YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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Michael Majhanovich & Doran James
Wyoming Wealth Management
2620 Commercial Way Ste 100
Rock Springs, WY 82901
307-382-1177
Fax: 307-382-1133
kathy.hickman@lpl.com
wyomingwealthmanagement.
org

In This Issue

Bond Market Perspectives | Week of September 11, 2017

Key Takeaways

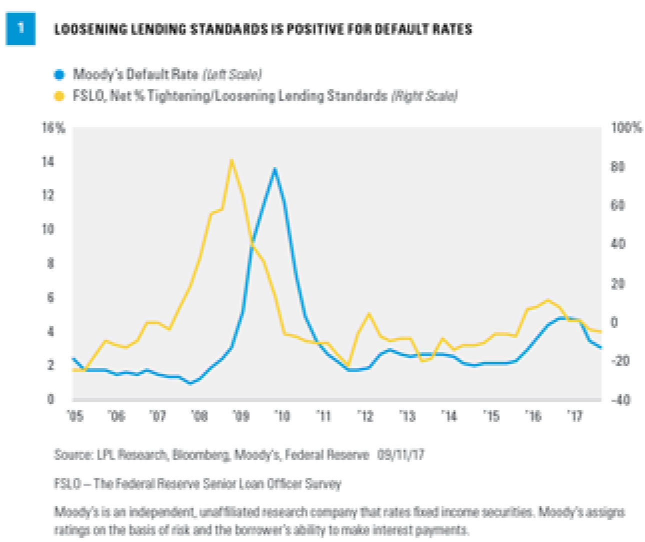
- Recent bank lending standards data provide further support for high-yield fundamentals.
- Spreads have widened since July lows, as high yield expressed caution regarding geopolitical tensions.
- Valuations are near fair value, given forward-looking default estimates.

High Yield: Finally Near Fair Value

High-yield fundamentals remain stable and leading indicators of default continue to improve, helping to corroborate the lower default expectations currently projected by rating agencies. Given the positive economic backdrop, default forecasts, and the widening of spreads over the last six weeks, we believe the high-yield market is priced near fair value and anticipate further stability assuming no new risks are introduced.

EASING LENDING STANDARDS

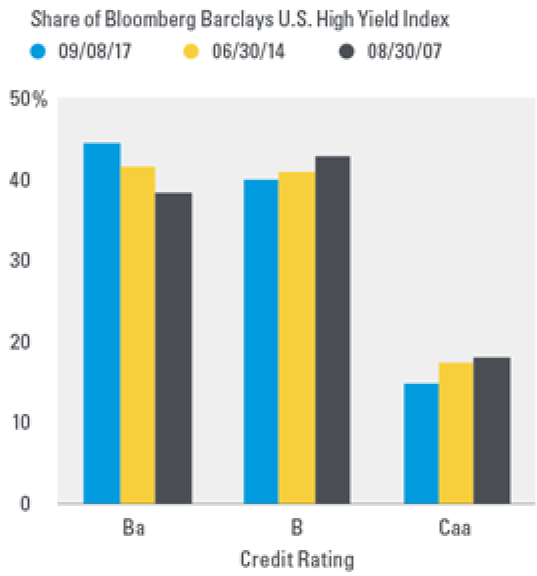
Defaults are declining and appear to be confirming the lower default forecasts for 2017 made by rating agencies early in the year. Forward-looking indicators also appear to be endorsing this sense of optimism. The Federal Reserve Senior Loan Officer Survey (FSLO) indicates whether banks are tightening or loosening lending standards for medium- and large-sized companies. The FSLO has historically been a good leading indicator of default rates [Figure 1], as it stands to reason that companies that can get a new loan will generally not default on an old one. As the modified adage goes, "a rolling loan gathers no loss." As of July 31, 2017, banks were loosening lending standards on a net basis even more quickly than in the previous reading on April 30, 2017, which was the first net loosening since July 2015.



CREDIT QUALITY ALSO ACCOUNTS FOR TIGHT SPREADS

In addition to relatively positive fundamentals for high yield, improved overall market credit quality may also warrant tighter spreads than seen historically. The U.S. high-yield market is higher in quality than during recent spread lows in mid-2014 and even more so than the market 10 years ago [Figure 2]. The highest-rated portion of the high-yield market represents over 6% more of the market than it did 10 years ago. All else equal, a higher rated market should require less additional compensation from investors, potentially contributing to spreads below historical averages.

2 HIGH-YIELD MARKET IS HIGHER QUALITY THAN IN THE PAST 10 YEARS



Source: LPL Research, Barclays 09/08/17

Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issuer's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

WHAT'S FAIR VALUE?

