Q2 2017 ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

SUMMARY

- **For the rest of 2017, we expect stock market volatility to pick up, for a variety of reasons:** less certainty about whether the Trump administration can implement pro-growth fiscal policy in 2017; historically high valuations on equities across the globe; the prospect of higher US interest rates; and greater geopolitical uncertainty, including upcoming elections in France and Germany and Britain leaving the EU.
- **Volatility can provide opportunity.** We remain optimistic regarding the US and most major economies. In the US, we think we will at some point see more market-friendly fiscal policy that has largely not been priced in. The major Eurozone economies have started to rebound, and monetary policy across the globe remains generally stimulative. With the anticipated increased volatility, we continue to advise portfolio diversification. Furthermore, we believe active management (where appropriate) can be cyclical and higher dispersion will provide greater opportunity.
- **The LNWM portfolio changes we outlined in our Q1 2017 Outlook have proven beneficial.** Specifically, we reduced our exposure to fixed income and alternative assets (hedge funds) in favor of international equities (both in emerging and developed markets). So far in 2017, emerging markets have been the best-performing asset class, despite headwinds from a stronger US dollar. Eurozone equities also turned in strong performance, due to productivity increases along with signs of growth.

UPDATE ON ECONOMIC DRIVERS

- **US Fiscal Stimulus**
  Markets are looking to see if at least one pro-growth fiscal policy will make it through Congress this year, be it tax reform, deregulation or higher infrastructure spending.
- **Global Monetary Policy**
  The Federal Reserve continues to tighten monetary policy, with a 0.25 point rate increase in mid-March and more expected in 2017. So far, the market impact here and abroad has been minimal, since central banks remain largely accommodative at this point.
- **US Dollar Strength**
  As we expected, the rally in the greenback slowed. With the Trump administration advocating for a weaker dollar (to promote exports), and limited US interest rate increases (beyond those already forecast by the Federal Reserve), we think dollar gains will remain subdued.
- **Corporate Profits**
  Corporate earnings for 1st quarter 2017 are just starting to be reported. Despite a few early hiccups, investors are anticipating solid results, and we have no reason to think any different at this point.
- **Emerging Markets Growth**
  As we expected, the growth forecasts for emerging markets as a whole are rising faster than for developed markets. We believe this will continue.

KEEPING ECONOMICS VS. POLITICS IN PERSPECTIVE

> “A tax loophole is something that benefits the other guy. If it benefits you, it is tax reform.”
>
> \- Russell B. Long

