Quarterly Strategy Letter

1st Quarter 2017

LET THE GOOD TIMES ROLL

State of the Markets Address

The optimism and market strength we saw in 2016 continued into the first quarter of this year with equity markets showing notable advances. International stocks showed their promise in the first three months of the year as emerging markets rallied 11.45 percent and developed international markets gained 7.39 percent, according to MSCI data. U.S. stocks were still in the race as the S&P 500 Index gained 6.07 percent during the first quarter of 2017; the Russell 3000 Index, a broader gauge of the U.S. stock market, gained 5.74 percent over the same period. We attribute much of the momentum to acceleration in earnings growth and improving global economic fundamentals, particularly surrounding the synchronized recovery in developed markets, as well as an extension of the "Trump trade" for domestic markets.

The benchmark 10-year Treasury yield jumped after the presidential election last year and has remained fairly range-bound between 2.4 percent and 2.6 percent for the past several months; the 10-year ended the first quarter yielding 2.39 percent. Correspondingly with rates ending the quarter fairly flat, the Barclays U.S. Universal Bond Index gained 1.07 percent despite fluctuating between positive and negative territory. Credit exposure continued to be a main source of return in the bond markets similar to much of last year.

Alternative assets were a mixed bag. The Bloomberg Commodity Index lost 2.47 percent during the quarter as oil dipped in the middle of March due to swelled U.S. inventories and a review by shale producers of the economies of production. Conversely, global real estate performed well as economic data continued to brighten and monetary policy remained accommodative in most countries; the MSCI World Real Estate Index gained 4.36 percent for the quarter. Hedge funds remain on modestly positive terrain as equity hedged and event driven funds gained with world equity markets, while relative value and macro strategies declined as managers found it difficult to navigate market trends, according to Hedge Fund Research.

The Year of Warm Porridge

Everyone seems to be feeling pretty good about the economy and the markets, barring a sneaking suspicion about stock valuations. The Conference Board Consumer Confidence Index is showing U.S. households are the most optimistic they have been since just before the dotcom crash back in 2000 and above even the most confident times just before the Great Recession. While we don't base much on sentiment, there might be good reason for consumers to be feeling so good. We believe the U.S., and most of the world, are in an economic sweet spot. The combination of low-to-no inflation, accelerating economic growth, and a recent uptick in wages has put consumers, and financial markets, in a "Goldilocks zone" – not too hot, not too cold.

While having the "just right" conditions is great for the moment, there may already be an end in sight. We see the existing growth trend as unlikely to produce meaningful inflation for the time being due to values being buoyed by oil and food prices. However, if U.S. fiscal spending does eventually enter the mix and economic data surprises to the upside, inflation will likely move markedly higher. The Fed may also raise rates sharply if legislation adds stimulus to a full-capacity economy. In the meantime, economic growth should continue to accelerate, but may slow over time as trends begin to collide and the business cycle matures. Despite the elevated sentiment, consumers have yet to return to their old spending habits and a resurgence of consumer expenditures could provide a noteworthy boost to the economy. For now, we would like to see more fundamental support for the riding high feeling of U.S. households.

According to Bank of the West Economics, the big driver to the high in sentiment has been from consumers' evaluation of the labor market. A recent outlook from the group states, "The labor market differential (i.e., the difference in the percentages of people who see jobs as plentiful minus those who see jobs as hard to get) improved to 12.2 this month. This was the highest reading on this measure in more than a decade." At the same time, the

hard data, such as spending and production, seems to be remaining stable, or even slightly deteriorating in some cases. We believe the harder fundamental economic data will catch-up to the soft data, but it may take some time – and a few good policy moves.

(Potential) Policy, Policy, Policy

In the world of politics, risks in Europe have begun to fade. Far-right party candidates that, if elected, would seek to leave the European Union and instate much more protectionist policies have fallen behind or lost in recent polls. Issues like immigration and populism remain significant topics for many countries, but it seems financial markets have avoided a possible shock from another surprise result similar to that of Brexit. In the interim, U.S. policymakers continue to spitball potentially meaningful changes to policy and legislation, but have yet to take much action.

