CRAWFORD
INVESTMENT COUNSEL
-EST. 1980-

Economic and Market Environment

Fourth Quarter 2017

THE FIRM'S OUTLOOK: SUMMARY AND CONCLUSION

THE ECONOMY

» The U.S. economy continues to provide investors and businesses with a benign environment that is conducive to success.

» Low but consistent Gross Domestic Product (GDP) growth, near full employment, low inflation, and low interest rates suggest a continuation of economic progress for the foreseeable future.

» Stress points or economic extremes are not apparent, leading to the conclusion that a recession is not likely over the near-to-intermediate term.

» Federal Reserve (Fed) policy continues to evolve. Further increases in the federal funds rate will be supplemented by a gradual unwinding of the Fed's balance sheet. The Fed will be cautious in implementing these moves, in recognition of potential economic vulnerabilities.

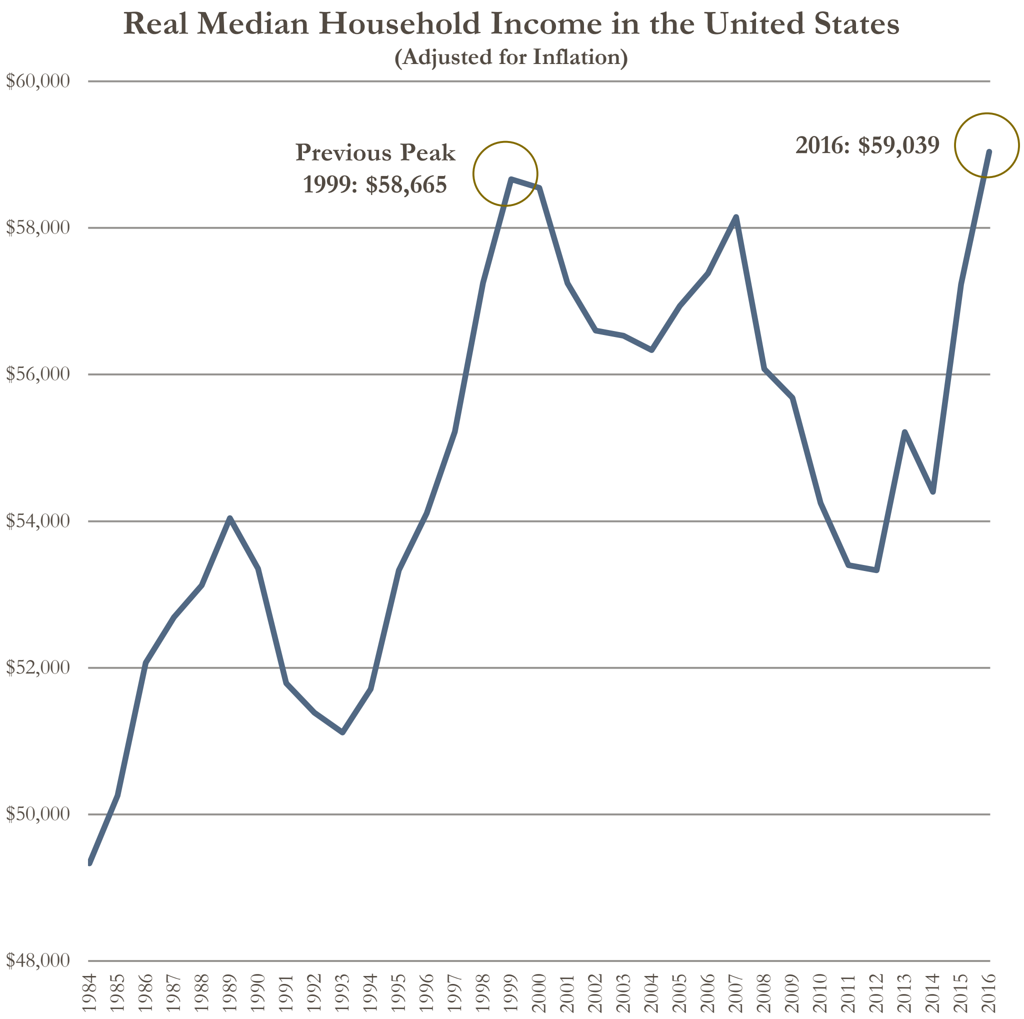
STOCKS AND BONDS

» The upward trend in stocks is being fueled by strong earnings performance by corporate America. Valuations are above average, but may be justified by low inflation and interest rates. Investors are currently favoring growth over value.

