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

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Bond Market Perspectives | Week of March 20, 2017

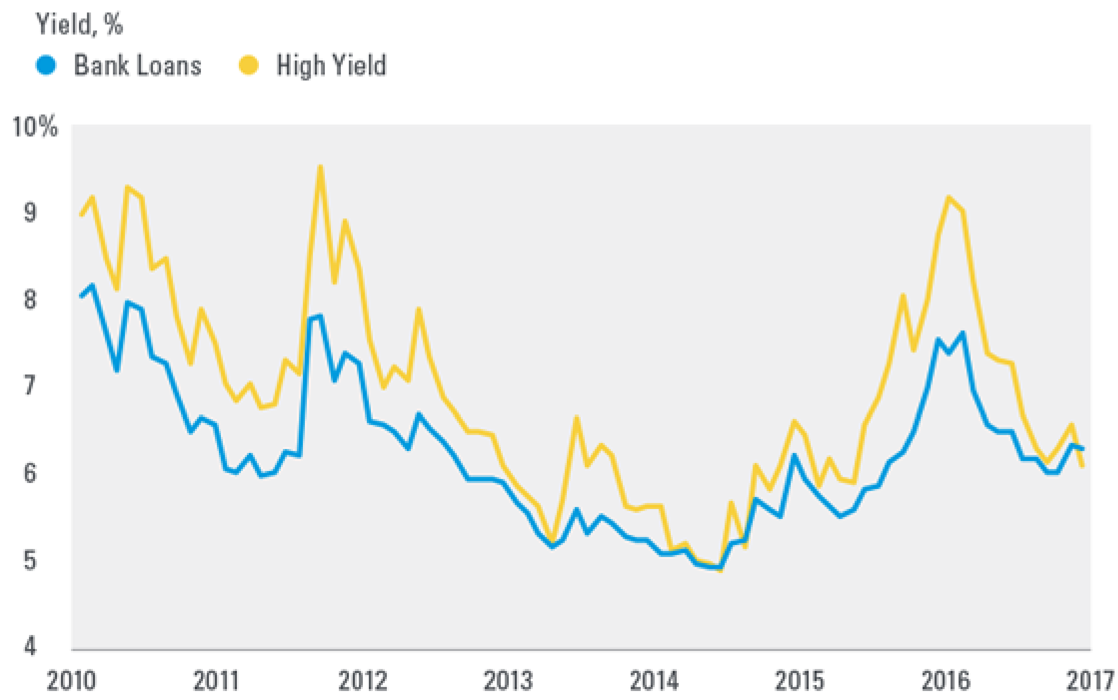
Highlights

- Bank loans may be positioned well for today's environment of gradually higher trending short-term interest rates.
- Bank loans' senior position in the capital structure has shown value in the form of higher historical recovery rates relative to high yield.
- Despite the optimistic outlook, bank loans are below investment grade, still exhibit credit risk, and should not be viewed as a replacement for high-quality fixed income.

Bank Loans Check In

Bank loans may be positioned well for today's environment of gradually higher trending short-term interest rates. Bank loans and high yield have much in common. Both represent debt of riskier companies, thus both carry higher credit risk for which investors are compensated with additional yield. One way to help gauge the relative value between bank loans and high yield is to examine the yield differential between the two sectors. High yield has usually enjoyed a yield advantage to bank loans. However, that trend has reversed as of late with bank loans generating a greater yield to end 2016 [Figure 1].

1 BANK LOANS OUT-YIELD HIGH YIELD FOR FIRST TIME SINCE 2014



Source: LPL Research, Bloomberg 03/20/17

Indexes shown: Bloomberg Barclays Capital High Yield Index, Credit Suisse Leveraged Loan Index.

Indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

CAPITAL STRUCTURE: HIGHER IS BETTER

In the event of a default, bank loan investors have historically recouped more of their money, relative to high-yield investors. Default forecasts for below-investment grade fixed income are quite good for 2017, with rating agencies forecasting a 3.0-3.5% high yield default rate at the end of this year and slightly lower for bank loans. Despite this optimistic outlook, defaults generally become more important to credit-focused investors later in the business cycle (see our *Recession Watch Dashboard* for where we are currently in the business cycle), when defaults start to materialize. Just as important as the overall rate of default is the recovery rate. The recovery rate is the overall percentage of capital that is recovered and returned to investors in the event of a default. An important difference between bank loans and high yield is the debts' place within the capital structure. Bank loans are senior-secured debt, meaning that these loans have a first lien claim on specific assets belonging to the corporation. This helps provide added protection in the event of bankruptcy. They also generally include contractual covenants like control of cash flows, maintenance of certain financial ratios, etc., which can help to protect investors further. The impact of this can be seen in the differential in recovery rates, historically about 80% for bank loans, while high yield has been about half that, near 40%.

