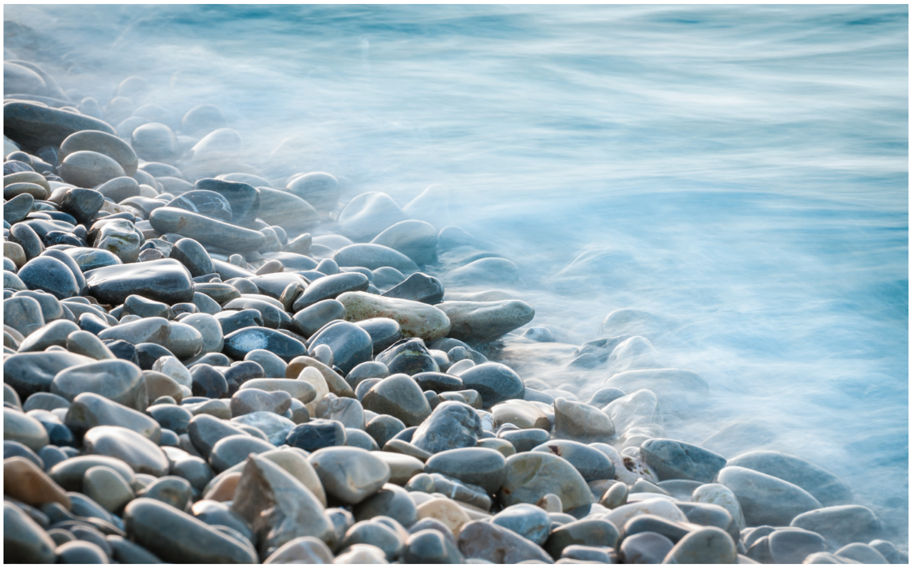
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



Reality Meets Rhetoric

"What separates the winners from the losers is how a person reacts to each new twist of fate"

—President Donald Trump

THE ELECTION OF DONALD TRUMP caused a significant change in sentiment for equity markets. While generally perceived as a negative before the election, Donald Trump's victory, backed by a Republican majority in the House and Senate, quickly created a very different and very positive narrative for the markets: more growth-oriented U.S. policy, constituting both tax cuts and infrastructure spending, as well as deregulation aimed at spurring corporate investment by creating new incentives for corporate America. This led to renewed hope that after years of stagnation, we might be on the cusp of a durable improvement in both U.S. and global growth trends.

Although markets overall have continued to rally in aggregate in 2017, it is interesting to note that there has been somewhat of a rotation, even within the first 100 days following the election result. A sifting exercise has begun, and now a more granular narrative is emerging. The market's initial reaction—buy cyclicals, sell defensives, buy value, sell growth—saw surges in financials, energy, copper, Japanese and Russian stocks. In contrast, risk-aversion proxies like Treasuries and gold, together with countries and regions in the firing line of Donald Trump's anti-globalization and immigration rhetoric, including Mexico, China, and Asia, initially took the brunt of

IN THIS ISSUE

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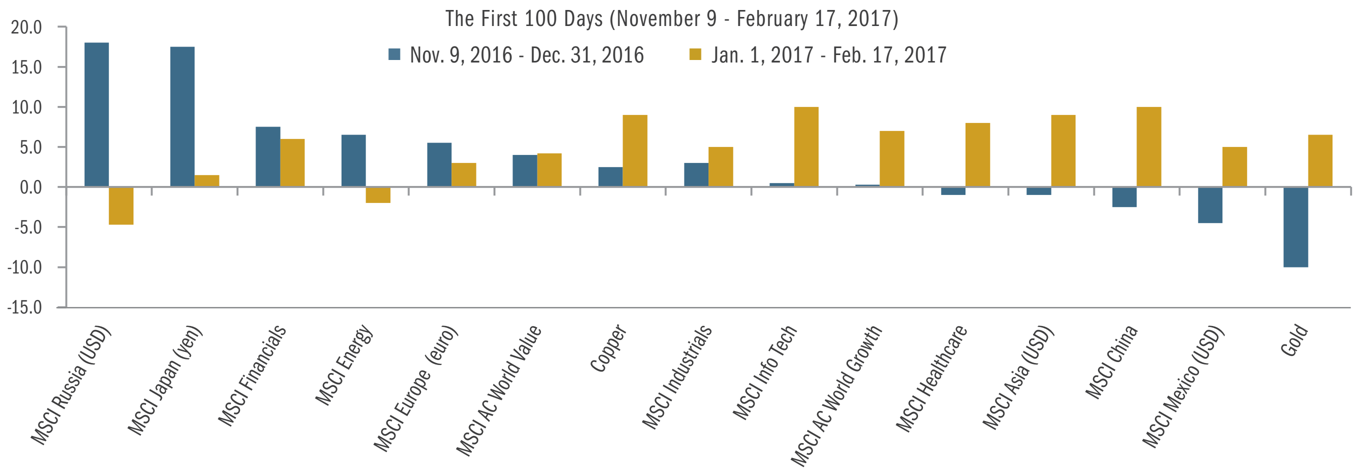
The two halves of the Trump rally



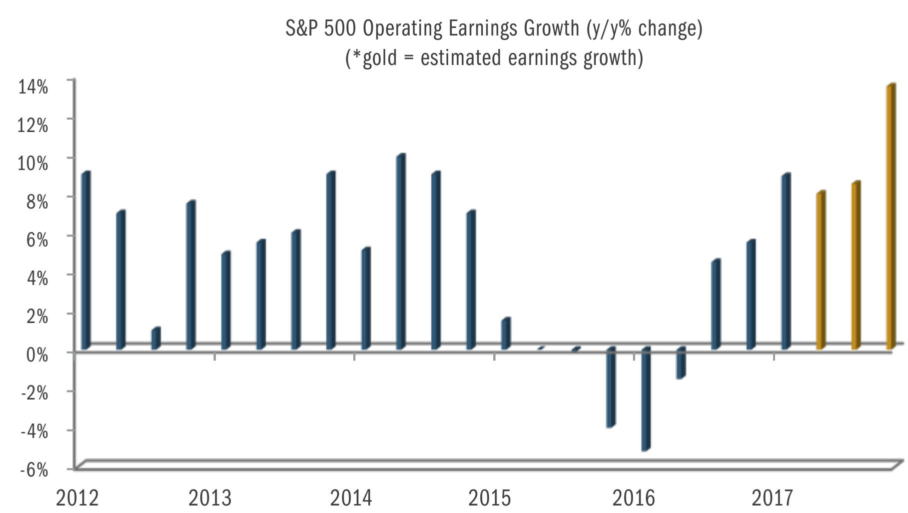
the sell-off. Healthcare also joined the list of losers upon expectations of a repeal of significant parts of the Affordable Care Act. Since then, emerging markets that were initially decimated have more than reversed their losses (with the exception of Mexico) and have made a strong start in 2017. Treasuries, gold, healthcare, and growth companies are also performing well in absolute and relative terms. In addition, while financials and copper (and materials more broadly) have followed on from their late 2016 strength, the uniform strength of cyclicals has somewhat faded, with energy pulling back and Japan pausing after a period of significant strength. Likewise, the force of expectation around earnings uplifts to sectors and industries via potential fiscal spending has become more balanced. Given the hurdles to passing such policy in light of Republicans' fiscally conservative history, euphoria has surely cooled.

Still, many are worried that the so-called "Trump Bump" in equities will reverse, and the risks of a "Trump Slump" are escalating, given how the President has struggled to implement his agenda in these early days. The fact that Trump's presidency is now mired in scandal over improper dealings with Russia is yet another reason to be cautious.

