Market Review & Outlook: Yield Curve Conundrum

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Executive Summary

- *Global equity and bond markets performed well in the second quarter of 2017 as the S&P 500 recorded new highs, long-term bond yields declined moderately, and long-lagging international markets outperformed.*
- *At this point, we see bonds primarily as a risk management tool. Because we do not know when equities will hit tough times, an allocation to high quality bonds is a good insurance policy.*
- *The equity market outlook is not perfect, but we do not believe that it is as dire as many would have you believe.*

Global equity and bond markets performed well in the second quarter of 2017 as the S&P 500 recorded new highs, long-term bond yields declined moderately, and long-lagging international markets outperformed. Donald Trump's political difficulties were offset by long-awaited clarity about the European Union's future and healthy first quarter earnings reports. The Federal Reserve increased rates again in June following a March increase, while 10-year Treasury yields seem to be stuck in a range between 2.2% and 2.5%. The United States economy continues to grow at a consistent, moderate pace. European economic performance continues to improve from depressed levels. So the foundation is in place for continued positive equity market returns. The devil's advocate is telling us to keep an eye on the yield curve and equity valuations.

We believe the market's strong response to Trump's victory was based primarily on three pro-growth campaign promises: reduced corporate tax rates, lighter regulation, and a much higher level of infrastructure spending. He decided to go with healthcare reform first and proposals have not met a warm reception. Beyond Trump's legislative difficulties in healthcare, his declining popularity threatens the prospects for corporate tax reform and infrastructure spending. In the best case, these initiatives will take longer to pass and will probably take some diluted form relative to what was promised due to budget realities. It is often said that markets like political gridlock. In this case, the equity markets shrugged off President Trump's setbacks while bond markets responded with a decrease in long-term bond yields despite the Federal Reserve's most aggressive series of interest rate increases yet.

Equity Market Index Returns

As of June 30, 2017

Asset Class	Index	2Q 2017 (%)	Year-to-Date	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	3.09	9.34	17.90	9.61	14.63	7.18
	Russell 1000 Large Growth Index	4.68	14.00	20.44	11.12	15.31	8.91
	Russell 1000 Large Value Index	1.34	4.64	15.50	7.35	13.93	5.56
	DJ US Select Dividend Index	2.08	6.09	11.99	10.15	14.54	6.91
Mid Cap U.S.	S&P 400 Mid Cap Index	1.97	5.98	18.56	8.52	14.92	8.56
Small Cap U.S.	S&P 600 Small Cap Index	1.70	2.79	22.45	9.32	15.47	8.44
Developed International	MSCI EAFE Index	6.11	13.80	20.25	1.15	8.69	1.03
Emerging Markets	MSCI Emerging Market Index	6.28	18.43	23.76	1.08	3.95	1.91
Commodities	Bloomberg Commodity Total Return Index	-3.00	-5.25	-6.50	-14.81	-9.25	-6.49
Real Estate	NAREIT Equity Index	1.52	2.70	-1.72	8.35	9.51	6.00
Global Market Cap Weighted	MSCI World Index*	4.03	10.65	18.17	5.23	11.38	3.97

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of June 30, 2017

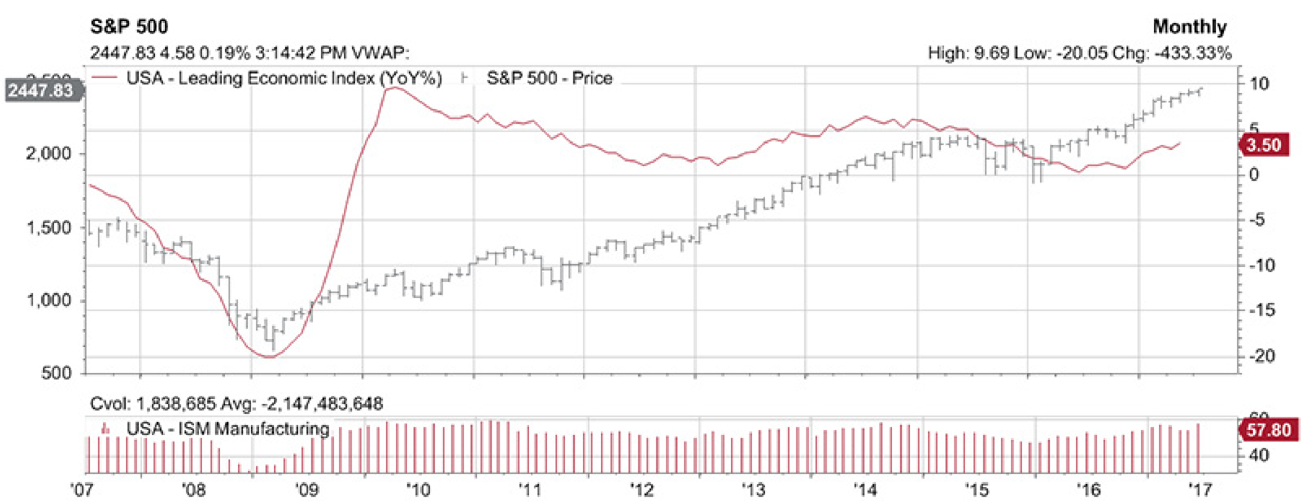
A flattening yield curve (where the difference between near-term and long-term rates decreases) is typically seen as harbinger of more difficult times to come because it is a necessary precursor to an inverted yield curve (a curve where near-term rates exceed long-term rates), which actually is a reliable predictor of recessions. When long-term rates fall below near-term rates, the aggregate demand for credit (at that maturity) is low reflecting a lack of confidence in future growth. The yield curve is not currently inverted and it is not really that flat; it is just flatter than it was. In addition to political setbacks, inflation readings have decelerated for five consecutive months. So the moderation in 10-year yields could reflect slower than previously expected future growth or lower than anticipated inflation. By the Federal Reserve's preferred measure, the latest inflation reading was 1.4% versus the stated 2% target. Conventional wisdom suggests an inverse relationship between the rate of unemployment and the rate of inflation, which we are not seeing this time around. Unemployment has fallen to 4.4%. The current vacillations in 10-year rates are not concerning, but a deeper and more concerted decline in 10-year rates would be.

