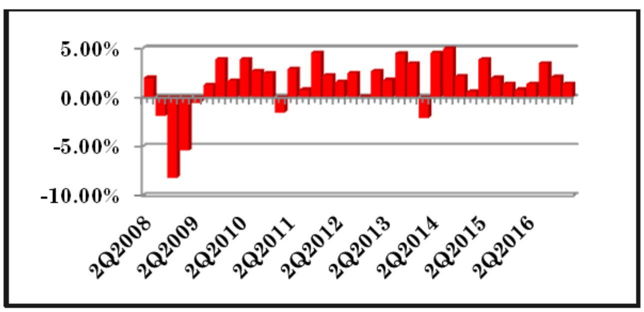
# Quarterly Commentary

CHESAPEAKE WEALTH MANAGEMENT

## U.S. Economy

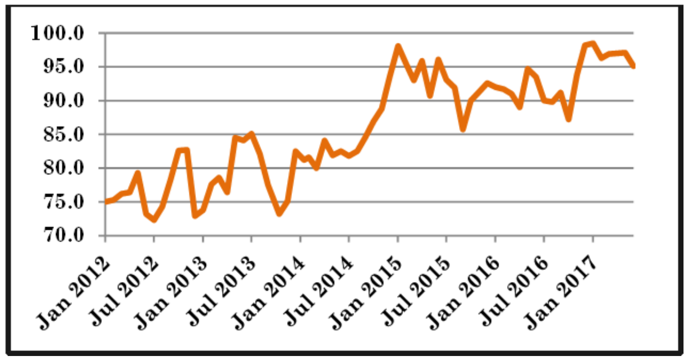
The U.S. economy continued its plodding pace in the second quarter of 2017. Job creation was healthy and there were even some hints of wage growth. While these and many other indicators spurred optimism, the all important GDP growth figure still came in at a lackluster 1.4% for the first quarter (results are lagged by a quarter).

**U.S. GDP Growth Rate**




The Fed, businesses and consumers all had increasing confidence in the economy. The one-quarter-point rate hike on June 14 was the second this year and the fourth since the end of quantitative easing. In its official statement, the FOMC reiterated its desire for 2% inflation and maximum employment, and felt this increase would not endanger those goals. Businesses showed their comfort with economic conditions by increasing their spending on plant property and equipment, although much of that increase was centered on oil and gas drilling. Consumers increased their spending slightly, but seemed to have lost some of their post-election elation as the promised stimulus initiatives have become stalled.

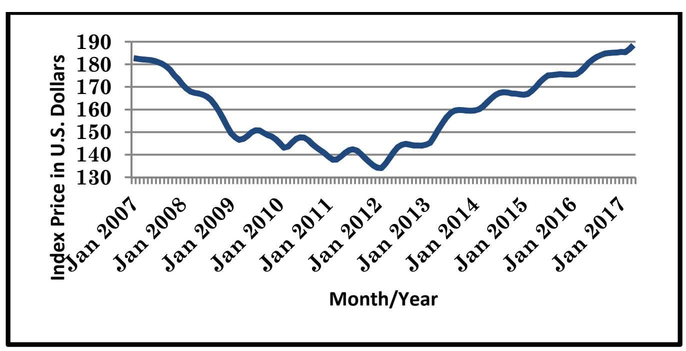
**Consumer Sentiment**




Not surprisingly, an increasing portion of consumers' spending was online, causing many traditional "bricks and mortar" retailers to miss their revenue targets.

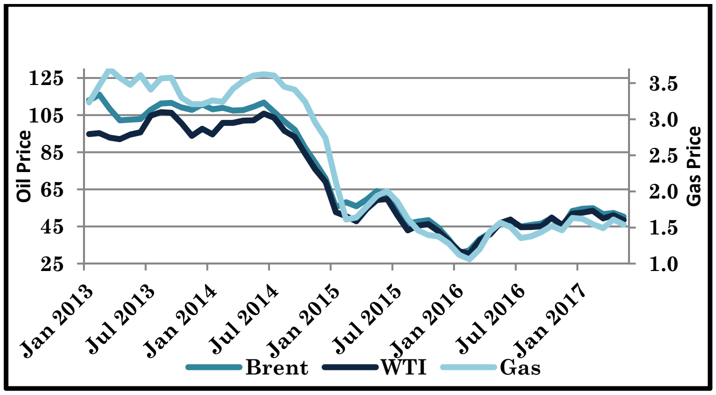
Housing prices improved enough to bring home equity figures to pre-crisis levels.

