Economic and Market Overview

First Quarter 2017

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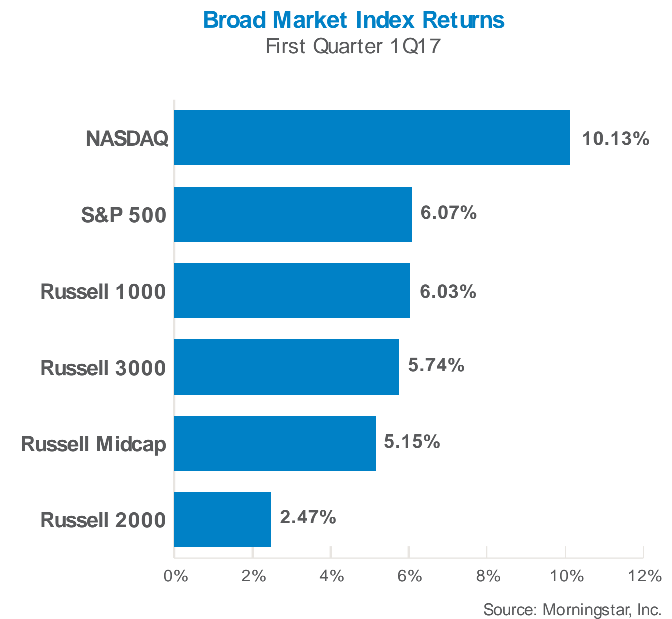
The Economy

In recent quarters, the US economy has proven to be a stable, steady grower, and according to most economists, few dark clouds are on the horizon. The economy continues to be supported by improving job growth and, more recently, a surge in consumer, business, and investor confidence. The first two months of the Trump administration have spawned a swell of enthusiasm, despite Congress' recent setback of failing to move ahead with overhauling health care. The Bureau of Economic Analysis reported its third estimate of fourth quarter 2016 gross domestic product (GDP) of +2.1%, up a notch from the prior estimate, but lower than the third quarter's +3.5% reading. The employment situation took a positive turn, with an average of nearly 209,000 jobs added each month, a further indication of an improving economy. The unemployment rate of 4.7% remained near cyclical lows. The better-than-expected jobs data was one data point the Federal Open Market Committee (FOMC) considered when it voted to raise short-term interest rates at its March meeting by 25 basis points to 0.75% - 1.00%. Analysts anticipate two more rate hikes in 2017.



The global economic landscape is improving. Although the dollar's appreciation has suppressed US growth, it has helped prospects for foreign economies exporting to the US, particularly Europe, Japan, and China. In addition, improving domestic growth will certainly help the outlook for economies worldwide, as US consumers demand more goods and services. The Eurozone's recovery is picking up steam, albeit modestly, on the back of rising export growth and the housing market's steady recovery. Although China is expected to see further easing in GDP growth, as the country continues its transition to a more consumer-oriented economy, analysts nevertheless expect its economy to grow at close to 6% in 2017. Additionally, domestic demand in China is increasing, as a result of a significant rise in consumer credit.

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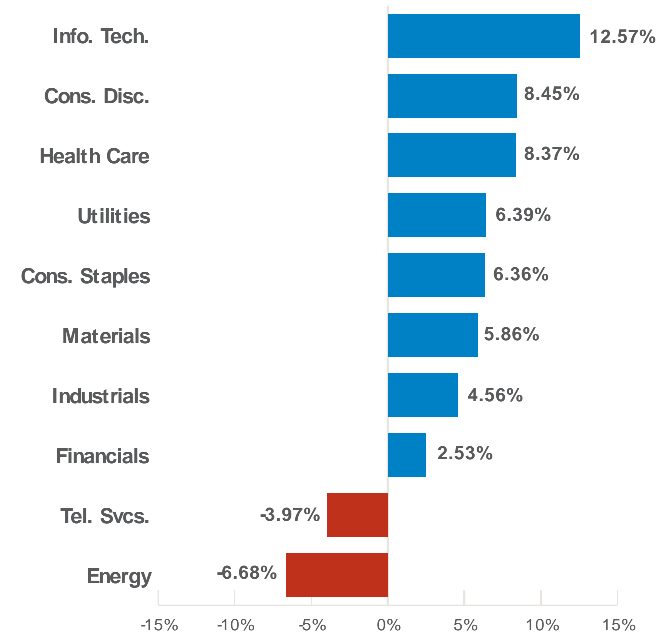
Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the fourth-quarter 2016 real GDP, a seasonally adjusted annualized rate of 2.1%, down from the third quarter's +3.5% annualized growth, but up slightly from the 1.9% prior estimate. Although the fourth-quarter results were lower than those of the prior quarter, they were still above the +1.7% average of the previous four quarters. Consumer spending was the primary growth driver during the quarter, whereas both government spending and trade proved to be key detractors. Analysts point out that the rising dollar is hindering US competitiveness, serving as a drag on growth. Although wage pressures have begun to pick up slightly, inflation remained stable in the quarter, with the personal consumption expenditures (PCE) index of prices rising +1.9%, following a +1.5% advance in the prior quarter. The consensus among economists is for little risk of recession over the next several quarters, as few imbalances exist in the economy, such as the housing bubble prior to the Great Recession.