The official plan from the Fed is a relatively aggressive series of interest rate hikes over the next few years to normalize overnight rates at about 3% (currently at 1.25%), but the markets appear to disagree. Fed Funds Futures have reduced the probability of another interest rate increase this year to below 50%. We believe the inflation readings are probably the primary factor here. 2% is the Fed's inflation target on the upside and the downside. Fed governors are going to have a difficult argument that the US economy is on track for 2% inflation when all of the readings are as far below as they are currently running. The other hawkish Fed plan is to "reduce the size of the balance sheet." The Fed owns $4.5 trillion in bonds that it purchased through quantitative easing (bond purchases) and the reinvestment of maturities since the new purchases ended in 2013. The plan sets caps for the maximum amount of maturities (to not be reinvested) each month. The plan did not include a specific time frame and can always be changed. We think it is a good sign that the equity markets and bond markets absorbed two rate increases and the near-term plans to reduce the Fed's balance sheet without material adverse reaction. "Normalized" rates and a "normalized" balance sheet are good goals after an extraordinary period of Fed activity.

While the story following the election was accelerating economic growth, let us not wish away what we have. First quarter GDP was disappointing, but the persistence of payroll growth and improvements in several forward looking indicators suggest that the economy is in pretty good shape. Private payrolls in the United States increased 222,000 for June, a positive surprise following several disappointing months. The 12-month average is 187,000 jobs per month. Unemployment stands at 4.4%, a slight increase versus the prior month due to growth in the labor force. Wage growth is moderating, but still positive at 2.5% and there are a lot of job openings. Household balance sheets are in good shape with 15.7% debt/ net worth. Consumer Sentiment has moderated some, but remains strong at 93 mid July. Housing remains choppy month to month. 5% or greater home price increases and slightly higher mortgage rates have cooled new home and existing home sales. Leading Economic Indicators and specifically the ISM Manufacturing Purchasing Managers' Index (PMI) forecast stronger growth from the more volatile private investment component of GDP, which directly impacts demand for technology, industrial and financial products and services. The S&P 500 is one of ten leading economic indicators, but you can see the responsiveness of the stock market to changes in the ISM Manufacturing PMI readings in the chart below.

Meanwhile, Europe has finally found some political clarity with Emmanuel Macron's victory in France and other political events suggesting that public sentiment toward the European Union (EU) is stable or improving. The French vote removed the greatest threat to the future of the EU while polling in other countries suggests that the groundswell for EU dissolution is likely behind us for the time being. Things are not perfect. There were several significant bank failures in southern Europe in the quarter, which were resolved in orderly fashion by local governments and regulators. Refugee requirements remain a contentious issue. The EU economy is growing at

Stock Market Responds to ISM Manufacturing PMI



Source: FactSet as of June 30, 2017

Fixed Income Market Index Returns

As of June 30, 2017

Asset Class	Index	2Q 2017 (%)	Year-to-Date	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	1.45	2.27	-0.31	2.48	2.21	4.48
	BC Intermediate Government Credit	0.94	1.73	-0.21	1.92	1.77	3.87
	BC US Intermediate Credit	1.38	2.54	1.36	2.60	2.99	4.88
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	1.25	3.17	0.44	2.02	2.06	4.00
International Bonds	Citigroup Non-US Government Bond	3.81	5.91	-5.01	-2.20	-0.80	3.21

All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of June 30, 2017

about 1.5%. Employment continues to improve with a current unemployment rate of 9.3%, down from over 12% in 2013.

Following another strong quarter, the price to earnings multiple for the S&P 500 is 18x next 12 months estimates versus the 25-year average of 15.9x. The consensus of estimates for S&P 500 earnings per share is slightly lower than peak levels seen in the spring, but still represents 5% growth with continued growth forecasted for 2018. We believe the prudent course is to maintain equity exposure commensurate with long-term strategic targets. While elevated valuations should reduce future expected returns, they do not mean that future returns will be negative. Even if they are over a short window, valuation is almost useless as a tool for timing the market. Companies continue to earn profits, which tend to grow at a rate faster than the rate of inflation. The price that people are willing to pay for these future profits depends on the rate of growth in those profits as well as the perceived value in other investments. What returns could be earned with the same money invested elsewhere? The simple answer right now is the yield on the 10-year Treasury: 2.32%. We have made decisions within our clients' portfolios to move some additional money to international equities, where valuations are lower and earnings prospects are improving. We also see many individual companies that offer attractive valuations relative to their risk and growth prospects.

Bond yields declined during the quarter (because values rose) resulting in positive total returns. At this point, we see bonds primarily as a risk management tool. Investment grade bond performance is less volatile than equity performance and bonds tend to do well when equity markets do not. Because we do not know when equities will hit tough times, an allocation to high quality bonds is a good insurance policy.

So the outlook is not perfect, but we do not believe that it is as dire as many would have you believe. The world is awash in capital and that capital is seeking the most compelling returns given individual risk tolerances. Higher valuations are a natural consequence of greater demand. The Fed might be responsible, but we take encouragement from the muted response to efforts to normalize rates and the Fed's balance sheet. We believe that the best course is to evaluate risk and return in terms of your own circumstances and create an appropriate target allocation and stick to it. Whatever happens over the next year will be a brief episode in a long process. We wish you well.