Investment Review and Outlook
June 30, 2017

"The greatest thrill in life is defying all odds and doing what everyone says cannot be done." **- Junko Tabei (1939-2016), Japanese mountaineer and first woman to climb Mount Everest in 1975.**

No market pundit or economic guru could offer a better description of the 2017 financial markets than climber Junko Tabei. Despite political, economic, and international headwinds that plagued the first half of the year, financial markets surged – with many indices hitting record highs. Investors looked through the chaos and focused on improving economic fundamentals, better than expected corporate earnings, and the synchronized upturn in global growth. While focusing on these economic improvements investors demonstrated patience with the new administration that it will ultimately deliver on its business-friendly tax and regulatory relief agenda.

The equity market's second quarter rally followed an equally strong first quarter. The S&P 500's 3.1% rise came on top of a 6% jump in the first quarter. At mid-year the S&P was up 9.3% and the broad-based Russell 3000 had gained 8.9%. Small and mid-cap stocks trailed large caps – however, returns ended midyear in solidly positive territory with the Russell Mid Cap Index up 7.9% and the Russell 2000 up 5.1%. Despite across the board index gains, sector returns for the first half were widely dispersed as technology and healthcare rose by over 16% against declines of over 10% for energy and telecom stocks.

Strong equity markets were not confined to the U.S. International stocks are off to their best start in over a decade. Developed and emerging markets both posted gains of over 6% in the second quarter – pushing mid-year results for EAFE up 13.9% and the MSCI Emerging Markets Index up 18.4%. The combination of improving global fundamentals and a prolonged period of underperformance has helped foster a more constructive outlook for these key markets.

The most remarkable achievement of the equity markets has been its consistent march higher with greatly reduced volatility – this is especially true with U.S. large caps. The S&P 500 posted positive results in every month in the first half of the year. In fact, this is the first time the S&P has started the year with six consecutive up months since the first half of 1995. In addition, as markets blew past record highs, volatility declined dramatically.

In mid-June the Fed took another step towards tighter monetary policy by bumping the fed funds rate up 25 basis points. Although this marks the third rate increase since December, the Fed's deliberate pace and gradual movement higher has allayed bond investor fears. Most major bond indices rose in the second quarter, and are in positive territory for the year. The Bloomberg Barclays Aggregate Index is up 2.3% at mid-year, and the Bloomberg Barclays 1-10 Year Municipal Index has advanced 3.0% this year. The closely tracked 10-year U.S. Treasury bond yield dropped 15 basis points to 2.27% in the second quarter and is down 25 basis points since early January. However, the Fed's actions have pushed short rates higher causing the closely watched yield curve to flatten.

Anxiety continued to escalate in commodity markets as the Commodity Research Board (CRB) Index of 23 commodities declined 5.2% in the quarter and is down 10.9% for the year. Downward pressure in commodities was most acute in the energy markets as oil prices have dropped by over 15% so far this year. This key economic commodity has been driven lower by continued dislocation within OPEC and heated rhetoric over the U.S.'s drive towards energy independence with no meaningful drop in production.

Overall, the first half of 2017 defied all odds by soaring through political mayhem, and overcoming rising fears of geopolitical instability. We agree with Junko Tabei that defying the odds is thrilling – however, the future will bring new challenges.

The Post-Election Market Surge: *What Now?*

"The world may seem immovable. It is not. With the slightest push, in the right place, at the right time – it can be tipped" **- Malcolm Gladwell, Author of "The Tipping Point: How Little Things Can Make a Big Difference"**

In late 2016, the U.S. elections set off a wave of economic optimism among investors. After years of economic expectations bouncing between "slow growth" and "no growth" investors unleashed a buying frenzy on the belief that a more prosperous economic path was ahead. Regardless of one's political turf, it is clear that last November's election proved Malcolm Gladwell's point that at the right time and in the right place, the slightest push can be the "tipping point" that moves us in a new direction.

The November elections set off a market reaction that drove stocks to record highs. However, much of what launched the market's rally was already well underway months prior to the election. Beginning last spring the U.S. economy was showing tangible signs of improvement from its prolonged period of stagnant growth. Unemployment had dipped below 5% in the spring, consumer spending was accelerating in the summer, and manufacturing began to re-emerge in the fall. Throughout the year interest rates were at historic lows, inflation was not a threat, and the risk of a meaningful slowdown in Europe or in the emerging markets had greatly diminished from earlier in the year. For months in advance of the November elections global fundamentals were turning positive. However, financial markets were not responding to the steady improvment. Between Memorial Day and Election Day the S&P 500 gained less than 1.0%, and the EAFE Index of developed international markets actually lost more than 2.0%.

