



ECONOMIC AND MARKET ENVIRONMENT

FIRST QUARTER 2018

THE FIRM'S OUTLOOK: SUMMARY AND CONCLUSION

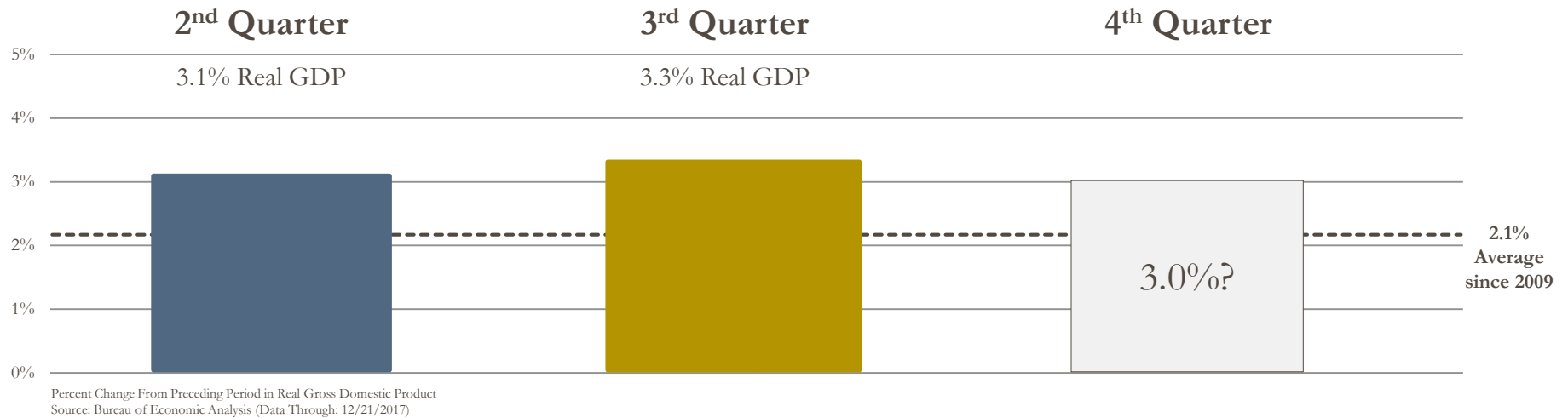
THE ECONOMY

- » After eight years of slower-than-normal Gross Domestic Product (GDP) growth, the U.S. economy is finally picking up steam. It appears likely that 3% real GDP growth has occurred in each of the last three quarters. If so, it will be the first time in over ten years.
- » Time will tell if higher growth can be sustained, but 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 seems set with further increases in the federal funds rate in 2018. These increases will be supplemented by a gradual unwinding of the Fed's balance sheet. A flattening yield curve could possibly inhibit the Fed if inflation does not show signs of increasing.

STOCKS AND BONDS

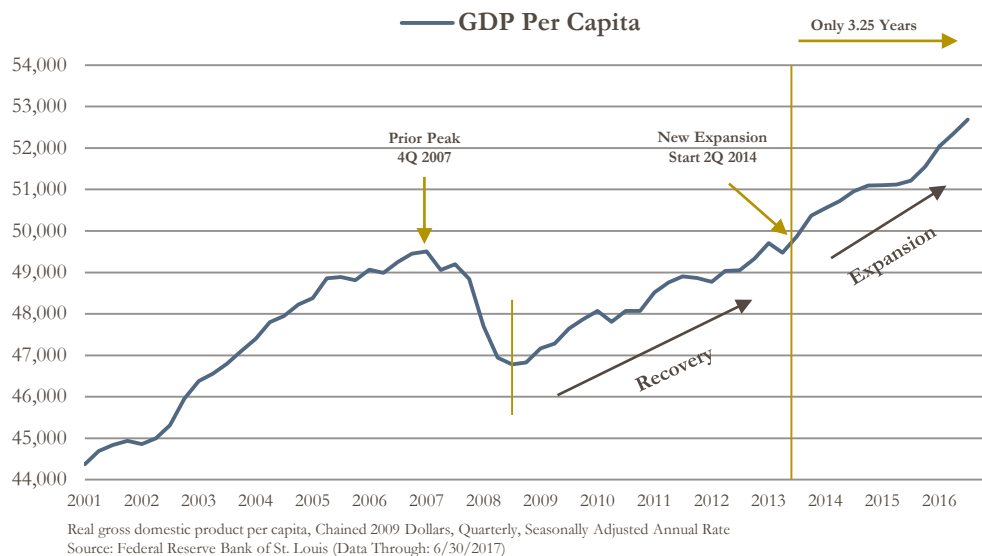
- » The upward trend in stocks is being fueled by strong earnings performance by corporate America. Recently passed tax cuts should strengthen the already strong trend. Valuations are above average, but may be justified by low inflation and interest rates. Investors are currently favoring growth over value.
- » Bond yields continue to resist 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 have increased, but investors do not seem concerned. Risk is always present in some form, and we suggest a strong emphasis on quality as the best means of controlling risk.

