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Market Commentary

Spring 2017

Q1 Key Takeaways

- **Global equities greeted the new year with the same degree of energy with which they closed 2016.** Emerging-market stocks led the way with double-digit gains, followed closely by developed international and U.S. stocks.

- **In Europe, stock gains seemed to reflect a combination of bullish investor sentiment and positive economic data, including rising corporate earnings.**

- **Investors took the Federal Reserve's widely anticipated rate hike on March 15 in stride, treating it as another indicator of the U.S. economy's return to form.** As Fed Chair Janet Yellen stated, "The simple message is the economy is doing well." On March 31, the Bureau of Economic Analysis released a revised GDP figure of 2.1% for the fourth quarter of 2016 versus an earlier estimate of 1.9%. While investor optimism seemed to leave no contingency for downside surprises in the first quarter, macroeconomic fundamentals were also broadly supportive across the globe.

- **Defensive assets turned in a solid performance, with core investment-grade bonds** making up some ground along with Treasurys in the latter half of March after the Fed's announcement.

- **It's too soon to know what the second quarter holds in store, but we remain alert to potentially policy-driven political risk in the United States.** In Europe, the outcome of upcoming elections in France and Germany may have unexpected impacts on markets.

- **As we discuss in this quarter's commentary, a quick survey of the economic landscape suggests the environment should remain supportive of stocks and other risk assets, at least over the next six to twelve months or so.**

Q1 Investment Commentary

Global economic growth is in sync and improving. A quick survey of the economic landscape suggests the environment should remain supportive of stocks and other risk assets over the coming year. We continue to believe while current valuations are above average, a corporate tax cut would put them back in line. We also remain concerned about the unresolved risks stemming from the global debt build-up and unprecedented central bank policies. But for the time being, the global macroeconomic backdrop offers reason for optimism that many of the reflationary trends that have benefited our portfolios in recent quarters can continue.

Across a wide range of measures, the global economy is in its best shape in many years. Economic growth in most countries and industries is in sync and has been accelerating, albeit modestly. Leading economic indicators suggest this trend can continue, and many of the respected economic research firms we follow agree. Global Manufacturing Purchasing Managers Indexes, which have been correlated with global equity returns over time, recently made new multiyear highs in the United States, the eurozone, and China. While unexpected macro shocks can occur at any time, causing at least a short-term flight from risk assets, the likelihood of an incipient U.S. or global economic recession appears low. Without a recession, history suggests a bear market in stocks is unlikely.

Macroeconomic fundamentals appear reasonably solid and are improving from cyclically depressed levels in many regions outside the United States. But financial markets respond to new data, information, and events that differ from consensus expectations already discounted in prices. The Citi Economic Surprise Indexes (see next page) are meant to capture whether and to what extent new economic data points are exceeding or disappointing consensus expectations. These indexes have rebounded sharply over the past year. In fact, the Surprise indexes for Europe and emerging markets both recently hit seven-year highs.

U.S. Markets

Real GDP will come in at 1.3% in Q1. While this is a bit lower than the average growth rate during the current recovery, it is only one data point. In addition, we have seen slow starts to

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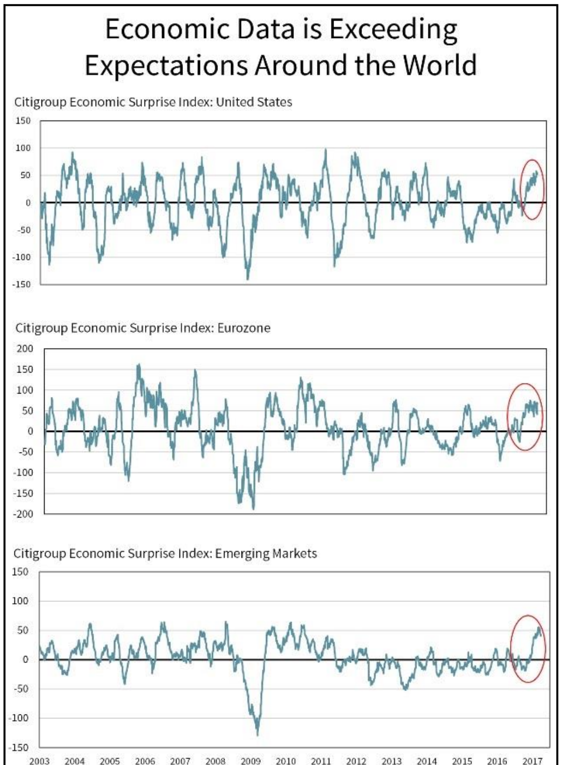

Data as of 3/29/17. Source: Citigroup and Bloomberg.

the year followed by accelerating growth before. And while the stock market has risen in anticipation of higher economic growth rates, that growth will not be realized until after major economic reforms, such as tax cuts and infrastructure spending bills, take place.

