Market Update and Outlook

July 2017

Second Quarter 2017 Recap

The second quarter of 2017 proved to be another strong quarter for diversified portfolios. U.S. equities built on their first quarter gains even though U.S. yields slumped, sending conflicting signals about anticipated growth and inflation. Not surprisingly, the Trump-led "reflation" trade, which led the market advance post-election through most of the first quarter, came to a screeching halt. During the second quarter, market leadership shifted to growth stocks (technology and biotech), which can grow earnings irrespective of the economy, and defensive stocks (healthcare and utilities), which are less economically sensitive and tend to pay attractive dividends.

> "Q2 2017 will be remembered as a period of exceptionally low equity volatility despite continued economic sluggishness and an increasingly fractured political environment"

Much like the first quarter of 2017, second quarter gains were led by equities. Europe led the pack with gains of 7.96%, followed closely by emerging markets (6.35%) and Japan (5.07%). Although not as stellar, the S&P 500 performed admirably with gains of 3.09%. In fixed income, the Bloomberg Barclays Aggregate Bond Index rose 1.45%, as 10-year yields dropped 9 bps to end the quarter at 2.30%, and the U.S. High Yield Index gained 2.06%, as credit spreads tightened marginally. Both the Wilshire Global REIT Index and Hedge Fund HFRI Index posted minimal gains, of 1.06% and 0.74%[1] respectively, trailing the MSCI All-World Index by over 300 bps. The Bloomberg Commodity Index declined -3.22%, led by a -9.01% decline in WTI Crude Oil prices, while gold was flat. Defying consensus, the USD Index continued its decline, losing -4.71% in the quarter and bringing its year-to-date decline to -6.44%, making it the worst performing major currency this year.

Equities continue to lead asset class gains year to date. On a total return basis, the Dow is now up 9.35%, and the S&P 500 is up 9.34% year to date. The Nasdaq is up 14.76%, which represents its best start in eight years. The small-cap Russell 2000 Index has lagged but still registered gains of 4.98%. Non-US equities registered notable gains as emerging markets are up 18.55%, Europe is up 16.39%, and Japan is up 9.82% year to date. Impressively, all but four of the 30 largest global stock markets by value have risen this year. Exhibit 1 highlights second quarter and year-to-date performance for select asset classes.

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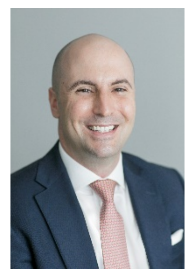

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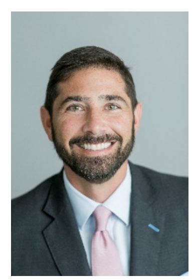

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[1] Hedge Fund HFRI Index performance data through May 31, 2017.

Perhaps the two biggest capital market stories of the quarter were the flattening yield curve and the sell-off in crude oil, which officially entered into a bear market in June with a decline of more than -20% from levels reached in February 2017. The yield spread between the 2-year and 10-year U.S. treasury yields ended the quarter at 91 basis points, a level not seen since before the election. The yield curve flattened 22 basis points in the quarter and has now flattened 49 basis points since late December. Of concern, a flattening yield curve is usually an indicator of an impending economic slowdown. Despite a 7% rally in the last week of the quarter, crude prices dropped -9% for the quarter and are down -14% on the year. For now, weak crude prices are being shrugged off as only an oversupply problem and not reflective of any broader demand issues. Regardless of the cause, we believe that if crude breaks convincingly below $40, it will have negative spillover effects into high yield bond prices, equity prices, and the industrial economy.

Exhibit 1: Asset Class Returns

Asset Class	2Q 2017 Total Return	2017 YTD Total Return	3 Year [(1)] Annualized
Cash	0.20%	0.30%	0.20%
Barclays U.S. Agg Index	1.45%	2.27%	2.48%
Municipal Bond Index	1.96%	3.57%	3.33%
U.S. High Yield Index	2.06%	5.06%	4.56%
Emerging Market Bonds (USD)	1.88%	5.46%	4.56%
Preferreds	2.72%	8.13%	6.09%
MSCI Alll-World Index	4.43%	11.81%	5.42%
Dow Jones Industrial Average	3.95%	9.35%	10.99%
S&P 500	3.09%	9.34%	9.59%
Nasdaq Composite	4.21%	14.76%	13.11%
Russell 2000	2.46%	4.98%	7.34%
Stoxx Europe 600 (USD)	7.96%	16.39%	0.71%
Japan - Nikkei Index (USD)	5.07%	9.82%	7.94%
MSCI Emerging Markets Index (USD)	6.35%	18.55%	1.41%
Hedge Funds - HFRI Index	0.74%	3.28%	2.88%
Wilshire Global REIT Index	1.06%	1.17%	2.19%
Bloomberg Commodity Index	-3.22%	-5.61%	-15.01%
WTI Crude Oil	-9.01%	-14.30%	-24.12%
Gold	0.05%	7.23%	-1.80%
USD Index	-4.71%	-6.44%	6.23%

