Quarterly Economic Update

December 6, 2017

MACROECONOMIC COMMENTARY

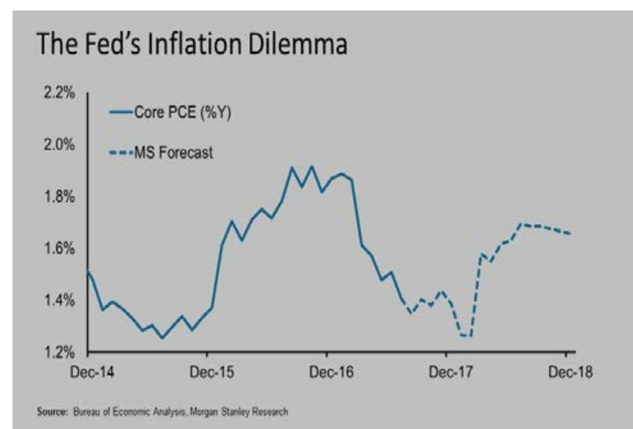
Monetary Policy

By Bobby Long

As expected, the most recent Federal Open Market Committee (FOMC) meeting held on November 1st was uneventful with no change to the federal funds rate or other policy shifts. The target range for the federal funds rate remains at 1 – 1 ¼ percent. The balance sheet normalization program initiated in October continued through November without any adverse results apparent so far. The November FOMC statement did upgrade their growth assessment noting that economic activity has been "rising at a solid rate" versus their previous assessment of only "rising moderately"; however inflation was viewed as "remaining soft" with core inflation continuing to run below the committee's 2 percent objective. The November meeting did not contain an updated Summary of Economic Projections, so we were left with only commentary and will have to wait for the next meeting to see how their more recent assessment factors into their longer run projections for growth, inflation, and the path of the federal funds rate.

The FOMC minutes from the most recent meeting did reveal a significant amount of discussion around inflation and indicated some growing concern that the persistent low inflation has not shown signs of picking up. On the whole, the committee maintains the view that cyclical pressures associated with a tightening labor market will push inflation higher over time and that the recent softness can be attributed to temporary or idiosyncratic factors. The minutes did recognize that "many participants observed that there was some likelihood that inflation might remain below 2 percent for longer than they currently expected." The reasons given for this were a diminished responsiveness of inflation to resource utilization, the possibility that the degree of labor market tightness was less than currently estimated, lags in the response of inflation to greater resource utilization, and secular influences like the disinflationary effects that technological innovation has in disrupting existing business models. Concerns were also expressed that continued weak inflation data could lead longer-term inflation expectations lower. The other side of the argument is that lags in the response of inflation to tightening resource utilization could represent upside risk to inflation as the labor market tightens further.

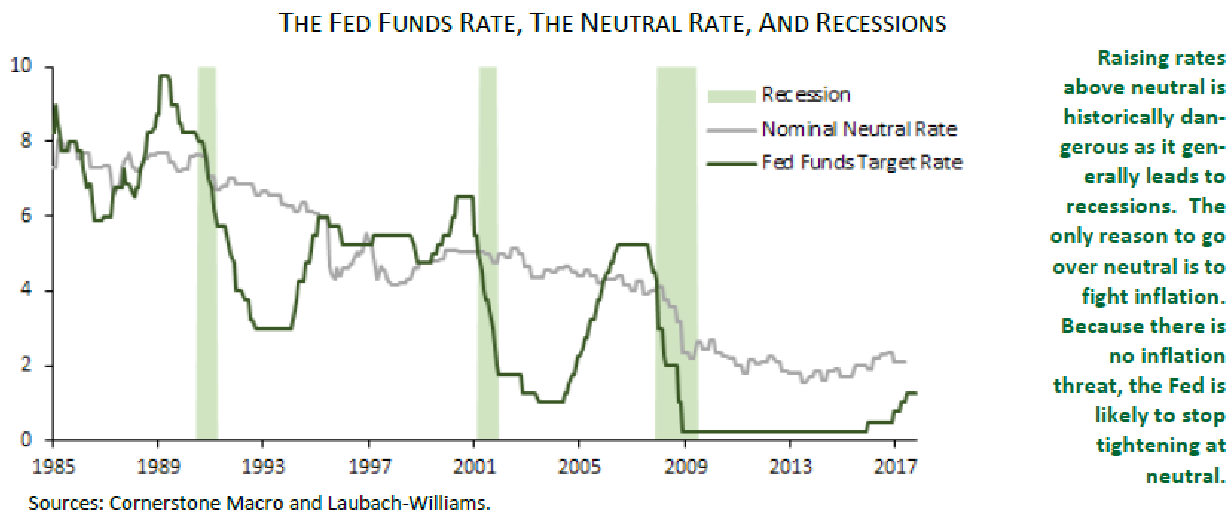
The chart on the right shows core PCE inflation and its struggles to climb back towards the FOMC's 2 percent objective. The most recent core PCE numbers from October showed a slight uptick from the previous month but remained low at 1.4%. The FOMC's most recent forecasts had median projections at 1.5% for 2017 and 1.9% for 2018, so we will have to see whether those numbers are adjusted down any following the December meeting.



On November 2nd, President Trump announced his nomination of Jerome Powell to serve as the next chairman of the Federal Reserve. Powell is a current member of the Federal Reserve Board of Governors where he has served in the position since his appointment in 2012. He has played an integral part on monetary policy decisions over the past five years and brings a diverse background in investment banking, law, and public policy with him. Powell will lead the Federal Reserve in his own direction as he takes the helm, but his approach and views on monetary policy should be fairly consistent with current Federal Reserve Chair Janet Yellen. Powell's confirmation hearing was held on November 28th and while there will be some political posturing around his nomination, he is expected to be confirmed with bipartisan support. Yellen has announced she will step down from her Board of Governors seat upon Powell's confirmation, which will leave four of the seven seats on the Board of Governors open. One of these seats will fill the role of vice chairman, which opened up following the resignation of Stanley Fischer in October. President Trump announced another nomination on November 29th, nominating Marvin Goodfriend to fill one of these open spots on the Board of Governors. Goodfriend is a professor at Carnegie Mellon University and a former director of research at the Richmond Fed who can provide the economic expertise that was lost with the resignations of Yellen and Fischer. Goodfriend is known to express some alternative views on monetary policy and has challenged some of the policy decisions made under the previous leadership. Another change within the composition of the FOMC will come from the announcement that New York Federal Reserve Bank President William Dudley will step down from his position in mid-2018. The FOMC voting members are comprised of the seven Federal Reserve Board Governors, the New York Federal Reserve Bank President, and four other rotating regional bank presidents. The change in the stable seat of the New York Bank President represents more uncertainty. Despite the substantial turnover within the composition of FOMC members, we expect a consistent approach to federal funds rate policy and the balance sheet normalization program over the near term.

The next FOMC meeting will be held December 12-13th. All indications are that they will raise the federal funds target range another quarter of a percent. The September Summary of Economic Projections indicated most participants expected one additional rate increase before year end. The minutes from the November meeting stated that "many" participants thought another rate increase would be appropriate in the near term if economic conditions remained unchanged. Recent speeches and testimony from Yellen, Powell, and other members have expressed a view that economic conditions remain supportive for another rate increase at the December meeting. Market expectations for a December rate increase have also risen with the current implied probability of a quarter point increase at 98.3%. Despite the increased concern around lower inflation trends, expectations are high for an increase. More importantly, FOMC participants will provide updated economic projections that will give us an indication whether their inflation concerns are leading them to shift their views on the future path for the federal funds rate. Their September inflation projections called for core PCE inflation of 1.5% in 2017 and 1.9% in 2018, before reaching their 2% objective in 2019. Having acknowledged concerns that inflation may run below the 2 percent objective for longer than currently expected, participants may see the need to

lower their 2018 inflation projections and potentially their 2019 projections also. If they do this, this may pull down their projections for the path of the federal funds rate. The chart below shows the path of the federal funds rate in relation to the nominal neutral rate.



Sources: Cornerstone Macro and Laubach-Williams.

The most recent median projections from the September meeting indicated participants viewed one additional increase in 2017 as appropriate and three quarter point increases as likely appropriate in 2018. That would move the target range for the federal funds rate roughly in line with the neutral rate. Expectations have been that as inflation picks up and moves toward their 2 percent objective, the neutral rate would move higher, leaving room for additional rate increases in 2019. If inflation continues to run below their 2 percent objective into 2019, the FOMC is unlikely to push the federal funds rate above the neutral rate. They have taken the approach that increasing the federal funds rate and reducing the size of the balance sheet is an effort to remove accommodation and normalize policy versus tightening policy. With economic activity and labor conditions showing positive momentum, they may not necessarily see a reason to alter the pace of moving the federal funds rate towards the neutral rate in 2018; however they may taper their projections for additional increases in the absence of inflation. As the chart above shows, increasing the federal funds rate above the neutral rate has historically had negative results and without clear evidence of inflationary pressures, FOMC members are likely to err on the side of caution.

Fiscal Policy

By Michael McNair

The progress in Washington over the next month will play a major role in shaping fiscal policy for years to come. Now that the House and Senate Finance committee have cleared tax reform legislation the two chambers must reconcile the differences and agree on a final Bill. There are many moving parts but we will focus on the major provisions, which we will place in one of three categories: individual, business, and international. We will also discuss the differences between the House and Senate legislation and explain which issues present the biggest obstacles in passing tax reform.

Major Provisions in the House and Senate Tax Bills

Individual Provisions

Individual Tax Rates

Tax rates are lowered in both Bills but the House proposes four tax brackets (12%, 25%, 35%, and 39.6%) while the Senate has seven tax brackets (10%, 12%, 22.5%, 25%, 32.5%, 35%, and 38.5%). In both versions the income subject to the top tax bracket is nearly doubled to $1 million for married couples (from $450K currently).

Child Tax Credit

The Child tax credit is increased in both Bills but with some subtle differences. The House Bill increases the credit to $1,600 per child under 17, provides a $300 credit for each parent, and a $300 credit for non-child dependents. The limit on the refundable portion remains $1,000, while the phase-out is increased from $110k to $230k for joint filers.

In the Senate Bill, the child tax credit is increased to $1,650, per qualifying child under 18, and provides a $500 credit for non-child dependents. The limit on refundable portion remains $1,000 but the threshold for the phase-out increases to $1mn for joint filers.

Mortgage Deduction

The House Bill limits the mortgage deduction for newly purchased homes from $1mn to $500k and permits the deduction for only a taxpayer's principal residence. However, the Senate Bill maintains the current law mortgage deduction but repeals the deduction for interest on home equity indebtedness.

Estate Tax

Both the House and Senate Bill double the estate tax exclusion from $5mn to $10mn. However, the House Bill repeals the estate tax after 2023, while the Senate Bill does not.

