

Economic and Market Overview

Second Quarter 2017



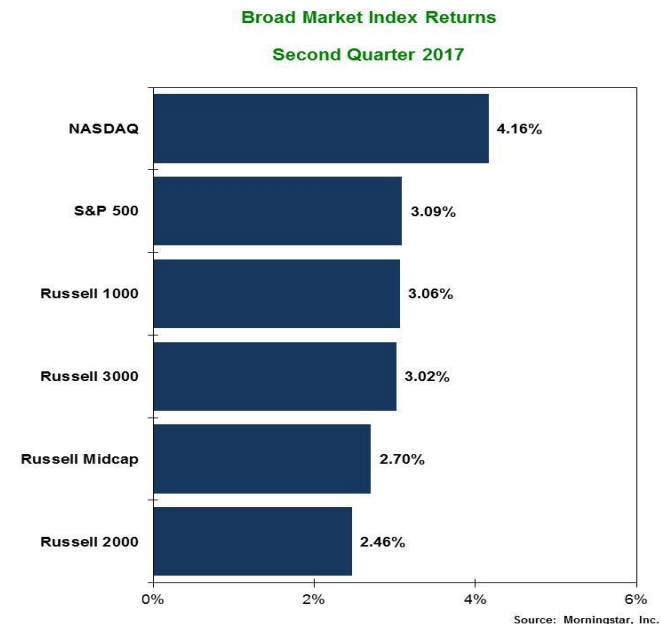
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The Economy

The US economy continues to generate solid and stable growth, and the expansion is now eight years old, making it the third-longest on record. In addition to the economy nearing full-employment levels, the broad-based and steady growth is supported by low energy prices, elevated consumer confidence, and stock prices hovering near record highs. While enthusiasm about the prospect of the Trump administration passing certain policies seems to have waned somewhat as a result of Washington's political climate, consumers and investors, nevertheless, have forged ahead. The Bureau of Economic Analysis reported its third estimate of first quarter 2017 gross domestic product (GDP) of +1.4%, up slightly from the prior estimate, but lower than the fourth quarter's +2.1% reading. The employment situation eroded somewhat, with an average of approximately 121,000 jobs added each month, disappointing economists. However, the unemployment rate of 4.3% established a new cyclical low. Despite worse-than-expected jobs data, the Federal Open Market Committee (FOMC) voted at its June meeting to raise short-term interest rates by 25 basis points to 1.00% - 1.25%. Analysts anticipate at least one more rate hike in 2017, as well as the Federal Reserve (Fed) beginning its long anticipated reduction of its balance sheet.

The global economic environment also continues to improve, with most regions of the world on track to deliver robust growth in 2017. The Eurozone economy grew at a 2% annual clip in the first quarter, an improvement from prior quarters. Recent data from the various economic segments has exceeded forecasts, an encouraging sign for future prospects. In addition, the outcomes of the French and Dutch elections have eased uncertainty in the region. China's economy is expected to grow close to its potential in 2017. The housing market has cooled as a result of policymakers' restrictions, and the Chinese economy should receive a boost from the mobile phone upgrade cycle in the second half of the year. China also is benefiting from a thawing in its relationship with the US, which should attract investors previously wary of investing due to fears of a trade war.



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Highlights and Perspectives

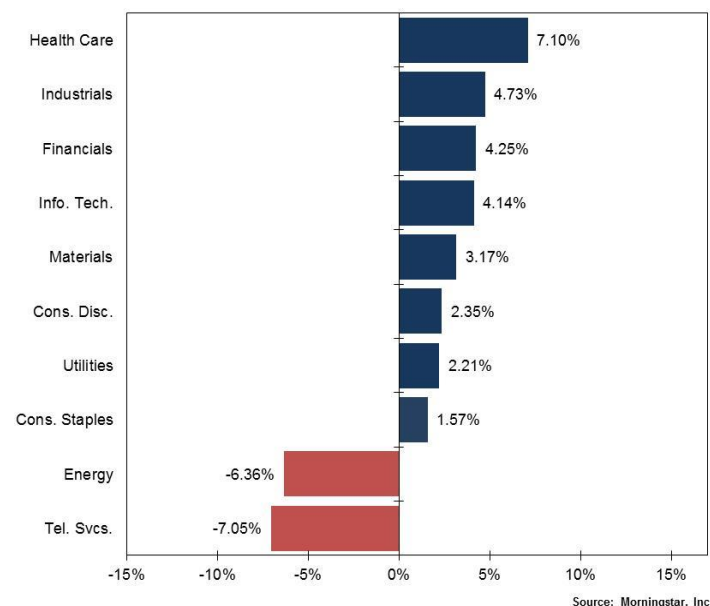
GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the first-quarter 2017 real GDP, a seasonally adjusted annualized rate of +1.4%, down from the fourth quarter's +2.1% annualized growth, but up slightly from the +1.2% prior estimate. Although the results were disappointing, economists point out that several seasonal factors came into play, which temporarily dampened growth. Consumer spending was a modest driver during the quarter, while inventories and government spending were drags. Inflation accelerated somewhat in the quarter, with the personal consumption expenditures (PCE) index of prices rising +2.4%, following a +1.9% advance in the prior quarter. Corporate profits fell -2.3% (not annualized) during the quarter. The consensus among economists is that the long expansion should continue for some time, but that there are signs—including low unemployment—that the economy may be at risk of overheating.

