Introduction

As the aging bull market in stocks enters its ninth year, investors in risk assets have been rewarded so far in 2017. At the same time, despite two interest rate increases by the Federal Reserve, bond investors saw positive returns both in the last quarter and year-to-date. Meanwhile, the ongoing decline in crude oil prices has been impacting both energy stocks and the commodity sector in general. The backdrop to all of this has been the uncertainty surrounding both US government and monetary policies but which has had minimal effect on financial markets to date.

The S&P 500 Index of large-cap US stocks is up 9.3% for the year, after rising 3.1% during the second quarter. Much of this has been due to technology stocks appreciating more than 17% in 2017, the 10th anniversary of the introduction of the iPhone. Not surprisingly, energy stocks have fared the worst, dropping 12.6% as the price of oil ended the first half of the year at $46.04, a decline of 14.3%. After years of underperformance relative to US markets, overseas stocks have been on a tear. Stocks in developed international markets are up 14.2% and emerging market stocks are up 18.6%, both rising 6.4% in the last quarter, benefiting in part from a decline in the US dollar. The Bloomberg Barclays US Aggregate Index has risen 2.3% year-to-date, with more than half of that coming in the second quarter, as low inflation offset the Fed's rate increases.

Looking to the second half of the year, rich stock valuations are a concern as are investor complacency and the challenging political climate. However, the current environment of subdued inflation, low interest rates and decent earnings growth may sustain equity markets for the time being, mitigating any impact from delays in pro-growth government policies. The Fed is signaling additional rate increases in conjunction with a reduction in its massive balance sheet, but with inflation more subdued than the 2% Fed target, policy implementation should remain gradual and well-communicated.

2nd Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 6/30/17

	2Q 2017	YTD Return	Price / Value
Dow Jones Industrial Average	4.0%	9.3%	21,350
S&P 500 Index	3.1	9.3	2,423
Russell 2000 Index	2.5	5.0	1,415
MSCI EAFE Index	6.4	14.2	7,397
MSCI EM (Emerging Markets)	6.4	18.6	2,171
Bloomberg Barclay's US Aggregate	1.4	2.3	103
Bloomberg Barclay's Municipal Bond	2.0	3.6	109
Gold – Continuous Contract	-0.7	7.9	$1,242
Light Crude Oil – Continuous Contract	-9.0	-14.3	$46

Source: Factset

Economy

The economy improved marginally from the first quarter's upwardly revised 1.4% annual rate of growth, likely operating at the 2% pace that has defined this subdued economic recovery. While many view the subdued yet positive growth as ideal in terms of keeping inflationary pressures at bay while job growth progresses, it seems many indicators have rolled over at a time when monetary policy is being slowly tightened. Fiscal policy, which was projected to take the stimulus baton from the Fed, seems bogged down by continued dysfunction in Washington, leaving the same recent drivers of growth carrying the load heading into the third quarter.

Given the outsized role of consumer spending in the domestic economy, wage growth always figures prominently, and the labor market appears healthy. The unemployment rate dropped to 4.3% in June, the lowest reading since 2001, while initial jobless claims are up only marginally from the recent 43-year low level. Unfortunately, the reduced slack in the labor market is not generating wage inflation, as is usually the case. Since February, the unemployment rate dropped 0.4% while year-over-year wage growth fell to a disappointing 2.5%. Consumption suffered accordingly as retail sales were negative in two of five monthly reports this year, including a significantly worse-than-expected reading in May. Clearly consumer behavior has become more defensive as evidenced by the personal savings rate, which remains above the 5% level that has prevailed for the majority of the time since the Great Recession.

Another factor that traditionally impacts the consumer is energy prices, especially in a low wage growth environment. It appears the increase in gas prices late in 2016 took a bite out of lower-income consumer spending, which likely played a large role in the disappointing consumption data in the first quarter. Gas prices have since retreated again in the second quarter, which should bode well for retail sales if recent trends hold. The timing would be beneficial since auto sales, which make up 20% of overall retail sales, are fading from the unsustainable pace in 2016. Likewise, new and existing home sales have been inconsistent contributors, while housing starts have been an outright detractor, falling four out of five months thus far this year. Manufacturing was the bright spot across the globe, and domestic industrial data was no exception. The June reading for the ISM manufacturing survey jumped nearly three points to 57.8, with new orders, often a leading indicator, showing strength. While encouraged, we are mindful that continued auto weakness could negatively impact factory activity in the second half of the year. However, the domestic industrial sector may be benefitting from a pickup in overseas activity, which should make recent gains more resilient.

