October 2016

INVESTMENT UPDATE

Executive Summary

- Economic growth remains slow and steady, while fundamentals point to an economy that can continue to grow at a modest pace for the foreseeable future.

- While the Fed appears poised to raise interest rates before the end of the year, we believe that it will not have a significant impact on the economy as interest rates would need to increase substantially before becoming restrictive to economic growth.

- After 6 straight quarters of declines, S&P 500 earnings were flat in the second quarter and are expected return to positive growth in the third quarter. This return to growth should support continued positive returns for stocks in the quarters ahead.

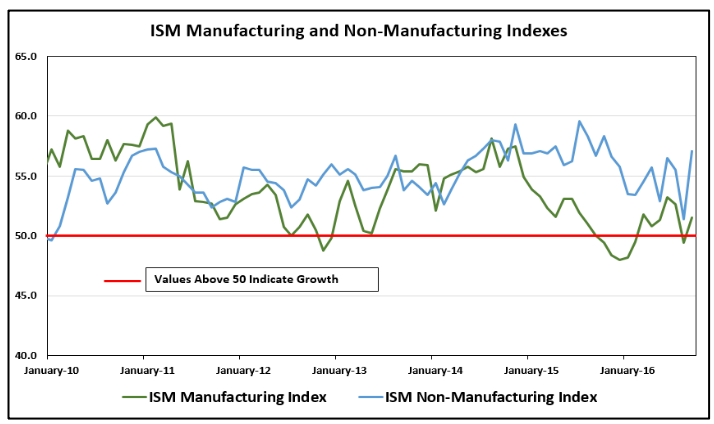
Economic Growth Remains Slow and Steady

Last quarter we advised our clients to "keep calm and stay the course" with regard to their investment allocation following the panic selling that took place in the days immediately following the Brexit vote. We viewed this event in a similar manner to the various fear-based events that were supposed to bring an end to the bull market over the past seven years. These events included a looming wave of foreclosures that were supposed to lead to a double-dip recession, impending hyperinflation due to quantitative easing, the fiscal cliff, the sequester, the federal government shutdown, and sharp oil price movements up and down. While the fears tied to these events brought volatility to the stock market, none of them were able to knock the economy into a recession or bring an end to the bull market as the S&P 500 set new highs during the third quarter.

This doesn't mean there can't be another recession ahead of us, in fact, eventually we will experience another one. However, at the time everyone was worrying about those fear-based events, the underlying economic fundamentals were strong enough to continue to push the economy forward. These fundamentals remain fairly strong today and should allow the U.S. economy to continue to generate slow and steady economic growth over the near-term. For example, while the ISM Manufacturing Index dipped below 50 (indicating contraction in the manufacturing sector) for 5 consecutive months from October of last year through February of this year, the primary cause of this was weak energy prices and the impact of the strong U.S. dollar on exports of goods manufactured in the U.S. Since then, the index has reported growth for the manufacturing sector in 6 out of the last 7 months, indicating that these headwinds may already be starting to subside (see Graph 1).

Another data point worth monitoring is the ISM Non-Manufacturing Index which measures the growth of the service sector of the economy. Over the past 65 years the services sector of the economy has grown from less than 50% of U.S. GDP to nearly 70% as growth in the services sector has outpaced that of the manufacturing sector. This sector has been expanding at a strong pace over the past several years and is the reason why the economy has continued to grow over the past 12 months despite the contraction in the manufacturing sector. While service sector growth has been volatile on a monthly basis, it posted its 80th consecutive month of growth in September and continues to point to growth for this important sector of the U.S. economy (see Graph 1).

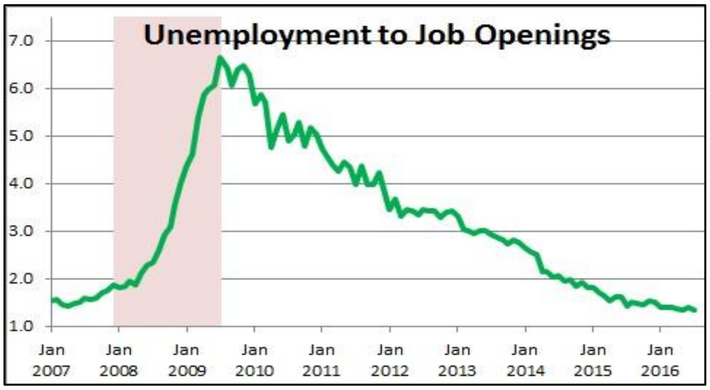
Graph 1. Manufacturing and Service Sectors Showing Growth



