Zacks
INVESTMENT
MANAGEMENT

Q3 2016

Personalized Wealth Management

IN THIS ISSUE:

October 28, 2016

Mitch Zacks
Senior Portfolio Manager

Stocks continued edging higher in the 3rd quarter as Brexit fears faded and central banks maintained accommodative stances virtually across the board. The S&P 500 climbed +3.9% for the three months ending September 30 (with dividends reinvested), which places it up +7.8% for the year.

The rocky start to 2016 dissipated and equities have resiliently climbed the "wall of worry." At the outset of the year, we called for mid-single digit returns – not too hot, not too cold – as we believed that middling economic growth and an earnings recovery in the back half of the year would support prices. We remain confident in our forecast and believe that stocks could even nudge higher; the fourth quarter is historically strong for equities markets.

Perhaps the most interesting shift we saw in Q3 was a notable rotation from defensive/noncyclical sectors into cyclicals, foreign (particularly Emerging Markets), and small-caps. It doesn't require sophisticated analysis to see that investors were actively moving further out on the risk curve. This movement may have been driven by a variety of factors – renewed confidence in global economic growth, desire to accept additional risk for yield/return, and/or mean reversion (since cyclicals underperformed last quarter). Whatever the cause, it is a positive sentiment indicator and plays nicely for diversified portfolios that have broad sector, capitalization and international exposure.

The Election and the Economy

Many investors are concerned about the upcoming election, fearing the erraticism of the campaign season will weigh on stocks. As I wrote recently on www.SteadyInvestor.com, I believe the market will be less concerned with the candidate who wins and more concerned with their ability to govern. To gauge that, it is important to pay close attention to the 'undercard,' or the House and Senate races. If the outcome portends gridlock – where the executive branch is controlled by one party and Congress is split or controlled by the other party – that generally bodes well for stocks. A gridlocked government often means legislative risk is low as campaign trail policy promises will have to be watered-down to pass.

On the economic front, the final Bureau of Economic Analysis estimate for Q2 U.S. Real GDP established economic growth at an annual rate of 1.4%, up from 0.8% posted in Q1. This growth rate is consistent with our expectation for 2016 – middling and somewhat uninspiring. Many prognosticators love to hate this U.S. economic expansion, but growth is growth and stock prices respond in kind.

Currently, the U.S. has a two-sided economy. On one side, consumption is growing solidly, but on the other side non-consumption components of GDP are flat-lining or negative. Consumers have benefited from lower gas prices, historically low borrowing rates and solid employment gains. Household net worth is rising (though largely due to stock market advances) and debt payments, as a percentage of discretionary income, are at 30 year lows. In all, the consumer is quite healthy and appears poised to remain that way over the medium term.

Overseas, the impact of the Brexit vote continues to be negligible, at least from a market perspective. The British pound has tumbled over 10% versus the U.S. dollar and the euro since the June 23 vote. However, in the equity markets, the bigger players (UK, US, and Germany) have all experienced gains since the vote and worries about shattered trade deals and muddied relationships have receded. The market was likely responding to the fact that the process of Britain exiting the European Union would take years to complete and months to even begin. So, between now and then, the situation is largely status quo. Once the UK invokes Article 50 (which allows for voluntary leave from the EU based on a member nation's constitutional requirements), we expect sentiment to change.

Deutsche Bank: The Next Lehman Brothers?

Deutsche Bank (DB) has been in the doghouse for most of the year, starting with extremely weak Q4 2015 earnings and failed Fed stress tests. And, rumors have accelerated that the largest German bank – and a centerpiece of the European financial system – could be nearing a "Lehman moment." Following the recent U.S. Department of Justice (DOJ) announcement that it is seeking up to $14 billion in penalties from the German bank for falsely stating the risks of mortgage backed securities, fears mounted that the fine could send the bank belly-up – and take the global financial system down with it.

But, a closer look at Deutsche Bank's financials reveal it should be able to withstand this hit. Deutsche Bank has a €1.7 trillion balance sheet with about €220 billion in liquid reserves (as of the end of Q2), with high quality liquid assets totaling €196 billion. Consider that, in 2007 (before the financial crisis), it had €65 billion in liquid reserves. If it managed the worst financial crisis in history with less than half the reserves it has today, it should be able to manage a $14 billion penalty.

Of Deutsche Bank's liquid reserves, it has €5.5 billion set aside for litigation costs which, essentially, already covers half the fine. Rules also allow for Deutsche to raise €5 billion by issuing new stock without requiring shareholder approval, which would basically mean having enough cash needed to cover the DOJ's suggested fine. Being a German bank, Deutsche also has access to a lender of last resort in the European Central Bank, which Lehman Brothers did not have.

