Investment Review and Outlook
September 30, 2017

***"I think I can, I think I can….Up, Up, Up, the little engine climbed and climbed…."* - From the children's' book The Little Engine That Could by Walter Piper (1888-1957).**

When this iconic children's book was first published in 1932 its message of determination and perseverance was aimed at children living through the grim days of the Great Depression. However, nearly ninety years after its release the image of the little train struggling slowly up the mountain carries a meaningful message for today's investors.

Despite the heavy burdens of political chaos, rising military tensions, escalating civil discord, and the ravages of natural disasters, financial markets continued to grind higher in the third quarter. Although there were plenty of distractions, investors maintained their focus on underlying market fundamentals. Economic data released during the quarter confirmed the synchronized global growth trend that began in late 2016. Employment gains and second quarter corporate profit growth exceeded investor expectations. The Federal Reserve's deliberate approach to raising interest rates helped allay fears that a monetary "shock" might derail credit markets. Overall, investors chose to focus on fundamentals which allowed markets to trudge higher. In fact, the closely watched Dow and S&P 500 ended the quarter at all-time record highs.

U.S. stocks posted their eighth consecutive quarterly advance – the longest winning streak since 1997. The market's rise was broad as the S&P 500 increased 4.5%, and the Russell 3000 rose 4.6%. After lagging for several quarters small caps outperformed large caps as the Russell 2000 jumped 6.0%. The strong quarter for U.S. stocks drove all major indices well into double digit return territory for the year. Adding to investor enthusiasm was that strong market performance was accompanied by historically low volatility.

International stocks continued their strong relative performance as better than anticipated global growth, coupled with accommodative monetary policy by foreign central banks, drove prices higher. Developed markets in the Eurozone and Japan pushed the MCSI EAFE Index up 5.4%, while China, Brazil, and India lifted the MSCI Emerging Markets Index 7.9%. Both international indices are up over 20% so far in 2017 – putting them on track to outperform U.S. stocks for the first time in six years.

Interest rates on Treasuries rose modestly in the quarter with the 10-year note gaining a mere five basis points. As expected with rising equity prices, rates on corporate bonds drifted lower causing yield spreads to tighten. As a result, bond markets posted solid gains for the quarter. The Bloomberg Barclays Aggregate Index rose 0.9% and the 1-10 Year Municipal Index increased 0.7%.

Despite several negative global events financial markets continued to climb higher in the third quarter. Much like the message in Walter Piper's *"Little Train That Could"* investors demonstrated great determination and perseverance by focusing on improving economic fundamentals.

As we enter the final quarter of the year new challenges and opportunities are expected.

The "Trump Effect" is Back!

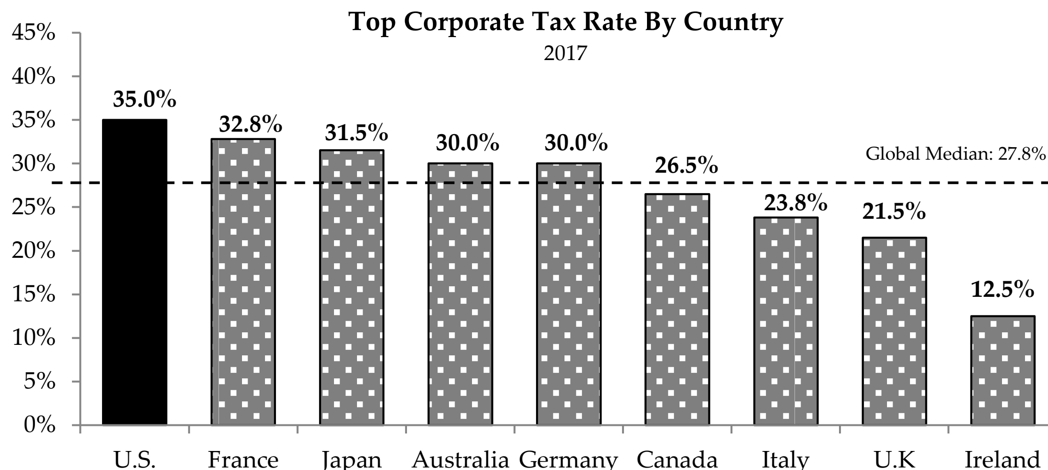
"I've made lots of comebacks from the brink of failure in my life. But, my comebacks as president were much easier because others made them happen" **– Harry Truman (1884-1972), 33rd President of the United States.**

Markets were euphoric after the November elections as investors prepared for a parade of business-friendly policies from the new administration. The "Trump Effect" drove equity prices to multiple record highs – even before his inauguration. However, coming into the third quarter the President's economic 'runway' was running out, and optimism over the "Trump Effect" was fading. The administration's economic agenda had become lost in a maze of distractions brought on by high-profile White House departures, escalating tensions with North Korea, and multiple failed attempts to repeal and replace the Affordable Care Act.