HOUSING

The housing segment has continued to contribute solidly to growth. Existing home sales for May (the latest monthly data available) grew at an annualized rate of 5.6 million units, an increase of about +1.1% from the 5.5 million-unit-rate reached in April, yet up +2.7% from February 2017. The inventory of existing homes was slightly more than four months of supply, roughly the same as year-ago levels. Existing home prices in May were up +3.1% from April, and have gained +5.9% from May 2016. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 67, slightly below both the prior month and in March. Despite the modest decline, homebuilders and analysts expect continued moderate improvement in housing in the months ahead.

Returns by Global Industry Classification Sectors in S&P 500
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EMPLOYMENT

The employment situation slowed considerably in the most recent monthly report. Employers added 138,000 jobs during May, far below the consensus expectations of 185,000 new jobs, and materially lagging the prior month's gain. The three-month moving average also declined, coming in at 121,000, the weakest average since 2012. The unemployment rate in May was 4.3%, a new cyclical low. Average hourly earnings increased by a modest +0.2% in May, and have risen +2.58% in the past 12 months. The consensus among economists is that while the disappointing recent data was likely an anomaly, job growth will be somewhat muted in the coming quarters.

FEDERAL RESERVE POLICY

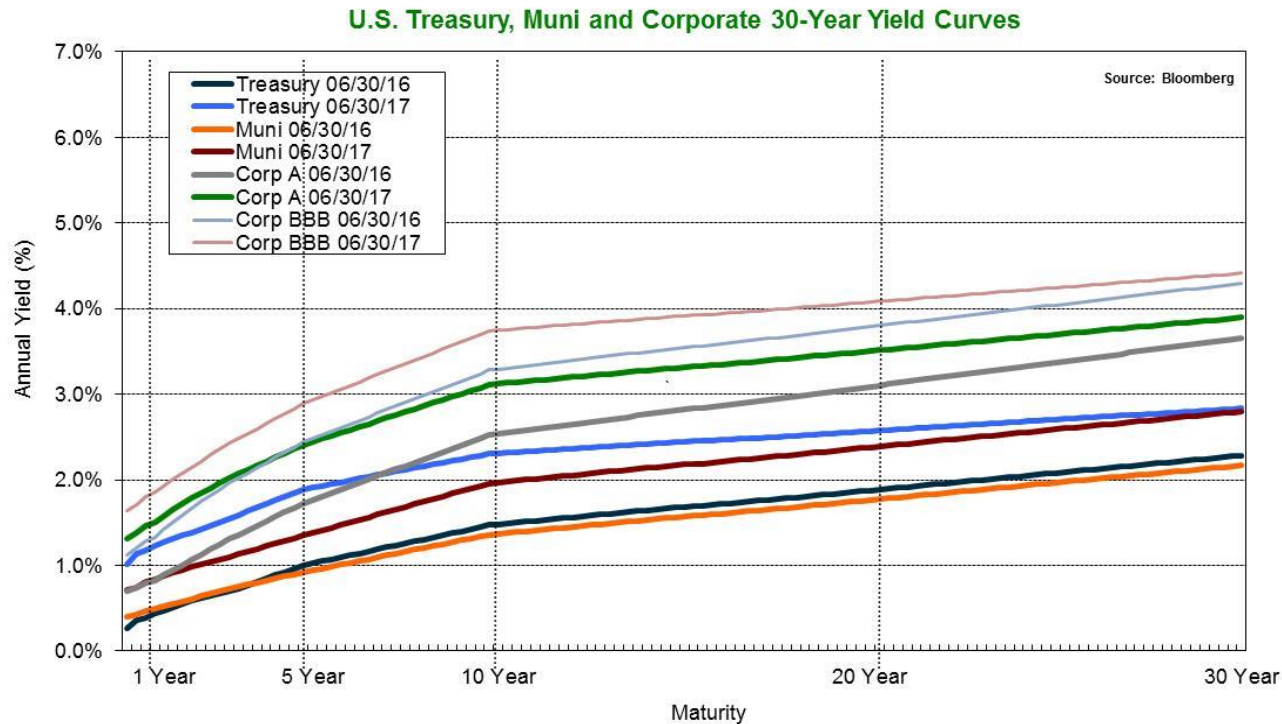
As the consensus among analysts had forecast, the FOMC ended its recent June meeting by raising the target range for the federal (fed) funds rate by 25 basis points to 1.00%-1.25%. In addition, the FOMC released an addendum to its Policy Normalization Principles and Plans, stating that it will begin reducing its balance sheet by \$10 billion per month at some point this year, with many analysts believing the reductions could begin in September. The FOMC will initially make the reduction by not reinvesting principal payments. In its statement, it indicated that inflation is currently running slightly below its 2% target, but that continued improvement in the economy will allow inflation to trend higher. The FOMC's median estimate for the long-term fed funds rate is 3%, suggesting that rate hikes will continue in conjunction with reducing its balance sheet.

