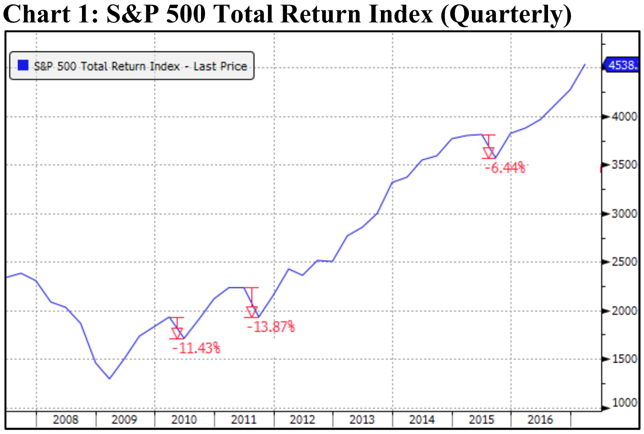
Table 1: Benchmark Returns as of March 31, 2017

INDEX	Last 3 Mo.	Last 6 Mo.	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	6.07	10.12	17.17
Russell 2000 Index (small-cap stocks)	2.47	11.52	26.22
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	7.25	6.48	11.67
MSCI Europe Net Total Return (US$) Index	7.45	7.01	9.76
MSCI Japan Net Total Return (US$) Index	4.49	4.32	14.44
MSCI Emerging Markets Net Total Return Index (US$)	11.44	6.80	17.21
COMMODITIES			
US Dollar Index (DXY)	(1.82)	5.20	6.09
Gold	7.40	(5.87)	0.63
Oil (WTI)	(5.81)	4.89	31.98
BONDS			
Bloom Barclays US Aggregate Bond (investment-grade bonds)	0.82	(2.18)	0.44
ICE U.S. Treasury 20+ Index	1.42	(10.88)	(5.17)
S&P National AMT-Free Municipal Bond Index	1.27	(2.20)	0.05
Markit iBoxx USD Liquid Investment Grade Idx (corporate bonds)	1.26	(2.52)	2.84
Bloom Barclays US Corp. High Yld Bon Index (high-yield bonds)	2.70	4.50	16.39
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	1.72	(8.28)	(4.97)

Source: iShares.com & Bloomberg

Global stocks and bonds posted strong returns during the first quarter of the year (Table 1) continuing a very strong run since bottoming in 2009. As shown in Chart 1 below, we have experienced only one quarterly decline over 5% since the third quarter of 2011 and three since the stock market bottomed in March, 2009.

Chart 1: S&P 500 Total Return Index (Quarterly)

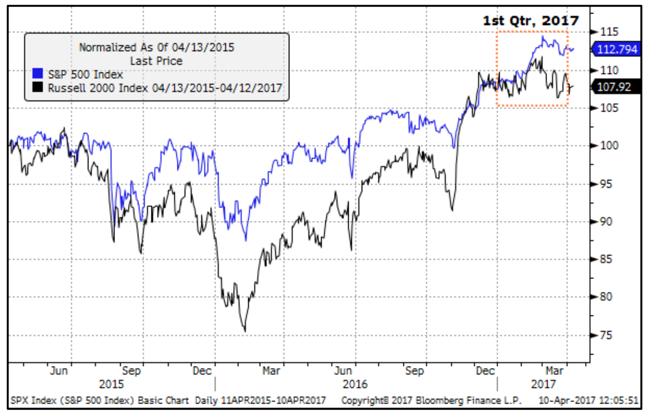


Source: Bloomberg

While US stocks as measured by the S&P 500 and the Russell 2000 posted new highs during the quarter, the momentum from January and February faded in March (Chart 2) as concerns grew over the Trump administration's plans for healthcare reform, new infrastructure spending and tax reform.

