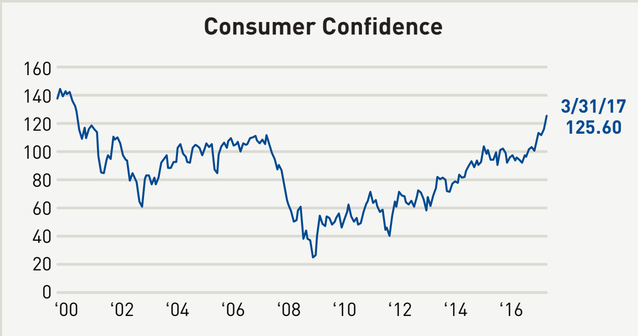
Economic and Capital Market Review

First Quarter 2017

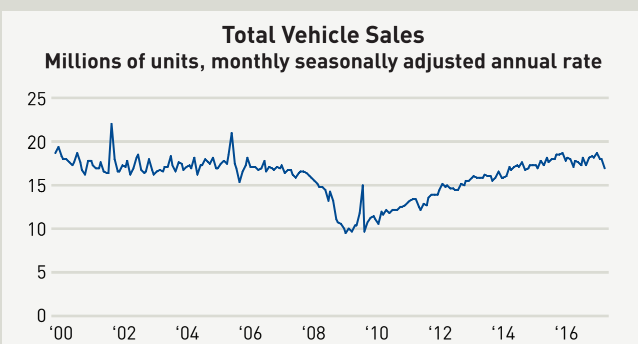
The economy likely grew at a more modest 1% to 1.5% real pace in the first quarter of 2017. After posting a 2.1% increase in the fourth quarter and a 2% gain for all of 2016, the first quarter looks like many previous first quarters' growth rate this decade with a more muted increase in GDP. Much of the downshift was likely caused by a slowing in personal consumption expenditures (a mild winter reduced utility usage) and a modest inventory retrenchment as vehicle production has slowed. However, as measured by sentiment indicators, both consumers and businesses continue to be optimistic on the outlook for the 2017 economy and beyond. Consumer confidence and expectations about the economy as measured by the Conference Board are at the highest levels since 2000. Small-business confidence, as measured by the National Federation of Independent Business survey, is at its highest level since the mid-2000's and over 30% of the respondents indicated a willingness to add to staff, again a reading that was last seen in the mid-2000's. Hiring expectations by small businesses are critical to a growing employment picture as small business is often the strongest driver for employment increases during expansions.



Source: Conference Board

Consumption, which represents nearly 70% of the U.S. domestic economy, is driven by two factors: employment growth and wage gains. Employment continues to be strong as most indicators show a vibrant labor market. The unemployment rate remains under 5% and, if not already there, continues to approach the full-employment level. Non-farm payrolls have been increasing at an average rate of approximately 180,000 per month over the trailing 12 months. Initial unemployment claims have been hovering around the 250,000 level for most of 2017 and have been below the 300,000 level for nearly two years. Moreover, as indicated above, small business continues to be confident of future hiring plans. Admittedly, the underemployment rate, also known as the U6 measure by the Bureau of Labor Statistics, is coming down slowly at this point in the expansion and is currently measured closer to 9% of the labor force. The underemployment rate measures those working part time, but who would prefer to be working full time, as well as those who are marginally attached to the labor force – unemployed, but not actively seeking employment in the recent period.

Despite the relatively strong employment situation, wage gains have been slowly rising. Average hourly earnings are up 2.7% year over year through March, while the employment-cost index, a broader measure of total compensation costs, has only increased 2.2% year over year through December 2016. While some industries and sectors are finding workers hard to get, and hence need to pay up for labor, on the broad scale, wage increases have been modest. Personal income, measured at the macro level, has been rising at a respectable 4.6% rate for the past year, while personal consumption growth at 4.8% year over year has modestly exceeded income and brought down the savings rate.



Source: U.S. Bureau of Economic Analysis

Motor vehicle sales continue at a strong pace of roughly 17.2 million units per annum in the first quarter. However sales dipped in the March period and we may be hitting the near-term peak of motor vehicle sales in the domestic economy. Longer-term secular trends don't bode well for a further surge past the 17.5 million annual sales rate we have seen recently. Meanwhile, housing starts continue their rising trend, with February's reading at a nearly 1.3 million annual pace. New-home sales rose smartly in February to an annual rate of 592,000. Again, mild weather likely stoked the demand. Existing-home sales fell in February, mainly due to supply. With only a 3.8 months' supply in the market, buyers don't have a wide range of properties from which to choose. A more robust inventory would be closer to a six months' supply.

