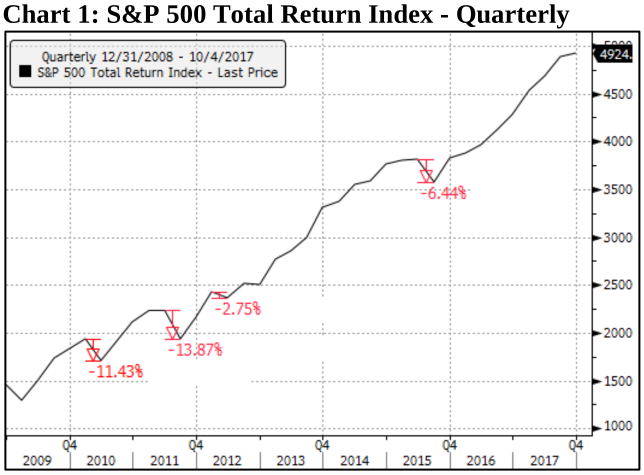
Table 1: Benchmark Returns as of September 30, 2017

INDEX	Last 3 Mo.	Year-To-Date	Last 12 Mo.
US STOCKS			
S&P 500 Index (large-cap stocks)	4.65	14.24	19.56
Russell 2000 Index (small-cap stocks)	5.61	10.94	22.10
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	4.71	19.96	18.76
S&P Europe 350 Index Net Total Return Index (US$)	5.91	22.72	22.62
MSCI Japan Net Total Return Index (US$)	3.38	14.28	12.82
MSCI Emerging Markets Net Total Return Index (US$)	7.56	27.78	21.13
COMMODITIES			
US Dollar Index (DXY)	(2.67)	(8.94)	(2.50)
Gold	3.19	10.70	(2.66)
Oil (WTI)	12.23	(3.82)	7.11
BONDS			
BBG US Aggregate Bond (investment-grade bonds)	0.70	3.14	(0.16)
ICE US Treasury 20+ Year TR Index	0.57	6.25	(6.63)
BBG US Treas. Inflation Protected Securities (TIPS)	0.67	1.72	(0.90)
S&P National AMT-Free Municipal Bond Index	1.22	4.42	0.78
Markit iBoxx Liquid Investment Grade Idx (corporate bonds)	1.30	5.85	1.51
Markit iBoxx USD Liquid High Yield Index (high-yield bonds)	1.71	6.22	7.81
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	2.84	9.58	(1.15)

Source: iShares.com & Bloomberg Finance LP

In financial speak, it continues to be a 'risk on' market. Financial assets delivered another solid quarter (Table 1) with the "riskiest" asset classes (small company and emerging markets stocks) turning in the strongest returns. As shown in Chart 1 below, we've now gone eight quarters without a setback for the S&P 500 Index and have had only four negative quarters since the stock market bottomed in 2009.

Chart 1: S&P 500 Total Return Index - Quarterly



Source: Bloomberg Finance LP

While there were some flare-ups with North Korea during the quarter, and the situation changes from day to day, it appears that investors are becoming increasingly desensitized to its provocations. We think there is a very low risk of an all-out war, but there could be a market rattling political crisis or even a military encounter before the North comes to the negotiating table. However, we may have already past peak tensions based on some key developments recently:

- Both China and Russia (two North Korean allies) have turned up the pressure. China appears to be enforcing sanctions and both China and Russia have agreed to reduce fuel supplies.
- There is evidence that the US and North Korea have held unofficial diplomatic talks behind the scenes. This may be a sign that North Korea is responding to pressure now that its critical fuel supplies are at risk.

We cannot rule out more provocations from Kim Jong Un, but we think it would require a major one (i.e. a direct attack on the US or its allies) for Pyongyang to escalate tensions from current levels. This would require the North to be very reckless with its own strategic assets, given that the US would likely conduct a proportional retaliation against any serious attack.

From an economic perspective, the global economy is firing on all cylinders. The Organization for Economic Cooperation and Development (OECD) estimates that all 46 of the nations' economies that it tracks will see positive growth this year, the first time this has happened since 2007. Most leading economic indicators remain positive (Chart 2).

