ECONOMIC REVIEW

US Advances Despite Mixed Signals

The US economy remains well on track, but weakness in areas like wages and household spending could suggest a softer outlook in coming months.

- **Q1 GDP proved fairly weak**, with the economy increasing by a modest 1.4%. First quarter readings have historically been underestimated, however, and current projections place second quarter growth at a more robust 2.7%.

- **Consumer spending decelerated in recent months**, as automakers, retailers and other businesses reported less-than-stellar sales. Given that consumption drives nearly 70% of economic activity, continued slack in purchases could create a drag on overall growth.

- **Hiring gained new momentum** after an apparent slow down earlier this year. May delivered a weaker-than-expected jobs report, but payrolls bounced back strongly in June. Yet personal earnings still lag stubbornly behind. After making slight progress in 2016, wage growth appears to have stalled so far this year.

- **Consumer confidence remains remarkably strong** well after its post-election surge. Even more US workers now say it has become easier to land a job, yet another sign of a tightening labor market.

- **The housing sector came back with uneven results.** Though construction of new homes decreased in both April and May, new and existing home sales made respectable gains throughout the same period.

Fed Boosts Rates While Eyeing Security Sell-Off

- Citing positive trends like falling unemployment, **the Federal Reserve lifted interest rates again in June**, the third such increase since December. However, officials also expressed concern over recent sluggishness in inflation, which has yet to consistently meet the bank’s key target of 2%.

The soft inflation figures have led Fed-watchers to downgrade their predictions for additional rate hikes this year, with markets anticipating another increase no earlier than the fall.
In their latest meeting, Fed officials also revealed more details about their proposed plan to reduce the central bank’s holdings in US securities, accumulated earlier through so-called “Quantitative Easing” or QE. The Fed intends to shed around $10 billion in assets each month, a move that would shrink the US money supply and help keep the economy from overheating. However, policymakers have stayed mum on when the program might actually begin.

**Europe and Japan Make Gains**

*Relative to the US, Europe’s recovery has been considerably less robust. Yet the region seems to be undergoing a prolonged period of growth, providing new grounds for optimism.*

- **The Eurozone made further steps toward stability.** GDP is progressively creeping upwards, with the economy enlarging 0.6% in Q1. And while unemployment remains high compared to the US and Britain, it continues to decline overall, dipping to 9.3% in May.

- **The prospect of a spreading populist wave may have subsided** following Emmanuel Macron’s decisive win in the French election. Macron’s victory follows other recent defeats of Euroskeptic politicians in Austria and the Netherlands, dampening the likelihood of additional Brexit-style departures from the EU.

- **Eurozone inflation fluctuated this quarter,** dipping from 1.9% in April to 1.3% in June. Though inflation rates have slowly trended upwards in the past year, they have yet to hit the European Central Bank’s elusive 2% target.

  Lagging inflation has convinced the ECB to maintain its ongoing bond purchases, with the bank giving no indication as to when it might taper its asset buying. Further, officials recently emphasized they will refrain from any interest rate hikes until quantitative easing is discontinued.

- **Japan displayed positive signs** after a somewhat subdued first quarter. GDP expanded for the fifth consecutive quarter in Q2, rising an annualized 1.0%. This marks the longest continuous stretch of growth since the 2008 global crisis.

  Meanwhile, inflation has increased slightly but steadily over the past several months. Should that pattern persist, it could bode well for Japan’s long-running battle against deflation.
China Stabilizes; India Pursues Reforms

- **China continues to recover from its 2015 downturn.** Increased hiring has boosted the employment rate. Meanwhile, manufacturing enjoyed a particularly robust second quarter, with factories reporting growth due to strong external demand.

  Overall, Beijing’s growth rate appears to be stabilizing, albeit one measurably slower than the red-hot expansion seen in earlier years. However, as policymakers grow increasingly concerned over high corporate debt levels, the government is now seeking to tighten the country’s credit supply, a move that could dampen future economic expansion.

- **Brazilian prosecutors charged President Michel Temer with corruption,** pushing the country into a fresh political crisis. Facing declining support from lawmakers and the public, Temer may find it harder to advance his legislative agenda, which includes a raft of austerity measures aimed at bolstering Brazil’s long-struggling economy.

- **India adopted wide-ranging tax reforms,** replacing a patchwork of state and federal taxes with a uniform national framework. The overhaul is intended to reduce tax evasion, lift government revenues, and enable more stimulus spending, all key goals of Prime Minister Narendra Modi.

