*"But as time passes, we forget the lessons learned, and as the particulars change, we lose sight of the fact that crashes don't have a single cause that is easy to recognize before the damage is done. Instead every crash is caused by a unique confluence of usually personal events."*

*- Scott Nations*

| EQUITIES | 3Q17 | 12 MONTHS | DIV. YIELD |
|---|---|---|---|
| All World Equity | 5.08% | 18.83% | 1.87% |
| | | | |
| U.S. Large Company | 3.89% | 17.80% | 1.77% |
| U.S. Mid Company | 3.04% | 14.59% | 1.67% |
| U.S. Small Company | 5.86% | 20.95% | 1.29% |
| | | | |
| U.S. | 4.55% | 18.54% | 1.68% |
| Developed Int'l | 5.03% | 18.90% | 2.42% |
| Emerging Markets | 8.26% | 21.58% | 1.32% |
| | | | |
| Growth Companies | 5.45% | 21.32% | 1.23% |
| Value Companies | 2.99% | 14.89% | 2.30% |
| High Dividend Payors | 4.50% | 15.91% | 2.99% |

| FIXED INCOME | 3Q17 | 12 MONTHS | DIV. YIELD |
|---|---|---|---|
| All World Bond | 1.76% | -1.26% | 2.11% |
| | | | |
| U.S. Treasuries | 0.43% | -1.51% | 1.58% |
| U.S. TIPS | 0.79% | -1.05% | 1.49% |
| U.S. Investment Grade | 1.36% | 1.46% | 3.20% |
| U.S. High Yield | 1.69% | 7.02% | 5.03% |
| | | | |
| Non-U.S. Developed | 1.76% | -2.51% | 0.09% |
| Emerging Market $ Bonds | 3.00% | 3.98% | 4.50% |

| COMMODITIES | 3Q17 | 12 MONTHS |
|---|---|---|
| Oil (WTI) | 12.28% | 8.28% |
| Gold | 3.02% | -3.23% |

*Source: CSI, Auour Analytics*

## The Quarter in Review

The quote used in our 1st quarter report was "It is best to rise from life as from a banquet, neither thirsty nor drunken." We have been investing in accordance with that quote and maintaining a near fully invested stance yet conscious of the growing optimism witnessed in the world markets.

Global markets, especially equity markets, have continued rising with little performance difference between the major equity classes. Emerging markets have continued their rebound this year and now match, looking back over the past 12 months, the equally impressive performance of smaller US companies. Growth companies have continued to lead this year while value-based firms absorb the euphoria experienced immediately after the presidential election.

Fixed income markets recovered slightly in the 3rd quarter. US treasuries treaded water as the Federal Reserve continues their push to normalize monetary policy. International sovereign debt also saw a jump in rates (declining local prices) from deeply negative levels though outperformed treasuries given the dollar weakening relative to most developed currencies. The low rate environment did not prevent corporate debt from continuing to produce strong returns this year as an improving economic outlook continued investors' push into higher risk debt instruments.

The year 2017 is seeing the first instance of synchronized global growth in over a decade. Barriers to economic activity are falling, business confidence is rising, and capital spending is finally showing strength. Global investors continue to climb the "wall of worry", reaping the benefits of an improving economic cycle yet continuing to look for some event that may lead to a meaningful correction. We are too.

## Waiting for the Second Domino to Drop

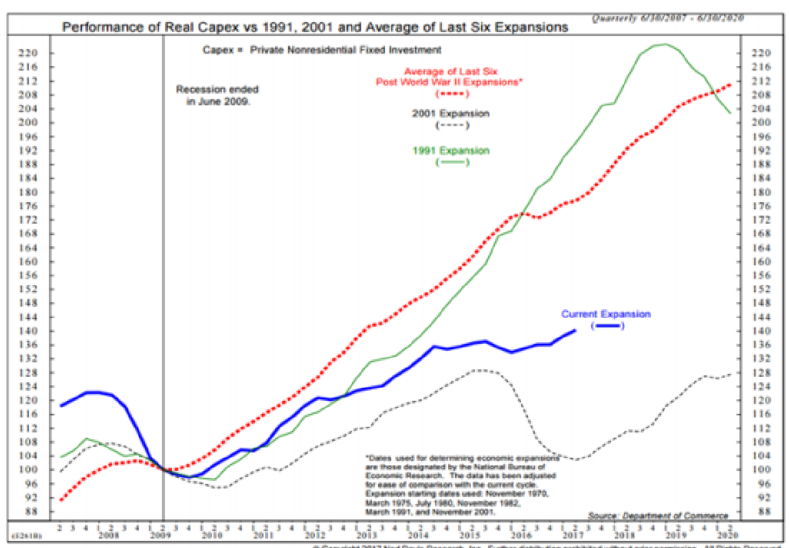
As children, we would build elaborate strands of dominos standing precariously on end. After hours of carefully laying out the path, we would anxiously tip the first in hopes of having it produce the desired chain effect. However, we remember many times when tipping the first domino did not bring about the anticipated chain reaction.

