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Economic and Market Environment

Second Quarter 2018

The Firm's Outlook: Summary And Conclusion

THE ECONOMY

- Almost all indicators of economic health remain positive. Gross Domestic Product (GDP), employment, inflation and interest rates are all at favorable levels.
- Federal fiscal policy has experienced a significant change in direction. The Trump tax cuts and recently passed appropriation bill point toward a period of higher Federal budget deficits. This has long-term implications for investors.
- Trade policy is also undergoing change, threatening a trade war which would not be good for either global or domestic economic growth.
- The Federal Reserve has a new Chair, Jerome Powell. Investors will be watching for policy changes, but for now further federal funds increases are scheduled for this year and next.

STOCKS AND BONDS

- In the first quarter stocks suffered their first correction in two years. It is too early to tell if the correction is the beginning of something more serious. Volatility has returned to the market.
- Stocks should be supported by further increases in corporate earnings this year. Also, higher levels of dividends and stock buybacks should result from the corporate tax rate reduction.
- The yield on the 10-year Treasury rose some 40 basis points during the first quarter. Well-contained-inflation expectations appear to be limiting further increases.
- Geopolitical tensions are increasing, but investors seem unconcerned. Risk is always present in some form, but we suggest a strong emphasis on quality as the best means of controlling risk.

Economic Checkup: A Good Report

The Four Pillars of Economic Activity

GDP	• 2.3% growth in 2017 over 2016 • Higher growth expected in 2018 • Secular headwinds threaten longer-term growth
Employment	• 4.1% unemployed • 313,000 new jobs in February • Participation rate picking up
Inflation	• Very low; no signs of upward pressures • Nominal CPI 2.2%, core PCE 1.8%, last 12 months • Wage gains still not normal
Interest Rates	• Federal Reserve "normalizing" rates • Low inflation expectations are resisting higher long-term rates • Should drift higher until next recession

Source: Federal Reserve Bank of St. Louis, Bureau of Labor Statistics, Bureau of Economic Analysis

» The four pillars of economic activity are all pointing in the right direction. This augurs well for further economic growth.

» In its ninth year of recovery/ expansion, the U.S. economy remains healthy and well-balanced.

» Longer-term challenges to economic growth remain but are of limited influence now.

THE GLOBAL ECONOMY: MAJOR ECONOMIES ARE ALL GROWING

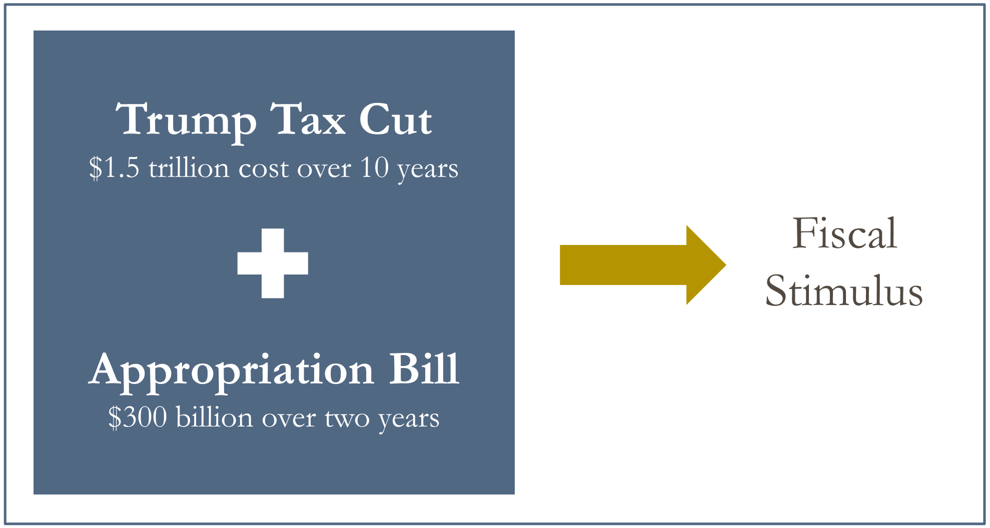
- All of the major economies in the world produced positive rates of growth in real GDP in 2017.
- For the first time in years a synchronized global expansion is benefitting businesses worldwide.
- Note that eight of the fourteen major economies produced higher growth in 2017 than in 2016.
- Not surprisingly, China and India produced the most rapid growth in 2017. Other emerging economies did well also.

