ACROPOLIS®
INVESTMENT MANAGEMENT

PORTFOLIO INSIGHTS

July 2017: Volume 15, Issue 3 // David Ott, Editor

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Contact us:

P | (888) 882-0072 (Toll Free)
| (636) 449-4900 (St. Louis)
F | (888) 453-1266 (Toll Free)
| (636) 778-2400 (St. Louis)
E | info@acrinv.com
A | 14755 North Outer Forty, Ste. 100, St. Louis, MO 63017

Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

Remembering Dan Esser

On the morning of Tuesday, April 18th, Acropolis received the terrible news that Dan Esser had passed away earlier that morning.

It's always upsetting when someone young dies unexpectedly, and Dan was just 57. He had been in the office the day before, following three weeks of recovery from a routine surgery. He was in good spirits and, by all outward appearances, seemed fine.

Acropolis is a tight-knit place, because almost everyone sits together in one big room. Sometimes we all could use a little more privacy, but the open seating arrangement allows for real relationships to develop over time, and Dan had been with us for almost a dozen years. The news hit us hard.

One of the really bothersome aspects of losing Dan was that he was a meticulous planner and his well-laid plans were interrupted. Although his desk didn't appear organized to the naked eye, his background in logistics for the Army meant he knew exactly where everything was at all times.

As you might expect, his planning carried over into his finances. Dan had plenty of life insurance and his estate was in order. He even went so far as to work with his estate lawyer before the surgery to make sure that everything was up to date. We should all take note from his experience and do the things that we know we should even though they can be unpleasant.

Dan was a wonderful person; thoughtful, principled and kind. Every person in the office has a story about how he helped them with a detail about Social Security, remembered their birthday, or simply had fun recounting a Mizzou game from the night before.

Dan was a real pleasure to work with, and he will be sorely missed by everyone that he touched, especially his Acropolis family.

Stock Market Summary

By Tim Side

Stocks continued to gain in the second quarter of 2017 as strong corporate earnings boosted investor confidence despite the political turbulence. Overall, it was another relatively quiet quarter with volatility at historically low levels.

All major equity asset classes were higher on the quarter as international stocks were once again the best performers, with Developed and Emerging Markets gaining 6.6 percent and 7.0 percent respectively. The Real Estate and the Mid-Cap asset classes were the worst relative performers gaining 1.7 percent and 2.1 percent respectively.

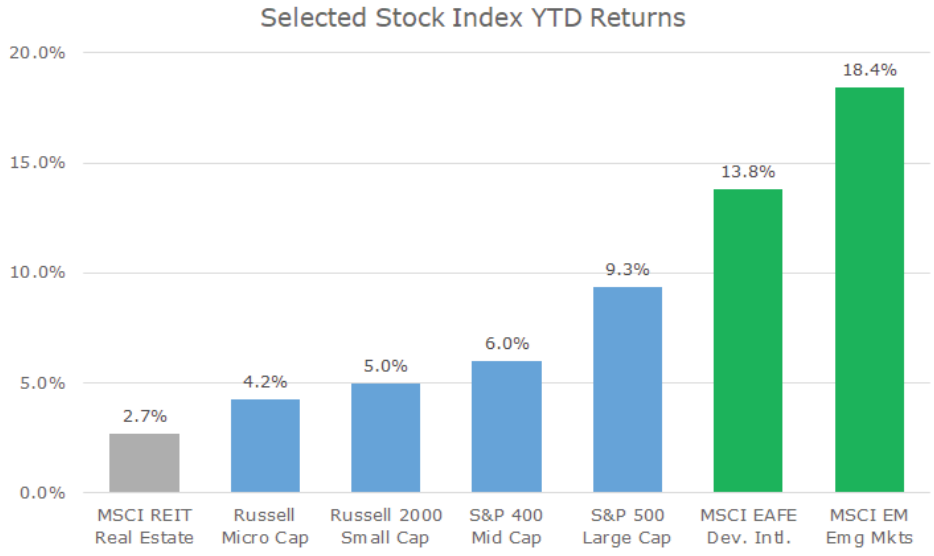
Energy was one of the worst performing sectors in the S&P 500, falling 6.3 percent on the quarter, and is now down 12.5 percent year-to-date as falling oil prices weigh on the sector.