There is no doubt that we live in interesting and unpredictable times. Even without the dynamics of this presidency, risks would be elevated as after eight years we are surely in the later stages of this business and market expansion. However, it is worth noting that global economic indicators were improving independently both before and after the U.S. election. This raised consensus earnings expectations and delivered some improvement as seen via a better U.S. fourth quarter earnings season versus previous quarters. In the technology and financials sectors, earnings showed material and broad-based strength. In contrast, weakness in fourth quarter earnings has somewhat put the brakes on the energy and industrials rally, where earnings have continued to fall, capping off a tough 2016 for the commodity and industrials complex, at least in profitability terms.

Only time will tell if the "Trump rally" continues and what underlying shape it will take. However, earnings seasons are always a timely reminder of the difference between rhetoric and reality, and that earnings improvement must follow through from sentiment improvement, and fundamentals always ultimately prevail. A return to fundamentals would be welcome following a year in which the market gravitated from macro-driven deep despair in early 2016 to irrationally exuberant complacency as the year finished on a high of politically inspired macroeconomic policy optimism. Looking ahead to this earnings season, the good news is that expectations are quite high for corporate America. In the first quarter, the

Earnings growth expected to bounce back after 2015-2016 slump



estimated earnings growth rate is 8.9%, with whispers it could improve to double digits. Even if we only hit the 8.9% growth rate, that would be the fastest growth in earnings on a year-on-year basis since the end of 2013—and well above what we have seen in the past two quarters.

The bigger picture is positive as well. Top-line revenues are expected to increase by 7.1%, the highest since the end of 2011, and 10 of 11 sectors should show revenue gains, led by energy. Energy is benefiting from a sustained recovery in oil prices, as well as ongoing restructuring, which should move the sector as a whole from loss back to profitable operation. This sector alone accounts for 3.8% of the S&P's estimated 8.9% earnings growth rate. Financials should report the highest growth in earnings of all sectors, at 14.3% on rising interest rates and capital markets. Materials and technology are both benefiting from recoveries in international markets and the moderation of the dollar's value.

There is no doubt that until the fundamentals picture is more clear, markets will continue backing and filling, and may gyrate based on rising political uncertainty, and now on rising geopolitical concerns. The bigger question for investors now is how long will this period of pent-up improvement in economic and earnings data last that is independent of Donald Trump, and has it largely been priced into stocks? A second question is whether any policy-inspired improvement will drop through to global growth and, ultimately, a durable upturn in the corporate profits growth cycle?

The evolution of the stock market rally into 2017 indicates that, in the near term at least, some dispersion and differentiation around earnings and valuation fundamentals is reasserting itself after an initial wave of repositioning. While this change in tone may halt the upward momentum of markets in the near term, if such a scenario evolves, we advocate careful contrarianism, given that any reemergence of volatility will provide valuable opportunities to upgrade portfolios. Ultimately, while the evolving patterns of economic growth, inflation, and interest rates will remain a source of intense focus and debate, we believe 2017 will be defined equally, if not more, by earnings delivery (or the lack of it) as reality meets rhetoric.

GLOBAL ECONOMIC OVERVIEW: A Firmer Tone

STRONG MACROECONOMIC DATA in many parts of the world confirm that growth is firming, and that both households and business have become increasingly confident. Job growth remains high, there are signs that investment activity is picking up across a range of countries, and there is clear evidence of strengthening activity in the global manufacturing sector. And in the ultimate irony given recent protectionist rhetoric, greater business activity is leading to increased trade across the world, which is now set to rise at its fastest rate since 2011.

For sure, the U.S. economy remains in a sweet spot of accelerating growth, moderate price pressures, improving labor markets, robust consumer demand, increasing manufacturing orders, and rising investment. At this time, there is little evidence that concerns about potential policy actions in the U.S are having a negative influence on the economy. Rather, the opposite is occurring as consumer confidence has reached its highest level since 2000, and purchasing manager indices are well into expansionary territory.

Though UK growth is cooling owing to the rise in inflation, the export sector continues to do well given the strength of foreign demand and a gain in competitiveness from the weaker pound sterling. The triggering of Article 50 is unlikely to have any major new near-term consequences for the outlook, but uncertainty will remain high and there is the potential for a more negative impact as negotiating positions become more clear.

Growth in mainland Europe continues to strengthen despite the challenging political calendar. Business and consumer confidence measures point to a strong acceleration of growth, and credit expansion is now at its strongest level since 2009. Accommodative monetary policy is still required to sustain positive momentum, though the ECB is signaling increased confidence in the recovery.

In Japan, growth is being supported by buoyant investment, a pick-up in export revenues on the back of an improving global growth environment and the yen's weakness, and fiscal spending from last year's supplementary budget. In China, high-frequency indicators imply the economy is off to a solid start in 2017, though the ongoing structural transformation of the economy will continue to act as a drag on growth.

Looking ahead, a major wildcard is the Trump Administration, and whether the President is going to move forward with extreme protectionist policies as well as the destination-based cash flow tax (which includes the border tax adjustment). Those risks remain, as well as others created by potential developments in Syria and North Korea. Indeed, just after quarter-end, President Trump launched missile strikes against Syrian air bases in the wake of chemical weapons attacks on civilians by President al-Assad. The President is also currently engaged in a war of words with North Korean tyrant Kim Jong-un over nuclear weapons. Election results in Europe will also play a major role in shaping market performance in the months ahead. Finally, it is fair to say that monetary balance, on balance, is becoming less accommodative, at least in the U.S. The impact of higher rates on global growth will be a critical test of the underlying strength and sustainability of global growth in the aftermath of the 2008 financial now. For now, though, it is our view that the global expansion seems poised to continue, and is even gaining steam in some places.

U.S. ECONOMY: Feeling Good

THE CURRENT U.S. ECONOMIC EXPANSION is already the third longest on record and could easily move further up the list. Weekly and monthly economic data continue to exceed analyst estimates, and is proving impervious to policy volatility in Washington, DC. U.S. consumer spending remains well-supported by robust job gains, solid income growth, and strong household balance sheets. Reflecting these sound fundamentals, consumer sentiment indices are around their highest levels since 2000.

Though the March payroll report fell short of expectations, with only 98,000 in job gains, monthly payroll increases have averaged almost 200,000 over the past year, led by the construction and service sectors. Hiring surveys signal continued brisk labor demand across most regions and industries in 2017; indeed, manufacturers report their strongest hiring plans since the 2008–09 recession. Nevertheless, with most indicators also showing that the U.S. labor market is near full employment, we expect the pace of hiring to slow as the year progresses. The U.S. unemployment rate is already at a decade-low of 4.7%, wage growth is starting to accelerate, labor-force participation rates are turning up, and the aggregate employment-to-population rate is at an eight-year high. Household incomes should get a further boost from higher minimum wages: increases took effect in 19 states during January 2017; three other states have legislated increases for July 2017 and additional increases are scheduled during 2018–20.