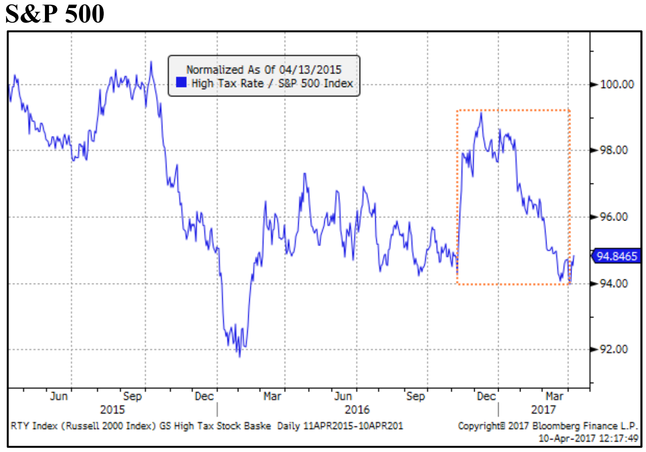
The failure to replace the Affordable Care Act (Obamacare) has cast doubt in the eyes of many about the ability of Congress to pass other parts of Trump's agenda. As a consequence, the "Trump Trade" has gone into reverse as shown on Chart 3 below which illustrates the performance of a sector neutral basket of the 50 S&P 500 stocks with the highest median effective tax rates relative to the S&P 500 Index.

Chart 2: S&P 500 & Russell 2000



Source: Bloomberg

Chart 3: Goldman Sachs High-Tax Basket Relative to S&P 500



Source: Bloomberg

If anything, the failure to repeal and replace the Affordable Care Act may turn out to be a blessing in disguise for the Republicans. Opinion polls suggest that the GOP would have suffered if the American Health Care Act had been signed into law.

The GOP's proposed legislation would have reduced federal government spending on health care by $1.2 trillion over ten years. Sixty-four year-olds with incomes of $26,500 would have seen their annual premiums soar from $1,700 to $14,600. Even if one includes the tax cuts in the proposed bill, the net effect would have been a major tightening in fiscal policy.

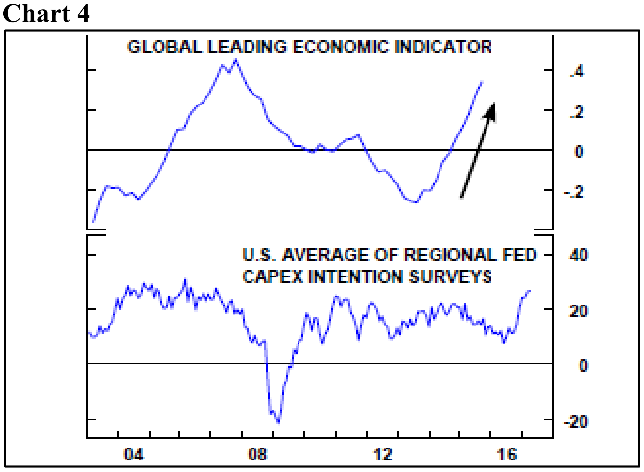
The failure to repeal and replace the ACA serves as a reminder that comprehensive tax reform will be more difficult to achieve than many had hoped. However, even if Republicans are unable to overhaul the tax code, this will not prevent them from simply cutting corporate and personal taxes. Worries that tax cuts will lead to larger budget deficits will be brushed aside on the grounds that they will "pay for themselves" through faster growth ("dynamic scoring"). Throw some infrastructure spending into the mix, and it will not take much for the "Trump Trade" to return in strength for a period of time.

Where the disappointment will most likely arise is not during the legislative process, but afterwards. The highly profitable companies that will benefit the most from corporate tax cuts are the ones who least need them. In many cases, these companies have plenty of cash and easy access to external financing. As a consequence, much of the corporate tax cuts may simply be hoarded or used to finance equity buybacks or dividend payments. A large share of personal tax cuts will also be saved, given that they will mostly accrue to higher income earners.

The amount of infrastructure spending that actually takes place will likely be a small fraction of the headline amount. This is not just because of the scarcity of "shovel ready" projects. It is also because the public-private partnership structure the GOP is touting will limit the universe of projects that can be considered. Most of America's infrastructure needs consist of basic maintenance, rather than the sort of high-profile projects that the private sector would be happy to invest in.

Meanwhile, the Trump administration is proposing large cuts to nondefense discretionary expenditures that go above and beyond the ones that are already a part of current law.