State and Local Tax Deduction (SALT)

One of the biggest hurdles Congress will face in pushing through tax reform is reconciling the difference between the House and Senate treatment of the state and local tax deduction. Both Bills repeal the state and local tax deduction for income and sales tax. However, the Senate Bill also repeals the deduction for property tax, while the House Bill retains the deduction for property taxes up to $10,000.

ACA Individual Mandate Repeal

A late amendment to the Senate Bill included a provision to "repeal" the individual mandate which requires healthy people to buy health insurance under Obamacare. Technically the provision does not repeal the mandate but instead drops the penalty to $0. Regardless of the semantics, this provision affectively kills Obamacare.

The House chose not to include this provision because they understood that the biggest battle on this issue will come in the Senate (because of a slimmer majority). Should the Senate agree to include this provision we believe that the House will follow suit. We will comment further on this measure later in the report.

Personal Exemption/Standard Deduction & Alternative Minimum Tax (AMT)

These are areas where House and the Senate Bills are in agreement. Both Bills will repeal the AMT and the personal exemption, while nearly doubling the standard deduction to $24,000 (currently $12,700).

Business Provisions

Corporate Tax Rate

Both the House and Senate Bills will bring the corporate tax rate down to 20%. However, the lower rate would be in effect for 2018 in the House Bill but does not go into effect until 2019 in the Senate Bill. More commentary on this debate later in the report.

100% Business Expensing

Under both Bills, businesses will be able to expense 100% of capital equipment purchases for 5 years. Utilities are excluded from this provision in both Bills but real property businesses are also excluded in the House version.

Net Interest Deduction

In the House Bill net interest deductions are limited to 30% of EBITDA, as opposed to 30% of EBIT in the Senate Bill. By leaving out the depreciation and amortization (the D&A), more businesses are negatively affected in the Senate version. The difference in the way each Bill deals with the net interest deduction will be a major battleground between the two houses.

Corporate Minimum Tax

Both Bills repeal the corporate minimum tax.

Section 179 Expensing

The House Bill increases the threshold for Section 179 expensing to $5m with a phase-out increase to $20m. The Senate Bill increases expensing to $1m with a phase-out range beginning at $2.5m and expands the qualified property to include certain property connected to furnishing lodging.

Pass-Through Income

Under the House Bill, net income from passive business activity is considered business income and eligible for the 25% pass-through rate. Owners and shareholders with active business income can have 30% of income at the 25% rate with the remaining 70% subject to ordinary individual rates.

The House provision also provides a 9% tax rate (phased in over 5 years) for the first $75k in net business taxable income for active shareholders or owners earning less than $150k (married) in taxable income from the pass-through business. The benefit is reduced for those earning more than $150k until it is phased out at $225k. Businesses of all types would be eligible for the preferential rate so long as income permits.

The Senate provision creates a new 17.4% deduction for pass-through income, but the deduction does not apply to certain service businesses unless the taxpayer makes less than $75k for individuals or $150k for married couples.

International Business Provisions

International Tax System

Both Bills will transition the US from the current worldwide system to a 100% territorial tax system. In a territorial system, all businesses operating within the United States are taxed based on the income earned within the country’s borders.

Deemed Repatriation

Both Bills impose a mandatory tax on unremitted foreign earnings. However, the House Bill taxes unremitted cash at 14% and plant and equipment at 7%. The tax rate is lower in the Senate Bill (10% for cash and 5% for plant and equipment) but we expect the higher House rates to eventually prevail.

Base Erosion

The House Bill limits interest deduction for US corporations with foreign affiliates to the extent that the US corporation's share of global net interest expense exceeds 110% of the US corporation's share of global EBITDA.

Payments, besides interest, from a US corporation to a related foreign corporation that are deductible or included in a depreciable asset will receive a 20% excise tax unless the foreign corporation chooses to treat them as income related to US trade or business making them subject to full US taxation.

Instead of a minimum tax on related party transfers like the House Bill, the Senate Bill denies the deduction for any interest or royalty amount paid from a hybrid transaction or to a hybrid entity where there is no corresponding inclusion to the related party in its home country or if the related party is able to deduct the amount in its home country.

The Senate Bill also includes a patent box-like system, which imposes a 12.5% tax on foreign income generated from the intellectual property. The idea is that by lowering the tax on intellectual property to the rate paid in Ireland, and other tax shelters, companies will be more willing to hold their IP in the US.

Reconciling the two Tax Bills

The House tax Bill has already been voted on and the Senate hopes to pass their version by the end of November. The two chambers will now need to form an agreement that reconciles the differences between the two pieces of legislation.

The budget resolution has capped the overall size of the tax package to $1.5t over 10 years; therefore, Republicans must find a way to reconcile the differences while adhering to this deficit limit. This will be a delicate balancing act by the Republican leadership.

We will examine which provisions will prove the biggest hurdles for Republicans to bridge the differences between the Bills.

State and Local Tax Deduction (SALT)

Recall that both Bills repeal the state and local tax deduction for income and sales tax. However, the Senate Bill also repeals the deduction for property tax, while the House Bill retains the deduction for property taxes up to $10,000.

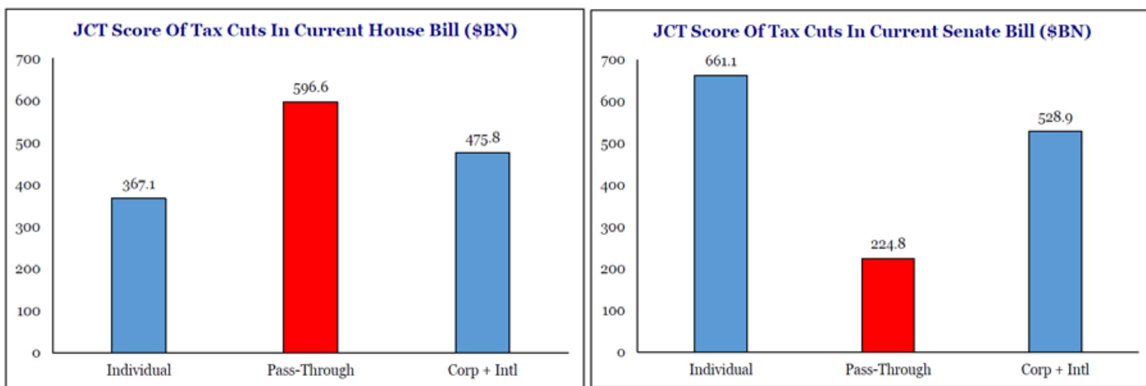
House Republicans from high tax states are digging in their heels and refusing to vote for legislation which repeals the state property tax deduction.

In the end, we believe the Senate will allow individuals to keep the SALT property deduction but not businesses. However, the Senate will need to find tax revenue from elsewhere to accommodate this change.

Pass-Through/Small Business Provisions

The House Bill has more cuts for small businesses than the Senate version and Senators Ron Johnson and Steve Daines have been publically voicing their concern. The Senate cannot afford to lose either of these two votes, especially with Sen. Johnson on the budget committee, and may need to weigh the corporate tax cuts more in the favor of pass-throughs and away from corporations.

As you can see below, the House Bill provides more tax cuts for Pass-through entities:



Source: Joint Committee on Taxation, Strategas

ACA Individual Mandate Repeal

A late amendment to the Senate Bill repeals the individual mandate of Obamacare. The individual mandate is the provision which incentivizes Americans to sign up for Obamacare by penalizing them for not doing so. In short, repealing the individual mandate effectively kills Obamacare.

By repealing the individual mandate the Senate raises $340b over 10 years and $500-$700b in years 11-20. The improved budget window in the final 10 years is critical because it allows Congress to make the tax changes permanent. This provision provides the Senate with needed fiscal space to implement targeted tax cuts elsewhere. However, if the previous failed attempts at addressing Obamacare are anything to go by, bringing the health care debate into tax reform will prove a deal breaker for some moderate Republican Congressmen.

Therefore, it is our belief that Senate provision for a repeal of the ACA individual mandate will not survive the legislative process and the Senate will need to find savings from elsewhere. The question is, does the Senate have the votes to support a Bill with only temporary tax cuts and find a way to raise $350b of revenue (or removal of tax cuts) from elsewhere?

Corporate Tax Rate Cut

Both the House and Senate's corporate tax rates are 20 percent, but the House has that tax rate come into effect immediately while the Senate waits until 2019.

The delay in the corporate tax cut generates $100b of savings for the Senate Bill. The problem is that it delays much of the economic stimulus until after the midterm election. We believe that the current political climate sets the Democrats up for a wave election in 2018, and the odds are increasingly pointing to the Republicans losing control of both houses of Congress. Therefore, we believe that in order for the Republicans to improve their chances in the midterm elections they must push as much fiscal stimulus as possible into next year. However, the Senate would need to find $100b from elsewhere to make the tax cuts immediate.

Dan Clifton, senior policy analyst at Strategas Research, believes a possible solution is to implement the corporate tax cut in 2018 but at 23% rather than 20%. Moving the corporate tax rate to 23% would generate over $100b in savings that would cover the cost of implementing the tax cut a year earlier and provide needed stimulus heading into the midterm elections. Thus far, President Trump has drawn a line in the sand at 20% but we view this more as a negotiating tactic. By anchoring Congressional Republicans at 20%, he ensures as low a corporate tax rate as possible. If the math is slightly off at 20% we believe the President will be willing to capitulate and allow the rate to rise to 23%.

Tax Reform Deadline

The developments in the Alabama Senate race have accelerated the timeline for Republicans to finish tax reform. The Republicans can only afford to lose two votes in the Senate and we believe that based on the current vote math, the loss of a "yes vote" from the Alabama Senate seat is enough to kill the Bill. According to Dan Clifton, "Republicans are convinced that no matter who wins the election, that candidate will not vote on tax reform." Our other Washington contacts echo this sentiment.

The Alabama Senate election will be held on December 12th but the results will not be certified until December 26th. This puts the last week of December as the deadline for Republicans to pass tax legislation.

Economic Outlook

By Kevin Gamble

The U.S. economy continues to chug along at a low single-digit growth rate without any flashing warning signs of a recession on the horizon. As a matter of fact, economic growth has actually accelerated of late and is projected to once again exceed 3% in the fourth quarter of the calendar year despite the hurricanes. President Trump has made no bones about being a pro-business president; so-far, so-good for his administration, at least as measured by economic statistics and stock market appreciation.

