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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

The current U.S. economic recovery, at 38 quarters, is tied with the decade of the 60s as the second longest since World War II. Its duration is only exceeded by the decade of the 90s which continued for 42 quarters. But, at 13%, the cumulative real gross domestic product (GDP) growth is anemic compared to all other post war cycles, including 40% in the 90s and more than 50% in the 60s. **After the short burst of excitement from the anticipation of a reflation trade following the election last year, we have seen a return to the low growth, low interest rate, low volatility market environment which has characterized the post financial crisis years.**

Perhaps it is the duration of the recovery which has caused some investors to worry about the next recession. Perhaps it is the clamoring for attention from those who see the very frequent announcements that markets are attaining new highs as "proof" that stocks are overvalued. **In either case, aside from grabbing a headline, these observations are of little value.**

First, it is noteworthy that economic recoveries and market trends are not organic. They are not born, nor do they die of old age. Rather, GDP, or economic growth, is merely an attempt to quantify and measure aggregate human activity. Markets are simply clearing mechanisms for buyers and sellers. The stock market goes up if buyers have more money than sellers have stock, and vice versa; by definition, they cannot be over or under valued. In the case of stocks, an investor buys an ownership interest in a company, which entitles the investor to a percentage of future cash flow for the life of the company. Since a dollar of current earnings is generally worth more than a dollar of future earnings, investors determine the value of the shares of a company by calculating the present value of all future earnings. In order to make this calculation, investors need to determine a company's future earnings potential; this stream is then discounted to a present value using a discount rate which is a function of future interest rates or inflation.

While we do not invest directly in GDP, individual companies tend to prosper when the economy is doing well and earnings growth tends to lag when the economy slows. As we look at the remainder of this year and most of next, we see the U.S. economy benefitting from the strongest global GDP growth since the global financial crisis. For the past year, aggregate earnings of U.S. companies have been recovering from two years of earnings recession, where earnings stopped increasing even as the economy continued to grow. One catalyst, for much of the recovery in earnings growth, is the recent rise in foreign sales due to a combination of energetic demand from the global recovery along with a recent 10% decline in the trade weighted dollar. The dollar decline simply makes the price of U.S. manufactured goods more competitive. **As a consequence, new orders are in an upward trend, giving us confidence that earnings will continue to grow well into 2018.**

Much of this synchronized global expansion can be attributed to years of unconventional monetary policy known as quantitative easing, where central banks bought bonds for cash, effectively flooding the world with liquidity. The combined balance sheets of the U.S. Federal Reserve Bank (Fed), the European Central Bank (ECB) and the Bank of Japan (BOJ) amounts to about $13.5 trillion, an increase from about $3 trillion before the financial crisis. The Fed recently announced its intention to reduce its balance sheet from $4.5 trillion starting in October. The plan is to retire bond holdings at a rate of $10 billion/month, increasing the monthly rate by an additional $10 billion each quarter until the reduction attains a monthly rate of $50 billion after five quarters. At this pace it will take about two years to reduce the balance sheet by $1 trillion. There has been no stated goal for how much would remain on the Fed balance sheet. The impact of this reduction of liquidity from the economy, on interest rates and on the term structure of the yield curve, ranges from modest to disastrous, depending on several factors. If the Fed simply allows bonds to mature without reinvesting, the impact should be modest and spread out over a long time. If the Fed chooses to move more quickly, actively selling bonds in the market, the rule of thumb may imply an impact of 130 basis points per $1 trillion, still quite manageable. A significant risk to the financial markets could occur, however, if the Fed were to choose to reduce its balance sheet more aggressively, effectively using balance sheet reduction in an attempt to manage the term structure of the yield curve. **We think the Fed has every intention of following a cautious approach in implementing this policy, but our vision is blurred by changes in the composition of the voting members of the Federal Reserve Board in the coming year as well as by quantitative easing policies employed by the other developed market central banks.**

The ECB will announce its intentions regarding quantitative easing in October or November. As long as inflation remains subdued, we expect ECB policy will tend toward further tapering of purchases through the first half of next year. Perhaps we will have a better perspective on tightening when the ECB makes its announcement, but we do not expect to see significant tightening until 2019. With inflation in Japan at less than 0.5%, well below its target of 2%, we expect the BOJ to continue its quantitative easing for the foreseeable future. **Since the post-financial-crisis economic recovery has been dependent on quantitative easing, and as unhealthy as we believe the scale and duration of this intervention has been on capital markets, the pace of the unwinding poses a significant risk to the financial markets. We take comfort in the belief that this will occur over many years.**

In conclusion, we expect to see continued moderate economic growth, higher global interest rates with continued low inflation expectations, and low near term recession risk.

Fixed Income

The Fed's highly anticipated announcement that balance sheet normalization would commence in October barely caused a ripple in the markets. Market reaction was fairly muted given the process of rolling off balance sheet security holdings is scheduled to begin slowly and looks set to run on autopilot over the coming years. At quarter end, the 10-year US Treasury yield remained over 10 bps lower from the end of last year, while the 2-year yield rose to its highest level since 2008. Short-term yields, already pushed higher by tighter monetary policy, were further boosted by comments from Fed Chair Janet Yellen that the Fed should be "wary of moving too gradually" and that "it would be imprudent to keep monetary policy on hold until inflation is back to 2.0%." After the September Fed meeting, we expect to be on course for another interest rate increase by year end, the fifth rate hike in the cycle. The rise in short-term yields versus lower long-term yields, which continue to be constrained by the subdued inflation outlook, has resulted in a flatter yield curve since the start of the year.

