ECONOMIC COMMENTARY & CAPITAL MARKET UPDATE

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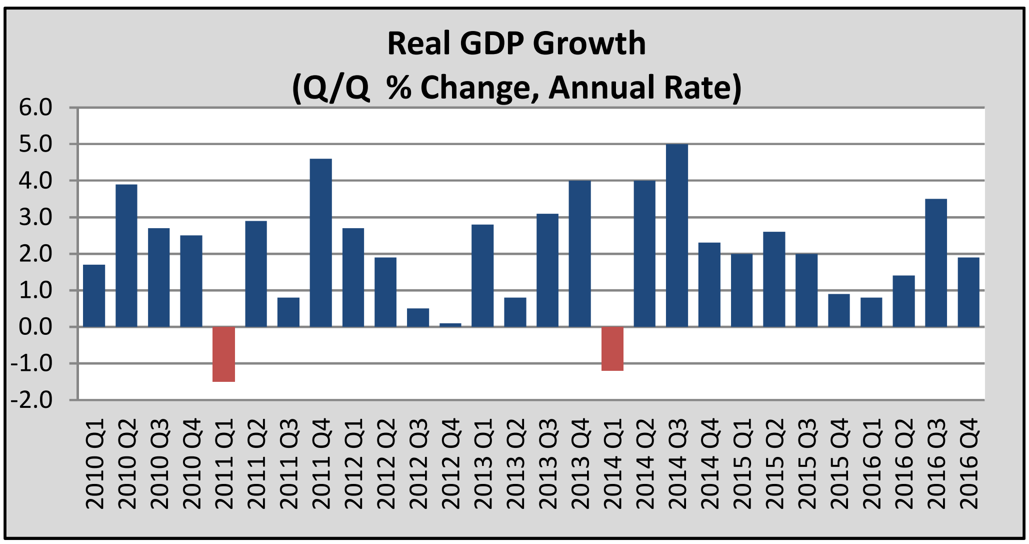
FEBRUARY 2017

Recap: The economic data in January have confirmed that the U.S. economy has been humming along at a solid pace. Labor markets were reported to be tight, or tightening while wage pressures were building. Initial jobless claims fell to a 43-year low. Moreover, December's inflation report showed that the dampening effect of declining energy prices was behind us. Headline inflation rose back above 2%, and is expected to head higher over the coming months. Core inflation has been more range bound over the past year but with wage pressures clearly building across the economy, underlying price pressures are expected to increase.

Homebuilding continued to make progress as 2016 ended. Permits for single-family homes rose in December, suggesting homebuilding has upward momentum in the months ahead. While the recent jump up in mortgage rates presented a headwind for the sector, demand has proven resilient, underpinned by rising wages, and a rebound in household formation.

GDP: The U.S. ended 2016 on a familiar trajectory of roughly 2% economic growth. This lackluster trend has prevailed through most of the current expansion and which President Donald Trump is seeking to double in the face of stubborn long-term headwinds.