» Bond yields have resisted the upward pressure from Fed rate increases. While Fed action may cause upward drift in yield levels, future inflation expectations remain very low, suggesting a limit to how high interest rates can go.

» Geopolitical concerns are on the rise, but investors appear to be taking these in stride. Risk comes in many forms, and we suggest a strong emphasis on quality as the best means of controlling risk.

THE ECONOMY: RISING INCOMES – THE GOOD AND THE BAD



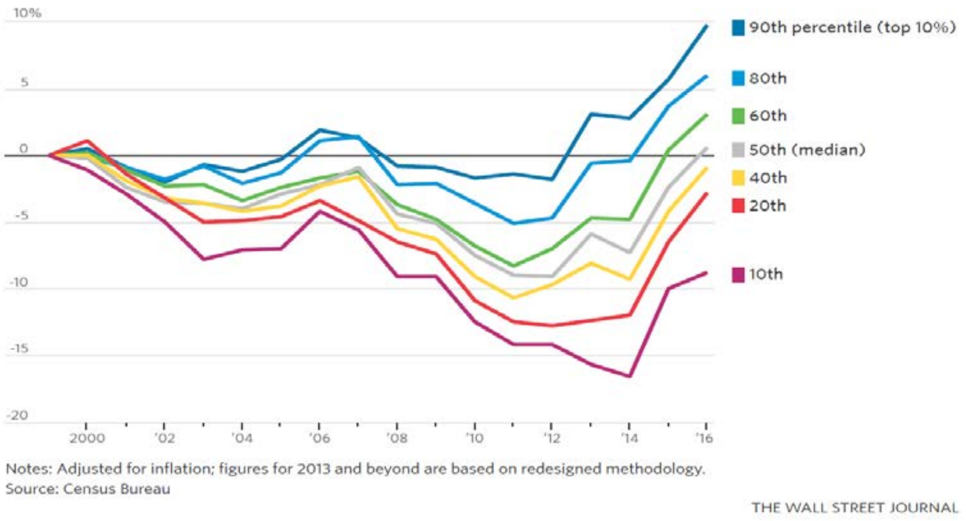
Real Median Household Income in the United States, 2016 CPI-U-RS Adjusted Dollars, Annual, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 1/1/2016)

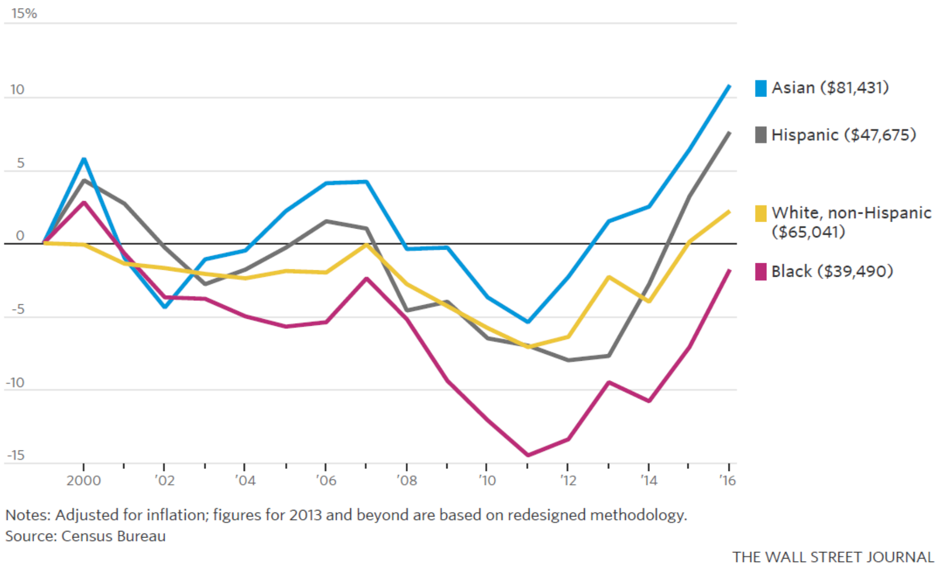
» Good news: Median annual household incomes (adjusted for inflation) reached a new peak in 2016, eclipsing the previous peak set in 1999.

