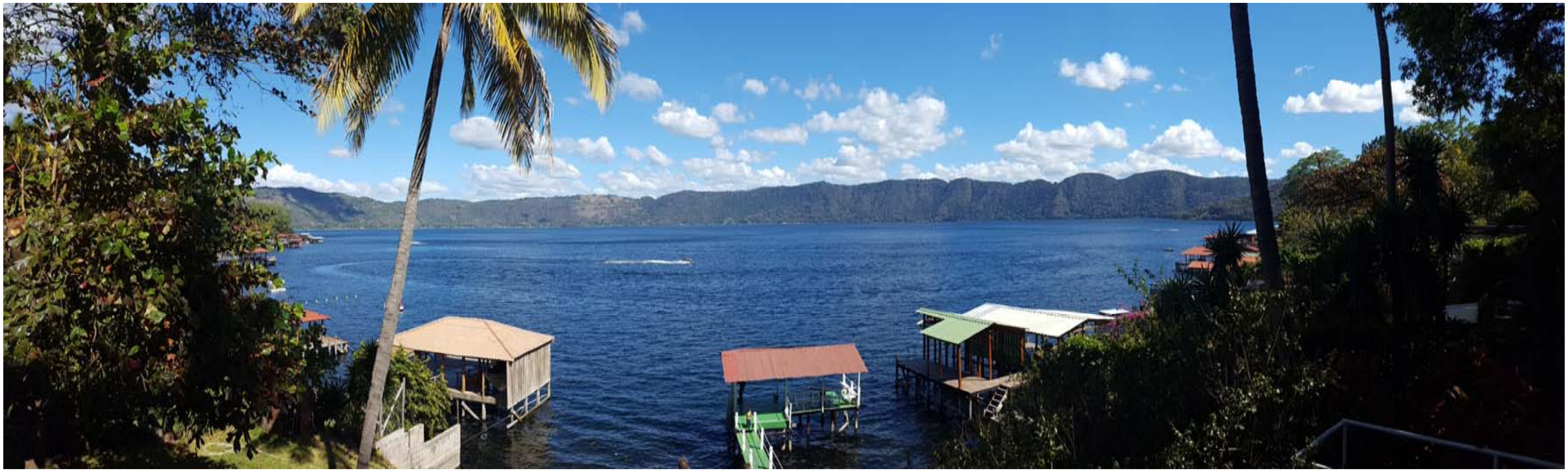


Photography: Jaimee Bernard - El Salvador 2017

Quarterly Update & Economic Commentary—June 30, 2017

Quarter in Review

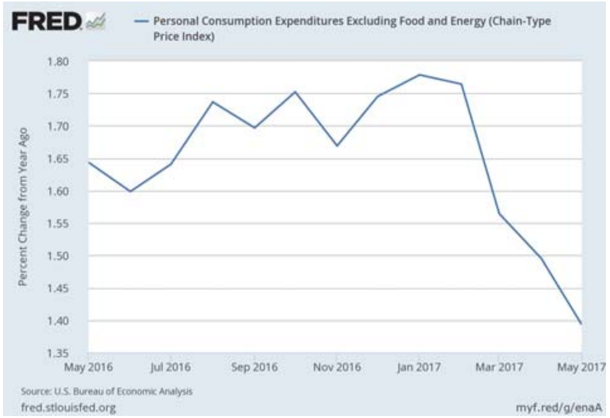
The markets had a good second quarter. The S&P 500 returned 3.09 percent and is positive by 9.34 percent year-to-date. The Health Care sector was the leading S&P 500 sector during the quarter, returning 7.10 percent. Health Care has the second highest year-to-date return of 16.07 percent. Information Technology is the leading sector at the halfway point of the year, the IT sector has gained 17.23 percent through June. The laggards through the first half of the year are the energy sector, which is down by 12.61 percent and Telecom which has lost 10.74 percent of its value. Large cap stocks have outperformed small cap stocks with the S&P SmallCap 600 returning 2.79 percent year-to-date compared to 9.34 percent for the S&P 500. With economic conditions improving around the globe, market returns outside the U.S. have begun to pick up steam. The MSCI EAFE NR, which is a proxy for international developed stocks, returned 6.12 percent for the quarter and is now positive by 13.81 percent year-to-date. The MSCI Emerging Markets NR, a proxy for international emerging stocks, returned 6.27 percent for the quarter and is positive by 18.43 percent year-to-date.

Fixed income investments were generally positive through the quarter as interest rates finished the year at a lower point than where they started. The U.S. 10-year Treasury Yield finished the quarter yielding 2.31 percent after starting the quarter at 2.40 percent and the year at 2.45 percent. Riskier bonds outperformed safer bonds as investors continued to favor risk assets. The Barclays US Aggregate Bond Index returned 1.45 percent during the quarter and has advanced 2.27 percent year-to-date. The lower credit quality index, the Barclays US Corporate High Yield Index, returned 2.17 percent for the quarter and is up by 4.93 percent year-to-date.