The Trump administration has been working feverishly to pass legislation that would repeal the Affordable Care Act and sign into law a new health care bill – with not much to show for it. The statutory process may be finally revealing the different bi-partisan obstacles to parts of Trump's pro-growth agenda. We believe U.S. stocks have partially priced in the potential policy changes on the agenda like infrastructure spending, tax reform, and easing of regulations. However, not all bills are created equal and some of these policy changes will be harder to pass than others. With that said, a cut to personal and corporate taxes may be an easier sell to lawmakers and could be considered a quick win for both the administration and the stock markets. We will be keeping an eye out for that in the latter part of this year. The fiscal spending deal is likely much more up in the air and has been a driver to stock markets based on the expectation that fiscal policy would take the reins from monetary policy for higher economic growth. If there is a disappointment in the fiscal stimulus to the U.S. economy, stocks would likely react negatively to the news.

Changes in monetary and fiscal policy continue to be crucial factors in the current investment and economic environment. Despite being in a "sweet spot" that we believe will persist over the short-term, the tightening monetary policy from the Fed could clash with expansionary fiscal spending from the federal government as inflation rises. Examining prior recessionary trends after a tightening of policy occurs from the Fed shows the probability for recession may grow over the next year or so and we could see a decline as early as 2019.

An Extraordinary Unwinding

The markets have been looking for a well-telegraphed guide to interest rates, but all the prep work that Yellen has done may be getting thrown out the window. The Wall Street Journal recently reported the Federal Reserve may be pausing rate hikes after this year, opting to address a ballooned $4.5 trillion balance sheet of Treasuries and mortgage-backed securities. The Fed amassed a colossal bond portfolio through their asset purchase program, a.k.a. "quantitative easing," in an effort to push down longer-term rates, which expanded their bond holdings from roughly $900 billion to around five times that amount. For the first time on record, the Fed discussed the portfolio and potentially unravelling the holdings under a new plan. Similar to the path for rates, investors will be anxiously awaiting a well-defined timeline for the "quantitative tightening." The Fed will likely push up the timing of interest rate hikes in 2017 to make way for the asset sales to occur in 2018. For that period, the Fed will likely focus on unwinding its portfolio and put rate hikes on hold.

While 2018 may be a moot point for interest rate forecasts, we continue to believe that the Fed has two more rate hikes in store for this year. Our base case has moved from hikes in June and December to June and September due to the new asset sale program. The Fed will most likely prepare the market by announcing the policy in December 2017 for implementation in early 2018. We anticipate that longer-term rates could fluctuate at current levels for a period before the economic growth picture becomes clearer and yields start to rise parallel with GDP growth – the asset sales would likely push long-term rates even higher. Higher rates may result in additional upward pressure on the U.S. dollar, which would have real impacts on trade and earnings.

One Eye on Earnings and the Other on China

Stock markets have experienced an amazingly resilient rally and have ignored many events in the global economy as well as geopolitics, though the road ahead may be a bit bumpier. Policy remains a key driver in the current environment, but U.S. stocks may go back to good old corporate earnings for price support and to possibly

extend the current equity rally. The market seems to be pricing in a rise of 10 percent in earnings for 2017, but may have not fully included the erosion stemming from an anticipated stronger USD and wage increases. A secular downtrend in margins may also be ahead for certain stock sectors. Regardless of expectations, the earnings rebound appears to be underway.

While we don't necessarily believe the current equity rally is over, we have said the road ahead may be more difficult. One of the larger bumps in the road could be China. The Chinese economy has been a main driver for global growth over the past decades and has been seen as irrepressible due to consistent reported growth. Recent data, however, has shown a more worrisome story and growth figures may begin to moderate further. Typically, stock markets have been fairly unkind to any notion of big trouble in China – our group believes markets may use China as an "excuse" to correct given a large enough disappointment in forward-looking economic data.

Where We Are

The Global Investment Management team has made some modifications to our views over the recent months as certain risks abate, while others grow. Our overall strategies remain slightly overweight to stocks, while marginally underweight to bonds and neutral within alternative assets. During the first quarter, we captured gains in large capitalization U.S. stocks and put proceeds into alternative fixed income. Within the stock portfolio, our team reduced exposure to larger companies abroad and reinvested into small-cap stocks in international developed regions. Our view is that this gives us a stronger tilt toward currency hedged international exposure versus unhedged. We believe these changes were warranted based on valuations of U.S. stocks, improving economic growth abroad, and expected currency fluctuations.

