investment Committee met with the following companies: J.P. Morgan, Deutsche Asset Management, Direxion, AllianceBernstein, Oppenheimer, SC Distributors, Janus Henderson, and Royal Bank of Canada Capital Markets.

In addition to meeting with these companies, the committee reviewed research from many other companies and outputs from our technologies in order to determine the most appropriate investments and advice for our clients.

Strategic Income Group Current Views (Q1 2018)

		Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish
Capital Market Outlook				X		
		Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Equities	U.S. Large Cap			X		
	U.S. Mid Cap			X		
	U.S. Small Cap			X		
	International				X	
	Emerging Markets				→	X
Fixed Income	U.S. Government		X			
	U.S. Investment Grade Corporate			X	←	
	U.S. High Yield		X			
	International			X		
Alternatives					X	
Cash				→	X	

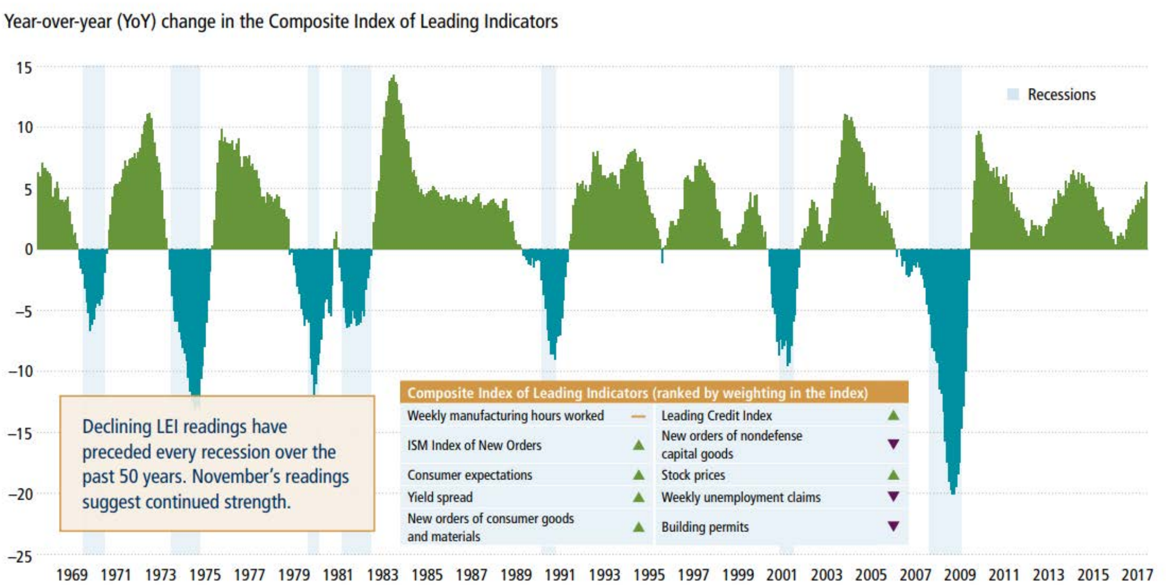
Please Note: These are 12- to 18-month views from the published date of the applicable commentary. Arrows represent movement from Q4 '17.

Capital Market Outlook

During times of volatility and market fluctuations, it is important to remind ourselves of information we should really be focusing on. As an investment committee, we have stayed true to our principles of focusing on the economic fundamentals with a 12- to 18-month time frame. By doing this, it allows us to not get caught up in the daily movements of the markets which tend to be driven much more on emotions and less on the fundamentals of the economy.