The general move of commodities was to the downside. The most significant commodity mover was oil which fell around nine percent during the quarter and is now down more than 14 percent year-to-date. The drop in oil prices led to the poor performance of the energy sector referenced earlier. Precious metals had a sporadic quarter. Gold was slightly down for the quarter but remains positive by 7.87 percent for the year. Silver lost almost nine percent during the quarter and Copper was positive by 1.69 percent; both remain positive year-to-date, Silver by 3.99 percent and Copper by 7.26 percent. Wheat had a very strong quarter, moving higher by 23.33 percent and finishing the halfway point positive by 28.92 percent.

The second quarter was favorable for most investors. The U.S. markets are being supported by an improving business environment and a solid economic picture. The markets started the year hopeful that President Trump would bring a pro-business culture to Washington, but there has been limited progress and decreasing optimism around tax reform or an infrastructure spending bill. The farthest the administration has gotten with big legislation was the House's passage of an Obamacare repeal bill. The Senate is having a tough time garnering support for its own version of the bill. Regardless of the outcome, the health care legislation process has shone a light on the deep divisions within the Republican-led Congress that will make any significant legislation difficult to pass.

The Fed continued to fulfill expectations by raising interest rates by 25 basis points during their June meeting despite a recent trend in inflation readings moving away from the Fed's two percent target. The Fed is trying to balance its self-proclaimed commitment to data dependency with the expectations for rate increases it has developed in the market, and while the employment picture is generally favorable, the current state of inflation is not supportive of a rate increase. The headline unemployment rate closed the quarter at 4.3 percent, however, the tightening jobs environment has failed to yield a significant increase in wages. Higher wages would help push inflation closer to the Fed's target but given the lack of substantial wage increases, falling energy prices and the war that Amazon is waging in the retail sector to bring goods to consumers cheaper, prices of goods are falling, not increasing. It is believed the Fed would like to raise rates one more time this



year, multiple times in 2018 and begin to reduce the balance sheet later this year, but the lack of inflation could create a difficult environment for the Fed to stay on its projected path. The wildcard in the Fed's decision making process is some sort of fiscal stimulus. If Congress and the President make progress on tax reform or infrastructure spending it may provide enough relief to allow the Fed to continue to work towards a normalized environment.

The first quarter corporate earnings season was one of the strongest in recent years. According to FactSet, the S&P 500 reported the highest earnings growth, 13.9 percent, since the third quarter of 2011. The earnings growth rate was quite impressive, but the biggest contributor was the energy sector which had a low bar to surpass after the past year of low oil prices. Excluding energy, the earnings growth rate was 9.7 percent. Seventy-five percent of S&P 500 companies exceeded Earnings per Share estimates compared to the five-year average of 68 percent. Another important statistic is the earnings and revenue growth rates of companies with more than 50 percent of their sales from outside the U.S. The earnings growth for companies with more than half of their sales outside the U.S. was 20.9 percent, compared to 13.6 percent for the entire S&P 500 and 9.9 percent for companies with more than 50 percent of their sales inside the U.S. There were similar results with regard to reported revenue; companies with more than 50 percent of their sales outside the U.S. reported a revenue growth rate of 9.4 percent compared to 7.1 percent for companies with more than 50 percent of their sales inside the U.S. and 7.8 percent for the entire S&P 500.

There is growing optimism for regions outside of the U.S. Europe in particular has seen increased sentiment indicators, improving GDP and strong market gains. The stock market in Europe remains well off the highs seen in 2007 but is approaching three-year highs. It has been a year since the citizens of the United Kingdom voted to leave the European Union but there is still a lack of clarity around what the future will look like. Weeks after Article 50 was triggered, which was the first necessary step to begin the process of leaving, U.K. Prime Minister Theresa May called for a snap election which she expected would increase her political control. The results did not go as she had planned, instead the election resulted in a hung Parliament. The political future of Britain is uncertain despite the Prime Minister's vow to create a new government.

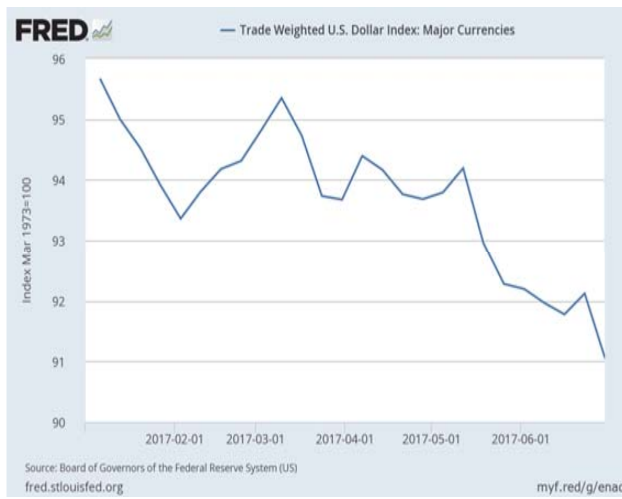
In addition to the rising sentiment in Europe, there is also a bullish tone coming out of many emerging market countries, especially those in Asia. A big driver of performance is strengthening currencies against the dollar which is a result of the improving economic news but also from the unwinding of the "Trump" trade. The dollar has weakened significantly as it has become increasingly clear that Trump's pro-growth agenda was originally overhyped. Brazil is one emerging market that has not performed well in the short-term. The government cannot seem to avoid corruption from one leader to another. The Brazilian stock market, as represented by the iShares Brazil ETF, lost 6.81 percent during quarter, compared to a six percent gain for the emerging markets index, the stock market is up about two percent year-to-date compared to 18.43 percent for the broad index.