Are higher interest rates a welcome sign? Of course when interest rates rise, bond prices react inversely. For portfolios holding fixed income securities, a bond ladder strategy helps to mitigate rising interest rate risk by using staggered maturity dates, so that bonds are constantly maturing and being reinvested at the current interest rate, i.e. at higher interest rates in a rising interest rate environment. Higher yields will also have positive impacts which include higher income for savers, reduced pressure on pension plans, and increased income for banks. Further, a rise in bond yields would be a sign that growth prospects have improved and the U.S. economy is not headed for deflation. Monetary deflation, a contraction in the supply of circulated money, makes it less economical for businesses to use debt financing and increases the risk premium on securities. Historically, it has also been associated with rising defaults. **A rise in bond yields in the coming months would therefore be a net positive for the economy.**

Although we do expect bond yields to rise at some point during the coming months, pending changes to members of the FOMC - the monetary policymaking body of the Fed - may result in an even more aggressive approach to current monetary policy. Janet Yellen's term as chair will expire in early February. President Trump has the option to either nominate a successor or reappoint Yellen to a second four-year term. There's a tradition of reappointing the Fed chair who was originally appointed by a member of the opposite party: President Obama did so with Ben Bernanke; Bill Clinton with Alan Greenspan; and Ronald Reagan with Paul Volcker. That tradition has helped keep the Fed, with its vast power over the economy and financial system, insulated a bit from politics, but President Trump has no obligation to follow it and has not said whether he will reappoint her. For her part, Yellen has continued to make a case for banking regulations following the financial crisis that have helped to "strengthen and make the system safer." That, however, is at odds with Trump who has vowed to roll back many of the post-financial-crisis rules. In addition to the potential leadership change, voting members of the FOMC will also experience turnover; Vice Chair Stanley Fischer has resigned prior to the expiration of his term and existing vacant positions within the Federal Reserve Board have yet to be nominated by the president and confirmed by the Senate. Consequently, the composition of those in charge of setting monetary policy may vary considerably next year.

International Market

The lagging performance of international equities compared to U.S. counterparts, despite an accommodative environment provided by years of unconventional monetary policy, has dismayed investors for a long time. Political uncertainty has been a cause for underperformance, although not the only factor that has driven this divergence from U.S. performance. **As investor concerns regarding political uncertainty have begun to ease, performance of international markets has finally started to reflect the accommodative environment, resulting in a synchronized global economic expansion.**

As we have discussed in prior newsletter articles, globalization became the scapegoat for politicians' failure to solve domestic problems. As a result, the outlook for international trade has been negative, with misleading headlines and financial "talking-heads" heralding the end of globalization. The future of globalization was perhaps the biggest cloud hanging over international equity markets following the Brexit Referendum in mid-2016 and peaked when Trump was elected President of the United States. Given the close ties between global economies, it is unsurprising that the market would react negatively to a slew of unfavorable opinions. Fortunately, recent data has not only confirmed that globalization has not ended, but that it has in fact strengthened. The recent data from New Export Orders PMIs by IHS Markit show that 90% of countries have reported higher new export orders and global trade growth has risen to its highest level since 2011. **This encouraging development for the global economy suggests we are entering a new stage of international relations. It is not a stage where globalization ends, but where national policies will shape how future globalization evolves.**

Investor concerns regarding political uncertainty had the greatest impact on European countries following the global financial crisis. The European sovereign debt crisis troubled the region for years and underlying structural issues have yet to be fully resolved. The results of the U.K. Brexit Referendum last year surprised the market, elevating uncertainty to a new high that questioned the very existence of the European Union (EU). With the calendar packed with European elections, concerns continue to linger as investors consider whether the result of the Brexit vote is an indication of continued voter discontent. Since the start of the year, major election results have confirmed one-by-one that large, pro-EU parties still remain the mainstream choice, in spite of inroads by conservative, populist parties. These results have helped to ease the near-term risk of an EU breakup and have revived animal spirits which have been dormant for some time. **Confidence levels from both the consumer and industrial sectors are at multiyear highs and this optimistic view has lifted European equity markets.**

Despite the political uncertainties surrounding the upcoming 19th National Congress of the Communist Party, Chinese markets have managed to deliver decent returns for the first half of 2017. GDP growth has exceeded the targeted 6.5%. Demand, both from abroad and domestically, is on the rise as volume growth on sea cargo and domestic freight has picked up. We believe the trend should continue based on expectations that a major shift in economic policy is unlikely. Even though this twice-a-decade gathering is traditionally viewed as a power reshuffling of the Chinese ruling elites, the fact that the opening day is set for October 18th –a full month ahead of the original schedule – could signal that President Xi has a tight grip on the outcome. Once the key appointments are made, Xi's agenda will likely be implemented; the big challenge for China will continue to be the balancing of reform with growth. **The agenda on how to address medium-term risks –including shadow banking, capital outflow, and a high debt to GDP ratio – without impairing near-term economic growth remains a delicate task for Xi.**

Investing in equity markets is a risky business and investors should not anticipate smooth sailing. This is particularly true when investing in international equities, especially emerging markets. In the past, we could see a clear correlation between policy uncertainty and equity volatility. However, in more recent periods, we are seeing a divergence between the two; during the last peak of policy uncertainty, which is still lower than the current period, equity volatility was at least twice the current level. **We continue to recommend an acceptable level of international exposure, but we caution that investors should appreciate the risk involved.** A disciplined approach is advised to maintain an asset allocation suitable to one's risk tolerance.