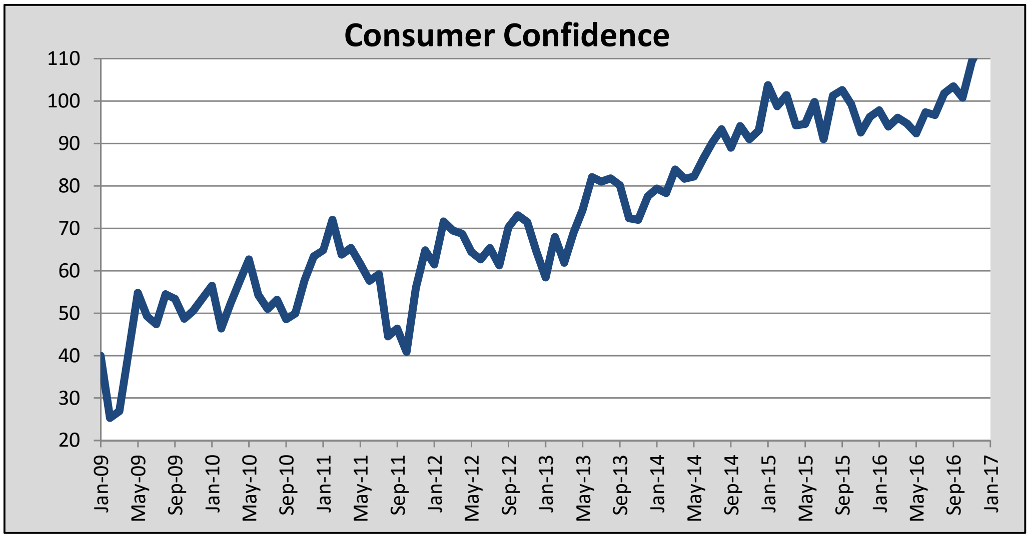


Real Gross domestic product expanded at a seasonally adjusted annual rate of 1.9% in the fourth quarter of 2016. That exceeded the pace of growth in a weak first half of 2016 but marked a slowdown from a fleeting third quarter 3.5% growth rate. The fourth quarter saw solid consumer spending, a pickup in business investment, a rebound for home construction and stronger spending by state and local governments. A widening in the foreign-trade deficit weighed on growth, offset in part by a buildup in domestic business inventories. The economy has grown at a 2.1% average rate since the recession ended in mid-2009 making it the slowest expansion since the WW II, though also one of the longest.

The latest data underscored the obstacles to stronger growth facing President Trump who has said that he will raise the pace of expansion to 4%. He has argued that the U.S. can achieve stronger growth by overhauling the tax code, boosting infrastructure spending, rolling back federal regulations and cutting new trade deals that narrow the foreign-trade deficit. A combination of these policy changes could boost growth. The real question is, does that turn out to be a short-term boost, or does it improve productivity growth and rates of potential growth at the same time.

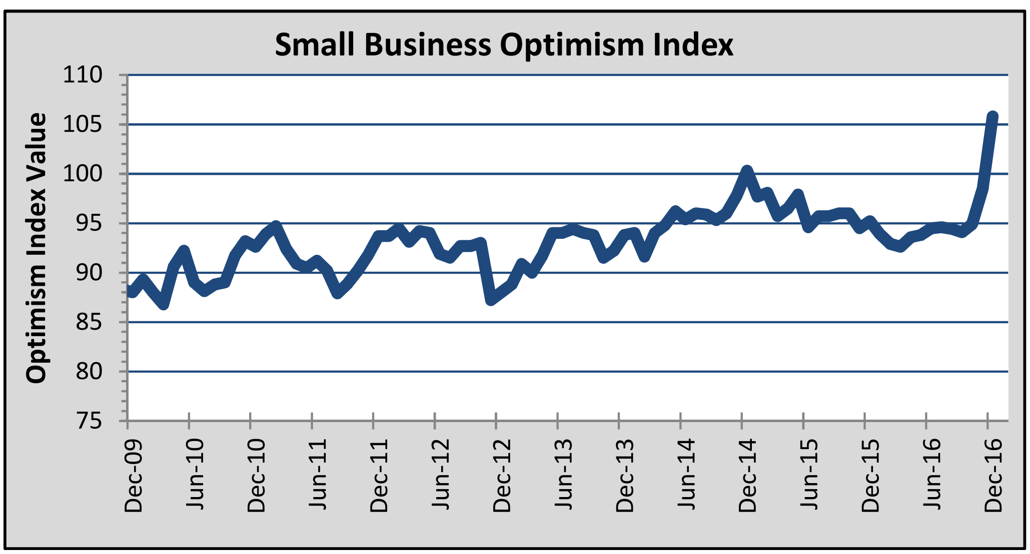
Slightly stronger growth in the next few years compared with pre-election estimates is now expected. However, there is ample skepticism for a significant shift in the long-term growth picture. This is due to a variety of forces depressing both supply and demand including slow growth in the size of the labor force produced by baby-boomer retirements and sluggish worker productivity.

Consumer Confidence: Americans grew less optimistic about the economy in January, in a sign that the post-election bump could be waning. The Consumer Confidence Index decreased to 111.8 in January after reaching a 15-year high in December. The decline in confidence was driven solely by a less optimistic outlook for business conditions, jobs, and especially consumers' income prospects.



Consumers' assessment of current conditions, on the other hand, improved in January. Consumers' assessment of current employment conditions has also improved along with the tightening U.S. labor market. The proportion of consumers claiming jobs are hard to get has fallen meaningfully in line with the unemployment rate. Despite the retreat in confidence, however, consumers remain confident that the economy will continue to expand in the coming months.