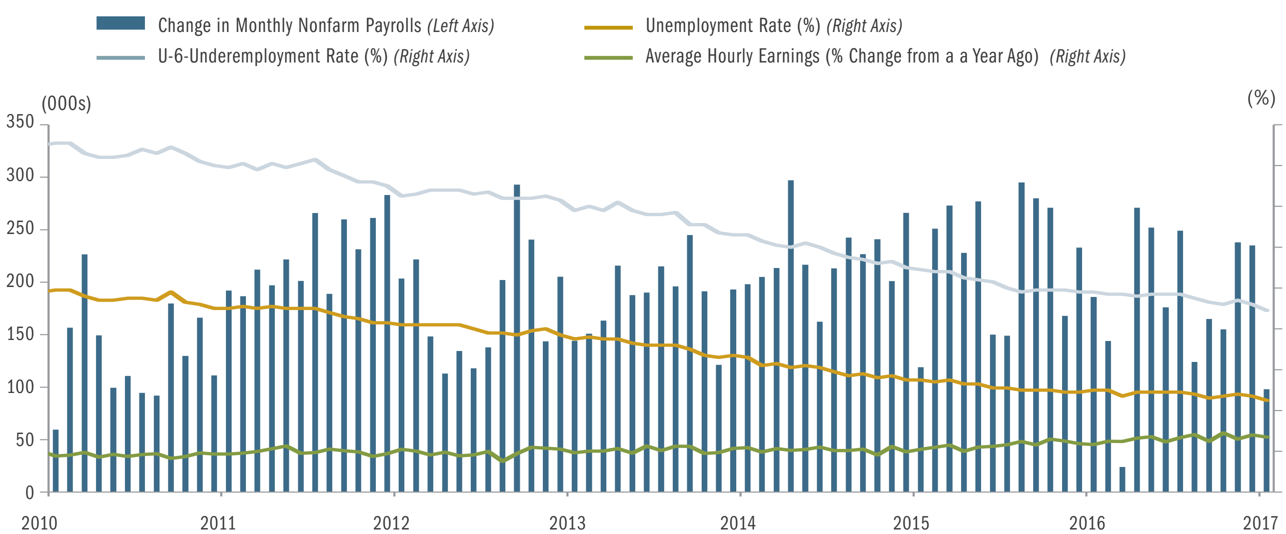
With such strength in jobs and rising incomes, the U.S. consumer's balance sheet should be able to support solid spending growth even as the Fed moves to raise the Fed funds target rate and increase consumer borrowing costs. Stronger household balance sheets have been shored up by rising home values and equity market gains. Household net worth relative to disposable income is at a record high near 650%, while household credit-market debt as a share of disposable income is at an eight-year low. At 10% of after-tax income, debt-service payments pose the weakest burden to consumers since at least 1980.

These strong household balance sheets have supported continued growth in residential investment, and demand for large-ticket consumer durables such as furniture, appliances, and electronics. The auto sector has also benefitted from a combination of solid household finances and increasing demand to replace ageing vehicles: some 40% of the U.S. vehicle fleet is as least 12 years old, owing to an extended period of weak vehicle purchases in the years following the global financial crisis. With interest rates still low and plentiful options for attractive financing, U.S. vehicle sales are expected to hit a third consecutive annual record in 2017.

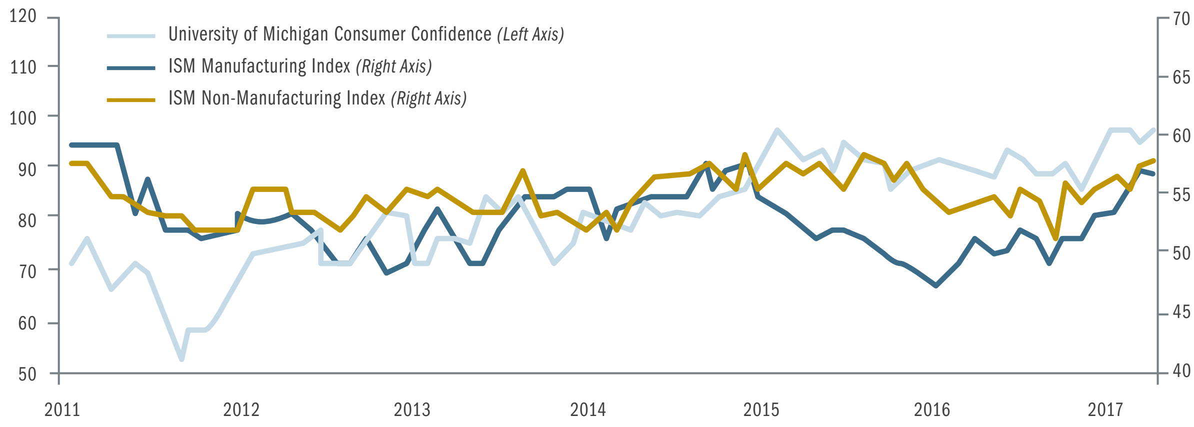
Increased participation by first-time buyers has helped to lift U.S. home sales to their highest levels in a decade. Purchases by non-occupying investors also remain elevated, a reflection of the ongoing strength in rental demand and historically low vacancy rates. However, the pace of housing sales growth is expected to slow during 2017. While affordability remains good from a historical perspective, it has begun to weaken alongside rising home prices and higher mortgage rates. A persistent shortage of listings, especially for lower-priced homes, is also restraining activity. The inventory of existing homes for sale stands at just 1.75 million, equivalent to 3.8 months' supply—near all-time lows. U.S. housing starts are forecast to increase to 1.26 million units in 2017 and 1.34 million in 2018, with builder confidence in the market emboldened by tight resale inventory, rising home prices, and the potential for regulatory reform under the Trump Administration.

As for business activity, U.S. industrial activity has been a standout with new orders for goods manufactured in the United States now advancing at the fastest

U.S. employment remains a bright spot



Business activity and consumer confidence surge



annualized pace since mid-2014. In fact, U.S. manufacturing output has increased for five consecutive months through February 2017, the best run in nearly three years.

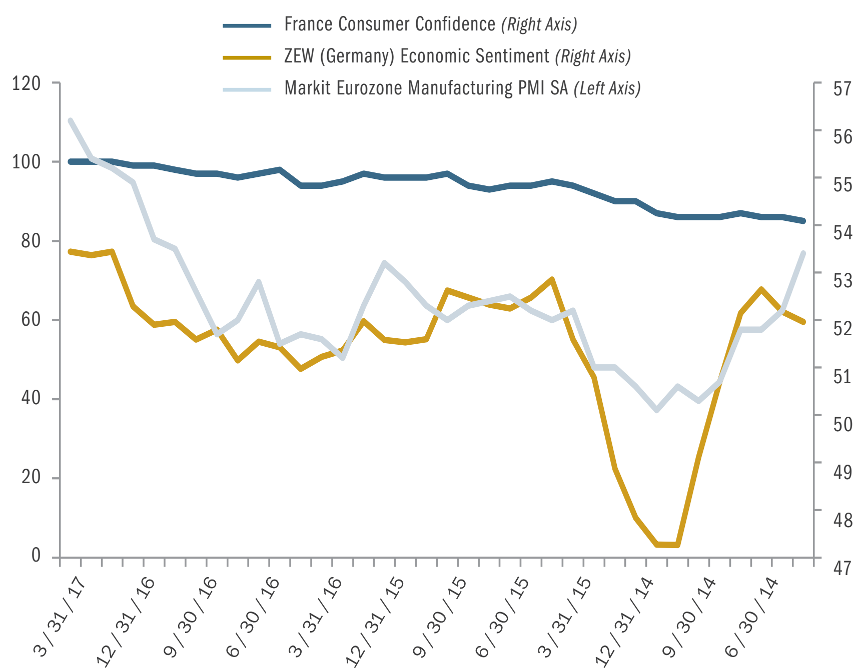
It was no surprise then that the Federal Reserve raised the policy rate in March to 1%, its highest level in nearly a decade, continuing its well-communicated path of slow and steady policy normalization. Assuming a calm geopolitical situation and no market turbulence in the wake of the upcoming French and German election outcomes, the Fed is on track to implement at least two more interest rate hikes in 2017. According to the most recent release of their meeting minutes, the Federal Open Market Committee (FOMC) is also weighing the option of shrinking its balance sheet later this year or early next year, which would be another important step forward in policy normalization. As for inflation, although both wages and prices are in an uptrend, the rate of growth is extremely mild. Core consumer inflation has stabilized in the vicinity of 1.75%, while wages are increasing at a modest 2.8% annual rate. The bottom line is that wage and price inflation should remain in a rising trend over the next two years, but a breakout to the upside appears unlikely any time soon. As such, the Fed will continue their methodical pace, and is unlikely to be the source of any dramatic surprises. The only wild card is if Trump chooses to reconstitute the Fed's leadership or makes their independence a source of political debate.