MARKET REVIEW

US Stocks Move Steadily Higher, Show Little Regard for Political Uncertainties

- **Despite increasing political turbulence, US stocks marched methodically higher** in the second quarter, with the S&P 500 stock index rising 3.1% for the period. The strong gains, combined with robust first quarter returns, puts US stocks up 9.3% for the year. With the political storm at times seemingly growing by the day, the stock market’s orderly rise was a welcome and reassuring surprise to many investors.

- **The technology and healthcare sectors remained red hot** and have now risen 14.3% and 16.0% respectively on the year. If you take just Facebook, Amazon, Netflix, and Google (now Alphabet)—known as the FANG stocks—and add Apple and Microsoft to the mix, the group has risen an average of 22% in 2017 and accounts for nearly one third of the S&P 500’s total return on the year. Gains in the healthcare sector have been equally impressive and seem to be driven by increasing skepticism among investors that significant healthcare reforms will be passed by Congress.
Large cap stocks continued to outperform mid and small cap stocks in the second quarter, as the Wilshire 4500 index rose 2.9%, compared to the S&P 500’s 3.1% gain. This continues a trend that began in the first quarter of the year and can be traced in part to the surge of some of the large technology firms mentioned above, which have a big impact on capitalization-weighted market indices. A weak US dollar, which fell 2.3% in the second quarter, also boosted large-cap returns, as profits earned abroad translated into more US dollars for large multinational firms.

Market volatility readings hovered near all-time lows on the quarter, providing formal confirmation that markets were in fact as tranquil as they seemed. The VIX volatility index spent most of the quarter under 11, and even dipped below 10 on occasion—not too far off from its all-time closing low of 9.3.

International Stocks Gain, Outpace the US; Emerging Markets Continue to Deliver

International developed markets outperformed the US for the second straight quarter, with the MSCI EAFE index rising 6.4% for the period. For the year-to-date, international developed stocks have now risen 14.2%, providing some long awaited reward to investors who diversified their equity holdings across foreign markets. The robust returns were driven by a positive economic backdrop for the Eurozone, improved corporate earnings, and reduced political risk (as evidenced by centrist and pro-EU candidate Emmanuel Macron’s victory in the French presidential elections). Japanese stocks also posted good returns for the quarter.

Emerging markets maintained their momentum in the second quarter, with the MSCI Emerging Markets index jumping 6.4% on the period, making it one of the best performing asset classes in 2017 so far, with an 18.6% return year-to-date. China, the largest component in leading emerging market indexes, posted strong gains as macroeconomic data remained firm. Signs of improving global growth also benefited Korea, Taiwan, and Poland. Lest you had forgotten about Greece’s fiscal woes, the country reached another agreement with creditors, securing the release of an $8.5 billion loan tranche, sending Greek stocks soaring.
Fed Bumps Short-Term Rates Again, But Bonds Move Higher as Long-Term Rates Fall

• The Fed raised short-term rates by 0.25% during the quarter, yet bond prices moved higher. The Bloomberg Barclays US Aggregate Bond index rose 1.5% on the period and is up 2.3% for the year-to-date, providing continued evidence that slow and steady short-term rate increases don’t necessarily mean bad news for the bond market as a whole.

• The 10-year US Treasury yield fell from 2.40% to 2.31% on the quarter, while the 2-year Treasury yield rose from 1.27% to 1.38%. This represents a flattening of the yield curve, with short-term rates rising in conjunction with falling long-term rates. This has the benefit of helping savers who should be able to earn higher interest rates on short-term savings deposits, as well as borrowers looking to secure longer term loans, such as 30-year mortgages.

• Municipal bonds posted another solid quarter, outperforming taxable fixed income investments, with the Bloomberg Barclays Municipal Bond Index rising 2.0% on the period. For the year-to-date, municipals have risen 3.6%—an excellent return considering the tax-free nature of most muni bond interest. High-yield bonds also posted another strong quarter, rising 2.2% on the period.