**S&P/Case Shiller U.S. National Home Price Level Index**



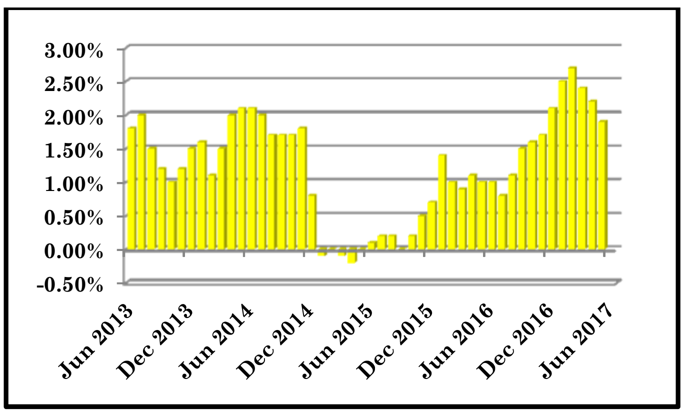

Oil and gas prices fell during the quarter as the Saudi lead OPEC production curtailment failed to reduce global stockpiles.

**Oil & Gas Spot Prices**




This cheaper energy was the greatest influence on the CPI slipping to 1.9% and ending an eight-month string of increases.

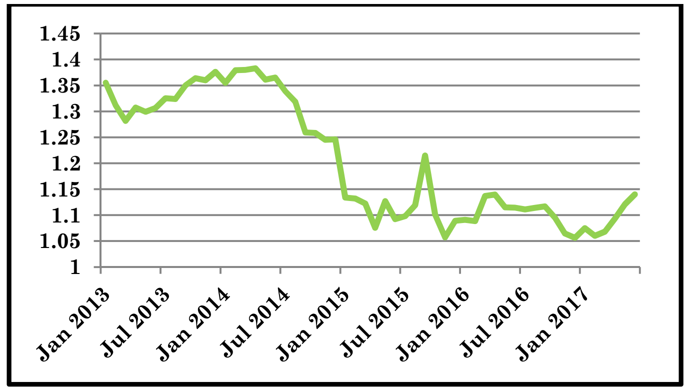
**12 Month Change in CPI**




## Global Economy

The global economy breathed a sigh of relief in the second quarter. The French election produced a "unity" winner and Angela Merkel seems poised to win again in Germany this September. China's economy is getting back on track and none of the other major economies are teetering on recession. Central banks remained accomodative and were clearly more concerned with job creation than inflation prevention. The Euro strengthened significantly as did European equity markets.

**Euro vs U.S. Dollar**

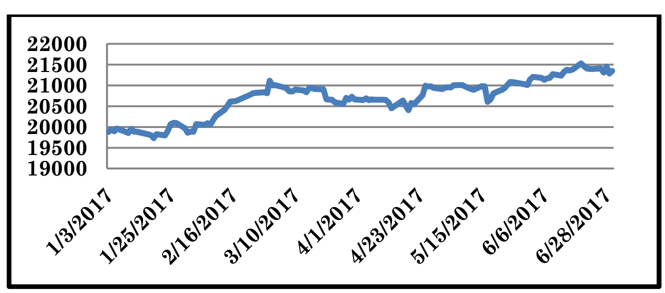



The UK stands out as the greatest unknown with Brexit progressing and Theresa May suffering a Parlimentary setback.