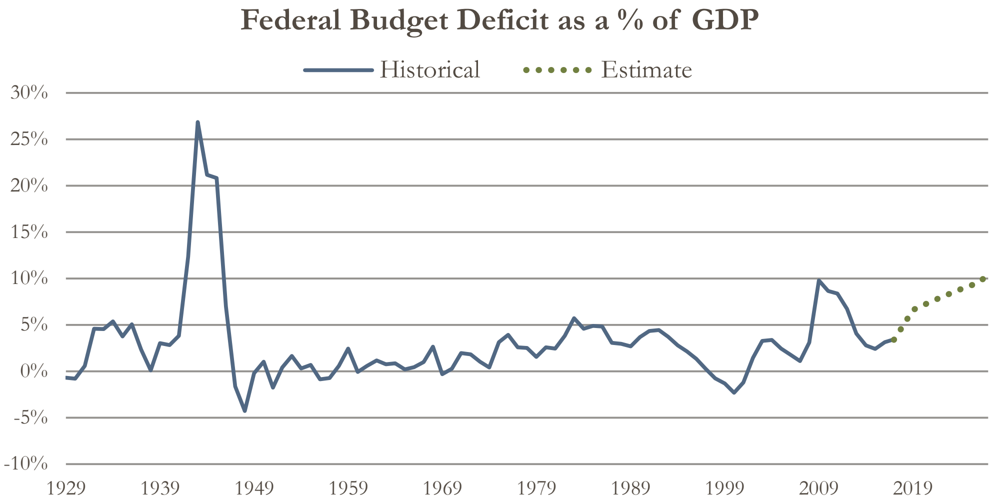
Year over Year % Change in Real GDP

Major Economies of the World	2016	2017
Australia	2.4	1.8
Britain	1.8	1.5
Brazil	-3.6	1.0
Canada	1.5	2.5
China	7.2	7.1
Euro Area	2.0	2.2
Japan	1.1	1.5
India	7.9	6.2
Indonesia	5.0	4.9
Russia	-0.2	1.8
South Korea	2.8	2.7
Turkey	3.2	4.0
Mexico	2.3	2.5
United States	1.7	2.3

Source: The Conference Board Total Economy Database™ (Adjusted version), November 2017

Fiscal Stimulus: Too Much Fuel on the Fire?





Source: Federal Reserve Bank of St. Louis
Federal Surplus or Deficit as Percent of Gross Domestic Product, Percent of GDP, Annual, Not Seasonally Adjusted (Data Through: December 2017)
Estimates Source: Committee for a Responsible Federal Budget

» After years of working high federal budget deficits down, U.S. fiscal policy has turned sharply expansionary.

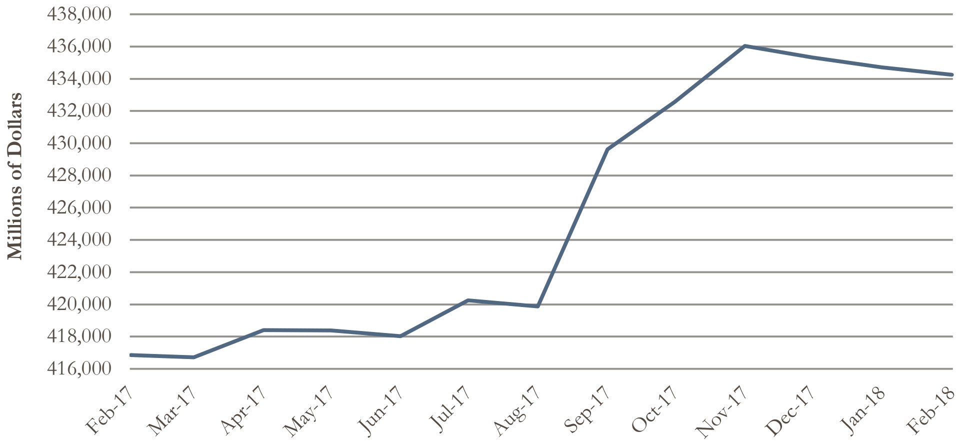
» Fiscal expansion usually occurs early in a business cycle to stimulate recovery. This fiscal expansion is arriving late in the cycle.

