Investment Perspective

Equities are attractive based on moderate growth, low interest rates and subdued inflation

What a difference a year makes! It has been a profitable and comfortable start to 2017 compared to a volatile first quarter last year. The first five days, week, month and quarter were all up, so the odds favor another double-digit return this year. Furthermore, the often discussed "Great Rotation" may be starting. Inflows into equities surpassed $118 billion since the election and were four times the size of inflows into bonds. This is a small offset to bond inflows that dwarfed equities by $650 billion since March 2009, but highlights the power if these trends were reversed. Given the healthy start to the year, is there anything to worry about? There are always worries, but the markets thrive on healthy skepticism. Fortunately, politics and valuation top the list, not the growth outlook. Investors remain concerned that bipartisan politics will derail progress and the market may be overbought following a 13% gain since the election. A healthy correction (5-10%) could occur anytime, but we focus longer term and believe equities are attractive based on moderate growth, low interest rates and subdued inflation. A summary of index returns for the quarter ending March 31, 2017 is as follows:

Dow Jones Industrials	+5.2%	Russell 2500	+3.8%
MSCI EAFE	+7.3%	S&P 500	+6.1%
NASDAQ Composite	+10.1%	Wilshire 5000	+5.1%

GLOBAL ECONOMY

Growth accelerated in the second half of 2016 and this momentum should continue

World economic growth (ex. U.S.) should increase 3.8% in 2017, an acceleration from 3.4% last year. Europe and Japan are growing approximately 1.5%, with improving trends after subdued economic performance over the last several years. Both regions are experiencing deflation and their central banks continue to stimulate aggressively. China is slowing to 6.5% growth with risk to the downside as it continues to reposition its economy from infrastructure and property investment towards consumption. China is pushing reforms to reduce debt and mitigate the risks of an overheated housing market. Geopolitical tensions and protectionist attitudes are risks to the global growth forecast along with a strong U.S. dollar.

The U.S. economy is expected to grow 2.1% in 2017 after 1.6% last year. Growth accelerated in the second half of 2016 and this momentum should continue. Consumer spending remains a leading contributor with 2.6% growth while other sectors of the economy, primarily nonresidential investment, are strengthening. Investment spending should rebound to 3-5% growth over the next few quarters after no growth in 2016. A national infrastructure policy would introduce upside to this projection. Residential investment continues at a healthy pace with 4.9% growth in 2016 and similar gains this year. Importantly, the Conference Board Consumer Confidence Index increased to its highest level since December 2000. Consumers are in the best financial shape in

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decades. Households have the lowest debt-to-disposable income ratio in 15 years and aggregate wealth has benefited from asset appreciation. Household mortgage debt outstanding declined by $1.3 trillion from the peak in first quarter of 2008 to the trough in early 2015. This reduction was unprecedented in modern times, but mortgage debt has now expanded for seven consecutive quarters. Credit growth is important for sustained economic growth and bank loans grew 7.5% in 2016. This is a positive dynamic that has multiplier effects throughout the economy. Most leading economic indicators point to solid growth and hint at a long awaited resurgence in capital expenditures and infrastructure spending. Overall, there is neither boom nor bust.

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FED POLICY & INTEREST RATES

This period of extraordinary monetary accommodation is ending. The Federal Reserve raised interest rates in March for the third time since December 2015 and is likely to raise rates twice more this year. The tightening is justified as inflation is nearing the 2% target and employment has returned to healthy levels. Furthermore, the Fed needs to normalize interest rate policy to restore its monetary policy tools and maintain credibility. The Fed may taper its $4.3 trillion balance sheet by letting bonds mature without reinvesting the proceeds. This will remove a steady buyer of bonds and represents indirect tightening. Most observers expect the Fed to reduce mortgage-backed securities in 2018 and subsequently let its Treasuries runoff.

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Many measures of U.S. inflation indicate prices are rising moderately at an acceptable level. Overall inflation is 2.2% and core inflation (excluding food and energy) is 2.4%. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.8%. The fear of U.S. deflation is off the table and a period of hyper-inflation is unlikely given lower commodity prices. For example, the 10-year breakeven inflation rate is 1.85%, which implies the inflation rate expected by bond investors as it measures the difference between the yield on inflation-protected and nominal Treasuries. Additionally, the market-based five-year forward inflation expectation is 1.89%. In general, subdued expectations for inflation and continued low interest rates overseas should help restrain U.S. interest rates from rising too rapidly.