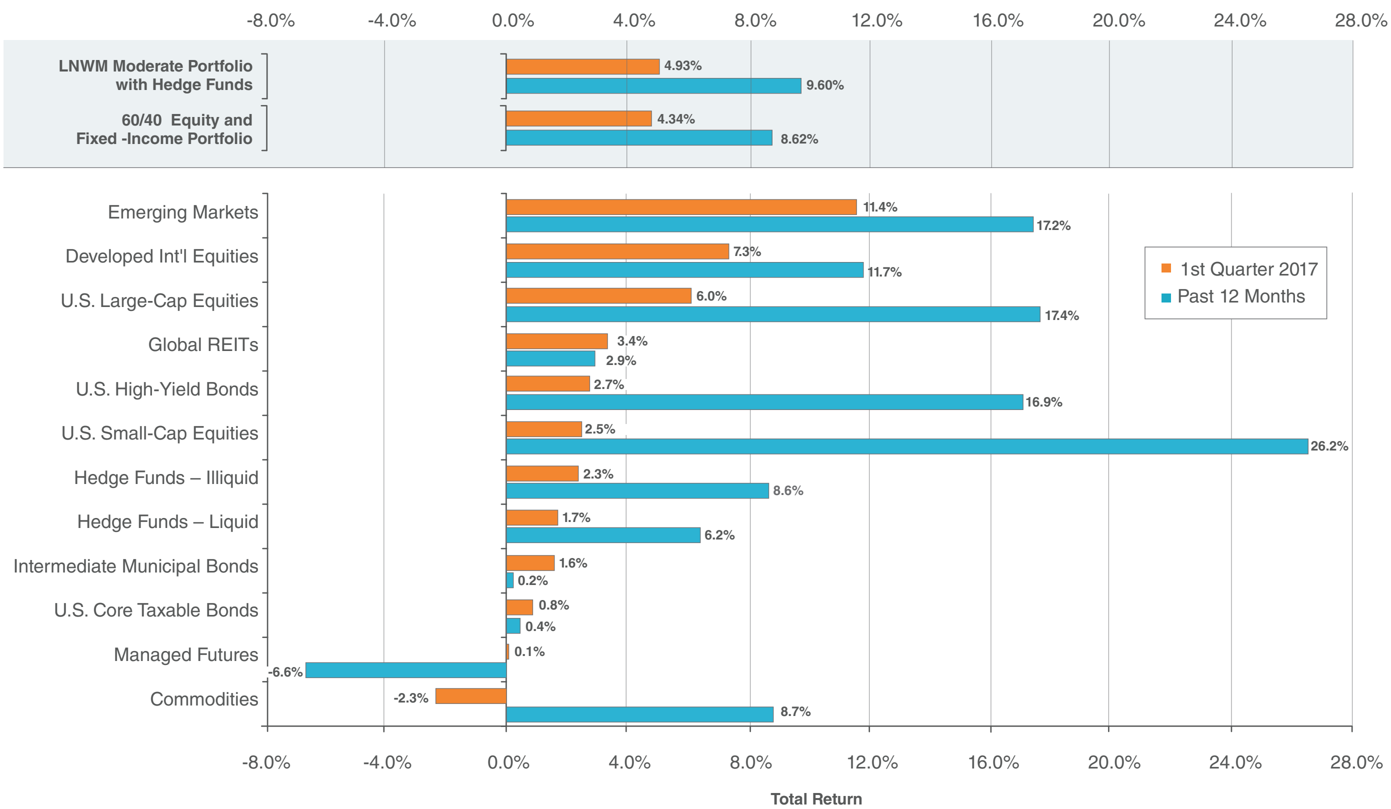
We think that the market rally so far in 2017 has been driven mostly by fundamentals, not the new administration's proposed fiscal policy. And this is likely to continue, as the markets continue to climb a “wall of worry,” given slightly higher economic growth and inflation, record-high equity valuations, and higher interest rates (though having minimal impact on growth and valuations). But we would add one more item to the list of things to worry about in 2017 – market volatility.

In the first quarter of 2017, equities and other risk assets continued higher until March. That’s when the Trump administration stumbled in executing its promise of healthcare reform, causing markets to reprice the likelihood of Washington being able to deliver on its promise of pro-growth policies.

In our Q1 2017 Outlook, we were optimistic about the possibility of the new administration’s pro-growth policies, but we remained skeptical given the limited detail. At this point, clarity regarding US government policy is not likely before the end of 2017, in our view. The legislative process almost always takes longer than expected. And this time around, we are faced with heightened levels of

2017 Performance of Asset Classes

1st Quarter and Past 12 Months (through Mar. 31, 2017)



SOURCE OF DATA: Morningstar, Bloomberg, Hedge Fund Research.

political infighting within the US Congress. So policy changes will not be easy. Still, sometime in the next several years, we do think we will see more market-friendly fiscal policy – some combination of tax cuts, deregulation and higher infrastructure spending.

Across the globe, we think geopolitical risks are elevated given the upcoming French and German elections, Britain's exit from the European Union and higher prospects for US-instigated trade disputes. Meanwhile, the economic fundamentals, including corporate earnings growth, remain robust in the US and in many foreign economies.

It is perhaps for this reason that capital markets have largely shrugged off recent geopolitical tensions. But further escalation in tensions could change things quickly. Given higher levels of uncertainty, and the relatively high valuations on equities, we look for US stock market returns to be in the single digits for 2017. In such an environment, we think it prudent to maintain globally diversified portfolios.