At this point, Deutsche Bank is preparing for the worst and has been cutting costs and exploring options to raise capital from additional share sales, asset disposals or both. It has currently secured backing from its largest investor and is seeking advice from other banks. We would not expect a capital raise until the actual fine is known, since the market will likely not be receptive to new shares without knowing the full impact on Deutsche Bank's capital position. But, interest in new shares has already been established as some of Germany's top industrial companies have revived a decades-old network to discuss taking a direct stake in the bank. Additionally, Qatari investors (who own the largest stake in the bank at ~10%) have indicated they do not plan to sell their shares and would consider buying more.

At the end of the day, it remains to be seen what the actual Department of Justice fine will be. In 2014, the DOJ sought $12 billion from Citigroup for the same allegations, but Citi ultimately knocked that number down to $7 billion. Additionally, some of the fines levied will be for consumer relief, which will mean forgiving loans or changing terms of loans for lower monthly payments. In essence, that means Deutsche Bank would not have to pay that amount and would just forego receiving this in the future.

Bottom Line for Investors

The risk of recession in the U.S. remains low and we continue to expect earnings to bounce nicely over the coming two quarters. The election looms in the background, but for investors it makes more sense to take a "wait-and-see" approach than to assume the worst without knowing the outcome. Stocks have performed largely in-line with our expectations this year and we believe that, with an earnings rebound and continued economic growth, multiples have room to move higher despite valuations being slightly greater than 20-year averages. Our outlook for stocks remains positive over the next six months.

All-Cap Core Strategy

In Q3 2016, the All-Cap Core Strategy returned +2.61% gross and +2.16% net. Its benchmark, the Russell 3000 Index, returned +4.40%, and the S&P 500 returned +3.85%. Zacks All-Cap Core Strategy ranks in the Top 7% out of 649 managers in the Morningstar All Domestic Equity Managers universe.

Investors were 'risk-on' in full force during the third quarter. Riskier cyclical sectors outperformed defensive indexes by a wide margin among all capitalization categories. Another risk category, small-caps, also exhibited stellar performance. The All-Cap Core Strategy maintained a defensive bias toward larger capitalization stocks throughout the quarter; one of the reasons it trailed the benchmark in Q3 as small and mid-cap companies led in performance.

Sectors contributing the most to portfolio performance were Information Technology and Industrials. Within Information Technology, Facebook and Microchip Tech were the largest contributors. Within Industrials, FedEx and A.O. Smith were the largest contributors to performance.

Sectors detracting the most from portfolio performance were Consumer Staples and Utilities. Within Consumer Staples, Hershey and Kroger were the largest detractors. Within Utilities, California Water Service and American Electric Power were the largest detractors to performance.

Dividend Strategy

In Q3 2016, Zacks Dividend Strategy returned +3.72% gross and +3.26% net; its dividend yield was 3.2%. The benchmark, Russell 1000 Value Index, returned +3.48%; its dividend yield was 2.6%. Zacks Dividend Strategy ranks in the Top 2% out of 945 managers in the Morningstar Large-Cap Value universe.

Weak economic growth in the U.S. and other developed countries persisted during the quarter and inflation stayed below central bank targets virtually across the board. In response, some central banks around the world increased their monetary stimulus (Bank of Japan and the Bank of England), some kept their easy policies in place (European Central Bank) and the Federal Reserve lowered its expectations for the pace of future rate increases.

On the Emerging Markets front, economic growth appeared stable over the quarter, led by China. This kept commodity and energy prices largely stable and allowed for increased risk appetites for investors hoping for stronger global economic and corporate profit growth. Equity markets responded favorably with strong returns for the quarter.

In the ‘large value’ space, Technology, Industrial, and Financial stocks outperformed over the quarter. Utilities, Consumer Staples, and Health Care underperformed. Our tactical decision to overweight Technology and underweight Utilities supported relative performance. Our overweight in Consumer Staples curbed relative performance.

If the Federal Reserve maintains their measured and market-friendly approach to raising interest rates, the UK and European Union manage an orderly separation, and the U.S. maintains growth momentum, then the market should do well in the coming months. We believe the strategy should continue to produce attractive returns.

Finally, due to the tax-advantaged nature of the dividend payments, as well as a more attractive yield of 3.2% in Q3 2016 compared to the 10-year US Treasury yield of 1.59%, we believe the strategy remains well-suited for investors seeking moderate growth and income.

