October 2017

INVESTMENT UPDATE

Executive Summary

- The stock market continued its remarkable post-election rally in the third quarter, driven by improving fundamentals and the prospect for business-friendly policy changes.
- While we continue to believe that stocks still offer the potential of good long-term returns, with valuations rising to 17.7x forward earnings, well above the 25-year average of around 16.0x, we believe now is an appropriate time to become a little more cautious on stocks.
- The President's tax reform proposal, aimed at increasing the competitiveness of the U.S. on a global basis and bringing nearly $2.5 trillion in unproductive overseas cash back to the U.S., should provide support for higher stock prices.
- Despite four rate hikes since December 2015, real U.S. GDP growth remains resilient and appears positioned for its first back-to-back quarters of +3% growth since the second and third quarters of 2014. While expectations call for continued gradual rate hikes, Federal Reserve policy should remain stimulative to economic growth for several years.

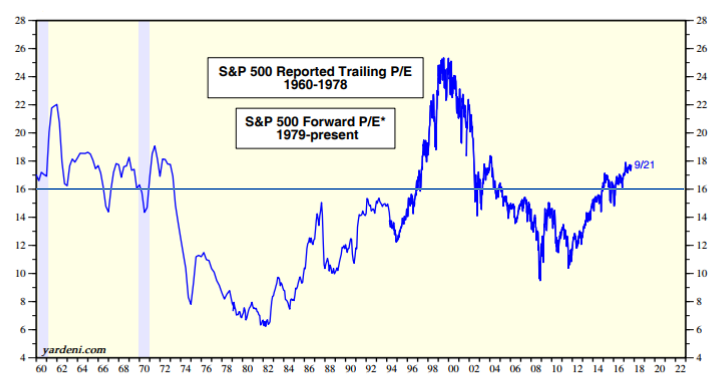
Stock Market Momentum Continues

The stock market (S&P 500) continued its remarkable post-election run generating a +4.5% return in the third quarter. Stocks have now generated a return of +19.9% since the Presidential election on improving fundamentals and the prospect for business-friendly policy changes. Perhaps the most important improving fundamental affecting stocks is the return of corporate profit growth following mostly flat profits in both 2015 and 2016. Corporate profits are running at all-time highs and are currently expected to grow at nearly +11% in both 2017 and 2018. This strength in corporate profits can largely be attributed to a strengthening domestic economy, which accelerated to +3.1% growth in the second quarter. With the ISM manufacturing index, which measures the health of the U.S. manufacturing sector, reaching a 13-year high in September and the ISM non-manufacturing index, which measures the health of the U.S. services sector, accelerating at the fastest pace since 2005 in September, the economy appears positioned to continue to grow at a rate faster than the +2.0% pace it has averaged since the end of the recession in 2009.

Some of the strength in the domestic economy can also be attributed to a weaker dollar since the start of the year, which makes U.S. manufactured goods more competitive in foreign markets. Also adding to demand for these goods is an improvement in Eurozone and emerging market economies, which are starting to show signs of life after nearly 10 years of little to no growth.

While most of the recent stock market performance can be attributed to an improving economic environment and a recovery in corporate profit growth expectations, it is hard to ignore that valuations have also risen. At 17.7x forward earnings, stocks are now well above the 25-year average of around 16.0x (see Graph 1), indicating that investors may be starting to become a little too optimistic and that future returns may be more muted.

Graph 1. Stock Market Valuations above Average



While we continue to believe that stocks still offer the potential of good long-term returns, we believe that now is an appropriate time to become a little more cautious with stock market valuations above the long-term average. Corrections, or pullbacks in the market of around -10%, typically occur once every 12 months on average, and with above average valuations, stocks are more vulnerable. We do not, however, believe that a recession (and a resulting bear market) is on the horizon as interest rates remain historically low, consumers and businesses are in strong financial condition, and the economy is modestly accelerating. As such, we recommend using the current

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strength in the market to rebalance equity ratios back towards the middle of one's targeted range. We continue to believe that making long-term investments in high quality, consistent growth companies is the best way to build capital.

