Q4 2017 ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

SUMMARY

- **LNWM portfolios have benefited from the positive momentum in equities**, especially in foreign markets this year. Given the eight-year bull market and shifting monetary policy, we are actively reevaluating how risk is allocated across the portfolio and remain focused on fundamental valuation.
- **We continue to focus on corporate earnings growth**, which has been robust and even surprised to the upside both in the US and in foreign markets, as most of the world's economies are now expanding. While US tax reform and other fiscal measures could lift equities higher, those policy developments remain uncertain.
- **We may be at the outset of a longer-term selloff in US bonds**, as interest rates shift to an upward path (assuming economic data remains relatively strong). The Federal Reserve has raised the target rate twice so far in 2017, and it is expected to do so again this December. In October, the Fed will also begin the process of balance sheet normalization by not reinvesting proceeds from a portion of securities that mature or pay interest.
- **LNWM Portfolio Positioning.** We continue to maintain globally diversified portfolios in terms of geographic regions and asset classes, with the changes that went into effect earlier this year: higher allocations to foreign equities, both in emerging and developed markets and lower allocations to US fixed income and alternative assets (hedge funds). Our fixed-income allocations have limited exposure to rising US interest rates and slightly higher exposure to credit. In the third quarter of 2017, we made these additional shifts: selling out of our relatively small exposure to Real Estate Investment Trusts (REITs) and investing in emerging market bonds.

UPDATE ON ECONOMIC DRIVERS

GLOBAL MONETARY POLICY

For the foreseeable future, monetary policy in the US will trend tighter while the rest of the developed world remains accommodative. Another US interest rate increase is expected this December, although of greater importance is the appointment of a new Chair of the Federal Reserve (Janet Yellen's term expires Feb. 2018).

US FISCAL STIMULUS

Very little progress has been made from legislators in the form of increased infrastructure spending or tax reform, which were both central to the Trump Administration's campaign. The policy gridlock is not likely to be resolved by year-end. However, significant tax reform could provide a boost to equity valuations, and negotiations have recently picked up, with both Democrats and Republicans incentivized to get something passed.

US DOLLAR STRENGTH

The US dollar has weakened 9% so far in 2017 (relative to a basket of global currencies), providing a boost to both emerging market equities and US multinationals. President Trump has indicated he prefers a weaker dollar, something that could be aided by appointing a Federal Reserve Chair who would keep interest rates lower for longer.

CORPORATE PROFITS

Our relatively bullish stance on equities earlier this year was based on earnings growth continuing to move higher as the global economy recovered. This has since become the consensus view, which we think increases the risk that the good news is priced in. That said, corporate profits have remained robust and we remain optimistic regarding corporate profitability.