## Equity Markets

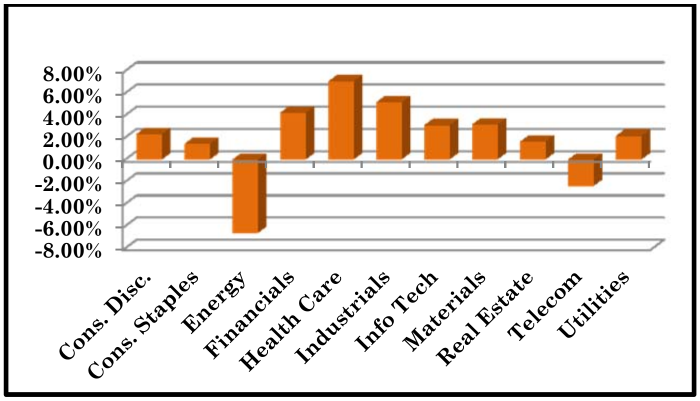
Even though the Republican growth initiatives (ACA repeal, tax reform, deregulation and infrastructure spending) seem stalled until 2018, the U.S. stock market finished the quarter near record highs. Ironically, the early winners in the Trump rally have reversed course during his term and a new set of market leaders has emerged. Highly taxed companies, highly regulated industries and contractors were thought to be the early beneficiaries of the new policies. As the proposed stimulus measures encountered bureaucratic resistance, those companies' fortunes waned. Conversely, some of the early losers, such as bio-tech, attracted bargain hunters and rallied.

**DJIA 2017**



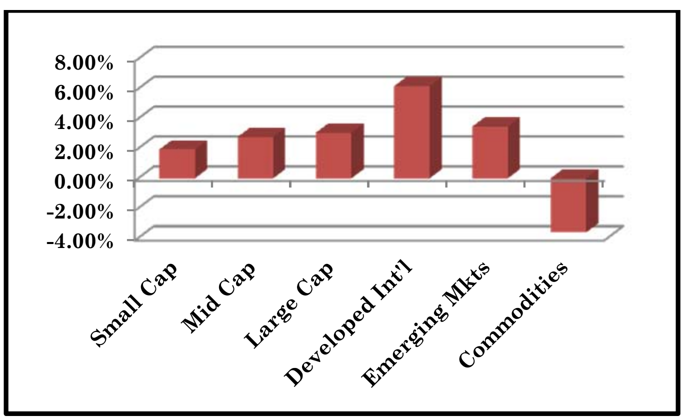
Corporate profits finally started to improve for the right reasons. Instead of using share buy-backs to increase EPS, companies actually invested in their businesses and grew revenues. This has helped investors feel good about paying up for stocks and held P/Es at lofty levels. It has also caused a rotation from the safer, higher yielding companies to the riskier, growth oriented companies.

**Second Quarter 2017**
**Sector Performance**




International and emerging markets stocks outperformed our domestic markets for the quarter and the trailing 12 months. In most cases it was not so much the strength of their earnings, but rather the appeal of their price and yield that drew investors. Commodities lost ground again for the quarter and trailing 12 months. Energy was certainly a major factor, but sugar, iron ore and orange juice did even worse.

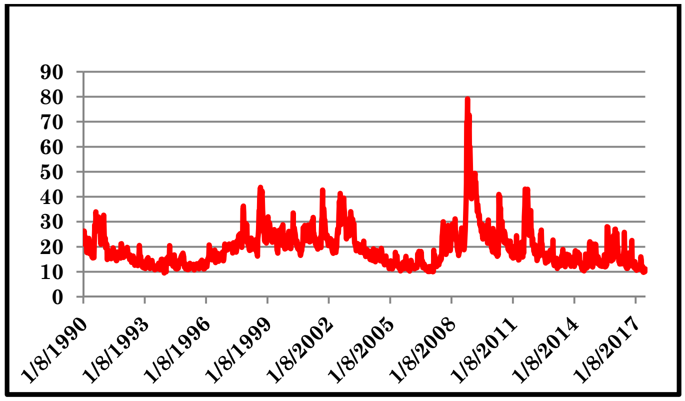
**Second Quarter 2017**
**Asset Class Performance**




### Concerns

A senior Wall Street analyst recently said, "The market only looks expensive if you look at it on a nominal basis". He then went on to measure it using PEG ratios (P/E to Growth), EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) and the Fed Model (Earnings Yield vs the 10 year Treasury). These alternative metrics raise their heads every time the market hits new highs as a way of justifying analysts' buy recommendations.

**VIX**




With the VIX near record lows, investors have become compacent. As Warren Buffett says, "Be fearful when others are greedy and greedy when others are fearful".