(1) Q2 2014 - Q2 2017

*Source: Bloomberg

** Dividends Reinvested in the Index

On the political front, the Republicans have once again taken on the Obamacare fight, pushing back the timeline for any possible tax reform or fiscal stimulus. The bigger issue is that Trump has shown no ability to work with Democrats, or even people in his own party, including many in his administration. In our opinion, the likelihood of any substantive pro-growth legislation getting passed is dwindling tweet by tweet. On the positive side, the unwinding of the reflation trade suggests that expectations for pro-growth legislation are already very low, leaving room for a nice upside surprise. On the negative side, we worry that Trump may soon get frustrated with the lack of progress, and instead turn to his protectionist instincts by raising tariffs and launching trade wars. Some of these measures could be implemented by executive order without the need for congressional support.

Notable Events During Q2 2017

1) The Federal Reserve raised the fed funds target rate by a quarter point to 1% – 1.25% and reconfirmed its expectation for one more rate hike this year, and three more in each of the next two years. Importantly, the Federal Reserve also outlined its plan to begin gradually winding down its balance sheet later this year.
2) Pro-Europe Emmanuel Macron won the French presidential election convincingly with 66.1% of the popular vote. His mandate was strengthened when his centrist party, En Marche!, won a strong majority of seats in the legislative elections that followed five weeks later.
3) OPEC extended its production cut agreement for nine more months starting July 1, 2017. The market shrugged off the announcement as crude prices continued dropping and entered a bear market in June.
4) Moody's downgraded China's sovereign rating one notch to A1 from Aa3. The firm expects China's financial strength to weaken as it addresses its mounting debt problem and slower economic growth.
5) In a blow to Prime Minister Theresa May, Britain's Conservative Party lost its majority in parliament during June's snap election. The election results raise Brexit uncertainty, likely weakening Britain's negotiating position.

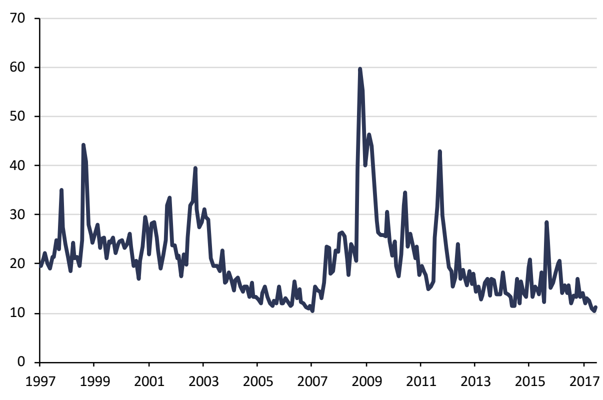
U.S. Equity

U.S. equities continued their march higher throughout the quarter, led by gains in health care, industrials, financials, and technology. The reported first quarter corporate earnings were very strong and lent support to rising equity prices. S&P 500 companies reported Q1 year-over-year revenue growth of 7% and earnings growth of 14%. The first quarter of 2017 posted the best quarterly increases in revenue and profit since the third quarter of 2011, giving investors and analysts reason to remain optimistic for the rest of the year. While earnings growth is expected to decelerate to high single digits through the remainder of the year, analysts have held back from cutting estimates. As a result, sentiment remains bullish and there is a strong demand for equities. Per Bloomberg estimates, the S&P 500 currently trades at a forward P/E of 18.6x, a multiple that exceeds its five and ten-year averages but remains in line with the forward multiple seen over the last few quarters.