REITs Rise; Energy and Commodities Move Lower as Oil Prices Fall

• Alternative investment performance was lackluster, aside from real estate investment trusts (REITs), which rose 1.7% in the second quarter. For the year, REITs have gained 2.7%, meaningfully behind the S&P 500’s gain of 9.3% but slightly better than the 2.3% return posted by bonds. REITs have characteristics of both asset classes as they have the potential for significant capital appreciation (similar to stocks) while also paying out higher than average income (similar to bonds). The price of gold was relatively unchanged on the quarter (down 0.2%) after a strong surge to start the year (up 9.2% in Q1).

• Oil prices plunged over 9% in the second quarter, dragging down returns on energy stocks and commodities, which fell 6.6% and 3.0% respectively on the period. 2017 has been unkind to both alternative asset classes, with energy stocks down 12.7% year-to-date and commodities down 5.3%. OPEC did institute production cuts to curb the supply of oil, but they were less than anticipated and also offset by rising US production. Growth in renewable energy sources, such as wind and solar, will also have a continuing impact on the sector.
## Market Summary

### Index Returns

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<tbody>
<tr>
<td>Q2 2017</td>
<td>3.09%</td>
<td>2.89%</td>
<td>6.37%</td>
<td>6.38%</td>
<td>1.45%</td>
<td>-2.26%</td>
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<table>
<thead>
<tr>
<th></th>
<th>Stocks</th>
<th>Bonds/Dollar</th>
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<tbody>
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<td>Q2 2017</td>
<td>3.09%</td>
<td>1.45%</td>
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### Since Jan. 2001

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<tr>
<td>Avg. Quarterly Return</td>
<td>1.8%</td>
<td>2.7%</td>
<td>1.5%</td>
<td>2.8%</td>
<td>1.2%</td>
<td>0.1%</td>
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<tr>
<td>Best Quarter</td>
<td>15.9% Q2 2009</td>
<td>21.4% Q2 2003</td>
<td>25.8% Q2 2009</td>
<td>34.8% Q2 2009</td>
<td>4.6% Q3 2001</td>
<td>5.9% Q4 2008</td>
</tr>
<tr>
<td>Worst Quarter</td>
<td>-21.9% Q4 2008</td>
<td>-23.7% Q4 2008</td>
<td>-20.5% Q3 2008</td>
<td>-27.6% Q4 2008</td>
<td>-3.0% Q4 2016</td>
<td>-5.4% Q2 2009</td>
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Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Market segment (index representation) as follows: US Large Cap (S&P 500 Index), US Mid/Small Cap (Wilshire 4500 Completion Index), International Developed (MSCI Europe Australasia Far East Index), Emerging Markets (MSCI Emerging Markets Index), US Bond Market (Bloomberg Barclays US Aggregate Index), and US Dollar (Trade Weighted US Dollar Index: Broad).
World Stock Market Performance
MSCI All Country World Index with selected headlines from Q2 2017

230
220
210
200
Apr
May
Jun

“Eurozone Housing Prices Rise at Fastest Pace since 2007”

“Nasdaq Soars to New Heights”

“UK Economy Slows Sharply Ahead of Election, Brexit Talks”

“Home Sales Jump to Near Prior Boom Levels”

“Eurozone Consumer Confidence at Highest Level in Nearly a Decade”

“Unemployment Rate Falls to 16-Year Low”

“US Oil Falls into Bear Market Amid Worries Over Supply Glut”

“Global Bonds Sell Off”

“IMF Lowers Forecast for US Economy Amid Rising Policy Uncertainty”

“Global Stocks Post Strongest First Half in Years”

“New-Home Prices Hit Record Level”

“IMF Upgrades UK 2017, 2018 Growth Forecast as Brexit Fears Ease”

“Eurozone Confidence Hits Post-Crisis High”

“Japan’s Growth Winning Streak Is Longest in Over a Decade”

“US Job Openings Hit New High”

“Eurozone Consumer Confidence at Highest Level in Nearly a Decade”

“IMF Lowers Forecast for US Economy Amid Rising Policy Uncertainty”

“Global Stocks Post Strongest First Half in Years”

Graph Source: MSCI ACWI Index. MSCI data © MSCI 2017, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.
US stocks posted yet another positive quarter and have risen nicely through the halfway point in the year. Large cap stocks continued to outperform mid and small cap stocks, and market volatility remained low.

Foreign equities fared best, as international developed and emerging markets stocks jumped in response to positive macroeconomic conditions. A 2.3% drop in the value of the US dollar also served to boost returns on international stocks.