Exhibit 1: Quarterly US GDP Growth

Source: Bloomberg

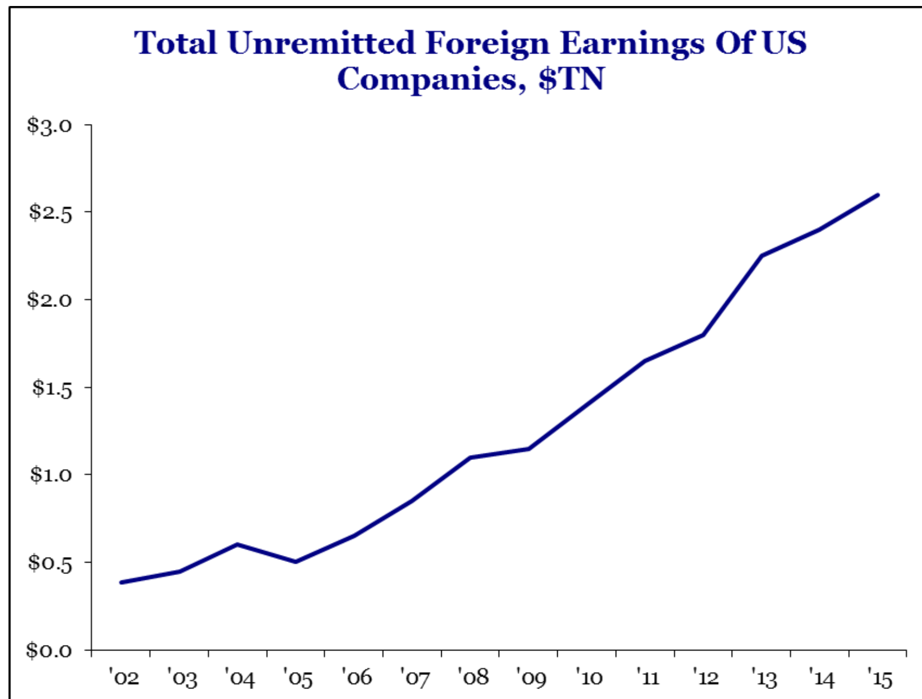
While the U.S. economy is accelerating and arguably operating at full employment, inflation has been largely absent at this point in the economic cycle due to several factors including automation, artificial intelligence, and increased productivity among the labor force. The disruptive force of Amazon on the retail landscape and the potential for driverless cars to disrupt the transportation marketplace are just a couple examples. As a case in point, Uber just committed to buying 24,000 driverless cars from Volvo by 2021. These factors have served as an offset to growth and have thus far allowed wages and interest rates in the marketplace to importantly stay accommodative for corporate investments, the housing market, and merger & acquisition activity.

Exhibit 2: US Unemployment Rate

Source: Strategas Research Partners

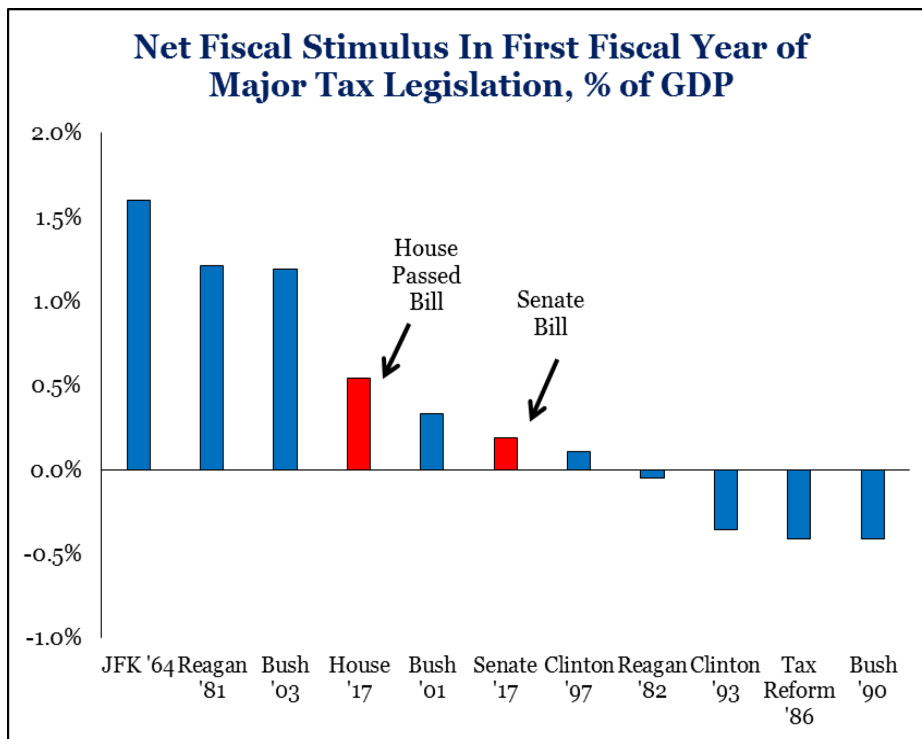
Tax reform continues to be an uncertainty in the marketplace, but is likely to be stimulative for both the economy and corporations. Repatriation as part of this reform is something we are certainly watching closely as it has the potential to be a QE3 of sorts as money moves back into the United States from abroad. As we discussed in the March of 2017 equity strategy piece, the last time we had a repatriation tax holiday (2005), roughly half of the $600 billion was returned to the United States. This time around companies have over 4x that amount of money, so the amount of repatriated earnings could easily top $1 trillion creating quite a capital markets and economic stimulus.

Exhibit 3: Potential Foreign Earnings Repatriation



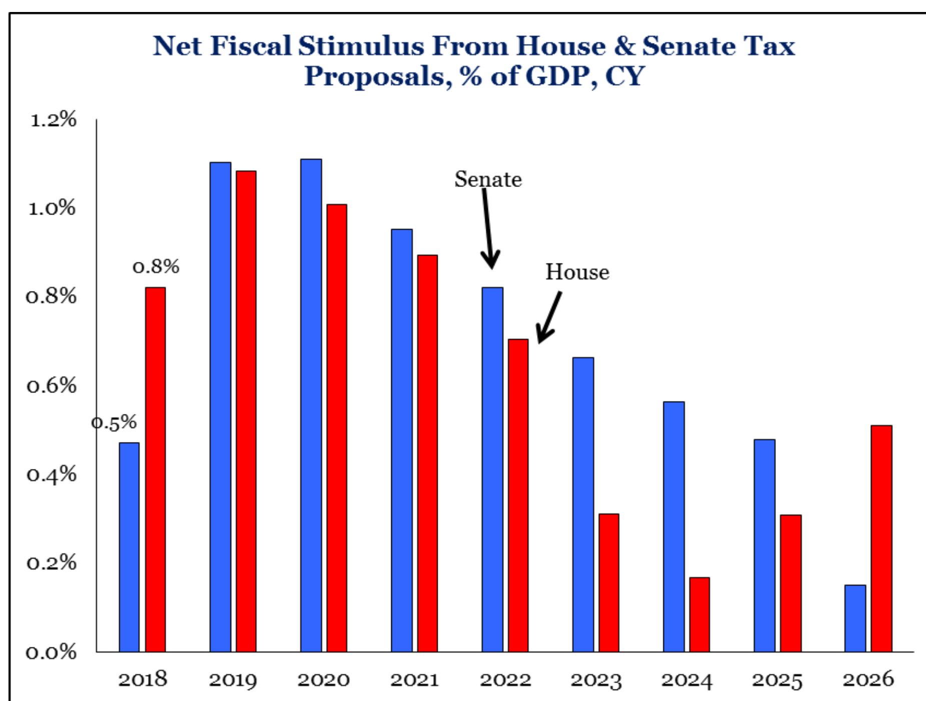
Source: Strategas Research Partners

Exhibit 4: Estimated Fiscal Stimulus in Year 1 of Proposed Tax Reform



Source: Strategas Research Partners

Exhibit 5: Estimated Fiscal Stimulus in Out Years of Proposed Tax Reform



Source: Strategas Research Partners

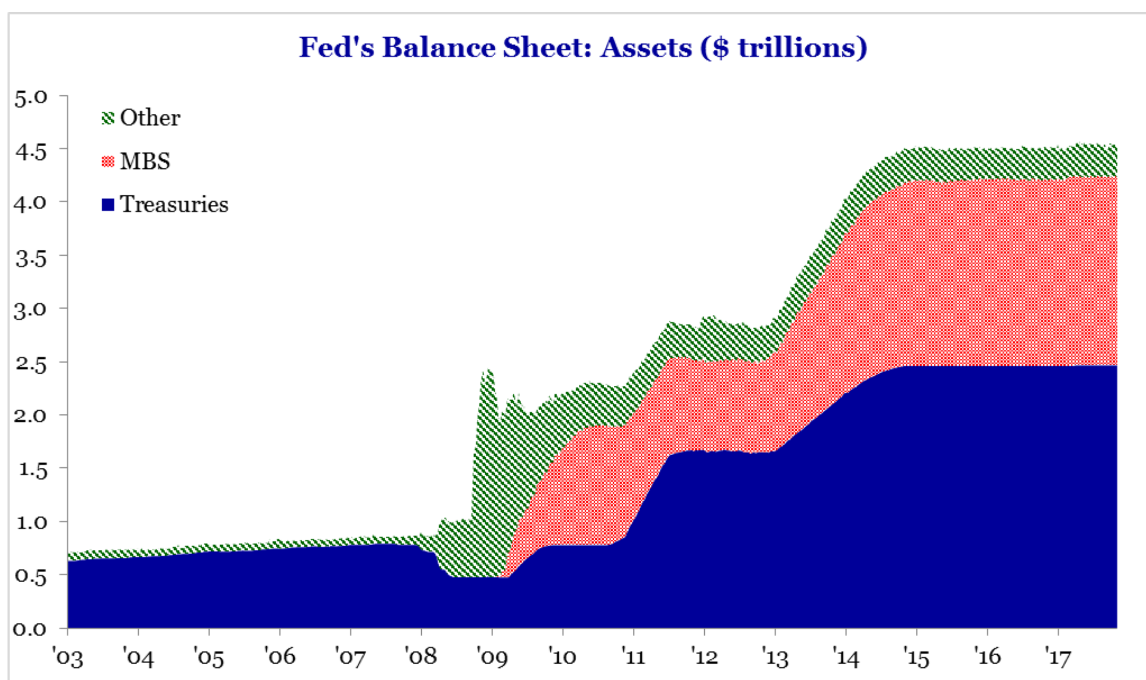
What are the risks to the current benign economic situation?

While there are currently elements of a Goldilocks situation for the current economy and markets in the United States, we of course realize things can change quickly and are constantly on alert for happenings which could alter the current positive situation.

Risk 1: The obvious thing many investors are watching is the shape of the yield curve. A positively sloped yield curve is generally seen as healthy and stimulative, while a negatively sloped yield curve can often, but not always, be a warning sign on future growth. While the yield curve has been flattening, it still has a positive slope. This is certainly something we are watching along with many other investors. This is the first risk that is often mentioned among educated market participants/observers at a cocktail party, so it is very well understood.

Risk 2: While interest rates remain accommodative, it is not lost on us that the Fed is no longer expanding its balance sheet (the expansion has had a statistically significant positive correlation with US equity markets) and is now in the midst of a tightening cycle both by raising the fed funds rate as well as by no longer buying bonds and expanding the balance sheet in the QE program. Will the Fed be able to manage this tightening cycle so as not to be too restrictive to cause a recession and not to be too accommodative to allow inflation to run hot? Time will tell. It is important to note that while the U.S. central bank is no longer expanding its balance sheet, global central banks continue to expand.

