HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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Students of stock market history know that the long-term trajectory of equities has been upward. Sometimes, however, there are valleys. At Hudson Advisors, we predict that we could be looking at some valleys – technically known as "corrections" – in the period ahead.

This viewpoint reflects the caution that we have expressed since the outset of 2017. Yes, we acknowledge that the first half of 2017 was a banner time for stocks – with some indexes hitting record high levels. But we do not see evidence to support continuation of that bull market. To the contrary, we are more likely to see a pull-back in the months ahead.

What explains our caution? The U.S. economy is in the same modest growth box of recent years. The idea of a "Trump bump" looks problematic. The impasse over health care legislation does not bode well for the initiatives on tax reform and infrastructure investment. Most important, stocks are now richly priced. Corporate earnings look positive – but not strong enough to drive stock prices higher.

In short, we forecast the markets to have some valleys before the end of the year. We expect some pause and retreat from the stellar first half of the year. We are not talking about a sustained bear market here. In fact, the market may bounce around and end close to its current position. But, to be cautious, we are moving to place client portfolios with a short investment time frame into defensive positions. We also are prepared for a test of our skills as "stock pickers" who can find selective growth opportunities.

MARKET TRENDS

The accompanying chart summarizes stock and bond market prices for the first quarter. The gains in the U.S. equity markets were influenced heavily by the broader gains in the global stock markets. Of the 30 major indexes representing the world's largest stock markets, 26 were positive in the first half of the year – the best performance since 2009. Meanwhile, U.S. Government bond prices edged slightly higher.

Volume 72 July 2107

Equity Market The Dow Jones Industrial Average increased 3.44% in the second quarter and was ahead 7.24% year-to-date. The S&P 500 index gained 2.57% for the quarter and was up 8.24% year-to-date. The Russell 2000 index of small cap equities was less impressive at 2.12% for the quarter and 4.29% for the year. The most impressive was technology with the Nasdaq Composite up 3.87% for the quarter and 14.07% for the year. Much of the growth was concentrated in the so-called FAANG stocks: Facebook, Apple, Netflix, and Google.

Fixed Income Market: The yield on the 10-year Treasury of 2.29% at the end of June was down from 2.39% at the end of March. (Yields move inversely to prices.) Despite this slight increase in prices, bonds showed no signs of recovering from the rout experienced in the last half of 2016. The certainty of measured interest rate increases from the Federal Reserve should act to keep bond prices subdued with greater prospect in the future for decline than for increase.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Industrials Composite PR	7.24
S&P 500 Index PR	8.24
Russell 2000 Index PR	4.29
NASDAQ Composite PR	14.07
EAFE Index NR	13.81
Barclays Aggregate Bond Index TR	1.87

source: Morningstar®

THE OUTLOOK

The Economy: The performance of the U.S. economy is solid but certainly not stellar. The current economic expansion is now entering its ninth year. But that expansion has been marked by annual GDP increases of 2%. While there is no recession in sight, faster growth seems elusive.

- **Growth Rate**: Many economists had forecast that 2017 would be the year when GDP hit 3%. Those hopes are now dashed. Growth in the first quarter was only 1.5%. The second quarter numbers should look better. But the full-year outlook is for the same 2% rate of recent years.
- **Labor Market:** The economy added 180,000 jobs a month on average in the first half of the year. The unemployment rate in June was 4.4% but wage growth remains surprisingly weak. Average hourly compensation rose only 2.25% in the 12 months

ending in March. Another concern is that only 62.8% of adults are working or looking for work – down from 66% a year ago. These last two factors have modified consumer confidence.

- **The Washington Outlook:** Many experts say that better economic growth requires meaningful change in government policies: greater infrastructure investment, an overhaul of the corporate tax code, a new commitment to improve the skills of American workers. Given the impasse over health care, the hope for meaningful reforms from the White House and Congress are dimming.
- **Federal Reserve Policy:** The Federal Reserve has tied further increases in interest rates to what happens with inflation. However, inflation is subdued, and thus the Fed is likely to raise rates only one more time this year. Again, it is a sign of the restrained economic growth.

The Market: In recent quarters we have expressed our caution about high stock valuations. Shares of companies in the S&P 500 are now trading at an average of 18 times projected earnings over the next 12 months. That level is the highest in 13 years. (It does still seem modest compared to the forward multiple of 26 times during the dot-come bubble of 2000.)

We are pleased that corporate earnings look healthy. The earnings recession of prior years has ended. The average earnings growth for S&P 500 companies in the first quarter was 15.5%. It looked especially good because earnings in the first quarter of 2016 were a negative 6.7%. The forecast for the second quarter is 6.2%.

But are these earnings strong enough to support current stock prices? Or to drive them even higher? We are skeptical. We think the market will pause and correct downward in the months ahead. It may then recover – but not beyond its current levels. We anticipate the year-to-date performances of the major indexes on December 31 to look similar to how they look at present.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities, 15% to cash, 15% to fixed income with maturities under two years, and 15% to alternative investments. We stagger the time period in which we reach that 55% level. For fully invested clients, we recommend to trim equities to 55% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. We are challenged to be good stock pickers in the current environment.