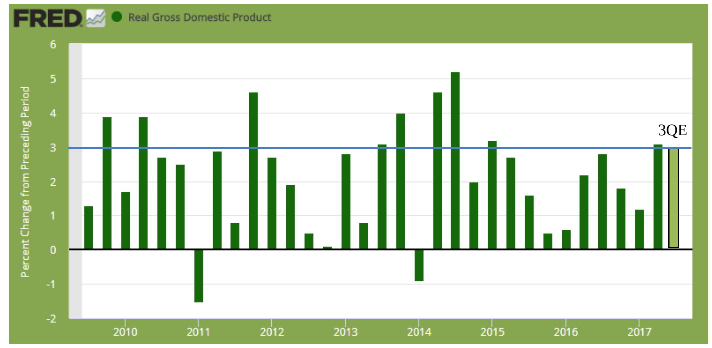
Tax Reform Proposal Could Support Higher Stock Prices

President Trump's corporate tax reform proposal, which calls for slashing the statutory corporate tax rate to 20.0% from 35.0%, should provide support for higher stock prices. While it remains to be determined how big of an impact tax reform can have on corporate profits, as the details of the bill still need to be hashed out in congress, the proposal should be positive for U.S. stocks as it aims to make the U.S. more competitive on a global basis and should encourage increased investment in the U.S. Additionally, the tax proposal also calls for a 10% corporate tax holiday on the repatriation of overseas cash, which could bring nearly $2.5 trillion of unproductive overseas cash that is sitting on corporate balance sheets back to the U.S. These corporations could then put the cash to work in more productive ways such as reinvesting in their businesses, making acquisitions, increasing dividends to shareholders, or buying back their own stock, all of which would be positive for stock valuations. Of course, there is also the possibility that Congress fails to get anything done at all, which would likely have a negative impact on stock prices as tax reform is certainly a factor contributing to above average stock valuations.

Despite the Higher Federal Funds Rate, The U.S. Economy Remains Strong

A common concern among investors when the Fed started to increase its Federal Funds rate in December 2015 was that these rate increases would slow the pace of economic growth and potentially put the U.S. economy back into a recession. Since that time, the Fed has gradually implemented a series of four rate increases, taking its key rate to 1.00-1.25%. Despite higher rates, real U.S. GDP growth has remained resilient and appears positioned for its first back to back quarters of +3% growth since the second and third quarters of 2014 (see Graph 2). We believe the Fed will continue its gradual approach to rate increases and anticipate one additional increase before the end of the year, followed by 3-4 increases in 2018 as it works to stay ahead of the curve on inflation. As long as the Fed continues its gradual pace of rate increases, we believe Federal Reserve policy will remain highly stimulative to economic growth for several years. To a certain extent, higher interest rates should be a positive for economic growth, as savers are currently being punished much more by low interest rates than borrowers are benefitting from them.

Graph 2. GDP Growth Remains Resilient



In response to the Fed's rate hikes, yields on bonds with short maturities have moved higher, though longer maturity bond yields have remained stubbornly low, resulting in a flattening of the yield curve. We expect yields on all maturities to begin to increase in the near-term, aided by continued Fed rate hikes, accelerating economic growth, rising inflation, and bond investors ultimately demanding a greater real rate of return on their longer maturity bonds. Therefore, we continue to recommend clients maintain defensive bond portfolios with shorter than market average durations.

Foreign Stocks Shine, while Small Capitalization Stocks Lag

Stocks have generated impressive returns through the end of the third quarter, as the momentum that started following the election last November continued. While large capitalization domestic stocks (S&P 500) have generated strong returns year-to-date of +14.2%, foreign stocks (MSCI EAFE) have performed even better, generating a return of +20.0%. This is a welcome development for diversified investors whose performance has been hampered by a decade of essentially no growth from foreign stocks. However, while small capitalization stocks (Russell 2000) outperformed their large capitalization peers in the third quarter, they still lag the S&P 500 for the year with returns of +10.9%. Lastly, bonds (Citi Broad Bond Index) have generated a reasonable return of +3.2% through the first three quarters of the year, benefitting from the flattening of the yield curve.