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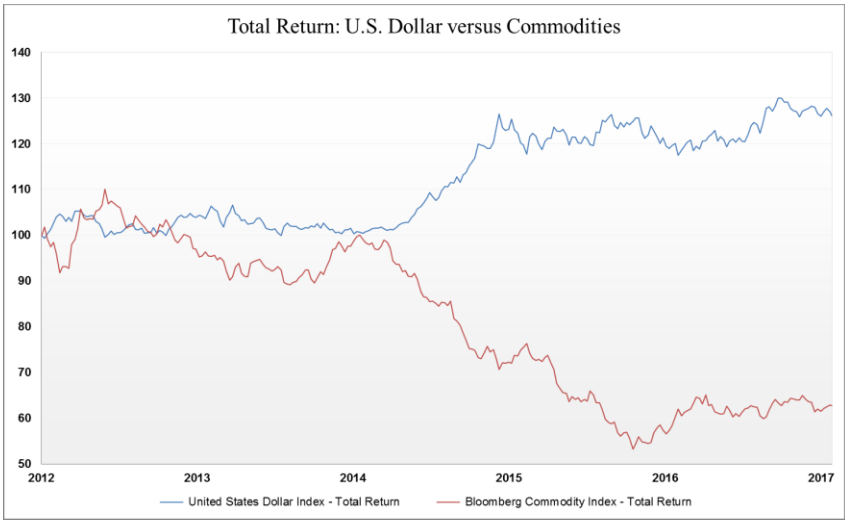
First Quarter 2017

Sound and Fury

Investor enthusiasm for stocks ignited after the U.S. election and continued throughout most of the first quarter, driving U.S. equity indexes to record high levels on March 1. The CBOE VIX (the Chicago Board Options Exchange Volatility Index, or the “fear gauge”), a widely followed measure of S&P 500 near-term volatility, dropped to near record lows in January and hovered there for weeks as investors felt little need of insurance. Foreign markets performed even better (see table below) as low volatility and a declining U.S. Dollar emboldened participants to look for cheaper ways to bet on a global recovery. The rose-colored glasses came off by late March, however, amid the failed Congressional rewrite of Obamacare, rising geopolitical tensions and some tepid economic data. As investors recalibrated expectations for the pace and substance of reforms, most stock markets trended modestly negative in April. That is, until the first round French presidential election produced a pro-growth, pro-EU front runner, and initial first quarter earnings showed marked improvement over expectations. As April comes to a close, equity buyers have resurfaced en masse, and long-term bond yields have started to move higher again after retracing to levels not seen since mid-November.

Index (as of 03/31/2017)	First Quarter 2017	One Year Trailing	Three Year Trailing
MSCI EMF (Emerging Markets)*	11.44%	17.21%	1.18%
MSCI AC World Index ex USA*	7.86%	13.13%	0.56%
MSCI Europe*	7.44%	9.76%	(1.51%)
S&P 500	6.07%	17.17%	10.37%
MSCI Japan*	4.49%	14.44%	6.02%
Russell 2000	2.47%	26.22%	7.22%
iBoxx USD Liquid High Yield Index	2.31%	14.20%	3.68%
Bloomberg Barclays 10-Yr Municipal Bond	1.78%	(0.24%)	3.60%
Bloomberg Barclays U.S. Treasury 20+ Year	1.41%	(5.18%)	6.20%
Bloomberg Barclays U.S. Aggregate	0.82%	0.44%	2.68%
S&P GSCI (Commodities)	(5.05%)	8.45%	(22.71%)

Total Returns in U.S. Dollars. Returns are calculated with net dividends (where applicable) in U.S. Dollars. Three year trailing returns are annualized.*