Some of the sectors we are like include:

- TECHNOLOGY: This sector presents some interesting opportunities in innovative semi-conductors and entertainment software.
- FINANCIALS: This sector should be assisted by the increase in interest rates which improves the profitability of many product lines. We like diversified banks.
- HEALTH CARE: The macro picture in this sector is obviously uncertain. However, within the sector, we like companies that are developing the whole range of medical devices for the aging baby boomer population.

Fixed Income: Nothing changes our aversion to bonds with long maturities. The pending increase in interest rates creates the risk of a sharp decline in bond prices. For the non-equity portion of client portfolios, we prefer to find vehicles such as municipal tax liens and other alternative investments.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending June 30, 2017)
Source: Morningstar®

Oil & Gas	-13.44	Consumer Services	9.45
Basic Materials	8.57	Telecommunications	-10.03
Industrials	10.19	Utilities	8.61
Consumer Goods	11.20	Financials	7.03
Health Care	16.32	Technology	17.09

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Top 25 Performing Stocks through YTD 6/30/17 - US Listed companies with a market cap above $5 Billion Source: Telemet ®				
Issue	**Name**	**Last**	**Mkt Cap**	**Net Pct Q**
OMNT	Ominto, Inc.	13.18	5,023	266.11
KITE	Kite Pharma, Inc.	105.63	5,973	135.57
ALNY	Alnylam Pharmaceuticals	84.08	7,247	124.57
MOMO	Momo Inc. ADS	39.27	7,742	113.66
W	Wayfair Inc Class A	74.06	6,416	111.3
SHOP	Shopify Inc.	88.99	8,031	107.58
OLED	Universal Display Corp	111.15	5,227	97.42
GOL	Gol Linhas Aereas Intelgentes	13.16	9,138	93.25
ATHM	Autohome Inc.	45.97	5,313	81.84
CC	Chemours Company	40.09	7,583	81.48
DLAKY	Deutsche Lufthansa	23.38	10,861	81.28
VRTX	Vertex Pharmaceuticals	130.35	32,466	76.94
TAL	TAL Education Group ADS	123.7	10,030	76.34
COHR	Coherent Inc.	236.11	5,814	71.86
EDU	New Oriental Education & Techn	72.12	11,367	71.31
WB	Weibo Corporation ADS	69.42	15,594	70.99
EXEL	Exelixis Inc.	25.21	7,374	69.08
CRZBY	Commerzbank AG	12.75	8,376	66.67
MBLY	Mobileye N.V.	63	13,981	65.27
MELI	MercadoLibre, Inc.	255.6	11,287	63.7
RWEOY	Rwe Ag	20.1	11,224	62.57
BABA	Alibaba Group Holding	142.43	353,939	62.2
ATVI	Activision Blizzard, Inc.	58.09	43,780	60.87
WUBA	58.com Inc.	45	6,525	60.71
IAC	IAC/InterActiveCorp	102.54	8,068	58.27

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Issue	**Name**	**Last**	**Mkt Cap**	**Net Pct Q**
SVCBY	Svenska Cellulosa Aktie	7.62	5,354	-72.92
CVE	Cenovus Energy Inc.	7	5,309	-53.73
FNMA	Fannie Mae	2.26	12,950	-42.05
CLR	Continental Resources, Inc.	30.03	11,267	-41.73
BHGE	Baker Hughes, a GE Co. Cl A	37.91	16,129	-41.65
AAP	Advance Auto Parts Inc	101.93	7,527	-39.73
ORLY	O'Reilly Automotive, Inc.	172.85	15,730	-37.92
RRC	Range Resources Corp	21.33	5,281	-37.92
APC	Anadarko Petroleum Corp	43.36	24,296	-37.82
M	Macy's Inc.	22.68	6,906	-36.67
AZO	AutoZone Inc.	501.39	14,054	-36.52
NFX	Newfield Exploration Co.	26.09	5,197	-35.58
DVN	Devon Energy Corp	29.54	15,529	-35.32
MRO	Marathon Oil Corp	11.47	9,749	-33.74
HES	Hess Corporation	41.79	13,286	-32.91
KR	Kroger Company	23.16	20,783	-32.89
TSCO	Tractor Supply Co.	51.06	6,564	-32.65
XEC	Cimarex Energy Co	91.6	8,712	-32.6
HP	Helmerich & Payne Inc	52.88	5,741	-31.68
LB	L Brands, Inc.	45.11	12,939	-31.49
EBR	Centrais Electricas Braz Eltbr	4.78	6,466	-30.32
FL	Foot Locker Inc	49.98	6,563	-29.5
TGT	Target Corporation	51.07	28,176	-29.3
NBL	Noble Energy Inc.	27	11,648	-29.06
UAA	Under Armour, Inc. Cl A	20.64	9,088	-28.95