» Bad news: It took 17 years to reach a new peak. This is the legacy of slower-than-normal economic growth and the Great Recession.

» Growth in incomes is important to overall economic progress. It signals rising standards of living, improves confidence, and fuels growth in consumption.

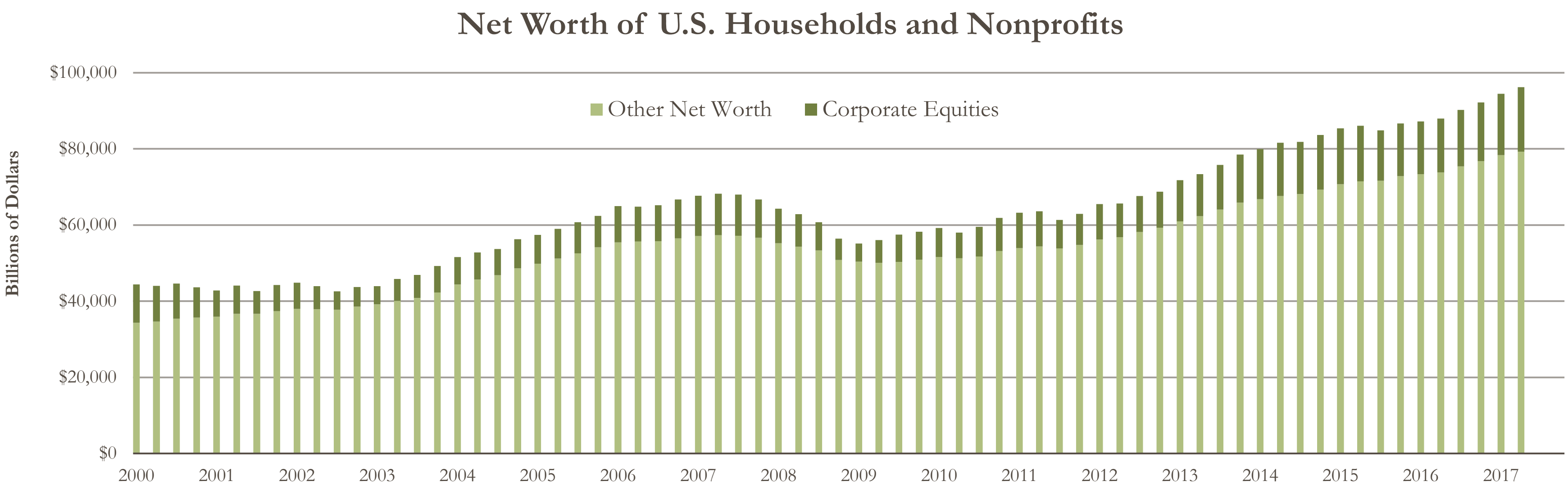
THE ECONOMY: RISING INCOMES – WHO IS PARTICIPATING?





- » Income growth has not been uniform across the population.
- » Income and wealth inequality remains as a significant economic issue. High concentrations of wealth and income among a small percentage of the population depresses consumption. Overall demand in the economy suffers.
- » A huge gap remains between the 90th percentile of income growth and the 10th percentile.
- » Asian and Hispanics have seen their income grow the fastest since the last peak.

