747 Third Avenue
New York, NY 10017

Tel. (212) 486-2004
Fax (212) 486-1822

Matrix Asset Advisors, Inc.

Capital Markets Commentary and Quarterly Report: 2nd Quarter 2017

The stock market added to its 2017 gains in the second quarter, with the S&P 500 rising by +3.09%. For the first six months of the year, the index was up +9.34%. The market's advance was propelled by continued good economic results in the U.S. and the Eurozone, while Asia maintained mid-single digit growth. Corporate earnings from S&P 500 companies this year are the best in nearly six years[1]. For now, the administration's inability to pass legislation and advance their health care, tax reform and fiscal stimulus initiatives has not impeded the market's move higher. Jamie Dimon, JP Morgan's CEO, recently said that "the American business sector is powerful and strong and is going to grow regardless…in spite of gridlock we will grow at 1.5% to 2%. It will be much stronger if we are not gridlocked" (JPM Q2, 2017 earnings conference call 7/14/2017).

Matrix's portfolios showed positive results in the quarter but lagged the S&P 500's return. Growth continued to outperform Value with the Russell 1000 Growth Index more than tripling the Value Index's return in the quarter, +4.67% versus + 1.34%. In the last month of the quarter, this year-to-date trend reversed, and Value outperformed Growth +1.63% versus -0.26%, and Matrix's portfolios posted their best monthly returns for the period.

As discussed below, we think our portfolios are well positioned to capitalize on a shift in sentiment from Growth to Value and recover the first six month's performance lag versus the S&P 500. According to *Barron's* (July 3rd, 2017), among large-cap stocks, **Value stocks are now cheaper relative to Growth stocks than at any time in the last six decades**, except for the top of the dot-com bubble in the late 1990's. As the article notes, "this wide spread provides a compelling statistical case for expecting Value investing to significantly outperform Growth investing in coming years." As evidenced by June's market reversal, when change comes, it can be fast and dramatic.

The earnings and dividend increases in our portfolios have met or exceeded expectations and we are optimistic about the portfolios' near-term prospects, and especially optimistic on a relative basis.

Healthcare was the best performing market sector in Q2 followed by Industrials and Financials. The worst performing market sector was Energy, down 6.32% in the quarter and more than 12% in the first half of 2017.

[1] The *Wall Street Journal*, 7/05/17 - Markets Review & Outlook

For the first half of the year, the best performing market sectors were Technology, Healthcare, Consumer Discretionary and Industrials. The worst performing sectors were Energy and Telecom. The 10-year Treasury yield declined from 2.39% to 2.31%, but was up sharply from its low of 2.13% on June 14th after central banks in the U.S. and Europe spoke about plans to raise interest rates and end their bond buying programs. Oil was down 9.3% in the quarter and 12.3% in the first half of 2017.

Matrix Portfolios and Outlook

As noted earlier, Matrix's Large Cap Value and Dividend Income portfolios posted positive returns in the quarter but lagged the benchmark's performance. Our Q2 underperformance was caused by a combination of being out of sync with the market's preference for Growth, our sector weightings and a handful of poor performing stocks.

While the market has continued its upward move, 2017 has seen a massive rotation and reversal of several trends that were driving stock prices since the presidential election. After a strong 2016, we have started this year off on a weak relative note but with positive returns.

After a poor 2016, Growth stocks and momentum stocks had a sharp recovery in the first half of 2017, while Value stocks slowed from their strong 2016 performance.

The change in market sentiment was caused by concerns about the strength of the economic recovery and a rethinking of the inflation and interest rate outlook. Growth stocks have thrived and Value stocks lagged as concerns about a slowing economy took hold. The outlook for faster economic growth has been negatively impacted by lower confidence in the Trump administration's ability to deliver on tax reform, healthcare legislation and their fiscal spending agenda.

Once these markets trends started to play out they took on a life of their own. Strength begot strength and weakness generated more weakness.

We think much of this market dynamic is driven by market psychology and momentum investing rather than the underlying fundamentals. We believe fundamentals would argue that these recent moves are not warranted and as discussed above, a look at the market in terms of Value vs. Growth suggests that Value stocks have only been this attractive relative to Growth one other time in the past 60 years. Importantly, the last time was after the Internet bubble of the late 90's and led to a very strong period for Value (*Barron's* on July 3, 2017 discussed this in some length, "Value Stocks set to Head Higher").

Beyond the macro headwind against Value, our portfolio was hurt by our exposure to Financials, Energy, and Consumer Discretionary stocks and our Value bias within Technology.

Looking forward, we are expecting much better trends in these areas, and we are very upbeat on a relative and absolute basis for these sectors and our holdings.

Performance and valuation differentials are at extremes and we think earnings and business outlooks argue for better stock price action in the areas where we are focused.