THE NEW CONCERN: Inflation (Not Deflation)

Since the 2008 financial crisis, global monetary policy first focused on avoiding a deeper recession and later on avoiding deflation. Just one year ago, investors were wondering what more the Federal Reserve could do to fight deflation. This seemed reasonable at the time: even though a US economic recovery had taken hold, inflationary pressures had not emerged. How things have changed…

Since December 2015, the US Federal Reserve has increased the Fed funds rate three times, and the markets expect at least two more increases (if not three) by the end of 2017 (we think there will be two). To understand why, it's important to realize that the Federal Reserve has a dual mandate: (1) full employment and (2) stable prices.

We think the primary reason the Fed has begun raising rates is fear of inflation, which has risen to an annual rate of 2% recently, if not higher. Housing and healthcare costs have been strong drivers of inflation recently and will continue to fuel fears of future inflation. What's more, across the globe we are seeing fewer government bonds with negative yields (less than zero) as investors continue to be more optimistic regarding growth.

The employment picture is less robust. Officially, the US is at "full employment," given an unemployment rate of only 4.5% recently. However, the Fed has indicated – and we agree – that US headline unemployment is too optimistic, resulting from fewer work-eligible Americans participating in the labor force (63%), a percentage that is just now starting to rise.

Other US economic data, including manufacturing and consumer and business confidence, are looking good, and there has been a recent upswing in positive global economic surprises. Add to this the prospect of US government policy that is pro-growth and you can see why equity prices have been rising.

HOW FAR CAN THIS RALLY GO?

Many are asking if the "Trump trade" is now over. While we spend considerable time thinking about the impact of changing political tides, we think the majority of the recent rally in equities and other risk assets can be attributed not to the Trump trade but to improving economic fundamentals.

Since the US election, the S&P 500 has risen about 10%, with virtually no change in volatility despite increased uncertainty regarding government actions. We think the rally in equities mainly reflects investor expectations regarding earnings growth. Looking forward, S&P 500 earnings are expected to rebound robustly, rising by 11% in 2017 and 12% in 2018.

A lot of the rebound is due to the energy sector, which was hurt by low prices and has since recovered as oil has stabilized around $50 per barrel. Looking forward, the key questions are: To what extent are these expectations already reflected in stock prices? Are these expectations realistic?

WHAT WE ARE DOING

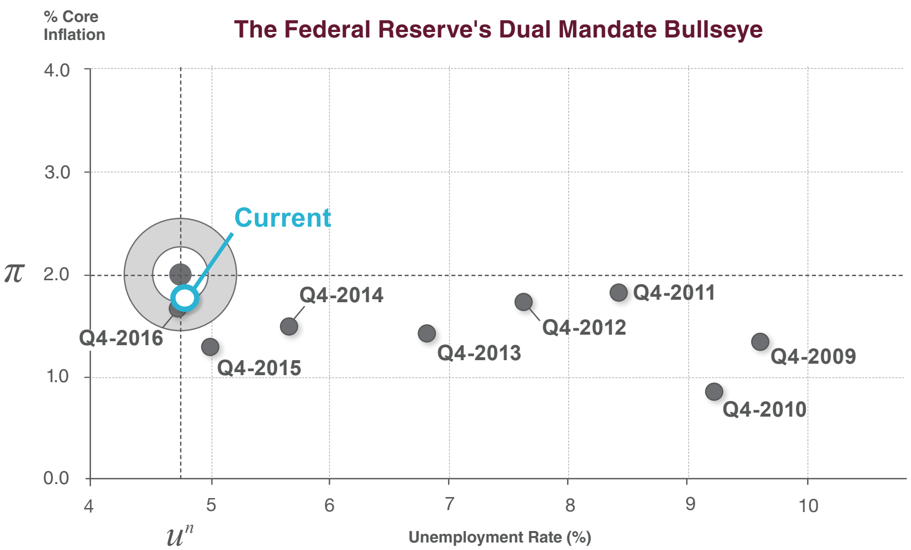
In our Q1 2017 Outlook, we described recent changes to LNWM portfolios. Primarily, we reduced our exposure to alternative assets and increased exposure to equities, mostly in emerging and foreign developed markets. Emerging markets have been the best performing asset class this year and it seems the revaluation has been independent of a strong dollar. In Europe, productivity continues to improve as signs of growth also emerge.

