EXECUTIVE SUMMARY

Our overall views are that the glass remains half full with respect to asset returns for the rest of 2017, but asset markets may shift to “show me” mode and the need to justify valuations across certain investment categories. Riskier asset prices have had a strong start to the year, continuing momentum from fourth quarter 2016 on the back of anticipated pro-growth policies from the new administration in the United States and largely improved data out of Europe and Asia. Our bias has been to emphasize growth within portfolio guidance, and our proprietary data suggests global growth momentum will continue.

Valuations of domestic stocks and high yield bonds are at the upper bounds of historical experience and while we do not believe valuation is a catalyst, price levels leave little room for surprises. Potential surprises not currently priced into markets include significant trade or tax policy delays, the U.S. Federal Reserve (Fed) adopting a more aggressive stance in raising interest rates or shortfalls in growth.

Our base case is to continue to emphasize growth, but to favor some of the historically undervalued asset classes that are demonstrating fundamental improvements, such as non-U.S. equities. We need to respect the likelihood of a pause in riskier asset class performance due to the aforementioned and other potential surprises, but we do expect asset prices to migrate higher over the balance of 2017.

Commentary provided by:
Eric J. Freedman — Chief Investment Officer

GLOBAL ECONOMIC VIEWS

Policy remains the key driver of change for the global economy in 2017. Fed rate increases and potential changes to U.S. fiscal policies are key risks to our modest U.S. outlook. Elections and Brexit are risks to our slow growth outlook in Europe, and fiscal and monetary policy maneuvers in China are key questions ahead of this fall’s Communist Party Congress. Modest Fed rate increases are unlikely to derail the U.S. slow growth trajectory and fiscal policy changes are likely to be too late in the year to change the 2017 story.

• We expect little change in the pattern of 2 percent average U.S. growth for the next year or so. Consumer spending remains the key driver, supported by payroll and wage growth. Business spending will be a swing factor for this year, with policy changes a key element. Inflation pressures remain modest, although levels should reach and exceed Fed targets.
• Policy mistakes remain the primary risk to the U.S. economy. An inflation surge could lead the Fed to accelerate interest rate increases, a potential dampener on economic activity. If tax cuts and infrastructure spending disappoint market expectations, we could see economic growth soften.

2016 European growth surprised market watchers, beating U.S. growth. Economic activity is likely to maintain its slow trajectory.

• An aging population and slowing immigration appear to be limiting potential European growth. Bank deleveraging, due to international regulations, is also a headwind. Despite downside risks, the European economy appears to be in recovery, supported by meaningful monetary policy measures.
Brexit and national elections are major risk factors for the European region. Brexit and the resulting negotiations will likely remain a headline risk for the next two years, although that appears to be mostly contained within England, with some implications to sectors such as financial services. Elections in Italy, France and Germany also provide some room for economic uncertainty given the rise of Eurosceptic parties.

The tailwind of massive monetary stimulus and structural reforms should help growth and inflation remain positive but slow in 2017.

2017 appears to be another year of moderating headline gross domestic product (GDP) growth in China. Policy actions will likely support the economy until the longer-term direction becomes clear this fall through the 19th National Congress of the Communist Party of China.

We believe authorities have sufficient tools in the near term to manage economic risks of high debt levels and risks from currency outflows.

Commentary provided by:
Robert L. Haworth, CFA – Senior Investment Strategist

EQUITY MARKETS

Our outlook for equities remains favorable, with a cautious near-term bias following strong first quarter performance. Relatively low interest rates, generally benign inflation and expectations for higher earnings present a favorable backdrop for equities.

Fed-driven liquidity, multiple expansion and, most recently, accelerating earnings growth have propelled the S&P 500 Index nearly three-fold from the lows of the financial crisis on March 9, 2009.

Increases to U.S. household net worth can be attributed to the current long-running bull market, which is also bolstering sentiment and consumer spending power. According to the Fed, U.S. households’ net worth rose to a record $92.8 trillion in the fourth quarter of 2016, with $38 trillion of net worth being added since the first quarter of 2009, which was the start of the bull market.

We look for equities to grind still higher in 2017, bolstered by modest U.S. economic growth, absent a looming recession or widespread inflation.

Revenue and earnings appear to be on the cusp of increasing. Manufacturing is rebounding, retail sales are improving, inflation is firming and the global environment appears to be stabilizing — all indicators of growth.

While our outlook for 2017 remains favorable, several indicators are pointing toward near-term caution.

Valuations are elevated. As of March 31, the S&P 500 traded at roughly 21 and 18 times trailing 12-month and 2017 consensus operating earnings estimates, respectively, which is at the high side of the trading range experienced during the 1960s and early 1970s when inflation was near similar levels.

Complacency is high. The “wall of worry” seems uncharacteristically low.