The dramatic shift in Washington following the surprise outcome of the election marked the "tipping point" for investors. This political push tipped the sentiment scales, causing an avalanche of optimism to rush into the market. Investors quickly embraced the view that positive economic fundamentals already in motion would accelerate by feeding off forthcoming pro-business policies. In fact, since early November all global markets are up nearly 20%, corporate bond yields have fallen, and yield spreads relative to Treasuries have narrowed considerably.

Good things happening too fast can sometimes create problems. As we enter the second half of the year the risk is increasing that investors become too complacent. Record market highs practically every month accompanied by record low volatility can lull investors into a false sense of security. However, this pattern of market behavior is not sustainable. Without implementation of meaningful pro-growth policies, investors will eventually grow impatient with the time lapse between promises, policy implementation, and visible results. We have growing concerns that a prolonged period without meaningful change could erode support for the market's current valuation levels – making markets vulnerable to extreme volatility and a correction.
Our belief is that the economic pendulum shift is underway, and future growth will outpace what we have experienced over the previous several years.

<u>Economic Outlook: "*Wheels Up, But Expect Turbulence*"</u>

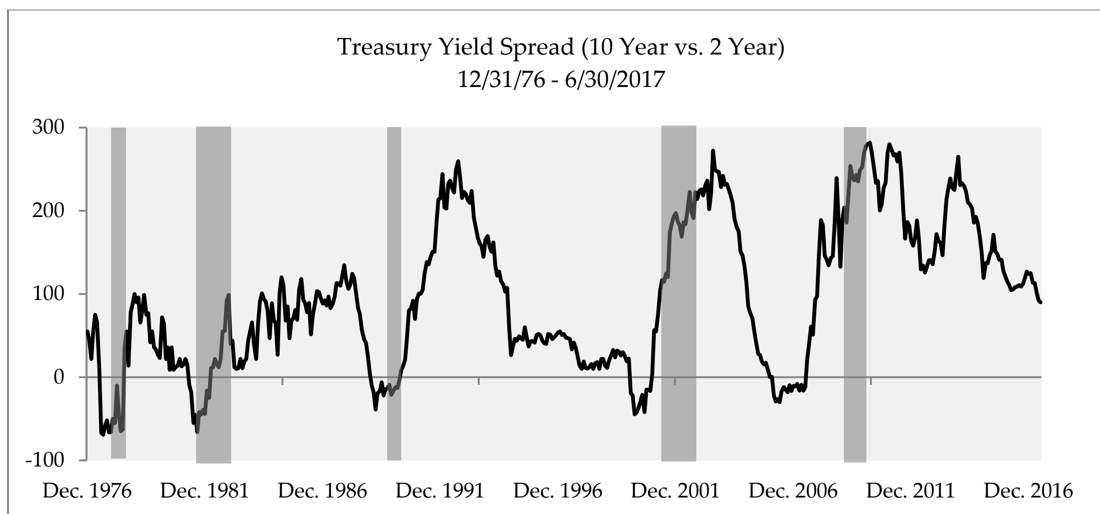
"When everything seems to be going against you, remember that an airplane takes off against the wind – not with it" **Howard Hughes (1905 – 1976), pilot, investor, film director, and philanthropist.**

Since the end of the financial crisis the U.S. economy has been moving in the right direction although economic growth has gained very little altitude. The U.S economy is on track to deliver its ninth consecutive year of economic expansion. However, the start to the year has been less than robust as first quarter GDP rose a meager 1.4%. While revised higher after an initial estimate of 0.7%, slow first quarter results make a pickup in economic activity essential to meet investors' full year expectations. Our view remains that despite the slow start 2017 GDP will expand by 2.50-2.75% - up from 2016's growth of 2.1%. Improvements in manufacturing, consumer spending, and employment should help boost second quarter growth. This view was supported by Fed Chair Janet Yellen when she said after the Fed's June meeting that "following a slowdown in the first quarter, economic growth appears to have rebounded, resulting in a moderate pace of growth so far this year".