International Strategy

In Q3 2016, Zacks International Strategy returned +6.09% gross and +5.63% net, while the benchmark MSCI EAFE returned +6.50%. Year-to-date (as of 9/30), the strategy has outperformed the benchmark, having returned +4.27% net versus the EAFE's lesser +2.20%.

We rebalanced the strategy in March and most of our tactical investment calls in developed markets have played out nicely. We sold Italy (EWI), Spain (EWP) and Israel (EIS) country ETFs which have returned -17.51%, -3.16% and -1.63%, respectively; these returns are for the year ending 9/30 and measured in U.S. dollars. Among the countries where we increased weight, Australia (EWA) is up +11.8%, New Zealand (ENZL) +26.59%, and Austria (EWO) is up +6.18%. These tactical rotations have benefited the strategy.

Among the major asset classes, Emerging Market Equity (EEM) has been a stellar performer this year after underperforming for several years. Year-to-date, ending 9/30/16, EEM returned +17.25% while Developed Market countries, as measured by EFA, rose by a much lesser +2.20%. Our allocation to Emerging Market countries helped drive performance for the strategy; those that stood out were Indonesia (EIDO, up +28%) and Chile (ECH, up +17%).

Focus Growth

In Q3 2016, Zacks Focus Growth Strategy returned +5.42% gross and +4.96% net outperforming its benchmark, the Russell 1000 Growth index, which returned +4.58%. Zacks Focus Growth Strategy ranks in the Top 1% of 1,076 managers in the Morningstar Large-Cap Growth universe.

During the quarter, most market participants expected the Federal Reserve to slow the pace of rate hikes which drove investors to high dividend stocks. However, Information Technology emerged as the leading sector in the quarter, outperforming all others by a fairly wide margin. The Consumer Discretionary, Basic Materials, and Retail sectors also contributed to the portfolio's positive return.

The Health Care and Consumer Staples sectors underperformed, as investors shifted to 'risk-on' mode following the Fed's interest rate policy guidance; our exposure to these sectors curbed relative performance. Other sectors, including Finance, Utility and Transportation, had a mostly neutral impact on the portfolio.

The third quarter was the first this year to see net positive cash flow into growth stocks, though most investors remain underweight to growth stocks in asset allocations. Strong economic data reaffirms our conservative optimism that investors will shift their focus more to growth fundamentals of each company, as Fed policy becomes clearer later this year. We are devoted to preserving the organic growth of the portfolio with a prudent valuation discipline.

Mid-Cap Core Strategy

Zacks Mid-Cap Core Strategy returned +3.41% gross and +2.96% net in Q3 2016. Its benchmark, the Russell Midcap Index, returned +4.52%. Zacks Mid-Cap Core Strategy ranks in the Top 3% out of 357 managers in the Morningstar Mid-Cap Blend universe.

Mid-cap stocks significantly underperformed small-caps, but outperformed large-caps during the quarter. The persistence of accommodative central bank monetary policies, along with the stabilization of commodity prices, drove investors to seek riskier smaller-cap companies.

The Mid-Cap Core Strategy was overweight to the outperforming Technology sector which supported relative performance. Still, the strategy was underweight to two outperforming sectors, Energy and Industrials, and overweight to the underperforming Consumer Staples and Financial sectors. These weightings hindered relative performance.

If U.S. economic growth accelerates, then growth-sensitive small and mid-cap stocks could continue experiencing strong relative gains. Mid-cap stocks in particular could benefit from investors deflecting risks associated with small-cap stocks, but who at the same time wish to pursue higher growth potential than they might see in large-cap stocks.

Market Neutral Strategy

Zacks Market Neutral Strategy delivered a strong third quarter producing positive excess return with minimum volatility. In the previous quarter, major sector contributors were Capital Goods and Basic Materials. These sectors showed continued strength in the third quarter, though Technology and Consumer Cyclicals were leading drivers of alpha (risk adjusted return) in both our long and short picks. Conversely, Consumer Staples, REITs and Utilities hindered performance, mainly from our long positions. The Health Care and Energy sectors were neutral in terms of overall performance.

Equity markets have expected ‘no action’ from the Fed on rate hikes resulting in a ‘pricing-in’ of this pending development. That sentiment drove asset prices upward across the board, dramatically reducing the dispersion within sectors. Additionally, we continue to witness notable merger and acquisition activity. These issues pose challenges for the Market Neutral Strategy, however the strategy successfully overcame these difficulties. In the coming quarter (in which a Fed rate hike is highly anticipated), we expect the stock market will be more sensitive to economic signals and central bank comments. We will stay cautious and closely monitor the portfolio with discipline.