INTEREST RATES

Fixed income securities' prices were affected by several important factors during the quarter, including investor anticipation of the FOMC's hike in the fed funds rate; an economy continuing on a modest uptrend; stock prices near record highs; and Washington's testy political environment. As in the prior quarter, the FOMC left little doubt as to whether it would move to raise rates, but the added wrinkle at its June meeting was the decision to move ahead with reducing its balance sheet, beginning perhaps as soon as September. Although fairly material news, investors digested it smoothly, at least initially. However, bonds suffered steep losses in the last week of the quarter, as investors realized that the combination of rate hikes and balance sheet reduction may mean that the long period of extremely accommodative monetary policy is ending.

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Continuing the trend from the prior quarter, the yield curve flattened, as yields on short-term securities rose, and those in the intermediate-to long-term end of the spectrum fell. The flattening was in large part a result of the FOMC's rate increase. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note was lower, ending the quarter at 2.31%, compared to 2.39% on March 31.

Yield changes during the quarter were muted, as the yield on the 10-year Treasury note traded within a 25 basis point range. The primary factors contributing to the yield changes were the FOMC's decision to raise the fed funds rate for a second time this year; investor perception regarding the future of the Trump administration's policy agenda, including health care overhaul and tax reform; and the various investigations into Russia's meddling in the 2016 election. Yields at the shortest end of the yield curve (up to one year) rose in line with the 25 basis point fed funds rate increase implemented in June, but maturities of longer than three years actually experienced a decline,

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resulting in a slightly flatter curve when compared to March 31. The yield on the 3-month Treasury Bill settled at 1.02% at the end of the quarter, up about 26 basis points from the end of the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 1.89%, compared to 1.92% on March 31, and as mentioned above, the yield on the 10-year Treasury Note fell to 2.31% from 2.39% over the same period. At the same time, the yield on the 30-year Treasury Bond also moved lower, ending the period at 2.84%, compared to 3.01% on March 31. Inflation expectations edged lower, with the Fed's gauge of five-year forward inflation expectations declining slightly from 1.93% on March 31.

Fixed income securities, on balance, generated positive total returns in all market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index gained +1.1% for the quarter, but is down a -2.3% return over the past 12 months. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index advanced +2.2% during the three months. High yield securities continued to produce positive returns, posting a gain of +2.2%; the asset class has gained +12.7% over the past year. Municipals also fared well, as the Bloomberg Barclays Municipal Bond Index rose by +2.0% during the quarter. Prices of non-U.S. fixed income securities were sharply higher in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index climbed +3.6%. Emerging markets bonds added on to gains from the first quarter, with the JPM EMBI Global Index tacking on +2.2%.

EQUITIES

Equity markets delivered robust gains in the quarter, extending the rally that began just after last November's presidential election. Gains were fueled by a mixture of a solid and stable domestic economy; a material recovery in European economies; clarity on the interest rate front; and continued investor optimism regarding the potential results of the Trump administration's policies. These and other factors combined to create a calm financial market environment, with the Chicago Board Options Exchange Volatility Index – better known as VIX – hovering at its lowest levels on record. Even potential political headwinds, such as the appointment of a special counsel to investigate Russia's interference in the 2016 election and Republicans' difficulty in repealing and replacing Obamacare, caused little angst in the markets. Within this environment, the S&P 500 Index finished the quarter with a gain of +3.1%. The index is now up +9.3% year-to-date.

On balance, the ten primary economic sectors produced positive returns, with two exceptions. Performance disparity between the sectors was not as wide as in recent quarters. Health Care, Industrials and Financials were the strongest performers, generating gains of +7.1%, +4.7%, and +4.3%, respectively. The Telecommunication Services, Energy, and Consumer Staples sectors were the poorest relative performers, posting returns of -7.1%, -6.4%, and +1.6%, respectively.