We are also closely monitoring the positioning of the Treasury yield curve. Historically, fixed income markets have been much better predictors of future economic activity than the equity markets. The yield curve traces the level of interest rates across the maturity spectrum. The shape of the yield curve is determined by key economic factors such as inflation expectations, investor risk tolerance, monetary and fiscal policy, and loan demand. These factors are essential components of the economy, and their influence on the shape of the yield curve gives strong signals as to where the economy is heading.

Economists view a "normal" yield curve as one that is upward sloping, with higher yields paid on longer maturities versus lower yields paid for short maturities. A closely watched indicator of the shape of the yield curve is tracking the spread between the 10-year Treasury and its 2-year counterpart. The wider apart these yields trade, the steeper the curve – and as they trade more closely, the flatter the curve becomes. Recently, the yield spread has tightened from 130 basis points in late December to 90 at the end of the second quarter indicating that the curve has flattened in recent months. This movement in the curve is to be expected in an environment where the Fed has initiated higher short rates, and expectations for economic growth and inflation are relatively low.

Although the recent flattening in the yield curve is not cause for alarm, it is important to pay close attention to where it moves from its current level. A flat yield curve signals a slowdown in economic growth while an "inverted" yield curve (where short rates are higher than long rates) indicates a recession is on the horizon. As the chart below shows the yield curve has inverted five times in the past forty years, all of which were followed by a recession.



Source: Factset Analytics. *Periods of economic recession are shaded.*

Although today's yield spread is far from inverted, the current 90 basis points gap in yields is approaching 2007 levels. Therefore, keeping a close watch on this extremely reliable economic indicator is important. Our view is that the curve can continue to flatten as the timing of the Fed's rate hikes don't precisely align with acceleration in economic growth. The flattening yield curve will attract attention though we do not see this as a threat to the economy's growth trajectory. We believe that several positive economic factors will allow the U.S. economy to continue to growth, and accelerate from its current slow pace. In fact, the yield curve was very flat throughout the bull market of the mid-to-late 1990's.

We maintain the belief that we are in the early stages of a pro-business era, and that lower taxes and regulatory reform will ultimately be implemented. Our view is that the economic policy pendulum has begun to swing back in the direction of meaningful reforms and pro-economic growth policies – however, the transition is not going to be smooth. And we anticipate significant delays and implementation hurdles.

Investment Strategy

The biggest risk for investors is that expectations for economic improvement get too far ahead of real fundamental results. As we move into the second half of the year this risk increases as time passes without the new administration scoring a major economic policy "win". The market's surge since the election is being driven by the expectation that tax reform, reduced regulations, and other business-friendly promises will be fulfilled. Without follow through and effective implementation, the market is exposed to heightened risk. However, despite these doubts, we believe progress ultimately be achieved over the next year. As this ugly process of reform plays out the market's future is expected to bring uncertainty, fear, and a return of tumultuous volatility. However, for investors that stay focused on market fundamentals, and can remain disciplined, attractive opportunities will develop.

U.S. Equities

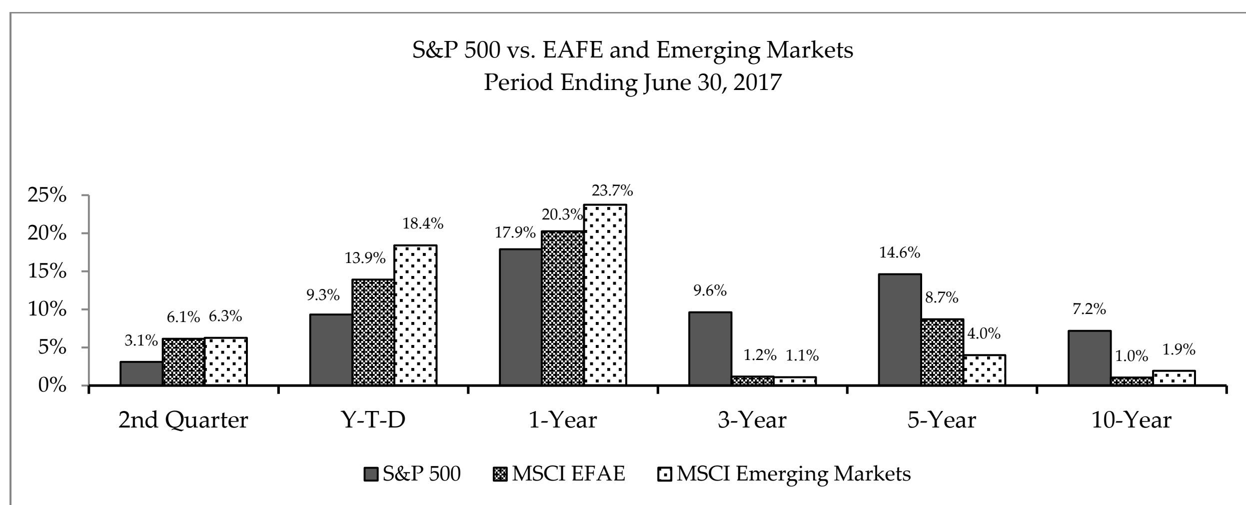
We remain committed to U.S. stocks with exposure across the capitalization spectrum. However, we do have a current emphasis on mid and small cap segments of the market. Although we continue to find large cap stocks attractive we believe compelling valuations and strong relative growth potential exists with companies that are more directly leveraged to the U.S. economy.

