CLS's WEEKLY 3

What You Need To Know About the Markets

FEBRUARY 27, 2018

1. When emotions hit extremes, be a contrarian.
2. Despite sharply higher rates, bond returns remain positive.
3. Minutes from the latest FOMC meeting send mixed signals.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+0.53%	+2.72%	+2.72%
Domestic Large-Cap Equity[2]	+0.58%	+3.05%	+3.05%
Domestic Small-Cap Equity[3]	+0.38%	+1.01%	+1.01%
International Equity[4]	+0.08%	+1.63%	+1.63%
Developed International Equity[5]	-0.44%	+0.91%	+0.91%
Emerging Market Equity[6]	+1.42%	+5.16%	+5.16%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	+0.00%	-2.13%	-2.13%
Cash Equivalent[8]	+0.03%	+0.18%	+0.18%
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+0.58%	+0.83%	+0.83%

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index [9]Bloomberg Commodity Index

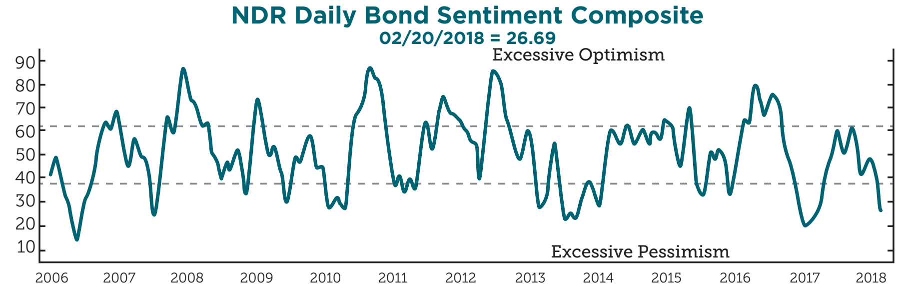
As of 2/23/2018

Week in Review

After starting last week down, the U.S. stock market rebounded late to end in positive territory. The S&P 500 Index has now recovered roughly 6% of the 10% decline experienced a few weeks ago. Domestically, large-cap companies marginally outperformed small-caps, and there was notable outperformance of growth oriented companies over value. Abroad, developed markets finished the week down, while emerging markets had the strongest performance. The fixed income market ended the week flat, while commodities advanced.

Last week saw the release of the minutes from January's Federal Open Market Committee (FOMC) meeting, as well as an assortment of U.S. economic data. This data included jobless claims, purchasing managers indices, existing home sales, and the leading index of economic indicators. As a whole, the data was positive.

Bond Sentiment is Tanking



Interest Rate Moves by Sentiment Regime

Prior to Calculation of Sentiment				
Sentiment Level	1 Month Prior	3 Months Prior	6 Months Prior	12 Months Prior
Excessive Optimism	(0.09)	(0.45)	(0.71)	(0.91)
Neutral	(0.04)	(0.10)	(0.17)	(0.29)
Excessive Pessimism	0.05	0.33	0.40	0.29

Source Ned Davis Research and Bloomberg. The rate moves are based on the 10 Year Treasury Yield. 6/6/84-2/20/18.

Interest Rate Moves by Sentiment Regime

Following Calculation of Sentiment				
Sentiment Level	1 Month Prior	3 Months Prior	6 Months Prior	12 Months Prior
Excessive Optimism	0.02	0.02	0.12	0.08
Neutral	(0.03)	(0.09)	(0.18)	(0.31)
Excessive Pessimism	(0.05)	(0.14)	(0.33)	(0.59)

Source Ned Davis Research and Bloomberg. The rate moves are based on the 10 Year Treasury Yield. 6/6/84-2/20/18.

The recent jump in rates has dampened sentiment within the bond market. Investors, both retail and professional, seem to be extrapolating recent moves into the future. By some measures, such as the Daily Bond Sentiment Composite compiled by Ned Davis Research, pessimism in the market appears to have entered an extreme level.

Market moves are often driven by emotion in the short term, with investors tending to overreact to both good and bad news. As the line chart to the right shows, investors' moods have moved to their most dour level since the presidential election. Incidentally, rates had experienced a sizable jump at that time as well. Could this be a coincidence? A simple analysis sheds some light on the matter.

We reviewed all the periods of extreme pessimism within the bond market and calculated how yields changed leading to the calculation of the composite. To do this, we used changes in the 10-year Treasury bond's yield, with data going back to June 1984. What we found was interest rates were typically on the rise as the composite moved into extreme pessimism. Over a 3- to 6-month window, the yield had typically increased by 0.33-0.40%. Conversely, excessively optimistic levels were preceded by sharp declines in the yield. The fact that the yield fell on average when sentiment was neither excessively optimistic nor pessimistic is likely a reflection of the decades-long bull market in bonds. The yield on the 10-year in the mid-1980s was in the teens.

Sizable moves in the level of rates can swing investor mood, but does this provide any insight into the future? Should we join the market and expect a continuation of the recent trend, or is it possible these participants have gone too far?