Small-Cap Core Strategy

Zacks Small-Cap Core Strategy returned +3.02% gross and +2.56% net in Q3 2016. Its benchmark, the Russell 2000 Index, returned +9.05%. Zacks Small-Cap Core Strategy ranks in the Top 14% out of 661 managers in the Morningstar Small Blend universe.

During the quarter, market sentiment shifted on expectations of continued “easy” monetary policy from the Federal Reserve. This, along with an unexpected increase in optimism that drove ‘betting’ on near term corporate profits recovery and stabilization of commodity prices, increased investors’ appetite for risk raising valuations in small-cap companies. In many cases, this type of unexpected shift in valuation tolerance by investors can precede the eventual confirmation by Wall Street analysts. Because the Small-Cap Core strategy uses a model driven by analysts’ estimate revision metrics, the strategy lagged the broader market’s small cap rally.

Should U.S. economic growth accelerate from here, then growth-sensitive small-cap stocks could continue to see strong gains.

Quantitative Strategy

In Q3 2016, Zacks Quantitative Strategy returned +5.03% gross and +4.58% net, outperforming its benchmark, the S&P 500, which returned +3.85%.

During the quarter, global political uncertainty increased, particularly in the wake of Brexit. Populist movements gained traction in parts of Europe, though the risk of full-scale political upheaval appears low (for now). The continued dovish tone of central banks, however, helped neutralize any legitimate market impact. Investors encouraged by “lower for longer” interest rates, and stabilizing commodity prices, sought increased risk and return which was reflected in allocations of total assets. This led to outperformance of cyclicals and assets further out on the risk curve, like small-cap stocks.

This ‘risk-seeking’ sentiment benefitted Zacks Quantitative Strategy, as we valued the true earnings growth potential for stocks. Growth-centric sectors outperformed value sectors nearly across the board. This was particularly true for Technology, which saw the strongest relative performance of any sector in the quarter. The Consumer Discretionary and Health Care sectors also saw solid performance, aided by rotation into cyclicals and from an uptick in merger and acquisition activity. The Consumer Staples and Utilities sectors were the most challenged sectors in our portfolio, followed by retail and wholesale, reversing their strong performance trend since the beginning of the year.

By end of Q3, the market recovered from the near-term economic impact of Brexit, and we believe investors will see a relatively quiet market prior to the U.S. presidential election. This may change when the election is decided, and emboldened by the likelihood of an interest rate hike at year end. It will be critical to weigh the impact of the events as they unfold and take appropriate portfolio action where necessary.

Fixed Income Strategy

Interest rates bounced off the lows of the year as investors digested hawkish statements by a few Fed Governors, and as stronger economic data accompanied improving investor sentiment following the Brexit vote.

The Fed remained on hold during their July and September meetings and did not raise rates, once again kicking the proverbial can down the road. While the July meeting results were as expected, due to global market volatility at that time, the decision not to raise rates in September was a mild surprise. Like us, the fed funds futures market is still expecting one interest rate hike this year, most likely in December. Both inflation and employment figures are running close to the levels that the Fed indicated would prompt raising rates. However, the Fed has continually found reasons to stay put, with political and economic uncertainty around the globe and sluggish U.S. GDP growth the 'excuses du jour.' Increasingly, central bankers are realizing the limitations of monetary policy and are calling for fiscal reforms to boost global growth.

While the Fed has stayed on the sidelines, a stealth tightening has been underway. The 3-Month Libor rate (which effects quite a bit of floating rate debt) has been up sharply over the past three months. The rate jumped from 0.65% at the start of the quarter to 0.88% currently, mostly in anticipation of the money market reform regulations that would go into effect on October 14, 2016. In a nutshell, the regulations require money market funds that invest in non-US government securities to allow their net asset value (NAV) to float with the value of their underlying holdings; previously, they were fixed at $1.00 per share. This regulation has caused, by some estimates, almost $1 trillion in assets to move from prime money market funds to government money market funds where the NAV will stay at $1.00. Banks, which had been using the money market funds as a source of funding, now have to offer higher short-term rates to entice investors. Libor, which is the bank's short term borrowing rate, has gone up as a result.