In late May, OPEC agreed to extend the production cuts into 2018 to help rising oil inventoriesm, which cast doubt on the effectiveness of the cuts. WTI Oil prices gained slightly in the final week to end the quarter at $46 per barrel.

Healthcare gained 7.1 percent on the quarter as the Trump administration continued to struggle to get health care reform passed. In early May, the House passed legislation to repeal and replace the major parts of the Affordable Care Act, and the Senate Republicans currently have a proposed bill, although they delayed a vote until after the 4th of July holiday.

In June, the Federal Open Market Committee raised rates for the second time this year and penciled in a third hike later this year. The Fed also outlined a plan to slowly unwind the balance sheet. Stocks took the hike in stride since it had largely been expected for several months.

For the love of money is the root of all evil.
- Timothy 6:10



Data Source: Bloomberg

Bond Market Review

By Ryan Craft, CFA

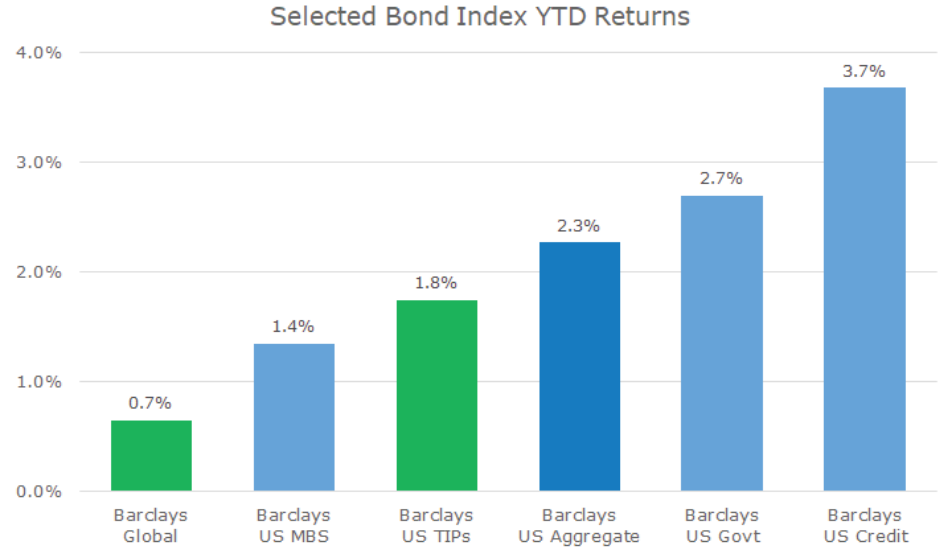
With half of 2017 in the books, bond market performance is behaving much different than many forecasters predicted. At the end of last year, bond yields were on a steep rise as investors expected the new administration to cut taxes and stoke the economy, resulting in rising inflationary pressures. After nearly a decade of false starts, this was to be 'the year' that interest rates finally began the long road up.

The Fed has held up its end of the bargain, raising rates twice this year, which has pushed up short term rates. Long term rates, on the other hand, have fallen with the 10yr Treasury now 15bps lower on the year and the 30yr Treasury down 23bps. These long bonds are the most influenced by inflation, which shows that the market is changing its inflationary outlook.

Throughout the year, real yields have increased rather sharply. Another way of stating it is that the inflation premium demanded by investors has decreased. Therefore, nominal Treasury yields, which include the real yield plus an inflation premium, have outperformed thus far in 2017 while Treasury Inflation Protected Securities (TIPS), which only follow real yields, have lagged behind the market quite substantially.

