Pilot Capital Management Inc.

Quarterly Investment Commentary

Date: July 14th, 2017
From: Greg Staub, CFA, Ph.D.; Matthew Staub, CFA
To: Pilot Capital Clients & Friends

Dear Clients and Friends,

Your reports for the second quarter of 2017 are enclosed. This letter gives a review of the quarter and briefly summarizes our current investment views.

Second Quarter 2017 Market Review

Market/Index	2016 Close	As of June 30th	Month Change	*Quarter Change*	Year-to-Date Change
DJIA	19,762.60	21,349.63	1.62%	*3.32%*	8.03%
S&P 500	2,238.83	2,423.41	0.48%	*2.57%*	8.24%
Russell 2000	1,357.13	1,415.36	3.30%	*2.12%*	4.29%
Global Dow	2,528.21	2,769.39	0.38%	*2.90%*	9.54%
Fed Funds	0.50% - 0.75%	1.00% - 1.25%	25 bps	*25 bps*	50 bps
10-Yr Treasury	2.44%	2.30%	10 bps	*-8 bps*	-14 bps

The second quarter proved to be a bit bumpy for equities, but each of the benchmarks listed here closed the quarter ahead of their first-quarter closing values. April saw equities close the month ahead of March, buoyed by favorable corporate earnings reports, proposed tax cuts, and strong foreign economic advances. Nasdaq led the way posting monthly gains of 2.30%, followed by the Global Dow, which gained almost 1.50%. The large-cap Dow advanced 1.34%, ahead of the S&P 500, which increased close to 1.00% for the month. Even the small-cap Russell 2000, which has had some rough weeks, closed April 1.05% ahead of its March close. May was a slower month as consumer spending and wage growth were relatively weak, with only 138,000 new jobs added in May, compared with an average monthly gain of 181,000 over the prior 12 months.

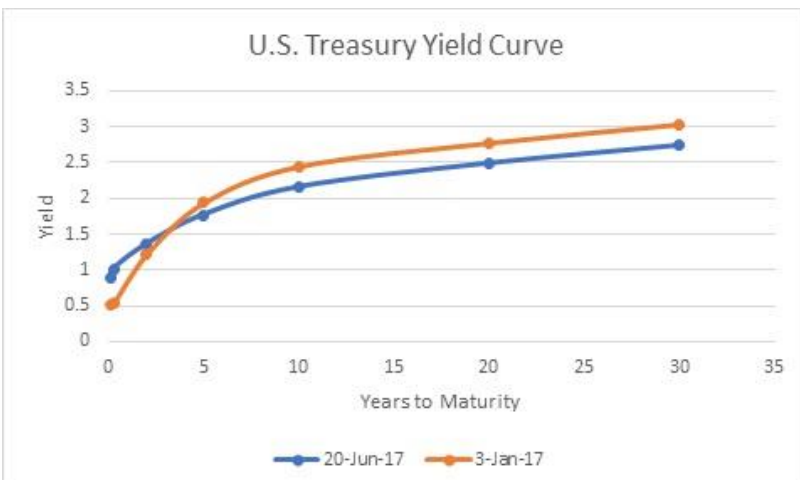
Nevertheless, only the Russell 2000 lost value, falling 2.16% from its April closing mark. Nasdaq continued to surge, ending May with a monthly gain of 2.50%. June saw mixed results for the indexes listed here. The Nasdaq lost almost 1.00%, while the Russell 2000 made up for its May losses, advancing almost 4.00% over May. The Dow had a strong June, closing the month up 1.62%, while the S&P 500 and the Global Dow failed to advance 0.50% over May. Long-term bond prices increased in the second quarter with the yield on 10-year Treasuries falling 8 basis points. The price of gold fell during the second quarter, closing June at $1,241.40, down from its $1,251.60 closing price at the end of the first quarter.

Investment Commentary

The Federal Reserve & Bond Market Resiliency

Mid-June saw another quarter-point hike of the Federal Funds Rate by the Federal Reserve. The Fed has now increased rates four times since the end of 2015, from an initial target range of 0.00-0.25% to a target range of 1.00-1.25%. While bond markets have not been stellar, they have been predictable, with the average intermediate-term bond fund investor earning roughly the stated yield over the past 1-2 years – nowhere near the apocalyptic predictions of some bond market pundits.

One key observation to note is a modest flattening of the yield curve, that is, short-term rates rising relative to long-term rates. This flattening of the yield curve sometimes precedes an inversion of the curve – long-maturity rates moving below short-term rates. While this is seen by some as a recession predictor, this is far from a certainty. The chart below shows the year-to-date shift in the U.S. Treasury yield curve as of June 20th.



Source: Treasury.gov

So why does this flattening happen? Doomsday predictions aside, this can be explained in two parts. First, the short end of the curve has risen with Fed rate increases because this is the end of the curve the Fed exerts more direct control on. Second, the long end of the curve is more complicated, but relatively easy to explain based on some very basic economic fundamentals – those being muted inflation expectations (low inflation is generally associated with lower yields) and low global interest rates (relative attractiveness of U.S. treasuries even at current yields). While a flattening yield curve may be a business cycle indicator, it would be improper to give full credence to the *recession theory* of the inverse yield curve given the unintended consequences of the world's artificially low interest rate environment.

We continue to employ fixed income strategies that produce portfolios with lower duration (interest rate sensitivity) than the U.S. Aggregate Bond Index. In general, we have found active bond strategies to be more successful at navigating rising interest rate environments than passive index strategies.

International vs. U.S. Stocks

Buoyed by currency tailwinds, both developed and emerging international equities have enjoyed a stellar start to 2017 after a difficult few years. While the S&P 500 Index returned approximately 10% YTD, the MSCI EAFE Index as well as the MSCI Emerging Markets index have returned approximately 14%. While the relative return between these asset classes will undoubtedly exhibit volatility, we are seeing positive signs out of international economies and believe this trend could continue.

*Source: Morningstar – Total International Stock vs S&P 500 YTD

Growth vs Value

On the domestic equity front, one development that stands out is the dramatic resurgence of our value managers over the last 12 months. During this period Dodge and Cox Stock (DODGX), which we consider the quintessential value manager, outperformed the S&P 500 by just over 9% and Oakmark Select (OAKLX) outpaced the benchmark by 5.6%. This outperformance came despite the average value manager in the Morningstar universe underperforming the S&P by 2%. We attribute this to a resurgence in financial stocks, particularly banks, that will see stronger profitability in a higher interest rate environment, as well as some pretty good stock-picking on the part of these managers. We plan on maintaining our holdings with our value managers at present levels. Investing away from the crowd is not always popular, but in the long run we find that it can be very profitable.

Thank you for your continued trust and confidence in Pilot Capital Management. As always, should there be any questions, please don't hesitate to contact us.

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