Investment Perspective

The stock market is steadily advancing to new highs due to robust fundamentals

The U.S. stock markets produced double-digit returns year-to-date in one of the calmest bull markets in 25 years. The S&P 500 fluctuated more than 1% in only eight days versus an average of 50 per year since 1945. The stock market is steadily advancing to new highs due to robust fundamentals. Most importantly, earnings growth has improved with the S&P 500 operating earnings experiencing double-digit gains the past two quarters for the first time since the fourth quarter of 2011. It is difficult to predict how long this trend will last. However, excessive caution appears unwarranted and we expect the favorable environment to continue with more investment success ahead. A summary of index returns for the year-to-date ending September 30 is as follows:

Dow Jones Industrials	+15.5%	Russell 2500	+11.0%
MSCI EAFE	+20.0%	S&P 500	+14.2%
NASDAQ Composite	+21.7%	Wilshire 5000	+13.8%

GLOBAL ECONOMY

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World economic growth (ex. U.S.) should increase 4.0% in 2017 accelerating from 3.3% last year. The global economy is improving faster than expected after a tepid period that caused doubts about the growth trajectory. Early forecasts for 2018 suggest another year of 4.0% growth. The massive stimulus measures by the major central banks are effectively increasing confidence and reflating low growth. The European region is strengthening and the growth forecast has been revised up to 2.1% for this year. Japan is sustaining a steady but positive 1.6% growth rate. Chinese growth is stabilizing around 6.5% as the country pushes reforms to reduce debt and mitigate the risks of overheated real property markets. The global outlook is healthy and more resilient to adversity, but geopolitical tensions and terrorism remain sizeable risks.

The U.S. economy is expected to grow 2.2% in 2017 after 1.5% last year. Growth accelerated in the second quarter to 3.0% after a slow first quarter. The economy should sustain 2.5% growth in the second half of the year with similar gains expected in 2018. Consumer spending is healthy because of job growth and confidence. It is an important component in this expansion's success. Employment remains healthy with recent evidence suggesting that labor force participation improved to 63.1% in September while average hourly earnings continue to grow 2.9% y/y. The Conference Board Consumer Confidence Index remains at its highest level in 15 years. Household net worth has risen to record highs, and the consumer debt-to-income ratio declined to its lowest point in 15 years. Despite the improvement in these consumer balance sheet ratios, consumer credit growth of 5% remains healthy supporting future spending. This is a helpful multiplier for the economy. Capital expenditures grew 7.0% in the first half of the year with gains in nonresidential investment expected to be 4.5% or greater this year—reversing the lack of

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growth in 2016. Residential investment is slowing to a 2.5% pace. This broad-based economic expansion has legs because the recent pattern of moderate growth does not create excesses or borrow too strongly from the future. We expect stable growth ahead in the 2-3% range. However, Hurricanes Harvey, Irma and Maria will slow near term growth, but reconstruction efforts will boost infrastructure spending over the intermediate term.

FED POLICY & INFLATION

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The Federal Reserve is gradually removing easy money. The next phase of the process will start with the runoff of the Fed's $4.3 trillion balance sheet. The central bank will initially taper its balance sheet by $10 billion per month with a gradual increase to approximately $50 billion by late 2018. The cumulative tapering could shrink its balance sheet to roughly $3.0 trillion by 2021. The Fed did not raise rates at its recent meeting because inflation is subdued, but a December hike is likely making this the third rate hike in 2017 and fifth since December 2015. The federal funds rate, now 1.25%, is likely to approach 2.25% in early 2019. This gradual tightening is justified by signs of full employment as the unemployment rate is 4.2%. This enables monetary policy to transition from an accommodative stance toward a neutral position.

Most measures of U.S. inflation indicate stable trends in the near-term. We are in a comfortable environment where the threat of deflation is low and the perceived threat of hyper-inflation is minimal. Overall, CPI inflation is 1.9% and core CPI inflation (excluding food and energy) is 1.7%. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.3% and has been fluctuating between 1.3% and 2.1% since early 2012. Several temporary factors that suppressed core PCE inflation in 2017 are abating, suggesting that inflation could rise over the next 12 months. Yet, tepid expectations for inflation remain and continued low interest rates overseas should help restrain a substantial rise in longer-term U.S. interest rates, although rates on 10-year bonds will likely drift higher.

