Stembrook
Asset Management

Stembrook Market Review — First Quarter 2017

Global equities continued their post-election upward march in the first quarter of 2017 despite continued political uncertainty in the United States and around the world. Indicators of consumer and business sentiment are strong in the U.S. and abroad. Following the November election, a survey of U.S. CEOs indicated the highest level of confidence in the economy since January 2006.[1] While indicators of future consumption and business investment remain robust, we have yet to see this sentiment reflected in the economic data. The global economy continues to grow at a slow, but steady pace.

As U.S.-based investors, it is easy to assume that all markets have been performing well for years. That picture changes dramatically if we look to other countries around the world. The center chart shows trailing returns and valuation metrics for stocks across the globe. Both of these factors led us to tilt our portfolio away from the U.S., with recent strong performance and higher valuations, towards other markets where returns have been lackluster and valuations are significantly cheaper. As a reminder, lower valuations tend to lead to higher future returns.

Bond yields retreated and prices rose in the first quarter, a slight rebound after the dramatic price drop in the final quarter of 2016. Short-term yields in the U.S. are expected to rise over the course of the year as the Federal Reserve continues its process of normalizing interest rates.

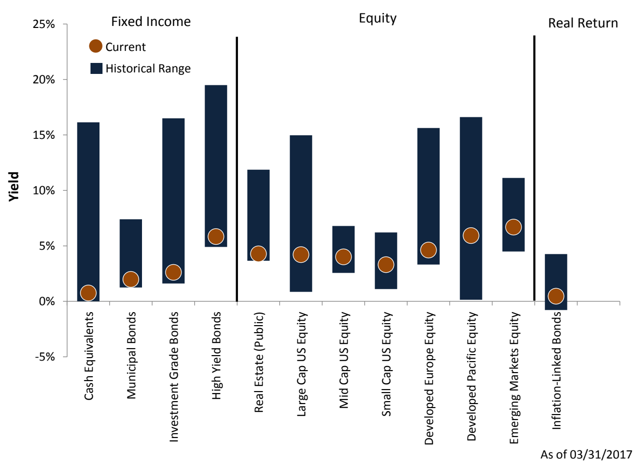
Our proprietary models forecast pre-tax returns ranging from 1% to 2% for fixed income-like asset classes and 4% to 10% for equity-like asset classes (see table to the right). We continue to favor stocks over bonds. Our views are outlined in the following comments.

Expected Market Returns and Risks
7-10 Year Horizon

	Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
Inflation	1.9%	1.9%	3.1%
Cash Equivalents	1.2%	0.6%	3.3%
Municipal Bonds	1.9%	1.9%	4.4%
Inflation-Linked Bonds	2.3%	1.3%	4.7%
Investment Grade Bonds	2.4%	1.3%	6.7%
High Yield Bonds	2.3%	0.9%	13.7%
Real Estate (Public)	4.3%	2.2%	18.3%
Broad Market US Equity	9.0%	7.0%	17.5%
Developed Non-US Equity	8.1%	6.2%	22.4%
Emerging Markets Equity	10.4%	6.7%	30.6%

A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



Yields are an indicator of future returns. Orange dots show current yields. Blue bars show historical ranges. Yields are generally low versus their historical range.

Global Equity Returns and Valuations

Annualized Returns

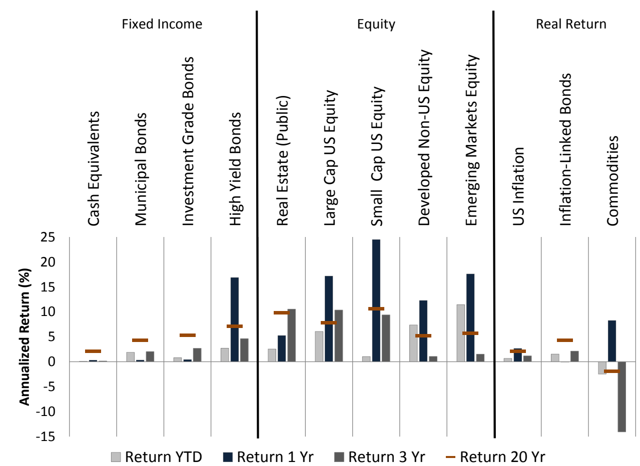
Index	1 Year Return	3 Year Return	5 Year Return
Large Cap U.S.	17.2%	10.1%	13.3%
Europe	10.6%	-1.2%	6.2%
Pacific	16.3%	5.3%	6.9%
Emerging Markets	17.6%	1.3%	1.2%