Chart 2: Global Leading Economic Indicator*

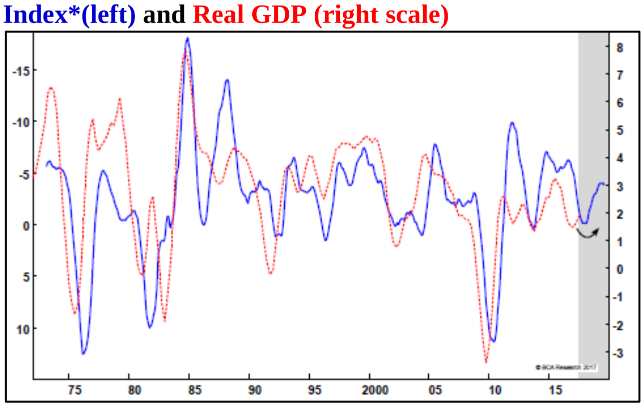
**Includes 23 countries, shown standardized*
Source: BCA Research

The world economy is also in a synchronized expansion with the largest share of countries operating at (or beyond) full employment since the pre-crisis years. The acceleration in global growth has occurred against the backdrop of tame inflation which has allowed most central banks to keep interest rates at exceptionally low levels. This has been a huge benefit to risk assets.

The sweet spot for risk assets has also been extended by the rise in oil prices and improving prospects for tax cuts in the US. Capital expenditures (capex) are also accelerating, which will give growth (and corporate earnings) another boost. The downtrends in both Treasury yields (intermediate and long term government bond interest rates) and the dollar have been additional supports this year, but appear to be over. We believe both have upside potential from here given that economic growth and leading inflation indicators are strengthening. Moreover, the Federal Open Market Committee (the "Fed") is still in a position to deliver on a December interest rate hike with two to three additional hikes in 2018, which will most likely put upward pressure on interest rates across the maturity spectrum.

Financial conditions have eased meaningfully this year thanks to lower bond yields (interest rates), narrower credit spreads (the interest rate differential between US Treasuries and corporate borrowing rates), a weaker dollar, and a surging stock market. Changes in financial conditions lead economic growth by around six to nine months (Chart 3) implying that US growth will continue to accelerate into next year. This could take the unemployment rate down below the 2008 low of 3.8% by the end of 2018, more than a full point below the Fed's estimate of full employment.

Chart 3: 12-Month Change in Financial Conditions Index*(left) and Real GDP (right scale)



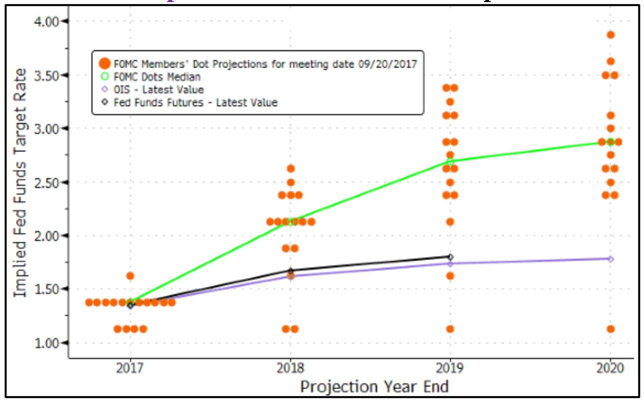
Source: BCA Research, shown advanced by 7-months

In last quarter's letter, we noted that the Fed's projection for the level of short term interest rates was significantly higher than the market's based on fed funds futures and the overnight index swap market. While the Fed's longer term median projection for short term interest rates came down a bit at their meeting on September 20, there still exists a sizable gap between where the Fed expects interest rates to be in the future versus investors' expectations as expressed in the interest rate markets (Chart 3 and Table 2).

This is setting up a potentially nasty surprise for the bond market because investors have become skeptical about the possibility of policymakers shifting in a more hawkish direction without an obvious trigger from faster inflation. We believe that inflation is in the process of stabilizing, or grinding higher, in most of the major economies.

If the markets come around to the Fed's projections, it will be a wake-up call for bonds and will most likely reverse this year's dollar weakness. It also has the potential to be the catalyst for a correction in risk asset markets.

