AMG Funds

Financial Markets Review

Second Quarter 2017

The second quarter picked up where the first quarter left off with more positive returns for stock and bond investors amid low levels of market volatility. The CBOE Volatility Index, also known as the "fear gauge", sank to post-crisis lows[1], surprising some investors who had expectations for higher volatility given Federal Reserve (Fed) policy normalization and ongoing distractions facing the Trump Administration related to the Russia investigation. So far this year, there have been only four trading days in which the S&P 500 Index rose or fell more than 1%[2]. By this measure, it would be the calmest first-half of a year since the S&P started recording daily returns thirty years ago[3].

Meanwhile, the Fed raised short-term rates a quarter-point again this quarter, the fourth such hike since they slowly began tightening rates in December 2015. Following their June policy meeting, the Fed also announced plans to shrink its $4.5 trillion balance sheet, which swelled to massive proportions following multiple rounds of quantitative easing in the wake of the Financial Crisis. Under the current plan set to begin in the next several months, the Fed will gradually decrease reinvestments of maturing U.S. Treasury and mortgage-backed securities and initiate a gradual decline in the size of its securities holdings. Despite additional policy tightening measures, the Fed is challenged with recent weaker inflation and labor reports. The Personal Consumption Expenditures Price Index, the Fed's preferred inflation measure, topped the important 2% annual rate for the first time in February, but has declined ever since in part due to lower oil prices[4]. While the unemployment rate improved to a 16-year low of 4.3% in June, Labor Department reports on new jobs has slowed. The economy created only 120,000 jobs on average over the prior three months, which is lower than the 201,000 pace set during the three months prior[5].

Investors balanced other mixed economic signals during the quarter. First quarter gross domestic product (GDP) growth slowed to a 1.4% annualized pace, down from the 2.1% pace set in the fourth quarter[6]. The Commerce Department attributed the slowdown primarily due to a reduction in private inventories, weaker consumer spending and lower government spending. The International Monetary Fund (IMF) also slashed its forecast for 2017 U.S. GDP Growth from 2.3% to 2.1% citing "larger than usual" risks to their forecast due to policy uncertainty surrounding the Trump Administration's fiscal stimulus plans[7]. Despite the relatively weak readings on GDP, the ISM reports on Manufacturing and Non-Manufacturing sectors continued to signal solid economic expansion with both Indexes above 50 throughout the quarter (a reading above 50 indicates economic expansion and a reading below 50 indicates contraction)[8]. Sales of new and existing homes slowed slightly during the quarter, but remain at healthy levels near post-crisis peaks. Home prices continued their ascent at a 5.7% annual pace according to the S&P CoreLogic Case-Schiller 20-City Composite Home Price NSA Index. U.S. auto sales continued to pump the brakes to a 16.4 million seasonally adjusted annual pace, down from the record high of 18.3 million set last December[9].

At the same time, the economic picture continued to brighten overseas. Economic growth improved in Europe as evidenced by 10 straight monthly increases in the Eurozone Manufacturing PMI Index[10]. The IMF also upgraded their global growth forecast from a 3.1% rise in 2016 to a 3.5% rise in 2017 citing stronger economic activity, expectations of more robust global demand, reduced deflationary pressures and optimistic financial markets[11]. Late in the quarter, global central banks hinted towards policy tightening. For instance, European Central Bank (ECB) President Mario Draghi acknowledged the economic strength in his speech, stating "All the signs now point to a strengthening and broadening recovery in the euro area. Deflationary forces have been replaced by reflationary ones[12]." Markets interpreted these statements as a signal the ECB is preparing to curtail its monetary stimulus and long-term government bond yields moved higher as a result.

Equities

Positive performance trends continued during the second quarter with the S&P 500 Index up 3.1%, marking the seventh straight quarter of positive returns for the widely followed benchmark. On a year-to-date basis through June 30, 2017, the Index is up 9.3%. The Dow Jones Industrial Average, S&P 500 Index and Nasdaq Composite Index all ended the quarter near record high levels. Large caps outperformed small caps again, as measured by the 3.1% and 2.5% returns for the large cap Russell 1000 Index and small cap Russell 2000 Index, respectively. Investors continued to prefer growth over value, with a 4.7% return for the Russell 1000 Growth compared to the 1.3% return for the Russell 1000 Value. Sector leadership rotated as health care and industrials outperformed with returns of 7.1% and 4.7%, respectively. Meanwhile, energy and telecommunication services were once again the only two negative sectors with returns of -6.4% and -7.1%, respectively. International equities outperformed their U.S. counterparts again with a 5.6% return for the MSCI World ex USA

