NELSON ROBERTS
INVESTMENT ADVISORS

# Quarterly Commentary

2017 | Q3

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## ECONOMIC OVERVIEW

### The Teflon Market

In the last few years, we have had events that created significant market declines. The “taper tantrum,” fear of a US Ebola virus outbreak, European deflation, Greek debt, decelerating growth in China (remember the 1,000-point market drop?), Brexit, the drop in oil prices and the US election all caused dramatic, if short-lived, moves in the market. The market sometimes even reacted to events that did not ultimately occur.

Similar events today seem to have little market impact. We have experienced natural disasters (hurricanes and earthquakes), North Korean nuclear threats and President Trump’s responses, failed healthcare legislation, debt ceiling worries and the Fed’s pivot toward a more restrictive monetary policy. But market participants have donned their “Don’t Worry Be Happy” t-shirts and steadfastly led the market to new highs. In fact, the S&P 500 has had eleven consecutive months in which it has posted a positive return, a winning streak that the US markets have not experienced since 1959.

Why are we seeing widespread market appreciation? As James Carville once said, it’s “the economy, stupid.” After years of hand-wringing about events that could disrupt a tepid yet persistent economic recovery, markets have gained confidence that this extended period of economic growth will continue. The current economic expansion is entering its 100th month and growth has shown signs of accelerating. As of June 30, US Gross Domestic Product (GDP) grew 2.2% over the previous year and was up 3.0% when compared to the first quarter of 2017.

The Federal Reserve Open Market Committee (FOMC) has tapped on the brakes several times, raising interest rates twice this year and signaling its intention to raise them for a third time by year-end. More notably, following the FOMC’s meeting in mid-September, there were indications that the FOMC would begin decreasing the size of the Federal Reserve’s balance sheet by allowing its bond holdings to mature without repurchasing a corresponding amount of new bonds. The Fed balance sheet, with less than $1 trillion in holdings in 2007, exploded to $4.5 trillion due to the three-part series of quantitative easing programs. A significant reduction would put material upward pressure on interest rates, perhaps stifling growth. Further analysis of Federal Reserve Chair Janet Yellen’s comments indicates that the accumulated reduction in holdings would total only 10% of the Fed’s balance sheet assets by the end of calendar year 2018. Clearly, the Fed is taking a cautious approach.

| Index Performance | Q3 '17 | YTD |
|---|---|---|
| Dow Jones Industrials | 5.57% | 15.41% |
| Standard & Poor’s 500 | 4.47% | 14.21% |
| EAFE (international stocks) | 5.45% | 20.41% |
| Russell 2000 (small stocks) | 5.65% | 10.91% |
| Barclays Interm. Gov/Credit | 0.60% | 2.34% |
| Barclays Municipal | 1.06% | 4.66% |

We apply rigorous analysis in asset selection so you can focus on your passion

ECONOMIC OVERVIEW

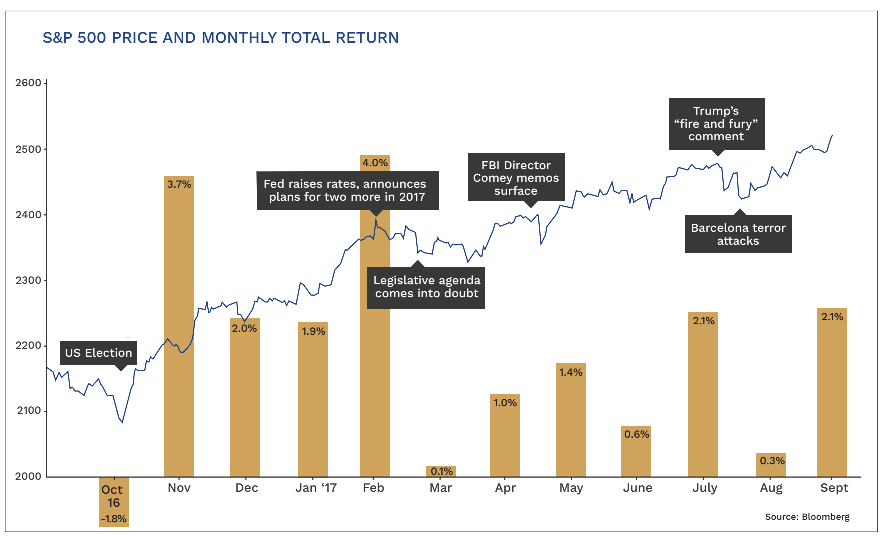
## The Teflon Market (cont.)