Small Business Optimism Index: The NFIB's small business optimism index jumped 7.3 points to 105.8 in December, marking the third consecutive monthly gain. This level of small business confidence has not been recorded since 2004. The details of the report were broadly encouraging as seven of the ten subcomponents rose in the month, one remained unchanged and two fell. Most notably, two of the worst-performing sub-indicators this year recorded massive improvements in December. The share of firms expecting the economy to improve climbed 38 points to 50 percent, while the share of firms expecting higher real sales rose 20 points to 31 percent. Capital outlay plans also improved 5 points to 29 percent. Labor market indicators remained generally supportive.



The surge in confidence in the election's aftermath continued to be accompanied by a heightened level of uncertainty, with readings above 85 in the sub-index only ever recorded in the last few months. More clarity should continue to emerge as the new administration begins to implement its vision. Keeping up with the recent momentum in optimism will depend on how quickly and how much the new administration can deliver on its pledges; it could be a challenge judging by the typically slow nature of the political process.

Retail Sales: American consumers finished 2016 spending at a solid pace, splurging on cars and pouring money into online shopping during the holidays, a sign the economy was on steady footing. Sales at U.S. retailers rose 0.6% in December from a month earlier, the eighth monthly increase in nine months, helping to extend the economy's long expansion. Retail sales rose 3.3% in all of 2016, faster than the prior year's gain of 2.3% and like the underlying trend during the expansion.

The holiday season is the most crucial part of the year for retailers, and the final months of 2016 coincided with a booming stock market and a pickup in Americans' wages. Measures of consumer confidence hit multi-year highs at the end of last year, too, helping to keep spending strong.

Several trends have been aligning to support spending. Worker wages have grown more quickly over the past year after a long period of stagnant growth, with average hourly earnings up 2.9% in December from a year earlier. At the same time, living costs—particularly for everyday items such as gasoline—continue to grow modestly, giving people more money for shopping and travel. Household wealth also hit a record in late 2016. A strong housing market enabled home values recently to recover all the ground lost in the housing crash. And the Dow Jones Industrial Average was up 13% last year. Those factors helped lift consumer confidence.

Household finances also improved compared with just a few years ago. Households collectively spent 10% of their disposable income in the third quarter paying down debt, hovering close to the lowest level since record-keeping began in 1980. Still, the spending at year-end wasn't evenly spread, creating clear winners and losers. Car sales helped drive holiday spending. Online stores also had a big quarter as consumers continued to turn to e-commerce retailers. On the other hand, departmental stores had a weak showing.

Industrial Production: A return to more-normal weather in December boosted industrial production (IP) through the utilities sector. Total IP rose 0.8% on the month. Unseasonably warm weather in the fall resulted in a significant utilities production bump in December, but industrial production outside of the utilities sector also showed improvement in the month. Manufacturing production was up 0.2% on the month, which was shared broadly across sectors. Mining output also stopped declining.

Housing: Housing starts jumped 11.3% in December, ending the year at a 1,226K-unit annual pace. The jump was not all that surprising given November's drop, but the bounce back was larger than expected. The multifamily portion was largely behind December's surge, as its usual volatility was exacerbated by the low level of activity this time of year. Looking at 2016 as a whole, the annual average for permits ran ahead of starts, which points to a pickup in activity in the year ahead. Homebuilder confidence retreated 2 points in January from its cycle high of 69 in December, as the recent jump in mortgage rates slightly offset builders' post-election confidence bump.

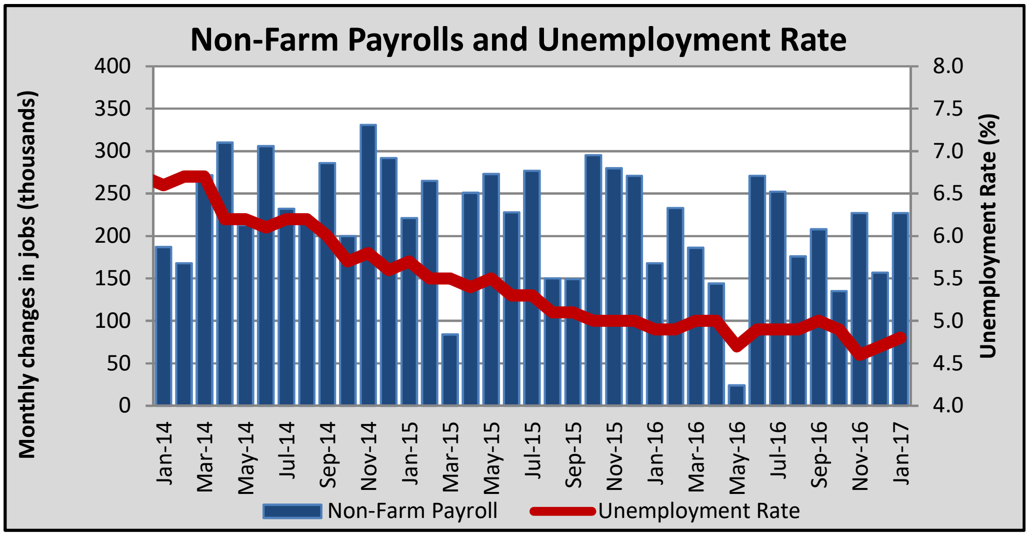
Inflation: The consumer-price index rose above 2% for the first time in 2½ years, a sign of diminished slack in the economy that could support additional moves by the Federal Reserve to lift interest rates this year. The latest figures – a 2.1% increase in December - driven in part by an uptick in energy prices suggest a four-year stretch of historically low inflation could be ending.