The analogy for investment markets is that an extended bull market will create a financial domino strand that upon one negative event, the chain reaction brings about a collapse of financial instruments of various types and regions. The Great Financial Crisis in 2008 was the most recent example and one of the worst. However, like noted above, one falling domino may not lead to the much-feared large destruction.

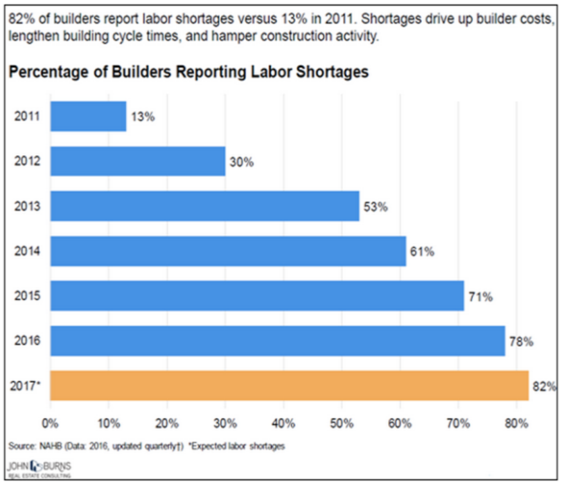
We believe we continue to sit at a point typical of the middle stages of an economic cycle. Headlines and talking heads are filled with data points suggesting a falling domino (North Korea, the end of quantitative easing, Catalonia, etc.) will extend itself to a large market correction. For Auour, we believe we structured our risk detection models to respect the falling first domino but more importantly to determine if it has the energy and linkages to lead to the next and more troublesome falling pieces. At this moment in time, we do not see the high level of instability that would lead to a deep and enduring correction.

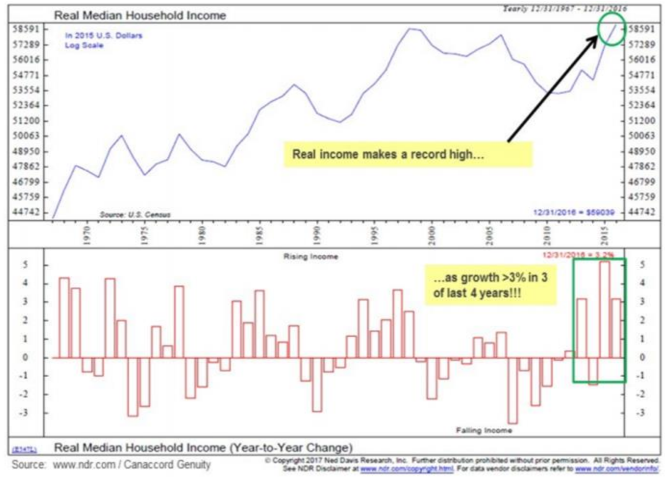
There are obvious areas of concern that we continue to monitor; a pick-up in global inflation that would lead to an acceleration in interest rate growth and the growth in leveraged Chinese wealth management products are two such concerns. As is typical, some of these will correct, taking on varying levels of destruction. Time and data will suggest if they deserve a proactive move in portfolio positioning.

