SPINNAKER

SPINNAKER TRUST QUARTERLY NEWSLETTER JULY, 2017

SECOND QUARTER 2017 MARKET REVIEW & OUTLOOK

The first half of 2017 is in the books with U.S. large-cap equities returning 9% year-to-date, developed international equities returning 15%, emerging markets equities returning 18.6%, and the bond market returning 2.4% on a total return basis. Large-cap U.S. equities gained 2.7% in the second quarter. A standard 60/40 portfolio should have returned 5%-7% in six months – a respectable result. The 2.8% peak-to-trough sell-off for the S&P 500 in March is the second smallest drawdown in a given year since 1930, with only the 2.5% sell-off in 1995 smaller.

Interestingly, the S&P 500, long-duration U.S. bonds and gold have all risen by approximately the same amount – somewhere between 8%-10%. This is odd, because asset classes that are often uncorrelated have been moving together.

The reacceleration in nominal growth and "soft" data continued to chug along during the second quarter and compared well with last year's relatively weak second quarter. Comparisons become more difficult in the back-half of the year. We are watching the pace of broad economic data – the second derivative of growth – and the flattening of the yield curve as the Federal Reserve continues to raise interest rates while estimates for long-term economic growth remain static.

Missing amid all of the market skepticism is the fact that corporate earnings are improving across the globe. Both Japan and the Eurozone have inflected toward modest inflation and relatively strong growth. Global manufacturing data remains robust. The U.S. dollar has weakened by a material amount since the beginning of the year which helps the multinational-heavy S&P 500 and sectors like the Industrials, Technology and Healthcare.

It is rare that the yield curve and company earnings are pointing in opposite directions as the two factors have been highly correlated historically. The divergence suggests that the fixed income and equity markets have opposing views on the durability of economic growth reacceleration, the chance for any positive tax and/or regulatory reform out of the Trump administration and the durability of the business cycle.

Deflation Takes the Baton: Deflation was the prominent theme during the second quarter, with the yield on the U.S. 10-year treasury falling from 2.6% in March to 2.1% in early June. This was the result of surprisingly benign CPI reports in recent months and a dramatic fall in energy prices. Flows and investor positioning in recent months affirm this skepticism, with defensive market sectors receiving the bulk of investment flows and growth investment styles handedly outperforming value.

We believe that inflation expectations are anchored and the recent upturn in capacity utilization in the U.S. and tight labor market suggest that some inflation is likely but not imminent. While inflation is typically thought of as a negative thing, particularly amongst those who were practicing their craft in the 1970s, modest inflation at this juncture would be quite positive for equity markets across the world. Inflation has not historically become a problem until it hits 4%. Our theme from previous newsletters remains the same. We believe that bond yields will slowly rise, peaking out at lower levels than have been typically observed in previous cycles and are positioned more cyclically in sectors like Financials and Technology.

Don't Call It a Comeback: Both developed and emerging international equity markets have handedly outperformed U.S. equities through the first half of the year. This long-awaited comeback has been rooted in accelerating growth and is completely justified.

In Europe, both corporate earnings and GDP growth should exceed that of the U.S. this year. Further, the favorable outcome of the French election paused populist momentum in the region. The German elections later this year should be Eurozone favorable no matter the outcome. The absolute level of Eurozone corporate earnings is exactly the same as it was in 2007 before the crisis; the region has shown zero operating leverage or margin improvement. We believe that this is set to improve thanks to a coordinated acceleration in global growth, a weak Euro and the end of austerity.