» The timing of fiscal expansion increases the risk of overheating and an aggressive response by the Federal Reserve.

» After years of gradually winding down the Federal deficit to more normal levels, it is set to rise sharply. This will have future economic implications.

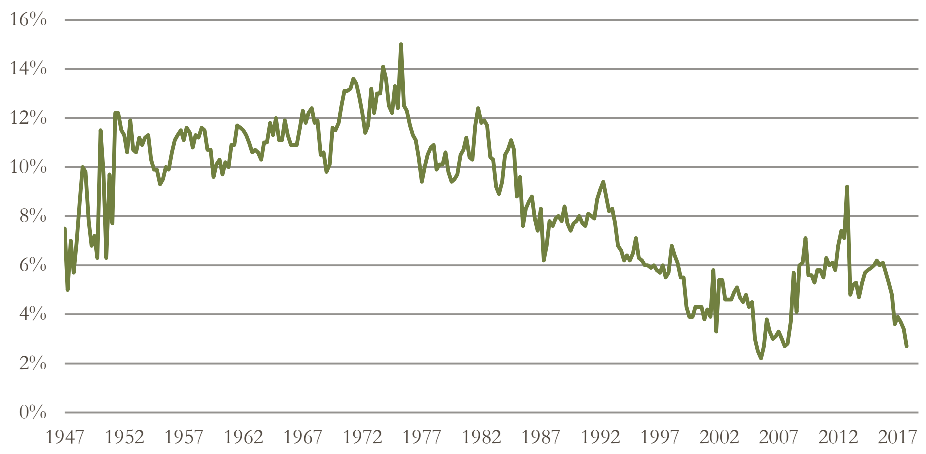
The Consumer: Still Strong But A Little Tired?

Advance Retail Sales: Retail (Excluding Food Services)



Source: Federal Reserve Bank of St. Louis
Advance Retail Sales: Retail (Excluding Food Services), Millions of Dollars, Monthly, Seasonally Adjusted (Data Through: 2/1/2018)

Personal Savings Rate



Source: Federal Reserve Bank of St. Louis
Personal saving as a percentage of disposable personal income, Percent, Quarterly, Seasonally Adjusted Annual Rate (Data Through: Q4 2017)

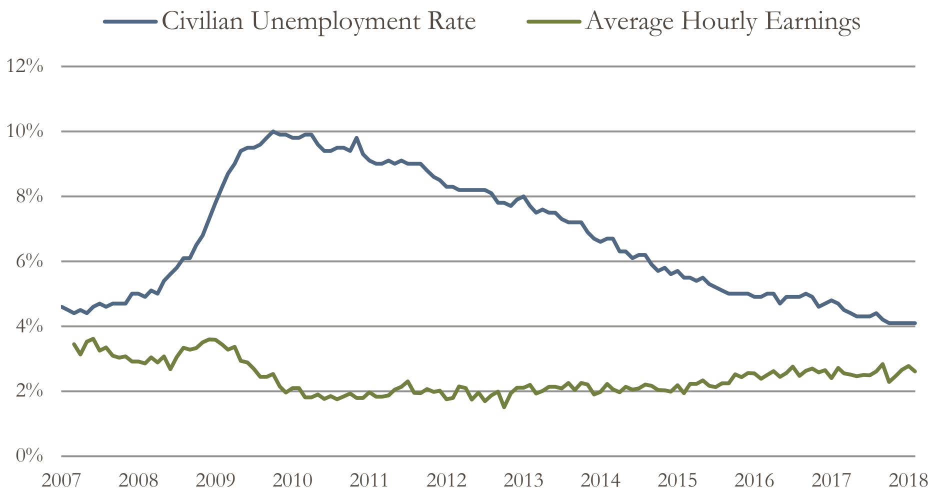
» The consumer, 70% of GDP, was very strong in 2017. Recent trends have been softer.

» Retail sales in the U.S. have declined for three consecutive months ending in February. This has not happened since 2015.