Although U.S. equity valuations appear a bit stretched based on current earnings, corporate profit growth is expected to be stronger than analysts' expectations over the next several quarters. After an earnings recession that lasted nearly two years corporate profit growth jumped by over 14% in the first quarter with 70% of companies reporting earnings above analysts' forecasts. Second quarter earnings are expected to beat current forecasts which should set off another round of positive earnings revisions.

Our continued focus is on balance sheets, cash flow, and sustainable earnings and dividend growth. However, we also believe strategies that incorporate earnings and price momentum will prove rewarding. Maintaining diversification will be important as market leadership will shift rapidly as investors' risk tolerances gyrate.

International Markets

After years of underperformance relative to U.S. stocks international equities have begun to outperform. As the chart below shows, developed and emerging markets have produced impressive gains over the past few quarters; however, returns have fallen well short of U.S. markets over the long term.



Source: Factset Analytics

Early in the second quarter we took a more positive view of international markets by moving from an underweight to an equal weighted position relative to our strategic allocation. We took this action based on several factors that we believe make this important segment of the market more attractive at this time. Most notably, we believe there is a reduced risk of an economic contraction in any major international economy. There is little evidence that any major economic region will suffer a recession in 2017 - marking the first year since before the 2008 global financial crisis that all major developed economies avoid economic contraction. In addition, we see improving fundamentals, favorable monetary policy by major global central banks, and attractive valuations.

Diversification across regions is critical in order to reduce country-specific risk. Our current bias is towards developed economies versus emerging markets due to our higher level of stability. However, we do believe having exposure to both markets will prove rewarding over time.

Fixed Income:

Our view on interest rates and fixed income markets remains unchanged. The improving U.S. economy with tightening labor markets, modest inflation, and synchronized global growth gives Chair Yellen ample cover to continue ratcheting the fed funds rate higher over the course of the year. After a year of sitting on the sidelines the Fed resumed rate hikes last December. Since then the Fed has initiated three rate hikes of 25 basis points each

bringing the fed funds target range up to 1.00-1.25%. With continued economic momentum we see the Fed bumping rates again in the fall.

We believe this economic backdrop will put upward pressure on rates across the maturity spectrum as stronger economic data is accompanied by rising inflationary expectations. Bond markets will face challenges in an environment where the improving economy pushes yields higher and the Fed is raising interest rates. Therefore, portfolio decisions regarding duration, credit, and yield curve positioning become extremely important.

Given the improvement in the economy and the upward bias of interest rates our strategy emphasizes corporate securities relative to Treasury and agency bonds in taxable portfolios. We are positioning portfolios short of benchmark duration in order to reduce negative price pressure and allow for reinvestment as rates rise. Municipal bonds experienced a solid first half. Rising concerns over the fiscal solvency of states such as Illinois grabbed headlines – however, these types of credit concerns reinforce our high quality approach to the municipal bond market. Overall, we believe bonds will face some headwinds for the balance of the year. However, the upward move in interest rates will eventually provide more attractive cash flow to meet income needs.

We are pleased with the markets in the first half of the year as every major global equity index and fixed income market posted positive returns. We gained comfort from the seemingly rational behavior of investors in an environment filled with distractions. Despite the smooth ride through midyear we don’t expect this market tranquility to last. Our plan is use the unsettling periods of volatility as opportunities.

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