All of this means that longer bonds have performed better than shorter bonds and credit spreads have continued their multi-year long grind tighter. Credit spreads and stock prices are highly correlated, so it is not surprising that investors require little credit premium for holding a corporate bond at a time that equity valuations are so rich.

It is futile to try to guess the market reaction for the second half of the year. The biggest drivers will all be policy related (Fed, taxes, debt ceiling, etc) and the policymakers themselves have no idea what will be enacted in the coming months. Expect it to be bumpy.



Data Source: Bloomberg

The lack of money is the root of all evil.
- Mark Twain, Author

My friends are my estate.
- Emily Dickinson, Poet

The Fed's New Conundrum

By Ryan Craft, CFA

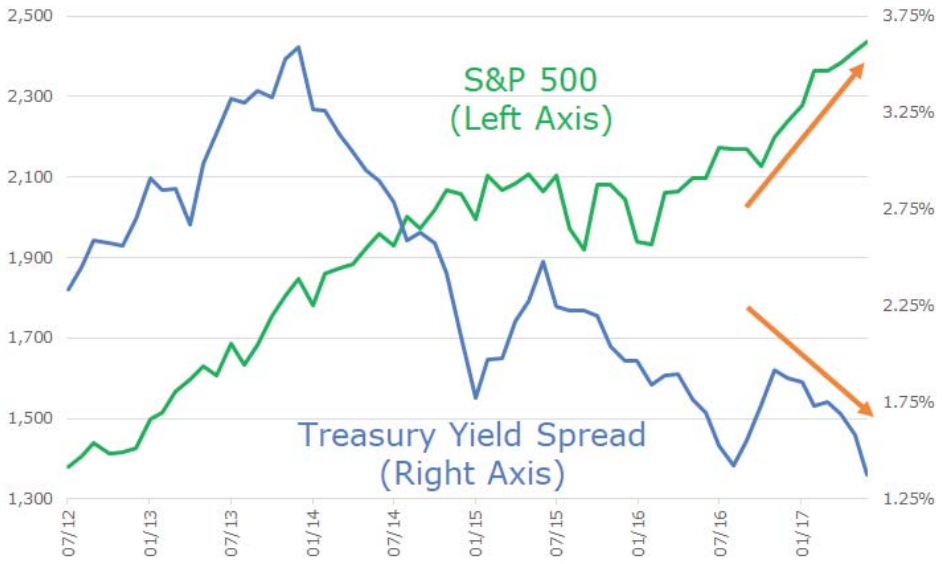
Earlier this month, the Federal Reserve raised its benchmark Fed Funds rate another 25 bps to 1.25 percent. This was the second such hike this year and the third in the past seven months. The committee also reaffirmed its forecast for another rate hike before the end of 2017, with another three hikes before the end of 2018. Additionally, the Fed outlined a plan to begin unwinding its massive securities portfolio and put the market on notice that this plan may begin in the fall.

All in all, this was a fairly hawkish announcement from the FOMC at a time that many in the market think a pause may be wise. For the past few years, the Fed would talk about raising rates but then always find an excuse of why it should hold off. In 2017, the Fed has been more aggressive than the market anticipated and continues to give a hawkish outlook despite weakening underlying data.

The Fed has plenty of reasons for this new hawkish stance. Asset inflation can be seen in nearly all markets. US equity markets continue to climb to new record highs with historically high valuations and low volatility. Credit spreads in high yield debt markets continue to grind tighter.

These are all examples of too much liquidity seeking a home and driving up prices of even the riskiest assets as investors seek yield. Leery of blowing the next bubble, the Fed is looking to soak up that excess liquidity via higher rates.