ENERGY: A LINGERING CONCERN

As we discussed in our recent *Bond Market Perspectives*, "Happy Anniversary High Yield and Oil," the price of oil is still an important driver of high-yield performance. That has been a boon for investors ever since mid-February 2016, as oil's recovery has led to high yield's dramatic performance year. High-yield investors were reminded of the other side of that coin recently as oil traded below $48/barrel for the first time since November 28, 2016, with corresponding weakness in high-yield bonds. Investors who are skittish about oil's influence on high-yield performance can take some solace in the fact that bank loan indices have far less exposure to energy than high yield indices do. As of February 28, 2017, the energy sector represented about 14% of the overall high-yield market, but just 3% of the bank loan market.

INTEREST RATE SENSITIVITY

Both high yield and bank loans tend to outperform higher-quality sectors in rising rate environments, but sometimes for different reasons. Generally, rising interest rate environments are ones in which growth and inflation rates are picking up due to improving economic conditions. High yield has historically outperformed higher-quality fixed income in those periods, partially due to its lower interest rate sensitivity. Importantly, some of the outperformance is attributable to high yield's equity-like performance characteristics. Improving economic fundamentals usually translate to lower default rates and investors thus require less additional compensation above and beyond the yield offered by high-quality fixed income (spread tightening). Bank loans tend to do well in those environments too, partially because of their similarly economically-sensitive nature, but also due to the floating rate coupons on the bank loans themselves. Bank loans are sometimes referred to as "floating rate securities" because their coupon payments are tied to a reference rate like 3-month London Interbank Offered Rate (Libor, a global market-determined reference rate). Libor generally moves with other short-term rates, thus when short-term rates rise, coupons rise, creating a tailwind for the bank loan sector relative to high-quality fixed income [Figure 2].

Click here for Figure 2: Rise in Libor Has Been a Tailwind for Bank Loans

CREDIT RISK IS STILL SIGNIFICANT

In times of economic (and equity market) weakness, the higher recovery rates of bank loans can aid in performance, but significant credit risk still exists within the asset class. Like high yield, the asset class is below-investment grade and should not be misconstrued for high-quality fixed income. Despite a lower historical standard deviation than high yield, bank loans will nonetheless generally share similar equity-like performance characteristics. This is especially evident in sharply down, or up, years for equity markets, when bank loans and high-yield performance bear little resemblance to high-quality fixed income [Figure 3].

3 **BANK LOAN PERFORMANCE CAN VARY FROM HIGH-QUALITY FIXED INCOME DRAMATICALLY**

Source: LPL Research, Bloomberg 03/20/17

Past performance is no guarantee of future results.

Indexes: High Yield shown is Bloomberg Barclays Capital High Yield Index; Bank Loans shown is S&P U.S. Leveraged Loan 100 Index Total Return.

Indexes are unmanaged and cannot be invested into directly.

As the performance in Figure 3 indicates, bank loans have the potential to be a good yield enhancer for portfolios or a good alpha generation tool relative to the high-quality Bloomberg Barclays Aggregate benchmark. However, large positions in lower-quality fixed income can be a double-edged sword: alpha generation in good times, but increased potential for downside risk in bad times. Investors should understand their own tolerance for risk, and just as importantly, think critically about the goals of their fixed income allocation.

CONCLUSION

We believe the absence of a recession in 2017 would bode moderately well for lower-quality fixed income. Low forecast default rates and relatively stable lending conditions mean that absent an unforeseen shock to the market, low-quality, below-investment grade fixed income may enjoy a good year, mostly driven by the yield component of return. Within lower credit quality fixed income, we maintain a slight preference for bank loans over high yield due to the potential for higher yields, seniority in the capital structure, and lower interest rate sensitivity.

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.

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.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Credit quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

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.

Standard deviation is a historical measure of the variability of returns relative to the average annual return. A higher number indicates higher overall volatility.

Alpha measures the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive/negative alpha indicates the portfolio has performed better/worse than its beta would predict.

DEFINITIONS

London Interbank Offered Rate (Libor): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Bloomberg Barclays Capital High Yield 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.

The S&P 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.