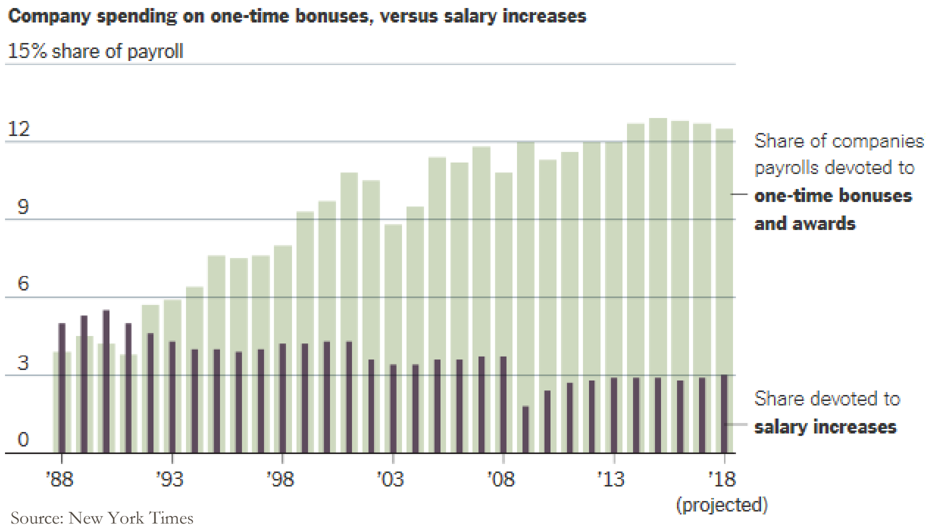
» Retail spending trends may be reflecting the low savings rate. At year-end the savings rate of 2.5% was approaching historic lows.

» A sustained boost to consumption will come with higher growth in wages.

ECONOMIC MYSTERY: WHERE ARE THE WAGE GAINS?



Source: Federal Reserve Bank of St. Louis
Civilian Unemployment Rate, Percent, Monthly, Seasonally Adjusted (Data Through: February 2018)
Average Hourly Earnings of All Employees: Total Private, Percent Change from Year Ago, Monthly, Seasonally Adjusted (Data Through: February 2018)



Source: New York Times
Where Did Your Pay Raise Go? It May Have Become a Bonus (February 10, 2018)

- Normally, as the labor markets tighten, wage growth tends to increase.
- In this cycle unemployment has dropped sharply, and while some wage increases have occurred, they are small and below normal.
- There may be several reasons for the lack of significant wage growth, but perhaps the labor market is not as tight as it appears.
- The bottom display indicates how companies have been shifting compensation practices, emphasizing one-time bonuses over more permanent salary increases.

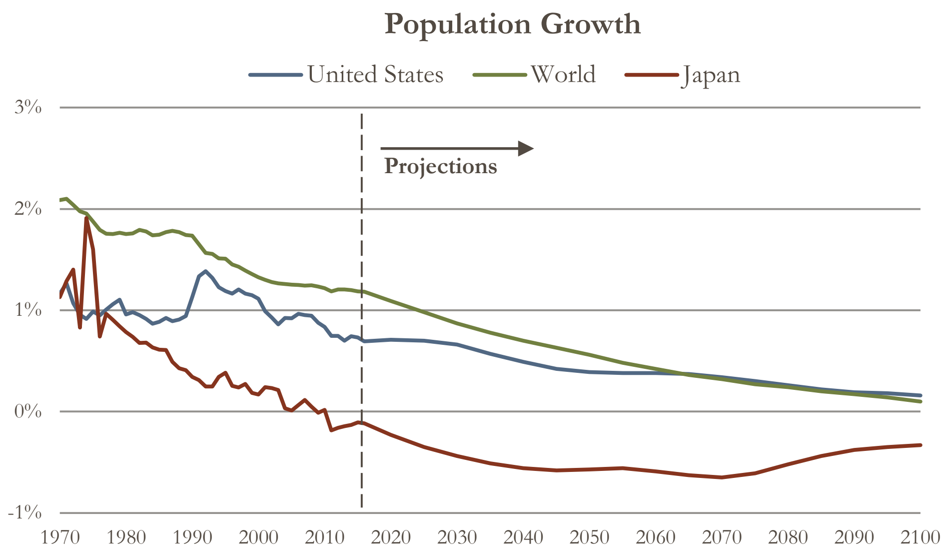
Tax Cuts And Wage Gains: They Are Linked, But It Is A Long Process

