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First Quarter 2017 Market Summary

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First Quarter 2017 Market Summary

The first quarter of 2017 was strong as equity markets advanced in each of the three months. Volatility, measured by the CBEO Volatility Index, had the second lowest quarterly reading ever. Business and market sentiment has been increasingly positive and investors have been undeterred by any macro headlines such as the failed "repeal and replace" strategy for the Affordable Care Act. The quarter was driven by confidence in the new administration's economic stimulus agenda and improving corporate earnings. Investors remain focused on the potential benefits from the new administration's proposed policies while largely ignoring any potential negatives.

The main narrative exiting the first quarter was the idea of perception vs. reality. Economic statistics can be separated into "soft data" and "hard data". "Soft data" includes business surveys, consumer confidence measurements, sentiment indicators, etc. These figures have marched higher and many are reaching levels last seen a decade ago. "Hard data" measures economic activity such as retail sales, auto sales, constructing spending and business lending. These figures have not improved since the election, creating a large gap between the optimism seen in "soft" data and the reality seen in the "hard" economic data. Businesses seem to be awaiting confirmation of policy and regulation changes before adding personnel or increasing capital expenditures. As a result, any economic benefits from potential pro-growth legislation could be push into 2018.

U.S. large company stocks, represented by the S&P 500 Index, were up 6.1% during the first quarter of 2017. U.S. small company stocks, represented by the Russell 2000 Index, had positive returns of 2.5%. Despite U.S. small company stocks having a relatively subdued first quarter, on a one year basis they have returned more than 26%. Broad U.S. equities, represented by the Russell 3000 Index, have had positive returns in 18 of the past 19 quarters. Over the past few quarters, market leadership has been narrow and rotating, leaving some sub-segments down 10%-20% while others have reached new highs.

Overall, international stock markets had strong performance for the quarter with the MSCI ACWI ex US Index up 7.9%. Emerging markets performed even better with a return of 11.5% during the quarter. European and emerging market companies had declining earnings from 2011 through the beginning of 2016, which hindered equity performance during that period. In 2016, earnings slowly started to rebound as the uncertainty in these regions moderated. This growth has continued into 2017 as global central banks remain accommodative. European economic data is strengthening including improving loan growth and employment. Likewise, China's economy has rebounded with help from the government's stimulus last year. Stable growth in China is beneficial for the rest of the emerging markets.

For the quarter, the Barclays U.S. Aggregate Index, which represents a broad basket of bonds, was up 0.8%. The Federal Reserve raised the Fed Funds rate by 25bps in March. Despite the action by the Fed, intermediate to long dated Treasury interest rates were flat to down during the quarter. The Fed is expected to raise rates at least two more times by year end, which will likely keep bond returns modest this year. In the long run, bond investors typically benefit from higher yields as the increase in income more than offsets short-term bond price changes.

The popular consensus view is currently calling for a pullback in the equity markets. The reasoning is that despite current optimism, market valuations are relatively high and there are a number of concerns that could weigh on the markets in the coming months, such as elections in Europe, the fate of U.S. tax reform and the current lack of progress in passing other pro-growth U.S. legislation. While those concerns are valid, valuations can stay high for long periods at a time. Furthermore, there are no signs of significant deterioration of economic data, credit markets or market sentiment.

HIGHLIGHTS

MACROECONOMICS

- The Bureau of Economic Analysis released the final estimate of fourth quarter 2016 real GDP, an upwardly revised annual rate increase of 2.1% from the preceding quarter. Many forecasts for first quarter GDP are around 1% as GDP has been seasonally softer in the first quarter.
- The University of Michigan Consumer Sentiment Index final reading for March was 96.9. Consumer sentiment has risen to levels last seen over a decade ago.
- The ISM Manufacturing Index increased during the quarter from 54.5 in December to 57.2 in March. The ISM Index has risen steadily since the beginning of 2016. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- In March, the Conference Board Leading Economic Index increased 0.4% month-over-month to 126.7. The Index has increased gradually over the past year showing steady growth in the economy.
- The price of WTI Crude Oil was $50.54 at the end of March, which is 6% lower than $53.75 at the end of December. The price of Brent Crude Oil decreased 5% in the quarter to $52.2. The price of oil is starting to find an equilibrium around $50.
- In March, headline CPI increased 2.4% year-over-year, up from an increase of 2.1% in December. Core CPI, which does not include food and energy, had a 2.0% increase. Inflation levels have increased over the past year as energy prices have risen; however, inflation remains less than historical averages and near the Fed's 2% inflation target.

