



# QUARTERLY MARKET INSIGHTS

*April 2017*

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## CORPORATE TAX REFORM

With the Republican Party controlling both houses of Congress and the White House, broad-based corporate tax reform is looking like a serious possibility for the first time since the Tax Reform Act of 1986 during the Reagan administration. There are several plans being discussed, but the overall direction appears to be a reduction in the proportion of corporate profits subjected to federal taxes. House Republicans have proposed a 20% maximum corporate tax rate, while the Trump administration has recommended a 15% top rate. Both represent a substantial reduction from the current maximum rate of 35%. According to Goldman Sachs, the median S&P 500 Index member's effective federal tax rate in 2016 was 24%. Larger U.S. companies with multinational sales are often better able, than their smaller peers, to capitalize on federal tax loopholes and indefinitely store foreign profits overseas. Thus, on average, even a moderate reduction in the top rate could have a disproportionately positive effect on smaller-sized U.S. companies than their larger counterparts.

An analysis by Bloomberg Intelligence suggested the S&P 500 Index after tax earnings per share (EPS) could increase by 6.7% in 2018 if the U.S. corporate tax rate is reduced to 20%, assuming all other variables are unchanged. The current median expectations for 2018 EPS growth is a healthy 12.1%, but adjusting for a tax rate reduction to 20% would imply a 19.4% EPS growth rate. The consumer discretionary, utilities, telecommunications and consumer staples sectors pay the highest effective tax rates, suggesting that stocks in these sectors could be the biggest beneficiaries of corporate tax reform. Specific industries within each of these sectors, like department stores, apparel retailers, and footwear retailers, may be positioned to benefit the most from corporate tax reform. According to Bloomberg, at least thirteen companies in these sectors paid an effective tax rate in 2016 of between 35% and 50%. Major U.S. carriers Verizon, Inc., AT&T, Inc. and T-Mobile, Inc. all paid taxes at an effective rate of at least 32.7% in 2016. All three would likely see improved after-tax profits in the event of a corporate tax rate reduction.

Companies bringing cash back to the U.S. could also stand to benefit from the proposals of a so-called "repatriation holiday." Republicans in the House of Congress target an 8.75% tax on accumulated foreign earnings brought back to the U.S. in cash, while the Trump administration proposes repatriation at a 10% rate. According to Bloomberg, S&P 500 Index companies hold \$966 billion of cash overseas, representing approximately 5.0% of the index's total market capitalization. A significant portion of this cash is held by technology companies; Apple, Inc. and

Microsoft, Inc. account for a combined 34% of all S&P 500 Index cash held outside the U.S. More than a decade ago, the repatriation holiday related to the Homeland Investment Act passed in 2004 led to S&P 500 companies bringing back about 40% of cash held abroad. Some commentators have suggested that increased share buybacks and capital spending could result from a large-scale repatriation of corporate cash.

The return of so much cash stateside could have a meaningful effect on trends in corporate bond issuance. With more cash at their fingertips, treasurers of U.S. multinational companies would be likely to reduce issuance of corporate bonds, thus reducing the supply of these assets. In turn, reduced supply and steady demand for corporate bonds, could very well increase prices and tighten spreads for the broad corporate bond universe.

Another potential aspect of broad-based tax reform that would affect the U.S. bond market is interest payment deductibility. Many commentators expect the Trump administration and House Republicans to propose removing the tax exemption on bond payments made by corporate issuers. Currently, U.S. corporations have the right to deduct interest payments from taxable income. This tax-exemption exclusion would likely be grandfathered in, such that any debt issued before the prospective exclusion would still receive the tax benefit. Going forward, however, any new debt would not benefit from the so-called "tax shelter" enabling U.S. corporations to reduce their taxable income by the amount of interest paid in a given calendar period. For highly leveraged companies, this could put significant pressure on profits. For all corporations, this would likely mean less debt issuance given the supply and demand landscape of the corporate bond market. Just like the repatriation example, less issuance combined with steady demand would most likely translate to increased prices and tighter spreads for the broad corporate bond universe.

