2017 Mid-Year Market Review
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2017 Major Investment Themes

- **Strong Equity Markets Performance** – Global stock markets continued to rally during the second quarter and collectively had their best opening six months in years. The S&P 500, MSCI EAFE, and MSCI Emerging Market indices gained 9.3%, 13.8%, and 18.4% YTD, respectively.

- **Strong Fundamental Backdrop** – Strong corporate earnings growth, steady global economic growth, and low interest rates made for a favorable environment for equities.

- **The Trump Effect** – Despite the new administration promoting pro-growth legislative policies, no new legislation has been passed. However, through the appointment of various agency heads (EPA, SEC, etc.) and a mandate to reduce red tape, there is a general sense the government is no longer the enemy of private businesses.

- **Low Equity Market Volatility** – Not only is equity market volatility at trough levels, the S&P 500’s largest drawdown over the first half of the year never exceeded 2.8%, which makes this the second smallest first-half drawdown in 89 years, and significantly less than the average first-half drawdown of 11.2%.

- **Interest Rates Remain Low** – Despite the Fed increasing interest rates twice during the first half of the year, rates remain at low levels with the 10-Year U.S. Treasury yield declining from 2.5% at the start of 2017 to 2.3% at mid-year.

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**EQUITY MARKET RETURNS**
FROM 12/31/16 THROUGH 6/30/17

![EQUITY MARKET RETURNS graph]

Source: Bloomberg
2017 YTD Outlook Scorecard

<table>
<thead>
<tr>
<th>2017 OUTLOOK</th>
<th>OUTCOME</th>
<th>WHAT IT MEANT FOR CHA CLIENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Domestic Equities:</strong> We remain cautiously optimistic about current data showing the U.S. economy continuing to gain momentum and corporate earnings growth recovering from last year’s energy-led slump. Based on fundamentals, we think this secular bull market still has room to run.</td>
<td>Correct</td>
<td>Year-to-date results have been quite strong for U.S. large cap equities which finished the first half of the year sharply higher.</td>
</tr>
<tr>
<td><strong>International Equities:</strong> Compelling valuations and better economic growth prospects should allow emerging markets to outperform international developed market equities.</td>
<td>Correct</td>
<td>Both developed international and emerging markets posted strong results during the first half of 2017. With approximately half of Cedar Hill’s international portfolios in emerging markets, performance has been especially strong.</td>
</tr>
<tr>
<td><strong>Equity Income:</strong> With underlying fundamentals continuing to improve across the energy sector, MLPs look poised to return to modest distribution growth in 2017. Assuming the cadence and magnitude of future Fed rate hikes are measured, which we expect, Equity Income should have another good year in 2017.</td>
<td>Incorrect</td>
<td>Despite improving fundamentals, MLPs have lagged this year alongside negative investor sentiment towards all energy investments. We expect to see much stronger results in the second half of the year.</td>
</tr>
<tr>
<td><strong>Fixed Income:</strong> Higher rates of economic growth and inflation, along with the Fed’s projection of three interest rate hikes, could put bond prices under pressure in 2017. Municipal bonds may offer better return prospects than corporate bonds given their post-election sell-off.</td>
<td>Partially Correct</td>
<td>Bond prices have rallied alongside declining rates. Municipal bonds outperformed taxable bonds amid easing fears that lower rates would reduce the value of tax-free interest.</td>
</tr>
</tbody>
</table>
• In the past 20 years, only four first-half rallies have been as widespread or better than the current global surge.

• Equity markets have been buoyed by multiple factors:
  – Strong Corporate Earnings Growth – According to FactSet, first quarter profits by S&P 500 companies reported during the second quarter were cumulatively 14% higher than a year ago.
  – Steady Economic Growth – Nearly every major economy in the world has posted positive year-to-date economic growth.
  – Low Interest Rates – While the U.S. Federal Reserve raised rates again in June, interest rates continue to hover at low levels by historical standards.

• Large cap technology names, including Facebook, Apple, Amazon, Microsoft and Google, led the way. Only telecommunications and energy sectors declined YTD.

