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ECONOMIC UPDATE

4th Quarter Review – Outlook

It was a remarkably calm year for global financial markets with most equity indices posting gains over the last three months of the year. In fact, many major indices finished near record or multi-year highs amid a global economy gaining upward momentum. The faster pace of economic growth seen during the third quarter continued throughout the fourth quarter while the U.S. Federal Reserve lifted its key interest rate for the third time in 2017. Earnings growth slowed a little during the third quarter, but exceeded expectations. And with U.S. tax reform passing late in the period, earnings and economic growth in the U.S. will likely see a near-term boost. Volatility across asset classes remained very low. For instance, the S&P 500 Index finished 2017 without experiencing a pullback of at least 3% while turning in its 14-straight month of positive total returns. Such a long stretch without a material decline is a feat not seen in the S&P 500's 90-year history. Market sentiment remained relatively high while valuations were also elevated as the year ended.

Unlike the third quarter, fixed income markets suffered a little during the fourth quarter as faster economic growth and the prospect for more interest rate hikes from the Fed began to sink in. The largest moves were at the short-end of the curve with the 2-year U.S. Treasury rising 42 basis points to 1.89%, its highest level since February 2008. Meanwhile, the 10-year U.S. Treasury yield rose from 2.33% to 2.40%, a much more modest increase. The flattening of the yield curve caused some concerns that the probability of a recession unfolding over the near term is rising, but tame inflation and continued central bank bond purchases outside of the U.S. may be keeping downward pressure on long-term rates in the U.S., which remain among the highest in the world. With the Fed now slowly unwinding its balance sheet, we might finally begin to see an upward move in long-term interest rates. The lack of a material move at the long-end of the curve kept returns for longer maturities from falling into negative territory during the quarter. Short-term U.S. Treasuries lost 0.3% during the period, but long-term U.S. Treasuries added 2.4%. For all of 2017, returns for both short- and long-term U.S. Treasuries were 0.4% and 8.5%, respectively. The more economically sensitive segments of fixed income posted lower returns than earlier in the year. Corporate credit gained only 1.4% while high yield bonds returned only 0.5% during the fourth quarter. For the year, investment-grade corporate credit gained 6.4% and high yield returned 7.5%. Spreads, or the difference between corporate bond yields and U.S. Treasury yields remained tight, a sign of elevated valuations. Couple this with the prospect for higher interest rates and corporate credit, returns could struggle despite a low risk of a recession unfolding over the near term.

On the equity side, stock prices throughout the globe continued to benefit from the healthy economic backdrop of synchronized global growth. In the U.S., tax reform passing late in the period provided a slight boost to sentiment and helped to keep a bid in U.S. stock prices despite concerns over elevated valuations and abnormally low volatility. U.S. large-cap stocks were among the best performing asset classes during the fourth quarter, adding 6.6% (up 21.8% in 2017). Small-cap stocks gained only 3.3% during the period (up 14.7% in 2017), while growth's dominance over value continued. In fact, 2017 saw one of the largest disparities between the performance of growth (+29.6%) and value stocks (+13.2%) in history. Outside of the U.S., emerging markets continued their recent leadership, gaining 7.5% in U.S. dollar terms during the quarter and 37.8% on the year. Developed international markets ended the quarter 4.2% higher (25.0% in 2017) as focus remained on the European Central Bank's continued bond purchases and the regions strengthening economic data. The U.S. dollar lost a little ground during the fourth quarter, turning in its worst year since 2007. This provided a tailwind for U.S. investors holding non-U.S. asset classes for the year. It also helped commodity prices. A broad commodity index returned 9.9% in the last three months of the year as oil prices surged above $60 for the first time since mid-2015. For all of 2017, commodities as a whole gained only 5.8%. Real Estate Investment Trusts (REITs) lagged during the quarter, posting a 2.4% gain (up 9.3% in 2017).

As we look across key sectors of the U.S. economy, we continue to see a healthy backdrop for risk assets. Manufacturing is still quite healthy. The housing market saw solid improvement during the quarter while businesses and consumers remain very confident. Labor markets are very tight with unemployment at 17-year lows, but wage pressures remain somewhat subdued. This has helped to keep inflation somewhat in check and the Fed puzzled, but cautious in raising

interest rates. The U.S. economy grew at an annualized rate of 3.0% in the third quarter, its second consecutive quarter of 3% plus growth, and monthly data during the period suggests the fourth quarter could see similar growth. Looking ahead, we believe the economic backdrop will continue to support risk assets well into the coming year, but the risks may begin to rise as the year progresses. At a minimum, we would expect volatility across asset classes to pick up in 2018.

While equity-market returns in 2018 may not be as strong as they were this past year, the recently passed tax reform could serve as a key near-term stimulus for both the economy and equity prices. It also could result in a more aggressive Fed. A key risk in our view is the potential for a monetary policy error and/or a faster pace of interest rate increases from the Fed than currently expected. We had three rate hikes in 2017 and the Fed sees three more as "appropriate" in 2018, but the market remains unconvinced. The Fed also took very small steps in unwinding its balance sheet during the fourth quarter. This appeared to have little impact on long-term interest rates, which remain relatively low despite a pick-up in economic growth. The pace of unwinding is scheduled to increase as the year progresses and we believe the likelihood of four more rate hikes is high. This will likely put upward pressure on interest rates and create somewhat of a headwind for equity returns in 2018. But the strong U.S. and global economies, coupled with faster earnings growth could help equity markets maintain their upward bias.

Another key risk is higher inflation than currently expected, as well as the potential for earnings to disappoint. Elevated valuations, particularly in the U.S., leaves little room for error in our view. As we mentioned last quarter and in our economic presentation in December, further equity-market gains would likely need to come from accelerating economic and earnings growth. We might see this over the first half of 2018. Lastly, our economic indicators suggest to us a low probability of a recession unfolding over the next several months while our technical indicators have yet to suggest to us that an end to the bull market is imminent. As a result, we remain cautiously optimistic and continue to favor risk assets. The prospect for higher interest rates makes bonds less appealing in our view. Therefore, we continued to hold an overweight in equities in our dynamic positioning at year end. Valuations outside of the U.S are more appealing to us, so we maintained our tilt towards international stocks at year end as well. As always, we continue to monitor the environment for potential risks while looking for opportunities to adjust dynamic positioning accordingly. We believe having flexibility to adjust portfolio exposures through our Dynamic Allocation Strategy will help us better manage risk and deliver better risk-adjusted performance over the long term. We think this approach combined with a comprehensive financial plan improves our ability to help our clients achieve long-term financial success.

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