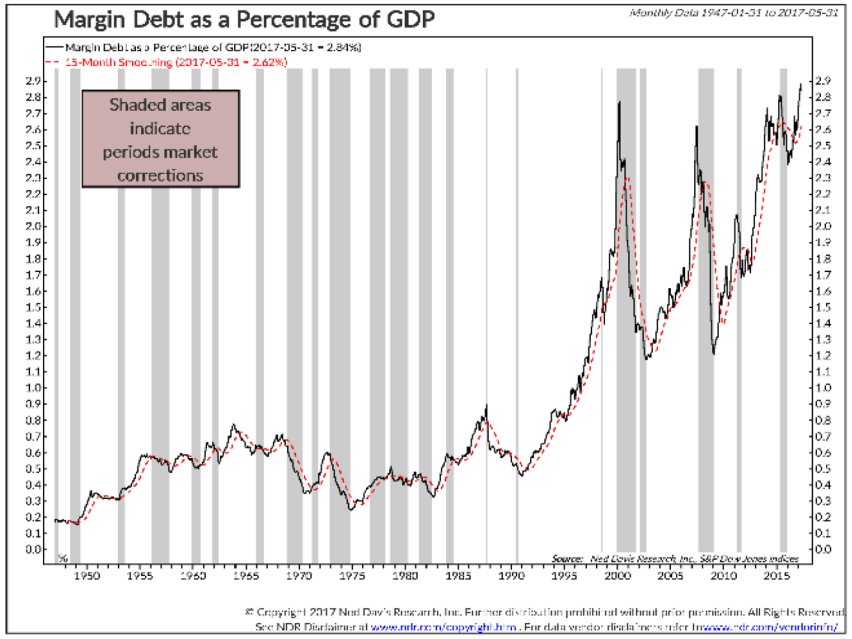
Clearly we need to see progress on the pro-growth policies promised by the Trump Administration to move into a higher level of sustainable growth. Healthcare reform pushes corporate and individual tax reform back in the queue, which subsequently creates a cautious business environment to the detriment of capital spending and investment. Even infrastructure spending, which has bipartisan support, is unlikely to be meaningfully enacted anytime soon. While President Trump and Treasury Secretary Mnuchin are correct that persistent 3% GDP growth will solve many of our problems, there is nothing of substance coming online that will move us closer to that goal, especially considering that the Fed is slowly removing monetary stimulus from the economy. While we believe the Fed is moving cautiously and would not kill the tepid recovery should activity or inflation fade meaningfully from here, our view is that 2% GDP growth remains an optimistic baseline until policy becomes more accretive.

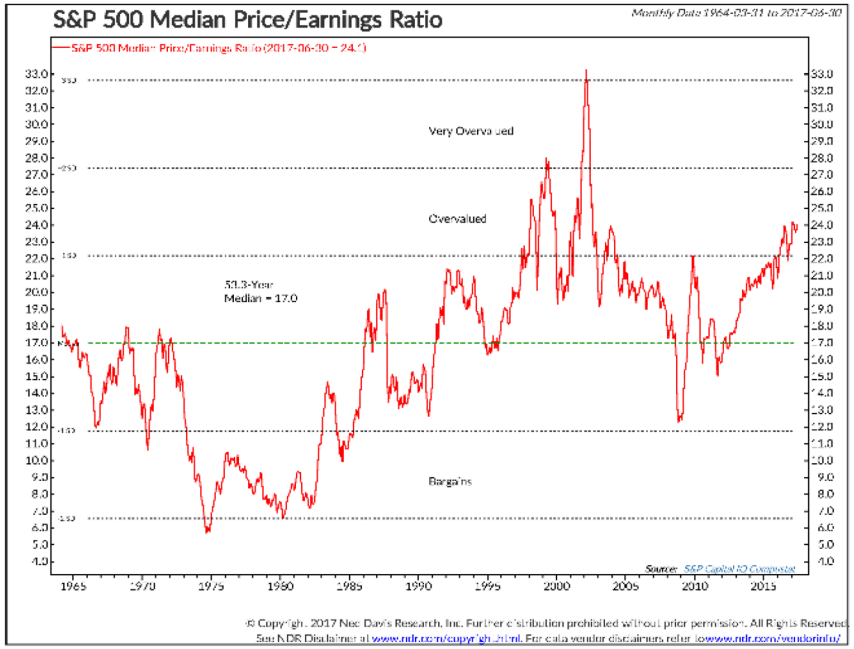
Equities

US and global equity markets continued their climb in the 2nd quarter. The S&P 500 returned 3.1% during the period for a year-to-date return of 9.3%, while the MSCI All-Country World (ex US) Index increased by 6% and 14.5% respectively. Since the November 8th election, the US market returned an impressive 15.1%, and global markets rose a similar 14.7%. Many have dubbed this well-above-average return as the "Trump Bump" with the promises of deregulation, tax reform and infrastructure investment encouraging many investors to think that an uptick in economic growth and corporate profits was on the way. However, as some of the optimism for real policy change waned, less-cyclical segments of the market have garnered more attention. We are enthusiastic about market performance and the return of animal spirits to business owners and executives but are concerned about high valuations, investor complacency and the challenging political environment.