The US is not alone in enjoying rising equity markets. Developed international equities are up 20.41% year to date and emerging markets have appreciated 28.03%. Foreign markets, like those in the US, have benefited from a growing economy, an uptick in company earnings and improving employment opportunities. For example, Japan's economy is growing at a 2.0% annual rate and has had positive wage growth for its workers. The Eurozone unemployment rate has dropped from an average of 13.1% in 2013 to 9.1% this summer. Dollar-to-euro exchange rates have responded to the resurgence in the Eurozone, with the dollar falling 10.96% since January 1, 2017. The decline in the dollar helps make US goods more attractive (cheaper) for foreign buyers.

Inflation in the US has remained surprisingly tame, with the August measure coming in at 1.90%. This in turn has kept bond yields low, with the 10-year US Treasury bond at 2.33%. More importantly, mortgage rates have stayed near historic lows, supporting the housing market. We have long expected an uptick in inflation and a corresponding move in longer-term interest rates. Now that growth is occurring across the globe, we think that the catalyst for higher inflation is in place.

As the market hits new highs on an almost daily basis, it is important to focus on stock valuations. Our message remains consistent with our second quarter commentary, when we wrote, "the only thing missing is euphoria." Stock valuations are not euphoric, but the market is fairly valued. We believe that further stock appreciation from these levels will be driven by growth in corporate earnings. This growth is likely, as we saw S&P 500 company earnings improve 5.9% from the first quarter to the second quarter of this year and a similar sequential improvement is forecast for the second to third quarter of 2017. Confidence is building among stock market participants and within the corporate sector as both domestic and foreign economies demonstrate growth.

The Trump administration has not backed off of its plan to further stimulate the economy with a corporate tax cut and an infrastructure spending plan. Legislative success with either of these two initiatives would provide a further boost to corporate earnings. Given the level of current economic growth and the continued ballooning of the federal deficit, further stimulus seems unnecessary at this time and could cause the economy to overheat.



## Managing Momentum

We believe the momentum stock rally, driven by Amazon (tkr: AMZN), Apple (tkr: AAPL), Microsoft (tkr: MSFT), Alphabet (tkr: GOOG), and Facebook (tkr: FB) will end, but we do not want to make the mistake of trying to time the turning point. We owned a substantial overweight in Amazon and a market weight in Alphabet, for a 10% combined exposure in our portfolios. To reduce that exposure, we decided to cut our Amazon position. The stock remains attractive, particularly since Amazon Web Services dominates the data center space and research suggests that more than half of product searches start on AMZN's website. However, since AMZN's outperformance had caused it to grow to 7% of our portfolios and the stock is among the most richly valued and volatile of the momentum stocks, we thought it prudent to trim our holdings. We think AMZN would react more negatively in a momentum pullback and we are also concerned about whether its growth trajectory can continue to meet market expectations. We still like the company and the stock, however, and will continue to hold a substantial overweight position.

This change reduced our consumer discretionary weight (AMZN falls into the consumer discretionary sector) and increased the technology weight, bringing our portfolio closer to market weight. It also slightly reduced our exposure to the "Fab Five" momentum stocks.

On the other hand, we think that Alphabet is the momentum stock with the most solid investment thesis and most attractive valuation in view of its growth prospects, and took the opportunity to add to our position when the stock declined. This brought us to an overweight in Alphabet.

We added to our Verizon (tkr: VZ) position because we believe that VZ is undervalued relative to the market, its peers and its own history. VZ's most recent quarterly report gives us confidence that it can regain customers, despite premium pricing, due to its superior network. Furthermore, it is a stable company with a 4.75% dividend yield, and should be a more defensive name if the market shows concern about valuations (please see Economic Overview). Adding to our position also enabled us to match our new telecom sector target.

In concert with increasing our telecom sector target, we reduced our energy sector weighting and trimmed Schlumberger (tkr: SLB). We think the company has potential cash flow issues, as some of its customers, particularly Venezuela's national oil company, may have trouble paying their bills.

We also sold our remaining F5 Networks (tkr: FFIV) position. In the short term, we believe its recent product refresh cycle is not living up to the hype. In the longer run, FFIV's core market is maturing. In anticipation of the product refresh hype waning, we had trimmed our position in January. We think it is increasingly likely that FFIV's products may be marginalized as workloads go to the cloud, leading us to close out our holdings.

> "After years of hand-wringing about events that could disrupt a tepid yet persistent economic recovery, markets have gained confidence that this extended period of economic growth will continue."

## FIRM UPDATES

Nelson Roberts Investment Advisors is pleased to welcome Chrissy Domingo to the team. Chrissy joined the firm August 1st after graduating from Santa Clara University with a degree in finance. She enjoys snowboarding, hiking and volunteering with local animal rescue organizations.