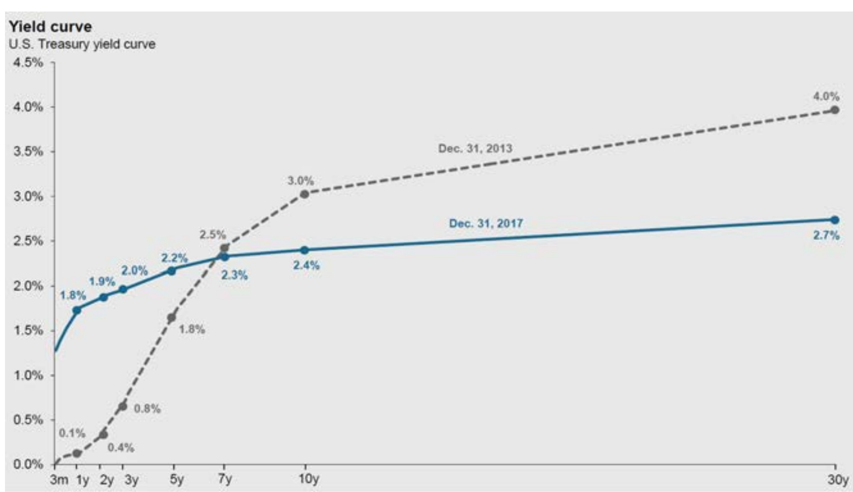
The committee did vote to make some changes from last quarter in our capital markets outlook. Based on our research, we have maintained our slight overweight to international investments. However, we increased our emerging markets weighting to overweight, reduced our U.S. investment-grade corporates to neutral from slightly overweight and increased our cash position from neutral to slightly overweight.

The good news for this quarter is that the overall fundamentals of the global economy are still strong. As we look at the leading economic indicators (see chart), we remain encouraged over our 12- to 18-month time frame.

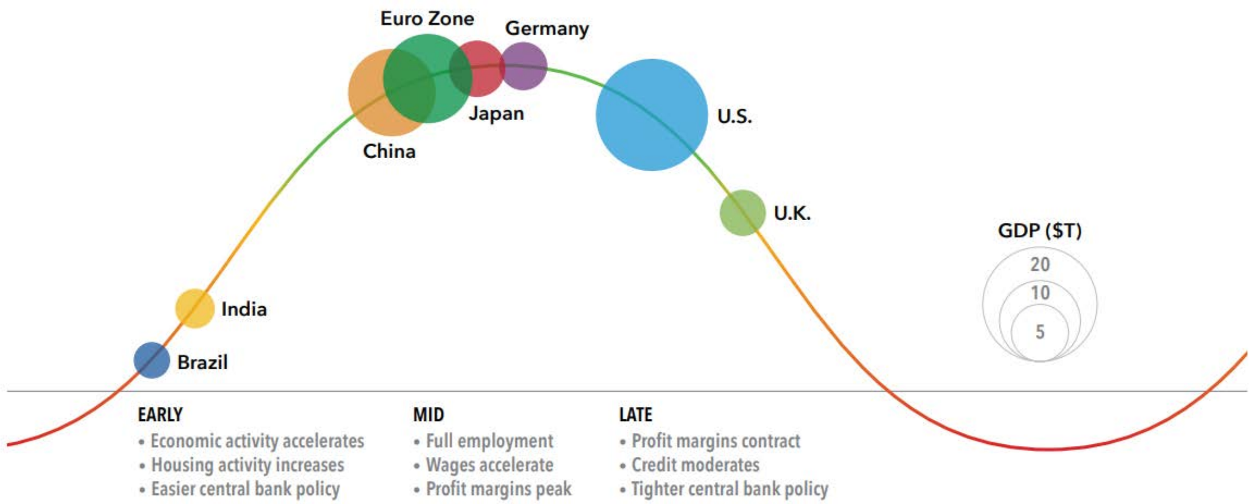


Source: The Conference Board, as of 11/30/17. The Composite Index of Leading Indicators is an index published monthly by The Conference Board, used to predict the direction of the economy's movements in the months to come. The index is made up of 10 economic components whose changes tend to precede changes in the overall economy. It is not possible to invest directly in an index. Past performance does not guarantee future results.

While most of the leading indicators in the Composite Index of Leading Indicators are still positive, there are a few items that are giving us some pause. One of those items relates to the U.S. Treasury yield curve. Currently, it is uncomfortably flat. With the Fed continuing to raise rates, it is possible that the yield curve, as measured by the two-year rate and the 10-year rate, could become inverted in the next 12 to 18 months. This is where the shorter two-year bonds are paying more than the 10-year bonds. If this happens, the chances of economic recession drastically increase over the following 18 months or in about 30 to 36 months from now (~2021).



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2017.



As mentioned in last quarter's investment commentary, the U.S. is in the later stages of the business cycle. With virtually no dark clouds on the horizons in the last few years, this has led to an increase in U.S. equity prices which have also increased in valuations. It is safe to say that the U.S. equities are overvalued by historic standards.