## ECONOMY

### SLOW, UNSPECTACULAR GROWTH CONTINUES

The positive momentum seen in the global economy in the fourth quarter carried over to the first quarter of 2017, as markets reacted favorably to stronger economic reports and increased corporate profits. Fourth quarter U.S. GDP growth was revised upward to an annualized rate of 2.1%, beating expectations of 2.0% and up from the 1.9% initially reported. The upward revision came in part due to increased spending on gasoline and travel-related services. The biggest contributor, however, was consumer spending, raised to 3.5% from 3.0% previously, and an original estimate of just 2.5%. Corporate profits increased again and rose by 9.3% in the second half of 2016, the fastest pace since 2012. Satisfied with the direction of the economy, the Federal Reserve (Fed) raised interest rates in March as expected. Fed officials' median interest rate projections indicate two additional 0.25% rate increases this year and three more next year.

Multiple reports this quarter showed that the post-election increase in optimism among businesses and consumers remains strong. The NFIB Small Business Optimism Index retreated slightly to 105.3 in February, but remained near an all-time high. Small business optimism has increased sharply since the election as business owners anticipate beneficial policy changes from the new administration. Another measure of business optimism, the Business Roundtable CEO Economic Outlook Index, jumped 19.1 points to 93.3 in the first quarter survey, which was its largest quarterly increase since the fourth quarter of 2009. Consumer confidence blew away February's reading and economists' expectations coming in at 125.6. This was roughly 10 points ahead of forecasts of 114.0 and well above February's reading of 116.1. March's confidence number is the highest level in more than 16 years and continues a

ECONOMIC INDICATORS	LATEST	3MO PRIOR	CHANGE*
REAL GDP	2.1%	3.5%	▼
TRADE BALANCE	-43.6	-45.5	▲
UNEMPLOYMENT RATE	4.7%	4.7%	
NON-FARM PAYROLLS	98K	155K	▼
ISM MANUFACTURING	57.2	54.5	▲
ISM NON-MANUFACTURING	55.2	56.6	▼
RETAIL SALES (LESS AUTOS)	0.2%	0.3%	▼
INDUSTRIAL PRODUCTION	0.1	-0.2	▲
HOUSING STARTS	1288	1149	▲
CONSUMER PRICE INDEX	2.7%	1.7%	▲
CONSUMER CONFIDENCE	125.6	113.3	▲
EXISTING HOME SALES	5.5M	5.6M	▼
CONSUMER CREDIT	15.2B	25.5B	▼
CRUDE OIL PRICE	50.6	53.72	▲

Source: Bloomberg. Past performance does not guarantee future results. \*The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to U.S. economic growth.

## ECONOMY CONTINUED

strong run since the election. Surprisingly, the boost was somewhat evenly dispersed across all household income levels and geographic regions. Jobs expectations also improved, as the number of consumers rating jobs as “plentiful” rose from 26.9% to 31.7%, and “hard to get” fell from 19.9% to 19.5%.

### HOUSING

The U.S. housing market continues to show strength, as the S&P/Case–Shiller U.S. National Home Price Index rose by 5.9% in January, the largest increase in 31 months. Much of this strength comes from a high demand for homes, particularly in the western region, as Seattle, Portland, and Denver all showed at least 9.0% gains over last year. Also noteworthy in the west region were San Francisco home prices, rising 6.3% in the last 12 months after overheating for a stretch. Further underscoring the strength in demand, February’s pending home sales rose 5.5% compared to January, marking the second highest level in more than a decade. The combination of higher mortgage rates and housing prices could lead to a softer housing market as we move through 2017.

### EMPLOYMENT AND MANUFACTURING

U.S. employers hired workers at a strong pace in February, as non-farm payrolls increased by 235,000 jobs, beating expectations of 200,000 jobs. The construction sector recorded its largest gain in roughly 10 years due to unseasonably warm weather. Manufacturing jobs added 28,000 while retail was a drag, declining 26,000. Additionally, the December and January job reports were revised upward by 9,000. Job gains have now averaged 209,000 per month for the past three months. Year-over-year wage growth rose to 2.8% driven by tight labor markets and minimum wage increases. With the labor market close to full employment, wage growth could be

pushed higher in coming months and quarters as companies attempt to retain employees and attract skilled workers. Economists believe wage growth between 3.0%-3.5% could lift inflation to the Fed’s preferred 2% target. The official unemployment rate in February declined to 4.7%, from 4.8% in January, even as more people entered the labor market. The labor force participation rate, representing the share of working age Americans who are currently employed or looking for employment, increased to 63.0%.