Looking back further, well before last year's acrimonious and unanticipated political changes in the U.K. and the U.S., we are approaching the third anniversary of an epic commodity collapse. The tumultuous market adjustments that followed were significant and are sometimes easy to forget amid the din of current events. The 50% plunge among global commodities and interest rates that began in June 2014, and the simultaneous 30% rise in the U.S. Dollar, were painful to digest for many countries (see graphs this page). In the U.S., these deflationary effects were mostly benign as consumers benefitted from cheap gas, cheaper mortgages and auto loans, lower energy bills, and less expensive imports. Foreign commodity producers (especially those with U.S. Dollar debt) and consumers fared much worse. The paltry annualized three-year returns nearly everywhere outside the U.S. (see far right column of the table on page one) helps put things in perspective, as does the table to the right.[1] Geographic diversification of portfolio risks during this three-year period was certainly frustrating. Furthermore, though U.S. stock indexes outperformed significantly, leadership was narrow. Some analysts have labeled this period between 2014 and 2016 a "stealth bear market" because 70% of S&P 500 stocks had drawdowns of 20% or more.[2] It was a challenging environment for stock pickers.

% Drawdown from mid-2014 to mid-2016	
Portugal PSI20	-46%
Brazil BOVESPA	-41%
Italy FTSE MIB	-38%
Spain IBEX	-36%
Hong Kong Hang Seng	-36%
Dow Transports	-31%
Germany DAX	-30%
Japan Nikkei	-29%
Taiwan TWSE	-28%
Sweden OMX	-28%
Russell 2000	-27%
EuroStoxx 600	-27%
Canada TSX	-27%
France CAC	-26%
India SENSEX	-25%
U.K. FTSE	-23%
Swiss Market Index	-22%
Australia ASX 200	-22%
Nasdaq 100	-19%
Korea KOSPI	-18%
S&P 500	-15%

If these aftershocks weren't jarring enough, we are now witnessing a long-awaited regime shift from monetary to fiscal policy solutions – to date a highly contentious process with little apparent progress or momentum outside the voting booth. What an unpleasant irony that a few unelected officials at the Federal Reserve and the European Central Bank seem better

[1] Strategas Technical Analysis Research, February 14, 2017
[2] Id.

equipped than our duly elected representatives to soften the effects of post-crisis market dislocations, employment hardships and growth issues. Some investors are surely pining for the days of monotonal central bankers armed with bazookas full of cash. Regardless, there are huge and unavoidable adjustments to fiscal policy that can only be made by legislators willing to compromise and make pro-growth decisions for the good of the country. We believe there are reasons for optimism:

1) **Fiscal reform is already underway.** Just as investors may have overestimated Congress' ability to act, they have underestimated what is possible from the executive branch. The notion of an activist administration (which has term limits) running rings around a do-nothing Congress (which does not) began with Obama and continues with Trump. Whatever reforms we get could be much more powerful and confidence-building than monetary easing, particularly after a scarring credit crisis has motivated people to save more and borrow less.
2) **Rising rates can be stimulative.** Longer term, low interest rates and quantitative easing do nothing for an aging population transitioning to retirement. BlackRock recently highlighted data from the Federal Reserve that shows a 1% rise in money market and deposit yields on $11 trillion of cash equating to $110 billion of new income, and a 1.2% rise in yields on $48 trillion of non-equity financial assets creates over $600 billion of income.[3] When added to proposed tax reforms and infrastructure spending, these numbers get one's attention. However, investors should be mindful that companies with weaker balance sheets will suffer. The 1% rate rise in the second half of 2016 has already begun to increase dispersion among individual stocks and create opportunities for active managers to outperform passive indexes, which many did in the first quarter.

All too often, here and in Europe, serious dysfunction must set in before real problem solving begins. The most impactful legislation is usually enacted under duress, though it can be discouraging to watch. The cacophony of issues on the evening news – demographics, disruptive technology, unfunded entitlement spending, immigration, foreign policy and economic growth – are all related and vital to the health of our democracy. After nine years of palliative monetary easing and political gridlock, we believe the pace of change will accelerate. At least we can see an emerging priority within governments to drive economic growth through fiscal reforms.

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Source of data not specifically cited: FactSet.

[3] Rieder, Rick, et. al., *Investing Within a System that is Only "Flating" During a Time of Increased Uncertainty*, BlackRock, April 20, 2017