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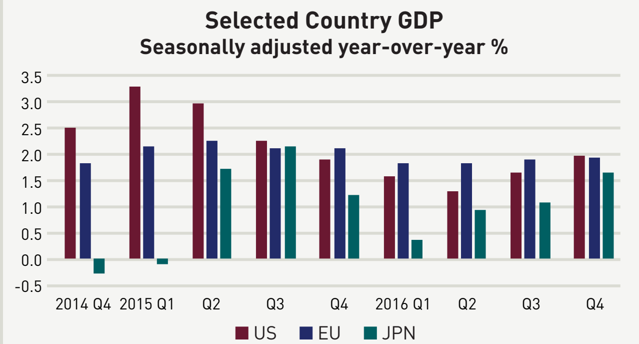
The production side of the economy started to improve in the fourth quarter and has followed through in the first quarter of 2017. Manufacturing grew at over a 5% seasonally adjusted annual rate (SAAR) through the three months ended February and total industrial production would have moved higher than its 2.4% SAAR over the same period, save for the fall-off in utility usage during the mild winter, which fell at a 23% seasonally adjusted annual rate over the same three months. Also, motor vehicle production has started off 2017 a little weaker. At the same time, the purchasing managers' survey continue to show strength. The manufacturing index had an average reading of 57 in the first quarter, its highest quarterly average in six years, with new orders near the highest level in three years. The non-manufacturing survey seems just as upbeat, with the index reading at the highest level since October 2015, and the new-orders component running at a two-year high in March.



Source: US Bureau of Economic Analysis, Eurostat, Japanese Cabinet Office

Looking abroad, the world economy continues to pick up as the accommodative monetary stance from the European Central Bank and the Bank of Japan remain in place. The Chinese economy also shows signs of strengthening. Both Europe and the developing markets in general look relatively strong. Europe is surprising on the upside due to cyclical factors in spite of political uncertainties and the emerging markets are rebounding after several years of stagnation due to weak commodity prices and increased corporate earnings expectations. Within Europe, confidence surveys, such as the German Ifo and the Markit PMI series, are generally stronger despite the political uncertainties as several countries go through their election cycles this year. As discussed in earlier commentaries, the populism and anti-immigrant/anti-globalization trend is further entrenched in European politics, with strengthening far-right political parties. However, in notable countertrends to the populism surge, both Austria and the Netherlands saw the populist, hard-right candidates lose their bids for the presidency and parliamentary majorities, respectively, in the past few months. Growth looks to be strengthening, Eurozone retail sales are starting to pick up, and unemployment fell 140,000 in February. Underneath the headline statistics, however, the growth is unbalanced with German unemployment below 4%, while French unemployment stands at 10%, and Spanish unemployment is a sobering 18% of the labor force.

China continues on its government targeted 6% to 7% growth path, after registering a 6.8% rate in both 2016 and 2015. A modestly weaker currency vis-à-vis the U.S. dollar over 2016, coupled with expansionary policies in much of last year, has led to stabilized growth for 2017. Export volumes appear to be increasing on strengthening global demand and domestic freight volumes have been rising. Against this strengthening demand, the monetary authorities at the People's Bank of China (PBOC) have been gradually tightening monetary conditions in 2017, with the seven-day repo rate in a rising trend. Indeed, the PBOC raised its repo rate in concert with the U.S. Federal Reserve's March increase in the U.S. fed funds rate.

Japan, by contrast, continues on its slow growth rate, despite the extraordinary monetary accommodation by the Bank of Japan. While the 3% unemployment rate is the lowest it has been since the mid 1990's, cash earnings are only up about 1% per annum and consumption is expected to grow by only 1% in 2017. By contrast, business sentiment has been improving, as measured by the Tankan survey, which could lead to better growth in the near term, especially in the export sector. The deflationary mindset that has bedeviled Japan for decades is slow to dissipate, even with the current run-up in headline inflation numbers due to the 2016 oil price recovery.

