REVIEW OF FIRST QUARTER PERFORMANCE

Equity markets surged ahead in the First Quarter, responding to lofty consumer confidence data and surveys showing rising business confidence. However, despite the appearance of positive momentum, recent market movements have been distinct from the post-election "Trump Bump:" stock prices increased sharply in the Fourth Quarter of 2016 for beneficiaries of tax cuts and border restriction, while in this quarter investors emphasized more defensive themes. In this quarter, the Russell 1000 Growth index, representing large capitalization growth stocks, returned +8.91%, while the Russell 2000 Value index, representing small capitalization value stocks, lost –0.13%. This performance differential in favor of large capitalization growth stocks reflects policy uncertainty, structural economic headwinds, and concerns about potentially softening economic growth.

FIRST QUARTER 2017 RETURNS

After increasing by +5.7% in the Fourth Quarter, the U.S. Trade-Weighted dollar decreased by –3.1% in the First Quarter. This softening dollar contributed to performance of non-U.S. stocks from the perspective of a U.S. investor, with the MSCI All-Country World Index excluding the U.S. up +7.98% for the quarter. Emerging markets benefited even more, with the MSCI Emerging Markets Index returning +11.45% for the quarter. In the U.S., large-cap stocks led the way in the First Quarter. The S&P 500 index of large-capitalization stocks returned +6.07%, and the S&P 1500 all-capitalization stocks returned +5.74%, while the Russell 2000 Index total return was just +2.46% for the quarter. The price of a barrel of West Texas Intermediate Oil finished the First Quarter down –5.81% at $50.60, after rising by +45% in 2016. Looking at the U.S. market on a sector-by-sector basis shows broad gains with the exception of Energy and Telecom stocks, which lost –6.68% and –3.97% respectively. The Information Technology sector led the market, gaining +12.57%, followed by the Consumer Discretionary and Healthcare sectors.

Bonds continued to show lack-luster returns, with the Bloomberg Barclays Intermediate U.S. Government/Credit Bond Index up +0.78% for the quarter and just +0.42% for the past twelve months. Municipal bonds did slightly better for the quarter, gaining +1.58%, but returning only +0.15% over the twelve-month period.

GOVERNING: IT'S COMPLICATED

After the November 2016 election resulted in Republican control of the House, the Senate, and the White House, markets anticipated that the Trump administration would be able to fulfill its big campaign promises, especially in light of the perceived advantages of single party control of both the Presidency and the Congress. Since the Inauguration, both his uneasy alliance with Speaker of the House Paul Ryan and the challenges of single party governance in today's political climate have been more complicated than Trump may have expected. Trump agreed to Ryan's advice to address health care before infrastructure or corporate and personal tax cuts. The administration's failure to put together a sufficient legislative coalition between moderate House Republicans and the Freedom Caucus stymied the effort to "repeal-and-replace" Obamacare with the Paul Ryan-aligned AHCA bill. This failure raised investor concerns about both the pace and the scope of any potential corporate tax cuts. Any tax structure has distribution effects: the goal of reducing the statutory corporate tax rate by simplifying the tax structure, broadening the base, and eliminating special write-offs and loopholes is, predictably enough, appealing to everyone except the current beneficiaries of those special write-offs and loopholes. The goal of simultaneously reducing the statutory corporate tax rate while either holding the Federal Deficit unchanged or reducing it cannot be met without increasing at least someone's taxes, and every potential source of revenue comes with its own set of dedicated opponents. Both personal tax cuts and infrastructure appear to have moved down on the priority list. The U.S. stock market, beginning to recognize the uncertain magnitude and timeline of these policy opportunities, was virtually flat in March.

STRUCTURAL ECONOMIC HEADWINDS

Positive economic data, including housing starts and a falling unemployment rate, coupled with rising business and consumer confidence, have supported the market's recent increases. During the quarter, there was an increasing divergence between slow improvements in "hard" data, such as retail sales, consumer spending, and wage growth and rapid increases in "soft" data, such as surveys of consumer and business intentions. We believe that structural headwinds limit the opportunities for continued economic growth, and that the soft data will move back in line with the slower pace

indicated by the hard data. Ultimately, economic growth is constrained by the combination of labor force growth and productivity growth. The unemployment rate fell to –4.5% in March, an almost 10-year low, indicating a tightening labor market. Demographic trends suggest minimal labor force growth.

The Federal Reserve continues to increase interest rates gradually, amid a broader tightening of financial markets. Rising interest rates and tightening lending standards by banks presage lower borrowing by corporations and by "smarter," more rate-sensitive consumers.

INTERNATIONAL UNCERTAINTY

The consensus estimate indicates global economic growth of approximately 3.2%, in line with the past five years. Geopolitical risk remains high and capable of significantly altering market trends, with an increased spate of bombings in Europe and the Middle East. President Trump's inchoate and shifting foreign policy positions regarding Syria and North Korea, as well as his apparent willingness to act without international consultation have introduced risk to U.S. relations with Russia and China, while his statements about our NATO alliance puzzle our allies in Europe. Upcoming European elections, particularly in France, will test the momentum of populist and nationalist political trends, which continue to threaten global trade relations. We expect that Prime Minister Theresa May's negotiation of the British exit from the European Union will be measured and thoughtful, but that it will have far-reaching economic consequences. China's ongoing attempt to tighten its financial conditions presents a risk to its growth, and in turn to the economic stability of its trade partners.

VALUATION AND POSITIONING

Given the economic headwinds addressed above, we continue to anticipate sluggish economic growth in the near future. In our view, the past six-month's strong equity returns have already priced in much of the benefit from Trump's economic agenda. As of March 31, the S&P 500 index was at 17.6 times expected earnings of $134 for the next twelve months, above the 25-year average of 15.9 times earnings. Yale Professor Robert Shiller's Cyclically Adjusted Price to Earnings ratio, or CAPE ratio, which looks at the average of ten year's trailing earnings, is at 29.0 times earnings, 0.5 standard deviations above the 25-year average of 26.1, and 1.8 standard deviations above the average since 1881. The expected earnings yield on the S&P 500 was 5.5%, while the yield on the 10 year Treasury Inflation-Protected Securities was 0.4%, indicating an approximately 5.1% greater expected return for large capitalization U.S. stocks than for bonds. We anticipate that the Federal Reserve will continue to raise short-term interest rates slowly, which should reduce anticipated bond returns.

Although the Price/Earnings (P/E) ratios are above average in both cases, an elevated P/E ratio does not predict an immediate decline in stock market prices. The stock market can continue at elevated P/E ratios for an extended time. Although stocks continue to have higher return potential than bonds, we believe that the potential for equity returns is reduced, while the risk has increased. As a result of this outlook, and with a goal of protecting client assets, we moved to a neutral equity exposure for clients where we have the ability to allocate between stocks and bonds, and we continue to maintain risk-neutral positioning in our equity strategies. Current levels of consumer and business confidence are inconsistent with our expectations for tightening economic conditions and the high level of policy uncertainty, leaving significant room for downside in 2017.

We anticipate that our portfolio companies, which we select based on their strong balance sheets, financial flexibility, strategic leadership in their products and markets, and strong environmental, social, and governance policies, will have the leadership wisdom to navigate choppy and volatile economic conditions. We also continue our active corporate engagement and policy work to encourage companies to address important structural issues such as climate change, the gender pay gap, and the need to pay a living wage. This work is made ever more important by an administration that does not share these priorities, and indeed, seeks to cut funding for environmental protection, and the Departments of Labor, Education, and Health and Human Services, among others. Please refer to our First Half 2017 Advocacy Update for details on our ongoing efforts in these areas.