HOUSING

The housing segment has steadily improved. Existing home sales for February (the latest monthly data available) grew at an annualized rate of 5.5 million units, a decrease of about -3.7% from the 5.7 million-unit-rate reached in January, yet up +5.4% from February 2016. The inventory of existing homes was slightly less than four months of supply, modestly lower than year-ago levels. Existing home prices in February were up a slight +0.4% from January, but have gained nearly +7.6% from February 2016, the fastest growth rate since early 2015. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 71, its highest reading in the past 12 months. Homebuilders and analysts expect the headline number to remain steady or pull back slightly in the quarters ahead, as higher interest and mortgage rates may dampen new homebuilding activity.

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EMPLOYMENT

The employment situation experienced resurgence in the most-recent monthly report. Employers added 235,000 jobs during February, far exceeding the consensus expectations of 190,000 new jobs, and in line with the prior month's gain. The three-month moving average also rose, coming in at 209,000, its highest level since September. The unemployment rate in February was 4.7%, just off its cyclical low of 4.6% reached in November. Average hourly earnings increased by a modest +0.2% in February, and have risen +2.8% in the past 12 months. Most economists agree that job growth should average somewhat below 200,000 per month for the remainder of the year. As the job market continues to improve, employers may face increasing difficulty in filling positions.

FEDERAL RESERVE POLICY

As analysts' consensus had expected, the FOMC ended its recent March meeting by raising the target range for the federal (fed) funds rate by 25 basis points to 0.75%-1.00%. In its statement accompanying the rate decision, the Committee said the risks to the economy remain balanced, and signaled there will be additional rate hikes over the course of 2017. The interest rate futures market is currently implying two additional increases before 2018. The Committee indicated that an improving economy, rebounding employment, and inflation nearing its target level of 2% made this an opportune time to initiate another increase. An encouraging addition to the FOMC's statement this time was the implication that it would not necessarily consider 2% inflation as a ceiling before it accelerated rate increases. Many economists believe the FOMC should allow the economy to "run hot" for a bit, or let the inflation rate rise above 2% before pulling in the reins again.

INTEREST RATES

As was the case over the prior two quarters, the primary drivers of fixed income securities' prices during the past three months were anticipation of (and ultimately the FOMC's decision to move ahead with) a hike in the fed funds rate, an improving economic outlook (especially the employment situation), and record-high stock prices. With the economic backdrop supporting a rate hike, there was little suspense as to whether the FOMC would move to increase rates, especially after members of the Committee, in the days leading up to their meeting, signaled such an outcome was likely. The fixed income markets also digested the inauguration of Donald Trump and the heightened activity surrounding his first weeks in office.