Chain of Events: Taxes to Wage Gains

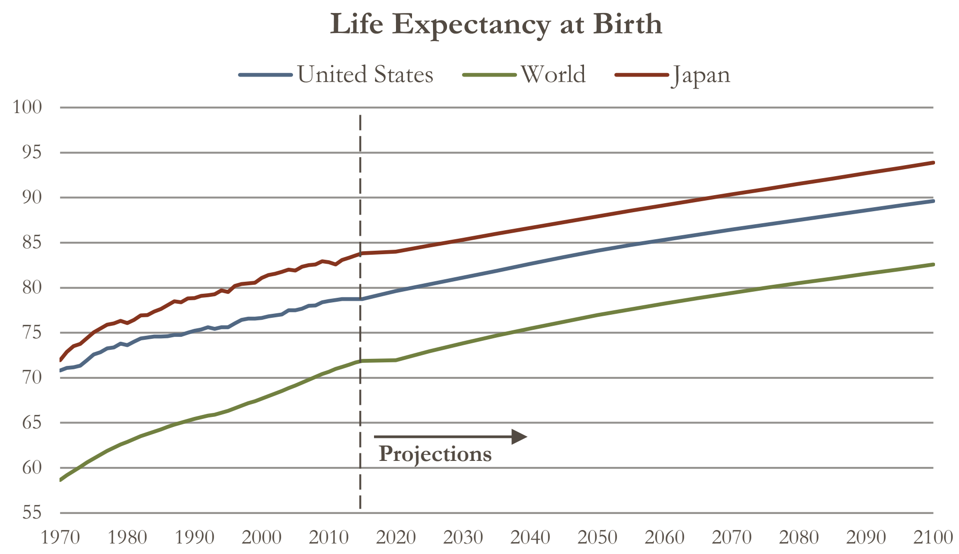
Source: The New York Times
Bonuses and Bogosity (February 27, 2018)

- The above sequence is a logical course of events that can eventually lead to wage gains.
- It will take at least a few years, if not more, for sustained wage gains to result from tax cuts.
- In the meantime, a fully employed labor force will in itself lead to some wage gains.
- It is yet to be seen how much of the recent corporate tax cut will go to capital investment instead of dividends and stock buybacks. Increases in capital investment will be of longer-term benefit to companies, employees and the economy in general.