Exhibit 6: US Federal Reserve Balance Sheet



Source: Strategas Research Partners

Risk 3: Geopolitical risk is certainly present as always. While the current focus is on the seemingly unstable situation in North Korea, this risk can take many different turns and is constantly present and fluid. Trump recently put North Korea on the state sponsor of terrorist list.

Risk 4: The economy runs too hot following corporate tax reform, inflation creeps in the picture, interest rates move higher causing the housing market and investment to slow, and profit margins begin to get squeezed by rising labor costs……this scenario is not necessarily a recipe for recession, but could be challenging to financial markets including both the stock market (with shrinking profit margins) and the bond market (with rising interest rates).

Risk 5: Unknown….this is really an all-encompassing risk, but tends to be the risk which can do the most damage.

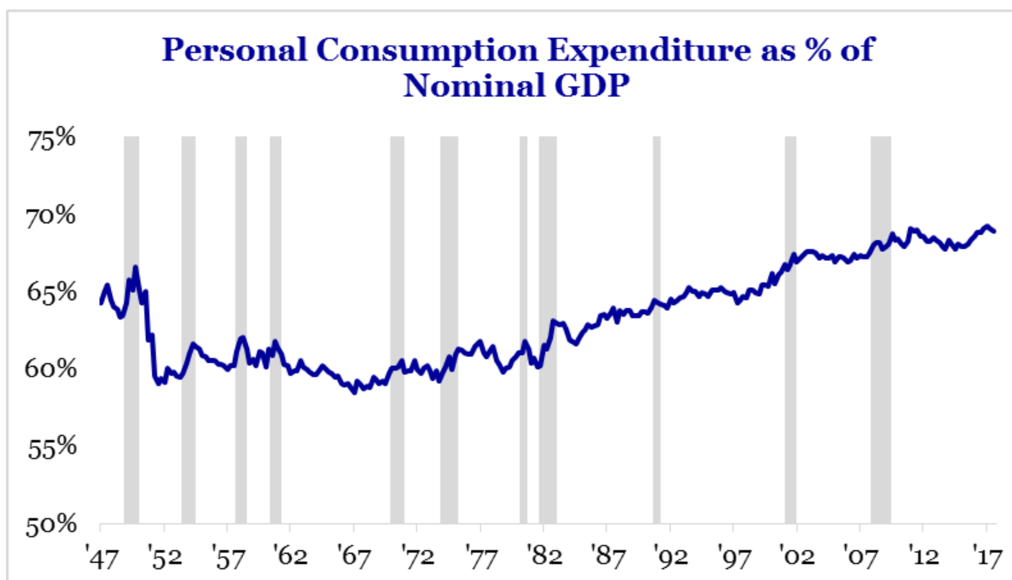
What is the most bullish global economic scenario going forward (updated from the December 2011 economic outlook)?

Given President Trump's recent Asian trip, we thought we would update our bullish global economic scenario first put forward in our December 2011 economic outlook piece. While the trip to China was perhaps overshadowed in the news by the shoplifting of the three UCLA basketball team members and subsequent release and tweets, the bigger picture economic relationship moving forward between the US and China is the more significant development. President Trump seems to understand well the bullish case made below as he announced a minimum of $300

billion worth of trade deals during his trip as supporting evidence of this with a promise of close to $1 trillion worth of deals to come in the near future.

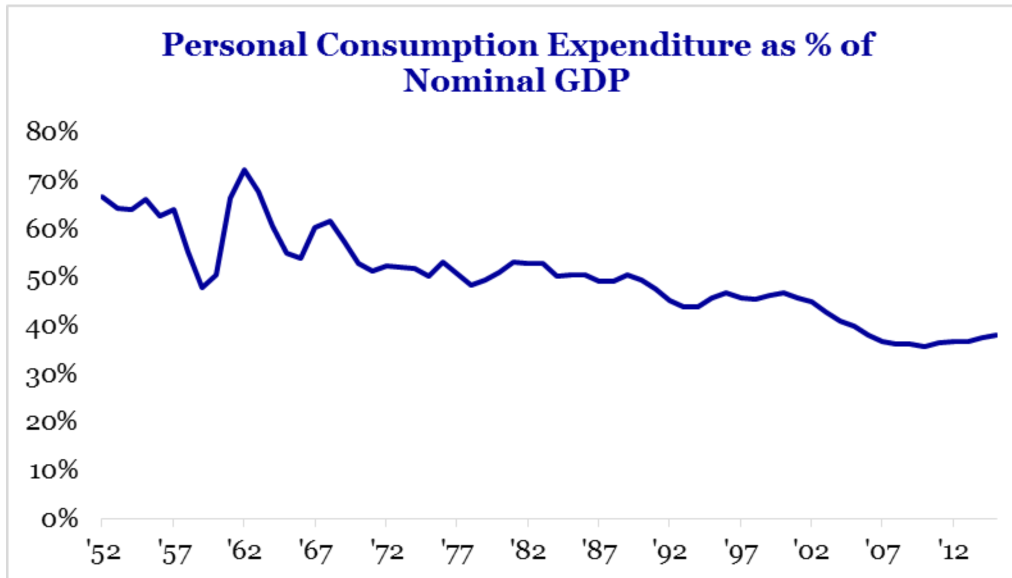
The two largest and most influential economies as we move through the 21st century are likely to be the United States and China. Each of these economies is arguably severely out of balance, with the United States overly exposed to consumption while China is overly exposed to investment. Both economies have been approaching these extremes for years and both have hit levels in which the extremes are unlikely to go any further. In other words, the United States economy needs to find a driver other than consumption and the Chinese economy must find a driver other than investment. Both economies should cease moving toward further imbalance and instead should move together toward a healthier balance. This can be done, but it requires cooperation and open markets. A healthy relationship moving forward between the US and China and between President Trump and President Xi Jinping is very important for both nations as well as the global economy.

Exhibit 7: United States Personal Consumption as a % of Nominal GDP



Source: Strategas Research Partners

Exhibit 8: Chinese Personal Consumption as a % of Nominal GDP



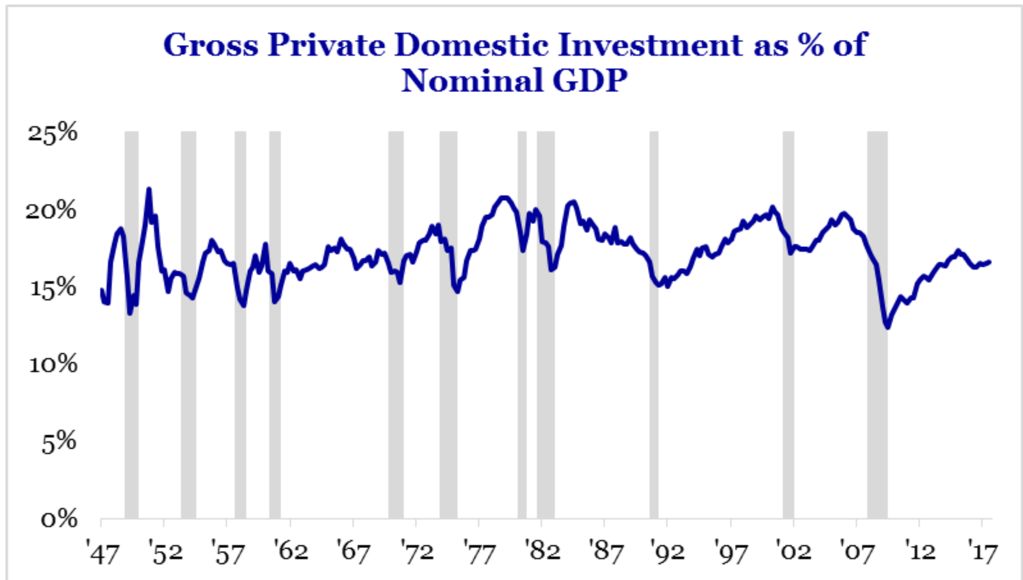
Source: Strategas Research Partners

The Chinese consumer and the U.S. consumer are mirror opposites in many ways. The Chinese have seen income growth, rising levels of employment, and have had a positive and rising savings rate for many years which has coiled a spring for potential future consumption growth.

Given that the consumption bull as a percentage of GDP has largely run its course in the United States, U.S. companies desperately need the Chinese consumer to pick up the baton and run with it. Chinese markets need to continue to open up and remain open to American brands to grow much like several American brands have done in the early innings of this move including Yum! Brands with their KFC Chicken franchise, McDonald's, and Starbucks to name a few. Given the population of China and the opportunity, the potential is quite large.

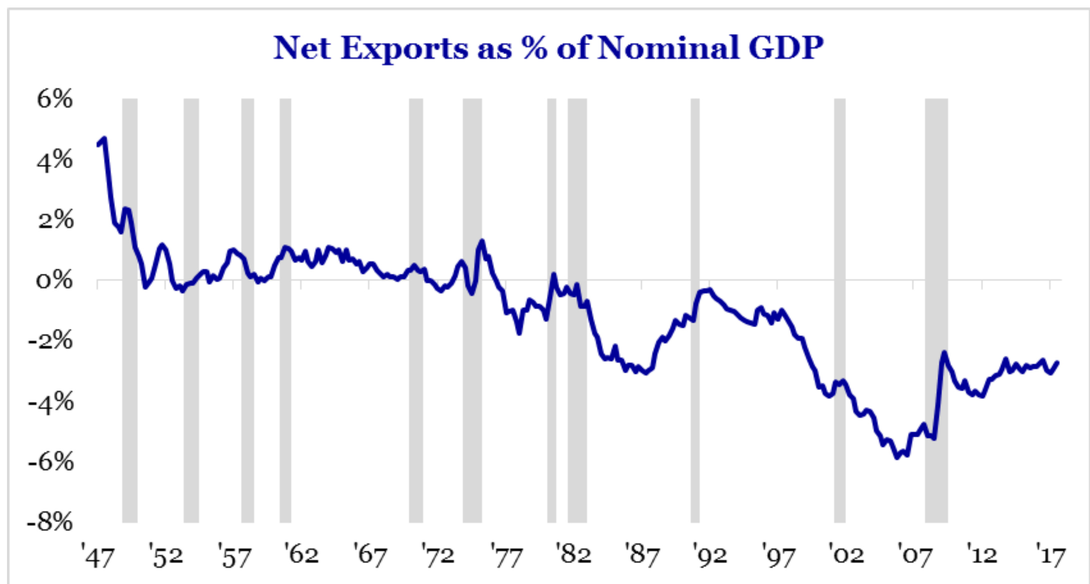
If consumption is largely tapped out in the U.S. and government spending is likely to fall as a % of GDP in the future, then what is left for us to focus on is the investment and net export side of the GDP equation. In other words, it would behoove us to focus on bringing back a manufacturing base in this country, investing in our domestic electric grid, airports, roads, transportation systems, etc…….in a productivity enhancing way.