Chart 4: Fed Funds Target Rate Expectations
Orange Dots: Individual Members' Interest Rate Proj.
Green Line: Median Fed Projection
Black and Purple Lines: Market Based Expectations



Source: Bloomberg Finance LP as of 10/5/17

Table 2

Curves (Current: 1.25/**1.125**/1.00)	YE 2017	YE 2018	YE 2019	YE 2020
FOMC Dots Median	**1.375**	**2.125**	**2.688**	**2.875**
Projected Minus Current	**0.250**	**1.000**	**1.563**	**1.750**
Fed Funds Futures - Latest Value	1.335	1.645	1.770	
Projected Minus Current	0.210	0.520	0.645	
OIS - Latest Value	1.320	1.589	1.716	1.782
Projected Minus Current	0.195	0.464	0.591	0.657

Source: Bloomberg Finance LP as of 10/5/17

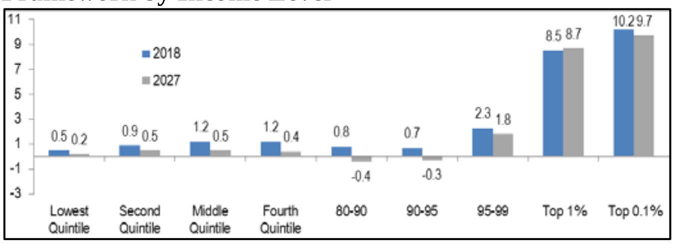
Last quarter we noted that what have become known as the "Trump trades" (high tax paying companies, small companies and infrastructure companies) had been unwinding following their post-election surge and that the market looked like it had priced out the likelihood of a boost in infrastructure spending and the potential for lower corporate tax rates. Now, it looks like President Trump's long awaited tax plan will likely be enacted in the first part of 2018. Trump and the Republicans in congress (still desperate for a legislative win after again failing to repeal and replace Obamacare) introduced the proposal in late September. However, the plan must clear several hurdles before it becomes law:

- The initial framework has tax decreases for many (but not all – see Chart 6), but no spending offsets. The implication is that the package would blow out the deficit, possibly alienating the fiscal conservatives.
- Moderates may not like the lack of cuts for the middle class. In a report issued by the Tax Policy Center on September 29, the top 1% of taxpayers would receive

50% of the tax benefits (Chart 5). This may be a difficult sell.

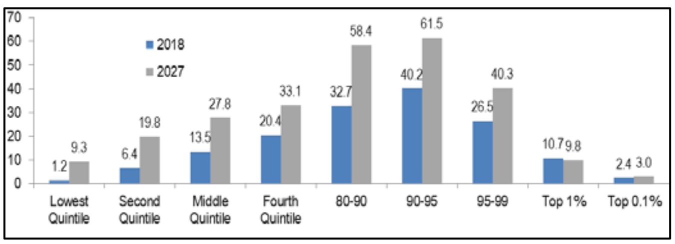
- The CBO still must score the legislation, and even with dynamic scoring which counts on stronger economic growth to boost revenues and reduce outlays, it will add to the deficit. This may not be acceptable in Congress.

Chart 5: Percent Change In After-Tax Income Resulting From Tax Proposals in the Unified Framework by Income Level



Source: Tax Policy Center – "A Preliminary Analysis of the Unified Framework", September 29, 2017

Chart 6: Percent of Households with Tax Increases by Income Level



Source: Tax Policy Center – "A Preliminary Analysis of the Unified Framework", September 29, 2017

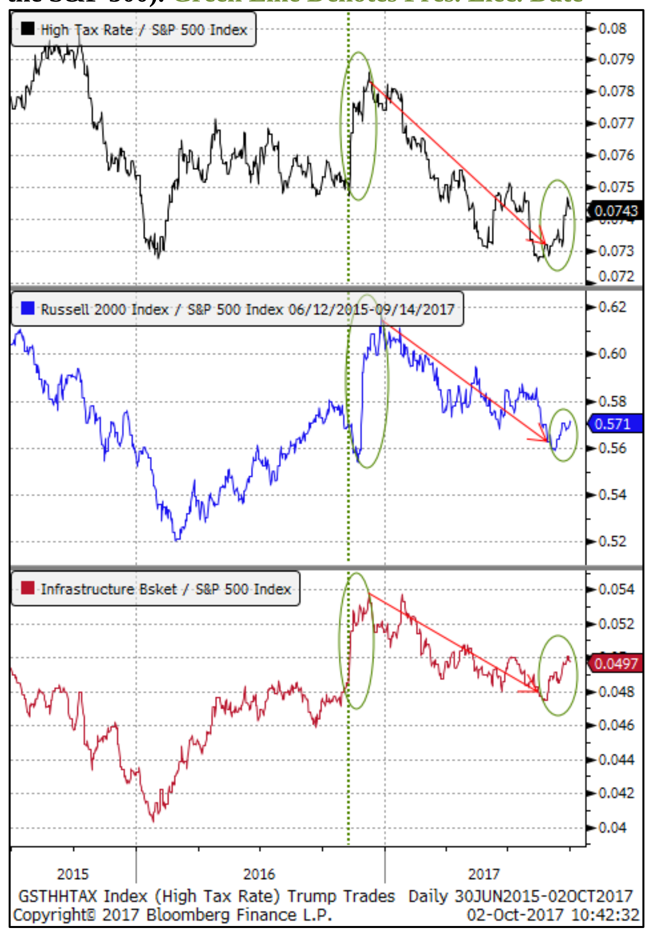
On a positive note, Trump has the support of both the House Ways and Means Committee and the Senate Finance Committee. This was not the case with the Obamacare repeal and replace when the President and his GOP allies were at odds.