THE ECONOMY: FINALLY GROWING AT 3%



- » Fourth quarter 2017 real GDP has yet to be reported. If it comes in at or above 3%, it will be the first time in over a decade that three consecutive quarters of 3% growth have been achieved.
- » The recently passed tax bill is designed to encourage investment by companies. Time will tell if this will provide a further boost to economic growth in 2018 and beyond.
- » The real question is whether this more normal growth is sustainable. Structural impediments such as slow labor force growth and low productivity will be difficult to overcome on a sustained basis.

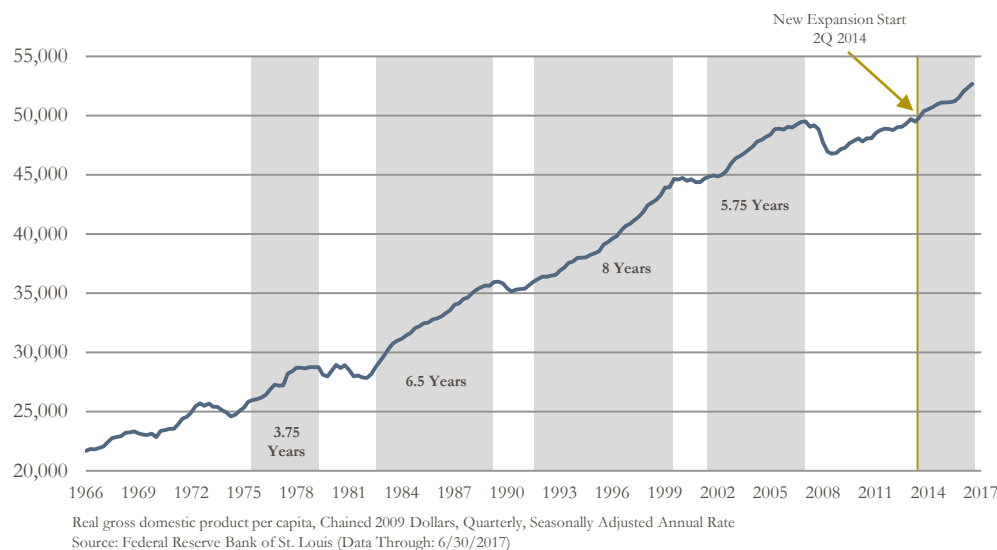
THE ECONOMY: UPDATE - A LONG RECOVERY/EXPANSION IS STILL IN THE CARDS



» Some are questioning the possible duration of the current economic recovery/expansion as it approaches its ninth year.

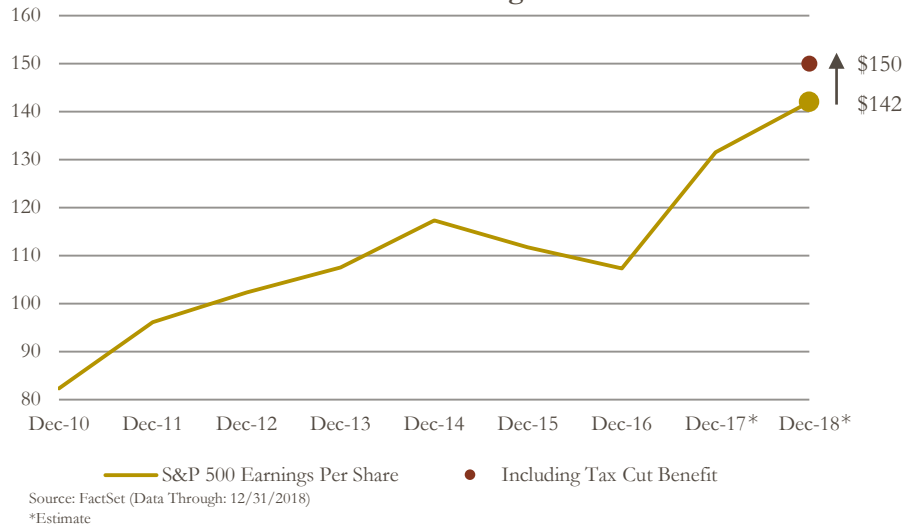
» It is important to distinguish between the recovery and expansion phases. Recovery is the stage from a trough of recession to the prior peak in GDP per capita. Expansion is the stage of growth beyond the previous peak.

