Second Quarter 2017

Economic Commentary

Economic indicators have lagged optimistic expectations but continue to trend positively. The Fed has continued tightening monetary policy by raising the Fed Funds rate and outlining their plan for the normalization of the balance sheet. The jobs market continues to show its strength, creating ample jobs to drive the unemployment rate down to 4.3 percent, the lowest reading since 2001. As the jobs market reaches full employment, it appears the skills gap may be growing as job openings are increasing while hirings moderate. The lower unemployment rate and increasing number of job openings should put upward pressure on wages, pushing inflation from the current 1.4 percent, as measured by Personal Consumption Expenditures (PCE), towards the Fed's 2 percent target.

The Federal Reserve met twice during the second quarter and continued their steady pace of increasing the Fed Funds rate, doing so for the third time since December. In addition to the rate hike, the committee also released details regarding the normalization of the balance sheet. The outline illustrated that the committee plans to begin tapering the reinvestment of principal and interest slowly, starting in late 2017. The most recent dot plot also indicated that members opinions have remained steady, forecasting one additional rate increase this year and three in 2018.

Home prices continue to remain resilient, driven largely by the record low inventory levels and high turnover ratios. Both new and existing home sales also continue to show growth due to limited inventory while housing starts and building permits have slowed, putting further pressure on inventory levels. Credit continues to remain tight, primarily due to down payment requirements, lessening the impact that rising rates will have on the housing market.

The final estimate of U.S. GDP growth for the first quarter was revised up to 1.4 percent from an initial estimate of 0.7 percent with positive contributions from fixed investment and exports while government spending detracted. After lagging behind consumer related indicators, corporations are experiencing positive momentum as well. Both revenues and earnings have consistently surprised to the upside and grew at 7.8 and 14.7 percent the previous quarter, respectively. The Institute for Supply Management's (ISM) survey of manufacturers also surprised to the upside after two months of declines. The improvement was broad based and is now at the highest level since 2011, signaling optimism across manufacturers.

Fixed Income Commentary

Summer is here and from all accounts it appears that fixed income investors are staying cool thanks in part to the not-too-hot and not-too-cold economic environment. That's not to say there isn't concern about recent weakness in the housing and retail sectors, but demand for yield and the lack of alternatives around the globe continues to drive investors to the U.S. markets.

Interest rates spent much of the quarter drifting lower as mixed economic data, weaker energy prices, and lower inflation indicators left investors less concerned about rising rates and negative returns. Rates, as measured by the 10-year U.S. Treasury yield, declined most of the quarter and reached lows for the year in mid-June after which they rebound somewhat to end the quarter at 2.31 percent.

The decline in rates, the flattening of the yield curve, and a decrease of risk premiums all led to solid returns for fixed income assets during the quarter. The Bloomberg Barclay's Aggregate index, a broad measure of the investment grade U.S. fixed income markets, returned 1.45 percent for the quarter and is up 2.27 percent for the year. Most spread related sectors, such as corporate and municipal bonds, outperformed similar duration U.S. Treasury securities for the quarter as risk premiums declined given strong investor demand. While commercial mortgage backed securities (MBS) outperformed, U.S. Agency MBS underperformed as the Federal Reserve announced initial plans to reduce their holdings of these securities starting later this year or next year.

Within the corporate sector, financials and communications sectors outperformed. The retail and energy sectors were among the weakest sectors. Energy prices declined for most of the quarter putting pressure on those companies sensitive to oil prices. Corporate sector spreads or risk premiums are at multi-year lows given the strong demand from overseas and domestic market participants. The municipal sector also experienced strong performance despite uncertainty regarding U.S. fiscal and tax policies.

The outlook for interest rates and fixed income markets will be heavily influenced by whether the recent economic sluggishness continues or if the data shows improvement through the summer. We believe the latter is more likely which will gradually pressure interest rates higher for the second half of 2017. A few themes worth watching are how and when the Fed reduces their $4.5 trillion portfolio of securities and if the markets can regain confidence that Washington D.C. can work and get some positive reform completed.

Equity Commentary

For the second quarter of 2017, the S&P 500 returned 3.1 percent. We have now had seven quarters in a row of positive returns. Stronger and more consistent economic data and positive earnings growth during the quarter drove equity market returns.