Fundamental Valuations

Index	Forward Price/ Earnings	Price/Book Value	Dividend Yield
Large Cap U.S.	18.1	3.1	2.0%
Europe	15.3	1.8	3.4%
Pacific	14.3	1.5	2.6%
Emerging Markets	12.3	1.6	2.5%

Non-U.S. equities have underperformed U.S. equities. Valuations remain favorable for non-U.S. equities.

Historical Market Returns



Historical market returns as of March 31st, 2017. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

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Global Asset Class Returns

Asset Class Name	Last 10 Years	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Small Cap US Equity	Small Cap 7.5%	EM Eq 39.8%	Inv Grd Bnd 5.2%	EM Eq 79.0%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%
High Yield Bonds	HY Bnd 6.0%	Commod 16.2%	CPI 0.1%	HY Bnd 56.3%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%
Large Cap US Equity	S&P 500 5.8%	Infl-Indx Bnd 11.6%	Infl-Indx Bnd -1.2%	Intl Eq 31.8%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%
Real Estate (Public)	Real Estate 4.0%	Intl Eq 11.2%	HY Bnd -26.2%	Real Estate 28.6%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%
Investment Grade Bonds	Inv Grd Bnd 3.6%	Inv Grd Bnd 7.0%	Small Cap -31.1%	S&P 500 26.5%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%
Inflation-Linked Bonds	Infl-Indx Bnd 3.6%	S&P 500 5.5%	Commod -35.6%	Small Cap 25.6%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%
Emerging Markets Equity	EM Eq 1.7%	CPI 4.1%	S&P 500 -37.0%	Commod 18.9%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%
Inflation	CPI 1.6%	HY Bnd 2.2%	Real Estate -39.2%	Infl-Indx Bnd 10.1%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%
Developed Non-US Equity	Intl Eq 0.8%	Small Cap -0.3%	Intl Eq -43.4%	Inv Grd Bnd 5.9%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%
Commodities	Commod -4.7%	Real Estate -17.6%	EM Eq -53.2%	CPI 2.7%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- GDP growth in major economies remains steady at 2.5%,[2] while global inflation is gaining momentum, up 2.2%.[3]
- In the U.S., GDP is forecasted to slow to a below-trend growth rate of 1.8% in the first quarter.[4] As drags from low energy prices and a strong dollar begin to fade, the economy will have the potential to gain momentum over the next year.
- The pace of Europe's economic growth increased slightly to 1.6% in the first quarter.[2] Ample slack in the labor market leaves room for stronger growth in future periods.
- GDP growth in Japan also picked up slightly to just below 1%.[2] Japan will continue to be inhibited by its aging labor force and restrictive immigration policy.
- Growth in emerging economies is expected to pick up in the first quarter to 4.4%. Brazil is the only member of the group that is expected to contract. China and India continue to lead the way with GDP growth of over 6.7%.[2]
- The Federal Open Market Committee raised the Discount Rate by 0.25% to 1.50% at their March meeting, citing increased inflation and strength in the labor market. Economists expect two more rate increases of 0.25% this year.
- Global manufacturing posted its fastest rate of quarterly expansion in almost 6 years, with the Global Manufacturing Purchasing Managers Index (PMI) reaching 53.0, while the Global Service Sector PMI remains at an elevated level of 53.6. Readings above 50 indicate expansion, while readings below 50 indicate contraction.[5]

Currencies

- After a strong 2016, the U.S. Dollar fell by 1.8% in the first quarter.[6] The Dollar remains overvalued versus other major currencies, as measured by Purchasing Power Parity.