Although it is impossible to know precisely what the "fair value" is, certain assumptions can be used to gauge how tight spreads are relative to other critical indicators within the market. Using forecasts of the coming year's default rate and assumptions of recovery rates in the event of a default, we can estimate what will be lost in total due to defaults in the market. Adding in a historically derived "liquidity premium," which reflects the risk that a bond cannot be traded quickly without materially impacting the market price, can help approximate fair value for high-yield spreads.

For the first time this year, the market is currently somewhat on the cheap side of our fair value estimate (assuming default forecasts prove accurate). Per Moody's, the high-yield default rate was 3.1% at the end of July 2017, and is expected to fall to just 2.2% in July 2018 on a trailing 12-month basis. The current spread already more than compensates investors for the default risk over the next year, including the liquidity premium [Figure 3]. However, a change in variables, such as lower than expected recovery rate on defaults over the next year, could shift the estimate materially.

3 HIGH YIELD PRICED NEAR FAIR VALUE

Forecast Default Rate		Estimated Default Loss*		Total Default Loss		Liquidity Premium**		Fair Value Spread		Current Spread
2.20%	x	65%	=	1.43%	+	2.20%	=	3.63%	VS.	3.81%

Source: LPL Research, Moody's, Barclays, Bloomberg 09/11/17

*Par value minus 35% estimated recovery rate. Par value is the nominal value of a bond, share of stock, or a coupon as indicated in writing on the document or specified by charter.

**High-yield spreads compensate investors not only for default risks but for liquidity risk, which can be termed the "liquidity premium." Liquidity risk is the risk that a bond cannot be traded quickly without materially impacting the market price.

RISK RELATIONSHIPS

Equity markets, however, remain a key driver of high-yield performance going forward. Spreads are still tightly correlated with equity market movements. High yield will not behave like high-quality fixed income, especially in times of market stress. Generally speaking, high-quality bonds protect against equity market weakness while high yield participates in that weakness. This is a double-edged sword, however, and given healthy market fundamentals, high yield should be poised to perform well if equity markets continue to rise.

CONCLUSION

The July reading for the FSLO, which showed a further net loosening of lending standards by banks, is a good indicator of fundamental strength within high yield, and corroborates the tight spreads within the market. Valuations are finally near fair value, and potentially slightly cheap given optimistic default forecasts, leading us to maintain our expectation for high-yield stability over the remainder of 2017, absent an equity market sell-off.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DEFINITION

The Bloomberg Barclays High Yield Bond Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment grade or high yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, and Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be U.S. dollar denominated and nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

RES 6044 0917 | Tracking #1-640778 (Exp. 09/18)

Weekly Market Commentary | Week of September 11, 2017

HIGHLIGHTS

- After years of disappointment, European earnings have been solid.
- Stronger earnings may have changed the valuation equation with respect to global asset allocation.
- Currency still matters, both for corporate earnings as well as for translation into dollars for U.S. investors.

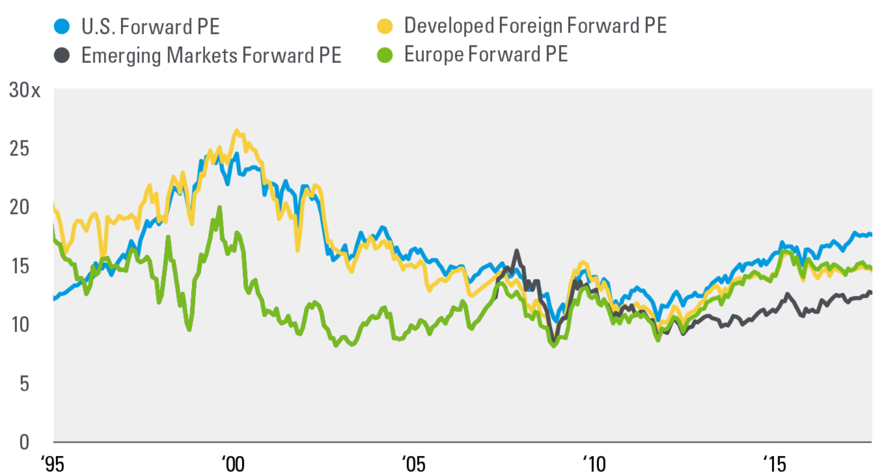
STRONG EUROPEAN EARNINGS ARE KEEPING EUROPE CHEAP

After years of diminished earnings ended in the third quarter of 2016, European companies have begun seeing sustained growth in their bottom lines. Ultimately, earnings drive stock prices, but the market is always trying to look forward; having strong earnings is not enough if the growth is fully priced in. That is the fundamental question with regard to stock market valuation--what are you paying for future earnings? Solid earnings in Europe are keeping price-to-earnings ratios (PE) static, while PEs on domestic stocks have been rising. This makes European equities increasingly attractive; however, currency remains a concern, as much of the recent performance of European stocks has been due to a strong euro relative to the dollar.