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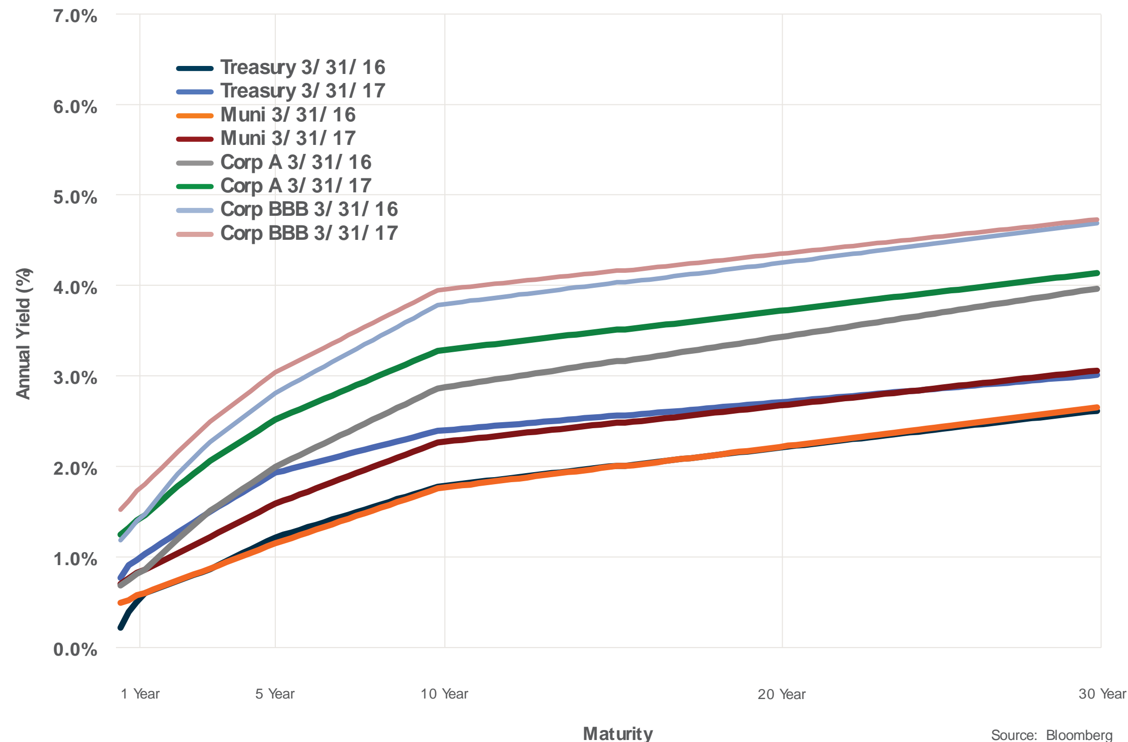

In contrast to the prior quarter, the yield curve flattened slightly, as yields on short-term securities rose more than those in the intermediate- to long-term end of the spectrum. The flattening was largely due to the FOMC's rate increase, which is expected to have little impact on longer-dated issues. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note was little changed, ending the quarter at 2.39%, compared to 2.45% on December 31.

As happened in the fourth quarter of 2016, yield changes along the maturity spectrum were largely a result of several primary factors: the FOMC's decision to raise the fed funds rate, a rebound in employment and other economic data, and the perception that the Trump administration will espouse pro-growth economic policies. Yields at the shortest end of the yield curve (up to one year) rose in line with the 25 basis point fed funds rate increase, but maturities of two years and longer experienced little change in yields. The yield on the 3-month

Treasury bill settled at 0.75% at the end of the quarter, up about 25 basis points from the end of the previous quarter. The yield on the 5-year Treasury note ended the quarter at 1.92%, compared to 1.93% on December 31, and as mentioned above, the yield on the 10-year Treasury note dipped to 2.39% from 2.45% over the same period. At the same time, the yield on the 30-year Treasury bond was slightly lower, ending the period at 3.01%, compared to its beginning level of 3.07%. Inflation expectations crept higher, with the Fed's gauge of five-year forward inflation expectations closing at 1.93% on March 31, the same level as December 31.

Fixed income securities generally produced positive total returns in most market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index gained +0.8% for the quarter, but is one of the only fixed income indices with a negative return over the past 12 months. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index advanced +1.4% during the three months. High yield securities once again followed rising stock prices, delivering a gain of +2.7%, and producing a return of more than +20% over the past year. Municipals performed admirably, as the Bloomberg Barclays Municipal Bond Index rose by +1.6% during the quarter. Prices of non-U.S. fixed income securities clawed back some of the losses suffered in the fourth quarter of 2016, as the Bloomberg Barclays Global Aggregate ex-U.S. Index jumped +2.5%. Emerging markets bonds also fared well after a dismal fourth quarter, as the JPM EMBI Global Index rallied +3.9%.

EQUITIES

Equity markets continued their recent trend of strong performance in the first quarter, rallying again to record highs in the midst of robust employment data, clarity on the interest rate front, and a flurry of initiatives in the Trump administration's first weeks in office. Stock prices gained ground right from the start of January, and didn't encounter much in the way of headwinds until the middle of March, when Congress shelved legislation to overhaul health care, due to its lack of support. Nevertheless, the March reading of consumer confidence checked in at its highest level since 2000, indicating that the rise in stock prices is supported by a great deal of optimism. Against this backdrop the S&P 500 Index finished the quarter with a gain of +6.1%.

The ten primary economic sectors delivered solid performance during the quarter, with only a couple of notable exceptions. Performance disparity between the extremes was wide, making sector allocations important. As with the prior two quarters, the performance disparity between the best- and worst-performing sectors was significant, amounting to more than 2000 basis points for the three months. Information Technology, Health Care, and Consumer Discretionary were the strongest performers, producing gains of +12.6%, +8.4%, and +8.5%, respectively. The Energy, Telecommunication Services, and Financials sectors were the poorest relative performers, posting returns of -6.7%, -4.0%, and +2.5%, respectively.