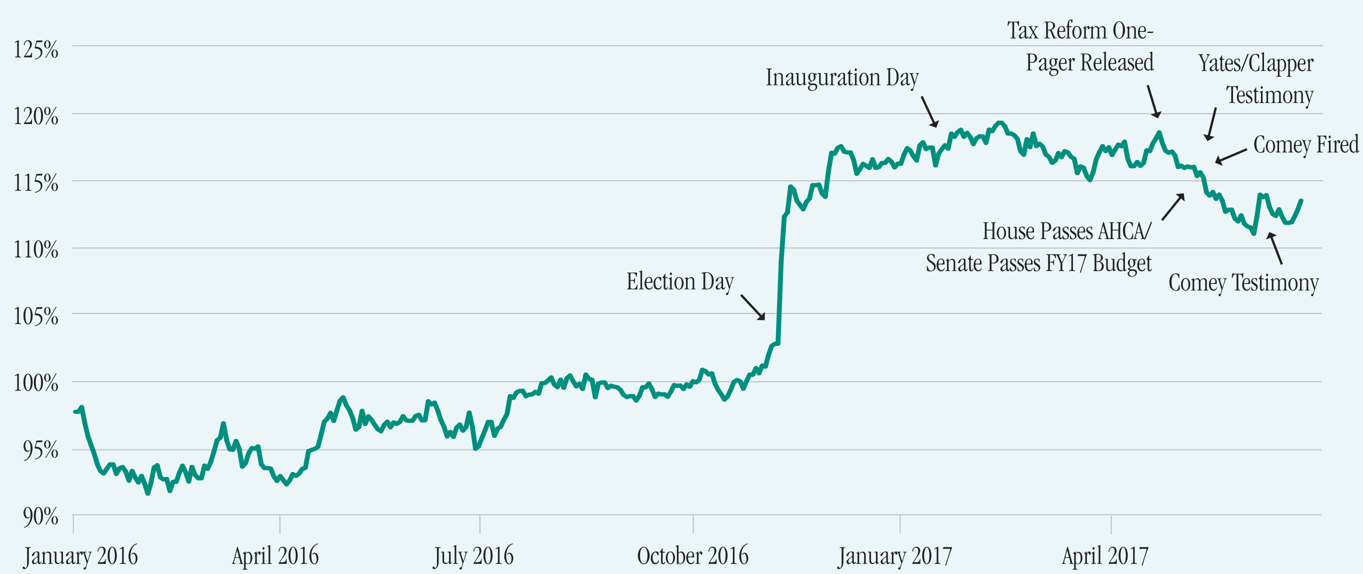
In Japan, Abenomics is proving fruitful in that the country is finally generating inflation. Real estate prices are rising again. It should be noted that wage inflation in Japan is likely for the foreseeable future given the unfavorable supply and demand balance in the labor force. Even more impressive is that Japan has boosted export growth in the face of a relatively strong and rising Yen.

Emerging Markets have had an impressive run over the last fourteen months. Most surprising is that the asset class has outperformed in 2017 in the face of declining commodity prices and Federal Reserve interest rate hikes. For those who are familiar with the playbook that emerged during the BRICs era, it should be noted that the drivers of Emerging Markets are completely different today. The asset class is heavily influenced by the fortunes of India, China and North Asia (South Korea and Taiwan) which make up 65% of the MSCI index. This ratio will grow even larger after the inclusion of Chinese A-shares (locally-listed shares) in 2018. All four of these countries are net commodity importers and, therefore, benefit from lower energy and commodity prices. While 2016 was led by commodity-sensitive and relatively small (in economic terms) countries like Brazil, South Africa and Russia, 2017 has been the year of Emerging Markets technology. Of note is that seven of the top ten holdings in the MSCI Emerging Markets Index are technology-driven stocks.

Policy & the Trump Agenda:
Investors no longer assume that the Trump administration will necessarily be successful in enacting any of its advertised agenda as evidenced by the dramatic underperformance of "Trump trade" sectors and individual stocks. We are certainly not ebullient about the prospects for a new healthcare plan or a 15% corporate tax rate. However, we do think that moderate corporate tax reform will happen and that the market is underpricing that prospect. Our research partner Strategas believes that the most likely outcome is a 23% corporate tax rate (from the 15%/20% rate proposed by Ryan and Trump, respectfully) that includes repatriation of overseas corporate profits.