LONG-TERM ECONOMIC GROWTH: SECULAR HEADWINDS



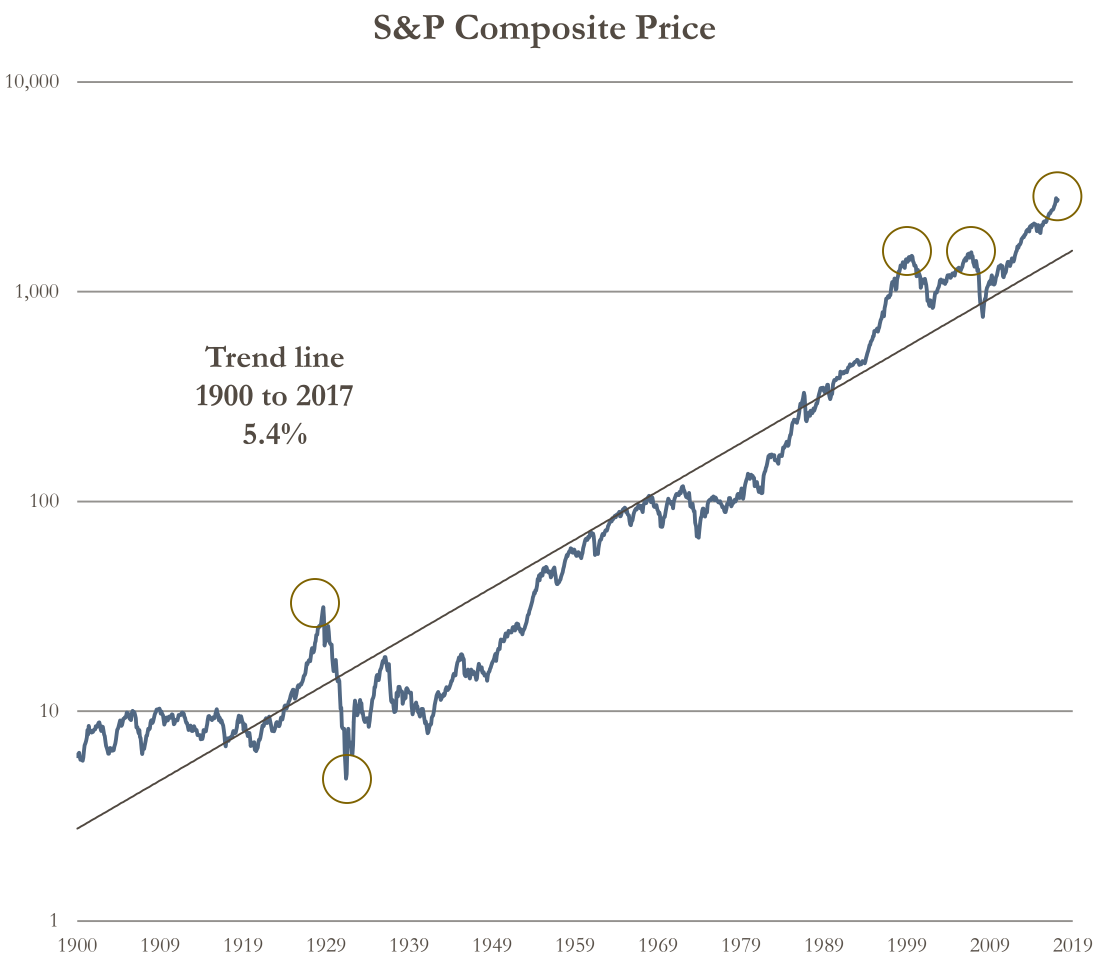
Source: Federal Reserve Bank of St. Louis, Projections - United Nations World Population Prospects
Population Growth, Percent Change at Annual Rate, Annual, Not Seasonally Adjusted (Historical Data Through: 2016)



Source: Federal Reserve Bank of St. Louis, Projections - United Nations World Population Prospects
Life Expectancy at Birth, Number of Years, Annual, Not Seasonally Adjusted (Historical Data Through: 2015)

- Shorter-term investors need not worry about these trends, but longer-term investors should.
- Slower population growth and longer life expectancy are significant headwinds to longer-term-economic growth.
- Fewer people working in the future imposes a significant burden on those who do work.
- Older people consume less, thereby lessening overall demand.
- Some will be consoled by the fact that these trends have been in place for a long time, and the economy is still growing. Perhaps these trends are influences that have caused economic growth to slow significantly in the last decade.

THE STOCK MARKET: CHEAP OR EXPENSIVE?

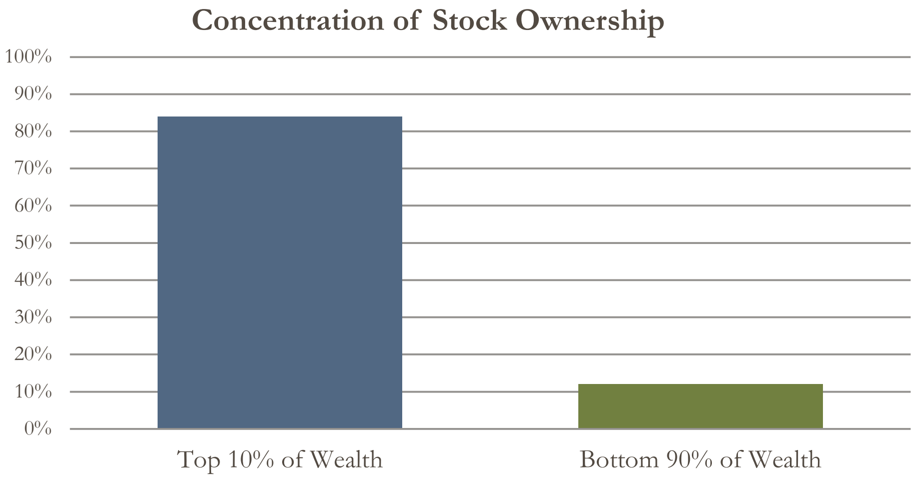


Source: Robert J. Shiller
(Data Through: 3/1/2018)