Then, the market's attention turned towards tax reform. Late in the third quarter investors showed renewed hope that a tax overhaul would finally give the U.S. economy the boost they had been promised. Similar to the period following the election, equity markets surged in the final two weeks of the quarter. Leadership abruptly shifted back to post-election favorites, including financial and industrial stocks. Small caps surged as the Russell 2000 rallied 6.4% in September relative to the S&P 500's gain of 2.1%. The U.S. dollar, after being beaten down throughout the summer, reversed course in late September and regained much of what it had lost relative to other major currencies. As the third quarter came to a close it was clear that the "Trump Effect" was back.

As we move into the final months of the year expectations are that a pro-growth policy "win" is on the horizon. The tax overhaul framework floated by the Trump team lacks the level of detail needed to constructively debate its specific impact on individuals and corporations. Although it is too early to identify specific winners and losers, the tax pendulum is clearly moving in a pro-business direction. Early drafts of the plan support a tax structure that emphasizes simplicity, reduces corporate rates, incentivizes capital investment, and allows corporations to re-patriate large foreign cash hoards without significant penalties. Any combination of these factors will prove positive – especially plans to reduce the corporate tax rate.

As the chart below shows, the U.S. corporate tax rate is substantially higher than most other developed economies. In fact, U.S. corporate rates have remained little changed over the past fifteen years while other countries have adjusted their rates lower, leaving the U.S. at a disadvantage relative to global competitors.



Source: KPMG Global Tax Review, July 2017. Median tax rate includes 22 developed countries.

Our view is that tax reform will ultimately be enacted; however, investors will have to wait until next year for the final version to be implemented. Although we are optimistic about the eventual outcome, we expect the debate to be fierce. Little disagreement is expected on whether tax reform is needed. Instead, the political battle will be centered on where, and how much, taxes should be cut. Although a fight is expected, we are optimistic that ample incentives exist for Washington to deliver tax reform. Warren Buffet appropriately suggested that *"if a politician can't pass a tax cut, he should find another line of work."* We agree!

Economic Outlook: A Global Perspective

"The key to a beautiful dance is when we all move together, and no one looks down" **– George Balanchine (1904-1983), Choreographer and founder of the New York City Ballet.**

Global economies are enjoying their own beautiful dance as all major economies are moving together in a positive direction. The Organization for Economic Cooperation and Development (OECD) estimates that all 45 member nations will show positive economic growth in 2017, with 34 countries posting growth rates higher than last year. In the OECD's economic report issued following the second quarter it is projected that global GDP growth will increase to 3.5% in 2017 and 3.7% in 2018 – up from 2.8% in 2016. This synchronized global expansion has not occurred in over twenty years.

Europe in particular is benefiting from improved manufacturing and rising global trade levels. Sentiment and confidence data shows businesses and households across the Eurozone are more upbeat about their prospects than at any time in over a decade. This positive economic mood has been bolstered by improvements in employment as the German unemployment rate dropped to 3.6% in August – its lowest level in history.

Despite geopolitical concerns involving threats from North Korea the Asian-Pacific region is expanding at rates not experienced since the financial crisis. The region is getting a big lift from accelerating trade and massive liquidity as most of the region's central banks remain in an accommodative mode.

Export-oriented emerging markets are expanding after years of declining growth expectations. Commodity price stability and rising capital investment by developed economies are helping drive demand higher. For instance, China grew GDP by 6.3% in 2016 – however, growth forecasts for full year 2017 and 2018 exceed 7.0%. This

marks the first time since 2011-2012 that China will show acceleration in their growth rate. Similar economic scenarios are playing out in India and Brazil.

The U.S. faces its own unique set of economic challenges. The economy is benefiting from an upturn in international growth and a strengthening of domestic consumption. Global demand is giving a boost to export-related activities. After shrinking by 0.3% in 2016 net exports are on pace to rebound by 4.7% in 2017, and continue to be a contributor to growth in 2018. Rising equity markets, employment growth, and continued low interest rates have pushed consumer confidence and spending higher. The lack of meaningful real wage gains will likely keep spending subdued. However, tax cuts, if passed, should provide an additional boost to incomes and consumption next year. For the full year 2017 we anticipate that GDP will expand by 2.5%, up from 2.1% in 2016. Our initial view of 2018 indicates that GDP will expand by 2.75%-3.00%.

In addition, investors are closely watching the next move by the Fed. The fed funds rate has been adjusted higher three times since last December, with the target range now at 1.00-1.25%. Our view is that there will be another rate hike coming out of their December meeting as they continue the process of reducing the Fed's balance sheet.