• While equity markets have been quite strong this year, risks remain:
  – High stock valuations (approximately 18x earnings) and tranquil trading this year have prompted concerns that investor complacency is setting in.
  – The Fed may take away the punch bowl by raising rates too high and too fast.
  – U.S. political and geopolitical risk may intensify.
International Equity Markets

**MARKET PERFORMANCE**

<table>
<thead>
<tr>
<th>INDEX NAME</th>
<th>YTD THROUGH 6/30/17</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>9.3%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>13.8%</td>
</tr>
<tr>
<td>MSCI Europe</td>
<td>15.4%</td>
</tr>
<tr>
<td>NIKKEI 225 (Japan)</td>
<td>4.8%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>18.4%</td>
</tr>
<tr>
<td>MSCI BRIC</td>
<td>16.8%</td>
</tr>
<tr>
<td>MSCI Emerging Asia</td>
<td>23.2%</td>
</tr>
<tr>
<td>MSCI Latin American</td>
<td>10.1%</td>
</tr>
</tbody>
</table>

Source: Bloomberg

**GROWTH OF $100,000**

FROM 1/1/08 THROUGH 6/30/17

- International equities, led by emerging markets, outperformed U.S. equities during the first half of 2017.
- The MSCI EAFE and MSCI Emerging Markets indices traded at 15 and 13 times projected earnings over the next 12 months, respectively. This is a discount to the S&P 500 which trades at approximately 18 times forward earnings.
- U.S. markets have outperformed international equities by nearly 100% since the beginning of the financial crisis. Though we have seen short-term periods of international equity outperformance during this time, this rally may be stronger for a number of reasons:
  - Political Stability – France’s election of Macron may indicate fringe parties are losing steam.
  - Currency Stability – Pundits are no longer talking about the break-up of the euro.
  - Economic Growth – With few exceptions, nearly every major global economy is experiencing economic growth.
  - Corporate Earnings Growth – After years of earnings coming in below analysts’ expectations, recent reports have exceeded estimates and analysts are raising forecasts.

Source: Bloomberg
Equity Income

MORTAR PERFORMANCE
INDEX NAME YTD THROUGH 6/30/17
Alerian MLP Index -2.7%
FTSE Mortgage REIT Index 4.9%
S&P 500 Index 9.3%
Bloomberg Barclays U.S. AGG Intermediate 2.3%
Source: Bloomberg

S&P 500 AND ALERIAN MLP GROWTH OF $1,000 FROM 1/1/07 THROUGH 6/30/17

- Mortgage Real Estate Investment Trusts (mREITs) posted strong performance for the first half of 2017 and continue to benefit from their high dividend yields in a low interest rate environment.

- Master Limited Partnerships (MLPs) are off to a difficult start in 2017 with the Alerian MLP index down 2.7% YTD.

- MLP fundamentals have improved since the beginning of the year, but equity prices have declined in 2017 due to negative investor sentiment towards all energy-related investments.

- Unlike 2015 when U.S oil and gas production fell alongside energy prices, energy production is actually increasing in 2017, and MLP revenues and profitability are improving accordingly.

- Over the past few years, MLPs have reduced the amount of leverage on their balance sheets, and the possibility that MLPs will need to cut their dividends has been dramatically reduced.

- While we do not know when oil prices will stabilize and/or rise, with the 7%+ dividend yields paid by MLPs appearing to be quite safe, investors are not only getting paid a very nice yield to wait, but should also benefit from 4% to 6% distribution growth expected over the next few years.
Fixed Income Markets

**INTEREST RATES**

**BOND INDEX**

<table>
<thead>
<tr>
<th>Bond Index</th>
<th>12/31/16</th>
<th>6/30/17</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-Year Treasury</td>
<td>0.8%</td>
<td>1.2%</td>
</tr>
<tr>
<td>5-Year Treasury</td>
<td>1.8%</td>
<td>1.9%</td>
</tr>
<tr>
<td>10-Year Treasury</td>
<td>2.4%</td>
<td>2.3%</td>
</tr>
<tr>
<td>30-Year Treasury</td>
<td>3.0%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Bloomberg Barclays U.S. AGG Intermediate</td>
<td>2.4%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Bloomberg Barclays 5-Yr Muni Bond</td>
<td>2.1%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Bloomberg Barclays U.S. Corporate Credit Index</td>
<td>3.4%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Bloomberg Barclays U.S. High Yield</td>
<td>6.1%</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

Source: Bloomberg

**U.S TREASURY YIELD CURVE**

**IN YEARS**

- Fixed income markets spent the second quarter of 2017 within a well-defined trading range with the 10-Year U.S. Treasury mainly trading at the low end of its 2.1% to 2.4% range.

- The 10-Year Treasury rallied in late June to finish the quarter at 2.3% fueled by increasing concerns that global central banks may reduce some of their easy monetary policies.

- The U.S Federal Reserve raised rates twice during the first half of 2017 and is expected to raise rates at least once more in late 2017.

- The Fed is expected to begin reducing the size of its balance sheet in the second half of this year. Though this is expected to be well telegraphed, a policy mistake could cause rates to rally much higher or economic activity to slow. A low rate environment remains the most likely outcome.

- Municipal bonds continue to be relatively attractive as yields remain elevated off 2016 lows with no credible tax reform actions in sight.

- Corporate credit spreads and yields remain near historical tight levels as default rates are expected to be quite low.

