Capital Market Summary

Volatility returned to U.S. equity markets in the first quarter as concerns over rising inflation and a potential trade war with China left investors feeling unsettled. The new year was off to a strong start as the S&P 500 Index® (S&P 500) reached a new all-time high of 2,872.87 on January 26.[1] Shortly thereafter, volatility increased as the January Employment Report showed stronger than expected wage growth causing interest rates to move higher and stocks to recede. Equity markets began to recover in February as bond yields stabilized. However, the exchange of proposed tariffs between the U.S. and China brought about another round of volatility. The S&P 500 finished the quarter with a modest loss of -0.76%.[2] As smaller companies tend to have more of a domestic focus and can be more isolated from the impact of tariffs, small cap stocks, as measured by the Russell 2000 Index®, fell -0.08% outperforming large cap stocks as represented by the S&P 500.[2]

Interest rates, as measured by the 10-year Treasury Bond, rose steadily throughout January. Given the strength of the fourth quarter earnings season, equity markets barely flinched. However, U.S. Equity markets began to display volatility later in the month as the yield on the 10-year Treasury Bond broke through 2.70%, a level not seen since early 2014.[1] In spite of what has been an extended period of below average volatility, U.S. equity markets finally succumbed to the first signs of a tightening labor market as indicated by the January Employment Report. While the U.S. economy added 200,000 new jobs in January, which was above economists' forecast of 180,000, it was the acceleration of average hourly wages that rattled the markets.[1] Average hourly wages for all employees rose 0.3% for the month and 2.9% from January 2017.[1] This was the largest 12-month increase in average hourly wages since June 2009.[3]

Concerns that the strength in wage growth would bring about the inflation that many market participants had been anticipating drove the S&P 500 into correction territory and interest rates even higher. The S&P 500 endured its first 10% correction since the start of 2016, falling 10.1% from January 26 to February 8.[1] The most widely known measure of market volatility is the Cboe Volatility Index®, commonly referred to as the VIX®. The VIX® had been below its long-term average of 19.35 for an extended period but rose to 50.20 intraday on February 6 and averaged 17.35 for the first quarter.[1] For a reference point, the level of the VIX® averaged 11.09 for all of last year.[1]

When equity markets recovered, investors looked back on what was a record earnings season for the S&P 500. Fourth quarter S&P 500 operating earnings came in at $33.86/share, surpassing the $31.33/share from previous quarter.[4] The final tally shows that 75% of the S&P 500 companies beat earnings expectations while 76% beat consensus sales forecasts.[4] S&P 500 operating earnings grew 17.2% in 2017.[4] As we look forward to the upcoming earnings season, estimates for S&P 500 operating earnings currently stand at $35.64, which would represent 5.3% earnings growth from the prior quarter and 23.7% growth from the first quarter of 2017.[4]

Investors, for the most part, have taken the headlines coming out of the White House in stride, in particular, the level of turnover in the Trump Administration. Therefore, it was not until President Trump proposed tariffs on imported steel and aluminum when investors began to take notice. Rhetoric was turned up as some of the U.S.' largest trading partners such as the European Union threatened retaliation if the tariffs were to take effect. Global equity markets became even more unsettled as President Trump specifically targeted Chinese imports on tariffs up to $60 billion. China then retaliated by proposing tariffs on $3 billion of U.S. goods.

Further magnifying the second bout of volatility was weakness within the technology sector. The technology sector was the top performing sector in the S&P 500 for 2017, and it remained the top performing sector through the end of the first quarter despite the selloff.[1] Concerns surrounding Facebook and the use of personal data by third parties arose. This, coupled with several prominent technology companies appearing in the crosshairs of regulators, pressured the sector. These additional headwinds started another downdraft for the S&P 500 as it declined -7.06% from March 9 to March 23, with the technology sector down -8.74% over the same period.[1]

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1 *Source Data: Bloomberg*
2 *Source Data: Morningstar, March 31, 2018*
3 *U.S. Department of Labor: Bureau of Labor Statistics, Average hourly earnings of all employees, total private seasonally adjusted, February 6, 2018*
4 *S&P Dow Jones Indices, March 29, 2018*