» The current expansion phase is 3.25 years old. This contrasts with an average expansion phase of 6 years over the four previous periods, suggesting the cycle is not as aged as it may appear.



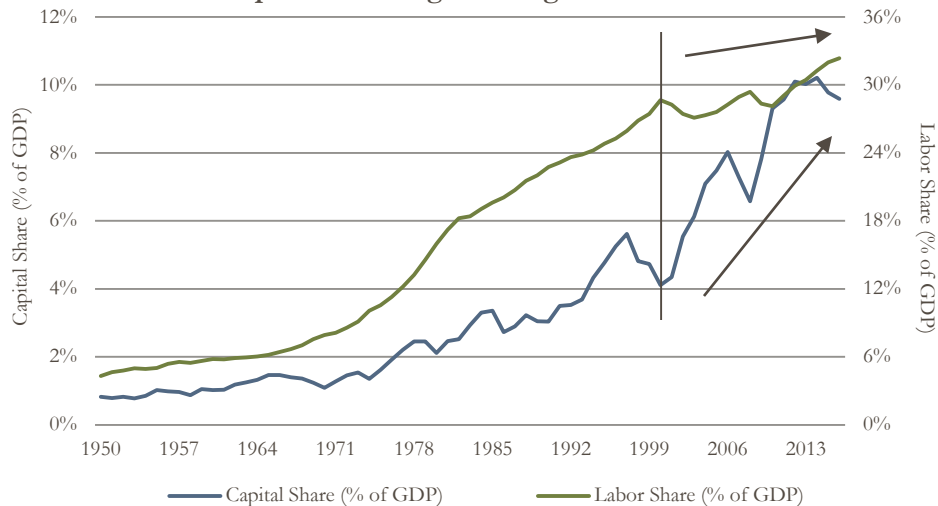
CORPORATE EARNINGS: THE DRIVING FORCE FOR STOCKS

S&P 500 Earnings



» The earnings cycle continues in a strong uptrend – consensus estimates for 2018 were \$142 per share for the S&P 500, but after the corporate tax cut it has widened out to \$150 per share.

Corporate Earnings vs. Wages and Salaries



Capital Share – NIPA Corporate Profits After tax with IVA & CC Adjustments as % of GDP
Labor Share – NIPA Nonfinancial Corporate Business Compensation of Employees (Wages and Salaries)
Source: Federal Reserve Bank of St. Louis (Data Through: 2016)

» The bottom clip illustrates how successful corporations have been in growing their profits. Corporate earnings have gone from 4% to near 10% of GDP over the last 17 years.

» While corporate earnings have increased dramatically, wage and salary growth has grown much more slowly. A more equitable split between wages and profits would most likely benefit the overall economy.