The bottom line is that we need to watch the response of Congressional Republicans to Trump's tax proposals. A lukewarm reception would indicate that investors' renewed optimism may be premature. The Trump trades have made a comeback in the past few weeks (Chart 7) and will continue to be profitable if the current proposal (or something similar) is signed into law next year.

The proposed tax legislation is a form of modest stimulus. If we assume that the $1.5 trillion in tax cuts will be offset with a combination of revenue-raising policies of around 50%, it still leaves roughly $750 billion in new deficit spending (stimulus) over the next ten years. A more likely figure for total revenue offsets is around $400 billion, which would put the cost of stimulus at roughly $1.1 billion. This is not unusually large, but even a modest effort this far into the economic cycle could have a meaningful effect. Pro-cyclical fiscal stimulus in the US should be positive for the US dollar, positive for US small company stocks relative to large ones, and negative for government bonds.

Looking ahead, we expect US inflation, which looks to be stabilizing after the downturn since the spring, to grind higher alongside a steadily expanding US economy and strengthening payrolls. With corporate profits and household incomes expanding, and with leading indicators steadily climbing, the investment environment looks good fundamentally.

Chart 7: S&P 500 High Tax Rate Companies, Small Cap Stocks, Infrastructure Companies (all *Relative to* the S&P 500). Green Line Denotes Pres. Elec. Date



Source: Bloomberg Finance LP

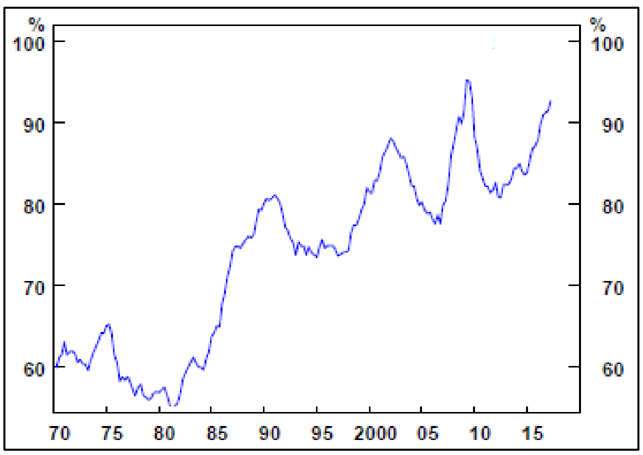
The current economic recovery in the US has now lasted over eight years, making it the third longest on record. If it continues until July 2019, it will take the top spot from the 1990s expansion. The Great Recession was one of the deepest in history, while the recovery that followed has been fairly drawn out. Such "slow burn" recoveries are typical following financial crises.

These "goldilocks" conditions should remain in place over the next 12 or so months. However, economic cycles have not been repealed. Broadly speaking, post-war recessions can be broken down into two categories. The first consists of recessions that resulted from the bursting of asset bubbles. The second category consists of recessions where the Fed found itself behind the curve in normalizing monetary policy and was forced to raise rates aggressively in response to rising inflation.

The last three recessions were all of the first variety. The 1990-91 recession stemmed from the commercial real estate bust and the ensuing Savings and Loan crisis. The 2001 recession was caused by the bursting of the dotcom bubble. And, of course, the Great Recession was largely the product of the housing bust and weak mortgage underwriting standards.

