North American Management
Ten Post Office Square, Suite 1200S
Boston, MA 02109
Telephone: 617.695.2100
Fax: 617.695.2121

One North Brentwood Boulevard
Suite 1510
St. Louis, MO 63105
Telephone: 314.833.6641
www.namcorp.com

Third Quarter 2016

Inflation Has a Pulse

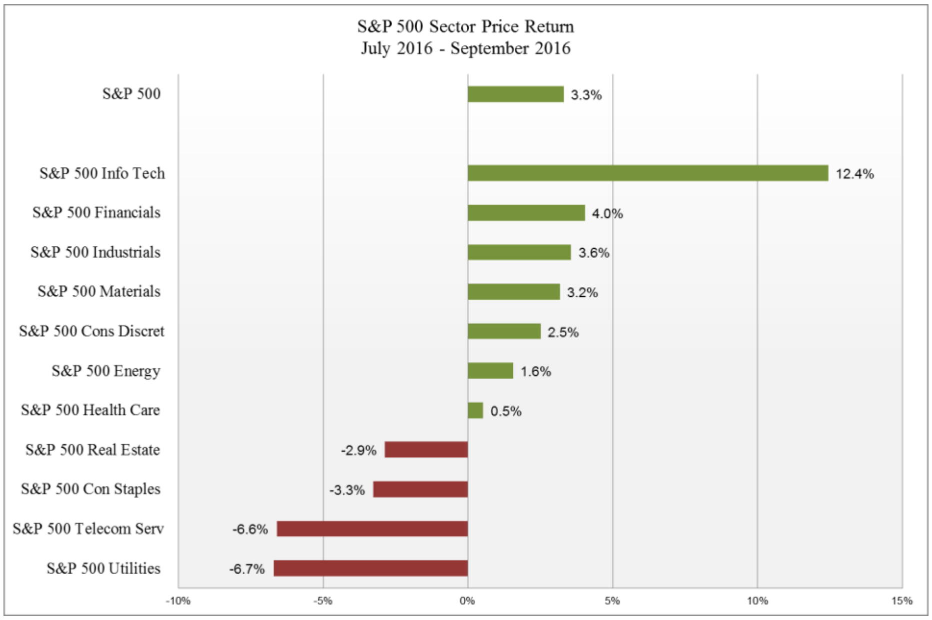
Global markets rose sharply to end the third quarter with substantial gains. Notable exceptions occurred among interest rate sensitive stocks and long duration bonds, both of which declined as interest rates rebounded from the exceptionally low levels reached after Brexit (see table below). Rates continued to march higher throughout the quarter, mostly in step with mildly hawkish comments from central bankers who would like to modify (Japan), taper (Europe), or end (U.S.) their unprecedented stimulus programs. Their rhetoric clings to a notion of grand design, but persistent weak productivity and modest growth make it sound like wishful thinking. It seems more likely that investors are betting on fiscal stimulus to pick up the baton and carry this aging recovery further, and they are beginning to assess the impact of various proposals on their portfolios as the U.S. election approaches.

Index (as of 09/30/2016)	Third Quarter 2016	Year to Date 2016	12 Months Trailing
S&P Telecommunication Services	(-5.60%)	17.86%	26.82%
S&P Utilities	(-5.91%)	16.13%	17.37%
MSCI EMF (Emerging Markets)*	9.03%	16.02%	16.78%
Bloomberg Barclays U.S. Treasury 20+Year	(-0.30%)	15.47%	13.88%
iBoxx USD Liquid High Yield Index	5.09%	13.76%	12.07%
MSCI U.S. REIT INDEX – Gross Return	(-1.45%)	11.91%	19.83%
Russell 2000	9.05%	11.46%	15.47%
S&P 500	3.85%	7.84%	15.43%
MSCI AC World Index ex USA*	6.91%	5.82%	9.26%
Bloomberg Barclays U.S. Aggregate	0.46%	5.80%	5.19%
S&P GSCI (Commodities)	(-4.15%)	5.30%	(-12.21%)
MSCI Japan*	8.60%	2.54%	12.13%
MSCI Europe*	5.40%	0.00%	2.49%