FANG Part II: Much was written about the FANG concept in 2015 when a narrow subset of growth and technology-oriented companies (Facebook, Amazon, Netflix and Google) led in an otherwise flat market. This trade reversed in 2016 when the same group of stocks fell by 6%. This year, the same four names have outperformed the

Post-Election Trump Portfolio Relative To The S&P 500 (100 = 12/31/2015)



Source: Strategas

market by approximately 18%. If one were to include Microsoft, Apple and perhaps a semiconductor name like Nvidia, the performance figure would be even more impressive.

We are not worried. While we believe that a continued pullback in these names is likely over the coming weeks, we think that the fundamentals of this market subset are robust and reasonably valued. Unlike its predecessors of the New Economy era, this group generates notable revenue and cash flow with improving margins. The vulnerabilities of this cohort stem largely from anti-trust initiatives.

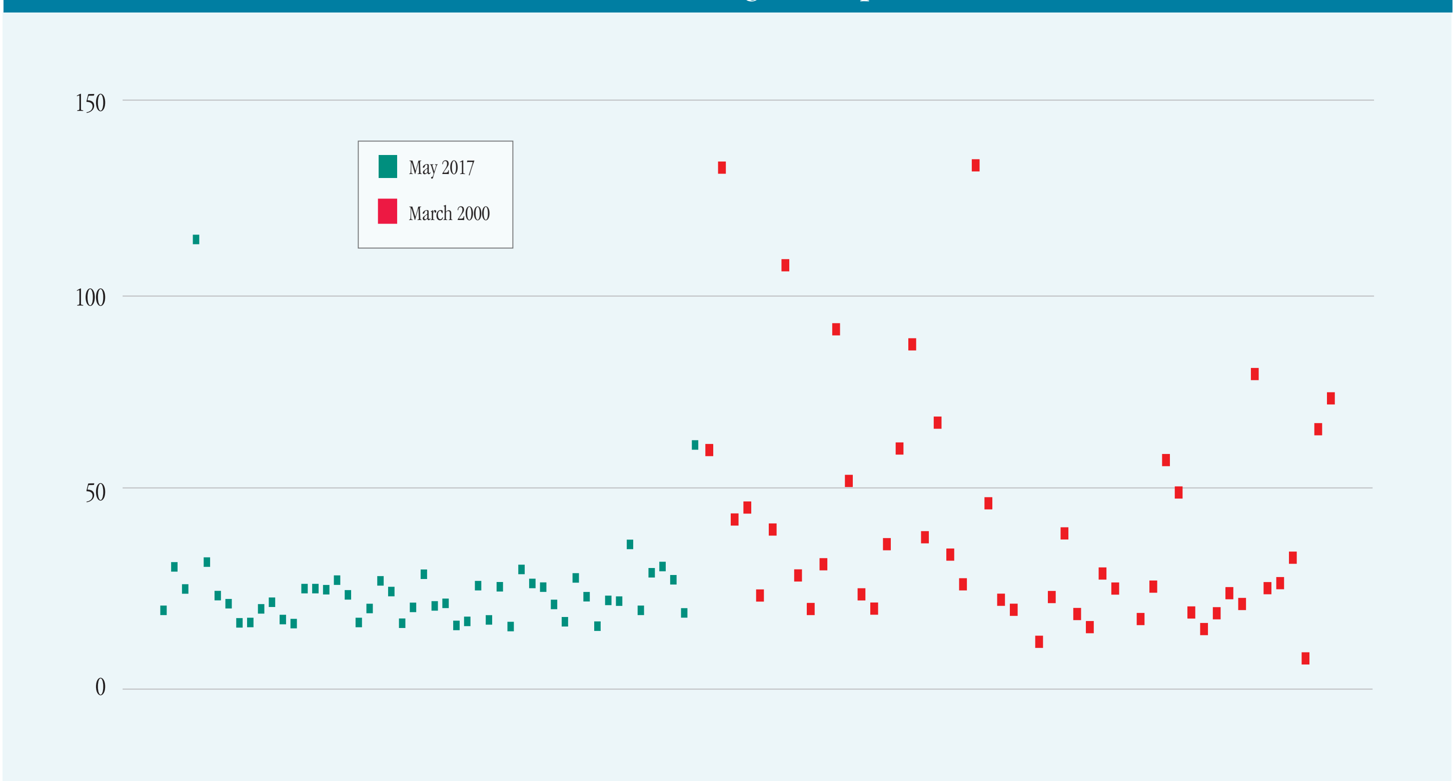
This is not a replay of the 1999 technology bubble. We remain constructive on the Technology sector broadly and the large-cap growth stocks within.

