ALPHA CUBED
INVESTMENTS

Investment Letter, Q4 2016

October 5, 2016

Fundamental Drivers of the Markets

OVERVIEW

After almost two years of consolidation (stagnation) the overall US equity markets broke out above what had been very strong resistance. And, while this is good news from a technical perspective, not much headway has been made by any of the major indexes year-to-date:

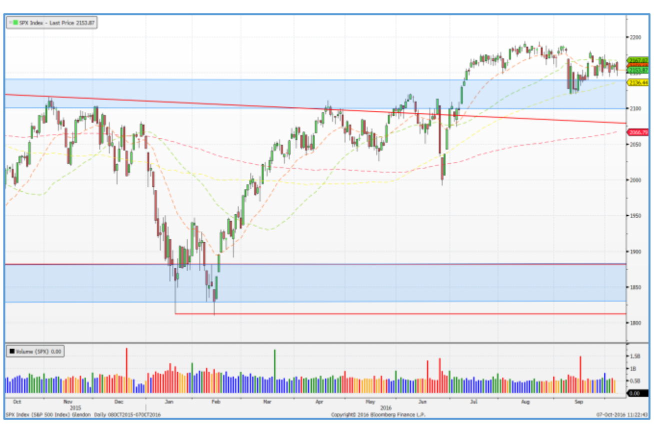
	2016 Q1	2016 Q2	2016 Q3
S&P 500 Total Return	1.35%	2.46%	3.85%
NYSE Composite Total Return	0.63%	2.77%	2.21%
Barclays Aggregate Bond Index	3.03%	2.21%	0.46%

Source: Bloomberg

	1/1/2016	3/31/2016	6/30/2016	9/30/2016
U.S. 2016 GDP Estimates	2.5%	2.1%	1.9%	1.5%
S&P 500 2016 Earnings Estimates	$125.56	$118.12	$114.31	$110.16
S&P 500 P/E (Current)	18.4	18.4	19.5	20.2
S&P 500 P/E (Forward)	17.4	17.1	17.3	16.8

Source: Bloomberg, Standard & Poor's

Below you will find the charts of both the S&P 500 Index and the NYSE Composite reflecting the move, although somewhat muted, to new highs (charts from Bloomberg):



S&P 500 (SPX Index)

NYSE Composite (NYA Index)

As you can see from the charts, despite all the gyrations at various times this year, the markets have not advanced in a significant way.

Of course, the important question is what are Alpha Cubed Investments' expectations and what investment policies will be implemented in response to those expectations? At Alpha Cubed Investments, we concentrate on four primary factors when analyzing markets: Valuations, Monetary Policy, Earnings Growth, and Economic Growth. Let's look under the hood at these critical factors in more detail to see their present status, what we should likely expect going forward, and what is Alpha Cubed Investments' approach to the future.

Valuations: The multiple of the S&P 500 is approximately 20.2. This is historically a high level of stock market valuation. However, when interest rates are very low, the opportunity cost of owning equities becomes low which fosters higher valuations. In other words, if you could earn 10% in a money market fund, equities would have to do a lot of heavy lifting to get an equivalent 10% risk-free return. With interest rates near 0% it makes the cost-benefit analysis of investing in equities much easier and allows valuations to stay at historically higher levels. Given that Valuations are at higher levels (which means that risk is elevated), any unfavorable changes in the three factors cited could induce a significant volatility in the overall market.