The Economy: More Good News – Net Worth On The Rise



Households and Nonprofit Organizations; Net Worth, Level, Billions of Dollars, Quarterly, Not Seasonally Adjusted
Households and Nonprofit Organizations; Corporate Equities; Asset, Billions of Dollars, Quarterly, Not Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis (Data Through: 4/1/2017)

» Not only is median income at a high, but net worth of households continues to reach record levels.

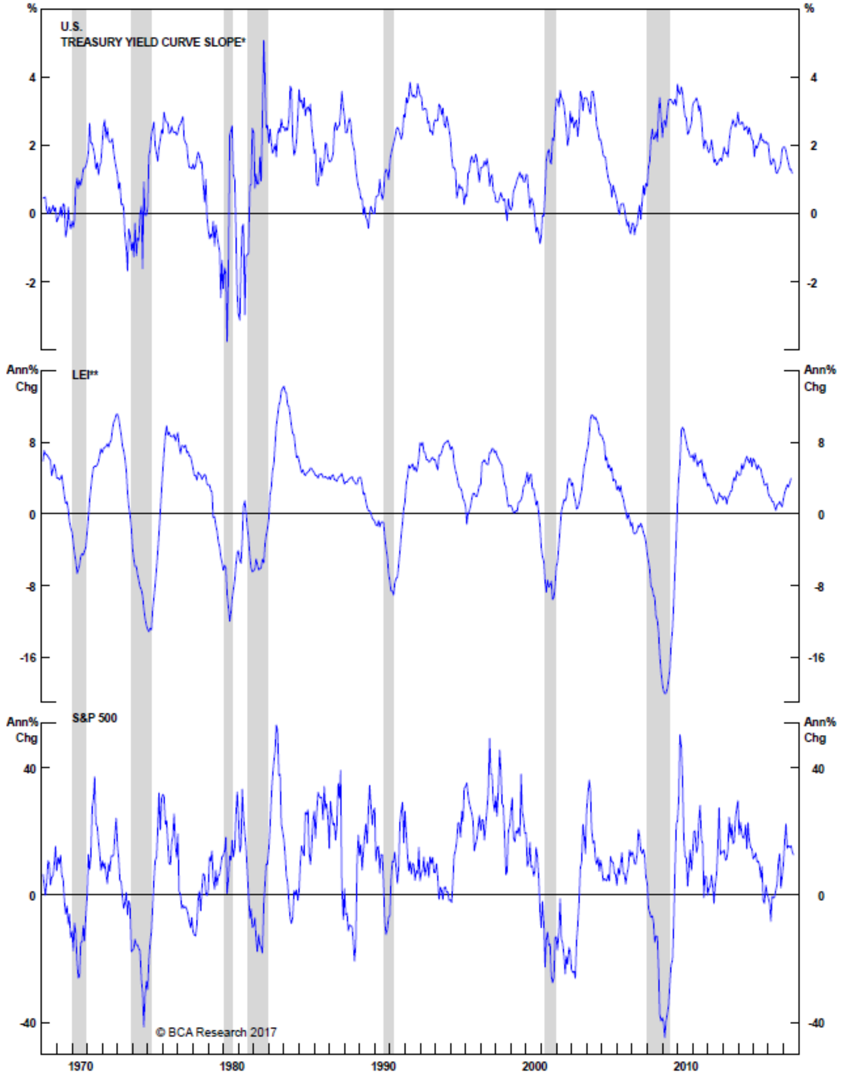
» Net worth, which includes major asset categories of stocks and real estate, has recovered more quickly than median income, benefitting primarily from strong gains in these two asset categories since 2009.

» Like income gains, growing net worth improves confidence, and encourages consumption which fuels demand.

» Gains in net worth, while important, impact economic growth less than income gains because the increases in stocks and real estate are concentrated in a smaller portion of the population.

The Economy: Time To Worry About The Next Recession?