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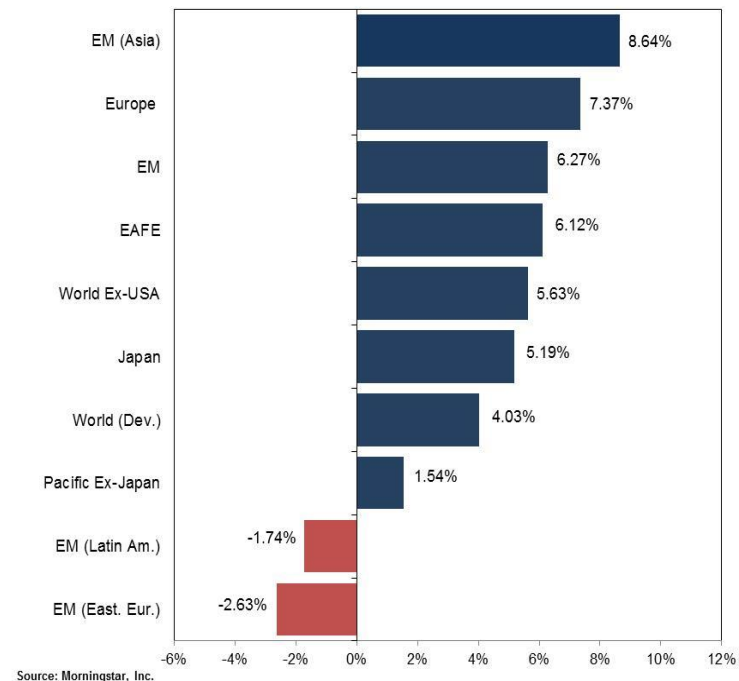
The Russell 1000 Index of large capitalization stocks generated a +3.1% total return, and is up +9.3% for the first half of 2017. Within the large cap segment, growth stocks meaningfully outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, slightly underperformed large caps, and finished the quarter with a total return of +2.5%. Small cap growth outperformed small cap value, with the outperformance now amounting to more than 900 basis points year-to-date. The Nasdaq Composite, dominated by information technology stocks, finished with a gain of +4.2%, and is now up +14.7% in 2017. The Dow Jones Industrial Average of 30 large industrial companies gained +4.0%.

Real Estate Investment Trusts (REITs) were modestly higher during the quarter, with the DJ US Select REIT Index –gaining +1.6%. Commodities disappointed, with the Bloomberg Commodity Index declining -3.0%.

As in the first quarter, international stocks generally outperformed US equities overall. European economies have begun to show signs of rebounding, and investors have greater confidence following the results of the French and Dutch elections. Even though China continues to go through structural reforms, its economy is expected to grow at potential this year, in part due to the new cycle of mobile phones that will be produced and delivered in the second half. Against this landscape, international stock indices were mostly higher. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the US, gained +5.8%. The MSCI EAFE Index of developed markets stocks climbed +6.1%, and is now up +13.8% in 2017. Regional performance was, on balance, positive. The Asia region was the strongest performer on a relative basis once again, with the MSCI EM Asia Index posting a return of +8.6%. Eastern Europe and Latin America were the poorest relative performers, posting declines of -2.6% and -1.7%, respectively. Emerging markets performance remained strong, as the MSCI Emerging Markets Index rallied by +6.3%, and is now up +18.4% for the first half of the year.

Non-U.S. Equity Market Returns
By Region (U.S. Dollars)
Second Quarter 2017

Source: Morningstar, Inc.



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Outlook

The US economic expansion is now eight years old, and is the third-longest on record, trailing only the expansions of the 1960s and 1990s. Because of the economy's currently stable underlying fundamentals and the lack of apparent speculative excesses, many economists believe that the prospects are good that the current expansion will eventually surpass the others in terms of duration. One of the benefits of having a steadily growing economy is declining equity market volatility over the past several years. However, a growing chorus of analysts cautions that with volatility near historic lows and valuations higher than long-term averages (although certainly not at bubble-like levels), the risk of an as-yet-undetermined event causing disruption in the market is not insignificant. The catalyst of heightened volatility and a decline in stock prices could be any number of events, including continued declining bonds experienced in the last week of the quarter; a FOMC policy misstep; Congress's failure to make progress on its key initiatives of healthcare overhaul and tax reform; legal entanglements resulting from the work of the special counsel investigating Russia's efforts to disrupt US elections; or geopolitical eruption in some area, such as North Korea or Syria. Although investors have good reason to be modestly confident and cautiously optimistic, markets are likely to exhibit greater volatility over the next few quarters compared to prior quarters.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization-index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid-cap representation across 4 Emerging Markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid-cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-U.S. Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1,000 largest US companies in the Russell 3000 Index (which comprises the 3000 largest U.S. companies). The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market, and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index (HMI)** is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index (EMBI**

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Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least \$500 million.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **Federal Funds Rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards individuals and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor's and MSCI Barra.