HOUSING

- The housing sector has been very strong the past few years with increasing sales and home prices.
- Preliminary existing home sales increased in the quarter with a monthly average annualized rate of 5.62 million units from 5.55 million units in the fourth quarter. The March annualized rate is 5.9% higher than the 5.39 million units in March 2016. Unsold home supply remains at very low levels.
- Median existing home sale prices increased during the quarter. However, the preliminary prices for March were 6.8% higher than the levels of one year ago and have been trending up since the beginning of 2012.
- New home sales have been strong to start the year and have been increasing since 2011. However, new home sales remain slightly below average due to the below average housing starts since 2009.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose 5.8% year-over-year in February.

EMPLOYMENT

- The labor market data has generally been positive. The job growth rate has slowed slightly as the labor market is closer to full employment. However, wages have been slowly rising over the past few years.
- During the quarter, nonfarm payrolls averaged 178,000 jobs added per month, which is lower than the first quarter in 2016 but still constructive.
- The unemployment rate declined to 4.5% from 4.7% during the quarter.
- Initial Jobless Claims have been decreasing since 2009 and dipped to lows last seen in 1973, reflecting a tight labor market.

DOMESTIC CORPORATIONS

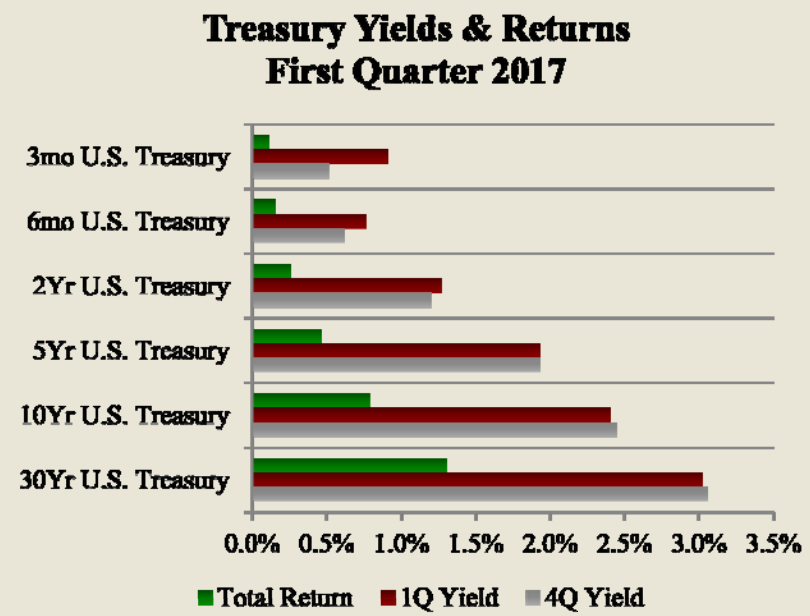
- Corporate operating earnings in the fourth quarter 2016 were higher than the previous year as the energy sector rebounded. Estimates for 2017 show an acceleration of earnings growth and should surpass peak levels set in 2014. However, current forecasts may end up being too optimistic as earnings estimates have historically been revised down throughout the year.
- Operating margins have retreated from their highs but remain well above historical averages. Margins could continue to be pressured if interest rates rise and wages increase.
- Forward and trailing P/E multiples are slightly above historical averages.
- The U.S. dollar depreciated vs. major currencies during the quarter. However, many investors are forecasting the U.S. dollar to appreciate with an improved growth outlook and rising interest rates in the U.S.