Much like the first quarter of 2017, Q2 2017 will be remembered as a period of exceptionally low equity volatility despite continued economic sluggishness and an increasingly fractured political environment. The period has been so unusual that it makes sense to highlight some remarkable statistics:

- As per Bloomberg data, the VIX volatility index has only closed below 10 on a total of eleven days over the last 20 years, seven of which were in May and June 2017.
- A study by Bespoke Investment Group noted that the S&P 500's maximum drawdown this year has been 2.8%, which is the second smallest first-half drawdown in 89 years. [2]
- The average daily range for the S&P 500 in the second quarter 2017 was 0.3%, which represents the lowest reading in more than 50 years. [3]
- The more volatile Nasdaq Composite Index has not had a 5% pullback since before the 2016 election, the longest such span since 1989. [4]

Exhibit 3: Chicago Board Options Exchange Volatility Index



Source: Bloomberg

Exhibit 2: GICS Sector Returns

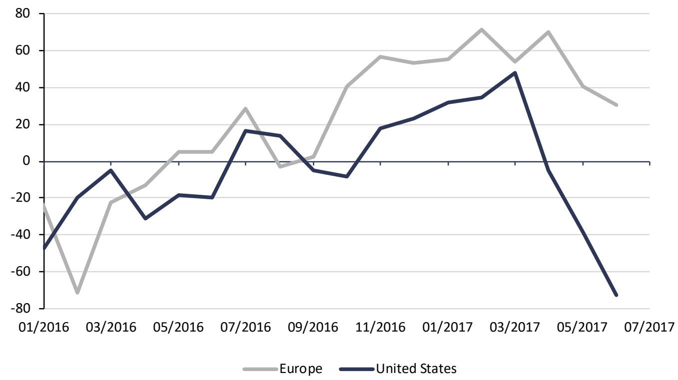
U.S. Sector	2Q 2017 % Return	YTD % Return
Health Care	7.10%	16.07%
Industrials	4.73%	9.51%
Financials	4.25%	6.88%
Information Technology	4.14%	17.23%
Materials	3.17%	9.21%
Real Estate	2.76%	6.40%
Consumer Discretionary	2.35%	11.00%
Utilities	2.21%	8.75%
Consumer Staples	1.57%	8.03%
Energy	-6.36%	-12.61%
Telecom	-6.97%	-10.74%

*Source: Bloomberg
**Dividends Reinvested in the Index

[2] Tan, Kopin. "Investors, Reasons to Beware the Second Half." Barron's. 24 June 2017. Web. 24 July 2017.
[3] Lahart, Justin. "If You Think Stocks Are Dull, Look at the Economy." *The Wall Street Journal*. Dow Jones & Company, 27 June 2017. Web. 27 June 2017.
[4] Dieterich, Chris. "Nasdaq Defies Gravity." The Wall Street Journal. Dow Jones & Company, 26 June 2017. Web. 26 June 2017.

While this lack of volatility can be partially explained by the synchronized nature of improving global economic growth, and strong corporate profits, it also speaks to the complacency that has set in across global asset classes. One important indicator that suggests to us that investors are being too complacent is the Citi Economic Surprise Index (Exhibit 4). After rising significantly late last year and throughout Q1 2017, the index took a sharp negative turn in April, and currently stands at levels not seen since 2011, when the U.S. was on the brink of a debt default. We pay close attention to the Citi Surprise Index because it has historically been a reliable leading indicator for U.S. equity prices.

Exhibit 4: Citi Economic Surprise Index



Source:Bloomberg

Also of concern, weak economic and inflation data has pushed 10-year bond yields down 9 basis points to 2.30% (but up sharply from a low for the quarter of 2.13%) and the yield curve (Exhibit 5) flattened to 91 basis points, a level not seen since before the election, when global deflationary fears were prevalent. Not surprisingly, forward inflation breakeven rates have collapsed and have only recently begun to stabilize (Exhibit 6).

Exhibit 5: Yield Premium – Spread between US 10-year Bond and US 2-year Bond

Source: Bloomberg

Currently, the stock market and the bond market are telling conflicting stories. The equity market is forecasting an increase in economic growth and an environment of strong earnings growth, while the bond market is indicating that inflation and growth will remain sluggish, creating headwinds for corporate earnings. These conflicting viewpoints are on a collision course; therefore, we forecast a period of increased volatility in Q3 2017 and likely an market pullback that is more consistent with historical averages.

Exhibit 6: Bloomberg Implied Five-Year Forward Inflation Rate

Source: Bloomberg

Despite an expected increase in volatility, we would look to be buyers of any significant pullback. Market internals remain very supportive, we do not yet see evidence of an impending recession, and, other than in "super-cap" tech and semiconductors, we do not yet see evidence of broad euphoria. We view the late quarter rotation out of growth and technology, into value and beaten up sectors, such as energy and brick-and-mortar retail, as a sign of a still healthy market. Falling correlations among U.S. stocks furthers this view. Looking ahead, our base case is for the S&P 500 to end the year between 2450 – 2500, representing marginal gains from current levels.