EMERGING MARKETS GROWTH

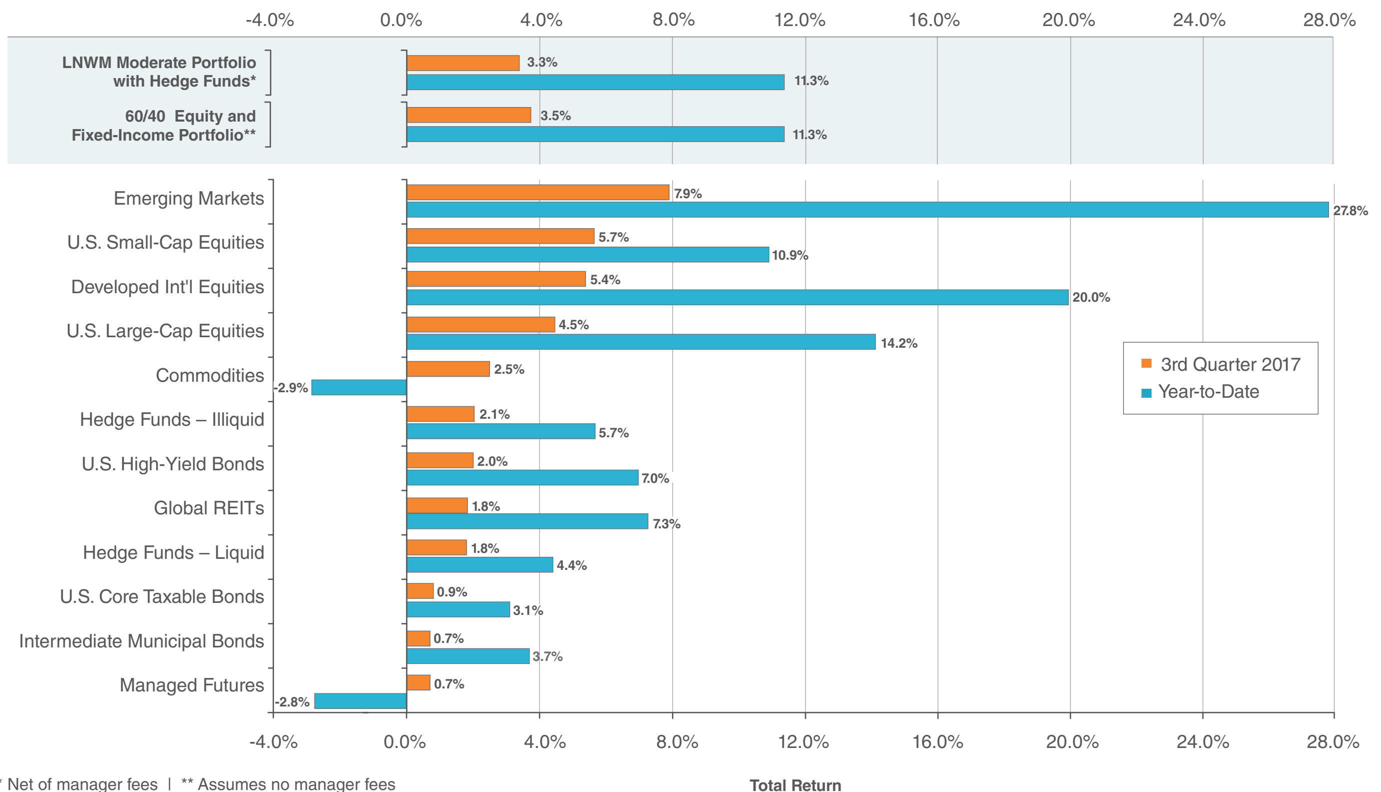
Economic reforms and above-trend growth continue to support valuations. However, currency weakness and geopolitical events are risks that could derail the growth.

THE MUSIC IS STILL PLAYING

> "It is always wise to look ahead, but difficult to look further than you can see."
>
> - Winston Churchill

Equity markets climbed higher still in the third quarter, even in the face of multiple natural disasters (hurricanes, flooding, wildfires, earthquakes) and geopolitical threats. Emerging markets have performed best year-to-date (up almost 28% this year), with the US and other developed markets also forging ahead. Through September, the S&P 500 is up about 14%. Most bond prices held relatively steady, with the current yield on 10-year US Treasuries at 2.3%, which is actually lower than it was at the beginning of 2017.

So far, so good. But the question on most people's minds is: After years of a bull market, are we at or near the top? Our short answer: not necessarily, but caution is definitely warranted.



