THIRD QUARTER REVIEW

The U.S. economy grew at a 3.1% annual pace in the second quarter driven by a 3.3% gain in consumer spending and a 3.1% increase in business investment. The economy continued to gain momentum through the third quarter, as near record levels of business and consumer confidence led to increased activity. The outlook for growth in the second half of the year remains solid, although third quarter GDP will likely be negatively impacted by the hurricanes in Texas, Florida and Puerto Rico. Corporate earnings rose 6.3% in the second quarter, helping to drive positive gains for the equity markets. The S&P 500 rose 4.5% for the third quarter, and is up 14.2% YTD. We continue to see Information Technology companies outperform, as businesses increase investment to improve productivity and drive increased profitability. Geopolitical risks remain elevated across the world, but the financial markets are focused on the underlying performance of the economy and individual companies. As expected, the Federal Reserve (Fed) did not raise rates over the summer, but they appear on track for one more rate increase before the end of the year.

THE ECONOMIC REACCELERATION SUPPORTS AN OPTIMISTIC OUTLOOK

While we are seeing some relief on the regulatory front that is leading to improved business confidence, movement on the legislative agenda is almost non-existent. Despite this lack of fiscal stimulus, we have seen economic growth accelerate, because of continued consumer spending, increased business investment and increased global demand for goods and services. We expect stronger growth to continue through the rest of the year, however, over the near-term, economic data is likely to show some weakness related to the recent hurricanes. Those impacts should be short-term in nature and we are optimistic that growth will remain solid through the remainder of the year.

The Consumer Remains Healthy.

Once again, the consumer is the primary driver of economic growth and we expect that to continue. The unemployment rate has fallen to 4.2% and the underemployment rate has fallen to 8.3%, a 10-year low (the underemployment rate includes high skilled workers in lower paying positions, and part-time workers who prefer to be full-time). The U.S. economy has created 1.3 million new jobs this year and 1.8 million over the last 12 months. In September, we saw a decline in jobs for the first time since 2010, but the hurricanes had a significant impact on the employment data and we expect that going forward we will see a return to trend. As the labor market tightens, wages are increasing, leading to gains in consumer disposable income. Consumer confidence remains near the highest levels in 16-years. These factors should keep consumer spending strong and provide a solid base for economic growth going forward.

Despite the Political Divide in Washington, We Remain Optimistic on Tax Cuts.

Monetary policy has been a key factor during the economic recovery, but at this point in the cycle we are looking for fiscal policy to drive additional growth. While we have been disappointed with the inability of Congress to pass legislation to this point, we still believe that we will see some form of tax package passed early next year. The likelihood of major tax reform versus tax cuts has declined, but in either case the economy will benefit. While it is very difficult to predict what a final tax package will look like, we do believe that at a minimum, it will include a reduction in the corporate tax rate, some type of lowered tax rate for cash held overseas and reductions in individual tax rates for the middle class.

A Stable Energy Market Supports U.S. Economic Growth.

Global supply and demand for oil is much more balanced than it has been in years. Global demand continues to increase and could accelerate further given the improving outlook for global growth. On the supply side, we have seen OPEC stick with its previously announced production cuts. Most OPEC countries have cut production versus last year. The exceptions are Iran, Iraq and Libya, where production is coming back on-line following major disruptions. During the downturn in oil prices, energy companies made significant changes to their cost structure that will enable many of them to be profitable at much lower prices that in the past. The increase in U.S. based production has offset some of the production cuts from OPEC, but has filled the gap of increasing demand. Increased U.S. production is also providing another positive contribution to U.S. economic growth.

Will there be Changes at the Federal Reserve?

The Fed is nearly 2-years into its strategy to normalize interest rates. To date, the Fed has raised the Federal Funds rate by 1.0% from range of 0.00% to 0.25% to the current range of 1.00% to 1.25%. More recently the Fed announced its plan to begin to reduce the size of its balance sheet. Over the course of several quantitative easing programs, the Fed purchased U.S. Treasury, Agency and mortgage securities increasing the size of the balance sheet from about $800 million to $4.5 trillion. Beginning this quarter, the Fed will start to reduce its bond holdings at what is expected to be a slow and measured pace. As with the process of normalizing interest rates, we expect that the Fed will continue to be very transparent with its plans, and measured in its actions. With Federal Reserve Chairwoman Janet Yellen's term ending in February of 2018, leadership uncertainty could lead to some volatility in the short run. However, no matter the outcome, it is likely that the Fed will remain on the current path of moderate normalization as long as economic growth remains solid and inflation is moderate.

GLOBAL ECONOMIC GROWTH LOOKS SOLID

For the first time in many years, we are seeing a synchronized global economic expansion. This has been driven in part by weaker foreign currencies and accommodative central banks. We have seen solid gains in manufacturing activity across Europe, Japan and China driven by increased demand for products. As with the U.S., both consumer and business confidence are rising which should help drive future demand. International equity markets have underperformed U.S. markets by a wide margin over the last 6-years. This underperformance was driven by many factors, including weaker economic growth, political uncertainty and deflationary pressures. As these headwinds subside, and corporate profits improve, we would expect that international markets will start to perform better. The improved economic growth and increased global trade activity will benefit not only international corporations, but also the U.S. based multi-national corporations utilized in our equity strategies.

IMPACT ON YOUR INVESTMENTS

The fundamentals of the economy remain strong, and we now believe that U.S. growth will exceed our base case outlook, even without fiscal stimulus. Equity markets have performed well this year and the gains have been driven by the improved economic outlook and the increase in corporate profits. Regulatory reform, along with anticipated tax cut packages next year should provide continued up-side to the market. In this environment, we intend to stay close to fully-invested and have positioned the portfolio to benefit from the improved global outlook. As short-term interest rates rise, we continue to invest in high-quality corporate bonds in the fixed income allocation. While we continue to monitor the rising geopolitical risks, we remain focused on the long-term fundamentals of the economy and the companies in your portfolio.

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