DEVELOPED INTERNATIONAL ECONOMIES: Comeback Kids

SINCE THE FINANCIAL CRISIS OF 2008, the euro zone has been in the midst of an epic struggle between deflationary and reflationary forces, with the European Central Bank (ECB) in the epicenter of the battle. As soon as ECB President Mario Draghi started to hint at an asset purchase program in 2014, reflation has been winning, although evidence of rising inflation may give pause to their efforts. We suspect that the ECB will attribute the rise in inflation to transitory forces, most notably a rise in energy prices. With the unemployment rate still at an elevated 9.5%, there is plenty of slack left in the labor market, meaning rising wage growth is some ways off.

Consequently, we expect the ECB to continue its accommodative stance while it awaits a "durable," "self-sustained" and "broad-based" rise in inflation over the

Stable and rising consumer confidence and recovering manufacturing show EU making gains



"medium term." Though the ECB is unlikely to make any change in the deposit rate before early 2018, it is highly possible they announce a reduction in the pace of its asset purchases by the third quarter of 2017, assuming the conditions for reflation continue.

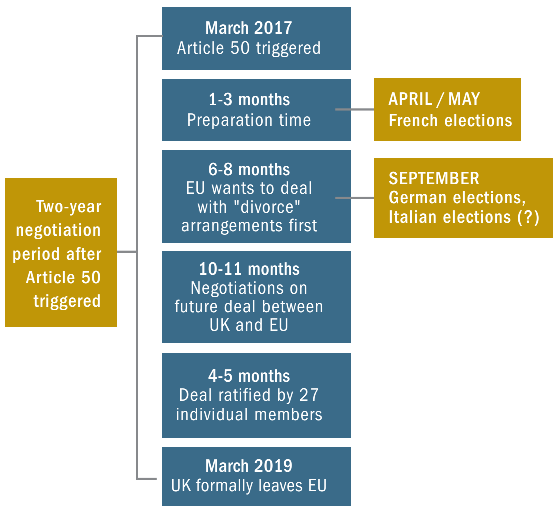
Indeed, the ECB will be looking for any reason to remain accommodative, to feed the building momentum in economic data that is finally showing through. Consumer spending has increased by 1.7% in 2016 (compared to trend growth of 1.5%), and remains the main component in euro zone economic growth. Purchasing manager indices across the continent have had a fairly spectacular run over recent months, highlighting the growing strength of the euro zone's economic recovery. Businesses appear to be shrugging off political risk, as is evident by the positive economic data coming out of France. Both business and consumer confidence are solid, and reflect little fear of electoral tail risks.

In contrast, Brexit will weigh on the U.K.'s economic prospects in the years to come. The British government triggered Article 50 of the Lisbon Treaty in March and the U.K. will have two years to settle the terms of separation and future engagement with the European Union.

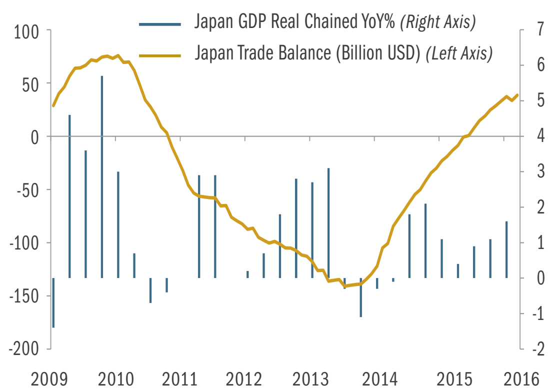
A recent contraction in business investment highlights the negative impact from the uncertainty around the U.K.'s future regulatory and trade regime. One of the immediate consequences of last year's referendum was a sharp depreciation of the pound sterling. For an economy where consumption makes up 60% of all economic activity, imported inflation combined with tepid nominal wage growth is an obvious challenge. Recent declines in consumer confidence and stretched household balance sheets indicate that retail sales will likely weaken further. Some relief has been provided by the boost to overseas revenues of U.K. corporations from sterling's depreciation, but that is unlikely to offset the weakness in other quarters.

Making matters worse, U.K. Chancellor Phillip Hammond has indicated an unwillingness to use fiscal policy to cushion the economy against the aforementioned headwinds. Real GDP growth is likely to decelerate from 2% in 2016 to 1.5% in 2017, with risks tilted to the downside. For this reason, we expect the Bank of England to maintain an accommodative stance and look through any further spike in inflation, though monetary policy on its own may not be enough to forestall a slowdown.

Article 50 triggered, kicking off two years of uncertainty for the UK and EU



Japanese exports expand, and growth continues to recover thanks to Abe's reforms



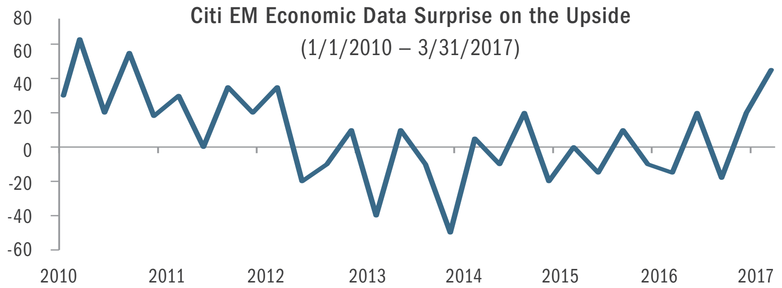
Turning to Japan, the economy is expected to grow at a steady, if uninspiring, pace of just above 1% in 2017. The Bank of Japan's (BoJ) policy stance should remain accommodative, with a benchmark policy rate of -0.1% and a 0% yield target for 10-year Japanese government bonds. While the BoJ's extraordinary support remains a positive catalyst, structural reforms must do the heavy lifting for the Japanese economy to truly achieve its growth nirvana.

Unfortunately, Prime Minister Abe's reform agenda was dealt a blow when President Trump withdrew from the Trans-Pacific Partnership (TPP) on his first full day in office. Undeterred by this setback, Abe traveled to meet Trump at Mar-a-Lago, making sure to secure Japan's long-standing security alliance with the U.S. Abe was also in the news after the ruling Liberal Democratic Party (LDP) rubber stamped a change in party rules that allows leaders to serve three consecutive terms for a total of nine years. The decision puts Shinzo Abe, who has been in office since December 2012, on a course to become the country's longest-serving leader since the end of World War II—a positive for a continuation of the country's growth revival. That said, recently Prime Minister Abe faced the first significant political scandal of his tenure when news broke of the sale of public land in Osaka for use as a kindergarten by an extreme-nationalist educational organization. After facing some dents to his public approval rating, Abe pushed forward with two new reform initiatives during in the quarter. Abe enacted monthly "Premium Fridays" in a work-life balance campaign that calls on employers to let staff off around 3:00 pm on the last Friday of every month. The goal of Premium Fridays is to boost consumer spending and alleviate the nation's health crisis stemming from notoriously long working hours. Even more significant, Abe made headlines by proceeding with his defense revitalization goals by formally breaking the country's policy of restricting defense spending to 1% of GDP.