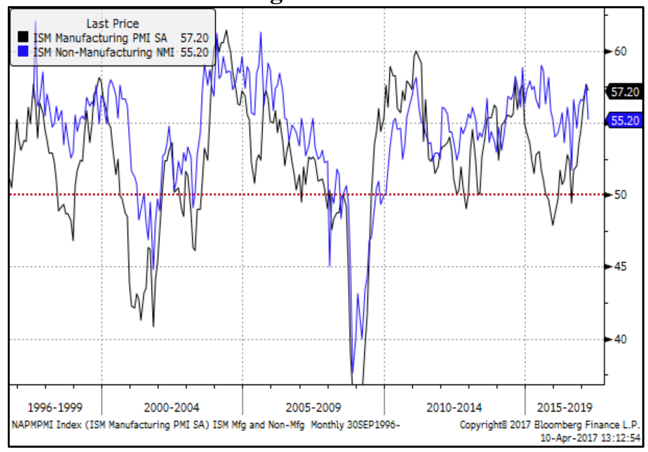
Chart 4



Source: BCA Research

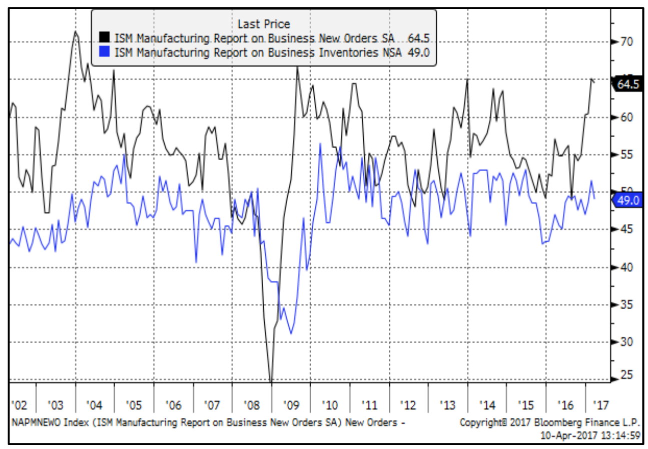
Regardless of politics, we think the outlook for stocks is reasonably good for the rest of the year. The recovery in global growth and corporate earnings started a few months before last year's election and does not appear to be weakening for the time being based on a number of measures as shown in Charts 4, 5, 6 and 7. The message from these indicators is that growth will remain sturdy for the rest of the year.

Chart 5: Manufacturing and Services Indices



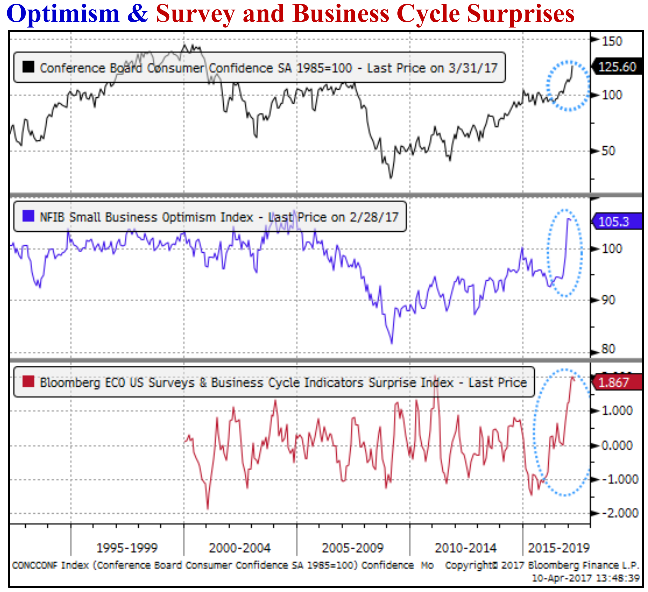
Source: Bloomberg

Chart 6: New Orders and Inventories



Source: Bloomberg

Chart 7: Consumer Confidence, Small Business Optimism & Survey and Business Cycle Surprises