Equities

- Developed non-U.S. equities returned 7.4%,[7] while broad market U.S. stocks were up 5.7% in the first quarter.[8]
- Within the U.S. stock market, technology-heavy Nasdaq stocks outperformed the S&P 500 by over 4% during the first quarter.[9] After outperforming their larger cap counterparts in 2016, small cap stocks returned 1.1%[10] in the first quarter versus a 6.1% return in large cap stocks.[11]
- After a strong year in 2016, emerging markets equities continued to outperform developed markets, returning 11.5% in the first quarter.[12]

Fixed Income

- Bond yields eased in the first quarter as rates fell and bond prices bounced back, after bond prices dropped dramatically in the fourth quarter of 2016.

Current Positioning

- We invest in **lower priced, value-oriented equities**, which tend to outperform the broad market over time. Despite weaker performance in the first quarter, value stocks outperformed in 2016.
- We have reduced our **large cap U.S. equity position from overweight to slightly underweight** after years of outperformance and rising valuations.
- We remain **overweight developed non-U.S. equities.**
- We remain **overweight emerging market equities**, where valuations and long-term growth potential remain attractive.
- We remain **overweight municipal bonds** for taxable investors. We have **sold our municipal position in tax-deferred portfolios** after municipals outperformed investment grade bonds by 6.7% since we initiated the position in May 2011. Proceeds were **reinvested in diversified taxable bonds.**
- Given our significant concerns regarding a longer-term, secular rise in interest rates and the resulting hit to bond prices, we continue to **hold shorter maturity bonds**, while steering away from **U.S. Treasuries** and investing in **corporate bonds, high yield bonds and floating rate bonds**.
- After adding to commodities in 2016 and a subsequent rebound in oil prices, we have **sold our commodity position, reinvesting the proceeds in global, deep value equities.**

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach incorporates time-tested return and risk models, fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in order to craft a customized solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D. D'Agati, CFA   Thomas Kosinski

Endnotes and Sources:

Text:

(1) Bloomberg: Chief Executive Magazine, CEO Confidence Index-Measures Confidence in the Economy 1 Year from Now.
(2) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated in to USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 3/31/17.
(3) Bloomberg, Stembrook Research: Inflation data as of 3/31/17. Aggregate statistics are weighted by each country's GDP translated in to USD.
(4) Bloomberg: Bloomberg Contributor Forecasted GDP First Quarter 2017. As of 3/31/17.
(5) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing. As of 3/31/17.
(6) Bloomberg: Dollar Index 12/31/16-3/31/17. Long-term average since March 1967.
(7) Bloomberg: MSCI Europe, Australia, Far East Total Return Index.
(8) Bloomberg: The S&P Composite 1500 combines three leading indices, the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600 to cover approximately 90% of the U.S. market capitalization.
(9) Bloomberg: Nasdaq versus S&P 500. 12/31/16 - 3/31/17 total return 10.13% versus 6.07%.
(10) Bloomberg: S&P SmallCap 600.
(11) Bloomberg: S&P 500.
(12) Bloomberg: MSCI Emerging Markets Total Return Index.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 3/31/17.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 3/31/17.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Global Stock Returns and Valuations: As of 3/31/17.
Sources: Bloomberg
Indices: S&P 500, MSCI Europe, MSCI Pacific, MSCI Emerging Markets

Historical Market Returns:
Source: Bloomberg, Stembrook Research.
Indices: BofA Merrill Lynch 0 to 3 Month US Treasury Bill Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Consumer Price Index – US, S&P 10 Year US TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns:
Source: Bloomberg, Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index Barclays Capital Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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Additional information is available upon request.