CHINA & EMERGING ECONOMIES: Surprising Strength

IN THE WAKE OF TRUMP'S ELECTION, emerging markets experienced a bout of pessimism as investors sought to digest how the campaign's protectionist rhetoric might translate to reality. While the protectionist threat is still legit, there are questions about how strong it will be when or if it is finally implemented. In addition, many of the structural headwinds that put off investors from emerging markets in recent years, primarily large current account deficits and weak currencies, have faded. Emerging market manufacturing PMI is rebounding and earnings growth is accelerating across all sectors and most countries. Indeed, the Citigroup EM Economic Surprise Index turned positive in December 2016 and is now at its highest level since 2010. Growth appears to be bottoming thanks to the easing recessions in Brazil and Russia. Commodity prices are supportive and U.S. rates and the dollar have not been the straight shot higher that many were expecting. Emerging markets, it seems, may at last be getting their due.

Citi EM Economic Surprise Index at its highest level since 2010

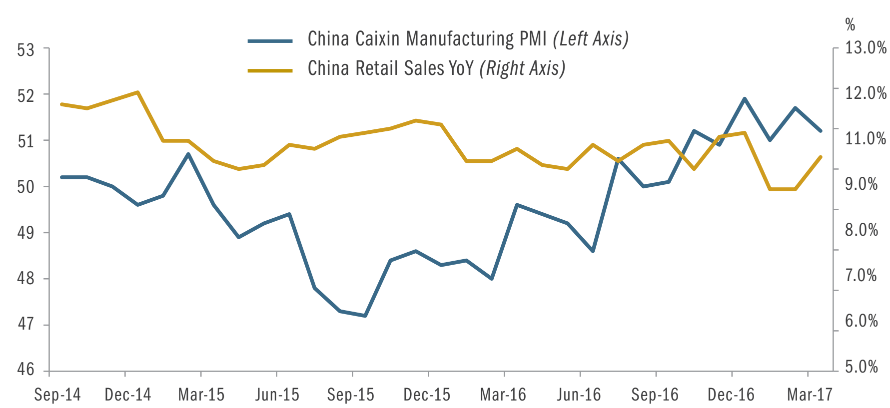


As is the case nowadays, Asia remains the key when it comes to deciphering the economic trajectory of the emerging markets. The Chinese economy has started the year with solid momentum, as implied by recent high-frequency indicators from the industrial and services sectors. However, authorities have emphasized financial stability over fast economic growth and lowered the 2017 real GDP growth target to around 6.5% from 6.5–7% in 2016. According to policymakers, increased attention will be paid to deleveraging and managing financial risks related to non-performing assets and high corporate leverage, bond defaults, shadow banking, and the heated real estate market. While the Chinese government will continue its sizeable fiscal injections in infrastructure, overall activity has been and will continue to be increasingly driven by the Chinese consumer and the services sector. And household spending is strong, supported by rapidly expanding incomes. Amazingly enough, the number of upper middle-class and affluent households is estimated to reach 100 million by the end of the decade, doubling from the 2015 level.

Meanwhile, India's outlook is improving as the economy recovers from the temporary cash shortage that followed the government's currency exchange initiative at the end of 2016. We expect India's real GDP growth to average 7.8% in 2017–18 following a 7.5% advance in 2016. Momentum will be driven by domestic demand—particularly household spending—on the back of India's rapidly expanding middle class and rising disposable incomes, as well as enhancements to the business environment following implementation of key reforms. Simultaneously, India's macroeconomic stability is improving, reflecting contained inflation, improved fiscal position, and reduced external vulnerabilities. In addition to stronger fundamentals, India's political environment seems set to support the economy's prospects. Legislative Assembly elections were held in five states at the end of February and early March; Prime Minister Narendra Modi's Bharatiya Janata Party (BPJ) performed well, which will improve the party's position in the upper house of parliament where it currently lacks a majority. Expectations for smoother passage of key structural reforms should enhance investor confidence and appetite toward India over the coming quarters.

As always, though, there are less constructive situations worth monitoring for their risks to collective outlook. For example, Turkey is at an important crossroads. On April 16, Turks narrowly voted for President Recep Tayyip Erdogan on an executive presidency following a coup attempt in July. This vote gives controversial President Erdogan carte blanche over Turkey's judiciary, parliament, and central bank. In South Africa, President Jacob Zuma's removal of 20 members of his cabinet on March 31, including Pravin Gordhan, a market-friendly finance minister, has put policy continuity at risk. These pockets of uncertainty, alongside events in Syria and North Korea, may restrain emerging markets to some extent.

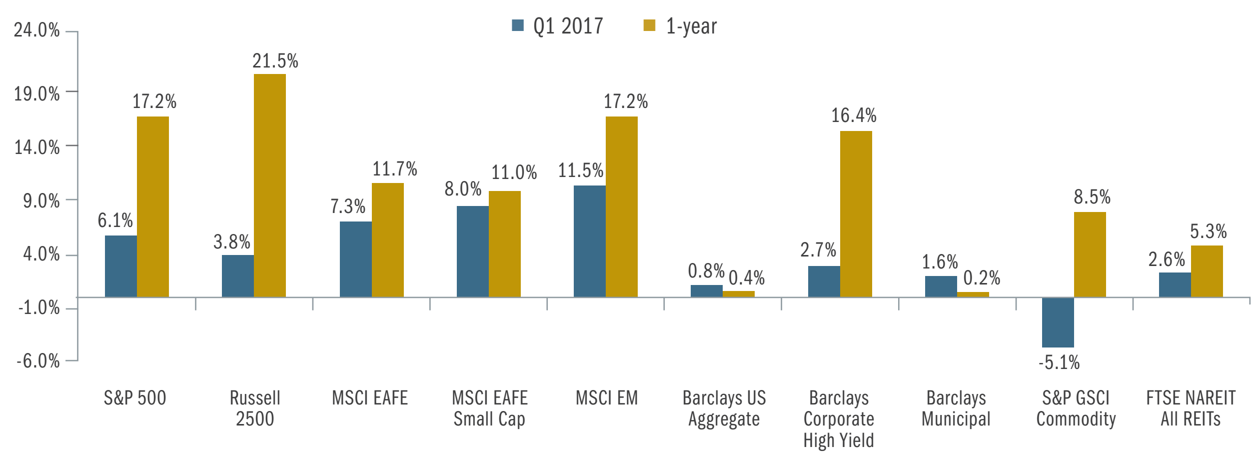
China continues to seek balance between industrial and service sectors



GLOBAL MARKET OUTLOOK: Reflation is Winning

GLOBAL EQUITIES DELIVERED ROBUST GAINS in the first quarter amid an upswing in global economic data. Emerging market equities were particularly strong while bond markets saw more mixed performance. U.S. equities initially advanced to fresh all-time highs, supported by positive economic data and President Trump's plans to cut taxes and regulations. By quarter-end, some of that narrative lost steam as efforts to repeal and replace Obamacare were defeated, and scrutiny increased over the Trump team's dealings with Russia. While the Federal Reserve raised rates by a further 0.25% in the quarter, there was very little fanfare in the markets over the decision, other than in REITs which sagged on the news though they still managed to deliver modest gains in the period. Overseas, euro zone equities delivered robust performance amid upbeat economic releases and receding political worries following the win for the center-right in the Dutch elections. U.K. equities also gained, supported by solid corporate results and merger & acquisition activity. Article 50 was triggered at the end of the period, signaling the formal start of the process to leave the EU. Japanese stocks saw positive but muted returns with the yen gradually appreciating over the quarter. Emerging markets were the standout, though, thanks to an upturn in global growth and after a lack of follow-through on protectionist trade policy from the Trump administration supported risk appetites. In the bond markets, high yield corporate bonds performed particularly well, and municipals returned to favor after a delay in Trump tax reform. Hedge funds had a decent showing in the quarter, with equity focused strategies including long/short in the strongest position. Commodities failed to build on last year's gains, with natural gas, coal, and oil under pressure, though lumber, palladium, gold, and silver advanced in a flight-to-quality.