The firm also welcomed Aubrey Smoot, daughter of Darcy Nelson Smoot and Cliff Smoot, and granddaughter of Brooks and Marilynn Nelson. Aubrey was born on August 22, 2017, and weighed 8 pounds, 6 ounces. She and her parents are doing well.

## WEALTH MANAGEMENT

# Protecting Your Identity

Cybercriminals recently gained access to 143 million credit records, including Social Security numbers, driver's license numbers and addresses, from Equifax, one of the three major consumer credit reporting agencies. It appears that the massive data breach stemmed from a failure by Equifax to keep its software up to date. This is not the first time hackers have accessed consumer information in the US and probably will not be last, so here are a few tips for protecting your credit.

How do you know if your information was stolen? It is too early to tell whose information was taken in the Equifax breach or how it was used, but if you have a credit history, there is a high probability that you were affected. Equifax has set up a website where you can type in your last name and the last six digits of your Social Security number and the site will tell you if you have been affected. Before you enter your information, however, remember that you are providing personal data to the same company that just had information stolen from it.

What can you do to protect your information? Here are three steps you can take to ensure that your identity is not being used by criminals:

**1. Freeze Your Credit**
The basic benefit of putting a freeze on your credit is that if someone attempts to take out a loan or get credit using your personal information, the lender will be unable to check your credit score or history and will not approve the application. The downside is the headache of having to unfreeze it if you need to apply for a credit card, lease a car or refinance your mortgage.

To place a freeze on your credit reports, you need to call the credit reporting companies or go to each website. The three major credit reporting companies are Equifax, Experian and TransUnion. While a freeze request can be filed on the company websites, many experts are recommending calling the companies directly. You will need to give them your name, address and Social Security number. The process takes 5-10 minutes via phone and you will be given a 10-digit PIN to use when you want to unfreeze your information.

*Equifax:** 1-800-349-9960
*Experian:** 1-888-397-3742
*TransUnion:** 1-888-909-8872

Fees: Each state has passed security freeze legislation setting the amount that a credit bureau is allowed to charge customers. The fee amount varies by state.

**2. Check Your Credit History for Free**
You can monitor your credit reports for any suspicious or unusual activity for free. Under the Fair Credit Reporting Act, consumers are entitled to one free credit report from each of the three major reporting bureaus once a year. You can safely access your reports by visiting annualcreditreport.com.

**3. Sign Up For a Monitoring Service**
There are several companies that will monitor your credit activity with a monthly subscription. Companies like IdentityForce or LifeLock charge $20-30 per month to provide monitoring of all three credit reporting agencies and they will alert you if an account or credit card is opened in your name. Equifax is offering free credit file monitoring and identity theft protection to consumers through its monitoring service called Trusted ID. The subscription is free for one year regardless of whether you were affected by the data breach. The service includes monitoring of all three credit bureaus. You can sign up on Equifax's website. Again, however, you have to decide how you feel about having the company that allowed the breach to happen in the first place provide a monitoring service.

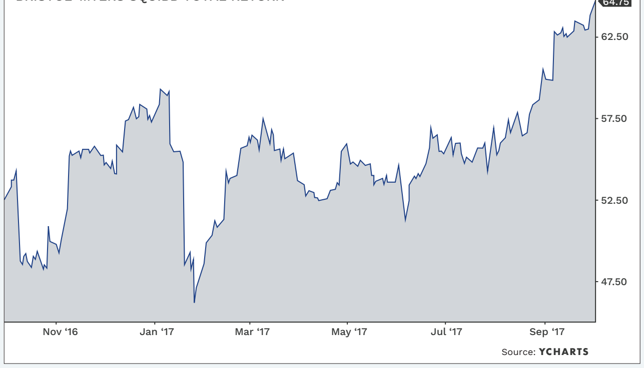
Our advice: the Equifax breach is not an isolated event and more hacks are likely to occur in the future. Consumers need to be vigilant and protect their data. We recommend being pro-active and taking steps to ensure your identity is protected by either freezing your credit or monitoring your credit reports.

FEATURED EQUITY

# Bristol-Myers Squibb

Bristol-Myers Squibb (tkr: BMY) is a pharmaceutical company focused on specialty medicines (those with higher margins and still under patent protection) with a further emphasis on immuno-oncology (please see Special Topics page 6). The company's drugs fall into six divisions: oncology, cardiovascular, immunology, neurology, virology/infectious disease and mature drugs in a variety of areas. BMY has made a big commitment to immuno-oncology and has two drugs approved for treatment of several different types of late stage cancer, Yervoy and Opdivo. Because immuno-oncology is such a new field, the results of drug clinical trials are closely scrutinized. When Opdivo failed to create better patient outcomes in first-line treatment of non-small cell lung cancer in a trial reported last fall, BMY's stock fell over 15%. A careful review of the company led us to conclude that immuno-oncology treatments will have an important and growing role in cancer treatment and that this was a buying opportunity.