A Look at the Numbers

Name	2nd Quarter Performance (%)	YTD Performance (%)
DJ Industrial Average TR USD	3.95	9.35
S&P 500 TR USD	3.09	9.34
S&P MidCap 400 TR	1.97	5.99
S&P SmallCap 600 TR USD	1.71	2.79
NASDAQ Composite TR USD	4.16	14.71
MSCI EAFE NR USD	6.12	13.81
BBgBarc US Agg Bond TR USD	1.45	2.27
Wilshire US REIT TR USD	1.78	1.82
IA SBBI US 30 Day TBill TR USD	0.18	0.29

Forecast in Brief

The third quarter is smack in the middle of summer which means less trading volume which sometimes leads to more volatility. An uptick in volatility would be welcomed given how complacent the market has been. The VIX, which is a measure used to track volatility and is sometimes referred to as the "fear index," has closed below 10 six times in the last two month, which is meaningful considering it has only done so 11 prior times since 1990. While it is unsettling to see such low volatility given all the risks that are present in the market, it is somewhat reassuring to see that the normal signs of market euphoria have not taken hold.



The start of the third quarter also means another earnings season is right around the corner. There are high expectations for a strong corporate earnings season in the U.S. Contrary to recent trends, companies with foreign revenues are expected to get an extra boost from the weakening U.S. dollar and global economic strength. In fact, according to FactSet, analysts have lowered their second quarter earnings estimates by only two percent, which is significant considering that it is common for analysts to lower estimates by a greater amount over the course of a given quarter. With such a bullish sentiment around the second quarter earnings, industry analysts in aggregate are predicting a 9.3 percent increase in the S&P 500 price over the next 12 months.

The most significant economic news in the third quarter will be centered on inflation data. Many economists and Fed officials believe the recent slowdown is transitory, however, the markets will want to see proof in the numbers in the coming months. The employment market is expected to continue to tighten and many economists that are calling for future inflation believe employers will soon need to raise wages to attract quality candidates. This is sound academic theory, but in practice many economists have been predicting wage increases for years with no results.

A rate hike is on the table for September, but given the recent inflation numbers December is more likely. In addition to future rate hikes, the Fed is also expected to provide some guidance on their intent of when and how to reduce their balance sheet. The Fed provided liquidity and helped drive longer-term rates down through their asset purchasing program which caused their balance sheet to grow to over $4 trillion. The Fed would like to begin decreasing their balance sheet so that they're able to loosen policy in the future when the next recession looms. When they decide to begin this process is still up in the air, but they will probably provide guidance about their intent and begin the process later this year or in 2018. The Fed will need to be careful to not trigger a recession by increasing rates too quickly or by reducing the balance sheet faster than the economy can handle.

It's unlikely that we'll see a boost to the markets from any development in Washington. Given the political difficulties facing the current government, investors should not expect any significant legislation passed in the coming months. Abroad, just about all of the geopolitical risks are to the downside. The North Korean problem is likely to become increasingly tense as the belligerent regime ramps up missile tests and threatens the United States. Diplomacy is always the preferred resolution, but it is particularly important in this case given the consequences of military action in North Korea. China is the key to any diplomacy with North Korea and the Trump Administration hoped they would exert more pressure on its neighbor, but unfortunately China's national interests don't align with the U.S. on this issue. Military action does not appear imminent at this time, but then again history has shown that these matters have a tendency to escalate quickly.

Economic progress in Europe will be closely followed, especially regarding the impact that Europe's economy has on U.S. interest rates. To a certain extent, U.S. rates were capped because of how low global interest rates traded. As economic conditions improved in the Eurozone, markets moved higher and interest rates move higher. Should the bullish sentiment continue in Europe, rates will continue higher and U.S. rates will follow. As President Trump continues to promote his "America First" campaign rhetoric other leaders are looking to put aside their differences in an effort to work together and fill the vacuum of American leadership. The EU and China have had decades of trade disputes and do not see eye-to-eye on human rights, but for now they seem willing to put those issues aside and work together as opposed to working with President Trump.

We remain optimistic. The U.S. economy is strong and global economies that have lagged for years are improving. Many people associate rising rates with negative stock market performance, but in the early stages of a rate hiking cycle equities tend to do well, and relative to other investments, equities appear fairly valued. With that being said, we would not be surprised to see a market correction during the second half of the year. We believe clients should invest based on their goals and objectives. If anything has changed in your life that may require a change to your investment portfolio, please let us know.

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