One may expect this hawkish outlook from the Fed to push interest rates higher today in anticipation of tighter policy tomorrow. However, the market has reacted in the exact opposite way. Long-term interest rates have been falling all year and continued to do so after the FOMC



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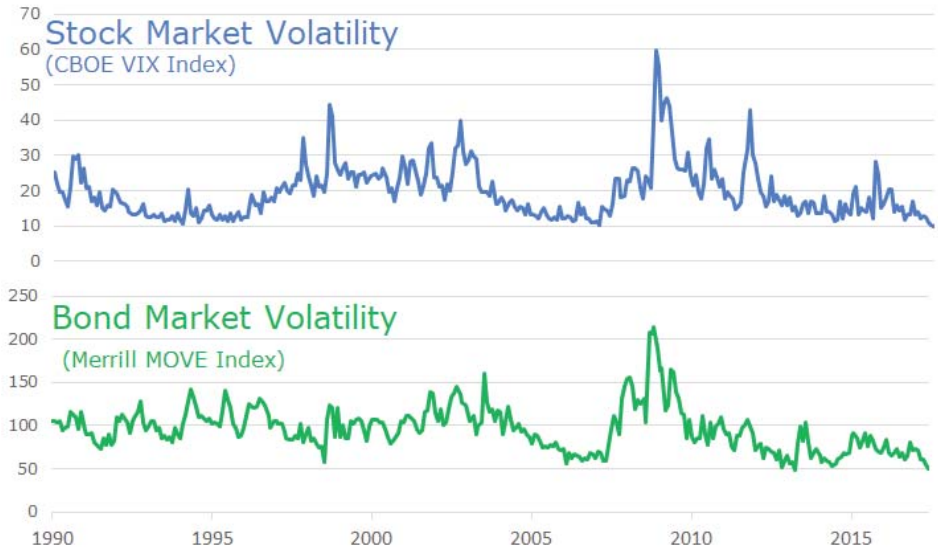


meeting. The Fed continues to push up short-term rates while the market pushes down long-term rates, flattening the yield curve. The only explanation for this is that the market believes the Fed is making a mistake.

The Fed has a history of raising rates until it breaks the economy. At just 1.25 percent, one would think that they have a lot of room to raise before inflicting harm, but with inflation remaining stubbornly low and trending lower, the neutral rate for Fed Funds is likely much lower than it has been in prior cycles.

Since the beginning of the year, there has been a sharp divergence in two forward-looking market indicators. US Large Cap stocks have accelerated higher, which is typically a sign of a strong view on the economy. Meanwhile, the yield curve for US Treasuries has fallen sharply, primarily due to a decline in long-term interest rates. Falling long-term bond yields and a flattening yield curve usually signify a slowing economic outlook coupled with lower inflation expectations. The outlook of one of these markets must be wrong and is, therefore, due for a correction.

Both the bond and stock markets are in the midst of historically low levels of volatility, as both seem to rise in price together, with a few intermittent days in the red. Eventually, markets will return to normal volatility levels, and the inverse relationship between stocks and bonds will resume.

Now is not a time for speculation, but rather a good time to use these positive, low volatility markets to rebalance and make sure your portfolio is in an appropriate risk position to withstand future markets when volatility returns.

Success seems to be connected with action. Successful people keep moving. They make mistakes, but they don't quit.
- Conrad Hilton, Hotelier

Inside the Yield Curve

By David Ott

The yield curve is a fascinating set of data because it contains so much information regarding investors' inflation expectations.

I've charted the difference in yield, or spread, between the two- and the ten-year yield on US Treasury bonds. This is a classic measure of the yield curve's 'steepness' or 'flatness.'