The Fed is raising interest rates. While we anticipate the path toward rate normalization to remain deliberate, bull markets ultimately end when the Fed goes too far in tightening.

Washington remains a wildcard. President Trump’s pro-growth agenda of lower taxes, deregulation, infrastructure spending and reflation has helped shape expectations for future growth while driving equity prices higher. Of near-term focus is the degree to which animal spirits will continue to bridge the gap between policy expectations and implementation. Delayed legislative progress toward this pro-growth agenda would likely be a near-term headwind for higher equity prices.

Technical trendlines appear extended. While equities continue to trend higher, it is unrealistic to expect stocks to advance throughout the year without experiencing a correction.

Our S&P 500 price target for 2017 is 2,475, based on a 19 multiple times earnings per share (EPS) of $130. We favor balanced exposure between growth and defensive sectors, with a bias toward growth.

Upside to both earnings and our price target are contingent on the magnitude and timing of fiscal stimulus.

We favor a balance between growth and defensive sector exposure, near term. For the longer run, we favor companies that grow revenues faster than peers, generating high returns on invested capital while operating in markets growing faster than the broad economy.
• Technology and Consumer Discretionary remain favored sectors based on valuation and favorable longer-term growth prospects.

• Healthcare is largely an out-of-favor sector due to lingering drug pricing concerns.

• Industrials, Materials, Energy and Financials sectors seem well positioned to benefit from the changing landscape in Washington. They also appear “rich” after rallying post-election.

• Utilities, Real Estate Investment Trusts (REITs), Telecom Services and, to a degree, Consumer Staples sectors may benefit if, contrary to consensus thinking, the pace of economic growth disappoints, or changes in Washington fall short of expectations.

While domestic politics will dominate the key macro events in foreign equity markets in 2017, we continue to see the glass as half full with respect to return opportunities.

• Voters in France and Germany, representing nearly half of the entire eurozone economy, will go to the polls in 2017. The leading candidate in the French election is a centrist running on a pro-euro, pro-growth reform platform (Emmanuel Macron) while Germany’s election will likely come down to the incumbent party of Angela Merkel and the equally pro-euro Social Democratic party of Martin Schulz, former head of the European parliament.

• With the 19th National Congress of the Communist Party of China convening in the fall of 2017, the desire to maintain its stable economic growth will continue to supersede all other domestic economic concerns. Issues such as reforming state-owned enterprises (SOEs), enacting productivity-enhancing policies, or tackling high levels of financial system leverage will take a back seat.

Among foreign developed equity markets, we favor both Japan and Europe over the United Kingdom due to modest reflation, firming and broadening economic growth and ongoing earnings improvement.

• While the threat of outright deflation has been averted, inflation remains well below targets in Japan and the eurozone. We expect monetary policy across all foreign developed markets (United Kingdom, eurozone, Japan) to remain extremely accommodative throughout 2017.

• The economic picture in Europe continues to improve. Growth is accelerating and broadening, with the lowest dispersion of economic growth rates across the eurozone since 1997. Construction activity, wage growth and credit to households and businesses in the region have all materially improved.

• While Japan’s growth has been more muted, construction activity has improved noticeably and a domestic real estate boom has been supported by increased bank lending to households, primarily mortgage debt. Corporate Japan has taken advantage of low interest rates to finance share buybacks and mergers and acquisitions, helping to support equity prices.

Emerging market equities performed extremely well in the first quarter of 2017. China, U.S. trade policies and the U.S. dollar will remain as key elements for emerging markets for the remainder of 2017.

• Emerging market equities posted strong gains in the first quarter, led by India, China and Brazil — three of the four “BRIC” countries.

• India’s major structural reforms appear back on track after the November shock “demonetization” (immediately replacing 90 percent of total currency in circulation in order to deter so-called “black money”).

• China’s manufacturing and financial system data continue to accelerate, likely providing a growth and reflationary impulse to the global economy. The housing market remains strong, supported by a 35 percent increase in long-term household loans (through February 2017).

• U.S.-China trade relations remain in flux. Potential U.S. actions vis-à-vis China range from symbolic (anti-dumping charges) to severe (across-the-board tariffs). China has significant resources to draw upon in the event of a “trade war” and Chinese retaliation in response would likely be measured and calibrated. We anticipate that in the end, economic pragmatism will prevail and any trade actions concerning China will likely prove to be more symbolic in nature.

Commentary provided by:
Terry D. Sandven – Chief Equity Strategist
Thomas M. Hainlin, CFA – National Investment Strategist
FIXED INCOME MARKETS

The Federal Open Market Committee (FOMC) elected to increase the federal funds rate by 25 basis points at their March meeting, citing realized and expected labor market conditions and inflation. We expect the Fed will increase the policy rate two more times this year, if the progress toward their dual mandate continues to improve.