While it was a poor relative quarter and six months, a lot of these negative underlying trends began to reverse in the last four weeks of the quarter after central banks noted improving global economic conditions and began preparing investors for a gradual increase in interest rates. As market psychology turned, the portfolio began to make up substantial ground in a short period.

Investors generally look to buy on a dip and/or understand that down markets or flat environments set the stage for better market returns.

We think the last six months has been one of those periods where our holding's fundamentals are strong, yet the portfolio has retrenched and lagged the market on a relative basis. This has been our dip.

We believe a combination of depressed valuations and strong outlooks, especially in a time where much of the market is richly priced, leaves us very well positioned for the second half of the year.

As noted earlier, with a small number of exceptions our investments are reporting earnings in-line or better than expected. During the quarter, over 85% of our portfolio holdings beat expectations versus 73% for the S&P 500 companies. We believe that both portfolio strategies hold companies that are well positioned for the economic environment we foresee over the next 12-18 months and expect them to show significantly improved absolute and relative performance in a market rotation back to Value from Growth.

The backdrop for continued earnings growth remains favorable with S&P 500 companies expected to show earnings growth of 9.8% in 2017 compared to last year, according to FactSet. The U.S. economy continues to expand, the European manufacturing index in June reached its highest level since April 2011, Japan's business confidence also hit its highest level in more than three years and China's manufacturing data showed a return to expansion in June.

The stronger economic data are moving central banks around the world towards actions that will lead to higher interest rates. Additionally, oil prices, which have been a depressant on

inflation and economic activity, are likely to move higher as supply and demand come closer to being in balance.

The risks to the stock market we see are mostly political, and a market pull back at any time in reaction to higher interest rates or a rotation out of high priced Growth stocks would not be surprising. We think our portfolios are positioned to do better than the Market in a higher interest rate environment or a rotation out of Growth correction.

Large Cap Value Strategy

Matrix's Large Cap Value portfolio showed a gain in the quarter but lagged the S&P 500's return. Positive performance in most portfolio sectors was offset by negative returns in Energy and Consumer Discretionary. We are overweight Energy, a poor performing sector in a period of declining oil prices. Weak share price performance from Harley-Davidson (HOG) and Viacom (VIAB) negatively impacted results in Consumer Discretionary.

HOG has a good, shareholder friendly management team who are actively managing inventory and new product introductions. This should position the company to weather the current challenging motorcycle market and thrive when business improves. Viacom brought in new senior management to revive a company that has suffered from poor leadership and we are already seeing meaningful progress in turning around their flagship brands like Nickelodeon, MTV, VH1 and Comedy Central as well as the Paramount Film Studio. We are optimistic about the prospects for both companies.

All other sectors in the portfolio showed positive returns in the quarter, led by Healthcare, Industrials and a late surge in Financials.

Healthcare was led by AbbVie and Thermo Fisher, Industrials by United Technologies and Eaton, and Financials by State Street, Chubb and American Express. As noted earlier, Financial stocks were very strong performers in June, after interest rates rose and the positive stress test results were announced.

During the quarter, we started a new position in GE. We sold GE for a healthy profit about a year ago, in the $31.50 area for our dividend portfolio. Since our sale, the shares have massively underperformed the Market and the activist investor group Trian has made a significant investment in the company. Our investment rational for repurchasing GE was that the status quo was unsustainable. Either CEO Jeff Immelt would turn the company around quickly or he would be replaced. Less than one month after we made our initial investment, Immelt announced his retirement as CEO, effective August 1. We think this is a very positive development and that under the right leadership the company has significantly better business

and stock price potential. The new CEO John Flannery, who had been the head of GE Healthcare, has a great reputation and we are very upbeat about this change. In the meantime, the shares have a dividend yield of 3.6%.

Where cash was available we started a small position in Scripps Networks Interactive (SNI), a leading lifestyle network whose channels (HGTV, Food Network, Travel Channel, DIY Network, Cooking Channel and Great American Country) enjoy very high subscriber loyalty among an upscale female demographic. The share price has been weak with the rest of the media group on concerns about declining cable subscriptions, but SNI is being included on almost all lower priced media packages and its unique programming commands above average advertising rates. At 12 times estimated earnings, we think the shares offer exceptional value.

Where cash was available we also added to positions in Harley Davidson, Viacom, Occidental Petroleum and Schlumberger. We completed the sale of Symantec at a substantial profit after it reached our target price. It's also important to point out that in addition to its healthy stock price appreciation, Symantec shareholders received an extra $4 per share of cash dividend in the spring of 2016.

Looking forward to the balance of the year, we are very optimistic about how the portfolio is positioned. We expect our large weighting in Financials to benefit from a gradual rise in interest rates, a less adversarial regulatory environment and improving loan demand. Energy is slogging along, with crude prices near the low end of an expected price range of $40-$60 and may be the most hated sector in the market outside of Retail. We think it is due for a bounce on any evidence that supply and demand are moving towards balance. Our Consumer Staples holdings provide good income and stability for the portfolio and our Industrial and Consumer Discretionary holdings will benefit from the improving economic picture we foresee in the months ahead.