Similar to our analysis of interest rate moves leading into the composite calculation, we analyzed the average move in the 10-year yield following the composite calculation. What we see is the exact opposite. When sentiment hits excessively pessimistic levels, yields have declined on average. For example, 6 to 12 months later we see an average yield decline of 0.33-0.59%.

This analysis clearly demonstrates that the market overreacts to recent moves, bracing for a continuation of the trend as it is poised to reverse. There are many valid reasons for the recent uptick, including (but not limited to) increasing supply of and decreasing demand for Treasury bonds, a continued tightening of monetary policy by the Fed, and an uptick in expectations for growth and inflation. There is also evidence we may be approaching a pause or near-term reversal of this trend. As the old (paraphrased) adage goes, "When 10 out of 10 dentists agree, it pays to heed their advice. When 10 out of 10 investors agree, it pays to do the opposite." At CLS, we have been using this selloff as an opportunity to add high-quality duration.

Josh Jenkins, CFA
Portfolio Manager

Joshua Jenkins manages CLS's moderate- to low-risk mutual funds and income-focused separate account strategies. He is a Portfolio Manager on the Milestone Treasury Obligations Fund, AdvisorOne CLS Growth and Income Fund, and AdvisorOne CLS Flexible Income Fund.

Mr. Jenkins joined CLS in 2013 as a Research Analyst and accepted the role of Portfolio Manager in 2015. Prior to joining CLS, he was an Analyst for Auriga, USA, LLC in New York City.

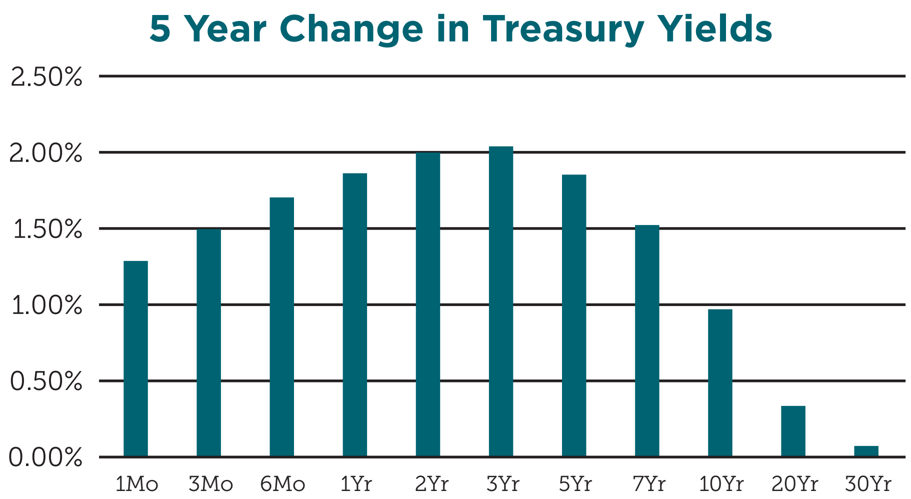
Mr. Jenkins received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln and holds the Chartered Financial Analyst (CFA) designation. He is a member of the CFA Society of Nebraska.

Did you know? Josh ran a 76-mile relay race for NorthStar.

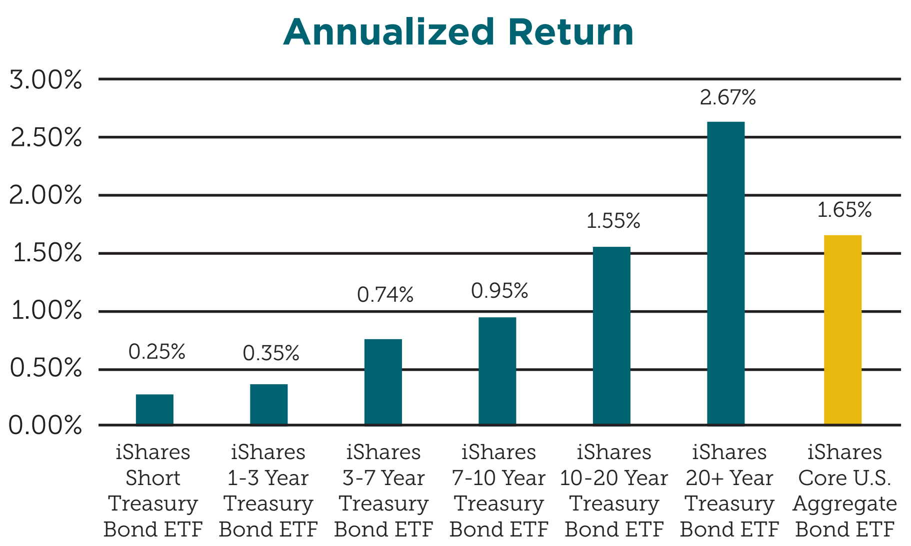
It Pays to Take Interest Rate Risk

The bond market has had a bumpy ride over the past five years. During this time, it has experienced the infamous "Taper Tantrum," where the 10-year Treasury yield nearly doubled in response to comments from previous Federal Reserve (Fed) Chairman, Ben Bernanke. Following the 2016 presidential election, the 10-year yield spiked more than 50 basis points (bps) in just three weeks. Finally, to start 2018, the yield jumped another 50 bps.