Exhibit 9: US Investment as a % of Nominal GDP



Source: Strategas Research Partners

Exhibit 10: US Net Exports as % of Nominal GDP



Source: Strategas Research Partners

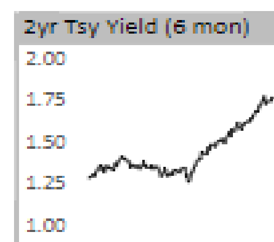
RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last meeting, the Federal Open Market Committee (FOMC) opted to stay on hold at its late September assembly. The Fed left its future rate expectations intact, indicating another rate hike by year-end and three more scheduled for 2018. Policymakers also released plans regarding the expected reduction in the Fed's balance sheet. Their guidance calls for a $10bn monthly reduction in the purchases of treasury and mortgage-backed securities. This amount will increase by an additional $10bn with each passing quarter. Domestic fixed income returns for the Retirement Systems finished up a little more than one percent for the fiscal year.

The month of October was very supportive of risk assets. The outperformance came on the heels of better than expected corporate earnings and fairly solid economic data. Credit spreads narrowed across the spectrum, finishing the month a few basis points shy of the tights of this cycle. Investment grade and high yield corporate debt returned approximately .40%, a 50bp outperformance relative to their treasury counterparts. The supply of high grade debt reached $130bn, a record for the month of October. Flows into the space continued for the 21st consecutive month. These outcomes have become customary given the backdrop of easy global monetary policies.



Stifel Fixed Income Strategy

The most recent peak in long-term yields coincided with the European Central Bank (ECB) policy meeting at the end of October. While the governing body laid out plans in reducing asset purchases beginning next year, it also promised negative interest rates well past the end of quantitative easing. Core inflation recently dropped below one percent, despite the euro-zone economy growing at its fastest pace in over five years. Low inflation has surprised monetary policymakers here at home as well given the solid employment picture. The Fed's preferred inflation measure has only exceeded its 2% target briefly over the last several years.

The latest FOMC minutes have confirmed the market's expectations of a December rate adjustment. This certainty has continued to push short term rates higher, a march that has been unrelenting since early September. However, the lack of inflation and uncertainty surrounding fiscal measures have allowed the long end of the yield curve to slide. The 2s/10s curve has now collapsed to a decade-low. The flattening of the yield curve has predictably led to further discussions of an inverted curve. The topic draws

Bloomberg

investors' interest as an inverted curve has led all recessions over the last 40 years. There needs to be some perspective when evaluating the current situation. The federal funds rate is being driven higher from a historically low level. It has been a process that involved several rounds of quantitative easing and took seven years before implementation even began. One needs to consider the linkage of sovereign yields between developed countries as well. Also of note, third quarter GDP has recently been revised upwards to 3.3%, a level that is not commensurate with an impending drop in economic activity.

Credit markets have rebounded somewhat from the earlier sessions of November. Corporates have managed to keep up with the pace in treasuries. Agency and mortgage-backed securities have underperformed at the margin due to their lower duration profile. High yields spreads have widened slightly in November, but after the run this asset class has experienced over the last two years, a breather is well deserved. Within the mortgage space, the Retirement Systems has reinvested prepayments and added exposure outright in a duration-neutral manner. The fund has also been able to pick up additional yield by swapping out of agency bullets trading at tight levels and into callable ones that are currently out of the money. On the corporate side, the purchases being made are in solid names like CBS, Anthem, and Goldman Sachs. The levels where these securities were purchased ranged from 75bps on the short end to 125bps in the intermediate part of the curve.

Going forward, it appears that a December interest rate hike by policymakers will happen as "conditions are supportive" of such a move. It is also likely that current member of the Federal Reserve Board of Governors, Jerome Powell, will be confirmed and take over the role of Fed Chairman in February. In his statements to lawmakers earlier this week, Powell intends to continue moving at a gradual pace in regards to interest rate increases. Given the luxury of the current inflationary environment, he stated that policymakers can afford to move more slowly if needed. He also projects that the Fed's balance sheet will fall to $2.5-3.0 trillion over the next few years. The 10yr treasury yield has been somewhat range-bound over the last month, and it will be interesting to see if it can breakout to the upside on a fiscal stimulus agreement or strengthening wage growth. Likewise, it is debatable how much further the front end of the curve will rise over the near term without a corresponding move in inflation. One thing not in dispute is that Americans are more confident about the employment landscape than they have been for some time.

Domestic Equity Strategy

By Allan Carr

Since our last update just seven weeks ago, domestic equity markets have continued to impress. On November 28th, the S&P 500, Nasdaq, Dow Jones Industrials, Russell 2000, and several other indices all made new highs. The S&P in Trump's first twelve months was up over 21% - making it the fourth best one year return following a presidential election in the last 80 years behind Clinton in 1996(32%), JFK in 1960 (29%), and the elder Bush in 1988 (23%).

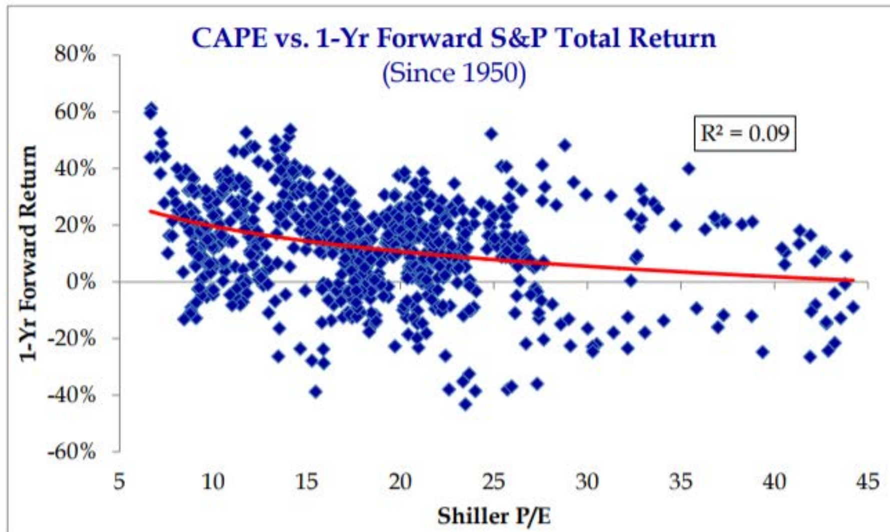
Historically, all-time highs are accompanied by excitement and euphoria. But to the contrary, the prevailing sentiment towards stocks continues to be that they are much more likely to go down versus up. We continue to hear a chorus of reasons why the market will sell off and that we are nearing the end of the cycle. Those focusing solely on D.C. have been clamoring, "how can the market be up", saying all the President is done is get in Twitter wars and has gotten virtually nothing accomplished on the legislative front. It's been over 350 trading days since we witnessed even a 5% drawdown, much less a 10% correction. The VIX is at historical lows which is viewed by many as a sign of complacency. Valuation is expensive relative to history. Bull markets don't last forever, and the current one is nearing the longest in history. These are some of the common arguments against stocks that we will address.

We will leave the political debates to others and simply say the market rally so far has been predominantly due to the global economic expansion and earnings acceleration that happened to coincide with the election. There has not been much progress in Washington, but prospects of tax reform are looking more promising in recent days. We remain hopeful that is the case.

We are wary of a pullback as we seem overdue for one, but trying to predict them is usually a fool's errand. We are not big fans of using the VIX as a predictive indicator. We think the historically low VIX is reflective of current conditions: extremely low realized volatility due to global economic strength, tight credit spreads, inflation being contained, etc. If and when the VIX spikes, it will be coincidental with something changing in the current landscape, such as credit spreads widening or a hiccup in the global economic expansion.

Valuations are above long term averages but not by an excessive amount. As we've mentioned many times, valuation tends to overshoot to the downside in bear markets and to the upside in bull markets. People have been beating the valuation drum for years to no avail. When viewed in the context of where interest rates are and likely to go, where inflation is, and the risk/return of other investment vehicles, we do not see valuations as overly concerning. Additionally, using valuation as a predictor of returns in the short term has an extremely poor track record. (Exhibit 1 from Strategas)

EXHIBIT 1



We've been consistent for years in saying that bull markets don't simply grow tired and die of old age. They die when a recession is imminent. Below is a list of some of the usual culprits that start to flash warning signs of bull markets ending (Exhibit 2 from Credit Suisse).

Exhibit 2

Start of Recession	Yield Curve	Inflation Trends	Labor Market	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	↓	↓	--	↓
Jan-80	↓	↓	↓	↓	↓	--	↓
Jul-81	↓	↑	↑	↓	↓	--	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↑	↑	↑	↑	↑	↑	↑

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Things can change quickly, but as of now, the usual signs of hubris, greed, and reckless behavior associated with bull market tops are not present. We aren't seeing money pour into U.S. stocks. Until recently, we had been in net redemption for U.S. stocks for the entirety of this cycle. The retail investor is still not participating in a meaningful way. CEO's aren't paying crazy multiples to do deals. Out of curiosity I revisited a similar checklist from the December 2013 economic update. Four years ago people said the market was getting long in the tooth and were warning of a crash. Those people missed out as the market is up 60% since then.

We bring this up only to say that trying to predict a market top is a very dangerous game. It can also be extremely painful as the late years in bull markets have historically been quite strong. Exhibit 3 from Bank of America shows returns in the final stages of the previous 12 bull markets as well as where we stand in the current one.