There have been 247 trading days since the 5% correction in the S&P 500 associated with the Brexit vote; this is the longest period in 20 years without even such a modest decline. This steady advance is remarkable for its persistently low volatility fueled by low interest rates and modest inflation expectations. During this quarter, there were only two days when the S&P 500 moved up (April 24) or down (May 17) by 1% or more. There have been four other periods of extremely low volatility during periods of Fed tightening (1952, 1964–1967, 1993-1996, 2005-2007). In all instances, volatility increased after the tightening and, except for the mid-1990s, a bear market ensued. A protracted period of low volatility and interest rates fosters investor complacency where required compensation for risk declines and the use of financial leverage increases. Both of these conditions are present to

some degree today as evidenced by high equity valuations, tight credit spreads, and an increase in margin debt.





The second quarter of 2017 marks a new high for S&P 500 earnings per share. Due to a sharp drop in the price of oil and its impact on the energy sector's profits, overall earnings have remained below the previous peak reached in the third quarter of 2014. We expect earnings for S&P 500 companies to grow approximately 8% in 2017 and 7% in 2018, without the benefit of a corporate tax cut. The financial services sector should provide the largest contribution to earnings growth due to an improved regulatory and interest rate environment. Technology companies continue to enjoy strong sales growth combined with record profit margins. This desirable combination attracted significant investment and drove the sector to a market leading 17.2% return for the year to date. At this point in the market cycle, we are focused on companies with secular growth opportunities that have the ability to maintain and grow profit margins. Additionally, we look for companies that will benefit from fiscal stimulus policies that have a reasonable probability of implementation.

We are optimistic that Congress will pass legislation to make the US corporate tax rate competitive with the rest of the world. If the agreed-upon rate is close to 23%, this would provide a welcome 10% lift to earnings in 2018. This change, combined with a tax incentive to repatriate foreign earnings, would provide very valuable stimulus to the economy through increased capital expenditures and related job creation. While it is hard to be optimistic given the lack of progress in Washington, policy change can be implemented through regulatory action as well as personnel appointments. At the Fed, three governor seats need to be filled, including the Vice-Chair for Supervision who will oversee stress tests and the resulting return of capital to shareholders. Further meaningful financial services deregulation can occur via the Fed rather than through Congress.

The Federal Energy Regulatory Commission (FERC) regulates the interstate transmission of electricity, natural gas and oil. It plays an important role in the approval of energy-related infrastructure projects, including pipelines and LNG terminals. The FERC has been short a quorum since February. President Trump announced three new proposed commissioners, with a fourth to be named in the coming weeks. Once the Senate approves the new commissioners, action can proceed on major energy infrastructure projects that will add valuable support for the economy. As expectations have declined for productive dialogue from Washington, these regulatory avenues offer hope for progress that likely will benefit economic activity and create jobs.

Economic and Market Drivers

Tailwinds	*Headwinds*
Low Interest Rates	Fed Policy - rising rates and balance sheet runoff
Fiscal Stimulus Package	Higher US Equity Valuations
Improving Real Household Income	Tight US labor market - rising labor costs
Low Inflation	Political confusion - debt ceiling
Animal Spirits Rising - Business Optimism	Protectionist Trade Policies
Household Formation Increasing	Aging Demographics in Developed Markets
Lack of Investor Euphoria	China Slowdown - Over Investment

Given our concerns about the heightened valuation of US equities, we believe increasing allocations to developed markets outside of the US will help portfolio returns. While we would like to see more pro-growth business-friendly policies in Europe to accelerate job creation, we are heartened by the elections in the Netherlands and France that clearly rejected the populist movement. Many markets outside the US offer more reasonable valuations with the backdrop of improving consumer confidence and GDP growth.