Our higher exposure to equities was a win in the first quarter of 2017, particularly in emerging markets. For the time being, we are not making further changes to our allocations, as we wait to see if corporate earnings and economic data can live up to expectations. Given that equity market valuations are above-average by traditional measures, we continue to review LNWM portfolios and are actively considering the most efficient allocations of risk.

IN SUM

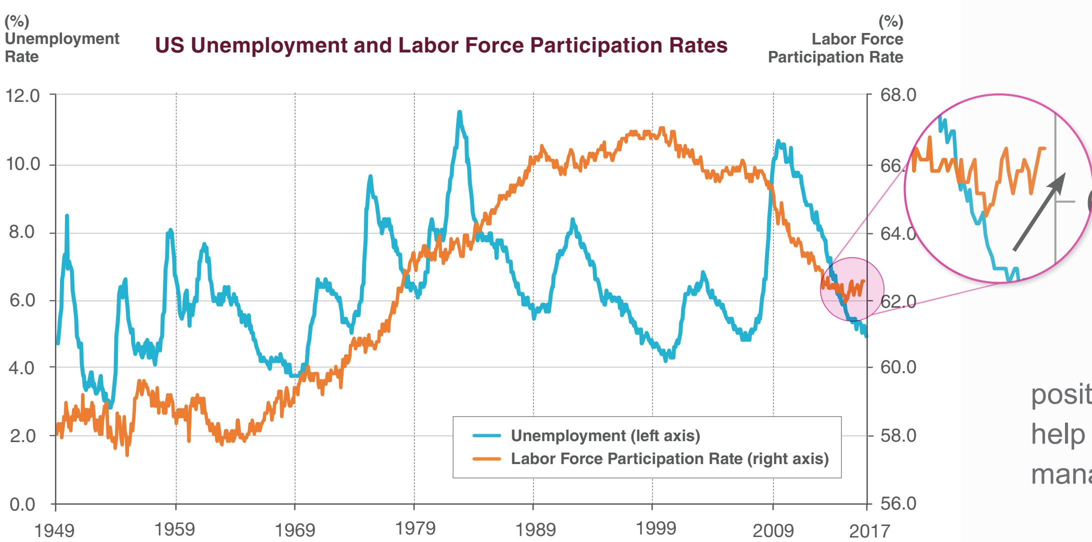
We continue to believe interest rates are headed higher, as inflation takes hold; therefore, we are maintaining our low exposure to interest rate risk. At the beginning of 2017, we also reduced our overall allocation to alternative assets, particularly hedge funds, and made some very significant changes to our “liquid alt” funds in 2016. Both the reduction in the overall allocation to alternatives and specific manager changes have proven beneficial. We continue to believe alternatives will play an important role in our portfolios, particularly given our view that volatility could increase in the coming year, and this is an area where we will continue to make incremental changes throughout 2017.

US ECONOMY & FIXED INCOME



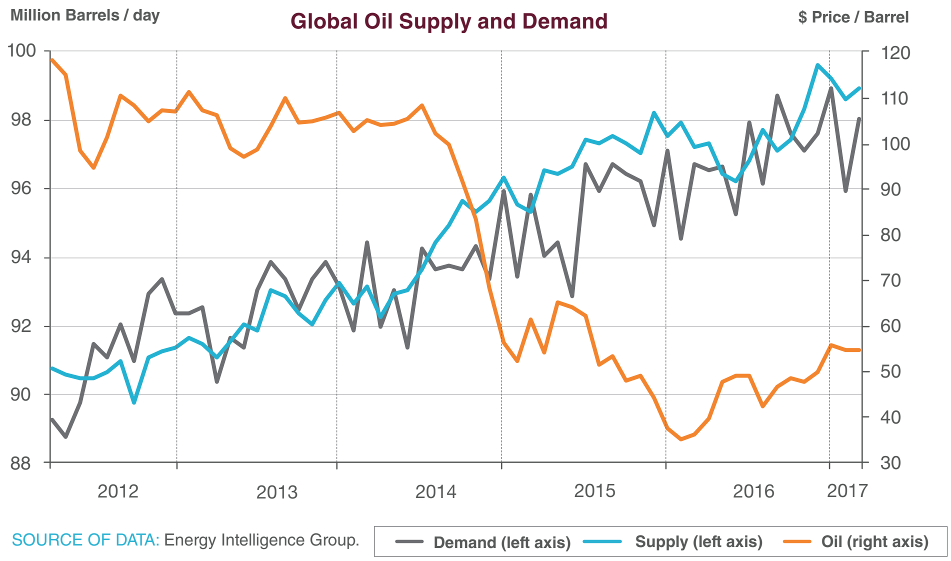
SOURCE OF DATA: Bloomberg, Bureau of Labor Statistics.