- We continue to stick to our high quality fixed income discipline as limited yield can be gained by taking additional credit risk.

Source: Bloomberg
Market Outlook

Although U.S. equities have performed quite nicely YTD, second half performance will likely be driven by continued earnings growth, rather than earnings multiple expansion.

While some economic results were weaker than expected during the second quarter, as long as GDP continues to show growth between 1.5% to 2.0%, equity markets are unlikely to have a significant reaction to economic statistics.

With the market not experiencing a 5% pullback in over a year, volatility hovers at all time trough levels. Any 5% to 10% market decline could quickly be made up as significant amounts of cash remain on the sidelines.

International equities appear well primed to rally, with both economic and corporate earnings growth tailwinds.

All eyes will be on the U.S. Fed and other global central banks. The magnitude and pace at which they reduce economic stimulus, both by raising interest rates and reducing the size of their balance sheets, will likely have significant impact on economic growth and market performance for years to come.

The potential threat posed by North Korea, as well as the investigation into Russia’s influence over the U.S. election, remain wild cards.
• **Fixed Income** – We recommend keeping duration relatively short in order to avoid backlash from potentially higher interest rates. Little additional return can be gained by extending maturities or reducing credit quality.

• **U.S. and International Equities**
  – Energy, Health Care and Technology are the best positioned sectors for growth and valuation reasons.
  – We recommend an overweight position in emerging markets relative to developed international markets, where growth rates and valuations remain more attractive.

• **Equity Income** – Provides attractive total return potential, strong diversification to traditional equity strategies and additional current income. Master Limited Partnerships (MLPs) should benefit from distribution growth.

• **Alternative Investments** – Where appropriate, use liquid alternatives, private equity and real estate to enhance returns, reduce risk, and/or provide further diversification.

• Remain **Opportunistic** and **Flexible** to changing market conditions.
Leading indicators include economic variables that tend to move before changes in the overall economy. A negative reading in these indicators preceded each of the last three recessions. The latest reading suggests current economic conditions still remain favorable.

**CONFERENCE BOARD U.S. LEADING ECONOMIC INDICATORS INDEX**
FROM 6/30/86 THROUGH 6/30/17

Source: Bloomberg
A comparison of long-term versus short-term Treasury rates illustrates that past recessions were preceded by an inverted yield curve (i.e., the 10-Year Treasury yield fell below the 2-Year yield). As of 6/30/17, the 10-Year yield remained 0.9% above the 2-Year yield.

**U.S. TREASURY 10-YEAR MINUS 2-YEAR YIELD**
FROM 6/30/86 THROUGH 6/30/17

Source: Bloomberg
10-Year U.S. Treasury bonds have historically provided a higher yield than equities. However, given today’s low interest rate environment, equities offer nearly an equivalent yield to Treasury bonds (while also providing greater price appreciation potential).

**S&P 500 DIVIDEND YIELD VERSUS 10-YEAR TREASURY YIELD**
FROM 6/30/94 THROUGH 6/30/17

Source: Bloomberg
## PERIODIC TABLE OF INVESTMENTS

### ASSET CLASS TOTAL RETURN, 1/1/07 THROUGH 6/30/17

<table>
<thead>
<tr>
<th>Short Name</th>
<th>Name</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017 YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>LARGE FOREIGN</td>
<td>MSCI EAFE</td>
<td>16.6</td>
<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
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<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
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</tr>
<tr>
<td>LT BOND</td>
<td>S&amp;P 500</td>
<td>9.8</td>
<td>24.6</td>
<td>17.4</td>
<td>26.9</td>
<td>19.2</td>
<td>19.2</td>
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<tr>
<td>ST/BOND</td>
<td>BARC US TREASURY LONG</td>
<td>7.4</td>
<td>27.5</td>
<td>27.5</td>
<td>27.5</td>
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<td>27.5</td>
<td>27.5</td>
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<tr>
<td>GLOBAL BOND</td>
<td>CITI WGBI</td>
<td>5.7</td>
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<tr>
<td>MID CAP</td>
<td>S&amp;P MIDCAP 400</td>
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<td>5.6</td>
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<tr>
<td>LARGE CAP</td>
<td>TSRE NAREIT ALL EQUITY REITS</td>
<td>5.5</td>
<td>5.5</td>
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<tr>
<td>HEDGE FUNDS</td>
<td>ST/BOND</td>
<td>1.5</td>
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<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
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<tr>
<td>HY BOND</td>
<td>HFRX GLOBAL HEDGE FUND INDEX</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
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<tr>
<td>SMALL CAP</td>
<td>S&amp;P SMALLCAP 600</td>
<td>1.6</td>
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<tr>
<td>REAL ESTATE</td>
<td>COMMODITY</td>
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<td>-1.8</td>
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</table>

Source: Bloomberg
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