The earnings rebound continued during the first quarter, with the S&P 500 now having three consecutive quarters of earnings growth. Telecommunications was the only sector to report negative earnings. Year over year, expectations are that earnings growth will be better than 10 percent.

Given the tight labor market, the Federal Reserve raised rates again in June. U.S. equities historically have been resilient to rising interest rates, so we continue to favor high quality stocks – stocks of companies with strong earnings, cash flow, and balance sheets. We prefer multiple potential sources of total return, including dividends, long term appreciation, or both.

Similar to the U.S., in Europe, economic fundamentals have grown in importance relative to the political stories. The MSCI EAFE outperformed the S&P 500 during the quarter (6.1 vs. 3.1 percent). The French elections resulted in pro-E.U. businessman Emmanuel Macron being elected, along with a majority in parliament. This helps reduce political uncertainty in Europe. Meanwhile, Eurozone consumer confidence is at its highest level since 2001. Valuations and dividend yields remain favorable vs. U.S. stocks.

For the second quarter, the MSCI Emerging Markets index returned about 6.3 percent. Similar to both the U.S. and developed markets, emerging markets are benefiting from improving fundamentals as well as from the "reflation trade" in developed markets. The weaker U.S. dollar provided a tailwind for non-U.S. equities.

Volatility in the second quarter, as measured by VIX, experienced some higher spikes but finished the quarter lower overall. Although political noise and central banks led the headlines, positive economic news abounded. We have begun to see an uptick in volatility and would expect that trend to continue. We continue to remain cautiously optimistic for equity returns due to firming equity fundamentals, and we are also aware of elevated valuations and remain vigilant in our stock selection.

Equity Income

The Health Care sector was the strongest performing sector of the index during the quarter on optimism of reform and innovation. Energy was the weakest performing sector of the index, primarily due to oil and natural gas price declines amidst continuing supply pressures.

During the quarter, the Equity Income portfolio increased 1.1 percent, performing in line with the index. Stock selection was the biggest driver of relative performance. Information Technology was the strongest performing sector relative to the index led primarily by an electronic equipment company who reported positive earnings. Our Consumer Staples holdings also performed relatively well, led by a grocer that was an acquisition target during the quarter.

In contrast, the Energy sector underperformed relative to the index due to a natural gas company that missed on earnings due to lower export margins and a dilutive share offering. The Industrials sector also detracted from performance. We continue to hold the Energy position due to our view on their long term growth potential.

Large Cap Diversified

The Health Care sector was the strongest performing sector of the index during the quarter on optimism of reform and innovation. Telecommunications was the weakest performing sector of the index, primarily due to poor earnings.

During the quarter, the Large Cap Diversified portfolio increased 5.6 percent, outperforming the index by 2.5 percent. Stock selection was the biggest driver of relative performance. For the portfolio, Information Technology was the strongest performing sector relative to the index. This sector was led by a semiconductor company that reported positive earnings. Our Consumer Staples holdings also performed relatively well, led by a grocer that was an acquisition target during the quarter.

In contrast, the Industrials sector underperformed relative to the index, led primarily by a shipbuilder that had a slight earnings miss. The Financials sector also underperformed relative to the index, primarily due to an underweight in large banks. We continue to hold the Industrial position due to our view on the long term growth potential.

Small Cap

The Telecommunications sector was the strongest performing sector of the index during the quarter as one of the companies led the small sector as the result of an acquisition announcement. Energy was the weakest performing sector of the index, primarily due to oil and natural gas price declines amidst continuing supply pressures.

During the quarter, the Small Cap portfolio increased 1.4 percent. Stock selection was the biggest driver of relative performance. Consumer Discretionary was the strongest performing sector relative to the index, led by a retail food products company. This company has reported strong earnings and recently sold its restaurant segment as the restaurant business suffers. The Energy sector also performed relatively well.

In contrast, the Health Care sector underperformed relative to the index, led primarily by a biopharmaceutical company that missed on earnings. The Information Technology sector also underperformed relative to the index, due to a manufacturer of automotive technology components that missed on earnings. We continue to hold both positions due to our view on their long term growth potential.

Past performance does not guarantee future results. The analysis above is subject to changes in economic and market conditions. Future results may vary. Also, this document is not a recommendation and is not for external distribution of any kind. Information contained in this report should be accompanied by the composite sheet.