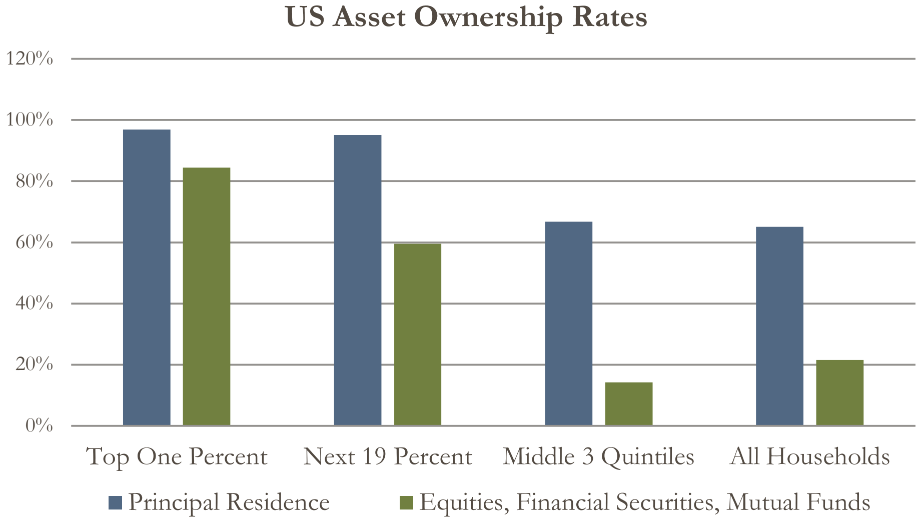
- Over the last 117 years the stock market as measured by S&P price only (does not include dividends) has fluctuated around a trend line return of 5.4% per year.
- This suggests that stocks are a good bet for longer-term investors. It says nothing about the short term.
- The circled areas represent extreme variations from trend.
- Note that 3 of the 5 extremes are in recent years. Does this mean there has been a permanent change in stock valuations?
- Based on history, it is difficult to make a case that stocks are cheap.

U.S. STOCKS: WHO OWNS THEM?

- It is assumed by many that common stocks are widely owned across the population.
- In fact, stock ownership is heavily concentrated among the top 10% of wealth. They own 84% of all stocks.
- Concentration of ownership means the stimulative effect of rising stock prices is muted, since the wealthy have a greater propensity to save than consume.
- Home ownership is more widespread; therefore, as home prices increase, it creates more purchasing power and stimulates consumption.



Source: NBER Working Paper Series – "Household Wealth Trends in the United States, 1962-2013: Has Middle Class Wealth Recovered?



Top One Percent: Net worth of $7.7M or more
Next 19 Percent: Net worth between $401,000 and $7.7M
Middle 3 Quintiles: Net worth between $0 and $401,000
Source: NBER – "Household Wealth Trends in the United States, 1962-2013: What Happened Over the Great Recession? Composition of Household Wealth by Wealth Class, 2013

THE BOND MARKET: HOW HIGH WILL RATES RISE?

United States 10-Year Bond Yield

Source: Bloomberg
United States 10-Year Bond Yield, Daily (Data Through: 2/28/2018)

Factors Influencing Bond Yields

- Federal Reserve Policy
  3 Fed Fund increases this year; 3 more in 2019
- Inflation and Inflation Expectations
- Economic Growth
- Wage Growth
- Budget Deficits

» The benchmark 10-year Treasury yield rose sharply in 1st quarter 2018. Its rise has levelled off recently.

» The Fed is now projecting a high of 3.4% on federal funds in 2020. This implies a yield in the area of 4.0% for the 10-year Treasury.

» We caution that a lot has to go right in the economy for the Fed target to be realized.

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