* Net of manager fees | ** Assumes no manager fees

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

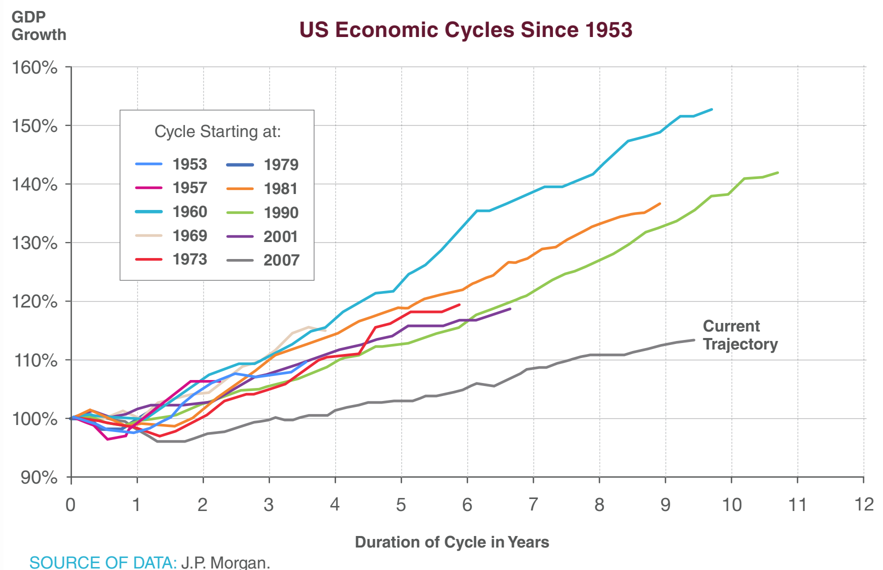
US GROWTH IN CONTEXT

We think economic growth could slow as central banks here and abroad begin to tighten monetary policy. But it's too early to call an end to the bull market.

While the current expansion has lasted nearly a decade, one of the longest in history, growth has been relatively lackluster. In the last eight years, real GDP growth has been around 20% cumulative, or 2.5% annually, which is about half the level of expansionary periods in the past. US GDP growth did tick up to 3% during the second quarter of 2017, but we do not think that is sustainable.

We think muted growth in the US (less than 3%) could continue for some time given that the imbalances that caused the 2008 Crisis have been addressed (huge debt levels, speculation), but loose monetary policy has run its course, and there's yet no clear path for fiscal policy to take its place -- tax reform, infrastructure spending, etc.

Recessions are typically preceded by tighter monetary policy. We acknowledge that we are moving toward that, globally. However, barring any policy missteps, we think growth could slow but is not likely to turn negative. As Churchill famously said, one cannot look farther than one can see. Based on what we know today, there is no reason to call an end to the current bull market. In terms of US economic expansions, the current one could have more room to run (see chart).

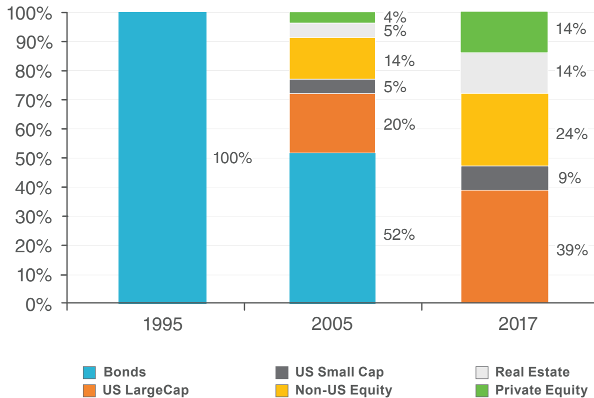


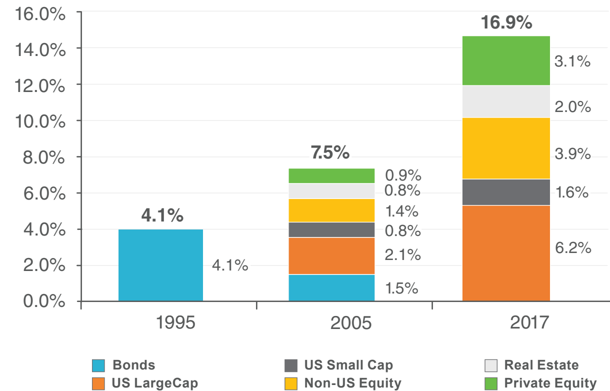
SOURCE OF DATA: J.P. Morgan.

WHAT IS A REALISTIC RETURN?

Prior to writing this Outlook, I reviewed my notes from previous memos we sent out. In writing, and in multiple meetings with clients, I've stressed that expected returns were likely to be muted going forward. In January 2017, I noted we should expect 6%-8% gain for US equities this year, which is partly what drove us to reallocate outside the US to emerging markets and to international developed. Clearly, performance has outpaced our expectations, and our allocations have worked out well, although our manager selection in certain areas has underperformed.

Looking forward, we think it will be even harder to get the same return that was possible 10 years ago, unless you take on much more risk. To put returns in perspective, take a look at the chart on the next page. It shows the asset allocation that would have been required to get a 7.5% return, based on return and volatility forecasts in effect for the years 1995, 2005 and 2017.