> *"We have an environment of synchronized global economic growth, strong corporate and consumer confidence levels, low inflation, low long-term rates and, importantly, tax reform for U.S. corporations that could raise profits and spur capital expenditures."*
>
> *— Janus Henderson*

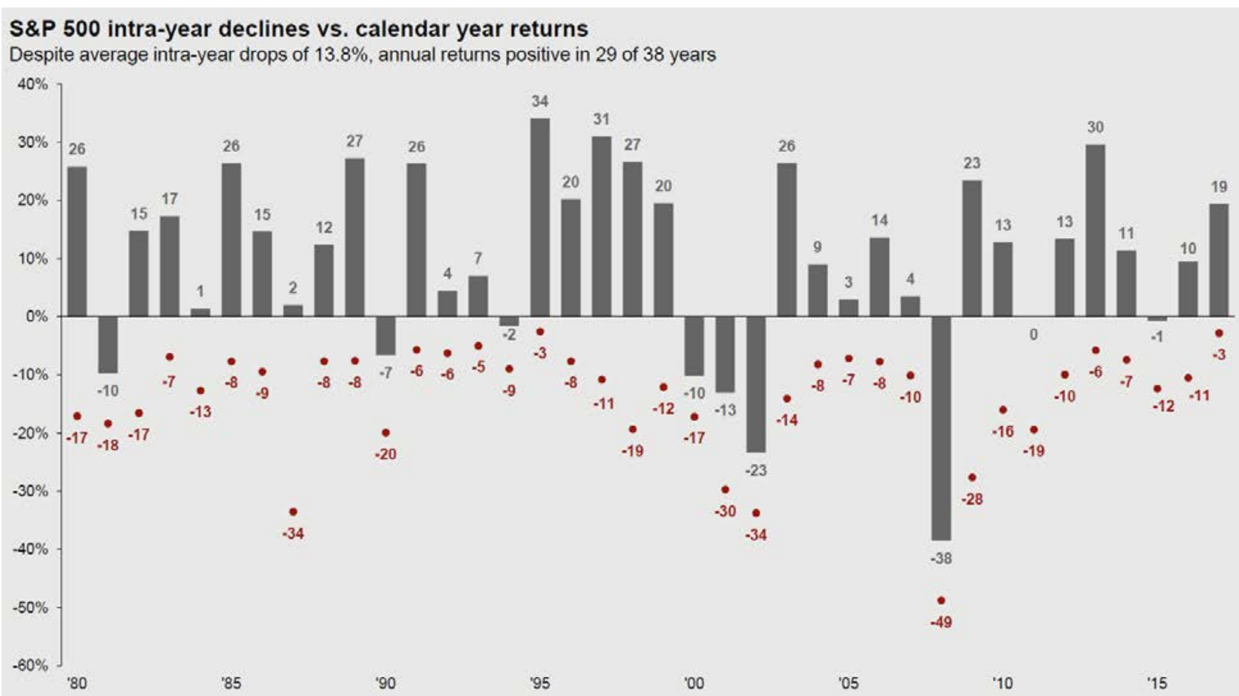
Many of the managers mentioned that the U.S. equities are justified at this above-average valuation and still consider equities on a global basis as the investment asset of choice. There is no avoiding it however: when valuations are high, volatility increases.

Using Volatility to Our Advantage

"If investors could sum up in a single word the biggest change in this year's equity market performance over last year's, it would likely be 'Volatility.' On the surface, they would be correct, since the S&P 500 has endured an average daily intra-day volatility of 1.32%, versus an average of only 0.51% during 2017. Yet as volatile as this year's action might feel, it has actually been calmer than the average of 1.43% experienced for all years since 1962. Indeed, the average thus far in 2018 ranks it only 32nd in the past 57 years, with 2008 suffering the most with an average intra-day swing of 2.8%. Not surprisingly, the remaining top 10 years also occurred during bear markets." (CFRA, Sam Stovall — Chief Investment Strategist)

Not all market corrections/sell-offs are equal. Fundamental sell-offs happen when the fundamentals in the economy are weakening which often causes a steeper and longer fundamental market sell-off. Technical sell-offs are different and quite often painful for investors. But they also tend to be short-lived and not followed by recession.