Within fixed income markets, the combination of expected interest rate increases from the Federal Reserve (Fed) and the fear of accelerating inflation caused bond yields to rise throughout most of the quarter. The yield on the 10-year Treasury Bond increased from 2.46% to a fresh high of 2.95%, while closing out the quarter at 2.74%.[1] Treasury bonds rallied in March as investors looked for safety given the higher levels of equity market volatility and the rising uncertainty over trade. As widely expected, the Fed at its March meeting, raised the target for the federal funds rate 0.25% to a range of 1.50% to 1.75%[5]. Based on the forecasts of the FOMC, it is anticipated that the federal funds rate will stand at 2.1% at the end of this year and 2.9% at the end of 2019.[6] This would imply that the Fed could raise interest rates two more times in 2018 and three times in 2019. The previous Fed forecast for the federal funds rate for 2019 was 2.7%, indicating an increase of one additional hike for next year, relative to the previous estimate.[6] The Bloomberg Barclays U.S. Aggregate Bond Index® lost-1.46% for the quarter.[2]

Turning to international equity markets, the MCSI EAFE Index® fell-1.53% as developed international markets represent many of the U.S.' major trading partners and could be subject to the U.S.' proposed tariffs and, in turn, retaliate.[2] Emerging market economies, while also trading partners with the U.S., were able to manage a slight gain as the MSCI EM Index® rose 1.42%.[2] The falling U.S. dollar also served as a tailwind for the asset class.

5 *Board of Governors of the Federal Reserve System, FOMC Statement, March 21, 2018*
6 *Board of Governors of the Federal Reserve System, Summary of Economic Projections, March 21, 2018*

Capital Market Outlook

It is certainly easy to fall into the trap of the media headlines. While we are not implying financial markets are without risk, as investing always involves varying degrees of risk; however, as portfolio managers, we analyze the current environment and ask ourselves if we see a change in our fundamental outlook. The risk of a global trade war, while not yet occurring, is a voice that is becoming louder. We believe the risk to the equity markets is greater than to the U.S. economy as a whole. The U.S. economy is mostly driven by domestic consumption as it represents 69.1% of GDP while exports contribute 12.2%.[7] However, 43% of S&P 500 revenues are derived from companies operating outside of the U.S.[8] The trade situation remains fluid and we will continue to monitor developments closely.

We are optimistic that current economic expansion is intact. However, we must acknowledge the risk investors currently face. The anti-trade exchanges between the U.S. and China are intensifying as both countries have proposed a specific list of goods that would be subject to tariffs. While these tariffs will not go into effect immediately, the level of uncertainty is increasing and the situation warrants our attention. We are also keeping a keen eye on inflation measures. Currently, the Fed is forecasting three 0.25% interest rate increases for 2018 and a similar pace for next year. If wage growth or the general level of inflation accelerates too rapidly, the Fed may become more aggressive in raising interest rates. This, in turn, would have the potential to pressure the capital markets.

7 *U.S. Department of Commerce: Bureau of Economic Analysis, Gross Domestic Product Fourth Quarter 2017, Third Estimate, March 28, 2018*
8 *J.P. Morgan Asset Management, Q2 2018 Guide to the Markets, March 31, 2018, Page 7*

Another item on our radar is the increase in the U.S. dollar-based London Interbank Offer Rate (LIBOR). The LIBOR rate is the rate at which banks lend to each other. An abnormal rise in LIBOR rates could be a leading indicator of stress within the global banking system. It is important to note that the elevation in LIBOR rates are occurring specifically in U.S. dollars. LIBOR rates denominated in Euros, Japanese Yen and Swiss Francs have remained stable. If stresses were building in the global banking system, we would expect to see LIBOR rates rise across multiple currencies. The rise in U.S. LIBOR rates appears to be technical. First of all, the expectation of future interest rate increases by the Fed are a factor. Additionally, with a reduction in estimated tax revenue from the tax cut and the recent spending bill, the U.S. Treasury has increased the supply of short-term Treasury Bills which has also pushed up short-term rates. As the U.S. Treasury moves out to longer maturities, we expect U.S. dollar-based LIBOR to stabilize.

Taking a step back, given continued economic growth, corporate tax reform, a weaker U.S. dollar, and higher oil prices, the fundamental outlook for earnings growth is encouraging. Based on current estimates, operating earnings for the S&P 500 are expected to grow 25.4% in 2018 and 10.6% for next year.[4] Even if these estimates are revised slightly downward over time, earnings growth would be considered at healthy levels given we are in the latter stages of the business cycle. Furthermore, initial readings on economic activity coming into

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the second quarter remain positive. The IHS Markit U.S. Manufacturing PMI™ reading for March came in at 55.6, its highest reading since March 2015. Additionally, manufacturing across the globe continues to expand as the March J.P. Morgan Global Manufacturing PMI™ posted a level of 53.4, firmly above the expansionary level of 50.