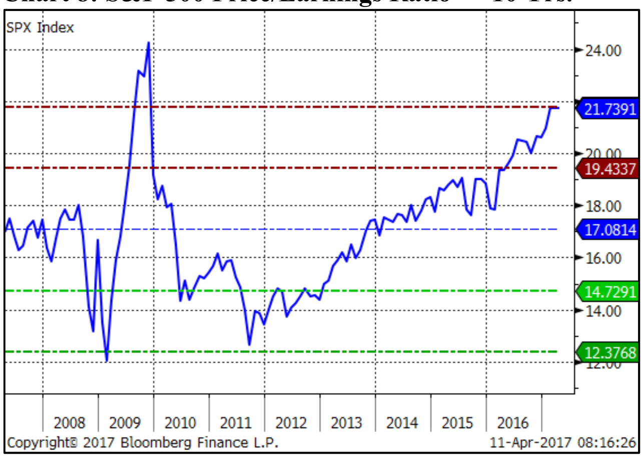


Source: Bloomberg

While the data looks good, much of the good news has been bought and paid for as stocks have already advanced significantly in anticipation of future growth. Other than new orders, the data in the charts above reflect strong measures of optimism ("soft data") rather than measures of actual growth ("hard data").

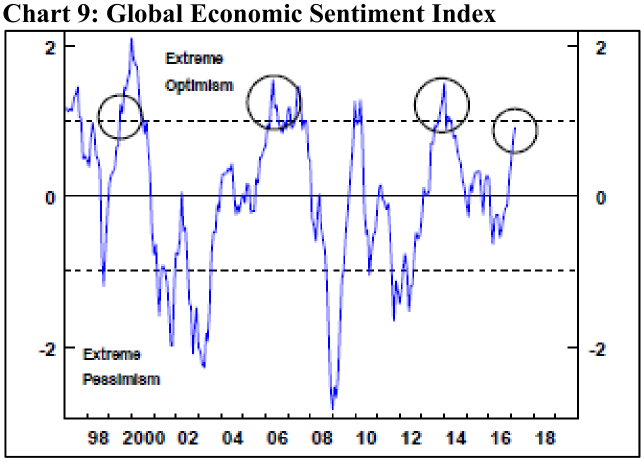
This is also reflected in various measures of market valuation. The S&P price/earnings ratio is currently two standard deviations above its 10-year average (Chart 8) and BCA Research's proprietary Global Economic Sentiment Index which is based on a comparison of stock and bond valuations is closing in on readings that reflect "extreme optimism" (Chart 9).

Chart 8: S&P 500 Price/Earnings Ratio* – 10 Yrs.



**Shown with Average (dashed blue line) and Standard Deviations (dashed green and red lines) Source: Bloomberg*

Chart 9: Global Economic Sentiment Index



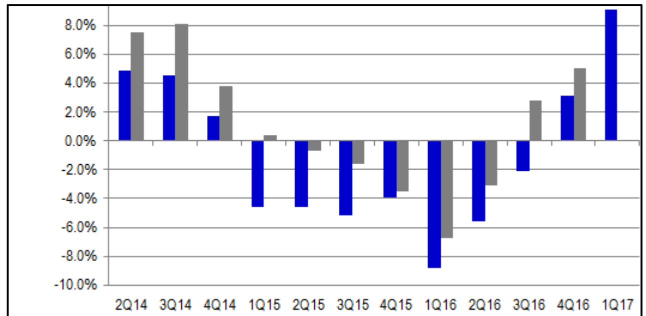
Source: BCA Research

The message from all of these indicators is that for the market to continue its advance, and for the optimism to continue, there's very little room for disappointment.

Fortunately, the underlying fundamentals for equities – earnings in particular – look good. After posting zero-to-negative earnings growth for the six-quarters between the first-quarter, 2015 through the second-quarter, 2016, earnings are once again positive with the outlook improving for now (Chart 10).

The fourth-quarter increase of 5% was the best year-over-year gain in earnings since the third quarter of 2015. As of today, the companies in the S&P 500 are expected to report earnings growth of 9.1% for the first quarter.