BRISTOL-MYERS SQUIBB TOTAL RETURN




BMY's strategy is to combine the resources, scale and capability of a large pharmaceutical company with the speed and focus on innovation more characteristic of the biotech industry. Analysts believe that the market for immuno-oncology drugs will be about $14 billion by 2019 and will grow to $34 billion by 2024. BMY's two drugs had sales of $6.7 billion last year, with Opdivo accounting for $3.77 billion in 2016. These treatments are very expensive: $140,000 for the initial round of administration and maintenance of $14,000 per month. Therefore, it is critical to sort out which patients will benefit. Opdivo and Yervoy have one main competitor at present, Merck's Keytruda.

With Pfizer, BMY also co-owns and markets one of the new novel oral anticoagulants (NOACs). Eliquis generated sales of $3.34 billion in 2016. Sales in this market are expected to be over $30 billion by 2024. Eliquis has three competitors, but is doing well and holds over 40% of the market. The NOACs all have a better safety profile than Coumadin, the longstanding standard anticoagulant, with fewer bleeding complications and equal efficacy. The main limitation in their use has been the lack of a reversal agent, but that is under active development.

BMY is also an attractive acquisition target, with cash on the books of $4 billion. The stock pays a solid dividend of 2.5%. BMY appointed a new chief science officer this year, Thomas Lynch, MD, who was an oncologist specializing in lung cancer treatment at Massachusetts General. His expertise in this field should tremendously benefit BMY.

(The preceding information regarding the featured equity should not be construed as a recommendation to purchase the security. It should not be assumed that future returns will be profitable or will equal the historical performance. Please contact us for a complete list of holdings.)

## TOP 15 HOLDINGS

- iSHARES CORE S&P SMALL-CAP ETF
- ALPHABET INC.
- AMAZON.COM INC.
- UNITEDHEALTH GROUP INC.
- VANGUARD FTSE EMERGING MARKETS ETF
- COSTCO WHOLESALE CORP.
- FIRST REPUBLIC BANK
- VERIZON COMMUNICATIONS INC.
- UTILITIES SELECT SECTOR SPDR
- STRYKER CORP.
- CISCO SYSTEMS INC.
- ROPER TECHNOLOGIES INC.
- INVESCO LTD.
- THE TRAVELERS COS INC.
- SALESFORCE.COM INC.

## OUR TEAM

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### SPECIAL TOPIC

# An Immuno-Oncology Primer

Immuno-oncology is the use of the body's own immune system to treat cancer. It is considered to be a subset of immunotherapy, which is the more general term used to describe manipulating the body's immune response in order to treat disease. The immune system is extremely complex (which makes figuring out how best to use the new treatments also very complex) but fundamentally consists of cellular elements (specialized white blood cells including T cells, B cells and macrophages) and non-cellular, or molecular components (antibodies produced by B cells, cytokines, which are proteins and glycoproteins secreted by certain cells to signal other cells, and others).

Different immuno-oncology treatments use different components of the immune system to attack the cancer. Monoclonal antibodies and chimeric antigen receptor therapy (CAR-T) are getting most of the attention right now.

An antibody works by attaching itself to a specific receptor (antigen) on the surface of another cell (which could be a virus, bacterium or cancer cell). This process flags that cell as abnormal and it can then be destroyed by T cells. The tricky thing about cancer cells is that they are sometimes able to "hide" from the normal surveillance of the immune system, allowing the cancer to grow. For example, two proteins designated PD-L1 and PD-L2 can be expressed by cancer cells. These interact with a protein on the body's T cells and are able to de-activate them so that they no longer recognize and destroy the cancer cells. These substances and others have been identified as critical to stopping the growth of cancerous tumors. The pathways are called "immune checkpoints," hence the drug class called "checkpoint inhibitors." BMY's two drugs, Opdivo and Yervoy, are both checkpoint inhibitors. Another avenue receiving a lot of research attention is CAR-T. In this approach, a patient's own T cells are removed from the body and have special receptors added to them in the lab. These receptors allow the T cells to recognize the specific cancer being treated and destroy it. The FDA has just approved the first CAR-T, made by Novartis. Kite Pharmaceuticals, recently acquired by Gilead, expects to have its CAR-T approved in November.

Recent research results suggest that combination therapy (more than one drug or a combination of older drugs and newer drugs) may be more effective than single-drug therapy. More work is also underway to identify which patients are likely to respond best to immunologic approaches to cancer treatment.

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