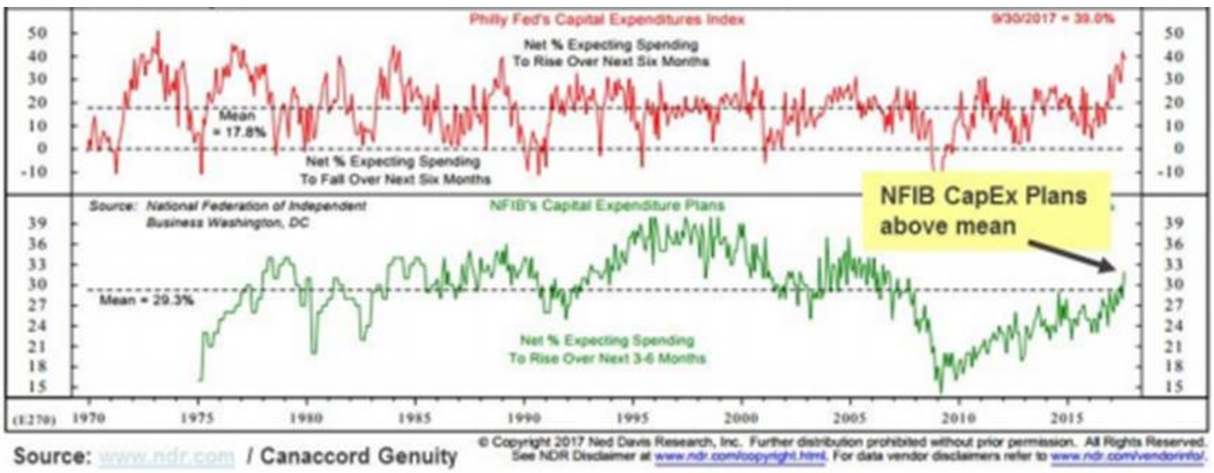
Before discussing those potential events, which we suspect could instigate a repositioning, we need to acknowledge the robust economic environment. The duration of the current expansion has been offset by such expansion experiencing a very slow rate of recovery from the bottom (relative to historical recoveries). It is only this year, a decade from the peak, that all global markets are experiencing growth with the majority witnessing accelerating activity.




Source: www.ndr.com / Canaccord Genuity



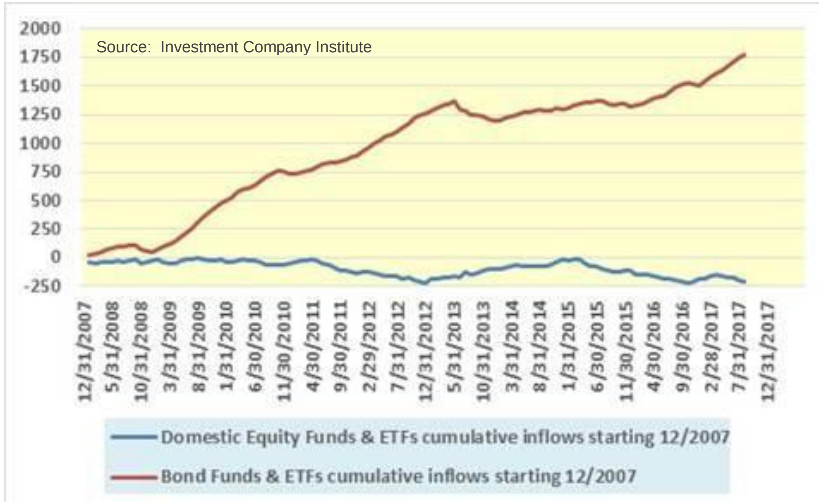




Specific to the US, employment opportunities have not been this good since 1999 with less than 2 available people for each job opportunity (having peaked at 10 people per opportunity in 2009). This, combined with new highs in real median household income and improved consumption levels, is leading to increasing investment spending within the corporate environment. High corporate free cash flows, low debt servicing levels for consumers, and accelerating wages are not indicating any material levels of economic instability within the US private sector. The same can also be said for many private sectors within the developed world.