IT'S WHAT YOU PAY THAT COUNTS

Two things determine stock prices: how much money a company earns, and the multiple of those earnings investors are willing to pay, i.e. the PE ratio. When we consider international investments, we have to be careful when comparing the PE ratio of one country's or region's stock market to another. For any number of reasons, some countries could systematically trade at higher or lower valuations than others. From the early 2000s until the beginning of the Great Recession, European stocks were consistently cheaper than U.S. stocks based on their PE ratio **[Figure 1]**. As the economy and financial markets recovered, U.S. and European stocks begun trading at nearly the same valuation.

1 STRONG EARNINGS SUPPORT EUROPEAN VALUATIONS



Source: LPL Research, FactSet 09/08/17

Indexes: S&P 500, MSCI EAFE, MSCI EM, MSCI Europe

The price-to-earnings (PE) ratio is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Forward price-to-earnings (PE) is a measure of the PE ratio using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

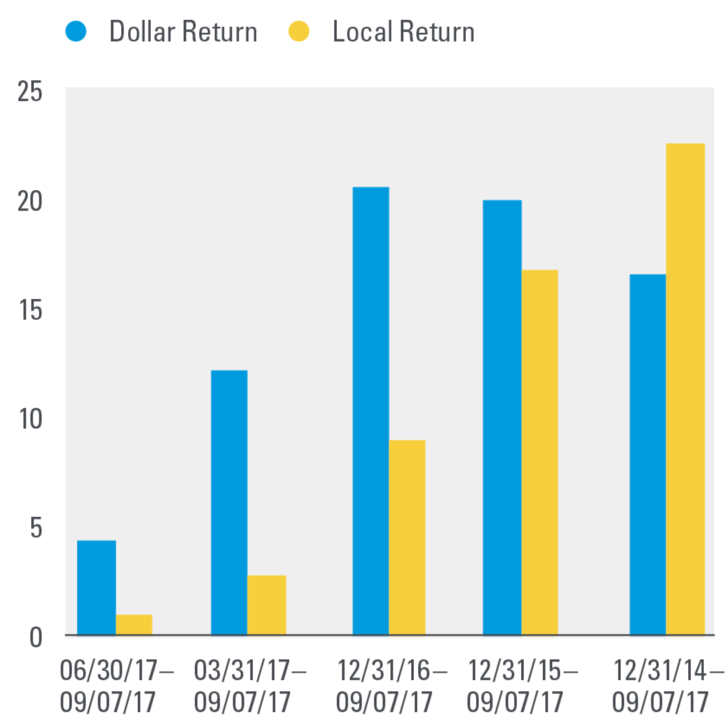
More recently, a different dynamic has surfaced within the United States. U.S. stocks, as represented by the S&P 500 Index, have become more expensive; that is, the aggregate price of domestic stocks has increased faster than their earnings. That has not been the case with European equities, whose valuations have been essentially unchanged for the past two years. More importantly, the PE has been stable for the right reason--earnings have been increasing. During the past 12 months (through August 31, 2017), earnings for European companies have increased over 25%, with further earnings growth expected for the rest of this year.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

HOW YOU PAY COUNTS AS WELL

Some observers may note that European stocks appear strong this year and wonder if they missed the rally. But we don't think so because the real rally has not been in European stocks, but in European currencies, particularly the euro. When we look at the returns on European equities for investors in Europe who do not benefit from the changes in currency, returns are less impressive **[Figure 2]**. In fact, they have been less than 9% year-to-date in local currency. On the positive side, this is why we are not seeing valuations increase in Europe--the performance has been driven as much by the currency and it has by strong earnings.

2 EUROPEAN PERFORMANCE DRIVEN BY WEAK DOLLAR



Source: LPL Research, Bloomberg 09/08/17

Return is total return of MSCI Europe Index, annualized for periods greater than one year.

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Though it clearly benefits those who invest in a non-native currency to have that currency appreciate, there is also a potential downside. One is that the currency market could reverse, and what had been adding to underlying stock returns becomes a detractor.

Another fear, one that was expressed during the European Central Bank's meeting on July 20, 2017, is that the strong euro may be eroding the competitiveness of European companies. When a company resides in a country with a currency that is too strong, it may suffer when competing against companies from weaker currency countries. It is estimated that on average about 50% of European companies' sales come from outside of Europe. So while the rising euro has benefited U.S. investors in Europe, the euro's strength may hinder the profit growth that makes investing in the region so attractive in the first place.

DOES EAFE COUNT ANYMORE?