Total Returns in U.S. Dollars. Returns are calculated with net dividends (where applicable) in U.S. Dollars.*

In our view lessons learned about the limitations of polling in the U.K. last June have, for now, kept further rotation out of long bonds and most dividend stocks in check as investors spread their bets among various election outcomes. However, there do seem to be common political threads behind improvements in more cyclical sectors within the S&P 500 - like industrials, materials, technology, defense and financials - namely increased emphasis on infrastructure projects, higher risk of cross-border conflict, and potentially more borrowing at higher interest rates to fund both. Healthcare stocks, on the other hand, experienced a sharp reversal since early August, ending about flat on the quarter (see graph below), as Big Pharma and Biotech stocks continue to suffer collateral damage in the ongoing battle to fix the U.S. healthcare delivery system.

All of these shifts are meaningful, but not large enough to discount a major inflection point that would change the post-crisis "low growth / low inflation / yield chasing" narrative that has arguably reached the point of complacency. Investors' long, ardent infatuation with "return of capital" strategies that emphasize dividends and stock buybacks have dominated this recovery and will not go quietly. Strategists at Pavilion Global Markets, a research firm, have captured the remarkable change of investor behavior under Quantitative Easing and other programs by simply observing that "bonds have been held for capital appreciation and equities for yield."[1] If implemented in a timely fashion, however, up to $1 trillion or more of infrastructure spending nationwide could initiate a number of long-term public works projects with levels of borrowing, hiring and work force mobility not seen for years, upending some longstanding trading patterns.



In the meantime, utilities and long-dated U.S. Government bonds were still up more than 15% year to date on September 30. Financials, however, after underperforming utilities and telecommunications by more than 25% in the first six months of 2016, outperformed both sectors by more than 10% in the third quarter. We take these gyrations as fair warning of how dramatic rotations can be when investors lose faith in popular themes. We continue to be suspicious of highly valued sectors facing cyclical and secular headwinds, such as utilities, and our clients' portfolios hold fewer of these types of companies as the risk return trade-off looks asymmetric. While not investing in these areas early in the year hurt performance, avoiding them helped in the third quarter and may help more in the future if inflation expectations gain traction.

As the political and monetary landscapes evolve, we will continue to evaluate our portfolios' sensitivity to both and carefully monitor the investment universe for opportunities. In our opinion, it will take more than just talk to shift low inflation expectations firmly entrenched in most consumers' minds since 2008. Slow or stagnant wage growth and higher credit standards from lenders tend to encourage restraint when prices increase. In recent years, for example, consumers have often responded to higher healthcare costs and rising rents by cutting expenditures elsewhere. Finally, the old adage that markets like divided government may not apply this season. If U.S. politicians remain deadlocked or slow to respond to economic

[1] Global Strategy Note: "Buybacks, dividends and weak cash flows." *Pavilion Global Markets*. October 20, 2016.

imperatives, what little growth and inflation (at least the good kind) we have now will likely flatline.

Robert G. Scott
Chairman & CEO

Fraser J. McLean, CFA, CFP®
Chief Investment Officer

Source of data not specifically cited: Fact Set.
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Special Note to Clients – North American Management Charitable Foundation

We are pleased to announce the formation of a new charitable entity called the North American Management Charitable Foundation. This fund is dedicated to support the passions of all employees who are giving their time and money to worthy causes. We are especially proud and supportive of members of the Firm who want to develop and expand their sense of community by giving back to others in need. While this effort, like all journeys, begins with a single step, we have high hopes for sharing some of our future growth and prosperity with communities and causes in need.

New Hire

We are very pleased to welcome **Pamela Woodruff** to the Firm as Head of Trading. Pam has over 25 years experience with institutional equity capital markets, trading, research, technical analysis and market structure. She started her career with Kidder, Peabody & Company and, after working at Fidelity Capital Markets and a few other financial services organizations, spent 15 years at Stephens Inc. Pam has her Bachelor of Arts from St. Lawrence University and is a past president of the Boston Security Traders Association.