Exhibit 3

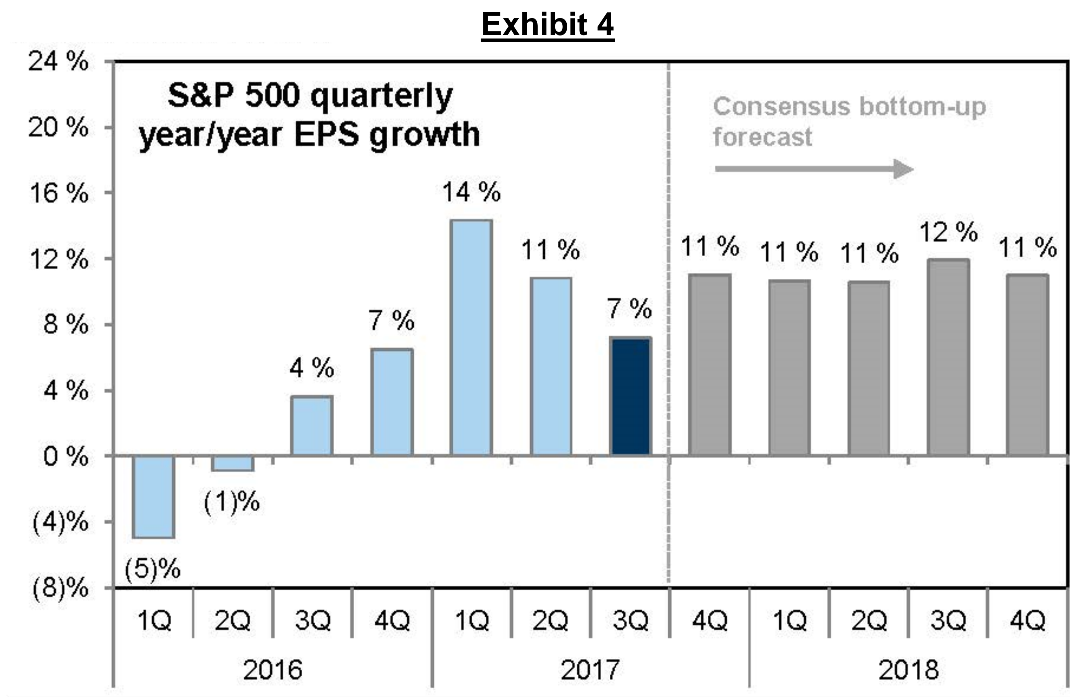
	Return			% of cycle return		
Peak	24 months	12 months	6 months	24 months	12 months	6 months
Mar-37	129%	33%	19%	58%	12%	7%
May-46	72%	33%	15%	46%	19%	8%
Aug-56	74%	20%	15%	24%	5%	3%
Dec-61	32%	32%	11%	34%	34%	11%
Feb-66	30%	11%	11%	34%	12%	12%
Nov-68	44%	18%	12%	82%	35%	23%
Jan-73	39%	19%	14%	52%	25%	17%
Nov-80	65%	39%	29%	44%	25%	18%
Aug-87	93%	40%	20%	46%	18%	8%
Jul-90	45%	15%	10%	65%	21%	14%
Mar-00	42%	22%	20%	11%	5%	4%
Oct-07	36%	18%	9%	38%	18%	9%
Today	29%	21%	11%	10%	7%	3%
Average	58%	25%	16%	44%	19%	11%
Median	45%	21%	14%	45%	19%	10%
Min	30%	11%	9%	11%	5%	3%
Max	129%	40%	29%	82%	35%	23%

In the last 80 years, the average return in the final two years of bull markets was 58%. In the final 12 months it was 25%. The worst return in the final two years of any of these bull markets was 30%. We are not using these numbers as any sort of guide but rather to point out that historically bull markets don't end softly. They usually go out with a bang, and missing out on the final stages can be quite costly.

Along these lines, Goldman Sachs published an interesting piece recently referencing the famous December 1996 Alan Greenspan speech where he voiced concerns over stock prices using the term "irrational exuberance". The Fed Chairman said he "worried that investors were getting carried away and stock prices were beginning to embody expectations so exorbitant that they could never be met." At the time of the speech, the market had been on a multi-year run following the infamous October 1987 crash. The market bottomed in December of 1987, so at the time of Greenspan's speech the bull market run was up roughly 335% in nine years. Ultimately, Greenspan was right as the tech bubble did in fact burst, however he was more than three years early. The market more than doubled from the day of that speech until the ultimate peak in March 2000, returning over 115%.

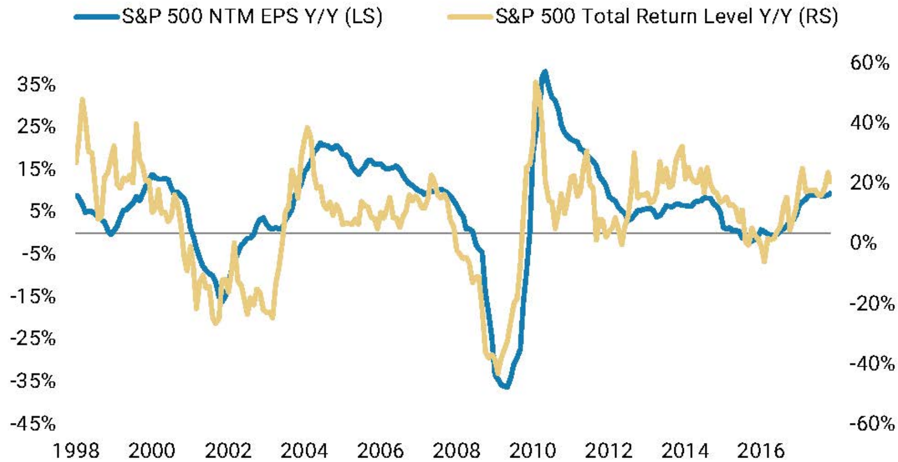
Looking ahead, we continue to be constructive on stocks primarily due to the earnings story. The "earnings recession" of 2014-2016 is well documented where earnings were more or less flat. Through three quarters of the year, earnings look on pace to be up around 9% for 2017. The outlook for 2018 looks promising as well as seen in Exhibit 4 from Goldman.

Exhibit 4



The big wildcard in earnings estimates going forward is what will ultimately become of the proposed tax reform. Refer to the Fiscal Policy piece in this packet for a detailed look at what's on the table for tax reform. As for what it means for equity markets, we will highlight that there could be 12-15% upside to 2018 earnings estimates if tax reform is enacted. We aren't political experts, but we can say that market action in recent days suggests the odds of tax reform getting pushed through have increased, as we've seen a re-up on the "Trump" reflation trade. If tax reform goes through, that would be an obvious positive for markets due to the earnings impact, as well as sentiment. Exhibit 5 from Morgan Stanley shows the strong fit of earnings driving the market.

Exhibit 5



Goldman recently published a multi-year forecast that they termed "rational exuberance". They rolled out earnings estimates and price targets that have the market following earnings, without the euphoric rise in multiples seen in the late 1990's. Based off a stable market multiple, they have a target of 2850 on the S&P for year end 2018 which inclusive of the 2% dividend would result in over a 10% return from current levels.

We are cognizant that things can turn on a dime and that something politically or geopolitically could derail us. We are closely monitoring the landscape for signs of trouble. But based on current information, staying invested in stocks and riding the earnings wave remains our preference. Nearly nine years into the recovery, it remains the road less traveled.

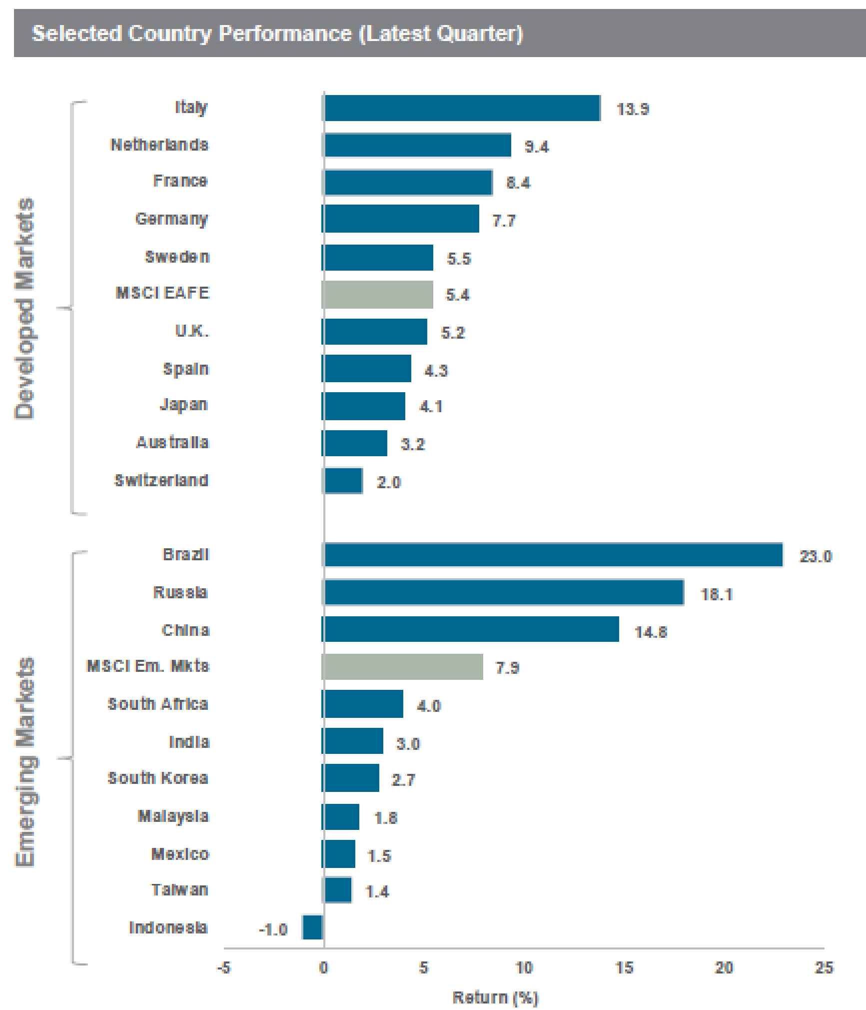
International Equity Strategy

By Steve Lambdin

The surge in the international equity markets continued in the third quarter as investors pushed many of these markets to all-time highs. Economic growth seemed to gain momentum in the period, corporate earnings accelerated, volatility remained low, and central bank rhetoric remained "well-telegraphed" to lead most markets higher. The weakening of the U.S. dollar continued to help U.S. investors in the quarter as the falling U.S. dollar provided approximately +2.0% of return for unhedged investors in the MSCI EAFE Index. Economic conditions continued to improve across Europe as PMI's remained strong, inflation held steady, and job gains were solid. Posturing around the Brexit negotiations continued with nothing of substance coming out. In addition, Merkel's re-election provided a bit of comfort to investors as well. The Japanese equity market was strong in the quarter as GDP growth accelerated as manufacturing surveys look strong and The Bank of Japan (BOJ) kept monetary policy relatively steady in the period. China experienced better than expected growth on several fronts as the transition to a more domestic focused economy continued. Emerging market equities remained very hot as investors continued to pour money into this asset class seeking higher returns from excellent growth prospects ahead after years of disappointment. Recent events in the Middle East and North Korea are still very concerning for most and present risk to this story going forward. However, beyond these geo-political risks, the global economy seems to be in a synchronized growth spurt and could push equities higher from current levels.