CORPORATE PROFITS

We expect S&P 500 operating earnings to increase 9% in 2017 to $130 per share, the first meaningful earnings increase in three years. The pick-up started in the second half of 2016 with back-to-back quarters of positive growth for the first time since early 2015. This year, the first quarter should be the best quarter of growth since late 2011 for both revenues and earnings, up 7% and 9%, respectively. Last year, S&P 500 revenues increased 2.2% – below a normal rate – but this year's revenues and earnings should grow 5% and 9%, respectively, helped by energy and foreign currency. If the corporate tax rate is reduced in line with President Trump's plan, S&P earnings could increase an additional $5-$8. Moreover, there may be a positive impact associated with the repatriation of cash trapped in foreign jurisdictions that may accelerate capital expenditures, dividend increases and stock buybacks. It is estimated U.S. companies

could re-shore over $1 trillion in offshore cash with appropriate tax legislation. Finally, if infrastructure spending is prioritized with legislative incentives, there could be another boost to corporate earnings as one firm's capex is often another firm's revenue. After a pause that refreshed, corporate earnings are on solid footing and poised for more growth with-or-without legislative change.

INVESTMENT OUTLOOK

Investors are on guard for economic data that is "too good" for fear that this may accelerate the tightening cycle

The fundamentals supporting a favorable outlook for equites – moderate growth, mild inflation and low interest rates – are complemented by increasing levels of business optimism. Confidence is rising, but skepticism remains high as the market continues climbing that "wall of worry." Today, the major worry is political, not economic. There is always something to fret about – giving rise to the expression "now is always the hardest time to invest." Fortunately, the economic fundamentals are firm and the investment risks relate to complacency and valuation, not growth. The psychology is changing. Investors are on guard for economic data that is "too good" for fear that this may accelerate the tightening cycle. Historically, the markets perform well for the first 12-24 months after the first rate hike and are not negatively impacted until the Fed is nearly done raising interest rates – which can take years. Bull markets do not die of old age, they die primarily from recessions. We are watching these developments.

Today, monetary tightening is appropriate given the current conditions. Higher interest rates signal stronger economic growth, which bodes well for earnings and equities. The stock market is reasonably valued at 18.3x estimated 2017 S&P 500 operating earnings of $130 per share, considering a 10-year Treasury yield of 2.31% and core inflation of 1.8%. This multiple compares to the long-term average of 16.6x and 20.0x during periods of low inflation and interest rates. Historically, P/E multiples generally move in long waves reaching extreme highs in bull markets on normal earnings. In our opinion, we see upside to both multiple expansion and earnings growth. Earnings could improve with a reduction in corporate taxes, infrastructure incentives and larger buybacks.

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The fixed income market may provide relative safety, but the outlook for outperformance is low. The unprecedented 35 year (1981-2016) decline in the 10-year Treasury yield (15.32% to 1.37%) reduces the odds of above-average future returns. Near term, global monetary accommodation may continue suppressing yields, but central banks will eventually stop buying government bonds exerting upward pressure on yields. In addition, the demand-and-supply technicals will adjust to the loss of a big systematic buyer, which means other sources of demand (investors, pensions, insurance companies) will need to pick up the slack.

From a technical perspective, the market backdrop remains constructive. Most signals confirm the bullish trend – both cyclical and secular – suggesting that the rally should be sustainable. Nearly 90% of stocks on the NYSE are above their 50-day moving averages. However, there are risks the market is overbought in the short term. The S&P 500 is within 2% of its all-time high after a strong six month rally and it may back-and-fill through some corrective action. The Investors Intelligence Bull/Bear Ratio (BBR) recently

rebounded from 2.73 to 3.05 after falling below 3.00 in late March for the first time since late November. Bullish sentiment recently hit 63% – the highest since 1987. Constructively, asset flows into U.S. equities are positive and improving after a period of outflows in 2015 and 2016. There is substantial buying power on the sidelines with high cash percentages among professional investors. In addition, state pension plans are underfunded by almost $1.75 trillion.

A few key risks include: a Chinese hard landing, cyber-attacks, military conflicts, political dysfunction, sharp dollar appreciation, “taper tantrum”, terrorism and unexpected inflation. Additionally, protectionism presents a significant wildcard for the economic outlook. The administration aims to move production and jobs back to America through a variety of means and tough bargaining. This will be difficult. Trump has also proposed corporate tax reform. If this effort is not accomplished by late 2017, the market could price in some loss of confidence in the pro-growth agenda.

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We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. The resumption of above-average earnings growth with some multiple expansion should support appreciation consistent with historic trends. We believe the odds favor higher equity prices, although we may experience some unexpected turbulence. Importantly, since 1928, those years with a positive first quarter rose 81% of the time with an average gain of 13%. Longer term, earnings growth is the key for stock price appreciation and the factors supporting further strength are evident for both the economy and the quality small and medium-sized growth companies of our investment focus. We favor growth over value and the health care and information technology industries.