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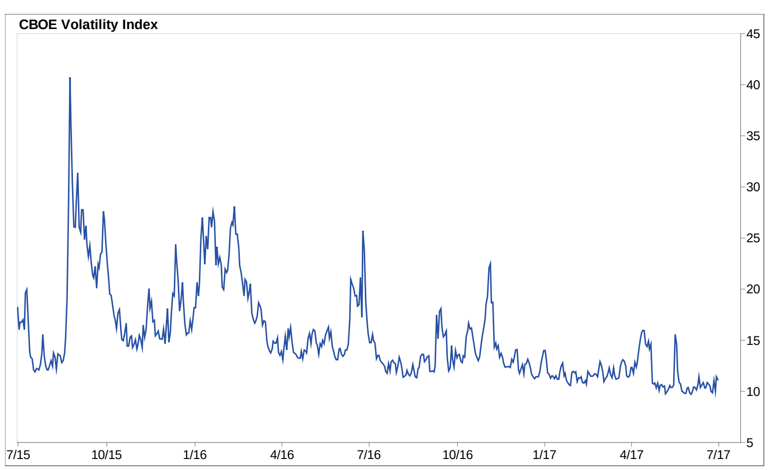
JUNE 30, 2017 INVESTMENT MARKET COMMENTARY

Stocks advanced in the most recent quarter, even as economic and geopolitical uncertainty grew, and market friendly government policies have yet to materialize. Bond returns were slightly positive due to a modest decline in interest rates. In the US, equity investors favored large companies over small, 'growth' over 'value', and low over high quality. In fact, most of the characteristics of last year's investment landscape have been turned upside down. From an industry perspective, health care and technology have led the market higher, while energy has fallen due to sagging oil prices. International equities have also performed well as there appears to be light at the end of what has been a long, dark tunnel for many foreign economies.

The Message of the Market

At times, investment markets tell an understandable tale. This is not one of those moments as uncertainty exists seemingly everywhere. For example, short-term interest rates have moved higher as the Federal Reserve has responded to improving corporate earnings and more buoyant sentiment about future economic conditions; yet longer term yields remain relatively low as subdued inflation persists. Typically, a narrowing spread between short and long-term yields is indicative of a slowing economy, as indeed some reports suggest. This contradicts the central banks expectation of renewed economic vitality. Uncertainty also exists outside of the financial world, as evidenced by a dysfunctional US political scene, the most powerful nations in the Middle East escalating already serious tensions, and North Korea brashly demonstrating its missile capabilities.

Despite these and other domestic and international challenges, stock market volatility recently hit multi-year lows and the major stock indices are near all-time highs. The chart below of the VIX, a key measure of market volatility and also known as the 'fear gauge', illustrates that volatility is muted and has steadily declined over the past year. **With this 'bull market' in its 9th year, the lack of meaningful volatility suggests a sense of investor complacency in what is clearly an uneven world. Coupled with elevated valuations, this environment almost seems too good to be true, and investors should be prepared for a more disruptive phase before too long.**



Identifying market tops is only possible in hindsight, but expecting a healthy correction is prudent. The obvious elephant in the room is timing. Investment trends often grow larger and last longer than most expect, and this one may continue to defy gravity for a time. Indeed, there is plenty of fire power available to fuel higher prices, including from central banks around the globe, some of which began buying stocks once bond yields declined to near zero. The world's largest central banks are on pace to purchase $3.5 trillion in assets this year, almost twice the amount of recent years; in fact, the Swiss National Bank is now one of the world's ten largest equity investors. This may provide comfort to some, as monetary authorities can provide support to financial markets by printing money to buy securities, but what happens if/when they stop, or worse, become sellers?

All of this is to say that the crystal ball is quite murky. There are reasons for caution short term, but we remain comfortable owning high quality securities, both bonds and stocks, including industry leading companies that pay growing dividends and compete successfully in good times and bad.

What We Are Watching

There are always crosscurrents with respect to the investment backdrop, with both positive and negative indicators. Some market prognosticators are issuing dire forecasts, while others say full steam ahead. **We tend to be more measured on the outlook, always vigilant to identify potential risk, but equally on alert with regard to seeking compelling value and opportunity.** In this time of seemingly heightened and potentially market moving contradictions, there are a number of factors that bear observation, including:

- After a lengthy period of stagnation, corporate earnings have turned up in 2017. The current pace of growth is supportive of stocks, but any deterioration of actual profitability or future expectations would provide a catalyst for a market downdraft;

- The Federal Reserve has raised short-term interest rates 3 times over the past 18 months, and the yield curve is flattening. While in the near term there is little danger of an inverted curve (short term yields higher than long term yields), typically a precursor to a recession, should monetary policy be perceived as too aggressive in the face of tepid economic growth, stock prices would be vulnerable;

- Much of this year's market advance has been driven by expectations of economic, tax and regulatory reform coming from Washington. If those initiatives fail to materialize, and growth does not accelerate, the stock market is likely ahead of itself. This does not mean a 'bear' market is inevitable, just that a potential pullback becomes more likely.

While it is clear that many headwinds exist, and this aged bull probably needs a rest, we remain hopeful that the 'normalization' process – proper interest rate levels, less Federal Reserve and government involvement, more focus on company fundamentals – will continue. This transition will promote a healthier economic environment, as well as a more positive landscape for investment markets over time.