The Traditional Recession Indicators Have Worked Well



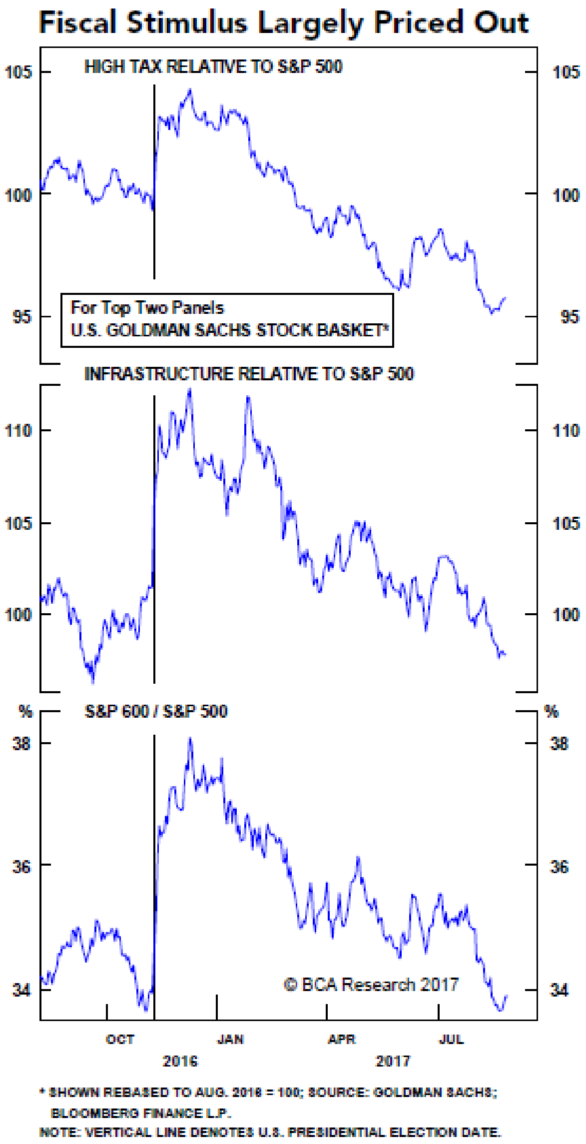
* 10-YEAR U.S. TREASURY YIELD LESS 3-MONTH U.S. TREASURY YIELD MONTHLY DATA.
** SOURCE: THE CONFERENCE BOARD.
NOTE: SHADED FOR NBER DESIGNATED RECESSIONS.

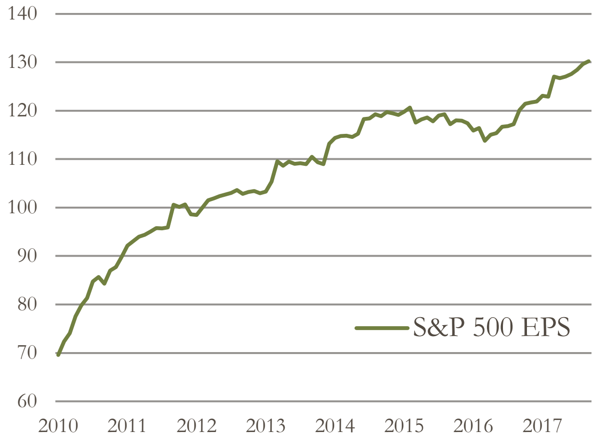
» Increasingly, because of the length of the economic recovery/expansion, investors are wondering if it is time for another recession.

» Two of the best recession indicators are the slope of the yield curve and the leading economic indicators index. Neither is currently indicating impending weakness in the economy.

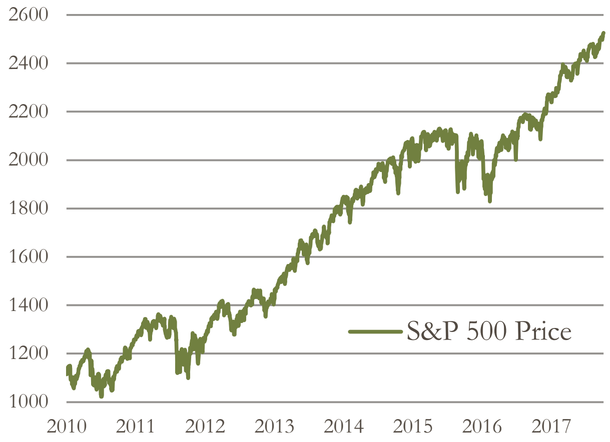
» We continue to believe the current recovery/expansion can continue for the foreseeable future. Economic excesses or extremes, which normally precede recessions, seem to be absent.