The ISM manufacturing PMI fell to 57.2 in March, down from 57.7 in February. The latest PMI reading remains comfortably over the 50 point mark that divides rising and falling activity levels. ISM’s New Orders Index registered 64.5% in March, which is a decrease of 0.6% compared to the 65.1% reported for February, indicating growth in new orders for the seventh consecutive month. All 18 industries reported growth in new orders in March. A decline in inventories at factories, coupled with an increase in suppliers’ delivery time, indicates increased demand in the sector and suggests momentum may sustain in coming months. Further, the backlog of orders index, which registered 57.5, the strongest reading in three years, also implies that healthy demand may continue in the near term. The new export orders index improved to 59.0, which is the highest reading since November 2013. Strong growth in new exports orders suggests improving global demand and appears consistent with upbeat readings in global PMI. Despite some cooling, these indicators still remain elevated, reflecting continued momentum in the manufacturing sector.

## THE BULL MARKET TURNS EIGHT

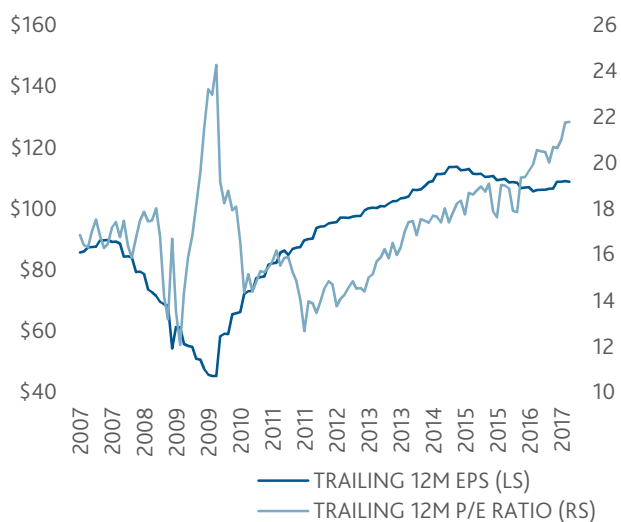
Global stocks posted an impressive 7.0% return in the first quarter of 2017 against a backdrop of improving economic fundamentals across most of the world. In the U.S., the first three months of the year witnessed heightened levels of consumer and investor optimism. This surge in domestic confidence notwithstanding, international stock indexes outperformed their U.S. counterparts in the first quarter, led by key emerging markets including India, Mexico, and China. In the U.S., most of the first quarter's gains occurred in the initial eight weeks of the period, as the S&P 500 Index touched an all-time closing high on March 1 of 2,395.96. The major U.S. averages then spent March in consolidation mode. Some of this consolidation was likely due to investors and traders awaiting the March Federal Reserve decision on interest rates. Market participants seemed to be in wait-and-see mode in the weeks before the kickoff of first quarter earnings season. It also appeared that some disillusionment bubbled to the surface concerning the speed and efficacy with which the Republican Party could implement the Trump administration's stated pro-growth policy objectives. This became particularly evident following House Majority Speaker Paul Ryan's decision to withdraw a GOP-sponsored bill designed to replace the Affordable Care Act after Republicans could not secure the necessary votes to pass the legislation.

Although the U.S. stock market hit a soft patch in recent weeks, March marked an extraordinary milestone. That is, the bull market in U.S. stocks, which began in the depths of the Great Recession on March 9, 2009, celebrated its eight-year anniversary this past quarter. This is the second longest bull market on record, spanning 2,902 days during which the S&P 500 Index more than tripled in price terms from 683 to 2362. Our unofficial definition

of a bull market is a continuous period during which a market proxy (in this case the S&P 500 Index) does not suffer a 20% correction.

Higher valuations have played just as big a role as earnings growth in the current bull market. From the March 2009 low, the S&P 500 has seen its ratio of price to trailing twelve-month earnings (P/E ratio) expand from 11.1 to today's 21.7 multiple. Meanwhile, the S&P 500 aggregate EPS increased from approximately \$58.18 in 2009 to about \$108.59 in 2016. If we assigned the S&P 500's 11.1 P/E ratio from March 2009 to its 2016 earnings per share, we would get an index level of just

S&P 500 INDEX: EARNINGS AND VALUATIONS



Source: Bloomberg. Past performance does not guarantee future results.

## EQUITY CONTINUED

1,205.34. Thus, we can infer that of the index's 1,679 point ascent from March 2009 to March 2017, approximately 522 points (or 31%) can be explained by earnings growth, while the other 1,157 points (or 69%) can be attributed to an expansion of its P/E ratio. Earnings may be ready to take the baton, however; according to Bloomberg median analysts' estimates, S&P 500 earnings are expected to grow 18.7% in 2017 and 12.3% in 2018. This compares to actual growth of just 0.2% in 2016.