As measured by the PCE index, U.S. inflation was a modest 1.6% in December. It has undershot the central bank's threshold for the past 4½ years, but it too has now firmed, from readings close to zero in 2015.

The unemployment rate was 4.7% in December, just below the Fed's long-run projection of 4.8%. The Fed sees joblessness as a key indicator of economic slack: Higher numbers of individuals looking for work would mean less upward pressure on wages and less of the consumer demand that drives up prices.

Fed policy makers in December decided to raise the central bank's benchmark interest rate for the second time in a decade, a reflection of their growing confidence that the economy was on firmer footing. Officials have penciled in an additional three quarter-percentage-point increases this year. Any changes in policy will take time to work through the economy and undue delay could risk a nasty surprise down the road—either too much inflation, financial instability, or both.

The Donald Trump administration is one wild card in the Fed's calculations. While details remain uncertain, the president has pledged lower taxes and more infrastructure spending. That could lead to faster economic growth and accelerating inflation. Already, firms are anticipating faster wage gains. Rising price pressures, should they materialize, could lead Fed officials to act sooner or more frequently than forecast. The Fed will be on the lookout for any price pressures showing signs of overheating in the economy. The risks are for more Fed rate increases than currently expected.



Strong Dollar: The stronger dollar has given some economies a boost that stimulus measures struggled to deliver, even as the U.S. currency's rally threatened commodity prices and emerging markets. By weakening other currencies, the dollar's surge has aided the efforts of governments and central banks to raise growth and spark inflation, goals that have proven difficult to achieve despite years of easy-money policies.

In Europe, the euro's almost 3% decline against the dollar since U.S election helped push consumer prices up at their fastest annual rate in three years in December. As the dollar rose against the Japanese yen, it fanned a 20% rally in the Nikkei since early November and bolstered growth expectations.

A dollar that rises too high or too quickly can become a problem. A strong U.S. currency tends to create headaches for emerging markets and others that have borrowed heavily in dollars by making their debt more difficult to service. Commodities, which are priced in dollars, come under pressure as they become more expensive to foreign buyers. U.S. growth tends to suffer too as the burgeoning currency hurts corporations. For some countries, weaker currencies have provided a tailwind.

Meanwhile, the stronger dollar's harmful effects may already be manifesting, especially in emerging markets, where rising consumer prices were already high and a falling local currency has risked capital outflows.

Central banks in emerging markets will be limited by how much monetary easing they can deliver, as lower rates make their currencies less attractive to investors while U.S. rates are rising. China raised interbank rates to their second-highest level ever in early January in a bid to support the yuan and stanch capital outflows. Central banks in Mexico and Turkey have also raised rates to defend their falling currencies.

Euro Zone: Euro zone economic growth accelerated at the end of 2016 while the jobless rate fell to its lowest level since 2009, putting the currency area on steadier footing at the start of a year clouded by political uncertainty.

Buoyed by the ECB's stimulus programs and a weaker currency that appears to have aided exports, the euro zone's gross domestic product in the fourth quarter was 0.5% higher than in the three months to September, and 1.8% higher than in the final three months of 2015. On an annualized basis, growth picked up to 2.0% from 1.8% in the third quarter. The fourth quarter pickup allowed the euro zone economy to grow more rapidly than its U.S. counterpart during 2016 expanding by 1.7% compared with 1.6% for the U.S., the first time that has happened since the crisis-year of 2008.