Bonds

With initial post-election optimism for reflation fading from the forefront, the Bloomberg Barclays Aggregate bond index posted a modest return of 1.5% in the second quarter, led by longer-dated maturities and riskier credits. This brought the year-to-date return to a respectable, if unexciting, 2.3%. The 30-year US Treasury produced a surprisingly decent 4.3% return for the period, as inflation fears receded and investors reached for yield. The result was a significant flattening of the yield curve as central bank policy on the front end combined with renewed demand on the long end. With the Fed hiking in June for a second time, and indicating another hike likely by year-end, the yield on the 2-year Treasury rose while the 10-year Treasury yield fell, as the agency has little influence over the long end of the curve.

Should inflation remain tame, the Fed's modest tightening bias likely will continue, barring significantly downbeat data or escalating geopolitical risk. We remain on guard for a general rise in rates, regardless of the magnitude in the front or long end and continue to buy in the intermediate part of the curve (4-7 year) where we have been long underweight. Several central banks around the world are signaling for higher rates and, at the very least, are done with quantitative easing.

Year-to-date supply has been at record levels and additional issuance to finance mergers and acquisitions is yet to come in the second half, although we are not likely to exceed last year's volume. On the demand side, ETF and mutual fund flows continue to be positive but may be starting to slow and could experience a sharp reversal should rates rise too quickly or more than expected. As such, we remain cautiously overweight corporates and are being very strategic about adding new names, while taking the opportunity to raise cash through the sale of smaller positions or bonds we consider to be fully valued. With our expectation for rates to climb, we look to strengthen our defensive posture by purchasing fuller coupon securities, which offer more protection in such an environment by providing larger cash flows to invest at better yields.

Municipal bonds thrived in an environment of political uncertainty for the second straight quarter. 10-year tax-free bond yields collapsed to a seven month low of 1.8% in early June, before rising a touch to finish the quarter closer to 2.0%. The Barclays Municipal Bond Index rose 2.0% during the quarter, driving the year-to-date advance to a sturdy 3.6%. However, twelve-month performance, albeit improving, remains negative by -0.5%, reflecting the rise in interest rates from the all-time lows seen in the immediate aftermath of last summer's surprising Brexit vote.

It seems the pillars of the "Trump Tantrum" that drove rates meaningfully higher late last year are crumbling, and habitual drivers of performance such as mutual fund flows and new supply have regained their traditional role. New issues are running 14% shy of last year's pace, as municipalities remain on the sidelines awaiting greater clarity on fiscal policy and an infrastructure buildout. As of this writing, the Senate's attempt to repeal the Affordable Care Act remains the current priority, pushing tax reform into a subordinate role. While the failure to lower tax rates would support tax-free bonds on the margin, it is a surprise to us that demand for municipal income, as evidenced by inflows into municipal bond funds, remains so strong. Not only are absolute yields low, but tax-free yields relative to Treasuries also are on the rich side.

While yields on longer maturities provide little value, interest rates on shorter bonds have moved a touch higher in sympathy with the Fed's gradual approach to tightening monetary policy. The result is a flatter yield curve, which means there is less incremental yield for taking on the interest rate risk inherent in long-dated bonds. While we expect the Fed to move slowly with further rate hikes, it remains to be seen how well the market digests an actual reduction in bond holdings currently on the Fed's balance sheet. Clearly the market is better prepared than in 2013, when then-Fed Chairman Bernanke first broached the idea of reversing the legacy of quantitative easing, and a bond rout promptly ensued. However, given that equities were unfazed and bond yields were not meaningfully impacted after the

recent Fed statement, perhaps the program will not be disruptive. However, the Fed's stated goal is for $50 billion in reductions per month, so there will be $600 billion of Treasuries and mortgage bonds looking for a new buyer, which is the equivalent of this year's federal budget deficit. We think in time this will have an impact and gives us another reason to be cautious.

With the labor market seemingly tight, we believe nothing short of a permanent unraveling of the president's stalled agenda is required to justify the current level of yields. While stimulative fiscal policy and tax reform are no sure thing in this toxic political environment, it likely is a matter of when, not if. At that time, we anticipate the push will be towards higher yields, although admittedly this might be a 2018 story, and we could see issuers increasingly come to the market, fearing the attractive borrowing environment is reversing.

Conclusion

We remain of the view that economic growth will remain in the range of 2%, where it has been throughout much of the recovery, modest but positive, with continued subdued inflation. In this environment, equities and bonds have managed to do well. However, there are plenty of headwinds facing investors: rich valuations and the advanced age of the bull market in stocks, investor complacency, Fed rate increases and balance sheet reduction, and the contentious political climate. We believe this elevates the potential for increasing volatility in all financial markets. We are looking for decent earnings growth for stocks and only gradual Fed tightening which leaves us cautious, but modestly optimistic, as we start the second half of the year.