Our relative results have been hurt by the market's bet on Growth and specifically Growth/Technology. June provided a reminder that sentiment can change rapidly.

The biggest risks we see to the stock market are political, both domestically and abroad. On this score though, the recent election of the pro-business, pro-Eurozone president in France was encouraging.

Dividend Income Strategy

The Matrix Dividend Income portfolio (MDI) posted another positive quarter, but below the benchmark's return. Strong performance from the Industrial, Healthcare and Financial sectors were offset by negative returns in the Telecom, Technology, and Energy, as well as

flattish performance in the Consumer Discretionary and Consumer Staples sectors. The MDI portfolio had its best month of the year in June, when market sentiment shifted away from Growth and Technology. We would not be surprised if this continues for a while as the valuation disparity between Growth and Value reached extreme levels in the first half of 2017.

Industrial sector performance was led by Eaton, UPS and United Technologies, Healthcare by AbbVie, Gilead and Johnson & Johnson, and Financials by J.P. Morgan Chase and MetLife.

Telecom was the worst performing sector in Q2, as the cell phone companies engaged in a price war to poach customers from each other in a business that has reached market saturation. We believe there are reasons for optimism for their share prices from current levels. Once Verizon and AT&T offered unlimited data plans, market shares stabilized. Of late, there is increasing talk of industry consolidation which should make competition less cut-throat, and T-Mobile just raised prices on its "best" unlimited data plans. With their high dividend yields and very attractive valuations it will not take much good news to get investors interested in AT&T and Verizon again.

During the quarter where cash was available we added to positions in CVS, Cisco, Gilead, UPS, AT&T and BBT. We trimmed the position in Johnson & Johnson and sold the last part of our very profitable position in McDonald's.

During the quarter, eight of our holdings raised their dividends by an average of 6.0%. Year-to-date, 16 holdings have raised their dividends by 6.4% on average. In the aftermath of the stress test, our three banks increased their dividends by 8.2% for the upcoming year and these increases will be included in our Q3 calculation. The portfolio ended the quarter with a 3.4% current yield, which is about 70% above the S&P 500's yield. Our current embedded appreciation in the portfolio is 27.5%, well above its long-term average.

We expect our relative and absolute results to improve as the year unfolds. June's market action is a reminder of how quickly investor sentiment can change. Historically, our Dividend Income strategy has added significant value for our investors by defending well when market volatility rises. For those who have an eye toward adding to investments in this area, we think this year's underperformance has created a timely opportunity.

<u>Bonds</u>

During the quarter, Treasury yields rose on the 2-year Treasury note as the Federal Reserve continued on its path to raise short-term rates. The yield was modestly lower on the 10-year Treasury, 2.31% at June 30 versus 2.39% on March 31, but the quarter-end numbers miss the big moves intra-quarter that took the yield down to 2.13% on June 14. The yield then moved

dramatically higher into the quarter's end after central bankers in the U.S., Canada, England and Europe discussed preparing for the end of their bond buying programs and raising interest rates.

We have been positioned for a move to higher rates by buying shorter-term maturities and investing in the higher quality parts of the bond universe.

In the second quarter this positioning resulted in positive performance that was modestly below the Barclay's return for taxable bonds with comparable duration and in-line with the returns for tax exempt bonds of similar duration.

So far in 2017, we have been right about the economy but wrong about the direction of interest rates, except for short-term rates which have moved higher. Treasury bonds of five years and more have seen their yields drift modestly lower this year despite stronger economic growth, the Federal Reserve raising the Fed Funds rate by 50 basis points and hinting that at least one more rate hike is in store for 2017.

Given our outlook for healthy global economic numbers, a modest pickup in inflation, rising international bond yields, a Federal Reserve that is still in the early stages of a rate increase cycle and is beginning the process of unwinding its massive fixed income balance sheet, and a new administration that has a pro-growth agenda, we look for rates to move higher through the end of the year and into 2018.

We continue to believe that we are well positioned by focusing on high quality short to intermediate-term fixed income investments.

Balanced Accounts

We had raised some cash in the first quarter, when in our opinion, the risk-reward relationship for stocks versus bonds was less compelling. During Q2 we used the weakness in some of our stocks to put part of that cash back to work and modestly increased our equity exposure. We are constantly monitoring the risk reward relationship between stocks and bonds, making adjustments when the relationship tips in favor of one versus the other.

* * *

We are truly grateful for your confidence and trust, and are committed to keeping it, and earning it, every day and in everything that we do for you.

Please call any of us at (212) 486-2004 or (800) 366-6223 with any questions. Best regards.