The U.S. Economy

The U.S. economy continues its path of slow but steady growth. After recent revisions, Q1 2017 GDP came in at 1.4%, led by a 10.4% increase in capital equipment spending which bodes well for future economic and earnings growth. We believe Q2 2017 GDP is tracking towards 2.3%, capturing the increase in growth from the seasonally slow first quarter. Given the lack of progress towards any substantive pro-growth legislation being passed, we are revising down our 2017 GDP forecast to a range of 2.2% - 2.5% from the 2.5% - 3% outlined at the beginning of the year. We still believe 2017 growth will be better than last year, due to the current friendlier business climate and the robust sentiment readings that should translate into continued business investment and sales.

This year marks the ninth year of the economic expansion, making it the third longest in the modern era. We believe that the low intensity of this economic recovery, along with wildly accommodative Fed policy, are the two primary reasons why this recovery has continued uninterrupted for so long. With the exception of an increasingly tight labor market, few economic imbalances have emerged during this expansionary period. That said, our economic indicator heat map shows that some key indicators have softened since Q1 2017 (Exhibit 7). Given the modest nature of the softening data, we are not ready to call it a trend; however, we continue to monitor the data releases closely. In the event the softening continues over the next few months, it would call into question our 2017 growth forecast and significantly raise the risk of a recession in 2018.

Exhibit 7: U.S. Economic Indicator Heat Map

	2016												2017					
Economic Indicator	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J
Annulized Core CPI (% Change)*	2.2	2.3	2.2	2.1	2.2	2.2	2.2	2.3	2.2	2.1	2.1	2.2	2.3	2.2	2.0	1.9	1.7	N/A
Annualized Auto Sales (Millions)	17.4	17.5	16.7	17.5	17.2	16.7	17.8	16.9	17.7	17.9	17.8	18.3	17.5	17.5	16.5	16.8	16.6	**16.4**
Consumer Confidence Index	97.8	94.0	96.1	94.7	92.4	97.4	96.7	101.8	103.5	100.8	109.4	113.3	111.6	116.1	124.9	119.4	117.6	**118.9**
Industrial Production	103.5	103.3	102.5	102.9	102.8	103.1	103.2	103.1	103.0	103.2	102.9	103.8	103.5	103.7	103.9	105.0	105.0	N/A
ISM PMI Manufacturing Index	48.6	49.7	51.7	50.7	51.0	52.8	52.3	49.4	51.7	52.0	53.5	54.5	56.0	57.7	57.2	54.8	54.9	**57.8**
PMI Service Index	53.2	49.7	51.3	52.8	51.3	51.4	51.4	51.0	52.3	54.8	54.6	53.9	55.6	53.8	52.8	53.1	53.6	**54.2**
Private Housing Starts (Thousands)	975	986	988	996	1009	1011	1028	1034	1033	1053	1046	1062	1071	1080	1074	1075	1067	N/A
Retail Sales Less Autos and Gas (Billions)	322.4	325.9	326.1	327.4	328.4	330.6	329.8	330.1	331.8	332.8	333.8	333.6	336.9	337.4	338.7	340.3	340.2	N/A
Employment Indicators																		
Jobless Claims (Thousands)	289	267	275	276	268	267	266	260	247	261	262	241	250	227	235	238	255	**248**
Non-Farm Payroll	126	237	225	153	43	297	291	176	249	124	164	155	216	232	50	174	138	N/A
Unemployment Rate	4.9	4.9	5.0	5.0	4.7	4.9	4.9	4.9	4.9	4.8	4.6	4.7	4.8	4.7	4.5	4.4	4.3	N/A

Source: Bloomberg

*Non-Seasonally Adjusted Data

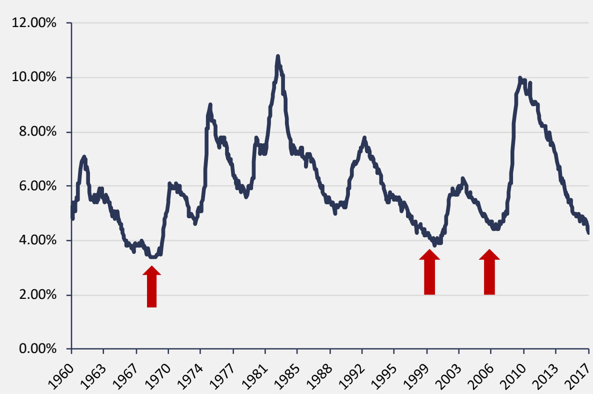
**Boxes labeled "N/A" indicate that data was not available at the time of publication

The unemployment rate has been this low only three other times in the last 50 years, all of which resulted in periods of economic troubles:

1) The period of low unemployment in the late 1960's gave way to the great inflation of the 1970's
2) Low unemployment of the late 1990's gave way to the tech and telecom bust of the early 2000's
3) The low unemployment of the mid-2000's gave way to the mortgage/housing crises and great recession of 2008.