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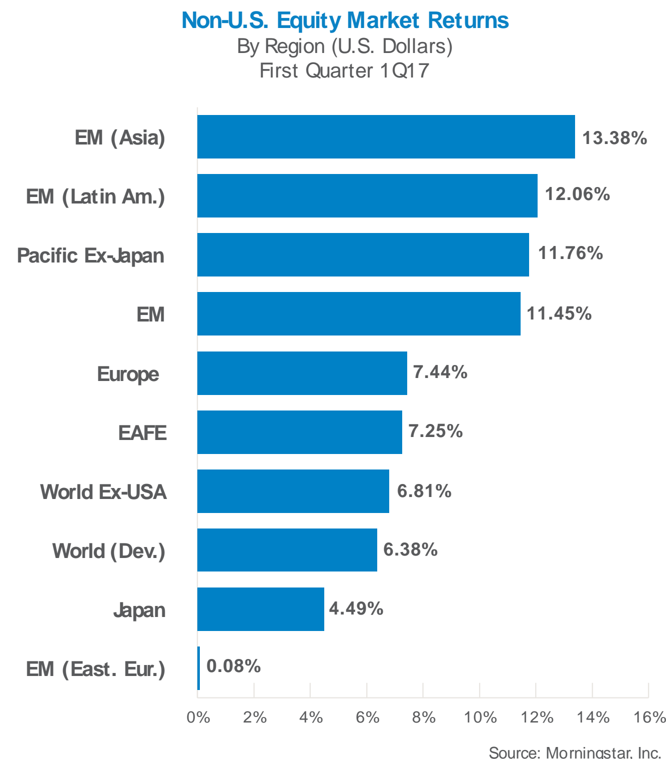
The Russell 1000 Index of large capitalization stocks generated a +6.0% total return, bringing its one-year advance to +17.4%. Within the large cap segment, growth stocks outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, underperformed large caps for the first time in several quarters, and finished with a total return of +2.5%. Small cap growth outperformed small cap value by more than 500 basis points. The Nasdaq Composite, dominated by information technology stocks, finished with a gain of +10.1%, and is now up +22.9% over the past year. The Dow Jones Industrial Average of 30 large industrial companies gained +5.2%.



Real Estate Investment Trusts (REITs) declined again during the quarter, with the DJ US Select REIT Index posting a loss of -0.3%. Commodities also generated losses, with the Bloomberg Commodity Index sliding -2.3%.

International stocks produced much more robust performance than US equities overall, at least temporarily reversing a prominent trend that has been in place for several years. Global investor confidence seems to be on the rise following the 2016 US election, European economic growth has stabilized, and many economists believe 2017 will bring more of the same. Within this context, international stock indices were mostly higher. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the US, gained +7.9%. The MSCI EAFE Index of developed markets stocks rose by +7.3%, and is now up +11.7% over the past 12 months. Regional performance was, on balance, positive. The Asia region was the strongest performer on a relative basis, with the MSCI EM Asia index posting a return of +13.4%. Eastern Europe and Japan were the poorest relative performers, with gains of +0.1% and +4.5%, respectively. Emerging markets performance was robust, as the MSCI Emerging Markets Index surged +11.5%, and is now up +17.2% on a year-over-year basis.

Outlook

Whatever one's political leanings and views on President Trump and his administration, there is little doubt that his election has generated a great deal of optimism about the economic outlook. The stock market rally (dubbed the "Trump Rally," and one the President has repeatedly taken credit for) that has occurred since Election Day has been driven, at least in part, by expectations for accelerated economic growth and improving employment. General optimism is reflected in the most-recent consumer, business, and investor confidence surveys, which in some cases show the highest levels of confidence since 2000. But, as has been evident in recent weeks, failing to meet these expectations can have serious consequences: Stock investors experienced a sharp drawdown as a result of Congress' tabling of health care legislation in March. Somewhat chastened, investors will now be watching carefully as Congress moves on to tackle tax reform and other elements of President Trump's economic agenda. If the outcome appears as though it will disappoint, stocks could face further vulnerability, due to extended valuations relative to historical norms. Reasons exist to be optimistic about the economic outlook going forward, but the ride may not be smooth, and stock prices may face bouts of volatility that have not been experienced in more than a year.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization-index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across 4 Emerging Markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid-cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1000 largest US companies in the Russell 3000 Index (which comprises the 3000 largest U.S. companies). The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market, and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **Federal Funds Rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB’s main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999.The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards individuals and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor’s and MSCI Barra.