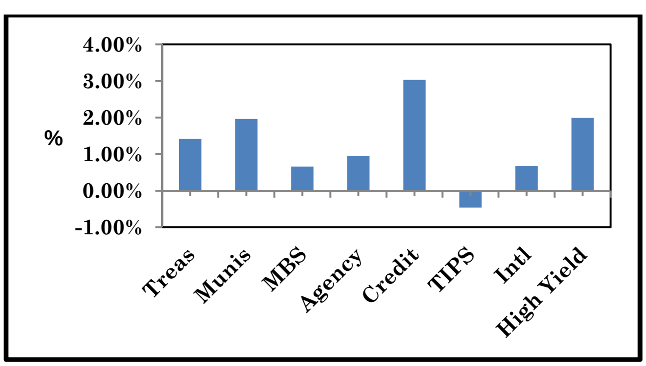
### Strategy

Pull backs are a fact of life when the market is at all-time highs. Trying to time the market, however, is a fool's game because no one knows when the sell off will hit. A more prudent strategy is to own high quality stocks that sell at reasonable valuation metrics and are well diversified. Additionally, one should own a wide variety of asset classes and rebalance as needed to an asset allocation that suits your risk tolerance. This will allow you to treat the downturn as a buying opportunity rather than a time to panic.

## Fixed Income Markets

The Federal Reserve raised short-term interest rates in June, marking the second time this year. In a similar fashion after previous rate hikes, the benchmark 10-year Treasury yield moved lower, reaching a 2.14% level. The Fed's confidence that the lack of inflationary pressures is temporary has strengthened, and expectations for this trend to reverse led to a slight upward revision in 2017 GDP. Currently their view is that the U.S. economy can handle future rate hikes and the slow unwinding of the Fed's balance sheet. Some analysts believe the reduction in the balance sheet will not have a huge impact on the markets (longer-term rates in particular) as long as the plan is slow and measured. Though the economy has shown signs of improvement, there are still factors which exist that call into question whether more action by the Fed is needed. Oil prices have drifted lower over the quarter and inflation levels continued to decline. Wage growth is below targeted levels and productivity still lags. Even though the FOMC has promised another rate hike, the bond market is not so confident that it is warranted. The yield curve continued to flatten, indicating doubt that the interest rate policy will be carried out as promised. Overall, the bond market performed well for the second quarter, with investment grade corporate bonds outperforming all other sectors.

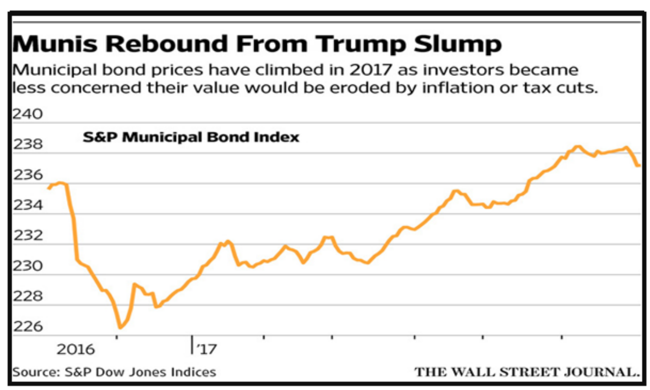
**Second Quarter 2017**
**Fixed Income Performance**




## Municipal Markets

The appetite for municipal debt continues to rise. Investors have bought close to $90 billion in new bond offerings during the first half of the year. An increase in debt coming due in 2017 and a reduction in refinancing debt has driven bond prices higher. Quality downgrades in Illinois to the lowest level of any state, and in Connecticut to near junk status, has yet to deter demand. The S&P Municipal Bond Index gained 3.25% year to date, which is surprising to some investors. After the November election, municipal bonds fell 3.46% in anticipation that tax cuts and higher inflation would erode the value of tax exempt debt. Investors withdrew funds from bond funds and ETF's at the end of 2016, but have reversed course as tax cuts seemed less likely to materialize in the short term. Inflation levels seem less problematic as wage growth hovers just over 2% and in spite of the Fed raising short-term interest rates, longer-term yields have moved lower.

