SECOND QUARTER REVIEW

The U.S. economy appears to have gained some momentum in the second quarter on rising consumer spending and expanded manufacturing activity. The economy grew at a 1.4% annualized pace in the first quarter of the year, but is expected to have expanded by over 2.0% for the second quarter. Geopolitical risks are on the rise with an escalation of tension with North Korea, increased terrorism across Europe and the highly contentious and volatile political divide here in the U.S. Despite these concerns, equity market volatility remains low as the market seems to shrug off negative news and instead focus on the fundamentals of the economy and improving corporate earnings. The S&P 500 increased 2.9% for the quarter led by gains in the healthcare, finance and information technology sectors. The S&P 500 is up 9.2% for the first half of the year. Despite another rate increase from the Federal Reserve (Fed) this quarter, longer-term interest rates declined and are still below where they started the year.

THE OUTLOOK FOR THE SECOND HALF REMAINS POSITIVE

While our optimism for accelerated economic growth has waned, we still believe that the economy is healthy and can continue to grow at a moderate pace for the foreseeable future. The strength of the labor market, modestly rising wages, and increased household net worth should continue to drive consumer spending. It is not clear if business investment will increase materially without corporate tax reform, but regulatory relief is helping to keep business confidence near all-time highs. After several quarters of declining corporate earnings, we are seeing solid growth in corporate profitability that will help support ongoing moderate gains for the equity market. The Federal Reserve is continuing to normalize the Federal Funds rate and may soon begin reducing the size of its balance sheet. Neither of these actions is expected to materially impact the economy.

The Consumer Remains the Key to Moderate Economic Growth.

Consumer spending has been the primary driver of this current economic recovery and we expect that to continue. So far this year, spending has been somewhat uneven from month–to-month, but the overall positive trend remains intact. The housing market continues to stabilize and more recently we have seen rising demand for lower-priced homes as younger buyers look to purchase their first homes. The labor market remains very healthy. During the second quarter over a half a million new jobs were created, which when added to the first quarter gains, means that more than one million new jobs have been created this year. The unemployment rate has fallen to 4.4%, and more importantly, the labor force participation rate has risen as more people are choosing to look for work. Wages are slowly rising and we could see more upward pressure on wages as employers are finding it increasingly difficult to fill job openings. In addition, the number of people voluntarily leaving their current jobs is rising, which is another sign of labor market health.

Fiscal Policy is Slow to Materialize.

While our base case outlook for 2017 remains intact, we have become less optimistic about the prospects for a fiscal policy led economic expansion. Moving new legislation through Congress is never an easy task, but in today's highly polarized environment it seems even more difficult. The agenda set forth by the Republican majority was to move on healthcare reform, followed by tax reform. As we near the middle of summer with healthcare reform still to be completed, it is less likely that we will see tax reform implemented this year. In addition to these large agenda items, Congress will also have to deal with a budget for fiscal 2018 as well as a debt ceiling increase in the next few months. The Congressional calendar is working against any major changes being implemented until 2018. While we still believe that there is enough agreement to get some tax cuts and potential tax reform passed through Congress, it will likely be too late to impact 2017 economic growth. Given the delays in implementing tax reform, it is likely that any major infrastructure programs will also be pushed into 2018. However, on the positive side, we are seeing significant headway in reviewing, and where prudent, relaxing government regulation in ways that can spur growth.

With Interest Rate Normalization Underway the Fed Shifts to Normalizing the Balance Sheet.

As expected the Federal Reserve raised the federal funds rate target by 0.25% at the June 14th meeting to a range between 1.0% and 1.25%. This is the second increase in the Fed Funds rate this year and the fourth since the normalization process began in December of 2015. The Fed expects to raise rates at least one more time this year. Recent declines in inflation have raised some doubt about the pace of future rate hikes, but Fed officials seem to believe that inflation remains biased toward the upside over the longer term. At the June meeting, Fed committee members discussed the process of reducing the size of its balance sheet sometime this year. After multiple iterations of quantitative easing since the last recession, the amount of U.S. Treasury and mortgage securities held by the Fed is now about $4.4 trillion. Historically, the Fed balance sheet averaged around $700-800 billion. Up to this point, as securities matured, the Fed was reinvesting in new securities. The Fed's plan to reduce the size of the balance sheet will begin with allowing $6B in U.S. Treasury and $4B of mortgage bonds to mature and not be replaced. They intend to increase the amount by $10B every quarter until it reaches $50B a quarter. They expect to continue to allow the maturities to roll off at that pace until the balance sheet reaches a target of around $2.0-$2.5 trillion. While they have not set a date to begin the process of normalizing the balance sheet, it is expected to occur sometime in the second half of the year. At this measured pace, the program should not have a significant impact on interest rates.

The Global Economy is Experiencing Synchronized Acceleration.

We continue to see signs of a synchronized global economic expansion, supported by improving labor markets, increased manufacturing activity and accommodative central banks. Across Europe both consumer and business confidence have been rising as people react to waning political uncertainty, specifically following the completion of the elections in France and the U.K. Retail sales have been trending higher and manufacturing activity has accelerated to a 6-year high. While uncertainty remains in the U.K. as it begins to work on exiting the E.U., the services and manufacturing sectors continue to expand. So far the labor market has not shown any negative impact from Brexit. In Japan, the combination of aggressive central bank activity and fiscal stimulus has led to improvements in the economy. Prices are rising as increased activity is pressuring capacity and labor markets. Private sector job creation has reached its highest level since 2007.

IMPACT ON YOUR INVESTMENTS

With equity market volatility low and geopolitical risks on the rise, there is a possibility that unexpected events could cause short-term disruptions in the market. Although it is important to recognize the potential for such risks to lead to short-term emotional reactions, we do not believe at this point that they will impact the long-term fundamental outlook. Economic growth is on-track and we continue to see long-term value in the many areas of the equity market. We remain focused on identifying companies that can perform well in a moderately growing economy, and that will participate if we do get a sustainable move to higher growth. We expect that over the longer-term, interest rates will be biased toward higher levels. In the fixed income allocation we continue to focus on opportunities to generate incremental income while minimizing risk. We have exposure to the global economy through investments in large multi-national corporations. However, we may look to take a more direct approach to investing internationally to benefit from the improving global growth and the attractive valuation. We expect to stay close to fully-invested over the remainder of the year, but will seek opportunities to take profits in some companies that have performed well, even if that means holding some cash over the near-term.