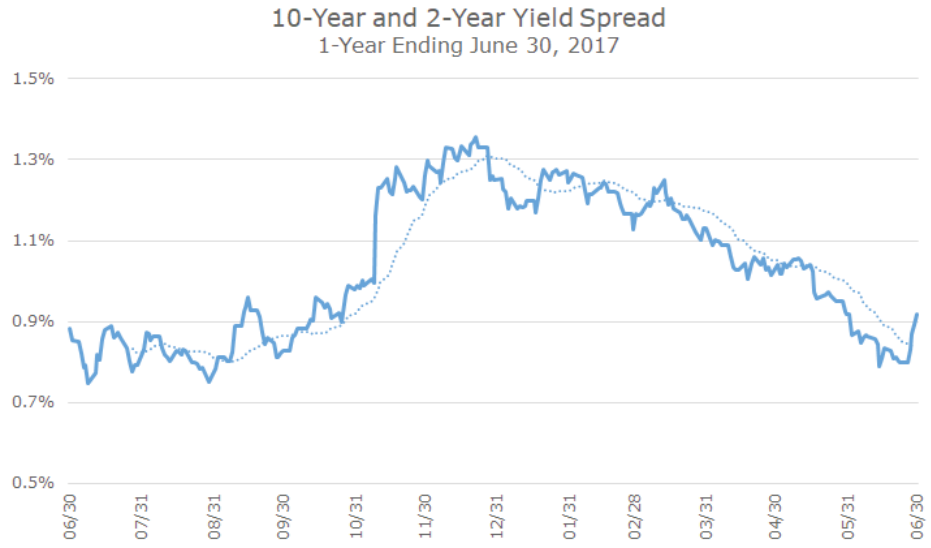
Inflation is one of the key risks for bonds since it eats away at the purchasing power of the bond's interest payments and principal payment at maturity. The yield that bond investors require says a lot about their views about future inflation.

For example, in the chart below, you can see that the spread between the two- and ten-year bond was fairly steady prior to the election. When President Trump was elected in November, the spread shot higher as investors assumed that his proposed tax cuts and deregulation would lead to higher economic growth, which in turn, would lead to higher inflation.

Since then, however, expectations have tempered, and the spread is about the same as it was just before the election. Ryan points out in his article on page four that there is a real divergence between stock and bond investors about where growth and inflation are headed.

And that's the trouble with market signals like this one - they tell you a lot about what investors are thinking today, but not much about what will actually happen in the future. It's useful to see what other investors are thinking since markets are driven by psychology as much as fundamentals over the short run, but in almost all cases, it just isn't enough to trade on with any confidence.

In investing, what is comfortable is rarely profitable.
- Rob Arnott, Investor



Social Security's Taxation Maze

By David Ott

While on vacation in the Pacific Northwest recently, my kids found a labyrinth in a church garden fashioned after the famous one in the nave of the Chartres Cathedral south of Paris. As we circled and circled trying to reach the center, I actually thought that this mystical pattern was a lot like Social Security, complicated and unnecessarily cumbersome. Then again, pilgrims have traveled to Chartres for 1,000 years, so we still probably have to deal with Social Security.

You may already know that a portion of your Social Security retirement benefit may be taxable. The first winding path to understanding how this tax is calculated is determining the amount of income that's taxed.

The first step is calculating your Modified Adjusted Gross Income (MAGI), which is your Adjusted Gross Income (AGI) plus some certain deductions that were used to calculate your AGI - most notably for seniors, your tax-exempt income.

Once you have your MAGI, the next step is to calculate your Provisional Income, or PI, which is your MAGI plus 50 percent of your Social Security benefits.

With the PI in hand, we have to look at taxation levels. For a married couple filing jointly, if your PI is less than $32,000, then none of your Social Security benefit is taxed (obviously, the levels of taxation vary depending on the filer, such as singles, widows, etc., but we don't need that many paths in the labyrinth at this point).

If your PI is between $32,000 and $44,000 for married filing jointly households, then 50 percent of your Social Security benefit may be included as taxable income. The only good news is that if your PI is above the second taxation level of $44,000, then a maximum of 85 percent of your Social Security benefit can be taxed.

Let's look at an example of someone with a MAGI of $55,000 and Social Security benefits of $20,000.

The first step is determining the PI, which is $55,000 plus $10,000 (half of the benefits), or $65,000. With the PI in hand, we can figure out how much is taxable. The first tier, up to $32,000 is tax-free, so no calculations are necessary. Half of the income in the second tier, $6,000 is taxable (half of difference of $44,000 and $32,000).