Chart Source: BCA Research
Please see the last page for important disclosures.





Source: FactSet (Data Through: 9/29/2017)



Source: FactSet (Data Through: 10/2/2017)

» Immediately after Trump's election, investors strongly favored companies related to infrastructure or those subject to high taxation.

» As Trump economic initiatives have stalled, these groups have faded from market leadership.

» Fortunately, corporate earnings have turned up sharply and are the driving force behind stock gains this year.

Stocks and Bonds for the Short Term – Scorecard

Stock Market Scorecard

Bullish	Bearish
• Consistent economic growth	• High valuation
• Record earnings per share	• Fed policy (Fed funds up; balance sheet unwinding)
• Global uptrend in growth	• Complacency (low volatility)
• Low interest rates	• ETF Risk
• Low inflation	• Surprise recession
• High cash reserves	• Corporate debt growth
	• Geopolitical issues or policy error

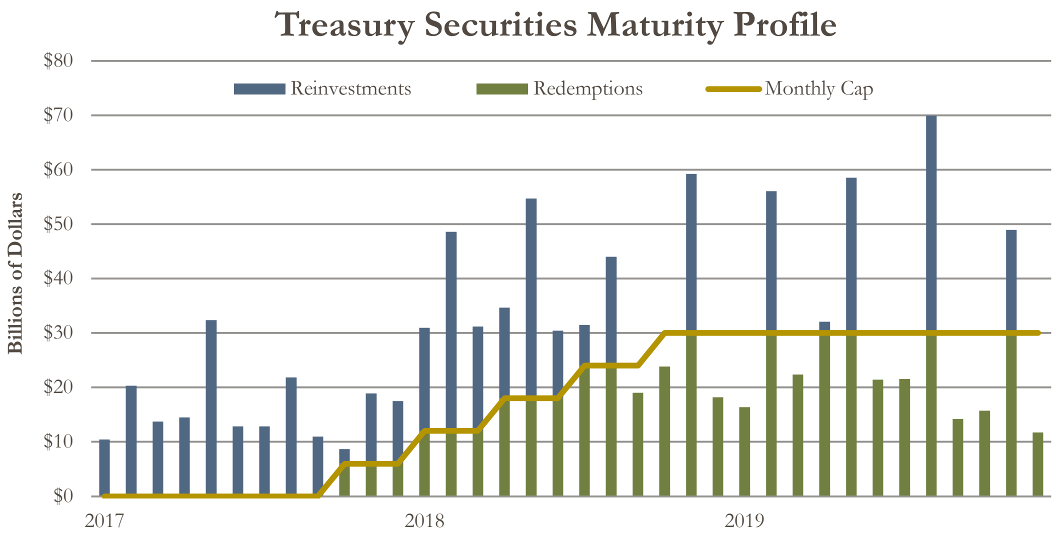
Conclusion: On balance, constructive: positives outweigh negatives, but some caution is warranted.