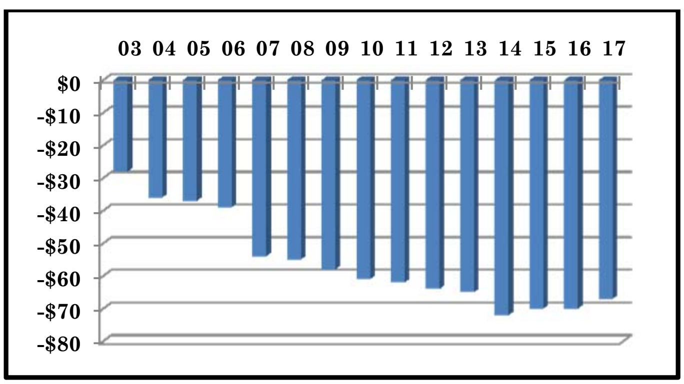
**S&P Municipal Bond Index**




As troubling as the financial conditions in Illinois and Connecticut are, the market seems to be performing well. The issues facing Puerto Rico, however, are more problematic. The Commonwealth has been in a recession since 2006, and even though its circumstances are somewhat unique, they are not too far off from those of some states and municipalities in the U.S.

Issues of rising pension costs, deteriorating infrastructure, and credit downgrades have made it more expensive to raise funds needed to provide its citizens certain essential services. Puerto Rico has been experiencing a decrease in the taxpayer base as many professionals have left the territory, looking for a better quality of life. 45% of the residents are below the poverty line and the government will be reducing public services and closing schools. States cannot declare bankruptcy and get protection from creditors and historically, Puerto Rico has been barred from this process as well. But with creditors growing impatient for a resolution, they have had to take extraordinary measures. In May a federal oversight board was created by Congress, placing Puerto Rico under court-supervised restructuring proceedings- not technically bankruptcy, but similar. The board will be faced with lengthy negotiations to reduce repayments to creditors and oversee a sustainable economic growth plan moving forward.

**Puerto Rico Debt Levels ($ bill)**




More recently, Puerto Rico has contemplated public-private partnerships to operate some of its public infrastructure. This would allow private companies to lease and or operate facilities ranging from seaports, airports, and passenger ferries in exchange for cash paid up front to the government. On one hand, it pledges away revenues that Puerto Rico would need to fund core services, but proponents claim there is evidence that privately run projects tend to be more efficient and better run than their public counterparts.

Puerto Rico's bond holders include mutual funds, bond insurers, hedge funds and individuals totally $74 billion. Depending upon the type of debt held, there could be significant reductions in payment-in-full, whether it is principal or interest payments. In addition to what is owed to creditors, there is also $40 billion in pension obligations. This may seem rather insignificant when looking at the total U.S. municipal bond market at approximately $4 trillion, but the ramifications could be far reaching. Puerto Rico has not only moved to the worst case scenario, but the law was changed to allow potentially massive forgiveness of debt. It will also make it that much harder for the Commonwealth to obtain capital, re-entering the debt markets in the future. The concern is that states with high debt levels and pension liabilities could look upon Puerto Rico's Title III process as a potential similar remedy available to them.

The impact on the overall municipal bond market is still unknown. It not only adds another layer of risk to a market known for a low risk profile, but could drive yields and overall investor demand in the future. This would affect mutual funds to a greater degree. Despite years of trouble, some mutual funds are still holding large amounts of Puerto Rico debt (more than 40% of U.S. municipal bond funds according to Morningstar data). The decline of the bonds' value and the elevated level of fund redemptions could put additional stress on the funds, forcing untimely sales of assets to meet liquidity needs which could have a ripple effect on the overall market. Chesapeake Wealth Management recommends investing in individual bonds when appropriate and the level of Puerto Rico debt in mutual funds emphasizes this point. Bond mutual funds may be appropriate to achieve levels of diversification otherwise not available to individual investors, but knowing and understanding your investments will help protect against a potential loss of principal.

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**June 30, 2017**

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**www.chesapeakewealth.com**

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3. S&P/Case Shilling US National Home Price Level Index
Meausres US residential real estate prices tracking changes in value nationally in 20 metropolitian regions.

4. Oil and Gas Spot Prices
U.S. Energy Informantion Administration: Average spot price over each calendar month.

5. 12 Month Change in CPI
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6. Euro vs US Dollar
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7. DJIA 2017
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8. Sector Performance
Morningstar: Sector performance of the 11 S&P 500 sectors on a quarterly basis.

9. Asset Class Performance
Morningstar: Smal Cap – Russell 2000 Index, Mid Cap- CRSP Mid Cap Index, Large Cap – S&P500, Dev. Int'l – EAFE Index, Em Mkts – FTSE Em Mkt Index.

10. VIX
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11. Fixed Income Sector Performance
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12. S&P Muni Bond Index
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13. Puerto Rico Debt Levels
Puerto Rico Government Development Bank

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