Another standout quarter builds on recent gains



U.S. equities rise again, sparking fears of complacency

U.S. equity markets continued their recent trend of strong performance in the first quarter, rallying again to record highs in the midst of robust employment data, clarity on the interest rate front, and a flurry of initiatives in the Trump administration's first weeks in office. Macroeconomic data continued to be supportive, and the market remained optimistic over President Trump's plans to cut taxes, boost infrastructure spend and reduce the regulatory burden on business. However, the failure at the period end to pass revisions to healthcare legislation did plant doubts about the administration's ability to implement some of its policies. Even so, U.S. equities performed well as the S&P 500 advanced 6.1%.

Performance disparity between the extremes was wide, making sector allocations important. As with the prior two quarters, the performance disparity between the best- and worst-performing sectors was significant, amounting to more than 2000 basis points for the three months. Information technology, healthcare, and consumer discretionary were the strongest performers, producing gains of +12.6%, +8.4%, and +8.5%, respectively. The energy, telecommunication services, and financials sectors were the poorest relative performers, posting returns of -6.7%, -4.0%, and +2.5%, respectively. REITs declined again during the quarter.

In a reversal of the performance patterns in the fourth quarter of 2016, small and mid-cap equities trailed large caps, with the Russell 2500 recording a gain of just 3.8% over the period. In terms of style, growth stocks outperformed value stocks significantly in both large- and small-cap market segments. The Nasdaq Composite, dominated by information technology stocks, finished stronger than the S&P 500 Index with a gain of +10.1%, and is now up +22.9% over the past year. The Dow Jones Industrial Average of 30 large industrial companies trailed the S&P 500, adding only +5.2%.

Developed international equities bounce back thanks to strong data

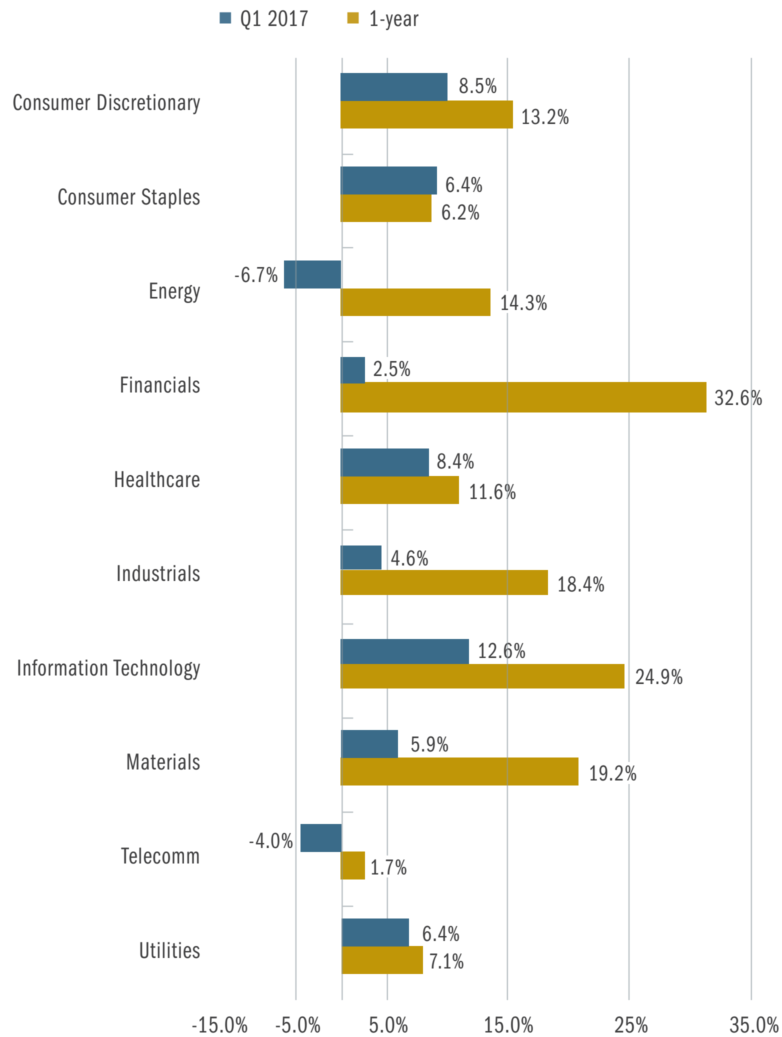
Developed international stocks produced more robust performance than U.S. equities in the first quarter, at least temporarily reversing a prominent trend that has been in place for several years. The MSCI EAFE Index of developed markets stocks rose by +7.3%, and is now up +11.7% over the past twelve months.

European equities were strong in Q1, though the period started on a weak note with negative returns in January. Those losses were quickly reversed as the quarter progressed, as the economic data released during the period was largely positive, and the Dutch election outcome was perceived as reaffirming the EU. The information technology sector was the top performer, followed by utilities and industrials. Energy was the only sector to register a negative return. The quarterly earnings season was a positive one for European equities, with many firms reporting double digit earnings growth and confident outlooks for 2017.

In the U.K., the FTSE All-Share index rose 4.0% amid further evidence of a recovery in the global economy and given the resilience of the U.K.'s domestic economy. Many cyclical sectors continued to outperform, building on their very strong performances at the end of 2016. Mergers & acquisitions also provided market support: British American Tobacco agreed to acquire the outstanding stake in Reynolds American it does not already own; Unilever received a bid from U.S. peer Kraft Heinz; Reckitt Benckiser agreed to acquire American baby milk manufacturer Mead; and Standard Life made a deal to acquire Aberdeen Asset Management. While the sterling strengthened over the period against a weaker U.S. dollar, the currency was under pressure again by the end of the quarter after Prime Minister Theresa May triggered Article 50 and suggested the U.K. was heading towards a harder variant of Brexit as she set out the government's negotiating priorities.

In contrast, the Japanese stock market traded in a tight range throughout the quarter, registering a total return of just 0.6%. After weakening sharply at the end of 2016, the Japanese yen appreciated gradually in the past three months. From Japan's perspective, the main political event was the meeting in February between Prime Minister Abe and President Trump in Washington and Florida. The meeting appeared to be surprisingly cordial despite Trump's withdrawal from the TPP and his previous rhetoric around trade imbalances and Japan's foreign exchange policy. Meanwhile, earnings season was very solid with over 60% of companies reporting positive surprises compared to the consensus. Cyclical sectors such as marine transportation, paper stocks, and chemical companies led returns as investors continued to discount the possibility of stronger global growth. Financial-related sectors, including banks and leasing companies, lagged the market although all of their underperformance accrued in a relatively brief period in March. Real estate stocks have shown a more consistent pattern of underperformance and were the weakest sector in the quarter.