Looking below the surface at the performance of U.S. equities in the first quarter, larger cap stocks beat their smaller cousins. The S&P 500 index of large cap stocks returned just over 6% in the period, compared to midcap stocks' gains of just under 4%, and small cap stocks' returns of about 1%. This was a reversal of the tilt towards smaller cap stocks that played out in the last part of 2016, and accelerated following the November election. Explosive growth in the smaller cap stocks at the end of 2016 was attributed to the theory that smaller businesses had relatively more to gain from Trump's tax reform agenda, and that larger businesses (and therefore larger cap stocks) had greater vulnerability to the President-elect's plans for a more protective tariff scheme, as bigger companies generally have more exposure to foreign trade. The reversal of the returns distributions in the first quarter of 2017, reflects some increasing doubts about the new administration's ability to deliver on those legislative goals, as well as some mean reversion of valuations after the big run up in the market.

The same reversal played out in the style categories of growth versus value in the first quarter. Value stocks indexes, heavily weighted towards cyclical sectors like Financial Services and Industrials, roared in late 2016 under hopes for a stronger overall economy and 'reflation'. Bank stocks, in particular, soared in late 2016 with the prospect

of higher interest rates boosting bank revenue, led by a Fed unleashed to hike based on stronger economic data. But that trend has reversed so far this year, as the S&P 1500 Growth Index has returned just over 8%, in contrast to the S&P 1500 Value Index, which has turned in just above 3%. The S&P Technology sector, made up primarily of non-cyclical growth stocks with longer dated cash flows, soared more than 12% in the first quarter, with the NASDAQ index rising more than 10%. Sectors more dependent on an increased level of widespread economic activity were left behind; Industrials rose less than 5% year to date, and Energy declined almost 7%.

Another reversal of leadership involves Emerging Market stocks. Major market indexes in Brazil, India and China all advanced at least 10% in the first quarter. After several years of underperformance relative to domestic equities, developing nations' stocks have led the way this year, with the MSCI EM index posting well above 11%. A stabilization of many emerging market currencies against the U.S. dollar boosts the financial health of these economies, many of which have issued dollar-denominated debt.

## THE FED MOVES, YIELDS DON'T

Last quarter we made the observation that the significant rise in intermediate rates that had occurred in the second half of the fourth quarter had likely brought U.S. Treasury yields closer to fair value. We also discussed the tradeoffs of investing in short-term fixed income or cash versus intermediate-term bonds. Following up on that discussion, investing in intermediate-term bonds as measured by the Bloomberg Barclays Intermediate Government Credit returned 0.78% during the first quarter. In contrast, the 1-3 year portion of the same index only returned 0.41% and a short Treasury index maintained by Bloomberg Barclays only returned 0.12% over the same time period. The disparity in performance displays the risks of abandoning your stated objective for just one quarter.

The U.S. bond markets were relatively tame during the first quarter as the yields across the U.S. Treasury curve traded in a very narrow range. That said, the curve did experience some flattening as shorter rates rose while longer rates edged ever so slightly lower. Even with that flattening, the curve remains steeper than average dating back to December 1979. The Merrill Lynch MOVE Index, a measure of bond market volatility, fell throughout the quarter as many market participants waited to see how the new President would implement his policy agenda and whether or not the Fed would hike rates. Corporate spreads remained relatively tight as spreads on non-investment grade corporates tightened by 22 basis points. All in all, it was an uneventful quarter for the U.S. bond market even as the FOMC hiked rates at their March meeting.

One of the more intriguing developments since the election of President Trump has been the large disparity between U.S. interest rates and those of its European counterparts, specifically Germany and the United Kingdom. Currently, the difference between 10-year rates in the U.S. and Germany stands at 2.06%. That is the eighth widest spread between the two rates dating back to January 1989 when Bloomberg began collecting data on the German 10-year rate. At the end of the first quarter, the difference between the U.S. and the U.K.'s 10-year rates was 1.25%, the widest yield advantage the U.S. has had over the U.K. going back to January 1989. In fact, each of the last five months falls into the top ten highest rate advantages the U.S. has had over either of the two

DEVELOPED EUROPE AND U.S. YIELD DIFFERENTIALS  
1978 THROUGH MARCH 2017



Source: Bloomberg. Past performance does not guarantee future results.