Source: Bloomberg

Along with a return to growth in the manufacturing sector and continued growth in the services sector there are numerous other positive indicators that support continued economic growth. For instance, personal consumption growth remains solid at +2.7% over the past 12 months while consumer incomes including growth in jobs, wages and hours worked are growing at around +4%. Additionally, consumer incomes should accelerate further as hourly wage growth is poised to improve, aided by a tightening labor market as demonstrated by an unemployment rate of 5%, job openings at 15 year highs, and only 1.2 unemployed workers available per job opening as compared to a peak of over 6.5 in 2009 (see Graph 2). Faster consumer income growth at a time when household net worth is at a record high and household debt service payments as a percent of disposable income is near 35 year lows should provide consumers with the confidence to increase spending and support continued economic growth.

Graph 2. The Labor Market Continues to Tighten



Source: BLS Data

Fed Poised to Raise Rates before Year End

Aided by expectations of continued economic growth and core inflation running near their 2% target, the Fed appears poised to raise interest rates before the end of the year. This is just the second rate hike in over a decade and will likely happen a full year after the first hike took place last December. While the market seems to react negatively every time the possibility of a rate hike is mentioned, we don't believe a hike from such low levels will negatively impact the economy. In fact, savers who have been earning next to nothing on their $9.5 trillion in cash deposits would see an almost immediate benefit from a rise in interest rates. Meanwhile, the vast majority of debt is locked in at fixed interest rates for several years tempering the negative impact on borrowers. Thus initial efforts to raise interest rates could actually support economic growth until rates reach a level where they become restrictive, a level we believe is significantly higher than rates are right now. For that reason, stock investors should not fear the rate hike. Alternatively, with real interest rates on the 10-year U.S. Treasury Note in negative territory, we continue to believe that bond investors will eventually demand a greater return on their fixed income investments. Therefore, we believe the current interest rate environment is unsustainable and continue to recommend our clients maintain defensive bond portfolios with relatively short durations.

Presidential Election to Bring Some Volatility

Like the Brexit vote and various other fear-based events over the past several years, the upcoming election may also introduce additional volatility into the stock market as the candidates present their plans for the country while the market works to interpret what those plans would mean for the economy and corporate profits. While Presidential elections are important and help shape the direction the country will move in, ultimately the ability of one person to implement drastic change is held in check by the legislative branch of the United States. Without total control of Congress, neither candidate will be able to easily implement major changes, limiting the impact that a new President will have on the economy and ultimately on the stock market. Therefore, while the uncertainty surrounding the election of a new President may bring added volatility to the market, this should be short-lived and we would view any significant pullback in stocks on an election related decline as a buying opportunity.

"Haves" vs. "Have Nots"

With interest rates remaining near record lows, income seeking investors have moved beyond traditional fixed income securities into slow growth but high dividend paying stocks, driving outperformance of the "haves" (those stocks with high dividend yields) relative to the "have nots." This outperformance has caused a divergence in returns with the average large cap growth fund (according to Morningstar research) generating a total return of just +3.4% so far this year compared to a total return of +7.8% for the S&P 500. This has also caused valuations of the "haves" to move above normal levels, while creating a lot of relative value in growth oriented stocks. We continue to believe that our approach of investing in high quality consistent growth companies will allow our clients to outperform over the long-term.

Corporate Profits Poised to Return to Growth

The earnings of the S&P 500 posted flat year-over-year growth in the second quarter of 2016 and appear poised for a return to growth in the third quarter following six straight quarters of declines caused by lower oil prices and the headwind of a significantly stronger dollar on foreign profits. The anticipation of this return to earnings growth has helped stocks generate strong returns during the third quarter, with the small capitalization stocks (Russell 2000) leading the way with a total return of +9.1%, followed by a +6.5% return for foreign stocks (EAFE) and +3.9% for large capitalization stocks (S&P 500). Small capitalization stocks are also leading through the first nine months of the year with a return of +11.5% compared to large capitalization stocks at +7.8% and foreign stocks at +1.7%. While stock valuations remain slightly above their historical average range at 16.8x earnings, the anticipated return to earnings growth should provide support for stocks to continue to generate positive returns in the quarters ahead. Therefore, we continue to recommend maintaining equity ratios at the mid-point of targeted equity ranges.