Economic Update

A Review of First Quarter 2017

While the first few months of the Trump presidency may have seemed chaotic, it is not the first time that an incoming president has struggled right out of the gate. Still, he has seen some success as well. On the plus side of the ledger, Trump's recent Syria strike has generally been viewed favorably throughout much of the world, his Supreme Court pick Neil Gorsuch was successfully confirmed and most of his cabinet picks survived unscathed. By comparison, Clinton, Bush and Obama all had more cabinet withdrawals during their first 100 days in office. On another positive note, public confidence in the economy remains high, as evidenced by employer and consumer surveys as well as the stock market in general.

On the minus side, our new president struggles with low approval ratings brought about by numerous PR gaffes, operates under the specter of congressional review of Russian interference in his recent election, and just experienced a high-profile legislative failure with the recently aborted attempt to repeal the Affordable Care Act.

Now that health care has been tabled for the time being, corporate tax reform appears to be next on the legislative agenda. Markets will be watching closely to see how those discussions evolve. Currently, the House Republican tax reform plan envisions a corporate tax rate reduction from 35 to 20 percent, which would result in a significant boost to corporate earnings. And these corporate earnings could be important fuel if we are to see further stock market growth.

U.S. Economy

At least in part due to the prospect for lower taxes on the horizon, business sentiment remains high. The most recent Chicago Purchasing Managers Index registered a robust 57.7 in March. Readings above 50.0 predict economic expansion.

Consumer sentiment remains high as well. The University of Michigan Consumer Sentiment reading registered 96.9 during March. While that remains below the 100.0 level normalized in December 1964, it is still is much higher than we have been for most of the past decade. But, not surprisingly, sentiment is strongly split along partisan lines. According to the survey's chief economist Richard Curtin, "Democrats expect an imminent recession, higher unemployment, lower income gains and more rapid inflation, while Republicans anticipate a new era of robust growth in incomes, job prospects and lower inflation."

The true state of the economy is probably somewhere in between the expectations of the Democrats and the Republicans. Aside from the most recent month, job growth has been strong. While the economy created just 98,000 new jobs in March, this follows tallies of 216,000 and 219,000 in January and February respectively. Additionally, unemployment fell to 4.5 percent and is now at its lowest level since May 2007.

However, the current unemployment rate is still not low enough to put substantial pressure on wages. As a result, income gains have remained muted. But continued job gains, combined with the prospect for

reduced future immigration, could push the unemployment rate to the 3.5 to 4.0 percent range by the end of this year. Perhaps those levels would unleash income growth.

Inflation has picked up a bit in recent months. Total inflation registered 2.8 percent during the 12 months ending in February. Core inflation, which strips out volatile food and energy costs, was 2.2 percent during that same time period. The Fed's explicit target for inflation is 2.0 percent, so future readings consistently in excess of that figure could force quicker interest rate increases than the Fed otherwise might want to do.

Economists are predicting that U.S. GDP growth was between 1.5 and 2.0 percent during the first quarter of 2017, per the Atlanta Federal Reserve Bank. Our economic expansion will soon enter its ninth year, which makes this the third longest expansion that our country has experienced since 1900. It looks like slow but steady growth will continue to be here for the foreseeable future.

International Economy

Brexit was officially triggered on March 29, with a letter delivered by British Prime Minister Theresa May to European Union President Donald Tusk. The two parties now have a two-year window to finalize the details. Initial meetings have already begun.

The next step will be for the European Council to meet on April 29 to approve negotiation guidelines. Britain has indicated the desire to discuss the terms of the impending exit in tandem with talks about future trade deals. The EU, on the other hand, favors first making progress on the exit agreement itself before trying to sort out a new relationship with the U.K.

Either way, expect a few hiccups over the next few years as Britain becomes the first country to pull out of the Union since its formation in 1992. For example, there already have been isolated rumblings about Britain going to war with Spain over Gibraltar. This is highly improbable, but it does serve as an example of the type of distraction that the two parties will have to deal with in the upcoming months.

Brexit aside, the Eurozone economy continues to improve. Just a few years ago, unemployment was stubbornly high, corrosive deflation was a real threat, and voters seemed to be increasingly turning to extremist parties in order to provide a solution. However, now that Eurozone unemployment has fallen to its lowest rate in eight years at 9.5 percent and manufacturing output experienced its highest growth in over six years, European politics seems to be normalizing as well. Dutch elections look as though they have returned a moderate prime minister while the French appear to be currently favoring a centrist candidate as well.

Asian economies also appear to be improving as recent stimulus from Beijing ahead of this fall's Communist Party Congress has led to more stability in China as well as some growth opportunities in neighboring economies. Firming commodity costs has also helped nearby materials exporters such as Indonesia and Australia.