Outside of interest rate policy the biggest challenge the Fed faces over the next several months will be politically driven. Fed Chair Janet Yellen's term comes to end in January. Although she has been effective during her tenure, we think the odds are she will be replaced. President Trump is likely to desire to put his own Fed leader in place. Names being kicked around for the top spot include several individuals that are more business-oriented, as opposed to the traditional economists. Moreover, there are three Federal Reserve Board of Governors vacancies that the president is in the process of appointing. While the current focus on the Fed revolves around the next rate hike, the Fed's evolution over the next year will draw considerable attention.

Overall, we are confident that global expansion will continue through the balance of the year, and well into 2018. However, we are far from complacent in this view. Our outlook is vulnerable to multiple factors that can derail our positive outlook. Several meaningful global threats make the geopolitical environment unstable. Expectations remain high that the new administration's pro-business agenda will be implemented. Should those expectations fail to be met, investor confidence in future growth will be negatively impacted. Given these risks we are diligently monitoring the current environment to insure we are appropriately positioned during this uncertain time. Our view is that when investing in financial markets it is important to balance optimism with a healthy dose of skepticism.

Investment Strategy: Keep Expectations in Check

"Stay grounded! Don't stray too far from reality, you may not find your way back" **– T.S. Eliot (1888-1965), British essayist, playwright, and social critic.**

Our outlook for the global economy is an important driver of investment strategy. However, when translating our economic outlook into how we manage portfolios we are fully aware of the realities that come with investing in financial markets. We believe there can be as much risk associated with being too *optimistic* than there is with being too *pessimistic*. Therefore, we are careful to stay grounded, and not position portfolios with excess risk, even when our outlook calls for strong economic growth. Global economic trends move at a more gradual pace than underlying security valuations. Investors that detach their investment strategy from the realities of the market are doomed to suffer unintended risk and return consequences. Understanding this important relationship is critical to how we establish effective investment strategy.

U.S. Equities

We believe U.S. stocks will be direct beneficiaries of sustained economic growth. We continue to emphasize diversification in order to mitigate volatility and insure participation in markets as leadership continues to rotate.

Although we maintain exposure across the capitalization spectrum, we find small and mid-cap stocks particularly attractive in the current environment. We believe strong relative earnings growth lies ahead for companies that are more directly leveraged to the U.S. economy. Small and mid-cap companies derive over 80% of their revenues from the U.S., while large cap multi-national companies source less than 50% of revenue from the domestic economy.

Small and mid-sized companies stand to benefit the most from corporate tax reform. Smaller companies tend to pay taxes at a higher rate than large companies that are better positioned to take advantage of tax breaks. In addition, tax reform that includes repatriation of the over $1 trillion in cash held outside of the U.S. is expected to help serve re-ignite M&A activity between large and small companies.

Although U.S. equity valuations appear a bit stretched based on current earnings, corporate profit growth has exceeded analysts' estimates for the past several quarters. We expect this profit momentum to continue well into next year. Despite our preference for small and mid-cap stocks we firmly believe diversification is more important now as market leadership shifts rapidly and volatility intensifies.

International Markets

Last spring our view of international equity markets shifted to a more favorable stance, and our conviction level continues to rise. Our positive view is driven by accelerating global growth, favorable monetary policy by global central banks, and attractive valuations. We believe these are the fundamental ingredients that will deliver strong relative performance over the next several quarters.

Diversification across regions is critical in order to reduce country-specific risk. Our current bias is towards developed economies versus emerging markets due to their higher level of stability. However, we do believe having exposure to both markets will prove rewarding over time. Despite favoring developed markets we see attractive opportunities in emerging markets. Broad-based global growth has a cascading effect on emerging markets. Since these economies are primarily export based they benefit directly from increased trade driven by higher demand from developed economies.

Fixed Income:

Our view on interest rates and fixed income markets has remained consistent throughout the year. The improving U.S. economy with tightening labor markets, modest inflation, and synchronized global growth gives the Fed suitable justification to normalize their balance sheet by methodically selling bonds.

We expect economic improvement will eventually put upward pressure on interest rates across the maturity spectrum, and ultimately drive inflationary expectations higher. Bond markets will face challenges in an environment where economic growth puts upward pressure on long yields while the Fed continues to push short rates higher. Therefore, portfolio decisions regarding duration, credit selection, and yield curve positioning become extremely important. Our current 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 have performed very well in 2017. We don't expect the final version of the tax reform bill to include any direct threats to the municipal bond market. Overall, we believe bonds will face some headwinds over the next several quarters. However, the upward move in interest rates will eventually provide more attractive cash flow to meet income needs.

As we enter the final quarter of the year we are pleased with how the financial markets have behaved during a year of significant change and uncertainty. Although markets have been surprisingly tranquil during this extended period of geopolitical turmoil, we do anticipate renewed bouts of volatility as we close out the year and move into next year. As always, our intent will be to use market volatility to discover opportunities when they are presented.

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