However, there are areas that should temper one's enthusiasm…

## Fixed Income Addiction

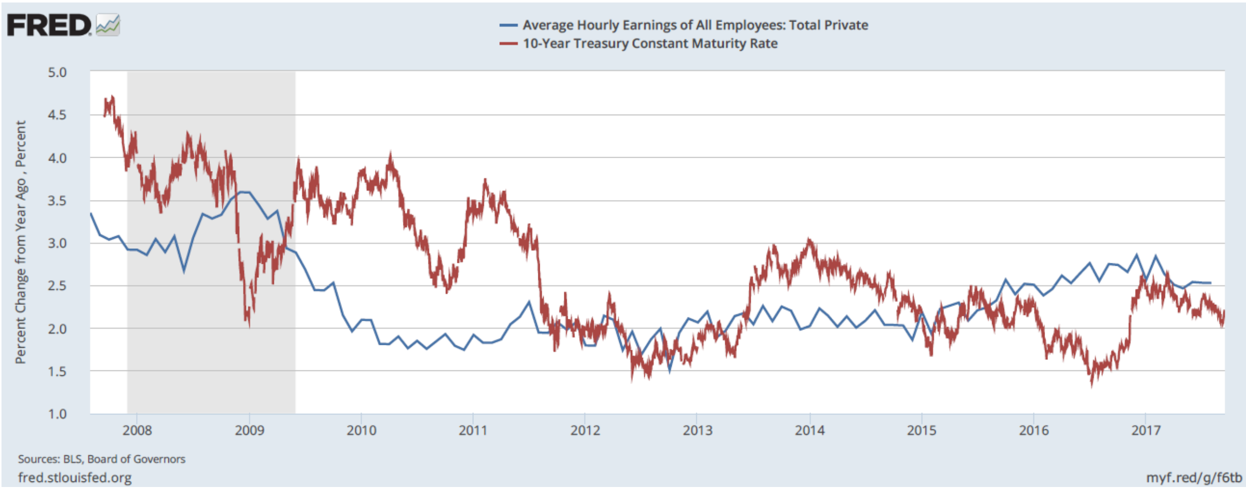



With the S&P 500 index up 250% from its 2009 lows, it may lead some to think excesses are showing themselves in the equity markets. However, investment fund flows indicate a bigger issue may be brewing within the bond markets. According to the Investment Company Institute, since the end of 2007, investors have placed more than $1.75T into domestic fixed income instruments. At the same time, domestic equity investing has seen net withdrawals. This is not just a US development. Global investor demand for yield is competing with the world's central banks in the debt buying spree. As discussed in prior commentary, over $8T of sovereign debt, 17% of global sovereign debt, is priced at negative interest rates (primarily Japan, Germany, and Switzerland). This could be listed in the Webster Dictionary as the definition of instability!

Though uncertainty revolves around when this debt addiction will end, it will likely be caused by a larger increase in inflation expectations. As discussed frequently, interest rates go hand in hand with inflation rates. Though many have stopped fearing deflation, very few are expressing concern that inflation is picking up. We see this as one of the largest areas for concern.


Global inflation measures bottomed in 2015. Since then, as global economies have picked up, we have seen an acceleration in price increases for the inputs to consumption. China has been a constant factor in subdued inflation around the world as they increasingly become the world's low-cost manufacturer. We may be in the early phases of a change in that trend. Real wage growth in China is expected to grow 4.7% in 2017 compared to global wage growth of 1.5%. This should be viewed as a reasonable outcome as China's workforce population is now declining given the long-term impact of the One Child Policy.

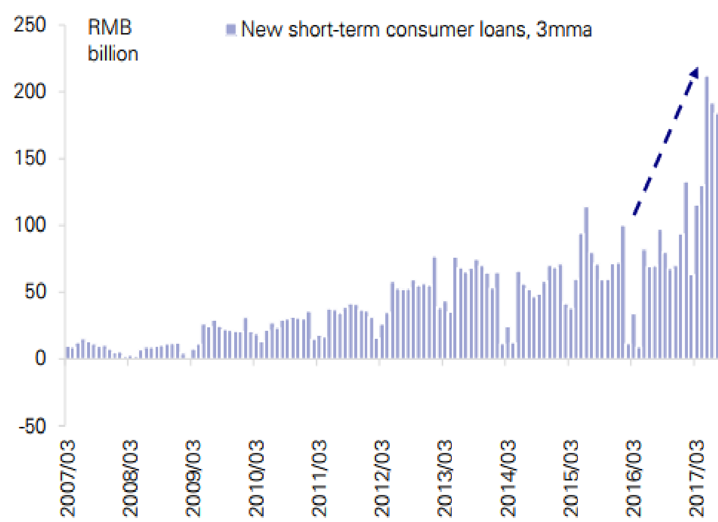
As we have mentioned many times in the past, we believe inflation is tied to wage growth and China is not the only one seeing strengthening wage growth. Average hourly wages in the US bottomed in 2010 and over the past 12 months have obtained levels typical of more normal inflationary periods. Yet, interest rates are still very low relative to history.