- In the short term, we expect the yield curve to modestly flatten through rates at the front end of the interest rate curve (referring to interest rates of bonds close to maturing) rising relative to interest rates at the back end of the curve. Although we expect to see some upward pressure on intermediate maturities, it will not be as substantial as the likely upward movement in the short end of the curve. As the Fed continues the process of normalizing the policy rate, it puts the greatest amount of pressure on the short end of the curve. Although there are several obstacles to marginally higher long-term rates, such as foreign investment in our long bond market, late-cycle inflation and the potential fiscal boost may negatively impact performance of longer-dated securities.

The European Central Bank (ECB) is expected to remain more accommodative than the Fed in 2017.

- Despite our expectation for an extension of the ECB’s quantitative easing (QE) program, we would expect to see a reduction in the size of the monthly purchases before year-end.

The Bank of Japan (BOJ) is also expected to remain relatively accommodative in 2017.

- With some of the pressure having been removed from a more modest yen, the BOJ has very little sense of urgency to drift off the current course.

We continue to be neutral on Treasury Inflation-Protected Securities (TIPS).

- Inflation appears to be rebounding from last year’s low levels and real yields are rising, with the 10-year maturity back in positive territory.
- Inflation pressures in the United States remain modest, but risks are beginning to normalize given the likely modest pace of Fed rate increases and risks of stimulus from President Trump and the Republican Congress.

We continue to be wary of sovereign debt.
- The U.S. dollar has remained in a relatively high range for the last few months because Fed policy rate increases are expected to continue supporting widening interest rate differentials.

We remain underweight municipal debt.
- Investors have remained attuned to the potential change of tax policy under the Trump administration and the resulting possibility of reduced municipal security demand.
- Spreads started to widen at the end of 2016 as investors responded to this potential scenario, although the market has recovered a bit in early 2017. Issuance has also been somewhat muted in early 2017 and is expected to remain modest this year compared to 2016.
- Tax policy changes are likely to be the key factor driving volatility in the municipal market, particularly relative to taxable investment grade issues.

Commentary provided by:
Jennifer L. Vail – Head of Fixed Income Research

REAL ESTATE MARKETS

Leading indicators for the real estate market look stable, but returns within public real estate could be affected by interest rate movements.

- Job creation, wage growth, household formation levels, and consumer and builder confidence support real estate investments, but as interest rates increase in concert with Fed actions, real estate’s bond-like properties could outweigh other favorable fundamentals.

- Housing: Building and sales activity remain modest compared to pre-housing bubble levels. Job and wage growth, along with relatively low mortgage rates (although anticipated to rise), should support demand. We expect housing starts and sales to demonstrate continued improvement.
  - Inventories continue to tighten, which produces increasing home prices. We expect existing home supply to be constrained while experiencing further gains in home building.
The current level of sales activity and construction remains below long-term averages, indicating additional room for recovery. Risks to our housing forecast include a reversal in the pace of wage growth, limited labor and materials, a rapid increase in mortgage rates and a decrease in first-time homebuyers.

Multifamily investment is set to continue but at a reduced pace. We believe some multifamily markets will be challenged to balance supply, demand and a slowing in rent rate growth.

**Direct commercial:** Current cash flow yields are reasonable and the economic environment remains positive. The opportunity has shifted to value-added and opportunistic strategies from core strategies. The market appears to favor direct strategies at this time.

**U.S.-listed commercial:** In our view, REITs will be subjected to some interest rate headwind, but underlying fundamentals, such as vacancy trends and cash flows, should benefit from an improving economy. However, we are clearly later in the economic cycle and lending conditions may begin to tighten.

**Foreign-listed commercial:** Inflation pressures remain modest outside the United States, limiting the pace of income growth. Political uncertainty may limit demand for foreign REITs. Currency trends are likely to be a headwind based on our near-term expectations for a stronger U.S. dollar.

**COMMODITIES MARKETS**

Fundamental supply overhang means price gains are likely to be modest in 2017.

- While the commodities bear market may be over, we are unlikely to see a bull market emerge in 2017. Market structure remains a challenge and fundamentals across many raw materials continue to point to concerns of an oversupply.

- The oil market should improve in 2017, with the overhang in inventories drawn down later in the year. Prices will likely struggle to exceed $60 per barrel, reflecting a boost in output by U.S. shale producers seeking to capitalize on rising prices.

- U.S. interest rate increases and a stronger dollar may dampen demand for gold in 2017. Events such as political strife and expansion of negative interest rate policies in Europe, or a crisis in China (neither of which are expected to occur) would be required to stimulate prices.

- The surge in the price of copper is likely to moderate in tandem with China’s subdued growth in 2017. Still, prices are unlikely to revisit their lows, reflecting some improvement in U.S. housing and infrastructure investments.

- It may be appropriate to consider investments that benefit from lower-than-normal prices. Qualified investors may want to explore private strategies, which can benefit from illiquidity discounts and operational improvements in acquired companies.
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