While there's a lot that's right about the economic and financial landscape, today's financial environment is far from pristine. Corporate debt is close to record high levels as a share of GDP (Chart 8) and asset valuations are stretched across the board (Chart 9). However, while these imbalances are bad enough to exacerbate a recession, they do not appear severe enough to cause one. This suggests that the next downturn may be the result of the second category outlined above.

Chart 8: US Nonfinancial Corporate Sector Debt as a Percent of GDP



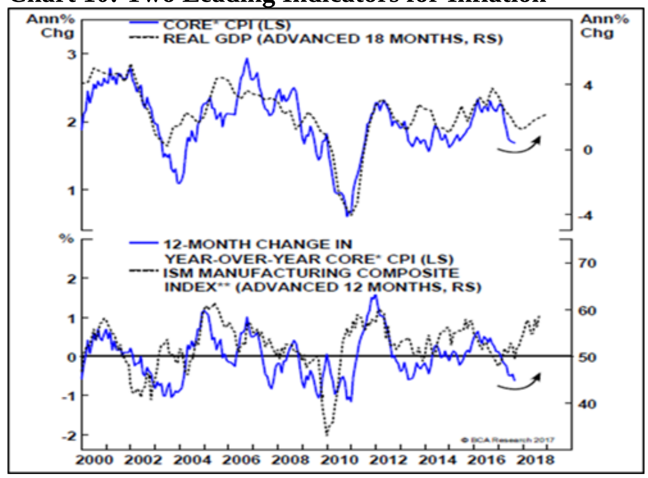
Source: BCA Research, US financial accounts & Bureau of Economic Analysis

Chart 9: S&P 500 Price/Earnings Ratio (10 Years)

Dashed lines indicate 10 year average (black) and 1 & 2 standard deviations (red and green)
Source: Bloomberg Finance LP

If this is the case, we need to keep a close eye on inflation because the Fed is unlikely to turn very hawkish until inflation starts accelerating. While we don't expect a near term surge in inflation, many indicators from employment data to economic growth to manufacturing data suggest we should expect it to begin rising in the months ahead (Chart 10). This will be the catalyst for the Fed to accelerate the pace of interest rate hikes.

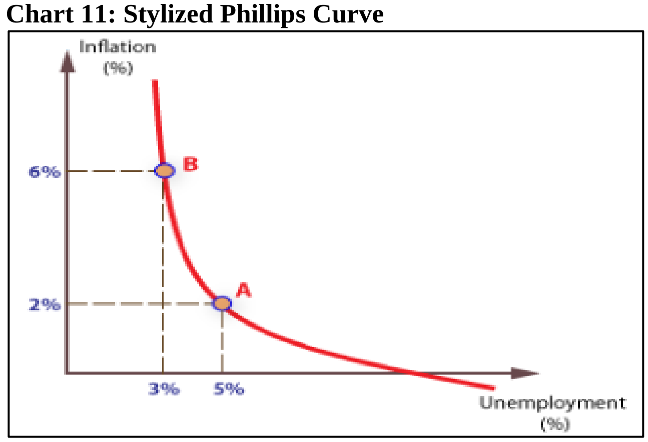
Chart 10: Two Leading Indicators for Inflation



Source: BCA Research

The so called Phillips curve, which depicts the relationship between employment and inflation, tends to steepen at an increasing rate as unemployment falls to very low levels (Chart 11). Rising inflation will compel the Fed to raise short term interest rates more aggressively toward the end of next year in order to push the unemployment rate back towards "NAIRU" (the non-accelerating inflation rate of unemployment).