The Federal Reserve is very close to meeting its dual mandate of full employment and inflation of 2%. We expect this to result in at least two more interest rate hikes this year.



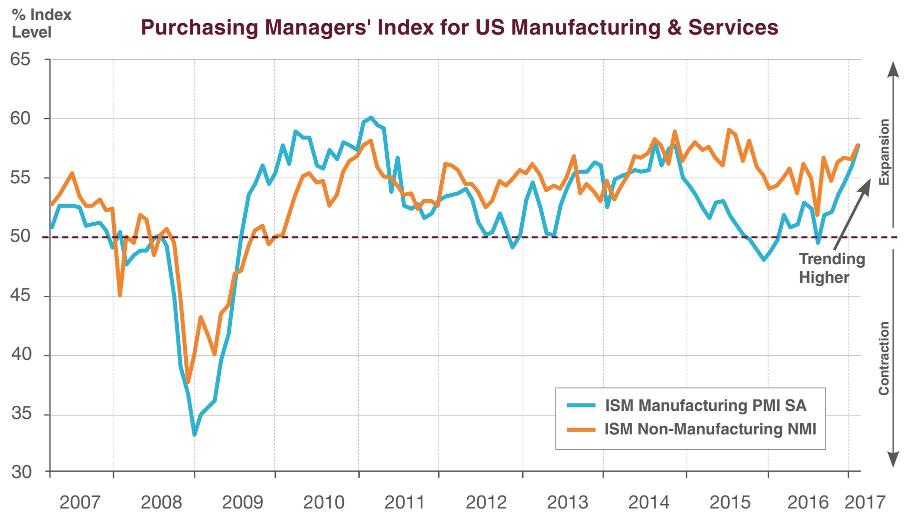
SOURCE OF DATA: Bloomberg, Bureau of Labor Statistics.

The headline unemployment rate, now about 4.5%, has continued to fall since 2009. The trend for labor force participation has recently turned positive, which we believe will help keep wage inflation at manageable levels.



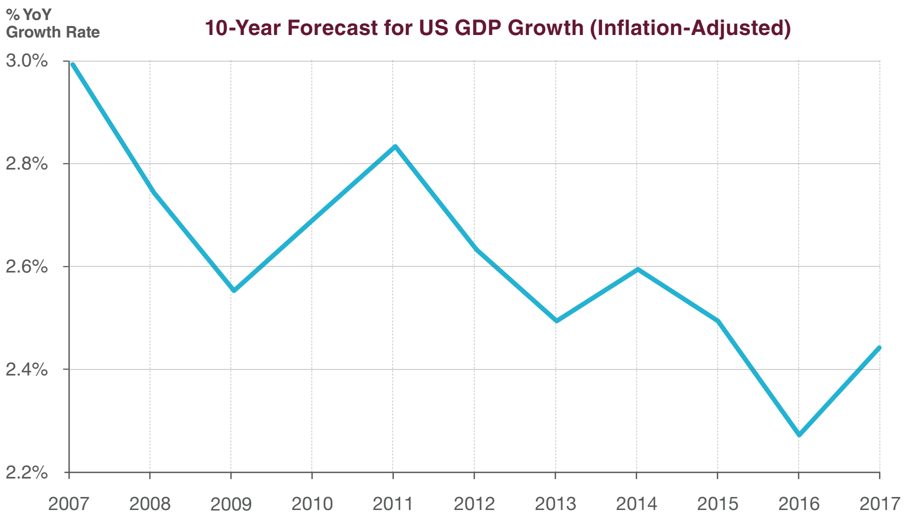
SOURCE OF DATA: Energy Intelligence Group.