MANUFACTURING RENAISSANCE

The ISM manufacturing index increased to its highest point since 2004

U.S. manufacturing activity is improving after a soft period the last two years. It is clear from a variety of hard data and survey results that activity, optimism and orders are increasing. The Small Business Optimism index hit 105 in August, among the highest levels in 30 years. The Institute of Supply Management (ISM) manufacturing index increased to 60.8%, its highest point since 2004 and one of the highest levels recorded since late 1987. The manufacturing sector created 83,000 jobs this summer – the best three month stretch since 2012. Durable goods orders are up 4% y/y after declining for part of 2016. Business capital spending is increasing and expected to continue growing. Both the New York and Philadelphia Fed manufacturing surveys have risen to 16 year highs. A sustained upturn in capital spending is positive for the economy as nonresidential investment spending could provide a next leg in this historically long expansion. The reshoring of manufacturing capacity to the U.S. is also helping the domestic economy. However, it is important to note that jobs are not the biggest

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beneficiary. A good portion of U.S. capacity is being added through automation – a capital expenditure. U.S. robot installations increased 14% in 2016 with similar growth expected over the next few years. The U.S. is the fourth largest market for industrial robots behind China, Korea and Japan. A Boston Consulting Group study notes that a human welder in a U.S. factory costs $25 per hour, while the equivalent operating cost for a robot is $8. Due to this dynamic, the robot density in America increased considerably, especially in the automotive industry. The U.S. ranked second after Korea with a density of 1,261 installed robots per 10,000 employees. The trends of reshoring and automation are augmenting a period of cyclical strength in U.S. manufacturing and making a positive impact on long-term growth and productivity. In addition, pro-growth policies aimed at infrastructure spending, tax-incentivized capital spending and offshore capital repatriation would help support these favorable economic trends.

INVESTMENT OUTLOOK

The fundamentals supporting the outlook for equites are positive. A few important variables explain the strength in the markets: stable economic growth, low interest rates, moderate inflation and expectations of double-digit earnings growth. These powerful ingredients are further enhanced by improving business confidence and expectations for tax-related stimulus. This bull market may last longer than expected because we currently enjoy a favorable combination of forces.

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Operating earnings for the S&P 500 are expected to increase 10% this year to $131 per share followed by an 8% increase to $142 in 2018. The third quarter will be the fifth consecutive quarter of earnings growth. If the corporate tax rate is reduced in line with President Trump's proposals, S&P earnings could increase an additional $5-8 next year. Moreover, tax changes favoring the repatriation of cash trapped in foreign jurisdictions could accelerate capital expenditures, mergers and acquisitions, dividend increases and stock buybacks. The positive outlook for corporate earnings growth is supported by an improving economy. The stock market is reasonably valued at 18.1x estimated 2018 operating earnings considering a 10-year Treasury yield of 2.38% and core PCE inflation of 1.3%. Also, the ratio of the S&P 500 price to after tax corporate profits is currently 1.39x versus 3.02x in March 2000 and its 67 year average of 1.27x. Most signs are pointing in the right direction.

From a technical perspective, the weight of evidence remains bullish. The S&P 500 secular bull trend signaled on the April 2013 breakout remains in effect. The advance-decline indicators are favorable and new highs in the industrials and transports confirm the positive secular trend. With the S&P 500 index above its 200-day moving average, the loss of current momentum is unlikely. The stock market hit 51 new highs this year for the third best start to a first-term presidency since 1945. Furthermore, we are heading into the most favorable seasonal period for the stock market. Historically, the November through April period is one of the best periods for rising prices. Tactically, there is rising anxiety, caution and nervousness associated with the "risk of complacency" which is contrarily positive. The variability of the S&P 500 daily returns has been the third lowest in

all years since 1926. Frankly, a 5-10% correction would help cleanse the market of worried investors. However, since 1928, when the S&P 500 is up through September 30, the fourth quarter is up 83% of the time with an average return of 4.32%.

It is difficult to gauge the possibility of worsening sentiment, but key fundamental risks to the outlook include: a Chinese hard landing, earnings disappointments, military conflict, over-tightening by the Fed, political gridlock, "taper tantrum", terrorism and unexpected inflation. The lack of action on Trump's pro-growth agenda presents a risk to business sentiment. Additionally, the stock market may correct if the president's agenda lacks support. Since 1887, every year ending in seven included a sharp decline in late summer or early fall. We expect 2017 to end that trend.

The animal spirits are alive with the global IPO market on pace for its strongest year since 2007

At this time, the virtuous circle is cycling favorably. The animal spirits are alive with the global initial public offering (IPO) market on pace for its strongest year since 2007. Nine months of activity has already exceeded the totals of 2016. In the U.S., IPO proceeds are up 89% and issuance is up 35% compared to the first nine months of last year. We are now witnessing a renewed period of hope and a willingness to take risks, which is good for businesses and equities. We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. The resumption of above-average earnings growth with modest multiple expansion should support appreciation consistent with historic trends. We believe the odds favor higher equity prices, although we may experience some unexpected turbulence. The investment risks primarily relate to complacency and valuation rather than growth. We favor growth over value.