We are therefore particularly mindful of today's job market tightness and fully support the Fed's normalization efforts.

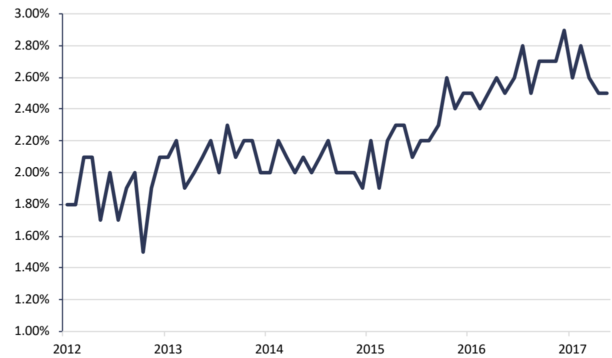
Exhibit 8: U.S. Unemployment Rates



Source: Bloomberg

As previously mentioned, the employment market remains very strong. Through May 2017, the unemployment rate stands at 4.3%, gains in monthly non-farm payrolls have averaged 162,000, and weekly jobless claims continue to hover at very low levels. One employment survey, the Job Openings and Labor Turnover Survey (JOLTS), strongly suggests that we are either at, or past, full employment. This survey indicates there are six million current jobs, leading to the highest percentage of job openings-to-unemployed since the overheated job market of 2000. This suggests that there is minimal slack in the market for qualified skill workers.

Exhibit 9: Average Hourly Earnings YoY% Growth



Source: Bloomberg

The big mystery remains why the tight labor market has not translated into stronger wage gains and higher inflation this year. The Phillips curve economic theory indicates a strong inverse correlation between the level of unemployment and the rate of inflation. Despite a strong drop in unemployment this year, average hourly earnings gains have unexpectedly dropped to 2.5% and CPI ex-food and energy has fallen to 1.7%. Some of the weakness in the data is transitory (e.g., wireless service pricing), while the combination of aging demographics and technological progress may be more deflationary than market participants had originally anticipated. However, despite near-term data that points to the contrary, we continue to give credence to the Phillips curve theory and thus believe there is significant upside risk to inflation.

"We continue to give credence to the Phillips curve theory and thus believe there is significant upside risk to inflation"

In summary, while we have slightly downgraded our view of U.S. economic growth for 2017, our base case is for the expansion to continue with the possibility of acceleration in the first half of next year, driven by the combination of modest tax cuts and an infrastructure package. Unfortunately, our hopes for significant tax reform have all but faded, but we do think the Republicans can coalesce around non-permanent tax cuts that will give the economy a short-term boost.

Monetary Policy

On June 14, 2017, the Fed concluded its latest two-day meeting and raised short-term interest rates for the fourth time since December 2015, taking the fed funds target rate to 1% - 1.25%. In its post-meeting statement and press conference, the Fed signaled continued confidence in the sustainability of the current economic recovery by guiding to seven more rate hikes by the end of 2019 (one more this year and three in each of the next two years) and outlining the process by which it will begin to gradually normalize its balance sheet later this year.

Most will recall that the Fed began its program of large scale asset purchases, dubbed Quantitative Easing ("QE"), back in September of 2008 to support the economy. The goal was to provide liquidity to the financial system and push long-term interest rates down, in order to foster economic growth and employment. Over the next six years and three different iterations of QE, the Fed's balance sheet grew from $900 billion to its current size of $4.5 trillion through its purchase of bonds in the open market. While the Fed has not been adding to the size of its balance sheet since the end of QE in October 2014, it has been reinvesting the proceeds of maturing securities to keep the size of its balance sheet stable. Balance sheet normalization is the process by which the Fed will gradually begin to let the balance sheet shrink by not reinvesting all of the proceeds of maturing securities. Although it is not yet clear what size the Fed would like the balance sheet to eventually get to, we estimate the level to be in the $2 - $2.5 trillion range.