Several headwinds remain as the risks surrounding the euro area growth outlook remain tilted to the downside. Rising energy prices threaten to dampen consumer spending unless workers can secure similarly large wage rises. Consumer prices were 1.8% higher in January than a year earlier, the highest inflation rate since February 2013. But higher wages have become slightly more likely with a sharper fall in unemployment toward the end of last year. The jobless rate fell to 9.6% in December from 9.7% in November, its lowest since May 2009.
Growth could be dampened by high levels of uncertainty ahead of a series of key elections that could lead to gains for parties hostile to the euro and the European Union, and the start of difficult talks that will pave the way for the U.K.'s exit from the bloc.

China: China's fourth quarter real gross domestic product (GDP) rose by 6.8% (year-on-year). The Chinese economy expanded at a 6.7% pace in 2016, the slowest since 1990. Growth continued to be fueled by credit expansion that has sent China's debt-to-GDP ratio to new highs in the corporate, household, and government sectors. This has added to domestic financial stability risks, particularly surrounding the solvency of some businesses in industries with overcapacity and the banking sector that has been operating in an environment of slowing income growth.

This confirms another year of strong, but slowing, Chinese growth. Momentum from the fourth quarter should carry through to support first quarter growth, which historically has been notoriously volatile given the massive economic disruption caused by the Chinese New Year holiday season.

Looking ahead, the rotation of growth toward consumption and away from debt-fueled investment is a theme that gained notable traction in 2016 and should persist over the next several years as Chinese authorities seek sustainable economic growth.

Outlook: The main question looming over the U.S. outlook for the next two years relate to the policies of the new President. Will President Trump implement fiscal stimulus that will boost short-term growth and increase the Fed's pace of rate hikes? Or will tax reform be paid for with spending cuts, potentially resulting in some near-term economic drag?

A major tax reform package is likely to come from the new administration, which ideally could reduce many costly distortions and complexities in the current tax system, while improving incentives for domestic business investment and potentially raising productivity. But, the leading House GOP tax plan has a $3 trillion price tag over ten years. If funded by spending cuts, it would require total federal government spending – including increasingly costly entitlements like Social Security – to be cut by roughly 8% every year over the decade.

At the end of the day, to make it more palatable, any fiscal package may need to be lower than what financial markets currently expect. That would mean less stimulus, and depending on the mix of spending and tax cuts, potentially economic drag in the short run, presenting downside risks to the "Trump bump" on financial markets.