All of the income above $44,000 is taxable, which works out to be $21,000 in this example ($65,000 minus $44,000). But this is where the good news figures back in because the maximum taxation is $17,000, or 85 percent of the Social Security benefit, which was $20,000 in this example. Therefore, in this case, the taxable amount is $17,000. The long and short of this maze is it doesn't take much income before Uncle Sam wants some of it back.

The future has a way of arriving unannounced.
- George Will, Commentator

Data Center	2017 YTD
Dow Jones	9.35%
S&P 500	9.34%
S&P Midcap	5.99%
Russell 2000	4.98%
MSCI EAFE (Intl)	13.81%
MSCI Emerging Mkt	18.43%

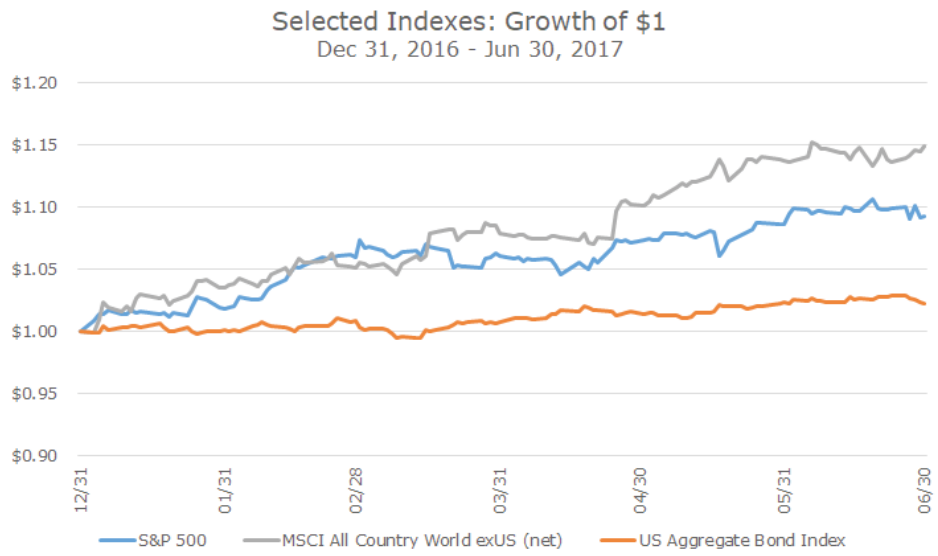
S&P Sectors	2017 YTD
Basic Materials	9.21%
Consumer Discretion.	11.00%
Consumer Staples	8.03%
Energy	-12.61%
Financials	6.88%
Healthcare	16.07%
Industrials	9.51%
REITs	6.40%
Technology	17.23%
Telecom	-10.74%
Utilities	8.75%

Interest Rates	2017 Q2
Fed Funds	1.25%
Prime Rate	4.25%
3-mo. Treasuries	1.01%
2-yr. Treasuries	1.38%
5-yr. Treasuries	1.89%
10-yr. Treasuries	2.30%

Currencies	2017 Q2
Euro	1.1426
Japanese Yen	112.39
British Pound	1.3025

All Data as of 6/30/2017

The Big Picture



Fast Facts: Federal Reserve Edition

4.5 Trillion The size of the Federal Reserve's balance sheet. Before the crisis, it stood at around $1 trillion but grew through their quantitative easing program. Now, the Fed is starting to let the balance sheet shrink by not investing coupons and maturities.

1668 The year that the oldest central bank in the world, Sweden's Sveriges Riksbank, was founded. Their central bank is 245 years older than the Federal Reserve.

34,000 The number of gold bars stored in an underground vault below the New York Federal Reserve Bank, which was featured in the 1995 action movie, Die Hard with a Vengeance. At the end of the quarter, this gold cache was worth $42.2 billion.

1,000 The size of the Federal Reserve Police personnel, the law enforcement arm of the Fed, which was formed in 2001. Officers are responsible for protecting Fed facilities.

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