> "We continue to believe there is upside risk to interest rates, and remain underweight duration despite middling economic growth and mild inflation readings"

Specifically, the Fed said that they will start by not reinvesting $10 billion (comprised of $6 billion in treasury securities and $4 billion in agency bonds and mortgage-backed securities) per month for a period of three months, and that figure would go up by $10 billion every quarter until a maximum of $50 billion (comprised of $30 billion in treasury securities and $20 billion in agency bonds and mortgage-backed securities) per month is reached. At its peak, the Fed will be reducing its balance sheet by $600 billion per year. We believe that the gradual unwind, which we anticipate will begin in September, may have significant implications for long-term U.S. rates. Many economists estimate that QE successfully brought down long-term interest rates by 1% - 1.5%. Taken in isolation, this new policy change should gradually push up long-term interest rates over time. We continue to believe there is upside risk to interest rates, and remain underweight duration despite middling economic growth and mild inflation readings.

While the Fed has not added to its balance sheet since late 2014, the Bank of Japan ("BOJ") and the European Central Bank ("ECB") are still engaging in large amounts of QE, leading to lower long-term interest rates in their respective economies. Although the BOJ has given no indication that it plans on stopping anytime soon, recent comments by ECB President Mario Draghi imply that the bank will gradually begin to reduce its stimulus programs in 2018 due to an improving European economy. As a reminder, the ECB currently purchases €60 billion of bonds each month, its key short-term interest rate is still set at zero, bank deposit rates are -0.40%, and the size of its balance sheet exceeds the Fed's.

There is no doubt that the BOJ's and ECB's bond purchases have contributed to the anchoring of global government bond yields at low levels, including those of the U.S. The U.S. bond market has benefited from global buyers attracted to the higher yields available in the U.S. We anticipate further upward pressure on global rates when the ECB begins tapering, which further substantiates our cautious view on duration. In perhaps a preview of what is to come, U.S. 10-year yields rose 15 bps late in the quarter in response to Mario Draghi's seemingly hawkish comments during a conference on June 27th.

Europe

The outlook for Europe is bright. The Eurozone economy continues to improve, as evidenced by a Q1 2017 annualized GDP reading of 2.3%, led by fixed investment and household consumption. This was Europe's strongest quarter since Q1 2015, and it marks the second straight quarter that Eurozone growth has exceeded that of the United States. The Q2 2017 GDP reading is projected to show further acceleration, supported by recent data points. The Eurozone manufacturing PMI continues its strong ascent and now sits at six year highs (Exhibit 10). Furthermore, lending to households and firms continues to increase, and the Eurozone has now marked sixteen consecutive quarters of growth, leading a broad range of consumer and business sentiment surveys to their highest levels in a decade.

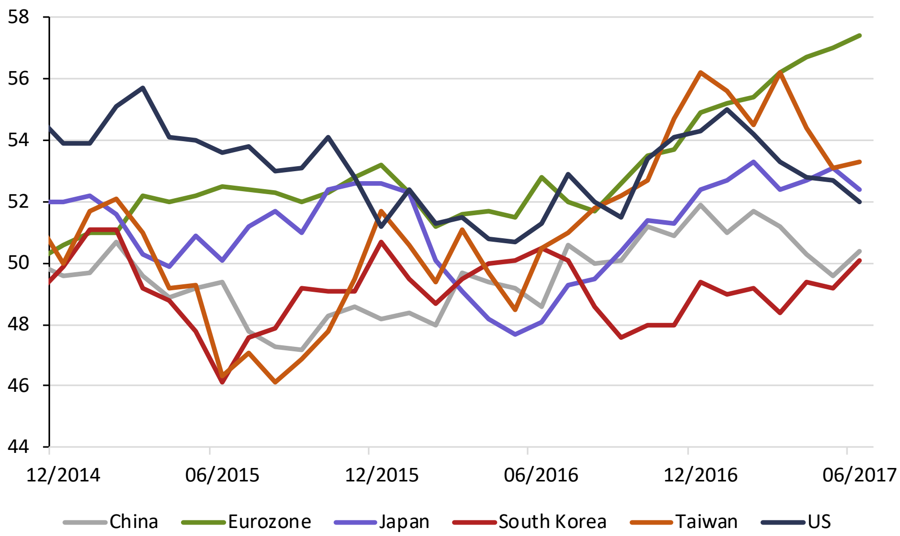
Political risks and uncertainty are on the decline after pro-European electoral victories in the Netherlands and France in the first half of the year. Europeans are gaining confidence in the reform process, resulting in the unleashing of pent-up demand for goods and investment. Although unemployment in the Eurozone continues to decline and now stands at an eight-year low of 9.3%, there remains plenty of slack in the labor market that can continue to fuel the recovery. With plenty of spare capacity in the economy as well, this improving economic performance looks sustainable for the next few years.