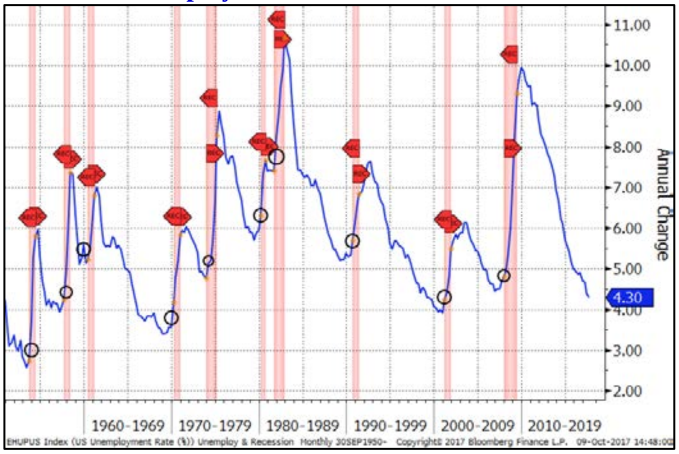
Chart 11: Stylized Phillips Curve



The problem is that it is very difficult to raise the unemployment rate by just a little bit and the economy is subject to considerable feedback loops. When unemployment begins rising, households lose confidence and reduce spending. This prompts firms to slow hiring, leading to even less spending. The US has never averted a recession in the post-war era whenever the unemployment rate has increased by more than one-third of a percentage point (Chart 12).

Lofty valuations are likely to exacerbate the adverse feedback loop described above during the next downturn. As growth slows, risk asset prices will decline. This will cause business investment spending to dry up. Given America's dominant role in global financial markets, the US recession will spread to the rest of the world.

Chart 12: Unemployment Rate & Periods of Recession



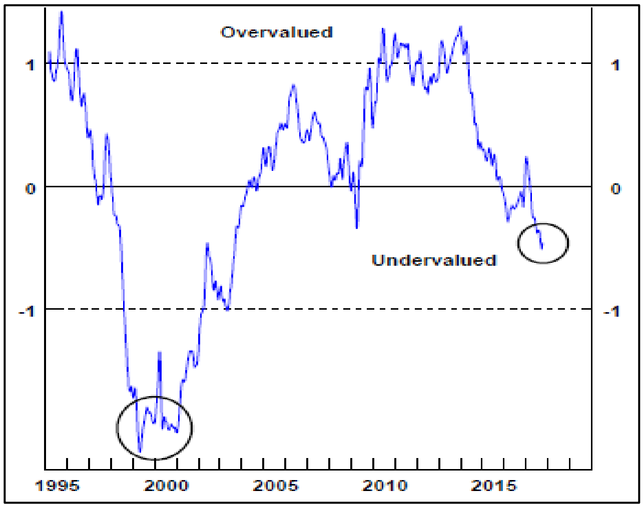
Circles on the chart indicate when the 3 month moving average of the unemployment rate increased by more than one-third of a percentage point.
Source: Bloomberg Finance LP

Recessions and bear markets tend to go hand in hand and at this point we don't believe a recession is imminent. This, along with strong growth in corporate earnings and other market friendly forces lead us to believe the current bull market in stocks has further room to run.

We expect the strongest relative performance over the next twelve months to come from small cap stocks, bank stocks, energy stocks and industrial stocks. We also expect foreign stocks in developed markets (Europe and Japan) to do well. Here's why:

- Small cap stocks are undervalued relative to large caps (Chart 13). Our outlook for regulation, inflation and the dollar also favor small over large caps: Trump has already made progress in slowing the pace of new regulations, which has long been a concern for small businesses; small caps often outperform when inflation accelerates; and small caps are less sensitive to US dollar movements (which we expect to rise) than large caps.
- Bank stocks will benefit from steeper yield curves (a larger difference between short term interest rates and long term interest rates), faster credit growth, and ongoing declines in nonperforming loans.
- Energy stocks should benefit from further upside in oil prices due to favorable supply and demand conditions. Geopolitical risks in Iraq, Libya and Venezuela could also adversely affect supply.
- Industrial stocks – Capital spending tends to accelerate in the later phases of business cycle expansions and many indicators currently point to strong capex growth over the next year. This should benefit industrial stocks.
- European and Japanese stocks should generate solid returns. The sector composition of both markets is tilted toward stocks that should benefit most from strong global growth and increased capital spending as both markets are dominated by large multinationals whose fortunes are tied more to the global economy than domestic prospects. If our outlook for a stronger dollar (and a weaker euro and yen) plays out, both regions will benefit from being more competitive from a pricing perspective. Valuations in Europe and Japan are also generally more attractive than in the US.

Chart 13: S&P 600 / S&P 500 Valuation Indicator



Source: BCA Research

We continue to expect interest rates to rise and, therefore, are underweight longer term government bonds and overweight shorter term corporate bonds and floating rate securities.

-Brant Kairies
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