Our team continues to closely scrutinize market data and even geopolitical headlines for opportunities. The prospects derived from fiscal stimulus via infrastructure spending, tax reform, and a rebound to corporate earnings will likely keep our strategies overweight to stocks for the time being. Meanwhile, we continue to benefit from credit risk in bonds as interest rates rise, looking to spaces like high yield and variable rate products for return. We believe prevailing economic and investment themes may point to greater emphasis on alternative assets for a less correlated source of return compared to traditional investments, which could lose some steam.

Glossary

Alternative investments are investments that are not one of the three traditional asset types (stocks, bonds and cash).

Barclays U.S. Universal Bond Index is an unmanaged index comprising US dollar-denominated, taxable bonds that are rated investment grade or below investment grade.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Brexit is an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.

Conference Board Consumer Confidence Index is a barometer of the health of the U.S. economy from the perspective of the consumer. The index is based on consumers' perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Sometimes referred to as "headline inflation."

Corporate bonds are debt obligations issued by corporations. An investment in corporate bonds is subject to a variety of risks including credit and default risk, market risk, event risk, call risk, interest rate risk, foreign risk, and sector risk.

Dow Jones Average (DOW) is a composite of the price movement of 65 stocks, including 30 industrials, 20 transportation, and 15 utilities.

Emerging Market countries have economies that are progressing towards becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU's goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.

Federal Reserve (Fed) is the federal banking authority in the U.S. that performs the functions of a central bank and is used to implement the country's monetary policy, providing a national system of reserve cash available to banks.

Frontier Markets are less advanced capital markets from the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. They are also known as "pre-emerging markets".

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. Real Gross Domestic Product is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices. Often referred to as "constant-price," "inflation-corrected" GDP or "constant dollar GDP". Real GDP can account for changes in the price level, and provide a more accurate figure.

Hedge Fund Research, Inc. is a hedge fund industry provider of hedge fund index information. HFR produces over 150 indices of hedge fund performance ranging from industry-aggregate levels down to specific, niche areas of sub-strategy and regional investment focus. HFR also provides visibility into funds via databases and reports on managers.

High yield bonds are high paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below 'BBB' from S&P, and below 'Baa' from Moody's. Bonds with ratings at or above these levels are considered investment grade. Credit ratings can be as low as 'D' (currently in default), and most bonds with 'C' ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Investment-grade (IG) is typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgement of the rating agency, are projected to have relatively low default risk.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

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.

MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed by Morgan Stanley International to measure the equity market performance of the developed markets in Europe.

MSCI World Real Estate Index is a free-float adjusted market capitalization index that consists of large and mid-cap equity REITs across 23 Developed Markets countries, which generate a majority of their revenue and income from real estate rental and leasing operations.

Municipal bonds are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects. The interest income from municipal bonds is generally exempt from federal taxes and may be exempt from state and local taxes. Municipal bonds are subject to a number of risks such as interest rate risk, call risk, inflation risk, credit and default risk, and tax risks.

Personal Consumption Expenditure (PCE) measure is the component statistic for consumption in GDP collected by the BEA. It consists of the actual and imputed expenditures of households and includes data pertaining to durable and non-durable goods and services. It is essentially a measure of goods and services targeted towards individuals and consumed by individuals.

Price-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings.

Russell 3000 Index is a market capitalization weighted equity index maintained by the Russell Investment Group that seeks to be a benchmark of the entire U.S. stock market. More specifically, this index encompasses the 3,000 largest U.S.-traded stocks, in which the underlying companies are all incorporated in the U.S.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

Treasuries are debt obligations issued and backed by the full faith and credit of the U.S. government. Treasuries are subject to interest rate risk, call risk, and inflation risk. As Treasuries are backed by the full faith and credit of the federal government, they have low credit or default risk. As a result they generally offer lower yields relative to other bonds.

One cannot invest directly in an index.

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Investing involves risk, including the possible loss of principal and fluctuation in value.

Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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