> "Europeans are gaining confidence in the reform process, resulting in the unleashing of pent-up demand for goods and investment."

Europe's improving economic performance is translating into strong first-half gains for its equity markets. The region's broad market index, the STOXX Europe 600, finished the quarter up 7.96% and is now up 16.39% for the year, led by strong earnings gains. First-quarter reported revenue is expected to be up 9.7%, and earnings are expected to increase by 15%. Importantly, with corporate margins still well below prior peaks and plenty of slack remaining in the economy, European companies have a good amount of operating leverage. With improving economic trends expected to continue and signs of political cohesion returning, we are forecasting double-digit earnings growth for both 2017 and 2018. Thus, we have added to European equities throughout the year, and we are now overweight Europe.

European markets began to soften a bit towards the end of the second quarter Mario Draghi, responding to firming economic data, suggested that the ECB will begin to gradually unwind its extraordinary stimulus efforts early next year. His comments further boosted the Euro, which had already strengthened during 2017. The EUR/USD ended the quarter at 1.142, a level not seen in over a year, and is now up 8.6% for the year. Furthermore, Draghi's comments sparked a global sell-off in government bonds, driving yields around the world up modestly from very low levels. For now, we see a strengthening Euro as the primary risk to short-term European equity prices. The more intermediate-term risks for European equity prices include rising bond yields, interest rates, an anticipated stimulus reduction, and the uncertainty of Brexit.

Exhibit 10: Global Manufacturing Purchasing Managers' Index



Source: Bloomberg

China and Emerging Markets

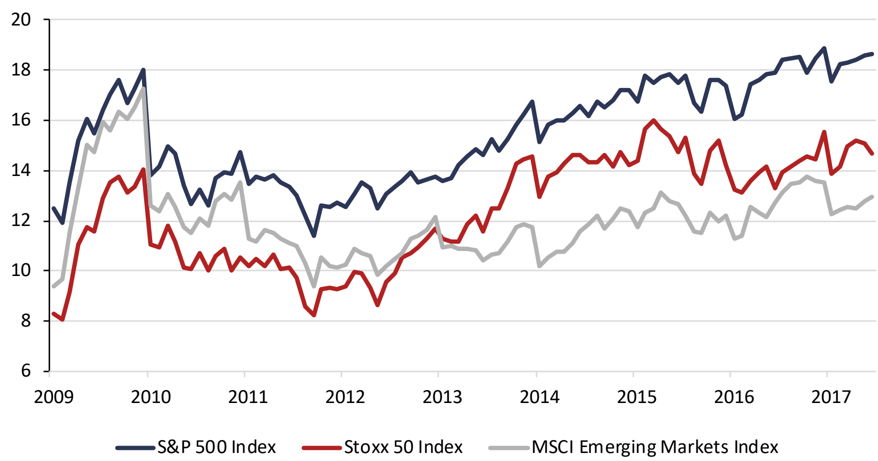
The Chinese economy has remained resilient this year despite efforts by the central bank to curb excessive lending by raising short-term interest rates in February and March of this year. China reported first-quarter GDP growth of 6.9%, which represented a slight increase from the prior quarter's 6.8% level. The Q2 2017 GDP reading is likely to decelerate only slightly to the 6.7% level. Chinese GDP growth, experienced this year, positively impacted global risk assets as many investors were expecting lower growth figures in the 6.0% range.

With the Communist Party National Congress[5] taking place this year, it is highly unlikely that the government will let growth dip much below the 6.5% level. Our concerns about China revolve around 2018 and beyond, as policy makers continue to try to reduce financial risk in the system. China's yield curve is now inverted as a result of the central bank's efforts earlier this year. The inverted yield curve may reflect investor pessimism about growth and inflation prospects. If China is resolute about curbing its debt problem, policy makers will have to keep short-term rates elevated, which will likely place significant downward pressure on economic growth as we head into 2018.

Led by strength in China, India, and Emerging Asia, the International Monetary Fund is forecasting that emerging market GDP growth will accelerate this year to 4.5%, from 4.1% in 2016. Improving emerging market economies and a relatively weak USD have driven emerging market equities up 18.55% year-to-date. Emerging markets have traded remarkably well despite persistent weakness in crude oil prices and the broader commodity complex. We came into the year overweight emerging market equities based on their attractive absolute and relative valuation (Exhibit 11), and thus far, our conviction has been rewarded. That said, a few risks could emerge during the second half of 2017, including continued weakness in crude prices, geopolitical instability, and any unexpected, strong gains in the US dollar.