Returns for the Quarter (%)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Years*</th>
<th>5 Years*</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Large Cap Stocks</td>
<td>3.09</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>US Mid/Small Cap Stocks</td>
<td>2.89</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>International Developed Stocks</td>
<td>6.37</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Emerging Markets Stocks</td>
<td>6.38</td>
<td></td>
<td></td>
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<tr>
<td>Global Stocks</td>
<td>4.45</td>
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Bonds
Second Quarter 2017 Index Returns

Bonds rose in the second quarter despite a 0.25% rate increase by the Federal Reserve in June. This was possible due to a dip in long-term interest rates (running counter to the rise in short-term rates) as evidenced by the 10-Year US Treasury yield, which fell from 2.40% to 2.31% on the quarter.

Weakness in the US dollar contributed to a good quarter for foreign bonds. Tax-exempt municipal bonds also moved higher and have outpaced taxable fixed income investments year-to-date.

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<tbody>
<tr>
<td>US Total Bond Market</td>
<td>2.27</td>
<td>-0.31</td>
<td>2.48</td>
<td>2.21</td>
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<tr>
<td>Short-Term Investment Grade Bonds</td>
<td>1.14</td>
<td>0.11</td>
<td>1.35</td>
<td>1.29</td>
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<tr>
<td>Long-Term Investment Grade Bonds</td>
<td>6.03</td>
<td>-1.07</td>
<td>5.28</td>
<td>4.26</td>
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<td>Municipal Bonds</td>
<td>3.57</td>
<td>-0.49</td>
<td>3.33</td>
<td>3.26</td>
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<tr>
<td>Mortgage-Backed Bonds</td>
<td>1.35</td>
<td>-0.06</td>
<td>2.17</td>
<td>2.00</td>
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<tr>
<td>Treasury Inflation-Protected Bonds</td>
<td>0.85</td>
<td>-0.63</td>
<td>0.63</td>
<td>0.27</td>
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<td>Foreign Bonds</td>
<td>5.91</td>
<td>-5.01</td>
<td>-2.20</td>
<td>-0.80</td>
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Alternatives
Second Quarter 2017 Index Returns

Alternative investment performance was lackluster, aside from real estate investment trusts, which rose modestly on the quarter.

The price of gold was relatively unchanged after a strong surge to start the year.

Oil prices fell 9% in the second quarter, dragging down returns on US energy stocks and commodities. This comes on the heels of a weak first quarter, driving disappointing year-to-date returns for both asset classes.

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<td>US Real Estate Investment Trusts</td>
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<td>US Energy Stocks</td>
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<td>-6.50</td>
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<td>-9.25</td>
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<tr>
<td>Gold</td>
<td>8.97</td>
<td>-4.37</td>
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Period Returns (%)

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Market segment (index representation) as follows: US Real Estate Investment Trusts (MSCI US REIT Index), US Energy Stocks (S&P 500 Energy), Commodities (Bloomberg Commodity Index), and Gold (London Bullion Market Association Gold P.M. Price). Gold spot price data obtained from Federal Reserve Economic Data.
The charts below show performance in four highly cyclical areas of the US economy, which in the past have played a large role in economic expansions and recessions. Some economists believe the recent downturns in these sectors portend a softening economy, but this is not yet a consensus view.
The Federal Budget
Second Quarter 2017

The left chart shows the 2017 US government budget—expenditures in the first column and revenue sources (taxes) in the second. “Borrowing” is the gap between the two—the budget deficit, funded through the sale of Treasury bonds. The top right chart shows the yearly deficits (past and projected) while the bottom right chart shows the national debt, which is the cumulative sum of the annual deficits. Both figures are shown as a percentage of GDP to illustrate magnitude relative to the total size of the economy. Note the large impact of the Great Recession (2007-2009). Note also the projections of higher deficits and debt levels in the future. Left unchecked, this could be a drag on economic growth. We expect the deficit/debt challenge to be among the most important public policy issues of the coming decade.
The Federal Reserve Balance Sheet
Second Quarter 2017

The chart below shows the historical and projected balance sheet of the Federal Reserve. During the financial crisis, the Fed initiated multiple “Quantitative Easing” programs (buying bonds in the open market), aimed at keeping interest rates low to support the economic recovery. The chart is suggestive of both the depth and duration of the Great Recession, as well as the relatively slow rate of recovery. The Fed is just now releasing details about a plan to begin reducing its balance sheet, nearly 10 years later.