The price of oil has been an oft discussed topic as it can be a significant driver of inflation. We believe the price of oil will remain stable at between $50 and $60 even as global supply and demand are both increasing.



SOURCE OF DATA: Bloomberg, ISM.

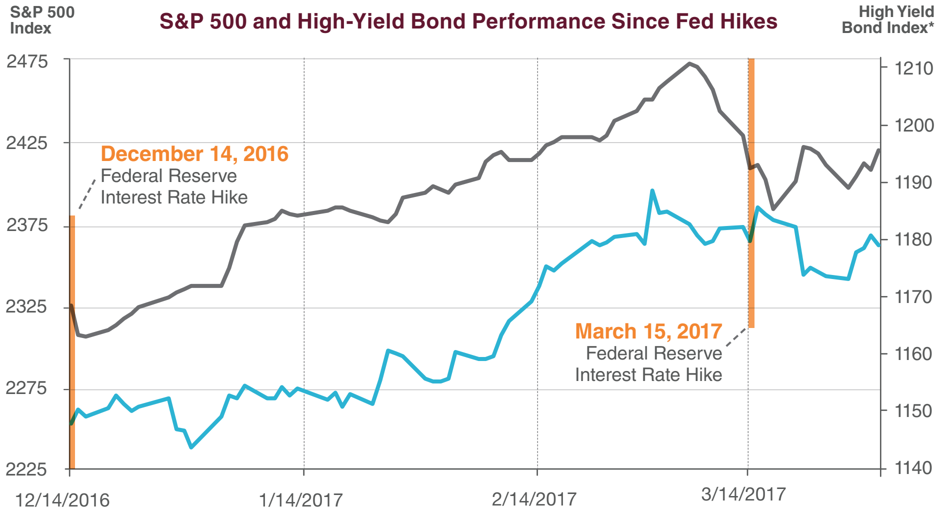
The outlook for manufacturing and services, based on the plans of purchasing managers, continues to point to expansion, which is key for continued GDP growth.



SOURCE OF DATA: Bloomberg, Philadelphia Fed.

The forecast for US economic growth 10 years out has accelerated, which we expect to continue. Consumer strength and an improving manufacturing sector will continue to be supportive. Geopolitical events could change this trajectory.