Outlook & Conclusion: To reiterate what we wrote last quarter, the market run since the depths of March 2009 is the second longest bull market on record and the fourth greatest in magnitude since 1928. It has taken eight long years to get here, but both Wall Street and Main Street seem to finally be cautiously optimistic. It is reasonable to expect that markets will continue to grind higher for another year or two.

What are the risks? We are watching commercial real estate, automobile sales and energy prices. We are also watching a fledgling corporate investment cycle. Up until this point, companies have been so shaken by the global financial crisis and political developments that they have chosen to spend nearly all of their collective cash flow on share buy-backs. We see evidence that this is turning.

All great market declines of modern times were preceded by universal euphoria and high prices. While we acknowledge that there are pockets of asset overpricing, there are few signs of speculative excess in the markets. As we wrote last quarter, some indicators are actually bearish. Outright deflation is unlikely while troublesome inflation is far away – a "goldilocks" scenario in terms of growth. The market can certainly hit us with an ordinary pullback of 10%, but a serious decline seems unlikely. As always, there remains risk from geopolitical events, and these are a source of meaningful concern today. So our optimism is tempered with a sense of caution that "we don't know what we don't know," and we continue to manage our clients' portfolios toward long-term targets that balance the opportunity for return with tolerance for risk.

Forward P/E Ratios of The 50 Largest Companies in the S&P 500



MARKET DATA

Index		*YTD*	*2016*	*2015*	*2014*
S&P 500	*U.S. Large-Capitalization Stocks*	9.34%	11.95%	1.37%	13.68%
S&P 400	*U.S. Mid-Cap Stocks*	5.99%	20.73%	-2.18%	9.74%
S&P 600	*U.S. Small-Cap Stocks*	2.78%	26.46%	-2.01%	5.74%
Russell 1000	*U.S. Large- and Mid-Cap*	9.27%	12.04%	0.91%	13.24%
Russell 1000 Growth	*Growth Stocks broken out*	13.99%	7.07%	5.67%	13.05%
Russell 1000 Value	*Value Stocks broken out*	4.66%	17.33%	-3.84%	13.45%
MSCI EAFE Index	*Established International Markets*	14.22%	1.59%	-0.28%	-4.32%
MSCI Emerging Markets	*Developing International Markets*	18.55%	11.27%	-14.61%	-1.97%
		6/30/17	12/31/16	12/31/15	12/31/14
90 day T-Bill	*Short-Term Interest Rate*	1.03%	0.51%	0.17%	0.02%
10 Year US Treasury Rate	*Longer-Term Interest Rate*	2.27%	2.45%	2.28%	2.17%
VIX Index	*Risk Measurement*	11.18	14.0	18.2	18.1
Corporate Bond Spread	*Risk Measurement*	109 bps	120 bps	165 bps	131 bps
TIPS Spread	*Inflation expectations*	145 bps	197 bps	171 bps	170 bps

WELCOME

John Leonard joined us as a Portfolio Manager in April from JP Morgan in Boston. We are thrilled to have John with us.

SPINNAKER TRUST

123 FREE STREET, PORTLAND, MAINE 04101 • (207)553-7160 www.spinnakertrust.com