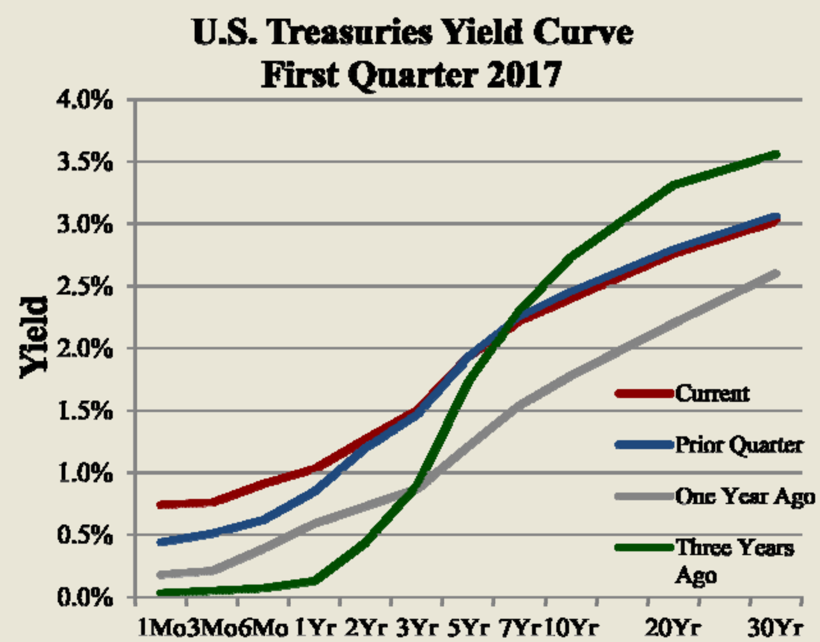
FED POLICY

- In March, the Federal Open Market Committee (FOMC) decided to raise the federal funds rate by a quarter percent to 0.75% - 1.00%. The announcement to raise rates was expected by the market as the Fed had been forecasting the rate hike for a while. The Fed's assessment of economic conditions were positive noting the economy is expanding moderately and the labor market continues to strengthen.
- The Fed is still forecasting that they expect to raise rates three times during 2017; however, they will remain data dependent. As 2017 progresses, the Fed believes consumption and capital expenditures will increase at a moderate pace which would support raising rates. Towards the end of the year, the FOMC may look to reduce the Federal Reserve's balance sheet by changing the reinvestment policy. Any change to the policy would likely be communicated well in advance.

FIXED INCOME

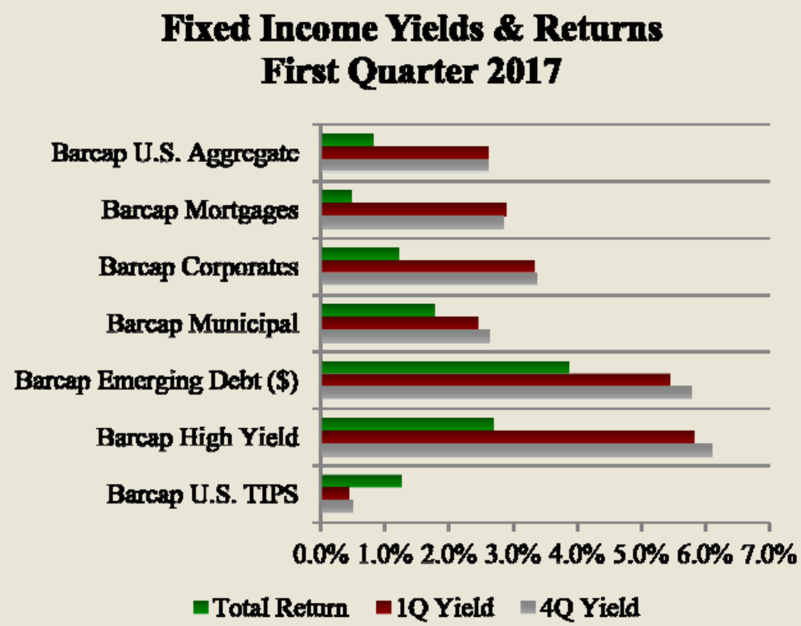
- Intermediate to long term yields were flat to down quarter-over-quarter; however, the short end of the curve rose causing the yield curve to flatten. The long end of the yield curve did not move as bond investors focused on the lack of improvement in "hard economic data" and the realization that any economic benefits from potential pro-growth legislation could be pushed into 2018. Short-term rates rose roughly in line with the Fed Funds rate increase. Short term interest rates are controlled or heavily influenced by central banks where as long term interest rates are controlled by market forces and economic growth.
- Despite the low rates of Treasuries and other developed country sovereign debt, investors have continued to buy fixed income. Flows into fixed income investments were positive in the quarter. There are several secular fundamental factors that are helping the bond market and keeping interest rates restrained. Many institutional mandates require income and investments that act defensively in volatile markets. In addition, there is a large population of people globally that are in or near retirement and typically as investors age they reduce portfolio risk and shift to income-generating assets.