Bond Market Scorecard

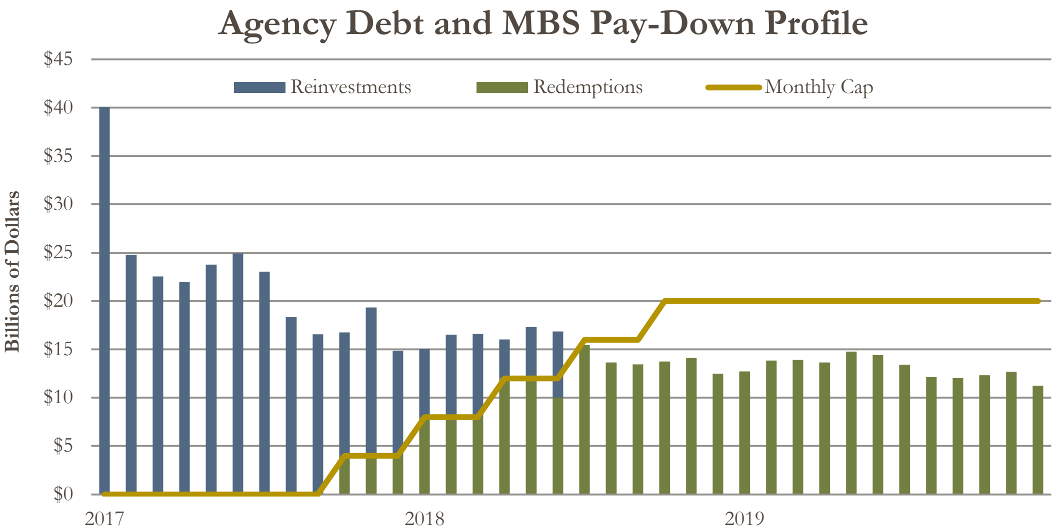
Steady/Declining Yields	Rising Yields
• Deflation or lower inflation	• Fed policy (Fed funds up; balance sheet unwinding)
• Secular stagnation	• Synchronized global growth
• Fed policy error	• Potential wage pressure
• Surprise recession	• More bond supply
• Geopolitical risk	

Conclusion: On balance, yields should drift higher, but higher inflation is needed to cause a sharp increase.

BONDS: BALANCE SHEET UNWINDING – A NEW FACTOR TO CONSIDER



SOMA Treasury Securities Maturity Profile, Monthly
Source: Federal Reserve Bank of New York (Data Through: 12/1/2019)



SOMA Agency Debt and MBS Pay-Down Profile, Monthly
Source: Federal Reserve Bank of New York (Data Through: 12/1/2019)

» The Fed is embarking on a program to unwind its balance sheet. This action is designed to correct the large balances created by quantitative easing.

» As bonds and mortgages held by the Fed mature, some will not be reinvested. The process is expected to be gradual.

» The Fed estimates this process could increase interest rates by approximately 50 basis points over the next several years.

» This action by the Fed, in conjunction with federal funds increases, should cause some drift upward in interest rates.

Stocks For The Long Term – What To Expect In The Future

Long-Term GDP, Corporate Earnings, and Stock Prices

	Nominal GDP	S&P 500 Operating Earnings	S&P 500 Price Change
1960 – 2016 (56 years) Compound Growth Rate	6.7%	6.8%	6.7%

Source: Bloomberg, FactSet (Data Through: 12/31/2016)