1 Chicago Board Options Exchange, FactSet
2 S&P 500 Total Return Index (including dividends), Standard & Poors, FactSet
3 S&P 500 Total Return Index (including dividends), Standard & Poors, FactSet
4 US Bureau of Economic Analysis, FactSet
5 U.S. Department of Labor, FactSet, as of May 31, 2017
6 Commerce Department, FactSet
7 2017 Article IV Consultation with the United States of America - Concluding Statement of the IMF Mission, June 27, 2017
8 ISM – Institute for Supply Management, FactSet
9 Total light vehicles, U.S. Bureau of Economic Analysis
10 Markit Economics, FactSet
11 World Economic Outlook, April 2017
12 U.S. Dollar Index, Factset

Index. Emerging Markets were even stronger with a 6.3% return for the MSCI Emerging Markets Index for the quarter, boosting year-to-date performance for Emerging Markets to 18.4%. International investors continued to benefit from the falling U.S. Dollar which has declined 6.5%[12] this year.

Bonds

Bonds had modestly positive returns in the second quarter as investors kept a watchful eye on the Fed. The Bloomberg Barclays U.S. Aggregate Bond Index, a broad gauge of bond market performance within the U.S., gained 1.5% during the quarter. Despite a steep increase late in the quarter, the 10 Year U.S. Treasury Note still finished nine basis points lower for the quarter at a yield of 2.31%. Municipal Bonds were positive with a 2.0% return for the Bloomberg Barclays Municipal Bond Index even with the mounting threat of a downgrade in Illinois to "junk" status by the major rating agencies. Investment grade corporates outperformed Treasuries and securitized credits with returns of 2.5%, 1.2% and 0.9%, respectively, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index.. Healthy risk appetite led to modestly tighter credit spreads for investment grade and high yield corporate issues. As a result, high yield bonds continued with a positive 2.2% return for the Bloomberg Barclays U.S. Corporate High Yield Bond Index. Foreign bonds, by comparison, were up 3.6% according to the Bloomberg Barclays Global Aggregate ex-USD Index.

Each of us at AMG Funds appreciates the continued opportunity to assist you with your investing needs.

All investments are subject to risk including possible loss of principal. Past performance is no guarantee of future results

Please note that all performance data and comments are for the period from April 1, 2017 through June 30, 2017. Any sectors, industries, or securities discussed should not be perceived as investment recommendations. The views expressed represent the opinions of AMG Funds and are not intended as a forecast or guarantee of future results. The information and opinions contained herein are current as of June 30, 2017 and are subject to change without notice. Information has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed.

The Russell 1000® Value Index is a large-cap value index measuring the performance of the largest 1,000 U.S. incorporated companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 1000® Growth Index is a market capitalization weighted index that measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000® Index is composed of the 2000 smallest stocks in the Russell 3000® Index and is widely regarded in the industry as the premier measure of small-cap stock performance.

The CBOE Volatility Index® (VIX® Index) is a leading measure of market expectations of near-term volatility conveyed by S&P 500 Index (SPX) option prices.

The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measures the value of residential real estate in 20 major U.S. metropolitan areas: Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, D.C.

The Eurozone Manufacturing Purchasing Managers' Index (PMI) is a weighted indicator calculated from indices of output, new orders, employment, suppliers' delivery times and stocks of purchases.

The MSCI World ex USA Index is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. The MSCI World ex USA Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

The U.S. Dollar Index is a measure of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index is a total return performance benchmark for fixed income securities having a maximum quality rating of Ba1 (as determined by Moody's Investors Service).

The Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies: Moody's, S&P, Fitch.

Dow Jones Industrial Average (Dow Jones) is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry and are listed on the New York Stock Exchange. It has been a widely followed indicator of the U.S. stock market since October 1, 1928.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Barclays Global Aggregate ex-USD Index is a broad-based measure of the global investment-grade fixed income markets, excluding U.S. dollar-denominated securities. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate Bond Index is an unmanaged index representative of publicly issued, SEC-registered U.S. corporate and specified foreign debentures and secured notes.

The Indices are unmanaged, are not available for investment and do not incur expenses.

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