## FIXED INCOME CONTINUED

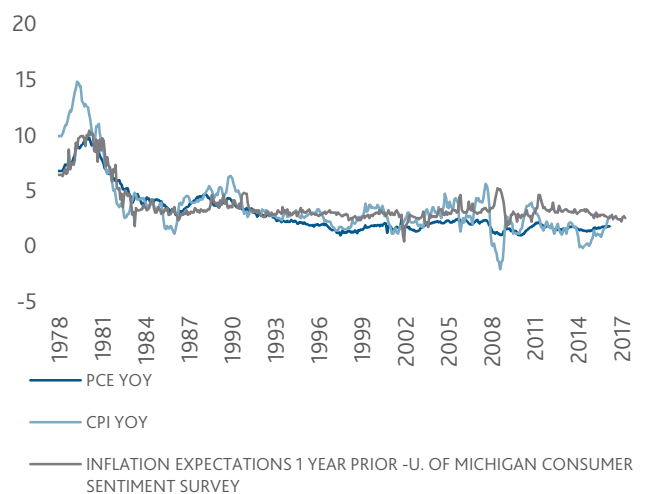
countries. With U.S. rates much higher than developed international rates, an argument could be made that the interest rates will have to converge at some point. Adding further credence to that argument is the fact that in all three of the aforementioned countries the most recent reports on inflation have shown that prices are rising at a pace not seen since at least 2014. While this suggests that developed international rates could potentially rise to meet U.S. rates, it is possible that U.S. rates fall to achieve convergence. In either likely scenario, an overweight to U.S. bonds would probably be preferred.

With the Fed's preferred measure of inflation, Personal Consumption Expenditure Core Price Index (PCE), continuing to rise, one more member of the FOMC believed that inflation risks were now tilted to the upside. While the majority of the committee continues to hold the view that inflation risks are balanced between the upside and downside, inflation expectations as measured by the University of Michigan Consumer Sentiment Survey remain around 2.5% over the next 12 months. While the Fed uses a 5-year forward breakeven inflation rate from a working paper, the correlation between the Consumer Sentiment inflation expectations and PCE 12 months later has been 0.87 since January 1978, suggesting that using such expectations might be helpful when trying to discern where inflation risks lie. As of March, the consumer sentiment survey shows that expectations for inflation over the next twelve months are 2.5%, whereas the 5-year forward breakeven inflation rate stands at 1.95%. The survey of inflation expectations also seems much more stable than the five-year forward breakevens, which plummeted as the market reacted to Brexit.

While the Fed does not appear to be behind the curve in hiking rates, if consumer inflation expectations turn out to

be a better estimate of inflation a year from now, then there is a risk that inflation starts to run away from the Fed and they are forced to aggressively hike to quell rapidly rising prices. The implications of this occurring are covered in the Outlook section. With that said, two economists at the Federal Reserve Board have recently published a paper suggesting that central banks, including the Fed, may actually want to seek inflation in excess of their current two percent target. That same paper also suggests that real interest rates are likely to be lower than they have been over the last half century. Either way it appears that for the time being inflation should be a concern for bond investors.

### REALIZED INFLATION VS. EXPECTED INFLATION 1978 THROUGH MARCH 2017



Source: Bloomberg. Past performance does not guarantee future results.



## OUTLOOK

### INTEREST RATES, RECESSIONS, AND EQUITY RETURNS

Compared to the equity rally that began in the middle of the fourth quarter, the closing weeks of the first quarter could demonstrate that any election-inspired rally may be slowing. A competing view is that the recent move in stocks can be more clearly understood in the rebound of corporate earnings that became clearly measurable during the earnings releases over this same period. Finally, after nearly a 20% rally in such a short time, it may be only natural for equities to take a breather.

Despite the leveling off in March, our review of eight macroeconomic factors continues to indicate the economy still provides support for better-than-average equity returns. It must be noted, however, that over the last several months the unemployment factor has reversed course several times, and in the short run should not be depended upon for continued support. Also, with wage inflation being cited by the Federal Open Market Committee (FOMC) as a key factor in their latest decision to hike, it would not be a surprise to see inflation turn against equities. These indicators are updated monthly to help investors better gauge the near-term outlook for equities.