Technology roars back in Q1, and is now second only to financials over the last year for the S&P 500



Reprieve in protectionist trade policy sparks Asia-led emerging markets rally

The MSCI Emerging Markets index posted a strong gain, with U.S. dollar weakness providing a tailwind to returns. In China, stocks gained strongly and had their best first quarter in over 10 years, driven by continued positive news for the world's second-largest economy. Better-than-expected data and a stabilizing Chinese yuan led to improved sentiment among investors. Ongoing restrictions on the property market and a tightening on capital outflows also saw liquidity diverted into equities. In nearby Hong Kong, stocks tracked China markets higher on investor optimism as well as strong buying interest from Mainland Chinese investors via the Southbound Stock Connect scheme. An upswing in global growth and a lack of follow-through on protectionist trade policy from the Trump administration also supported risk appetites. Korea, Mexico, and Taiwan all benefited from these factors and outperformed. Indian equities rallied as GDP growth appeared to shrug off demonetisation concerns. The ruling BJP also performed well in state elections, reflecting support for ongoing reforms. Thai and Philippine stocks all gained although the Philippines was the regional underperformer as concerns lingered over the weakness of its currency and the erratic policymaking of President Duterte. Poland was the strongest emerging market as positive economic data increased expectations for growth this year. By contrast, Russia posted a negative return and was the weakest emerging market. A decline in energy prices and reduced optimism towards a significant improvement in relations with the West were Russia's key headwinds. Greece also recorded a negative return with banking stocks leading the market lower.

Global equities hit their stride in Q1, closing the gap with U.S. stocks

Trailing Returns (%)	Q1 2017	1-year
Developed Markets	7.3%	11.7%
Emerging Markets	11.5%	17.2%
BRIC	11.6%	23.7%
Value	6.1%	16.0%
Growth	8.5%	7.5%
Large Cap	7.1%	12.3%
Small Cap	8.0%	11.0%
Europe	7.6%	10.5%
Japan	4.6%	14.8%
Pacific (ex-Japan)	11.8%	18.5%

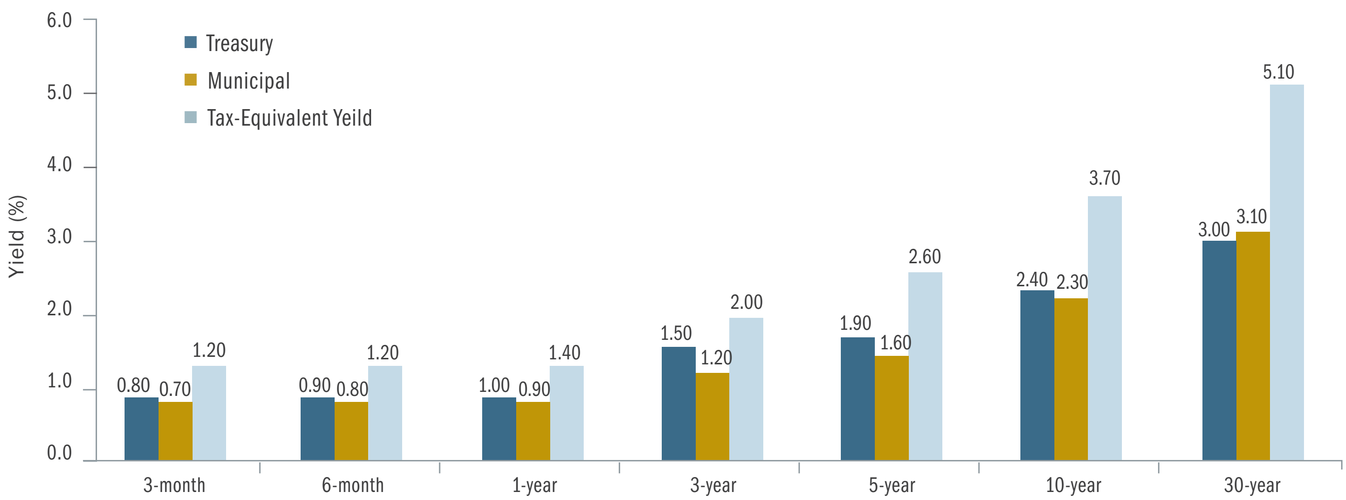
Fixed income finds its footing in the first quarter

As was the case over the prior two quarters, the primary drivers of fixed income securities' prices during the past three months were anticipation of (and ultimately the FOMC's decision to move ahead with) a hike in the fed funds rate, an improving economic outlook (especially the employment situation), and record-high stock prices. With the economic backdrop supporting a rate hike, there was little suspense as to whether the FOMC would move to increase rates, especially after members of the Committee, in the days leading up to their meeting, signaled such an outcome was likely. The fixed income markets also digested the inauguration of Donald Trump and the heightened activity surrounding his first weeks in office.

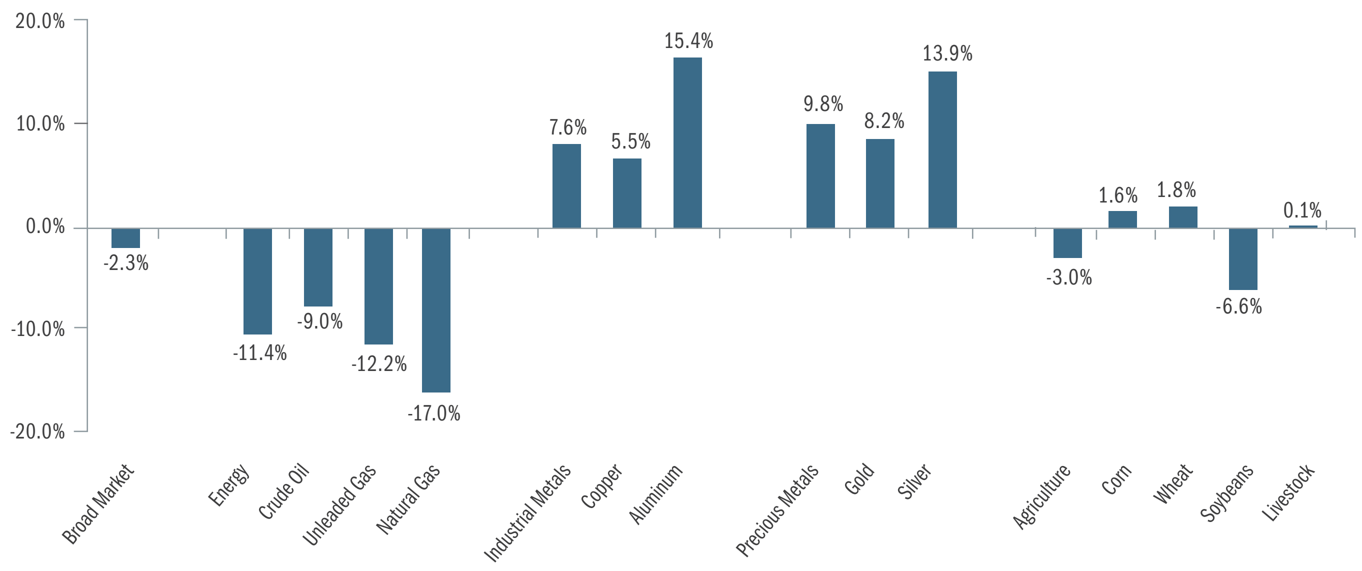
In contrast to the prior quarter, the yield curve flattened slightly, as yields on short-term securities rose more than those in the intermediate- to long-term end of the spectrum. The flattening was largely due to the FOMC's rate increase, which is expected to have little impact on longer-dated issues. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note was little changed, ending the quarter at 2.39%, compared to 2.45% on December 31.