Monetary and Fiscal Policy

Given the strength of the U.S. economic statistics post the November election, as well as the firming of the inflation statistics, the Federal Open Market Committee (FOMC) voted to raise the targeted fed funds rate 25 basis points (bps) in March to a range of 0.75% to 1.00%. Roughly a month prior to the March 15, 2017 FOMC meeting, and through various media interviews and speeches, Fed governors indicated a greater willingness to raise interest rates in the near term, after having just raised rates in December 2016. By the time of the actual meeting, the market had been well prepared for the increase in the target fed funds range. Subsequent to the meeting, more fed governors have spoken about the probability of two more increases over the year, which, if they come to pass, would put the total increase year over year at 100 bps by December 2017. Moreover, Federal Reserve

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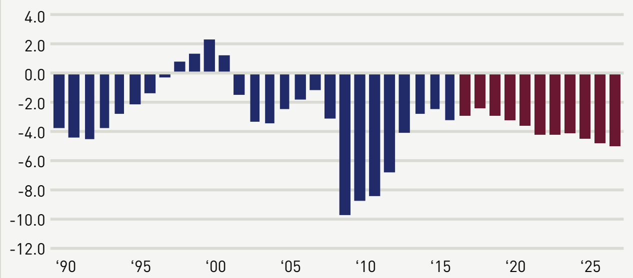
Bank of New York President William Dudley recently indicated that, if the U.S. economy progresses as the FOMC believes it will, the Fed should begin to normalize its balance sheet by allowing maturing securities to roll off starting at the end of this year. We would expect this process to begin prior to the end of Chairman Yellen's term in February 2018.



Source: Congressional Budget Office; March 2017 Long-Term Budget Outlook

According to the Congressional Budget Office, with current law and economic growth rates, fiscal policy is set to expand modestly in the next few years and then grow more unbalanced by 2023 as the baby-boom generation hits retirement full on. Current forecasts have the budget deficit moving from roughly 3% of GDP in fiscal 2016 to 5% by 2027. However, the current administration is seeking corporate and personal tax-rate cuts and tax reform and $1 trillion in infrastructure spending over 10 years. All are lofty goals on their own, but they need to be paid for along with the president's promise to not cut current Medicare or Social Security programs. This is a very tall order and one that likely can't be solved without raising the deficit faster or cutting some entitlements. Both of these will be fought vociferously by the fiscal conservatives on the deficit and by both progressives and seniors on the entitlements. When the Administration puts forth a plan (or plans), we would expect the tax reform debate to take most of the summer and fall with the passage of a more modest proposal by late 2017 or even the first quarter of 2018.

Equity Market review

Looking at the first quarter of 2017, riskier positions fared better than defensive ones as the so called "risk-on" trade took the lead position in the performance race. Emerging markets (EM) fared best with an over 11% return in U.S. dollars. Indeed, EM currencies strengthened during the quarter, despite the protectionist rhetoric of the current Administration and the Fed's gradual rise in interest rates. The Mexican peso appreciated nearly 11% in the quarter, despite the prospect of renegotiating the North American Free Trade Agreement treaty. International developed-market equities bettered the U.S. stock market as well, returning over 7% in U.S. dollar terms versus the S&P 500's 6.1% return. Domestic small-cap stocks did not participate in the rally as strongly however, returning about 2.5% for the quarter.

Equity markets did well during the period as reported fourth-quarter earnings increased about 5% year over year, improving sequentially from the third quarter. Additionally, the earnings outlook for calendar years 2017 and 2018 has not diminished much, with a nearly double-digit gain expected by fourth quarter of 2017, and a mid-single-digit gain for 2018. Once again we saw some market themes reverse in the first quarter, just as we saw reversals in 2016 from 2015. For example, value stocks (as measured by the Russell 1000 Value Index) underperformed growth stocks (as measured by the Russell 1000 Growth Index) 3.3% versus 8.9%, respectively, in the first quarter. After a terrific back half of 2016, the Financials sector took a backseat in the first quarter of 2017, returning 2.5% compared to the Information Technology sector, which jumped 12.6%. A favorite bond surrogate, the Utility sector, had a solid 6.4% return, compared to a 0.1% return for fourth quarter, as longer-term interest rates eased modestly during the quarter.