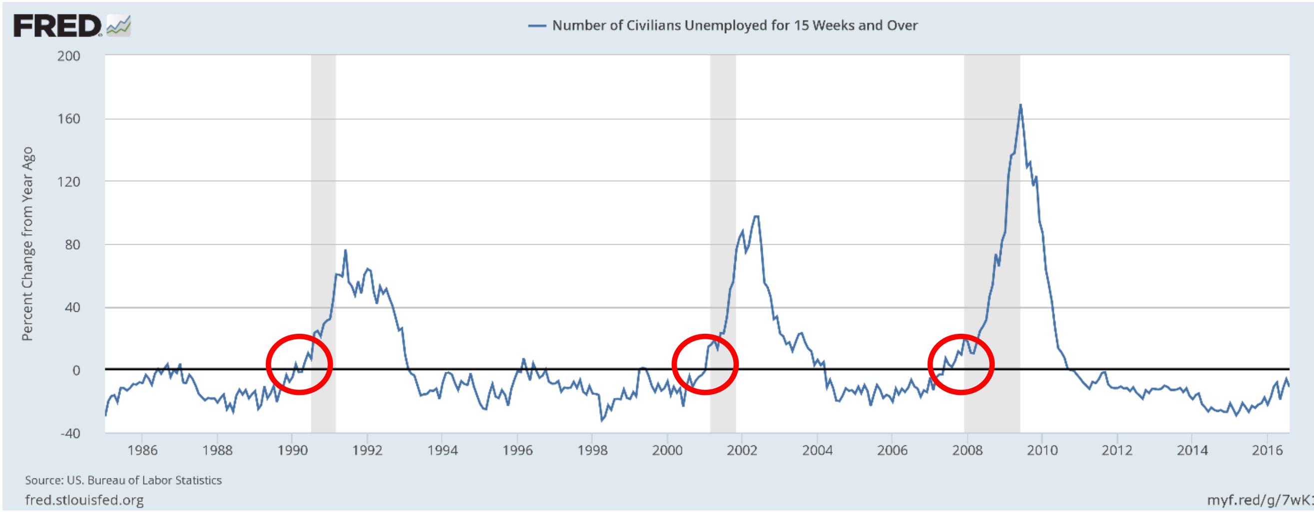
Monetary Policy: Most of the world's central banks are easing right now, but the US Federal Reserve seems intent on raising the Fed Funds rate by an additional 0.25% as early as December. At the time of this writing the probability of a rate increase in December stands at 61%, implied by the pricing of the Fed Funds Futures. The Alpha Cubed Investments' Portfolio Management Team has many years of experience and is well aware that a protracted period of increases in interest rates can have a negative effect on stock prices as has happened in the past. The early upward adjustments to rates may be greeted as an indication of strength in the economy, but eventually the weight of the math works against equities and overall they tend to struggle in a longer term rising rate environment.

Earnings Growth/Economic Growth (GDP): Consensus S&P 500 earnings growth for 2017 is currently at 13.49% year-over-year and consensus GDP for 2017 is now forecast at 2.2% (*Source: Bloomberg*). While these metrics seem very positive when compared to the rest of the developed world, as you can see from the chart at the beginning of this letter these forecasts tend to be overly optimistic and come down over time.

Considering all the future factors affecting stock prices, while Earnings Growth and Economic Growth appear favorable, the change in Fed policy to progressively higher interest rates may be a negative factor. In other words, the risk in the equity markets will increase if the Fed pursues a policy of progressively higher interest rates over time.

Therefore, in most of our portfolios (though not all based on mandate), we generally favor larger, US based companies with larger dividend payouts and even some cash in the accounts. In a return constrained environment, the return from dividends and income becomes even more important and we are cognizant of that.

We closely monitor the data point of "Number of Civilians Unemployed for 15 Weeks and Over" to watch for early signs of a potential recession. At this time we do not see or expect a recession on the near term horizon in 2016:



Despite consistent but moderate growth in the US economy, investor sentiment has been generally negative which, counterintuitively, supports a generally rising equity market. But that doesn't mean we will not experience shocks to the system and volatility like we saw with Brexit early in the summer. There are plenty of catalysts for volatility such as the US election, geopolitical events/conflicts, potential terrorism, consternation about the health of European banks, and other economic shocks that are impossible to predict. We are in the seventh year of economic recovery in the US and as investors continue to reach for yield we may also be in the later stages of the credit cycle. Accommodation from the world's central banks continues to be the backstop of the equity markets so it remains to be seen how the markets will digest an incremental raise by the US Federal Reserve when and if it happens. Ultimately, we are constructive on the long term future of US markets and will continue to pursue our goals of building strong portfolios while managing downside risk presently including the selective maintenance of cash reserves if appropriate. In times like these, with uncertainty in the markets, economy and election, dynamic investment management gives investors the greatest probability of success and consistent investment returns. This is and will always be our goal at Alpha Cubed Investments.

Sincerely,

Todd Walsh & the ACI Portfolio Management Team