As we wrote recently, the inflationary signals we are currently experiencing would argue for an interest rate environment approximately 35% higher than current levels. Having been in an interest rate bull market for over 30 years, it is difficult to fully appreciate the impact such a move up in rates would have on global markets. We are, of course, continuing to monitor the situation and looking for points of instability.

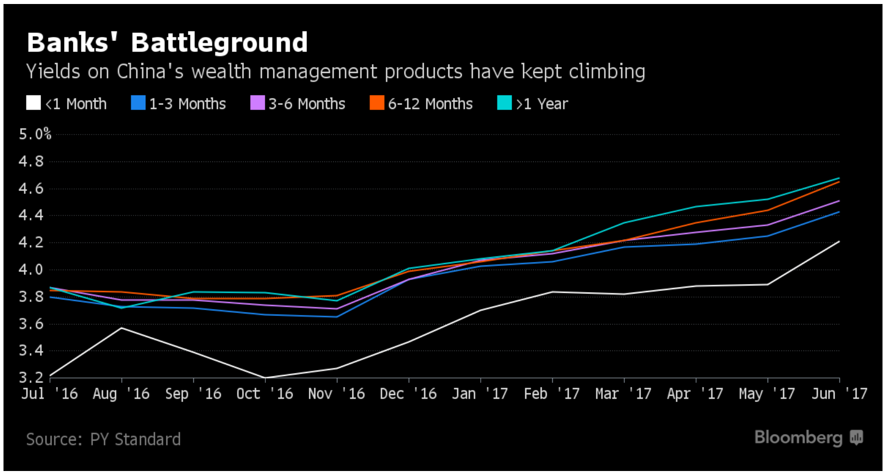
## China's Shadow Banking Experiment

We continue to be concerned with China's shadow banking system. When we refer to shadow banking, we mean the creation of credit by financial firms that runs outside the regulated and protected financial system. As we have all seen, financial markets can become 'temperamental'. Regulations are put in place to lessen the destructive capability when markets become scared. As shadow banking ecosystems become material to the economy, they bring instability with an increasing probability of having them bleed into global markets.




Source: Deutsche Bank, WIND

We believe we are seeing a growing level of instability brewing within the China banking system. The International Monetary Fund (IMF) recently calculated that China created 3x more credit in 2016 versus 2008 to achieve the same level of economic growth. It suggests a lower asset and income base to cover the larger amount of debt. China has a debt level 2.7 times




larger than their economy (as measured by GDP) with over half of the debt on corporate balance sheets. Consumer debt is starting to accelerate as well, with faster growth in short term loans; another unstable domino.

The accelerated growth in debt has been achieved through the shadow banking funding mechanism. In other words, the increase in debt is being funded by individuals' investments into the wealth management products (WMPs). One item that brought about the Great Financial Crisis was the large growth in credit products that used leverage to make more attractive investments. Though this worked at the beginning, it dramatically increased the level of instability within the financial system. Once the music stopped, fear drove a massive run for the exits, exacerbating the drop in assets and freezing the economy.

We fear the probability of the same happening in China increase as most of the WMP's are leveraged short-term instruments funding long term projects. If fears rise to the point of lessening demand for WMPs, the underlying values covering the debt will be at risk. We are seeing rising rates in WMPs suggesting that the smaller banks are needing to be more competitive in order to fund their needs. This is another point of instability that requires more of our attention.

Of course, to be fair, China has a large savings rate and currency reserves that may lessen the impact of any rising fear. We are seeing the Peoples Bank of China and the central government implement new protocols and guardrails, hopefully learning from our mistakes.

## Conclusion

Deep market corrections do not run on clocks. You will hear that a market correction averages once every 8 years. There is nothing definite in the length between them. Corrections come about from a growing instability in robust economic conditions. The depth and severity of the correction is a function of how much that inherent instability has infected the banking system, specifically the US banking system which is at the center of most global transactions. At this time, the concerns we have are outside the core of our system so the probably, again at this time, of a meaningful and prolong drop appear low. We maintain a near fully invested stance and continue to monitor the potential for the dominos to start falling.