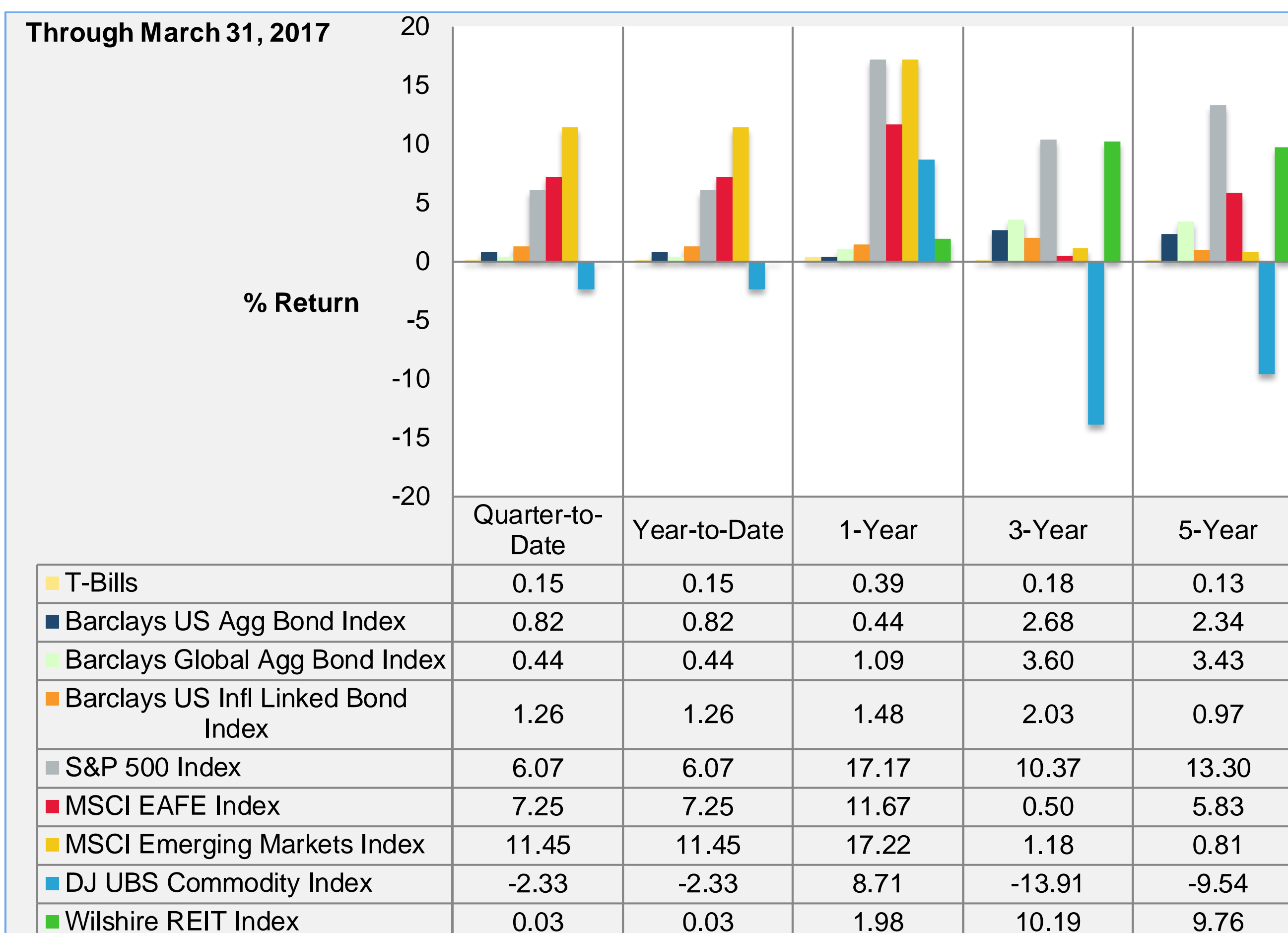
Overall, the most recent World Economic Outlook report released by the International Monetary Fund calls for 3.4 percent global GDP growth for 2017, with 1.9 percent GDP growth for developed market countries.

Markets

Equity markets throughout the world have had a good start to the new year. Large companies in the U.S., as represented by the S&P 500 Index, gained 6.07 for the first three months of 2017. Developed international equity markets performed slightly better, as they were up 7.25 percent for the same time period, as represented by the MSCI EAFE Index.

Emerging markets have also bounced back sharply from a poor showing during the fourth quarter of 2016. During the first quarter of 2017, the MSCI Emerging Markets Index was up 11.45 percent. Commodities and Real Estate did not fare as well, however. The DJ UBS Commodity Index lost 2.33 percent while the Wilshire REIT Index was basically unchanged, with a mere 0.03 percent gain for the quarter just ended.

Fixed income returns appear to have settled as interest rates stabilized following a big spike at the end of 2016. The Barclays U.S. Aggregate Bond Index was up 0.82 percent for the first quarter of 2017. Global bonds, as measured by the Barclays Global Aggregate Bond Index, also eked out small gains, earning 0.44 percent for the quarter. The Barclays U.S. Inflation-Linked Bond Index gained a little more due to slightly higher inflation expectations, finishing the quarter up 1.26 percent.



Through March 31, 2017	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.15	0.15	0.39	0.18	0.13
Barclays US Agg Bond Index	0.82	0.82	0.44	2.68	2.34
Barclays Global Agg Bond Index	0.44	0.44	1.09	3.60	3.43
Barclays US Infl Linked Bond Index	1.26	1.26	1.48	2.03	0.97
S&P 500 Index	6.07	6.07	17.17	10.37	13.30
MSCI EAFE Index	7.25	7.25	11.67	0.50	5.83
MSCI Emerging Markets Index	11.45	11.45	17.22	1.18	0.81
DJ UBS Commodity Index	-2.33	-2.33	8.71	-13.91	-9.54
Wilshire REIT Index	0.03	0.03	1.98	10.19	9.76

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

Corporate earnings had been weak but rebounded during the second half of last year. However, additional earnings growth during 2017 will be harder to achieve. On that basis, the United States stock market looks fairly expensive by historical standards.

However, given the returns available on other alternatives such as cash and fixed income, markets might actually not be expensive at all. Now that the Fed appears to be committed to raising rates, the primary question is how high will they eventually go? Current market valuations are very sustainable if we are truly in a new era of relatively low interest rates. On the other hand, a reversion to historical rate norms could portend future market losses.

After years of underperformance, international equities now look relatively attractive as compared to the United States. Overseas valuations appear to be less stretched and the path to further earnings growth is more apparent in other areas of the world. That could make this a good time to rethink allocations, especially in cases where portfolios have naturally drifted more and more to U.S. equities as a result of its outperformance over the last few years.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0 percent of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index

consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ The DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.