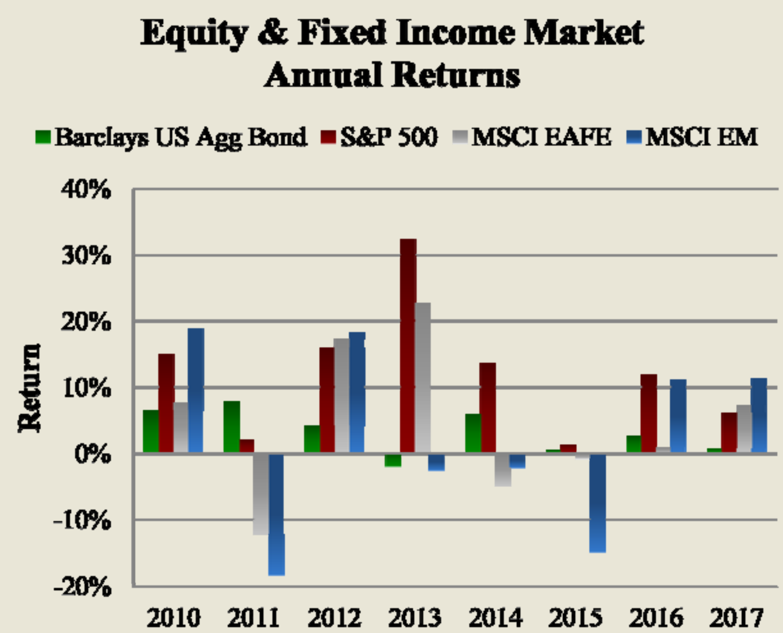
FIXED INCOME (continued)

- Returns across fixed income sectors were positive. The Barclays U.S. Aggregate was up almost one percent during the quarter. Municipal returns outperformed taxable bonds. Technicals benefitted the municipal sector during the quarter as supply was light while demand increased as the sector saw inflows. High yield and corporates performed well as credit spreads tightened. Emerging market debt was the best performing sector due to rising global growth prospects and more attractive valuations than other credit sectors.
- Fixed income returns, going forward, are expected to be lower than historical averages as interest rates are still at a very low level. Historically, future ten year fixed income annualized returns have been about equal to the 10 year Treasury yield at the start of the period. However, spreads in credit sectors are near historical averages which could benefit credit returns if the economy continues to grow.



EQUITIES

- There is evidence of a global synchronized global economic expansion which led global equities to have strong performance during the quarter with limited volatility. In the U.S., equity investors have focused on the strong "soft economic data" and the potential benefits from the Trump administration's proposed policies while largely ignoring any macro risks.
- Recent economic data has pointed to stronger growth; however, the equity markets have some headwinds. Valuations remain higher than average which should give caution to investors if earnings and policy do not meet expectations. However, valuations have little correlation with equity returns over the short-term. Equity returns will likely be driven by revenue and earnings growth rather than valuation expansion.