How does this impact you? If you have an adjustable rate mortgage or student debt, where the interest rate is based on the Libor rate, your monthly interest payment has likely risen. A year ago, the Libor rate stood at 0.32%. So, the interest rate on your debt has gone up by 0.50% over the past year, while the Fed has only raised rates once.

The 2-Year Treasury bond ended Q3 with a yield of 0.76%, up from 0.58% at the beginning of the quarter. The 10-Year Treasury bond ended Q3 with a yield of 1.59%, up slightly from 1.47% at the start of the quarter. Still, yields are lower than where they began the year. The yield curve has started to show signs of steepening. Sovereign bond rates of developed countries have increased recently, though a good majority of them are still yielding lower than U.S. Treasuries.

We continue to favor investment grade corporate bonds over Treasuries for yield, as the risk reward scenario still looks favorable in this space. Year-to-date issuance remains strong (+7% over 2015), as investors continue the search for yield, though spreads have tightened slightly. Increasingly, corporations have been borrowing at low rates to fund dividend payouts and buybacks, pushing share prices higher. We fear this cannot continue much longer without companies generating higher earnings and cash flows, as the debt will come due at some point and companies may not be able to refinance at attractive rates. Interest coverage ratio is one of the key financial data points we are using as we select corporate bonds.

The municipal bond market is on track to have a record yearly issuance of new debt, as municipalities take advantage of low yields and refinance their old, higher interest-paying debt. While that is good news for residents of the municipalities (lower expenses), it is at the expense of investors (lower yield). Property values and taxes continue to stabilize. The taxable equivalent yields are still very attractive for investors in higher tax brackets. We remain cautious on states and localities with poor fundamentals, such as Illinois.

While rates have moved upward recently, we do not expect a continued sharp increase in yields. Short-term rates are going to be affected by the actions of the Federal Reserve. Intermediate and longer-term bonds carry both duration and credit risk. If earnings and internally generated cash flows are not as strong as expected, credit spreads will widen, undercutting performance of corporate bonds. However, if international bond yields remain at their current levels, any increase in U.S. bonds yields will make U.S. bonds highly attractive to investors, thus potentially capping any major yield increases.

We continue to favor corporate and municipal bonds over Treasuries. Review of credit quality and managing duration risk remain keys in our selection methodology.

Disclosure

DISCLOSURE Past performance is no guarantee of future results. Results for Zacks Strategies ("Strategies") are shown both gross and net of fees. Results for the Strategies reflect the reinvestment of dividends and other earnings. The results portrayed are the performance history of a single representative managed separate account that ZIM believes is representative of client accounts invested in the Strategy. A representative account must meet the following ZIM criteria to be selected: 1) there are no restrictions placed on the account, 2) ZIM has discretionary authority over the account, 3) the account has no capital additions and withdrawals and 4) dividends are reinvested. If the single representative account in use no longer meets ZIM selection criteria, ZIM will replace the representative account with another that meets the above ZIM selection criteria.

Prospective clients and clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the Strategies during the period. Clients of the firm may receive different performance than the representative account. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), and client-mandated investment restrictions. Wholesale, retail and institutional clients of the firm may have differing performance due to timing of trades.

Investments in the Strategies are not deposits of any bank, are not guaranteed by any bank, are not insured by FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested. Net of fees performance is based on the maximum fee of 1.75% for a $500,000 account. Lower fees may apply to larger accounts; higher fees may apply to smaller accounts. Separately managed account minimums apply. Inherent in any investment is the potential for loss. Standard management fees are available on request and are described in Part 2A of Form ADV.

Morningstar Rank:

The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile as of 06/30/16. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.

Zacks
INVESTMENT
MANAGEMENT

Indexes Presented:

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. An investor cannot invest directly in this Index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 2000 Index is a well-known, unmanaged index of the prices of 2000 small-cap company common stocks, selected by Russell. The Russell 2000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell Mid Cap Index is a well-known, unmanaged index of the prices of approximately 800 mid-cap company common stocks, selected by Russell. The Russell Mid Cap Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Value Index is a well-known, unmanaged index of the price of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 3000 Index is a well-known, unmanaged index of the prices of 3000 broad U.S. equity company common stocks, selected by Russell. The Russell 3000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The MSCI EAFE is an index from Morgan Stanley Capital International. The MSCI EAFE is a well-known, unmanaged index representing developed nation countries around the world. The MSCI EAFE Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Zacks Investment Management may utilize mutual funds in some client portfolios. Zacks Investment Management is the advisor to these funds and will receive compensation from the funds and their shareholders for advisory services. Additional information is available upon request.