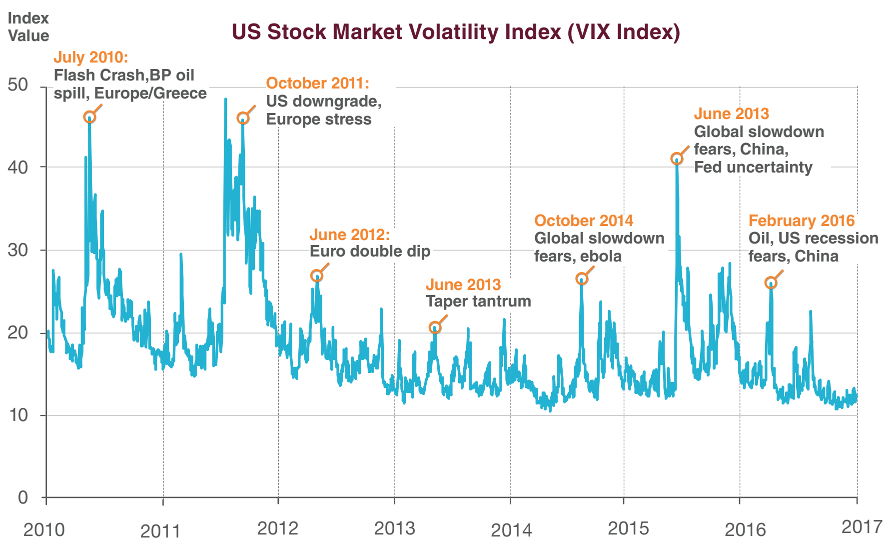
US EQUITIES



*High Yield Bond Index represented by BofA Merrill Lynch High Yield Index

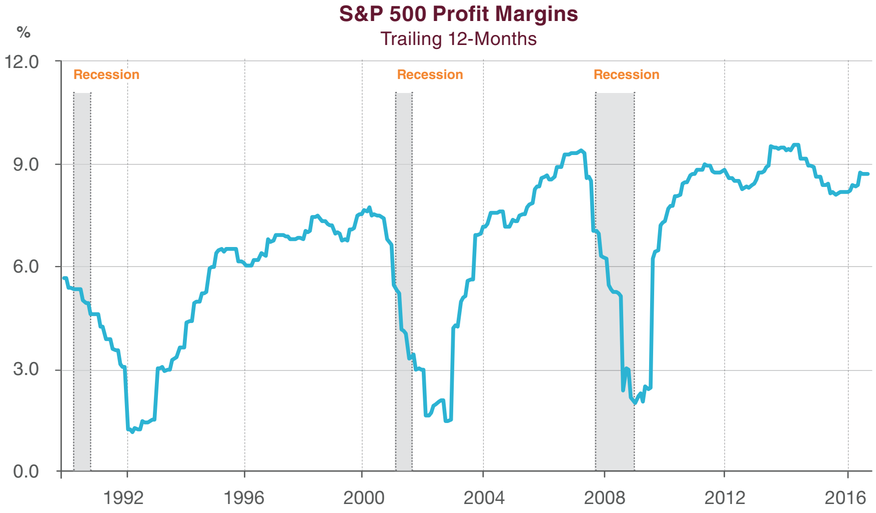
SOURCE OF DATA: Bloomberg.

Capital markets have largely anticipated, and generally absorbed, the increase in the Federal funds discount rate. Globally, central banks remain relatively accommodative.



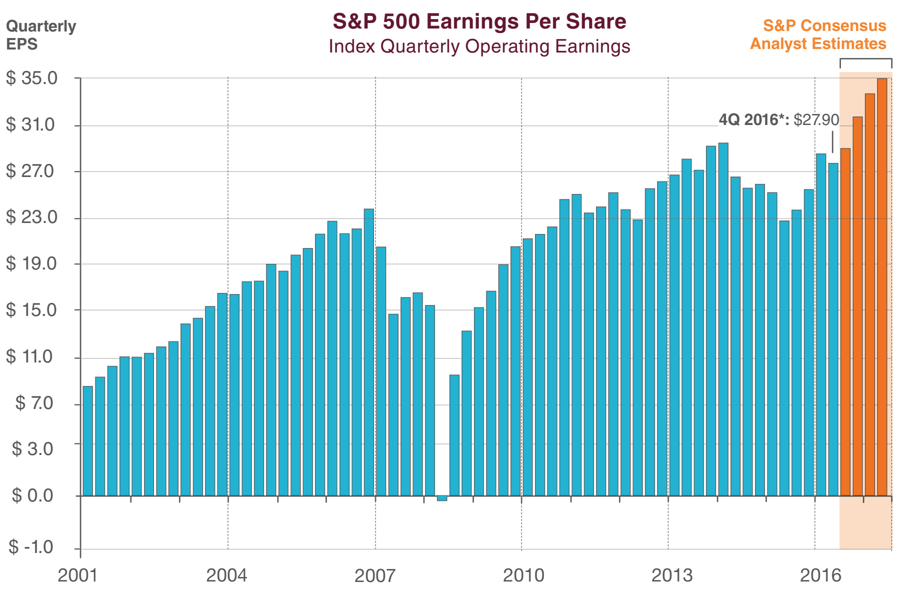
SOURCE OF DATA: Bloomberg, JPMorgan.

Many use the VIX Index as a measure of fear in capital markets. Currently, it is at, or near, multiperiod lows. Given upcoming European elections, Brexit, and increasing global tensions, this could quickly change.



SOURCE OF DATA: Bloomberg.