Index Performance as of 1/31/17

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-0.22	0.60	0.60	9.73	0.60	25.70	10.10	14.04
3000	-0.11	1.88	1.88	8.52	1.88	21.68	10.28	13.96
3000 Growth	0.01	3.23	3.23	7.31	3.23	17.87	10.44	13.81
1000 Value	-0.16	0.71	0.71	9.13	0.71	24.56	10.16	14.11
1000	-0.07	2.01	2.01	8.02	2.01	20.76	10.50	14.05
1000 Growth	0.02	3.37	3.37	6.93	3.37	17.19	10.82	13.93
Mid Cap Value	-0.39	1.68	1.68	9.96	1.68	29.09	10.68	14.98
Mid Cap	-0.27	2.41	2.41	9.16	2.41	24.66	9.50	13.91
Mid Cap Growth	-0.11	3.33	3.33	8.20	3.33	19.95	8.18	12.66
2000 Value	-0.91	-0.71	-0.71	17.11	-0.71	40.12	9.47	13.43
2000	-0.53	0.39	0.39	14.72	0.39	33.45	7.89	12.99
2000 Growth	-0.12	1.62	1.62	12.23	1.62	26.81	6.23	12.47
Standard & Poors								
S&P 500	-0.04	1.90	1.90	7.76	1.90	20.00	10.85	14.08
Consumer Disc	0.16	4.24	4.24	9.20	4.24	16.44	12.36	17.44
Consumer Staples	-0.61	1.65	1.65	0.37	1.65	6.41	11.76	13.43
Energy	-2.22	-3.60	-3.60	6.52	-3.60	26.54	-1.59	2.86
Financials	0.13	0.23	0.23	18.66	0.23	34.96	13.15	17.66
Health Care	1.95	2.25	2.25	5.00	2.25	7.65	9.71	16.60
Industrials	-0.59	1.41	1.41	10.95	1.41	27.81	10.54	14.37
Information Technology	-0.23	4.41	4.41	5.72	4.41	24.85	15.76	15.68
Materials	-1.01	4.64	4.64	11.95	4.64	36.44	7.81	9.20
Real Estate	-1.21	-0.06	-0.06	1.09	-0.06	8.27	11.01	10.04
Telecom Services	0.15	-2.48	-2.48	9.25	-2.48	12.77	9.81	11.70
Utilities	1.69	1.25	1.25	0.52	1.25	12.18	11.95	11.45
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.24	0.62	0.62	10.21	0.62	23.84	10.88	12.27
MSCI USA	-0.02	2.07	2.07	7.73	2.07	20.27	10.64	13.98
Wilshire 5000 (Full Cap)	-0.13	1.97	1.97	8.65	1.97	22.25	9.91	13.80
International Equity - Broad Market								
MSCI EAFE	0.42	2.90	2.90	4.30	2.90	12.01	0.71	6.03
MSCI EM	0.07	5.47	5.47	0.84	5.47	25.35	1.44	0.19
MSCI Frontier Markets	-0.15	6.66	6.66	7.61	6.66	17.51	-0.26	6.40
MSCI ACWI	0.11	2.73	2.73	5.75	2.73	17.89	5.49	8.71
MSCI ACWI Ex USA	0.27	3.54	3.54	3.73	3.54	16.06	0.92	4.36
MSCI AC Asia Ex Japan	0.71	6.20	6.20	1.03	6.20	21.19	3.92	3.95
International Equity - Country Region								
MSCI Brazil	-1.20	10.74	10.74	-0.84	10.74	98.36	1.24	-7.51
MSCI BRIC	0.52	6.33	6.33	1.24	6.33	32.35	2.79	-0.61
MSCI China	0.85	6.79	6.79	1.19	6.79	23.39	4.74	4.24
MSCI Europe	-0.06	2.08	2.08	5.09	2.08	8.82	-1.22	5.72
MSCI India	1.18	4.35	4.35	-3.51	4.35	10.44	7.53	3.67
MSCI Japan	1.67	3.72	3.72	2.20	3.72	15.67	5.12	8.00
MSCI EM Latin America	-0.74	7.61	7.61	-2.97	7.61	47.69	-1.97	-6.54
MSCI Russia	0.50	-0.27	-0.27	17.50	-0.27	55.61	-1.28	-2.92

Index Performance as of 1/31/17

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Fixed Income								
Barclays U.S. Aggregate	0.15	0.20	0.20	-2.04	0.20	1.45	2.59	2.09
BofAML 3-Month T-Bill	0.01	0.04	0.04	0.10	0.04	0.37	0.15	0.13
Barclays U.S. Gov't	0.14	0.23	0.23	-2.47	0.23	-0.77	1.89	1.18
Barclays U.S. Credit	0.15	0.34	0.34	-1.81	0.34	5.42	3.60	3.49
Barclays High Yield Corp.	0.28	1.45	1.45	2.83	1.45	20.73	4.92	7.03
Barclays Municipal	0.04	0.66	0.66	-1.96	0.66	-0.28	3.70	2.94
Barclays TIPS	0.27	0.84	0.84	-1.19	0.84	4.01	1.88	0.61
Barclays Gbl Agg Ex USD	0.16	1.88	1.88	-4.42	1.88	2.87	-2.24	-1.45
Barclays Global Aggregate	0.16	1.13	1.13	-3.34	1.13	2.34	-0.16	0.10
BofAML Emerg. Mkt. Cred	0.29	2.58	2.58	2.94	2.58	24.76	9.60	9.24
Alternative Investments								
Alerian MLP	1.18	4.89	4.89	12.02	4.89	39.50	-4.48	2.83
Bloomberg Commodity	-1.30	0.14	0.14	3.30	0.14	13.80	-11.30	-9.37
FTSE NAREIT Equity REIT	-1.66	0.11	0.11	3.05	0.11	12.39	11.89	10.63
S&P Global Natural Res.	-1.73	4.48	4.48	11.38	4.48	48.67	0.19	-0.97
S&P N. Amer Natural Res.	-2.05	-0.69	-0.69	7.89	-0.69	36.33	-2.38	0.10

Sources: Department of Commerce, Department of Labor, National Federation of Independent Business, National Association of Realtors.

Our professionals are always available to speak as financial authorities in the media.

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