While equity markets have certainly been volatile, it is important to remember throughout the quarter as companies have announced the impact of tax reform to their bottom line and the U.S. dollar continues to weaken, earnings estimates have been rising, not falling. We believe it would be quite difficult to enter into a bear market while earnings continue to grow. At the end of last year, the S&P 500 was trading at 18.3x one-year forward earnings.[4] Given the small loss suffered by the S&P 500 and the pace of positive earnings revisions, the S&P 500 currently trades at 16.5x one-year forward earnings, much more in line with the long-term average of 16.1x.[4, 9] However, given the challenges that investors continue to face, we believe that broad diversification across asset classes and geographic regions is the most prudent approach for our clients.

9 J.P. Morgan Asset Management, Q2 2018 Guide to the Markets, March 31, 2018, Page 5

Economic Perspectives

Economic Growth & Profits

- Real gross domestic product (GDP) for the fourth quarter of 2017 came in at a 2.9% annualized growth rate.[10] This compares to the 1.8% rate of growth for the same quarter a year ago.[10] Stronger personal consumption and government expenditures offset a slower pace of growth in private domestic investment.
- S&P 500 operating earnings grew 17.2% in 2017.[11]
- Estimates for first quarter S&P 500 operating earnings currently stand at $35.64, which would represent 5.3% growth from the prior quarter and 23.7% earnings growth from the first quarter of last year.[11]
- Corporate profits across the U.S. economy for the fourth quarter, as measured by the U.S. Bureau of Economic Analysis (BEA), fell -0.1% from the prior quarter, but are 2.7% higher from the fourth quarter a year ago.[12] Profits from the financial industry were the top contributor to the decline in profits from the prior quarter. Over the past year, profits from non-financial domestic industries have grown by 7.7%.[12] Non-financial domestic industries account for 58.6% of total U.S. corporate profits.[3]

10 U.S. Department of Commerce: Bureau of Economic Analysis, Gross Domestic Product Fourth Quarter 2017, Third Estimate, March 28, 2018

Interest Rates

- The Federal Open Market Committee (FOMC) of the Federal Reserve (Fed) held two meetings during the quarter. At its March meeting, the first under new Fed Chair, Jerome Powell, the FOMC raised the target for the federal funds rate 0.25% to a range of 1.50% to 1.75%.[13] The move was widely expected by the markets.
- Based on the forecasts of the FOMC, it is anticipated that the federal funds rate will stand at 2.1% at the end of this year, and 2.9% at the end of 2019.[14] This would imply the Fed raises interest rates two more times in 2018 and three times in 2019. The previous Fed forecast for the federal funds rate for 2019 was 2.7%, an increase of one additional hike for next year.[14]

11 S&P Dow Jones Indices, March 29, 2018
12 U.S. Department of Commerce: Bureau of Economic Analysis, Corporate Profits by Industry Fourth Quarter 2017, March 28, 2018
13 Board of Governors of the Federal Reserve System, FOMC Statement, March 21, 2018

Employment

- The employment picture remains bright as the U.S. economy added 313,000 new jobs in February while the unemployment rate was unchanged at 4.1%.[15]
- The January Employment Report showed a strong gain in wages, as average hourly earnings for all employees rose 0.3% for the month and 2.9% from January of last year.[16]
- With the February Employment Report, the pace of wage gains eased as average hourly earnings for all employees rose 0.1% for the month and 2.6% from February of last year.[17] This helped reduce investor fears of rising wage pressure leading to higher levels of inflation.

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14 Board of Governors of the Federal Reserve System, Summary of Economic Projections, March 21, 2018
15 U.S. Department of Labor: Bureau of Labor Statistics, The Employment Situation – February 2018, March 9, 2018
16 U.S. Department of Labor: Bureau of Labor Statistics, The Employment Situation – January 2018, February 2, 2018
17 U.S. Department of Labor: Bureau of Labor Statistics, Employment, Hours, and Earnings from the Current Employment Statistics Survey (National), April 5, 2018

- The U.S. economy added 727,000 new jobs for the three months ending February 2018 compared to 639,000 new jobs for the similar three-month period of last year.[18]