#### STEEPNESS OF THE YIELD CURVE

Under the guiding hand of Fed Chair Yellen, the Fed raised the federal funds rate by a quarter of a percent without any significant reaction in bonds or stocks. This marks the first time in her tenure as Fed Chair that an FOMC rate hike did not spook the market, as evidenced by little to no change in the yield of the U.S. 10-Year Treasury Note nor any 1% or greater intraday swing in the major equity indexes, each of which happened near previous rate announcements.

Why should investors care that a Fed hike failed to garner a reaction? Our thinking is beyond the simple fact that their telegraphing finally worked. Ever since previous Fed Chair Ben Bernanke spooked the markets in 2012 with the announcement that the Fed would begin to slow the pace of their monthly bond purchases the bond markets have exhibited higher volatility around rate announcements. In their own words, the "FOMC seeks to explain its

monetary decision to the public as clearly as possible."<sup>1</sup> If the bond prices behave erratically around FOMC announcement dates, one might conclude they have not explained well enough.

Throughout this economic expansion, which began in June of 2009<sup>2</sup>, investors have been concerned about the pace of rate hikes that would be required to prevent the next inflationary spiral, especially since rates were cut to zero to stimulate the recovery in the first place. The FOMC is very sensitive to the fact that inflation expectations have considerable influence over longer term interest rates set in the marketplace by investors. Were the FOMC to hike too slowly and allow inflation a greater chance to take hold, investors in longer term bonds would judge them as more risky, curtail their purchases and long-term rates could rise. Alternatively, if the FOMC were to hike too quickly and stave off inflationary pressures before

ECONOMIC INDICATOR	LATEST	SIGNAL
FED FUNDS POLICY	1.00%	BEAR
STEEPNESS OF YIELD CURVE	1.64%	BULL
UNEMPLOYMENT RATE	4.70%	BULL
WTI OIL PRICE	\$53.72	BEAR
S&P 500 INDEX	2362.72	BULL
S&P/CASE SHILLER HOME PRICE INDEX	192.81	BULL
PRODUCER PRICE INDEX	3.70%	BULL
PHILADELPHIA FED SURVEY	32.80	NEUTRAL

Source: Bloomberg

<sup>1</sup> [https://www.federalreserve.gov/faqs/money\\_12848.htm](https://www.federalreserve.gov/faqs/money_12848.htm)

<sup>2</sup> <http://www.nber.org/cycles.html>

## OUTLOOK CONTINUED

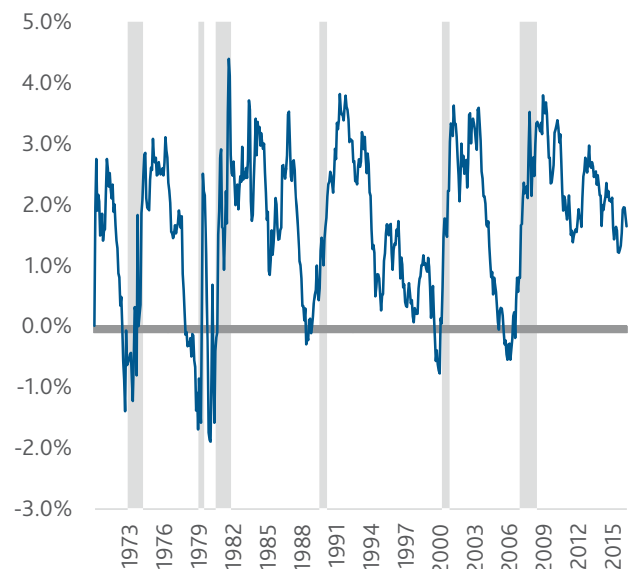
they had even begun to build, investors in long-term bonds might become overly complacent and could potentially increase their purchases which could cause long-term rates to fall.

The difference between longer term bond yields, like the 10-year bond and the shortest T-Bill rates, indicate the steepness of the yield curve. When the yield curve is steep, long rates are higher than short ones, indicating longer term bond investors want extra compensation for inflation risks. When short- and long-term rates are nearly the same, the yield curve is called “flat” and if shorts are higher than longs it is “inverted.” Flat and inverted yield curves have occurred when inflation expectations are extremely low or even deflation is expected. Historically, when the yield curve flattens or inverts, recessions have occurred within less than a year.