Chart 10: S&P 500 Estimated Earnings Growth vs. Actual Growth

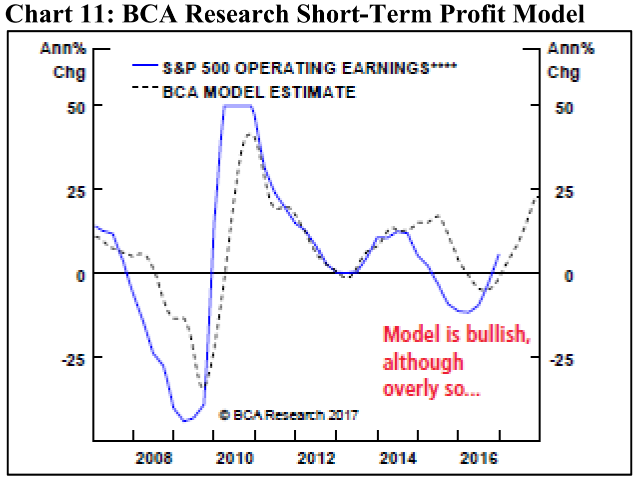


	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17
Quarter End	4.9%	4.5%	1.7%	-4.6%	-4.6%	-5.2%	-3.9%	-8.8%	-5.6%	-2.1%	3.1%	9.1%
Actual	7.5%	8.1%	3.8%	0.4%	-0.7%	-1.6%	-3.5%	-6.7%	-3.1%	2.8%	5.0%	
Difference	2.6%	3.6%	2.1%	5.0%	3.9%	3.6%	0.4%	2.1%	2.5%	4.9%	1.9%	

Source: FactSet

Despite our view that profit margins are going to contract in the coming years as a tight labor market pushes up wages (compensation is 2/3 of business costs) which are growing faster than selling prices, we are finally becoming optimistic about earnings growth this year. This conclusion is also supported by another of BCA Research's profit models (Chart 11).

Chart 11: BCA Research Short-Term Profit Model

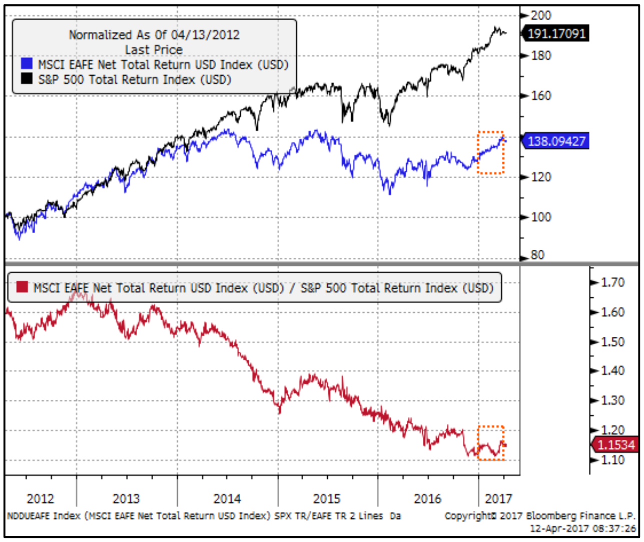


Source: BCA Research

Foreign stocks also performed well during the quarter (Chart 12) and we think the outlook is good.

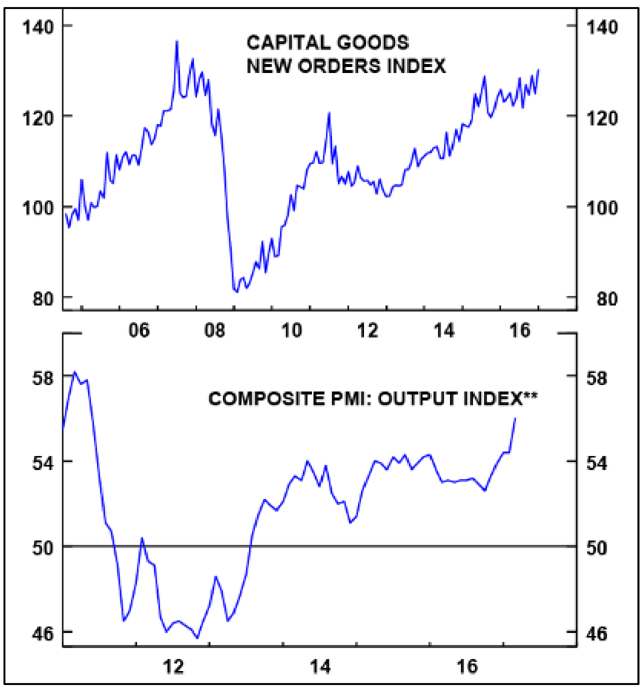
The euro area grew faster than the US (on a per capita basis) in 2016, the first time this has happened since 2008. While the US is likely to resume its outperformance in 2017, we still expect the euro area economy to expand at an above-trend pace. That should be enough to keep unemployment on a downward trajectory. Other measures such as the composite Purchasing Managers Index (PMI) and the forward-looking new orders component (Chart 13) are hitting new cyclical highs, which bode well for investment spending over the coming months.