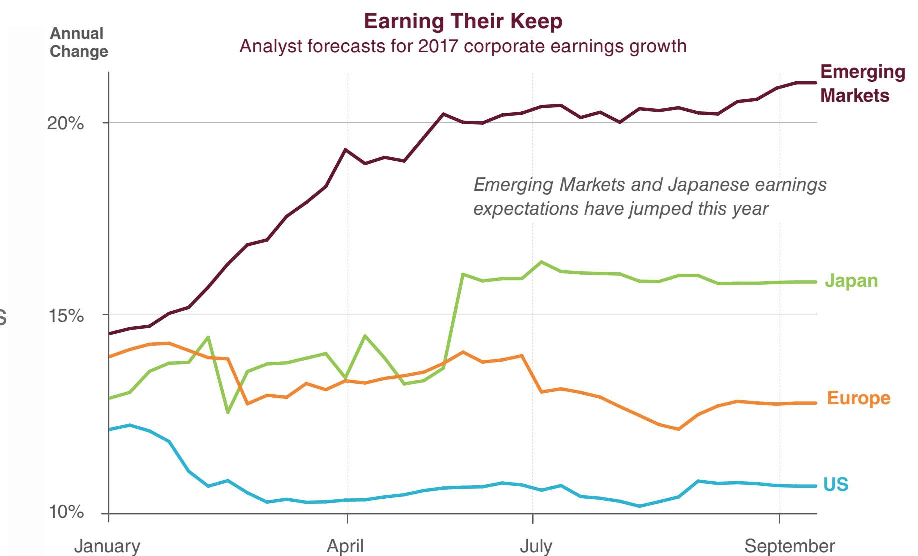
SOURCE OF DATA: BlackRock, Morningstar Direct, LNWM.

In 1995, an investor could have invested his/her entire portfolio in bonds and achieved a great result —7.5% return with only 4% volatility. To achieve that same return in 2017, a much higher level of volatility would be required — roughly 17%. That's because an investor would have to allocate zero to bonds and instead allocate to riskier investments, including alternatives such as real estate and private equity, all with much higher volatility and less liquidity. We acknowledge that we underestimated the strength of US equities in 2017 and could be underestimating yet again for 2018. However, the unclear economic trajectory (geopolitics, legislation, monetary policy) gives us reason to pause.

WHY CAUTION IS WARRANTED

LNWM portfolios have benefited this year from the positive momentum in equities, especially in foreign markets. At this time, we are actively looking for ways to reduce risk.

While US tax reform and other fiscal measures could lift equity valuations further, those policy developments are uncertain. What we do know, and where our focus lies, is fundamentals, especially earnings growth, which has been robust and even surprised to the upside. However, we think forecasts for improving earnings growth are largely priced in, which could limit upside potential and increase downside risk.