The current worry would be for the FOMC to hike too aggressively, causing the bond market to overreact to falling inflationary pressures, eventually resulting in a flat or inverted yield curve. The nearby chart shows the steepness of the yield curve over the past 40 years, with recessions depicted by grey shading. Though the current level of steepness is near the historical average, it can be seen how it has become less steep over the past few years.

This cycle has one key difference. At present, the Fed owns about \$4.5 trillion in U.S. government securities that were purchased through their quantitative easing (QE) programs. Before the Fed began QE, it was reported they owned only \$700 billion in Treasuries. Recent news reports indicate the Fed may begin to reduce these holdings towards the end of 2017. If QE reduced yields, then selling these could increase them. If the Fed hikes the short end of the yield curve while at the same time sells bonds in the long end of the curve, they might actually prevent the yield curve from flattening, providing a strong signal that the expansion can continue, and along with it the current bull market for stocks.

STEEPNESS OF THE YIELD CURVE  
1971 THROUGH MARCH 2017



Source: Bloomberg. Past performance does not guarantee future results.

## ECONOMIC OUTLOOK

### ECONOMIC FACTORS CURRENT OUTLOOK

U.S. GDP Growth	The median forecast for U.S. GDP growth in 2017 is 2.2%, as pro-growth policies may be slow to materialize.
Federal Funds Rate	The expectations for three quarter-point rate hikes in 2017 could be tempered if the Fed begins to unwind its balance sheet late this year.
Inflation	The Fed's preferred inflation measure (core PCE) hit their target level in February, climbing 2.1% YOY and clearing the way for additional rate hikes.
Employment	Growth in both the labor participation rate and in wages should keep the unemployment rate near post-recession lows.
Consumer Confidence	Sustained optimism for the implementation of pro-growth policies has consumer confidence at a 16-year high, likely buoying risk asset prices.
Oil	OPEC's decision to cut output and rebalance the oil market should keep prices stable in 2017.
Housing	The housing recovery is likely to move slowly forward in 2017, as increased demand is offset by higher interest rates.
International Economies	The IMF sees India and China driving global GDP growth in 2017.

### FIXED INCOME CURRENT OUTLOOK

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	
Core Bonds		●		<p>We suggest a neutral allocation to core, investment grade bonds. We recommend an underweight to below investment grade bonds, as their spreads still appear compressed even as credit concerns have dissipated. International bonds currently have no place in our fixed income portfolios, especially developed international, where German 10-year rates are more than 2% lower than U.S. rates. Finally, we advise an overweight to TIPs in an effort to provide protection against rising interest rates that will likely be driven by an escalation in inflation expectations.</p> <p><i>Benchmark: BB BC Intermediate Government/Credit Index</i></p>
TIPS			●	
Non-Investment Grade		●		
International	●			

### EQUITIES CURRENT OUTLOOK

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	
Large Cap			●	<p>We believe an overweight to U.S. equities relative to our benchmark remains appropriate given underlying domestic economic strength, the likelihood that U.S. multinationals will be able to repatriate overseas profits at favorable tax rates, and potential economic and market volatility in the U.K. and euro zone in coming quarters. Within our U.S. allocation, we view mid and small cap companies as better positioned to benefit from corporate tax reform and a stronger dollar than their large cap peers. We continue to favor emerging market equities over developed market international equities against a backdrop of improving emerging market economic fundamentals and potential political disruptions related to upcoming elections in France and Germany.</p> <p><i>Benchmark: MSCI All Country World Index (ACWI)</i></p>
Mid Cap			●	
Small Cap			●	
Developed International	●			
Emerging Markets			●	

### ALTERNATIVES\* CURRENT OUTLOOK

	CAP PRES	IWSG	BAL	GWSI	GROWTH	
Global Real Estate				●	●	<p>Given our expectation for increased periods of both equity and fixed income volatility in 2017, we have moderately increased our weighting to alternative investments. It is our view that both equities and fixed income are approaching full valuation, and the early policy implementation challenges for the Trump administration may have appreciably increased the likelihood of downside volatility. In response, we have constructed diversified alternatives portfolios meant to decrease the risk profile of their respective recommended total AI portfolios, which are listed to the left (CAP PRES, IWSG, BAL, GWSI, GROWTH).</p>
Global Infrastructure	●	●	●	●	●	
Hedged Equity	●	●	●	●	●	
Arbitrage	●	●	●	●	●	
Strategic Income		●	●	●	●	

The above underweight/neutral/overweight calls represent the MainStreet Advisors current positions relative to market weights.

\*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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