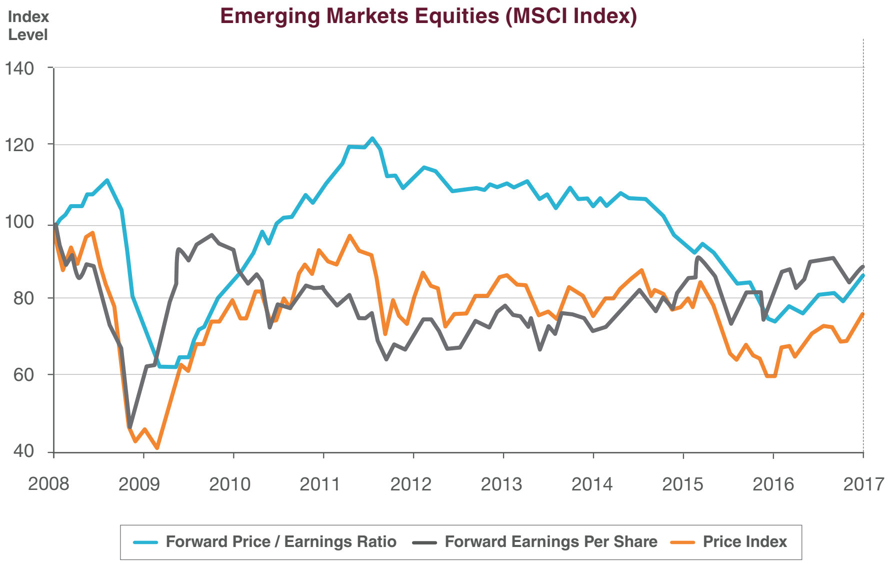
Profit margins for S&P 500 companies have continued to rise since mid-2015. We believe that fundamental valuation metrics, such as earnings, have been the primary driver of equity performance.



SOURCE OF DATA: JPMorgan.

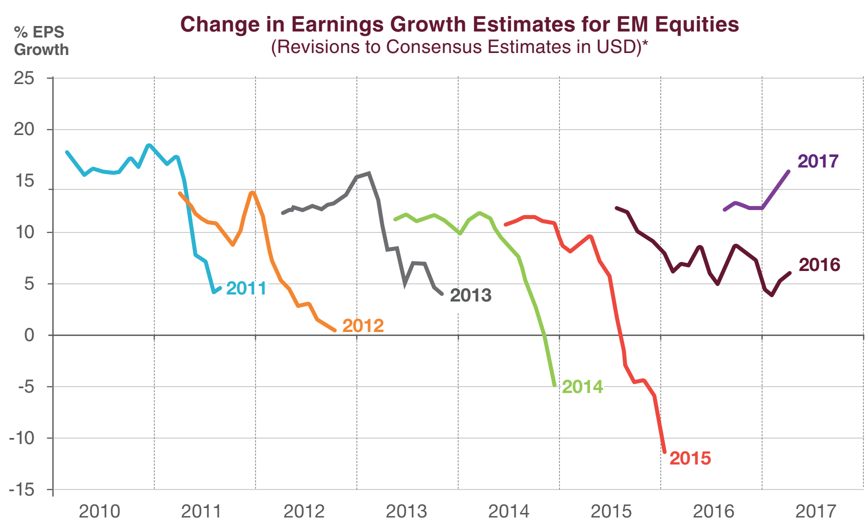
Earnings projections for the S&P 500 are very optimistic. This has led to elevated equity valuations in the US. We will continue to monitor the level of corporate earnings in the US to see if expectations are likely to be realized.

EMERGING MARKETS



SOURCE OF DATA: Datastream, MSCI, and Goldman Sachs.

Emerging markets (EM) equities have been the best-performing asset class so far in 2017. We expect this positive performance to continue and are maintaining our EM allocations.



*Change in analyst estimates for the growth rate in earnings per share (EPS) during the time period indicated.

SOURCE OF DATA: Datastream, MSCI, and Goldman Sachs.

Earnings per share (EPS) forecasts for emerging markets equities are being revised higher. We expect this positive performance to continue.

ABOUT THE AUTHOR

GINO PERRINA, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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