As happened in the fourth quarter of 2016, yield changes along the maturity spectrum were largely a result of several primary factors: the FOMC's decision to raise the fed funds rate, a rebound in employment and other economic data, and the perception that the Trump administration will espouse pro-growth economic policies. 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, but maturities of two years and longer experienced little change in yields. The yield on the 3-month Treasury bill settled at 0.75% at the end of the quarter, up about 25 basis points from the end of the previous quarter. The yield on the 5-year Treasury note ended the quarter at

Municipal bond yields offer attractive taxable equivalent yields in the wake of tax reform speculation



Only metals shine in first quarter commodity price action



1.92%, compared to 1.93% on December 31, and as mentioned above, the yield on the 10-year Treasury note dipped to 2.39% from 2.45% over the same period. At the same time, the yield on the 30-year Treasury bond was slightly lower, ending the period at 3.01%, compared to its beginning level of 3.07%. Inflation expectations crept higher, with the Fed's gauge of five-year forward inflation expectations closing at 1.93% on March 31, the same level as December 31.

Fixed income securities generally produced positive total returns in most market segments. The Barclays Treasury 5-7 Yr. Index gained +0.8% for the quarter, though Treasuries are one of the only fixed income markets with a negative return over the past twelve months. Corporate bonds advanced modestly, and high yield securities once again followed rising stock prices, delivering a gain of +2.7%, and producing a return of more than +20% over the past year. Municipals performed admirably, as the Barclays Municipal Bond Index rose by +1.6% during the quarter. It seems that tax reform will be delayed at least, if not watered down, which helped municipal bond prices to recover. Likewise, the prices of non-U.S. fixed income securities clawed back some of the losses suffered in the fourth quarter of 2016. Emerging markets bonds also fared well after a dismal fourth quarter, with the JPM EMBI Global Index rallying some +3.9%.

Hedged strategies hit a high note

Hedged strategies posted a positive first quarter, and the best opening performance since 2013, led by strength in equity-focused strategies and long-short approaches which were up over 4%. Fixed income-based relative value arbitrage strategies posted the lowest returns in Q1 of 1.06%, after the strategy also recorded the smallest gains in 2016. Gains by merger arbitrage and special situation strategies were offset by distressed funds' 0.9% decline. Macro strategies fell 0.5% in March, and are down 0.2% for the year.

In a similar manner to the 2016 intra-year market cycles that were driven by Brexit and the U.S. election, 2017 financial market performance is likely to be driven by similar intra-year cycles, including upcoming European elections.

Hedge funds will also be impacted by industry dynamics: these strategies have underperformed the market every year since 2008, and 2016 marked the highest level of hedge fund closures and lowest levels of openings since 2008. Notably, Eton Park Capital Management, helmed by Goldman Sachs alum Eric Mindich, shut down and returned its capital to investors after a run of poor performance. This was a disappointing end for the fund, which opened in 2004, marking the biggest-ever hedge fund launch with $3.5 billion in capital commitments. Fees also remain a hot topic in the industry, adding pressure to the outlook as flows reflect shifting investor preferences and the extended bull market.

Commodities take a breather in the first quarter

The Bloomberg Commodities index lost ground in Q1, largely due to a decline in energy. WTI crude fell -9% as oil inventories and production in the U.S. increased at a faster rate than expected. Natural gas was down 17% and coal declined -8.7%. Agriculture also declined, largely attributed to weakness from sugar and soybeans prices. By contrast, industrial metals generated a positive return. Iron ore rallied 5.7% while copper (+5.5%) and zinc (+7.5%) also rose on higher demand from China. Precious metals finished in positive territory, with gold (+8.2%) and silver (+13.9%) both posting gains. After last year's recovery in commodities, it is reasonable for some consolidation to occur as prices settle into these new higher ranges, and geopolitical risks are assessed.

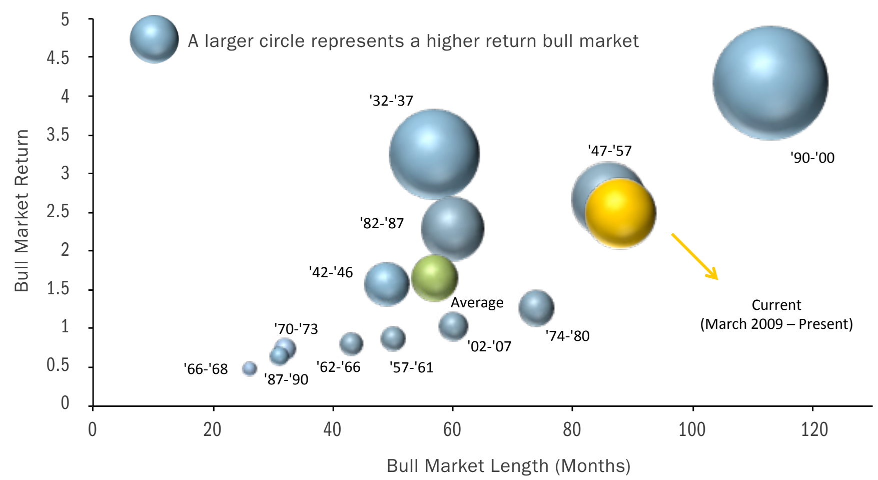
Looking ahead

With this great quarter now history, investors wonder what to expect out of Q2. A bullish outlook still predominates on Wall Street, though questions linger. Is the market overbought, with a correction ahead? How much of a lift can stocks really get from this next earnings season? What if Trump's proposed tax reforms and fiscal stimulus fail to materialize or falter, like the repeal and replace of Obamacare? Will Syria or North Korea spell the end of financial market stability? Will French voters affirm the EU or take the "Frexit" route?

Markets have been exceptionally strong in the last year, shaking off bad news and the unexpected with very little angst or agitation. The pace of global growth has picked up, but the stock market has clearly outperformed the economy. Though equity prices are always a forward-looking indicator, there must ultimately be a follow-through on the fundamentals for gains to sustain. The age of the bull market is also a concern, though we acknowledge that bull markets do not die of old age. They do die of recessions, though, and any hint of an impending change to the business cycle would surely be enough to choke off returns at these high levels. For now, corporate earnings and economic data are supportive of the upward stock market trend. Companies are growing both top and bottom lines, and the economy, while not out performing, is meeting the expectations built into stock prices. Vulnerability runs deep, however, given the unknown policy agenda of Washington, and evolving political regimes overseas. One wrong move could shift the tectonics of the market's momentum, and create the conditions of a repricing in anticipation of a recession (though a normal business cycle recession, and not a credit crisis akin to 2008).

Against this backdrop, we have been thoroughly focused on how to position portfolios to enjoy the equity market gains that typically accompany late market cycle economies, while using each and every opportunity to upgrade the quality of our investments as a form of defense in a market seemingly priced for perfection. We have also been careful to rebalance portfolios at disciplined intervals when equity market appreciation has caused allocations to become extended. Always, we remain flexible as we monitor the risks and opportunities offered by the market, and stand ready to make adjustments in order to achieve optimal returns within a reasonable level of risk.

This bull market has exceeded the average bull-market return and length



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