S&P U.S. Leveraged Loan Indexes (S&P LL indexes) are capitalization-weighted syndicated loan indexes based upon market weightings, spreads and interest payments.

The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market. Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. Only fully funded, term loan facilities are included. The tenor must be at least one year. Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

RES 5827 0317 | Tracking #1-592590 (Exp. 03/18)

Weekly Market Commentary | Week of March 20, 2017

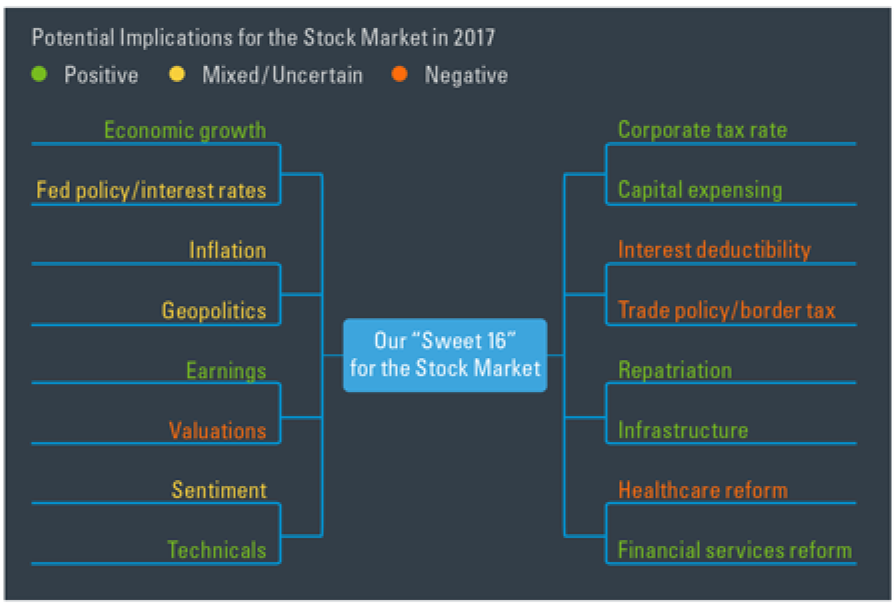
HIGHLIGHTS

- In the spirit of the exciting NCAA college basketball tournament, we have compiled our "Sweet 16" for the markets.
- We have identified 16 keys for stocks--many of them policy related--for the rest of 2017 and assessed their implications for the market.
- While the policy path is uncertain, we believe stocks have the potential to deliver solid gains in 2017.

WILL THIS SIXTEEN BE SWEET?

The "Sweet 16" is set. So in the spirit of March Madness and an exciting NCAA college basketball tournament that has already brought us two shockers in second round exits by Duke and Villanova, we have compiled our "Sweet 16" for the stock market. Specifically, we have identified 16 keys--many of them policy related--for stocks for the remainder of the year [Figure 1] and assessed their implications for the market. While the path for several policy-related areas is uncertain, we still expect a solid year for stocks in 2017--potentially even slightly above our year-end S&P 500 target of mid-single-digit gains,* depending on that policy path. Look for a deeper dive into some of these market drivers in our "Final Four" next week.

1 16 KEYS FOR STOCKS FOR THE REST OF 2017



Source: LPL Research 03/20/17

**As noted in our Outlook 2017: Gauging Market Milestones, we expect mid-single-digit returns for the S&P 500 in 2017 and the continuation of the eight-year-old bull market, consistent with historical mid-to-late economic cycle performance. We expect S&P 500 gains to be driven by: 1) a pickup in U.S. economic growth partly due to fiscal stimulus; 2) mid- to high-single-digit earnings gains; 3) an expansion in bank lending; and 4) a stable price-to-earnings ratio (PE) of 18 - 19. Gains will likely come with increased volatility as the economic cycle ages.*

OUR "SWEET 16" FOR THE MARKETS

Economic growth: We continue to expect near 2.5% growth in U.S. gross domestic product (GDP) in 2017, roughly in line with long-term averages, supported by improving business investment, steady consumer spending gains, and pro-growth fiscal policy. Our favorite leading indicators, including the just-released Conference Board Leading Economic Index (LEI), the Institute for Supply Management (ISM) Manufacturing Index, and the yield curve, suggest a low probability of recession over the next 12-18 months. Economic data have broadly surprised to the upside in the U.S. in recent months and are improving overseas. **IMPLICATION=POSITIVE**