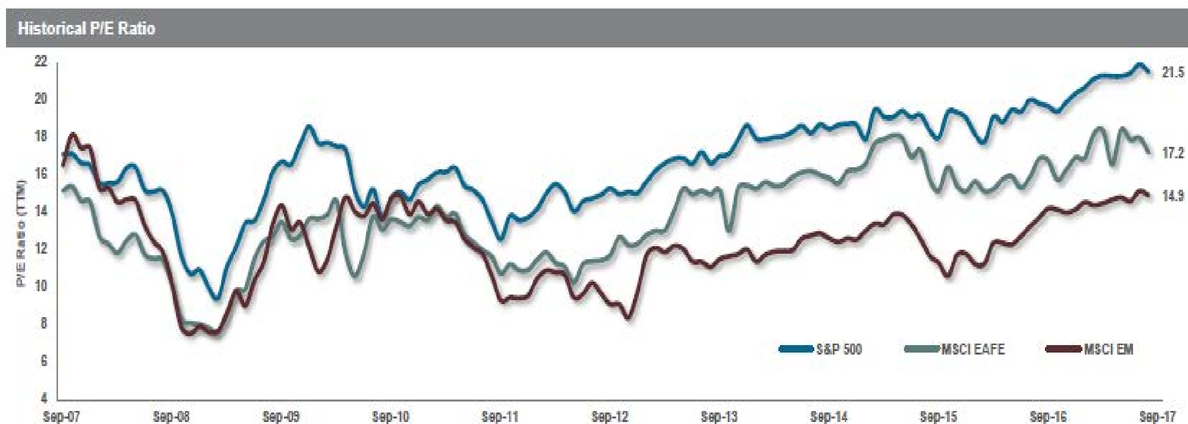
Source: John Hancock Investments; Morningstar Direct

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +5.4% and +7.89% respectively during the third quarter of 2017 versus +4.48% for the S&P 500 Index. This was the third straight quarter where global stocks outperformed U.S. stocks. In addition, global equities outperformed U.S. stocks for our fiscal year as well. The U.S. dollar continued to fall in the third quarter and provided a positive boost for unhedged U.S. investors. The U.S. dollar fell -3.6% versus the Euro, -3.1% versus the British Pound, and was nearly flat against the Japanese Yen. As mentioned earlier, currency was an approximate +2.0% benefit to unhedged U.S. investors in the MSCI EAFE Index in the quarter. The European region was significantly stronger than the Pacific region yet again, as the movement of the Euro continued to be a positive kicker to performance. From an economic standpoint, all sectors posted positive returns for the third quarter as Energy was the strongest with a +12.9% return. Crude oil did rise +12.2% in the period, which is indicative of a stronger global economy.



Source: Baird Market Chartbook; Morningstar Direct; MSCI

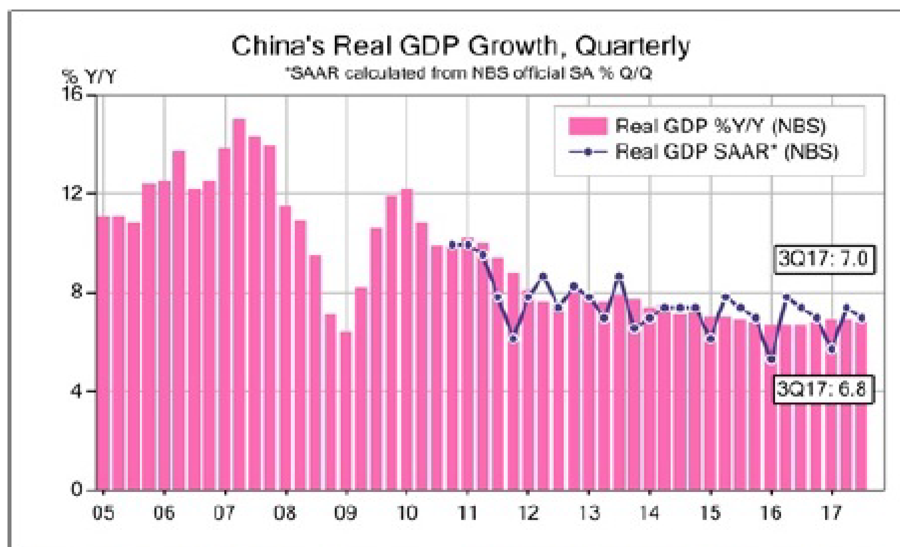
So far into the fourth quarter of 2017, global equities continue on an upward trajectory. Many markets around the globe are setting new highs almost on a weekly basis. A truly synchronized global recovery is upon us with nearly every region around the world pointing to higher growth ahead. We see rational central bank actions, escalating profit growth, tepid inflation, improving employment levels, and very reasonable interest rates at the moment. We just do not know the magnitude or duration of this recovery at this point. This has pushed the MSCI EAFE Index and the MSCI Emerging Markets Index up +2.4% and +5.6% respectively thru late November, vs. +4.6% for the S&P 500 Index. Emerging market equities still seem to be the place to be for most investors looking to add more risk in this environment.



Source: Baird Market Chartbook; Morningstar Direct; MSCI

Asia Update

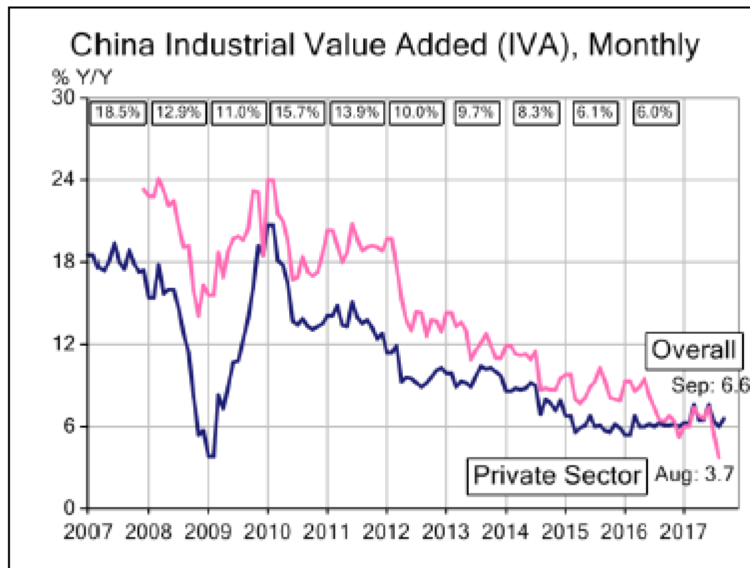
The Asian equity markets kept the recent momentum going in third quarter as the MSCI Pacific region rose +3.87% as economic growth was generally considered decent across the region, which was very pleasing to investors. Currency movements did help just slightly, but not to the extent we saw in Europe. Once again, the Japanese equity market was one of the best performing markets as this market recorded a +4.1% return in the period on the strength of a strong GDP report. In addition, Chinese equities were very strong in the period and returned +14.8%, as growth and reforms continue to surprise most investors. Even the resource dependent Australian equity market performed well in the quarter and returned +3.2% as optimism returned to the commodity markets in the period. All in all, returns across the Asian basin were impressive to us.



Source: Evercore ISI

The Chinese economy continued to be rather resilient in the third quarter as GDP rose +6.8% from a year earlier, about in line with what we have seen for all of 2017. The rather stable picture in China right now is a welcomed relief for the communist party leaders while this economy continues to move toward a more domestic oriented flow. This also gives officials here more opportunity to strengthen regulations aimed at systemic risks as the global growth environment remains good. Industrial production has actually slowed just a bit lately as October rose +6.2% from a year earlier, which is off the pace of a few months back. However, this production is still up +6.7% YTD in 2017. Fixed asset growth has slowed some as well as October climbed +7.3% from a year earlier, which is right in line with YTD levels as well. However, infrastructure spending still looks robust in this economy. Exports were about as expected in October as they were reported up +6.9% from a year earlier. This should remain steady going forward as China's trading partners in Asia seem to be on solid footing at this time. Retail sales continued recent trends as October sales rose +10.0%, which puts sales growth at +10.3% for all of 2017. We see these numbers are still very solid for this economy. Inflation continues to tick up slightly as October consumer prices rose +1.9% from the year earlier period. Factory inflation has been a bit sticky recently, but shouldn't be a real issue going forward. With CPI still well below the government's targeted rate, this leaves plenty of room for the People's Bank of China (PBOC) to push for more measures to curb excesses in the economy. As we head into early 2018, it seems investors have a new found acceptance of the measured slowing of this economy going forward. It seems real surprises are becoming fewer in this economy lately, especially as the world seems to be firmly in growth mode. Most will be watching trade negotiations with the

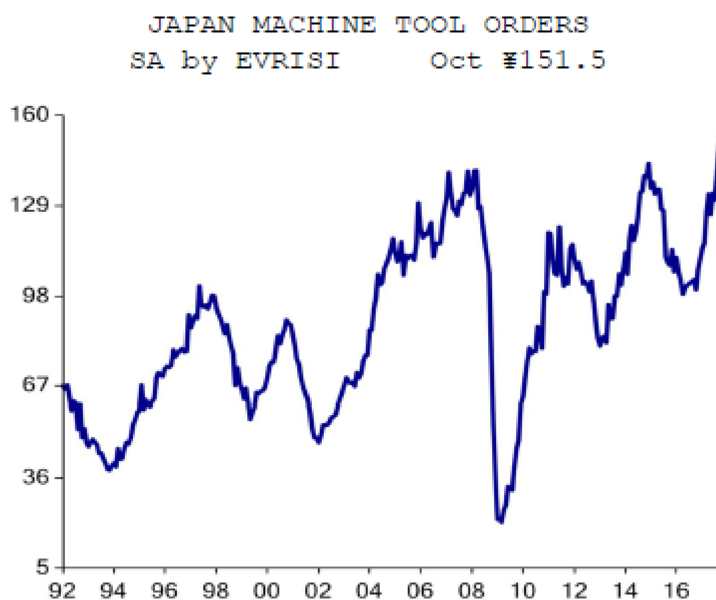
U.S. going forward. Any surprise negative developments can change the outlook in a hurry. Absent this issue, we see this region as relatively decent at the moment, which could push the equity markets even higher over the next few months.



Source: Evercore ISI

The economy in Japan continued its recent growth path in the third quarter, as GDP grew +.3% from the previous quarter, or +1.5% from the year earlier period. This now makes the 7th quarter of growth in a row and still remains the longest period of expansion in over 15 years. Corporate profit growth remains quite stellar as Japan continues to benefit significantly from the growth in global trade. Recent manufacturing surveys seem to indicate the most confidence seen in a while, especially as Olympic preparations are bustling for the 2020 games. As has been the case for some time, the BOJ kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0%. Its massive monetary stimulus remains in place, even as its stock market is at 20-year highs. Industrial production has been a mixed bag lately, as September was down about -1.0% from a healthy August reading. However, we are still seeing year over year gains in the +2.5% to +5.0% range over the last three months, which we view as decently strong. Recent business confidence index readings all seem to indicate a strong business climate at the moment, which should indicate strength ahead as well. Consumer confidence continues to gradually improve as October's reading of 44.5 matched the highest level in four

years. Though not nearly what we would like to see, this seems to be going in the right direction. Core prices are still moving higher in Japan as September prices rose +.7% from a year earlier, which is what we have seen over the last few months. This still leaves plenty of room before this ever becomes an issue for the BOJ. The labor market is still very tight as the jobless rate remained at 2.8% in September while the jobs-to-applicant ratio stayed at 1.52. These readings along with the highest labor participation rate since 2008 means the climate for wage gains seems to be present, which we believe is the next story in the ongoing recovery in this economy.