The failure by the Republican party to pass a health care bill put the brakes on rising economic expectations, at least for 2017. This is because the savings that were expected on a new health care bill over the next decade, approximately $1 trillion, could have been used for tax cuts. Without 60 votes, the Republicans can only cut taxes to the extent they cut spending in other areas. This is why, as we stated in our blog during the quarter, that we believe the Republicans have no choice but to go back to health care. Recently, there has been talk about the Freedom Caucus in Congress making progress with the balance of the Republican party on health care. If a health care bill ultimately gets passed and frees up dollars for tax cuts, we believe the market will find its way higher.

Once health care and taxes are addressed, Washington can move on to further pro-growth actions such as infrastructure, tax repatriation and deregulation, especially in the banking sector.

From a fundamental perspective, initial earnings reports for Q1 have been strong not only from an earnings perspective, but, more importantly, from a revenue stance. One can only grow earnings so far without growth in revenue. According to Factset, as of April 13th, over one-half of the companies reporting so far have exceeded sales expectations while over three-quarters have beaten earnings expectations. The growth in earnings for the quarter is at the fastest pace in over five years.

Developed Markets

Primarily due to the onset of a regional debt crisis in 2011, European corporate earnings have barely grown since the 2008–2009 financial crisis. Fiscal and monetary policies have not been simulative enough to offset this. Meanwhile, U.S. company earnings have grown strongly, exceeding prior cyclical highs due to historically high profit margins, stock buybacks, and low interest expenses.

We estimate that over the next five years, European companies will likely grow earnings at a much faster rate than their U.S. counterparts; this would lead to outperformance by European stocks. We believe European earnings are cyclically depressed, yet there are reasons for optimism.

Last year, for the first time since the 2008–2009 financial crisis, Europe's economy grew faster than that of the United States. Improving economic growth ultimately leads to better sales growth and gets consumers and corporations to borrow and spend, furthering the cycle. According to the Bank Credit Analyst, private sector credit growth in Europe is running at the fastest rate since the financial crisis.

The European Central Bank has revised upward both its inflation and growth projections for 2017–2018. We are also finally seeing better earnings from European companies. According to Ned Davis Research, the most beaten down sectors, such as financials and energy, are seeing the fastest earnings growth year over year in local-currency terms. Europe has a relatively large exposure to these sectors and any improvement will reflect positively in index-level earnings growth.

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Stocks in the Eurozone are cheap and have been for a while. However, after many years of declining or stagnant growth, growth expectations are changing. Also, we have been closely watching the French election where the first of two rounds took place on April 21. If one enjoyed the Brexit vote last summer, one surely will be looking forward to the final round. The markets have rallied this week as there were no surprises in last Sunday's results with an independent centrist, Emmanaul Macron, and a far-right candidate, Marine Le Pen, winning the round. The final election will take place May 8. Markets would prefer Macron to win as he wishes to keep France in the European Union. However, if Le Pen wins, she would try to move the country toward a "Frexit" (French exit) from the European Union. Although it would be difficult for Le Pen to accomplish this even if she wins, the market would not take the uncertainty well.

Fixed-Income

We continue to believe that over the next several years the most likely direction for U.S. interest rates is higher, although the path will likely be bumpy. That would be consistent with the evidence of global economic reflation. However, despite the fact that the Fed has raised interest rates three times and central banks are backing off easy monetary policies (the Fed is no longer reinvesting maturing bonds and the ECB is trimming purchase levels) we believe the process of normalizing rates will be a slow one.

While returns for fixed income should be lower than what we have seen over the past few years, the purpose of this asset class still remains a vital component in balanced portfolios, providing income and stability. Our fixed income strategy revolves around keeping maturities, on average, short, so as to mitigate price sensitivity in a rising rate environment.

Putting It All Together

It appears that economies around the globe are finding traction and starting to accelerate. While this certainly reduces the fear of any recession, we do not see a booming economy either. GDP estimates for 2017 are just above 2%. This level of growth would support a gradual rise in interest rates keeping pressure off both the stock and bond markets. Upside to equity markets could come from Washington via tax reform, infrastructure spending and further deregulation.

Finally, despite a high level of volatility emanating from U.S. politics in recent months, U.S. stock market volatility has remained very low. That is unlikely to last. Our portfolios are prepared for more oscillations, particularly downside risk to U.S. stocks. We remain confident in our positioning and in our investment process, both of which allow us to look past periods of uncertainty and keep our focus where it should be: on prudently managing our diversified portfolios to achieve long-term, risk-adjusted returns.