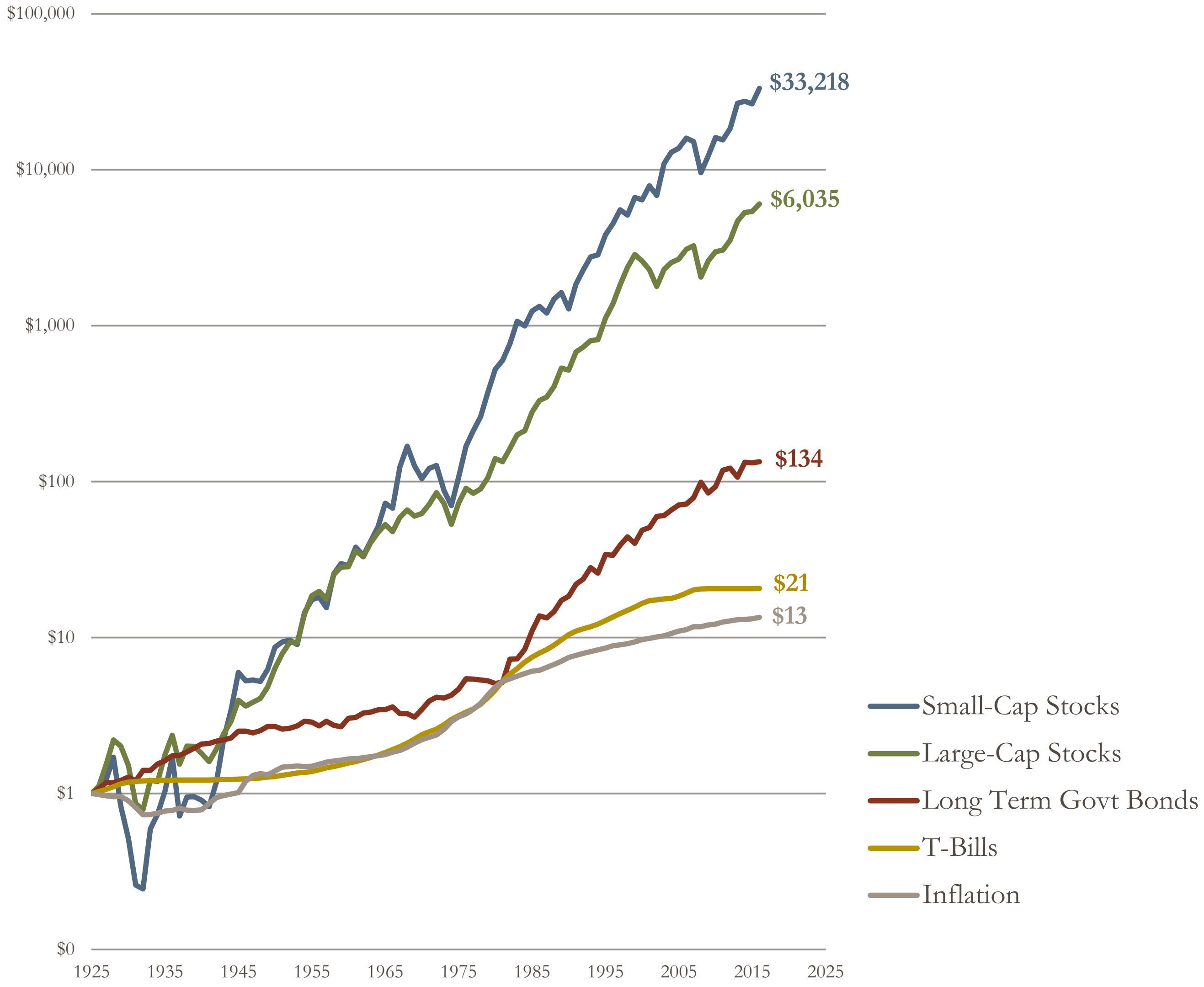
- We prefer to focus on the long term, when consistent investment success is more likely to be achieved.
- Over the last 56 years nominal GDP, corporate operating earnings, and stock prices have all grown at almost the same rate. This suggests that the rate of growth in nominal GDP may be one of the best predictors of future stock returns over the long term. Year-to-year comparisons may be meaningless as an indicator of returns.
- These figures do not include dividends, which we expect to be a major contributor to total returns over time.
- If one believes the U. S. economy will continue growing, long-term stock returns should be positive.
- Nominal GDP is currently being depressed by slow real GDP growth and low inflation. In 2016 nominal GDP grew by 2.9%, the slowest rate since 2008-2009.

Stocks and Bonds: The Long-term Perspective

» We present this chart as encouragement to invest for the longer term. Both stocks and bonds have done well over the longer term despite multiple shorter-term and adverse circumstances over the years.

» The power of compounding cannot be overstated. But compounding can only take place over the longer term.

» Stocks have done better than bonds, which properly reflects higher risk in equities. Bonds, while lower returning than stocks over the long term, provide risk control, downside protection, and stabilize overall returns when mixed with stocks.



Source: 2017 SBBI Yearbook: Stocks, Bonds, Bills and Inflation (Data Through: 12/31/2016)

Disclosure Statement

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