Inflation

- The Consumer Price Index (CPI) in February rose 0.2%; excluding food and energy, the Core CPI also came in at 0.2%.[18] Over the past 12 months, the CPI has risen 2.2% while the Core CPI rose 1.8%.[18]
- The Fed's preferred measure of inflation, personal consumption expenditures (PCE), is rising at a slower rate relative to the CPI. Over the past 12 months, PCE has risen 1.8%.[19] Personal consumption expenditures excluding food and energy (Core PCE) rose 1.6% from February of last year.[19]
- While acknowledging that inflation readings have been running below 2%, the Fed expects inflation to rise and "stabilize" around the 2% inflation target.[13]

Risks

- Given we are in the latter stages of the business cycle with the expectations that interest rates will continue to rise, investor expectations of returns for the remainder of the year should be muted.
- The anti-trade exchanges between the U.S. and China are intensifying as both countries have proposed a specific list of goods that would be subject to tariffs. While these tariffs will not go into effect immediately, the level of uncertainty is increasing and bears our watching.
- The Fed may accelerate the pace of raising interest rates if wage pressures continue to build. Presently, the Fed is forecasting three 0.25% interest rate increases for 2018 and a similar pace for next year.
- The U.S. faces mid-term elections in 2018 and, historically, mid-term elections have been a root of increased equity market volatility.

Index Returns Table Included on the Following Page

18 U.S. Department of Labor: Bureau of Labor Statistics, Consumer Price Index – February 2018, March 13, 2018
19 U.S. Department of Commerce: Bureau of Economic Analysis, Personal Income and Outlays, – February 2018, March 29, 2018

Index Returns Table

Index	Total Return (%) 3 Mo (Mo-End) USD	Total Return (%) 1 Yr (Mo-End) USD	Total Return (%) Annualized 3 Yr (Mo-End) USD	Total Return (%) Annualized 5 Yr (Mo-End) USD
DJ Industrial Average TR USD	(1.96)	19.39	13.48	13.32
S&P 500 TR USD	(0.76)	13.99	10.78	13.31
S&P 400 Mid Cap TR USD	(0.77)	10.97	8.96	11.97
S&P 600 Small Cap TR USD	0.57	12.68	10.76	13.56
MSCI KLD 400 Social GR USD	(0.08)	14.67	10.30	13.05
MSCI EAFE NR USD	(1.53)	14.80	5.55	6.50
MSCI EM NR USD	1.42	24.93	8.81	4.99
Barclays U.S. Agg Bond TR USD	(1.46)	1.20	1.20	1.82
Barclays Global Agg Bond TR USD	1.36	6.97	3.14	1.49
S&P GSCI Spot	2.37	16.67	4.52	(7.11)
S&P Target Risk Cons. TR USD	(0.82)	5.90	3.76	4.22
S&P Target Risk Mod. TR USD	(0.76)	7.31	4.54	5.30
S&P Target Risk Aggr. TR USD	(0.52)	12.82	7.53	9.15
Source: Morningstar® as of March 31, 2018				

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI U.S. Broad Market Index is comprised of nearly 100% of the total market capitalization of U.S. stocks traded on the NYSE and the NASDAQ. The S&P 500 Index is a market capitalization free-float adjusted index of the prices of 500 large capitalization common stocks traded in the United States. The S&P 400 Mid Cap Index serves as a barometer for the U.S. mid-cap equities sector and includes stocks with total market capitalization that ranges from roughly $750 million to $3 billion. The S&P 600 Small Cap Index covers a broad range of U.S. small cap stocks and is weighted according to market capitalization covering about 3-4% of the total market for U.S. equities. The MSCI KLD 400 Social Index is a free float-adjusted market capitalization index designed to target U.S. companies that have positive environmental, social, and governance (ESG) characteristics. The MSCI EAFE Index is a market capitalization weighted index and is designed to measure the equity market performance of developed markets (Europe, Australasia, and Far East) excluding the U.S. and Canada. The MSCI EM NR USD Index is a free-float adjusted market capitalization index that is designed to measure the equity market performance in the global emerging markets. The Barclays Aggregate Bond Index is a market-capitalization weighted index that is considered to be representative of U.S. traded investment grade bonds. The Barclays Global Aggregate Bond Index includes government securities, mortgage-backed securities, asset-based securities and corporate securities to simulate the universe of bonds in the market. The S&P GSCI Spot is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures. The S&P Target Risk series of indices comprise multi asset class indices that correspond to a particular risk tolerance with varying levels of exposure to equities and fixed income intended to represent stock and bond allocations across a risk spectrum. The market indices referenced are unmanaged. You cannot invest directly in an index.

Disclosure