According to Figure 1, in the late 1990s there was a great difference in the PE ratio of the MSCI EAFE and Europe indexes, and these two essentially converged over time. For most investors, the EAFE Index, which stands for Europe, Australasia, and the Far East, is the primary benchmark for developed market international investing. In practice, this index is made up of over 60% European and 23% Japanese stocks. In the late 1980s these percentages were nearly reversed; however, the Japanese stock market peaked on December 29, 1989, and is still down some 50% since then. We believe that investors making tactical asset allocation decisions should consider focusing on these regions separately, and not necessarily combine them into one all-encompassing asset class.

CONCLUSION

The improvement in earnings and valuations is causing us to warm up on European equities. However, there remains real risk. Currency markets can be volatile, and the gains made by currency this year can reverse just as quickly. We don't expect that to happen, but we are always more cautious when recommending international investments and need to have relatively high conviction that there is some additional reward to compensate for taking the additional risk. When looking at Europe, we see several positives, including an improving economy, good earnings growth, and the recent success of mainstream political movements relative to more extreme movements on the right and the left. However, the region still has vast political challenges, including Brexit, as well as the anticipation of change in monetary policy, that still warrant a degree of caution.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

The fast price swings in currencies will result in significant volatility in an investor's holdings. Tactical allocation may involve more frequent buying and selling of assets. Investors should consider the tax consequences of moving positions more frequently.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI EAFE Index is made up of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in U.S. dollars.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The MSCI Europe Index is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

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IRAs: Who's Contributing Today?

IRAs account for nearly half of all assets in private sector retirement plans, far exceeding monies held in either defined benefit or defined contribution plans.

When traditional IRAs were introduced more than four decades ago, the federal government sought to give individuals without access to an employer-sponsored retirement plan a way to save for retirement in a tax-advantaged manner. Fast-forward to today, and IRAs account for nearly half of all assets in private sector retirement plans, far exceeding monies held in defined benefit and defined contribution plans.[1]

Retirement Assets by Plan Type -- Q3 2016

Defined Benefit Plans	Defined Contribution Plans	IRAs
$3.3 trillion	$5.7 trillion	$7.8 trillion

Sources: The Center for Retirement Research at Boston College and the U.S. Board of Governors of the Federal Reserve Systems, *Flow of Funds Accounts* (2016).

Yet even though more than one-third of American households -- some 43 million -- now own IRAs, just 14% of all U.S. households contributed to an IRA in 2015. Instead, the vast majority of assets held in IRAs come by way of rollovers from employer-sponsored retirement plans.

Who's Using IRAs?

With rollover assets dominating the IRA landscape, the real question becomes: Who is contributing to an IRA today? To help answer this question we turn to recent research published by The Center for Retirement Research at Boston College (CRR). The CRR compiled key demographic and financial data about IRA owners who contribute to their accounts versus those who do not.

Among other discoveries, the report revealed that IRA contributors are more likely to be white, college educated, married individuals in two-earner households. IRA contributors are also more likely to contribute to a 401(k) account (in addition to an IRA) and have higher household earnings that non-contributors.

Characteristics of IRA Owners by Contribution Status, 2011
(Ages 25-70)

Characteristic	Not Contributing	Contributing
Demographic		
White	68%	86%
College or more	33%	61%
Average age	45	47
Marital status		
Single	30%	26%
Married, one earner	39%	35%
Married, two earners	31%	39%
Employment and financial		
Currently participates in a 401(k)	30%	53%
Average household earnings	$70,197	$110,523
Self-employed	9%	14%

Sources: The Center for Retirement Research at Boston College. Authors' calculations from U.S. Census Bureau *Survey* *of Income and Program Participation*, 2008 panel.

Find Your Match

The researchers further broke down the data, creating three prominent subgroups within the IRA contributing population.

1. Dual-income super savers -- Married couples in two-income households that frequently also contribute to an employer-sponsored retirement plan. This group is motivated to save beyond their 401(k)s and is attracted by the tax benefits of IRAs.

2. Frugal breadwinners -- Either single individuals or one-earner married couples in the middle-income range that also tend to participate in an employer's retirement plan. This group could be described as thrifty and knowledgeable about the income requirements of retirement.

3. Successful entrepreneurs -- Higher-income, self-employed individuals who are not currently contributing to a 401(k). This group uses IRAs as an alternative vehicle to an employer plan to save for retirement.

Keep in mind that with just 14% of American households contributing to IRAs, these groups represent a very small minority of the population. As for IRAs, they continue to serve primarily as repositories for assets accumulated in employer-based plans -- not as the tax-advantaged retirement savings vehicles intended for those individuals without access to a workplace plan.

[1]*The Center for Retirement Research at Boston College, "Who Contributes to Individual Retirement Accounts?" April 2017, Number 17-8.*

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