U.S. STOCKS: STRONG RETURNS CAN BE INTERRUPTED BY RECESSIONS

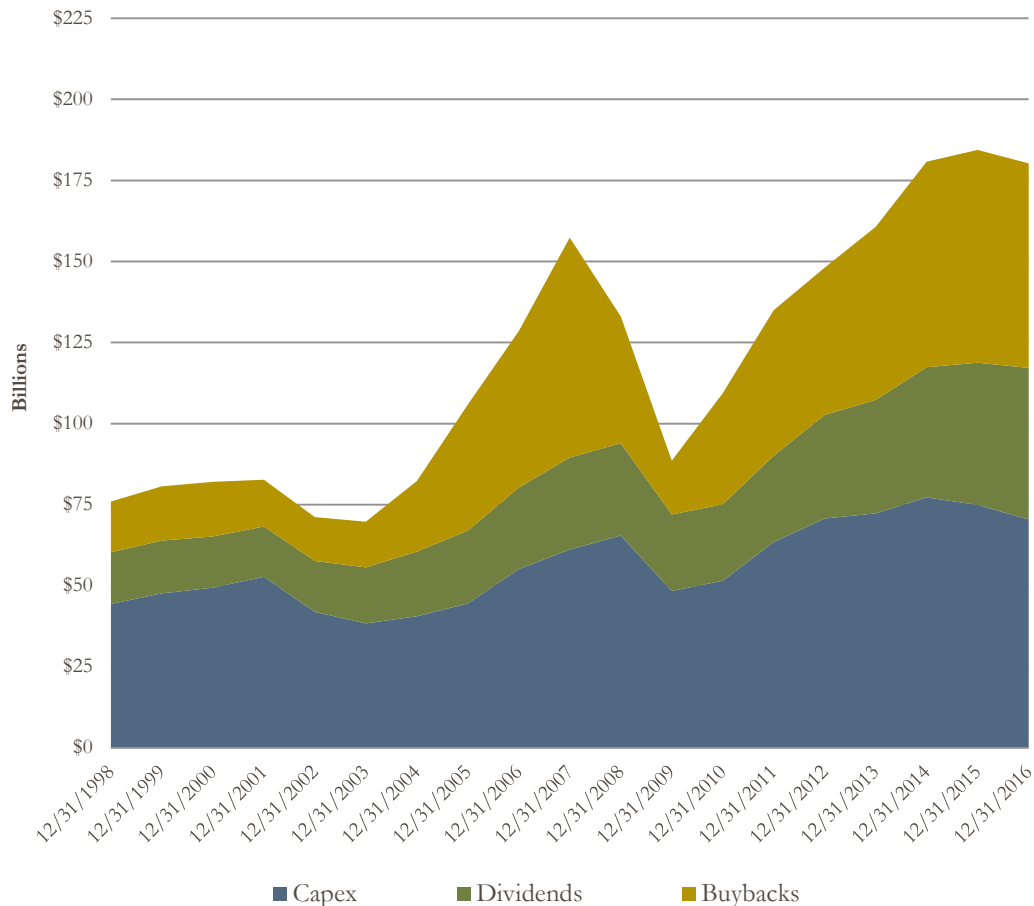
- » Over the last 20 years there have been 10 bear markets in stocks, each associated with a recession.
- » The bad news is that the average decline in these periods has been 31%.
- » On average, stocks have peaked seven months prior to the beginning of a recession, but troughed eight months later.
- » It is no secret that stocks decline in recessions. Investors should keep in mind the strongly positive returns that have been earned over the longer term by staying invested during market downturns.

Recessions	S&P 500 Peak	S&P 500 Trough	Peak-to-Trough Decline
JUL 1953 – MAY 1954	-7 months	+1 months	-12.5%
AUG 1957 – APR 1958	-13 months	+4 months	-20.3%
APR 1960 – FEB 1961	-9 months	+6 months	-12.1%
DEC 1969 – NOV 1970	-13 months	+6 months	-38.3%
NOV 1973 – MAR 1975	-11 months	+10 months	-53.8%
JAN 1980 – JUL 1980	0 months	+2 months	-18.2%
JUL 1981 – NOV 1982	-8 months	+12 months	-29.9%
JUL 1990 – MAR 1991	-2 months	+3 months	-20.9%
MAR 2001 – NOV 2001	-7 months	+18 months	-50.4%
DEC 2007 – JUN 2009	-2 months	+14 months	-56.1%
Average	-7 months	+8 months	-31.2%

Source: BCA Research
 Peak and trough columns relative to the start of the recession, as defined by the NBE
 Peak-to-trough decline calculations based on real total return index