> "Emerging markets have traded remarkably well despite persistent weakness in crude oil prices and the broader commodity complex.

Exhibit 11: Global Equity Valuations (BEst P/E Ratio)



Source: Bloomberg

*BEst P/E Ratio measures the 12 month forward looking P/E ratio using estimated 12 month EPS obtained through a consensus of bank analysts

[5] The National Congress of the Communist Party of China is a party congress held every five years and scheduled for the autumn of 2017.

2017 Outlook

The table below outlines our view at the start of the year and any update as of the end of Q2 2017

Category	Outlook 2017 View	Updated Commentary
U.S. Economy	We expect GDP growth of 2.5% - 3% with growth tilted more towards the latter half of the year.	We have revised down our 2017 GDP forecast to 2.2% - 2.5%.
Inflation	We expect persistently higher inflation readings as the year progresses.	Inflation readings turned sharply lower this quarter mainly driven by lower commodity and telecom service prices. We continue to believe that there is upside risk to inflation driven by a tight labor market.
Monetary Policy	We anticipate at least three rate hikes in 2017 are necessary, but question whether the Fed would deliver.	The Fed raised rates for the second time this year in June. We believe they will raise rates again in December and begin balance sheet normalization in September.
U.S. Dollar	We forecast mid-single digit gains for the year.	The US Dollar Index (DXY) continued to decline in Q2 2017 and is now down -6.44% YTD. We believe the DXY will stabilize and show modest gains in the second half of the year as 10-year yields rise.
U.S. 10-year Yield	We expect the 10-yr yield to end the year between 3% - 3.25% with most of the move coming in the second half of the year.	We have lowered our end of year forecast to 2.6% - 2.75%. We see strong upside risk-reward on rates from current levels.
U.S. Equities	We expect modest gains with risk to the upside. Gains will come mostly in the first half of the year.	As we had expected, U.S. equities rallied during the first half of the year. We anticipate the market will pull back this summer and then build modestly on its first half gains.
Volatility	We expect an uptick in volatility given the unconventional nature of the Trump Presidency and elevated valuations.	The first half of 2017 has been one of the least volatile periods on record. We expect a second half increase in volatility as valuations and Fed tightening begin to weigh on sentiment.

The table below outlines our current views on various asset class:

Asset Class / Sub-asset Class	Current View	Change
Cash & Cash Equivalents	**Overweight**	
Fixed Income	**Underweight**	
Core Fixed Income	Neutral	↑
High Yield	Underweight	
Emerging Market Bonds	Underweight	
Preferreds	Neutral	
Equities	**Overweight**	
U.S.	Overweight	
Europe	Overweight	↑
Japan	Underweight	
Emerging Markets	Overweight	
Private Equity	**Neutral**	
Hedge Funds	**Underweight**	
Real Estate	**Underweight**	
Commodities	**Underweight**	

Conclusion

Overall, the second quarter of 2017 and first half of the year have led to strong performance of diversified portfolios. Both global equities and bonds posted strong gains, a paradox that is unlikely to continue unabated in the face of continued Fed interest rate hikes and balance sheet normalization. Both major asset classes experienced late-quarter volatility and small losses, as European central banks (European Central Bank and Bank of England) began to hint that they will soon be joining the normalization party. While we believe that this is the right course of action for central banks to take, we also recognize that normalization will pull forward the timing of the next recession and bear market. We see this as a necessary evil to avoid a more destructive asset bubble that impairs the financial system and causes widespread losses. Fortunately, low inflation rates around the world provide central bankers room to maneuver and enables them to slowly work towards rate normalization.

As we look to the rest of 2017, we expect higher asset class volatility and a possible equity market correction, followed by a strong end to the year for equities and diversified portfolios. We have taken steps to slightly de-risk portfolios late in the second quarter. However, we believe that broad-based strength in the global economy will outweigh any concerns over central bank tightening given the fact that, for now, monetary policy remains broadly accommodative. We anticipate that in 2018, these normalization efforts may begin to dampen economic growth, placing significant pressure on Trump and the Republicans to deliver on their pro-growth agenda.

As always, we continue to monitor global economic and market conditions, and we remain available to discuss any of these topics further. On behalf of Element Pointe, thank you for your continued trust and confidence in our team. We hope you have an adventurous and relaxing summer!

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