As you can see from the chart below, despite the average intra-year drop of 13.8%, the annual returns were still positive in 29 of the 38 years since 1980.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%.

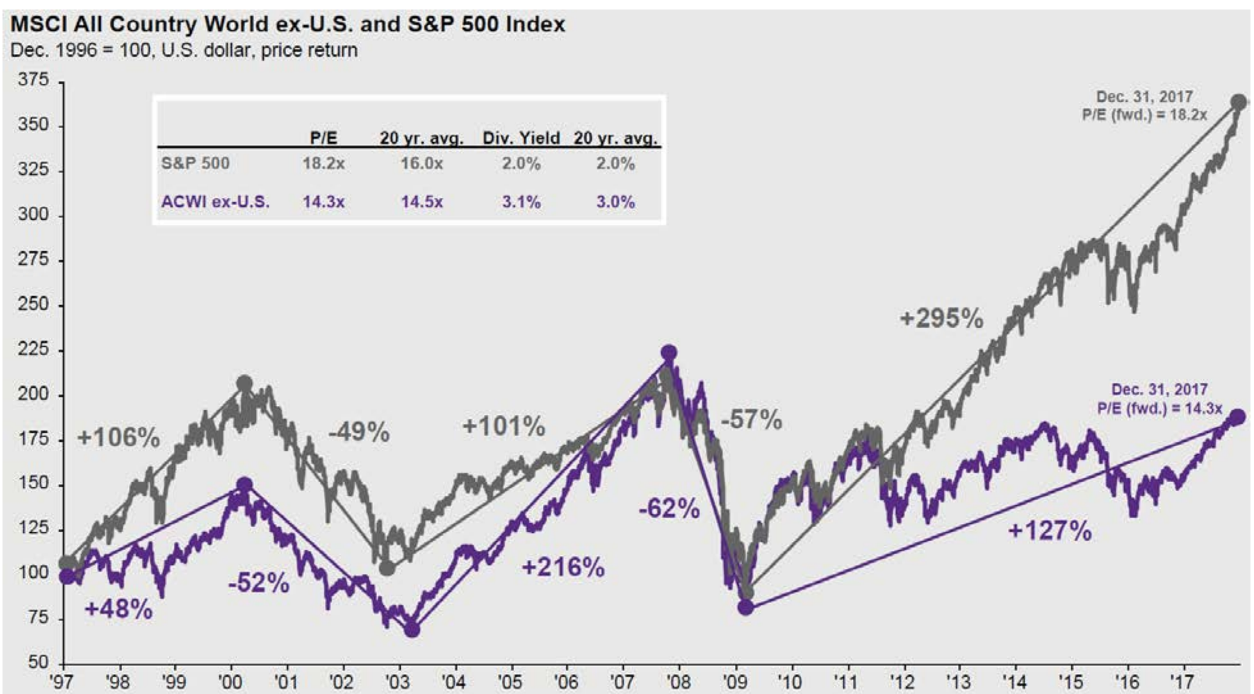
We believe that the current sell-off that we have seen in 2018 is a technical sell-off. In fact, we have used this sell-off as an opportunity to invest cash that was on the sideline. Our committee's strategy continues to be: *buy on technical/emotional weakness and fundamental strength*.

Looking at the fundamental backdrop, not much has changed in the past few weeks: economic growth remains on an improving trend, corporate earnings seem robust, and access to credit remains easy and abundant. The longer-term outlook appears favorable but we should expect near-term bouts of volatility to persist every so often.

Buy Low, Sell High — the Right Way to Find Opportunities

It is important to our investment committee to not just understand the economy, markets, and investments, but also to be able to take action on that information. In the coming months, we will be looking for opportunities to reduce our U.S. equity positions slightly in favor of international and emerging market positions.

Janus Henderson mentioned that "U.S. equities are trading 73% above 2007 highs while developed international equities are trading 14% below 2007 highs." As you can see from the chart below, the international equities have not had nearly the increase in value as U.S. equities. Furthermore, their economies are not as deep into the business cycle as the U.S.