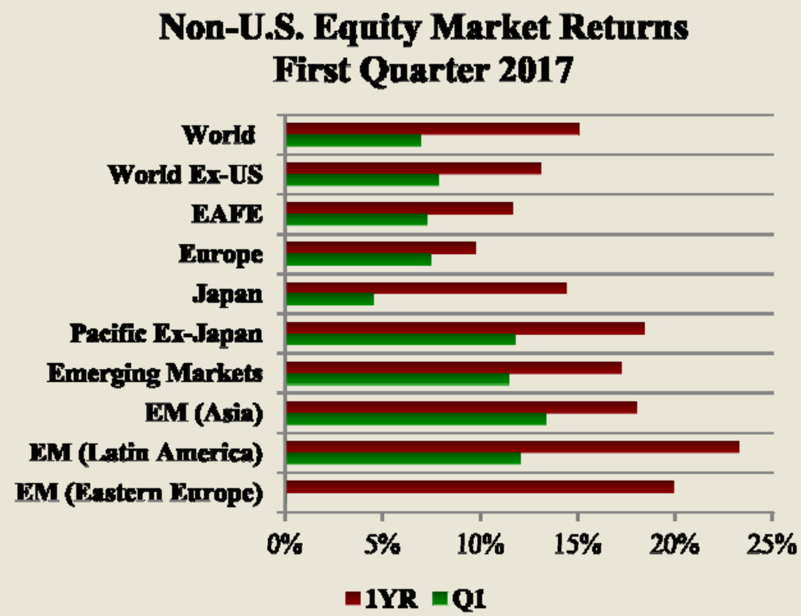


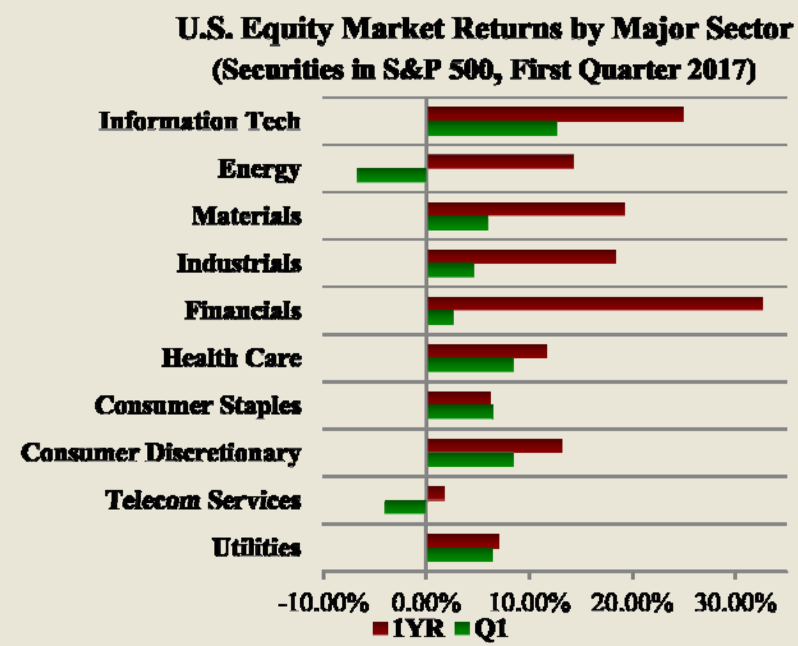
INTERNATIONAL EQUITIES (continued)

- Developed international stocks, as represented by the MSCI EAFE, were up 7.3% during the quarter and performed better than U.S. domestic equities. On a year-over-year basis, the EAFE is up 11.7%.
- Emerging market stocks had a strong quarter, outperforming developed markets. The MSCI Emerging Markets Index increased 11.5% in the quarter and has increased 17.2% over the past year.
- European and emerging market companies had declining earnings from 2011 through the beginning of 2016 which hindered equity performance during that period. In 2016, earnings slowly started to rebound as the uncertainty in these regions moderated. This momentum has continued into 2017 as there are more signs of improved sentiment, economic growth, increased loan demand and labor market recovery. Despite these positives, the political risks remain elevated for much of the world.

DOMESTIC EQUITIES (continued)

- The Russell 1000 Index of large capitalization stocks posted a total return of 6.0% during the quarter. On a year-over-year basis, the Russell 1000 Index has increased 17.4%.
- Small capitalization stocks, as represented by the Russell 2000 Index, posted a total return of 2.5% during the quarter. On a year-over-year basis, the index has increased 26.2%.
- The first quarter saw market leadership change relative to last year. Growth outperformed value across market capitalization and geography. Technology, Health Care and Consumer Discretionary were the best performing sectors. Energy stocks lagged with the price of oil declining during the quarter. Large capitalization stocks outperformed small capitalization stocks.





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