In total, the 10-year is up nearly a full percent over the period. As the top right table of 5-year yield changes illustrates, that move was subdued relative to other areas of the curve. The belly took the brunt of it, with the 3-year Treasury yield increasing by more than 2% (a sixfold jump)! It shouldn't be a surprise shorter-term yields have risen more sharply than those on the long end. Short-term rates, especially in the bill market, are more responsive to monetary policy. With five increases of 25 bps in the federal funds rate during the 5-year period, 1- and 3-month Treasury bills are up roughly the same amount. The long end of the curve, on the other hand, is much more responsive to expectations for growth and inflation, which until recently have remained lackluster.



Source: Treasury.gov. Table reflects the five years ending February 21, 2018.



Source: Bloomberg. Chart reflects the annualized five-year return ending February 21, 2018.

With rate increases of this magnitude, it would be natural to assume the bond market has struggled over the last five years. While returns were lower than average, Treasury bonds were positive across the entire curve. They also offered an incremental improvement over cash. Not bad! Broaden the scope from a portfolio of Treasuries alone, returns are even better. The Bloomberg Barclays U.S. Aggregate Bond Index (AGG) represents a commonly used proxy for the domestic, investment-grade bond market. The AGG, which primarily includes Treasury bonds, agency mortgage-backed securities, and corporate bonds, has a duration of approximately six years, which falls between the iShares 3-7 Year Treasury Bond ETF (IEI) and the iShares 7-10 Year Treasury Bond ETF (IEF).

One of the best predictors of future returns in the bond market is the current yield. With yields higher today than they were five years ago, our expectation for returns is also higher over the next five years. Rising rates are good for investors! To learn more, check out our whitepaper, Bonds in a Rising-Rate Environment.

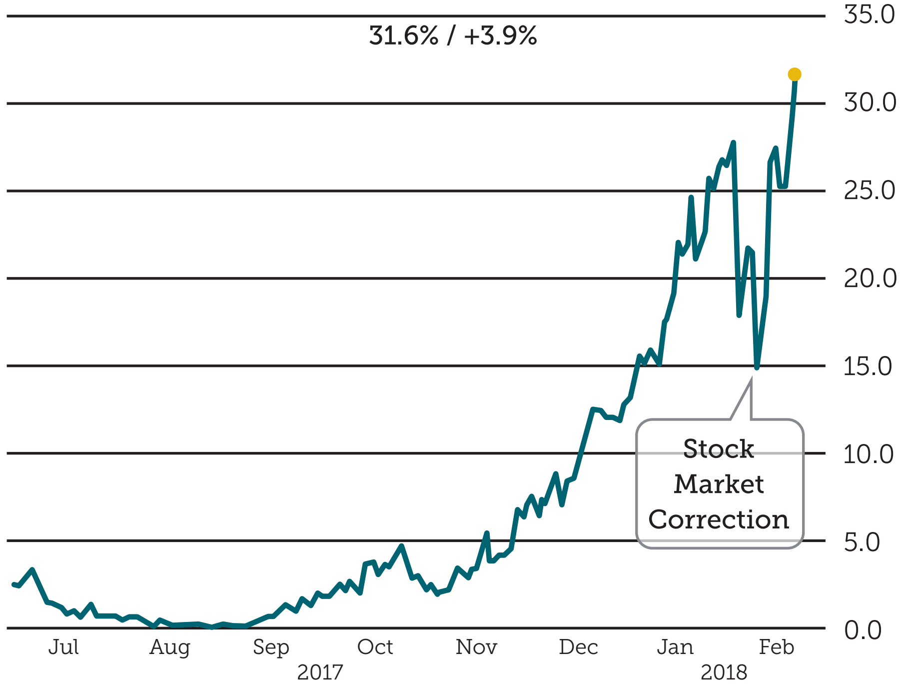
This section was provided by Senior Portfolio Manager, Marc Pfeffer.

Last week's somewhat uncertain, if not outright confusing, FOMC meeting minutes left the market on eggshells and sent long-term interest rates to their highest levels in four years. A number of Fed officials agreed the near-term outlook is mostly stronger, and most participants still expect that if economic growth remains moderate, labor markets will continue to tighten gradually.

On inflation, a few participants noted other measures provide additional evidence that inflation is approaching the committee's objective, while others disagreed. A majority said stronger growth makes further rate hikes more likely. The market's interpretation was a hike in March is a certainty, and the door is open for more than the widely expected three rate hikes this year.

As a result of the FOMC minutes, the futures-based probability of four or more U.S. rate hikes in 2018 climbed above 30% for the first time.

Probability of 4 (or more) Fed Rate Hikes in 2018



Source: Bloomberg

Financial markets will be all ears as new Fed Chair Jerome Powell addresses Congress on February 27. In light of the strong inflation readings in January, his comments may move markets sharply. The bond market has been especially jittery to start 2018. While Powell may not clarify anything, market participants are hopeful he will provide clues into his thinking. At a minimum, expect confirmation that more rate hikes are on the way, economic activity is on solid footing, and inflation is running higher. Comments on fiscal stimulus could be most telling and impactful. It should be interesting.

The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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