ICR® 2nd Quarter Newsletter – July 2017

The second quarter of the year was highlighted by relative calmness in the markets. The S&P 500 edged up 2.6% and the VIX (a measure of volatility in the markets) came close to its all-time lows. One source of some volatility was the NASDAQ, as investors took profits in June in the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google). At one point, the NASDAQ was up almost 7% for the quarter, but still managed to gain 3.9% despite the late-quarter sell-off.

Foreign markets fared slightly better with the MSCI EAFE adding 5.0% and emerging markets gaining 5.5%. With China and South Korea comprising over 43% of the emerging markets index, their respective 9% and 10% gains were enough to make up for losses in some of the other large constituents like Brazil and Russia.

Interest rates fell slightly, with the 10-year Treasury yield dropping from 2.39% to 2.30%. The story of the year in bond markets has been the gradual flattening of the yield curve. Spurred by the Federal Reserve's rate-raising campaign, the short end of the yield curve has been moving up over the course of the year, with the three-month treasury yield doubling from 0.51% at the beginning of the year to 1.03% on June 30th. Meanwhile, the 30-year yield has dropped from 3.04% to 2.84% in that time.

Changing of the Monetary Tide

> "Make haste! The tide of Fortune soon ebbs." — Silius Italicus

For nearly a decade, central banks have pumped money into the global economy through low interest rates and quantitative easing (QE). Although there is considerable debate as to the long-term consequences, these actions have pushed up asset prices and have contributed to a modest and increasingly resilient economic expansion. According to the Bank for International Settlements (BIS) 87th Annual Report, economic conditions have become the most favorable since before the Financial Crisis. This "goldilocks" environment - improving growth, falling unemployment, and low inflation - has bolstered a very favorable mood across financial markets with most asset classes continuing to move up amidst record-low volatility.

Against this backdrop, it is appropriate - perhaps overdue - that central banks begin reversing their unconventional policies. And a host of central banks, including the Fed, ECB, BOE, and BOC, have now signaled a reduction in monetary accommodation. The Fed is leading this policy shift by raising rates three times in six months and officially providing some details on how they intend to shrink their balance sheet, which has ballooned to $4.5 trillion following multiple rounds of QE. If other central banks follow through on their intentions, monetary policy divergence may have peaked, and investors will shift their focus to the effects of a gradual policy convergence that is less accommodative.

This policy shift is a sea change, and it remains to be seen if central banks can normalize rates and unwind their balance sheets without disrupting financial markets and smothering the recovery. As we enter the latter phase of the current financial cycle, it is reasonable to ask if historical patterns might be repeated. That is, central bankers try to tighten at exactly the right pace, keeping growth and inflation balanced, until they don't get it right, and we have our next recession. Of course, these have been unprecedented monetary policies, and there really is no precedent for how to unwind them. As the BIS Report puts it, "Policy normalization presents unprecedented challenges, given the current high debt levels and unusual uncertainty." So, the end-game has yet to play out.

Investment Implications

While the near-term economic outlook has become somewhat more stable, investors need to be cautious about expected future investment returns, given the elevated valuations across asset classes. After all, if accommodative monetary policies have pushed up asset prices, it is reasonable to expect that the withdrawal of accommodation might result in broadly lower prices.

That said, we believe the current policy shifts should provide fruitful opportunities in multiple markets. We remain attracted to emerging markets given low valuation levels, improved earnings dynamics, and the early stage of their economic recovery (see last quarter's commentary).

European economies are also playing catch-up, and we see room for European mergers and acquisitions (M&A) to add value. In the first six months of this year, the value of M&A transactions rose 13% year-on-year in Europe, versus a 19% decline in the U.S. In our opinion, the catalyst for the pickup in European M&A activity is improved business confidence in the wake of greater near-term economic stability. However, the currency appreciation that should coincide with improved European economic momentum might eventually dampen some companies' earnings prospects. We therefore favor small-cap European companies that are less affected by currency appreciation and may be more attractive targets of M&A.

More generally, we will stay focused on capital preservation as we seek diversified sources of return from investments that are less dependent on central bank support. We plan to maintain a flexible but disciplined approach that allows us to prudently take advantage of market opportunities. We believe this approach is in keeping with your investment goals.

We appreciate your confidence and support. And, we look forward to speaking with you regarding your questions or thoughts.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 6/30/17)

Index	**2017 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	8.24	7.32	12.21
Dow Jones Industrial Average	8.03	8.26	10.63
U.S. Aggregate Bond Index	0.82	2.48	2.21
MSCI EAFE (Foreign Index)	11.83	-1.53	5.76