Fixed Income Market review

During the quarter, the Treasury yield curve flattened, as money-market rates rose 20 to 30 bps, 2-year note yields moved higher by a handful of bps, and longer-term yields declined modestly, with a change of under 10 bps. The yield curve flattened as market expectations were centered on the Fed raising rates in measured steps, inflationary expectations that were being held in check by the weakness in oil prices, and the more moderate GDP reading expected for the first quarter.

Credit spreads narrowed over the course of the quarter, but spread volatility picked up in March. Gross issuance of investment-grade credit was strong over the three months, increasing at a 15% increase year over year according to Citigroup. High-yield issuance was solid, but not as robust as investment grade. The high-yield market was weighed down at the end of the quarter by the renewed weakness in energy prices.

One industry that has come under greater scrutiny during the period was traditional bricks-and-mortar retail. As more consumers choose to purchase their needs through online conduits such as Amazon, many traditional retailers have seen sales slump repeatedly. Several, such as Macy's, J.C. Penny, and Sears have announced another round of store closings and layoffs. This has translated into slumping retail stocks and wider credit spreads on their bonds. Indeed, the concern has seeped into the retail mall space and the commercial mortgage-backed securities market, as the impending loss of some big-box anchors will weigh on the mall traffic and consequent business results of the affected retail space.

Outlook

The U.S. and international economies continue on a modest acceleration and expansion. Stimulative monetary policies, as well as a firmer oil and commodity prices over the balance of 2016 have acted to stabilize and reinvigorate world growth. Within the large, developed economies, most should experience some modest acceleration. Emerging markets should see better growth as stronger commodity prices and consumer demand emanating from both the developed markets and emerging markets themselves will help to buoy world growth.

The Federal Reserve appears more determined to proceed with its monetary policy normalization process uninterrupted in 2017, as contrasted with 2016's 12-month hiatus. With economic growth seemingly on better footing, the unemployment rate at or near full employment, and the inflation rate approaching the 2% target, Fed officials have been reinforcing their desire to return both interest rates and the Fed's balance sheet back toward "normal" levels.

The markets have been sanguine about the moderate pace of Fed tightening. Indeed, the Treasury bond market has been signaling an "all clear" message by generally benign interest-rate moves on the long end of the curve and with credit spreads remaining attractive for issuers. As noted earlier, the large-cap equity indices have generated solid mid-single digit returns in the first quarter – an attractive return itself in a low interest rate, low inflation, low growth environment.

However, the sector and style churn that appears to be underlying the solid first quarter in the equity and other "risk-on" markets should give us some pause in our market outlook. We have gone through an extended period of little to no correction in the equity markets. Indeed, the first quarter only saw a handful of days when the price action in the S&P 500 was greater than 1%. With no meaningful corrections during the quarter, it seems as though we have been in an extraordinarily calm environment. Market participants know that extraordinarily calm periods usually give way to greater volatility.

The market has been pricing in better earnings and better growth emanating from the current administration's desire for regulatory relief, corporate tax reform (including corporate tax rate cuts), personal tax cuts, and fiscal spending through increased defense spending and a $1 trillion infrastructure spend. Given the embarrassing lack of success on the first major legislative initiative (the long-practiced Obamacare repeal, where the bipartisan participation was obviously unexpected), markets should be, and likely will become, more skeptical of the administration's ability to deliver on the speed and magnitude of policy changes already discounted. In an environment where equity markets are priced on great expectations, we may be in store for some substantial volatility caused by political disappointment.

At the same time, bull markets rarely end quietly. Historically, healthy skepticism of the last stages of a bull market are overridden by investor euphoria. Being out of the market in those late stages can be costly. Research from Merrill Lynch, shows an average 12-month return of 25% for the S&P 500 in the late stages of the past twelve bull markets since 1937. Think how deep value equity managers felt in the last few years leading up to the peak of the internet bubble in the late 1990's. While they decried the overvalued state of many internet stocks (with many value managers generating negative returns at the time), they still had to endure watching the then tech-heavy S&P 500 post several 20%-plus return years before the bubble burst.

We are not forecasting an equity market bubble with an accelerating melt-up and subsequent meltdown. Rather, we believe investors must reinsert equity market volatility back into their return expectations. With the S&P 500 and the Russell 2000 up 32% and 47%, respectively, since the oil-bust lows of February 2016, investors have been lulled into complacency, as earnings growth has come nowhere near matching those growth rates. The market needs solid earnings growth to follow through in 2017 to better support its current lofty valuation levels.

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