Dr. Kelly from J.P. Morgan said recently that he's more bullish on international equity than he was on U.S. equity in 2011. With the U.S. near all-time highs and carrying higher valuations, the committee feels it is time to increase our international and emerging markets to take advantage of what could be a longer runway and additional growth potential at lower valuations.

Deutsche Asset Management stated that emerging market equity is discounted 30% to the U.S. market and discounted 20% to developed international markets. In addition, the average emerging market equity run lasts nine years. 2018 marks the second year of the current run.

In Closing

While recent volatility can be frustrating, it also allows us to take advantage of the opportunities it creates. We believe the fundamentals are still favorable for equities. Considering the health of international economies and lower valuations, we believe these factors allow us to increase our international holdings, buy in at a lower valuation (buy low), and fund those positions with some of the U.S. positions that have increased in value and in valuations (sell high).

Our investors can be categorized in three groups: (1) those who are retired and taking income from their portfolio, (2) those who are working and saving or are retired and not taking income, and (3) clients that have cash on the sideline from sale of property or inheritance, etc.

For these three groups of investors, none were negatively impacted from a financial planning perspective. For the first group, we have "reserve accounts" set up that currently carry 10 months in cash. This allowed us to use their cash reserves to make their monthly payments without having the need to sell shares in a down market. For our second group, most of these clients have monthly savings going into their retirement and investment accounts. This volatility allows them to accumulate more shares as they go down in value. And for the third group, we were able to utilize this recent sell-off and volatility to find more attractive opportunities to put that cash to work.

Thank you for your continued trust you place with Strategic Income Group. We do not take that lightly and continue to put our efforts and resources into helping you achieve your financial goals.

As always, if you do not have a meeting set up with your advisor, please contact our office at (480) 466-7070 to get something on the calendar.

Interesting Facts

- It took the Dow Jones 103 years to break 10,000. Over the past nine years, the Dow Jones has gained roughly 18,300 points.
- If we had our smartphone that we have today in the '80s the technology would cost $160MM — Janus Henderson
- What used to cost $1MM and a year to map genes, now costs $100 and can be done in a day.
- EM is 30% discounted to U.S. market and 20% discounted to developed international markets. — Deutsche
- U.S. equities are trading 73% above 2007 highs while developed international equities are trading 14% below 2007 highs. — Janus Henderson
- **Inflation:** Since rising by +6.1% in 1990, inflation (as measured by the Consumer Price Index) has averaged just +2.3% per year and has been as high as +4% in only one year (2007) over the last 27 years, i.e., 1991 to 2017. The Consumer Price Index is a measure of inflation compiled by the Bureau of Labor Statistics. (Source: DOL)
- The global economy is as healthy as it's been since 2008 — AllianceBernstein
- Europe will stop QE in the fall and will raise rates in 2019 — AllianceBernstein
- Best quote of the week: "You know what the goal of billionaire is, not to be a millionaire."

STRATEGIC TAX

Haven't done your taxes yet? Strategic Tax is here to help. Let our CPAs remove the burden of preparing your taxes. The best advantage, however, can be giving your financial planner the ability to integrate your true tax picture with your overall financial plan. Call us today for your tax planner!

(480) 466-7070

Certified Fiduciary Services

Strategic Income Group's wholly-owned subsidiary company, Certified Fiduciary Services, Inc., is here to serve you and your family.

Certified Fiduciary Services provides a variety of estate and trust administration services that complement Strategic Income Group's offerings. Clients enjoy seamless financial services with the two companies working together.

Visit CFSArizona.com to learn more today!

What Are Investment Manager Meetings?

At Strategic Income Group, we believe in reviewing detailed investment research. Every 90 days we set aside a week during which around 7 to 10 investment managers give us recommendations on our current portfolios as well as share their firms' current views on the market and economy. This recap is our commentary on the most recent meetings.

Did You Know?

Strategic Income Group has an official financial planning process called “The Three Phases of Wealth” designed to help you wherever you’re at in your financial journey.

Visit http://strategicincomegroup.com/start/ to learn and set some financial goals!

Questions?

If you have any questions whatsoever regarding our investment manager meetings or any of the notes, give us a phone call or stop by our office:

Strategic Income Group
Ph. 480-466-7070
2330 W. Ray Road, #3
Chandler, AZ 85224
StrategicIncomeGroup.com