Chart 12: US Stocks, Foreign Stocks & Foreign Relative to US



Source: Bloomberg

Chart 13

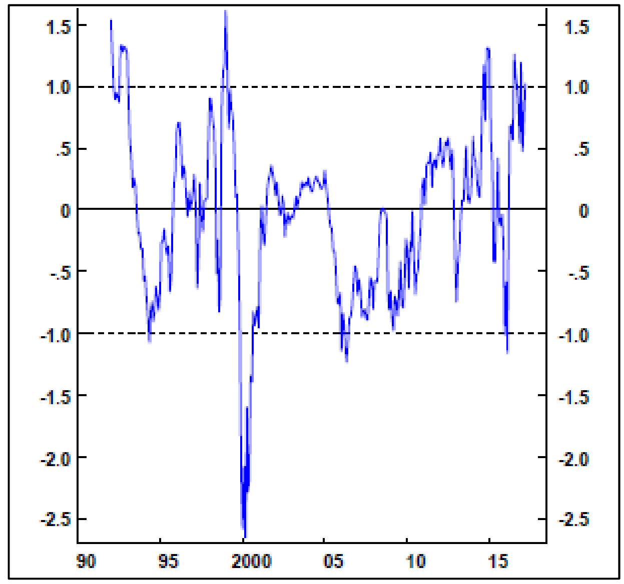


Source: BCA Research

Euro area stocks are also relatively cheap. They trade at a Shiller P/E ratio[1] of only 17 compared with 29 for the US. Some of this valuation gap can be explained by different sector weights across the two regions. However, even if one controls for this factor, as well as the fact that euro area stocks have historically traded at a discount to the US, the euro area still comes out as being roughly one standard deviation cheap compared with the US (Chart 14).

Additionally, monetary policy in the euro area (and Japan) continues to be more stimulative than in the US.

Chart 14: Valuation Indicator* – US Minus Euro Area**



**Difference in deviation from 5-yr. moving averages adjusted for volatility. Includes P/E ratio, forward P/E ratio, P/S ratio, EV/EBITDA, P/B ratio and Shiller P/E ratio. **Calculated using US sector weights*
Source: BCA Reseach

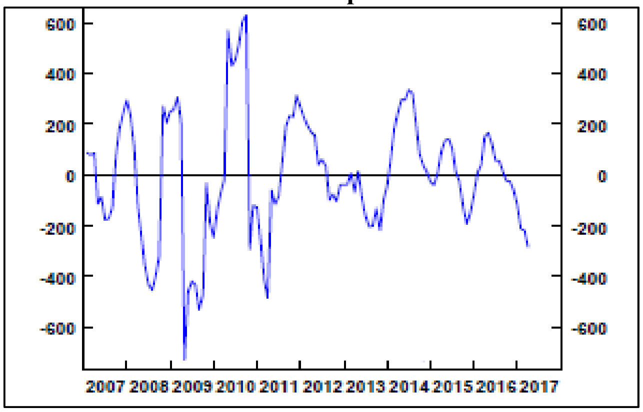
Many investors, including us, have been expecting a stock market correction for some time. But the longer that the market goes without a correction, the “fear of missing out” forces more investors to throw in the towel and add to their stock holdings which continues to push prices higher. When optimism is high and rising, disappointments become increasingly likely. For now, the impressive upturn in economic and earnings data keeps us optimistic.

However, it’s important to keep in mind that strong sentiment and survey data that reflect soaring “animal spirits” in isolation do not cause advances in the economic cycle. While wide spread optimism creates a tailwind for credit creation, any associated rise in the cost of long-term borrowing costs generates an offsetting headwind.

One issue with real potential for disappointment is credit growth and its implications for economic growth. The hard data on bank lending are sending the opposite signal than the soft data on expectations. Over the last few months, global credit flows have slumped, which leads to a negative “credit impulse” (as measured by the six-month rate of change in credit growth) shown in chart 15. The concern here is that the credit impulse has been shown to lead economic growth (Chart 16). The message from the credit impulse is also consistent with the Atlanta Fed’s GDP Forecast (Chart 17) which has been declining since early this year. At the very least, until the conflict between soaring animal spirits and weakening credit impulses is resolved (possibly with clarity on tax policy), caution is warranted.