Fed policy & interest rates: We expect the Federal Reserve (Fed) to hike interest rates twice more in 2017 following last week's (March 15, 2017) well-telegraphed 0.25% hike. The Fed's acknowledgement of the improved economic outlook and its plan to hike rates gradually are encouraging. While a better growth outlook may support further gains for stocks even if accompanied by rate hikes, there is still a possibility that the Fed spooks markets by speeding up its timetable. **IMPLICATION=MIXED**

Inflation: The Consumer Price Index (CPI) posted a 2.7% year-over-year increase in February 2017, accelerating from January's 2.5% reading amid increases in energy prices. CPI excluding food and energy (core CPI) rose 2.2% from a year ago, decelerating from January's 2.3% gain but still above the Fed's 2% target. While core CPI may continue to drift higher, headline CPI could level off and decelerate over the second half of 2017, assuming oil prices stay in the $50/barrel range, reducing the likelihood that inflation disrupts markets. Bottom line, though further acceleration in inflation presents some risk to stocks, we expect it to be contained. **IMPLICATION=MIXED**

Geopolitics: Europe passed a test in the Dutch elections last week (March 15, 2017) as the anti-European Union party failed to wrestle power from current Dutch Prime Minister Rutte; but French elections in April may spark another wave of structural concerns in the Eurozone. China's debt problem remains a risk, but when it will matter to markets is impossible to predict. Finally, military conflicts overseas could disrupt markets at any time. **IMPLICATION=UNCERTAIN**

Earnings: Earnings are one of the biggest keys for stocks to produce additional gains in 2017. The latest reading near 58 for the ISM Manufacturing Index, historically a good earnings indicator, suggests continued earnings growth (above 50 indicates expansion). Fourth quarter earnings season was generally good, with high-single-digit S&P 500 earnings gains and supportive guidance that helped 2017 estimates hold up relatively well. Additionally, better economic growth and supportive fiscal policy later in the year offer potential upside. **IMPLICATION=POSITIVE**

Valuations: We acknowledge rich valuations are a concern. On a trailing four-quarter basis, the price-earnings ratio (PE) for the S&P 500 is over 19, several points above long-term averages in the 16-17 range and above where most bull markets peaked. Longer term, higher valuations have historically translated into below-average returns. However, valuations are not good predictors of near-term stock market performance, and moderate inflation and low interest rates are supportive of above average valuations in the short term. **IMPLICATION=LONG TERM NEGATIVE**

Sentiment: Our analysis of investor sentiment reveals signs of increasing worry. From a contrarian perspective, this could be a positive sign. First, the recent American Association of Individual Investors (AAII) Sentiment Survey had more bears than bulls for the second straight week. Also, the National Association of Active Investment Managers (NAAIM) essentially reported its lowest equity exposure for active managers since the week of the U.S. election. Bottom line, there are signs of optimism, but we are not seeing the type of exuberance observed at previous stock market peaks. **IMPLICATION=MIXED**

Technicals: The technical indicators for U.S. equities continue to exhibit bullish momentum above shorter and longer-term moving averages, while the S&P 500's price near all-time highs increases the potential for a sustained bullish trend. As long as the index remains above its 200-day moving average, the long-term price trend remains bullish for stocks. IMPLICATION=SHORT TERM & LONG TERM POSITIVE

Corporate tax rate: The current rate (35%) is one of the highest in the world and encourages companies to relocate overseas. Bringing the rate down, potentially to 25%, would help keep U.S. companies from moving offshore and boost corporate profits and U.S. economic growth. Some estimates suggest S&P 500 earnings could get a more than 10% boost in 2018, although offsets to keep the budget deficit in check will be needed. **IMPLICATION=VERY POSITIVE**

Capital expensing: To incentivize capital investment, tax reform may include a provision to allow immediate depreciation of capital expenditures. Bigger upfront depreciation depresses companies' taxable profits, thereby lowering their tax bill. This measure, which stands a reasonable chance at approval, would stimulate capital spending and lift U.S. manufacturing if enacted, but would have to be paired with the elimination of the deductibility of interest expense. **IMPLICATION=POSITIVE**

Interest deductibility: Current tax policy enables companies to deduct the interest paid on their debt to lower their tax bill. Eliminating the deductibility of interest on debt as House Republicans have proposed would help pay for lower corporate tax rates and offset the lost tax revenue from full capital expensing. Although it may be politically messy by hurting the biggest borrowers, we believe this provision stands a fair probability of being enacted as a revenue raiser paired with full capital expensing. **IMPLICATION=NEGATIVE**