CORPORATE CASH FLOW: WHERE THE MONEY GOES

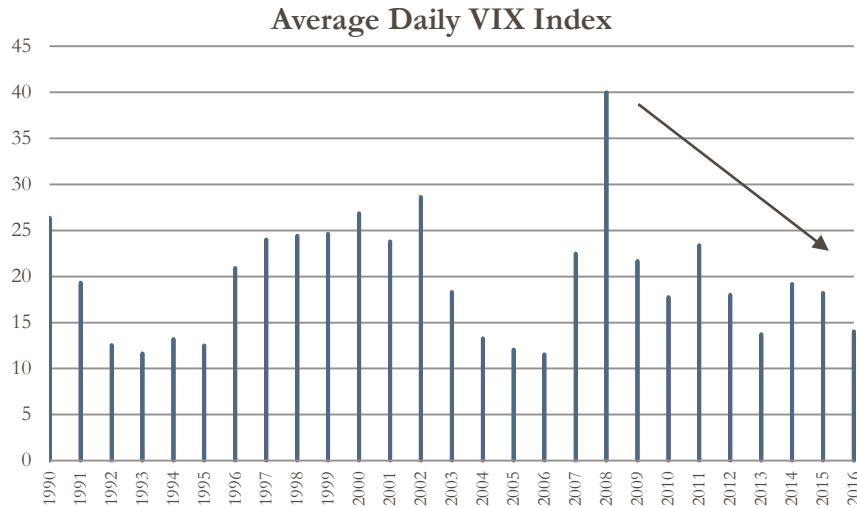
S&P 500 Uses of Cash



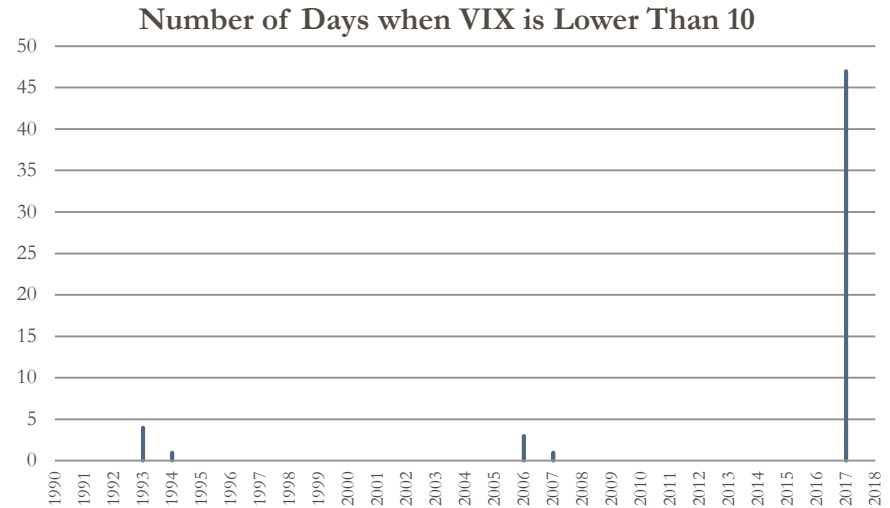
S&P 500 Index
Source: S&P, Bloomberg, FactSet (Data Through: 12/31/2016)

- » Companies typically allocate capital in three ways: capital expenditures, dividends, and stock buybacks.
- » In the last 18 years there has been a dramatic shift in capital allocation, with buybacks being the winner.
- » The slower growth in capital expenditures may reflect 1) less demand in the overall economy and thus less need for expansion, and 2) a reason why productivity is currently so low.
- » Corporations have just received a large tax cut. It will be interesting to observe how they allocate capital going forward. The hope is that capital expenditures will grow.
- » Continued high levels of buybacks should provide ongoing support for stocks.

THE STOCK MARKET: SHOULD WE WORRY ABOUT UNUSUALLY LOW VOLATILITY?



The Chicago Board Options Exchange Volatility Index ("VIX Index") is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.
Source: FactSet (Data Through: 12/31/2016)



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Source: FactSet (Data Through: 12/15/2017)

- » The VIX Index is an index of daily volatility in the stock market.
- » Stock market volatility has been trending downward since a peak in 2008, during the Great Recession.
- » 2017 was most unusual. The right chart above illustrates how unusual it is to have daily VIX readings of less than 10. Yet, in 2017, there were 47 such days.
- » Low volatility may reflect complacency among equity investors. If economic conditions deteriorate, volatility is likely to increase.
- » We are reminded of Hyman Minsky's famous quote: "Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits." We shall see.

BONDS: THE YIELD CURVE IS FLATTENING

Yield Spread Between 2 and 10 Year Treasuries



Source: Bloomberg (Data Through: 12/19/2017)

	2 year Treasury	10 Year Treasury	Difference
12/31/2016	1.19%	2.44%	125 bps
12/31/2017	1.88%	2.40%	52 bps

Source: Bloomberg (Data Through: 12/31/2017)

- » While still positively sloped, over recent years the yield curve has flattened considerably. Short-term interest rates have moved up, but longer-term rates have remained steady.
- » Rising short-term rates are a direct result of Federal Reserve action on federal funds, while longer-term rates are more a reflection of inflation and inflation expectations. Unless inflation increases in 2018, it is likely that the yield curve will flatten even further.
- » Should the yield curve become inverted it would be of concern since an inverted yield curve has in the past been a good predictor of recession.

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