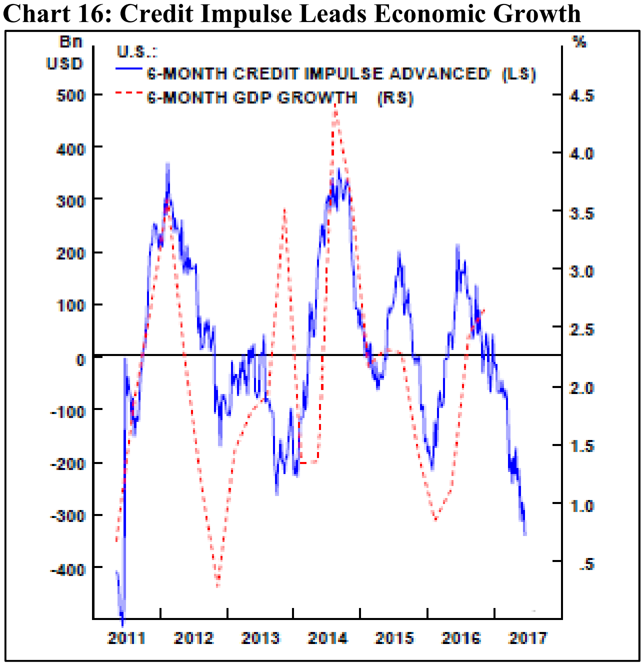
[1] Price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years.

Chart 15: US 6-Mo. Credit Impulse*



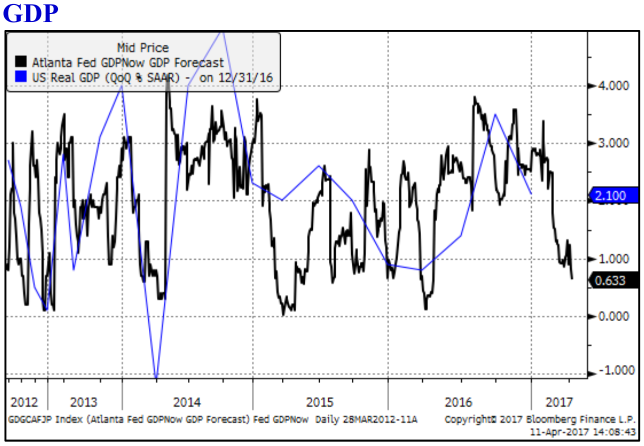
**Billions of dollars; Source: BCA Research*

Chart 16: Credit Impulse Leads Economic Growth



Source: BCA Research

Chart 17: Atlanta Fed GDPNow Forecast & Actual GDP



Source: Bloomberg

In sum, we expect the current consolidation phase to persist and certainly aren't ruling out a pullback in equities due to very high expectations and the potential for disappointment surrounding a lack of follow-through by Congress and the Trump Administration on tax cut, tax reform and infrastructure. However, we expect stocks – both in the US and developed foreign markets – to outperform bonds this year even though outsized gains are unlikely.

In this environment, we remain fully invested at our benchmark allocation weights. We see no reason to get more aggressive than that given that potential returns don't justify taking additional risk.

Turning to the bond market, we expect the benchmark 10-year Treasury yield (interest rate) to rise over the next 12 months. We think the Fed will raise short-term interest rates more than is being priced by the financial markets over that period of time (currently about 0.50% as shown in Chart 18). Additionally, the Fed is likely to announce later this year or in early 2018 that it will begin reducing the size of its balance sheet by allowing the bonds it owns to run off as they mature (versus using the proceeds from the redemptions to purchase replacement securities) thereby creating less demand in the market.

Chart 18: The Market Expects about 0.50% of Tightening Over the Next 12 Months

**Based on overnight index swap (OIS); Source: BCA Research*

Our fixed income investment strategy is unchanged. We are underweight US Treasuries, Agencies, mortgages and high grade corporate bonds, and overweight floating-rate and preferred securities.

-Brant Kairies
952-885-2732