Trade policy/border tax: The House tax plan included a provision that essentially taxes imports, but not exports in order to encourage U.S. production--called a border adjustment tax. Although the proposal could be a big source of tax revenue to help pay for the corporate tax cuts, we do not expect this plan as proposed to make it through Congress because of the outsized impact on certain industries. The concern is that a tax on imports could contribute to escalating trade tensions with China and Mexico. The proposal appears to lack the sponsorship to become law, though a watered down version or targeted and temporary tariffs are possible to bring the fairer trade Trump has promised to pursue. **IMPLICATION=POSSIBLE NEGATIVE**

Repatriation: A policy with bipartisan support, a lower tax rate for companies to bring cash back from overseas would generate additional tax revenue (the cash is otherwise trapped) and likely drive additional capital investment, as well as shareholder-friendly dividends and share repurchases. Repatriation is very likely given the tax revenues that must be raised to offset lost revenue from a lower corporate tax rate or fund infrastructure projects. **IMPLICATION=POSITIVE**

Infrastructure: President Trump has proposed $100 billion per year in infrastructure spending via public-private partnerships. Bipartisan support makes some sort of program likely, but we are skeptical that this level of spending will be achieved given the limited number of attractive revenue-generating projects and constraints from the deficit hawks in Congress. Plus, the impact of the spending may be a couple years away. **IMPLICATION=POSSIBLE MODEST POSITIVE**

Healthcare reform: From an economic and broad stock market perspective, the importance of the Affordable Care Act (ACA) lies in its tie to corporate tax reform because tax reform cannot happen until the first phase of the healthcare overhaul is completed. What the replacement will look like, of great interest to healthcare sector investors, is uncertain though the basic principles are coming into view. **IMPLICATION=POSSIBLE NEGATIVE**

Financial services reform: President Trump has already taken steps to overhaul the financial services regulatory framework through executive orders. Changes will take time, but the end result is likely to be more lending and less friction in capital markets, both good for the economy and potentially equity markets. The downside is of course the possibility we are sowing the seeds of the next crisis. **IMPLICATION=SHORT TERM POSITIVE**

IMPORTANT DISCLOSURES

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This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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.

All investing involves risk including loss of principal.

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

DEFINITIONS

The PE ratio (price-to-earnings 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.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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 Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Index of Leading Economic Indicators is a monthly publication from the Conference Board that attempts to predict future movements in the economy based on a composite of 10 economic indicators whose changes tend to precede changes in the overall economy.

This research material has been prepared by LPL Financial LLC.

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Tracking #1-592008 (Exp. 03/18)

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index.

Understanding Value Investing

As volatility in the stock market continues, some investors may be tempted to buy on the dips. But this practice raises an important question: Is a low price by itself a true measure of a value stock? If an investor plans to hold a stock for the long term, how might an investor gauge its future potential compared with the broader market?

Value Investing Defined

Value stocks are those that have fallen out of favor in the marketplace and are considered bargain priced compared with book value, replacement value, or liquidation value. Value fund managers typically invest only when they believe the underlying company has good fundamentals. Many value investors think that a majority of value stocks are created because investors overreact to negative events, which can include:

- Disappointing earnings.
- A negative outlook for the industry.
- A regulatory setback.
- Substantive litigation.

The idea behind value investing is that stocks of good companies will bounce back in time when a company overcomes a short-term obstacle and investors ultimately recognize fair value. But this recognition may take time or, in some instances, may never materialize.

Comparative Analysis

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index. Here are some other suggestions:

- Consider whether a stock has dropped more than the average stock in the S&P 500 during the past three months.
- Examine whether earnings estimates are being revised downward faster when compared with a peer group.
- Compare analyst estimates of future profit margins to historical margins. If expectations for future profits exceed past earnings, the company could end up disappointing investors.

Another technique for potentially avoiding a value mistake is to look for stocks paying dividends. Dividends historically have been seen as a sign of management's confidence in healthy cash flow over the long term, as well as an indicator that management's interests align with shareholders. Even if a stock price languishes for a period of time, a dividend provides an investor with something in the way of a return. Note that dividends are not guaranteed, and a company can reduce or eliminate a dividend at any time.

Perhaps the best strategy for avoiding a value mistake is to combine value stocks with growth stocks, international stocks, and other types of equities to pursue diversification. Although there are no guarantees, owning some of each could help to balance an equity portfolio over the long term.[1]

[1]Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Investing in stocks involves risks, including loss of principal.

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