Source: Evercore ISI

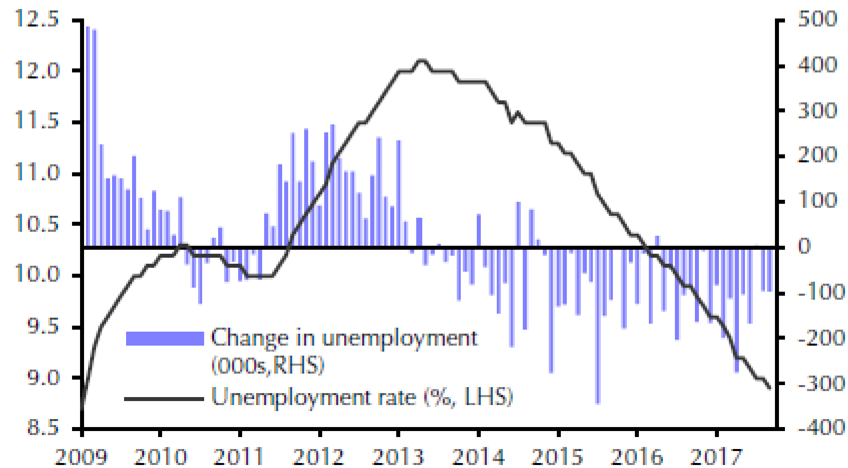
Europe Update

European equities continued to move higher in the third quarter as economic data points continued to strengthen, little new negative news on the political front, good corporate profits, and a better consumer outlook pushed investors toward these equity markets in the quarter. Most of the equity markets in the Eurozone moved higher and were led by Italy (+13.9%), Netherlands (+9.45), France (+8.4%), and Germany (+7.7%) in the period. U.S. investors benefitted from currency movements in the quarter as this provided about half of the return of the MSCI European Index. The higher beta sectors of Materials, Technology, and Energy led the way as investors opted for more risk in the region. At its late October meeting, The European Central Bank (ECB) continued to maintain its key interest rate levels as well

as its asset purchase targets for this year, which is little surprise. Even with the intention to scale back from the massive stimulus program, we don't see much of a chance for interest rate increases over the next several months at this point. The MSCI European Index (ex. U.K.) continued to grind higher in the third quarter and was up +6.45%, which was the best performing region in the EAFE Index this quarter.

The European economy expanded even further in the third quarter as GDP climbed another +.6% from the previous quarter, or +2.5% from the year earlier period. The region seems to have nice momentum at this time, which has been pleasing to most investors. The German, Spanish, French, and Italian economies all experienced good growth in the quarter. Industrial production continues to be a bright spot and rose +3.8% in August and +3.3% in September from the year earlier periods. This continues to move in the right direction and could even get better in the months to come. The index of executive and consumer sentiment continues to climb and rose to 114.6 in November and remains at the highest level in 10 years. This is very impressive and makes most investors feel confident in the economic climate in the region. Retail sales continue to improve as September sales were reported up +3.7% from a year earlier, which is at the best pace in two years. Strength was seen in clothing & footwear as well as food in the month. We believe the consumer is getting much more confident in the recovery here and will hold the key if this recovery is to move higher in the coming months. The CPI continued to fall recently as October Core CPI rose only +.9% from a year earlier, which is yet again the slowest pace of 2017. No doubt this is a signal that price increases are tougher to hold in this region and could put a damper on future plans to curtail stimulus actions as well as the prospects for wage gains. The unemployment rate continues to fall as September unemployment fell to 8.9%, which is now the best level we have seen since 2009. Overall, we like what we see happening in the Eurozone economy right now. Things are moving in the right direction and appear on solid footing. If this can continue, then we could see even further upside in the equity markets in the coming months.

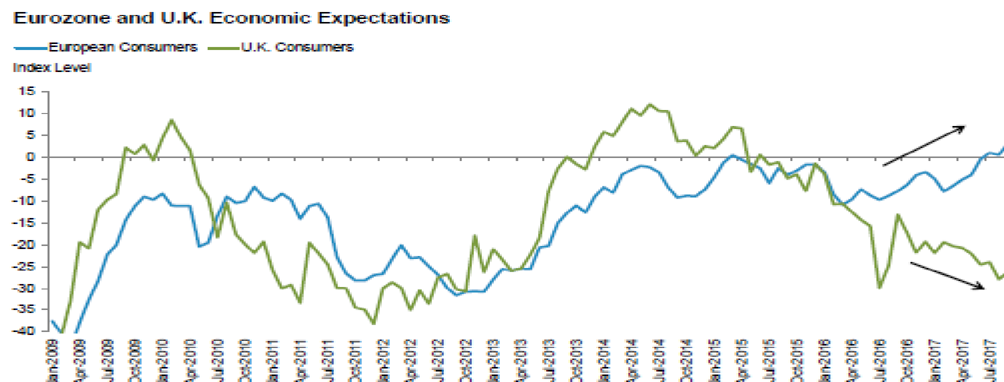
Chart 1: Euro-zone Unemployment



Source: Capital Economics

Most investors continue to focus on what Brexit will mean for the U.K. economy. While this road can take many paths to the unknown, what we currently see has been a weakening of economic trends lately vs. a strengthening of trends in other regions of the world. We find this a bit concerning and leads us to believe that Brexit uncertainty is coming into play here. To what degree, we still do not know at this point, but many will be watching. The economy still seems somewhat resilient lately, as GDP grew by +.4% in the third quarter from the previous quarter, or +1.5% from the year earlier period. This has been a consistent level of growth from the last two quarters. Business investment was the weakest it has been in a year and net trade was very weak as exports surprised to the downside in the period. Industrial production grew +1.1% in the quarter and remains somewhat stable at the moment. Many expect this key statistic to improve slightly in the last quarter of the year. Retail sales have been weak lately as October sales fell -.3% from a year earlier as food and clothing sales dropped more than expected. This is the first decline in four years and is very concerning. Core CPI continued to remain at somewhat elevated levels as October's reading of +2.7% from a year earlier remained above the Bank of England's (BOE) targeted rate. Food and beverage prices as well as recreational goods are trending higher than expected. As a result, at its recent November meeting, the Monetary Policy Committee (MPC) opted to raise its benchmark interest rate by .25% to .50%, while maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. This was right in line with what many were expecting and came as little to no surprise to the markets. With Brexit negotiations beginning to take center stage, we expect the BOE to remain on hold in the coming months. The employment situation remained steady lately, as the September unemployment rate remained at 4.3%, which is still a 42 year low. Employment rose by 50,000 workers in the three month period to

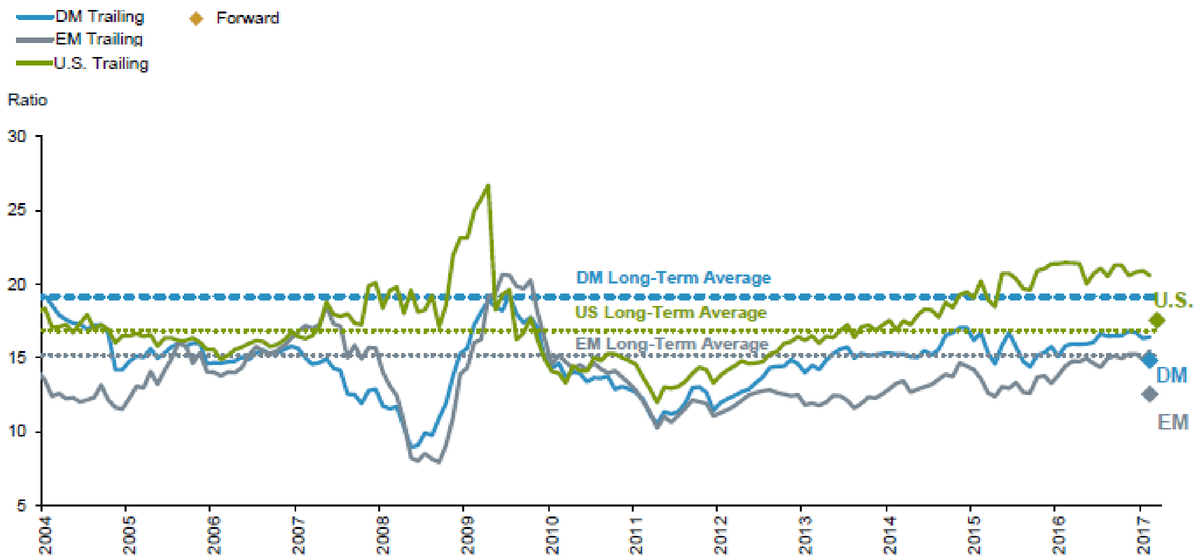
September with ending employment remaining at a record 32.1 million workers. Wage growth remained weak but moved up just a hair, as wages grew by +2.2% in the three months to September. We still need to see improvement in this key metric if this economy is to gain any momentum going forward.



Source: European Commission, Haver Analytics, Fidelity Investments

Emerging Markets

Emerging market equities continued to produce stellar returns as the MSCI Emerging Markets Index was up +7.9% in the quarter, +27.8% YTD, and +22.4% in the past fiscal year. These are some of the best results from this asset class in quite some time. Easy monetary policies, a weak U.S. dollar, higher commodity prices, and accelerating corporate earnings are coming together to bring investors back to these equities. The BRIC countries were very strong in the third quarter. With the growing middle class in many of these countries as well as the many political and economic reforms happening, it's easy to see why most investors are positive on these equity markets. Also, with long term 10-year returns that are barely positive, we could see a lot of runway ahead for emerging market equities. Valuations remain below that of other equity asset classes and give investors a bit of comfort. With these points in mind, we continue to like the story and expect to see these equities perform better in the months ahead.



Source: Fidelity Investments, MSCI, and Factset

International Equity Activity/Strategy

Nothing has drastically changed with our current outlook vs. just a couple of months back. We still like what we are seeing around the globe from an economic standpoint and this view results in a continued positive outlook toward the global equity markets. In fact, the improving economic conditions around the world could actually be picking up some steam. We still expect a gradual withdrawal of monetary stimulus over the next year from many of the central banks around the world that may catch a few by surprise. Corporate earnings look relatively robust at the moment and could still surprise to the upside in the coming quarters. Equity valuations still look a bit extended at the moment, much the same as it has been over the last couple of quarters. However, this alone is generally not a good indicator of future equity returns. Most of the European election drama has passed and many remain focused on the Brexit rhetoric, which seems to be moving rather slowly at the moment. As always, the North Korean situation remains one area that can change in a moment's notice. Absent any new developments on this front, we see a decent chance of higher equity markets from current levels over the next couple of months.

We have been adding aggressively to our emerging markets exposure since our last meeting. Since the beginning of our fiscal year, we have purchased approximately $420 million in emerging market equities. This still remains one area we believe has the potential for good gains over the next several years. We also have remained very active with our put writing on EEM over

the last few months and expect to continue to be going forward in an effort to add further to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 3.1% of total assets and approximately 11.2% for MSCI EAFE equities. *(Credit is given to the following entities for charts provided: Capital Economics, European Commission, Haver Analytics, Blackrock, MSCI, Thomson Reuters, Baird Market Chartbook, Strategas, Fidelity Investments, Factset, John Hancock Investments, Evercore ISI, and Morningstar Direct)*