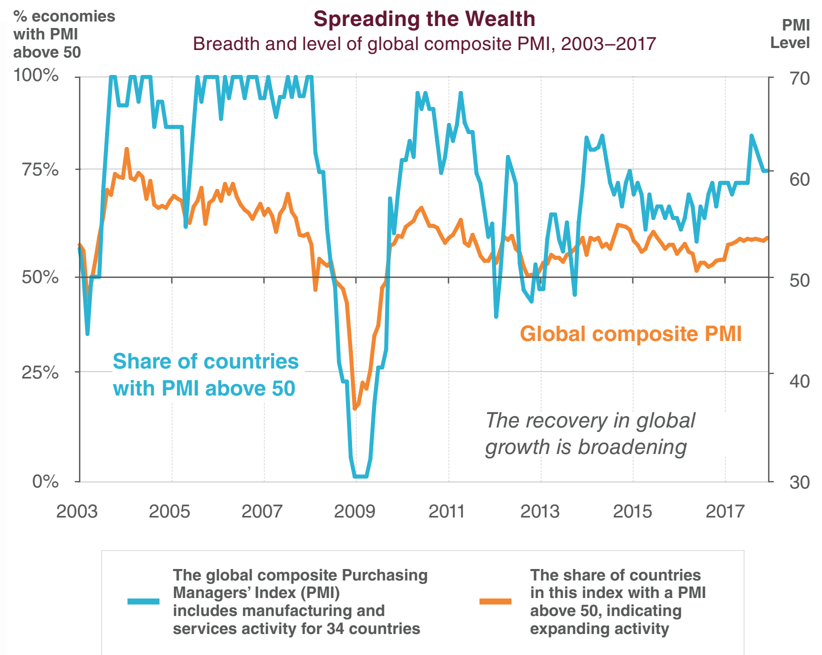


SOURCE OF DATA: BlackRock Investment Institute.

As previously mentioned, we think earnings growth has been the primary driver of stock market returns. In fact, earnings are forecast to grow faster than 10% in the coming year in all major world economies (see chart above), with US corporations demonstrating the slowest rate of growth. Supporting this growth is many years of coordinated policy by the world's major central banks to keep interest rates low in order to promote borrowing and consumption. The prospect of continued growth is the wind behind the sails of equity markets.

Consider that about 75% of the world's economies were recently expanding, according to the Purchasing Managers' Index (PMI), which is a gauge for economic activity. A PMI reading of above 50 indicates economic expansion. In Europe, where growth has been particularly difficult, all eurozone economies are in positive territory, which is a first since the 2008 Crisis.

While the outlook for growth is positive, this also increases the probability of monetary policy changes, which could alter the path of growth. The change in monetary policy will largely be driven by inflation, which will differ across economies and will ultimately drive some divergence in growth. We view policy missteps as one of the key risks for 2018.



SOURCE OF DATA: BlackRock Investment Institute.

INFLATION WILL PLAY KEY ROLE

In the US, core inflation is trending higher, which will give the Fed ammunition to raise target interest rates. Further, US labor force participation is at the highest point in several years – see chart on page 8 – which should drive wage increases, a key focus of the Fed when it considers interest rate increases. Tighter monetary policy could slow US growth, but if the Federal Reserve remains as transparent as it has been so far, markets should have time to absorb policy changes.

SOURCE OF DATA: US Census, company reports, MKM estimates.

With regard to inflation, technology is a secular force that cannot be ignored. Amazon and other online firms are having a dramatic deflationary impact on the "goods" economy, even as they drive up real estate prices locally. Amazon began by eroding the pricing power of booksellers and has moved into a wide variety of other consumer goods. My family, for one, rarely goes to a retail

outlet or mall because of the convenience Amazon offers. Pricing power in virtually every sector of consumer goods is being eroded, and Amazon still accounts for less than 10% of US retail sales.

This is key because traditional measures of inflation will obscure deflation in goods. It is also a reason why in a period of limited inflation, we can certainly experience robust growth. Low inflation coupled with growth is actually an ideal economic scenario, if it can be sustained.

POLITICS AND GEOPOLITICS

This year began with market euphoria about Trump policies on tax reform, infrastructure spending and deregulation. Instead, we focused on growth in the economy and corporate earnings, which were positive and drove our investment decisions. In fact, none of the issues the current administration campaigned on have become reality, and the likelihood and timing of implementation seems to get lower and longer daily. Capital markets have continued to move forward despite this, and any significant progress on tax reform and other fiscal issues will only be additive.

However, we also see several issues which could hinder economic growth, especially the geopolitical situation. The US has recently been involved in a war of words in many parts of the world. Three areas are of particular concern for us: the potential for conflict between the US and North Korea, renegotiation of the North American Free Trade Agreement (NAFTA), and US-China tensions.

It seems the potential for armed conflict with North Korea continues to rise, although we see that as a low probability given that it would be extremely costly for either side. The US-North Korea tensions have already affected US-China relations, which were strained to begin with. Additionally, failure to renegotiate NAFTA would signal a move toward protectionist trade policies and potentially trade wars, which would be harmful to equity markets.

LNWM PORTFOLIO UPDATES

- **Foreign equities:** These have been the best-performing asset classes in 2017, and our portfolios have benefited. We continue to favor non-US equities and will maintain our overweight position to both emerging and developed market equities. However, we remain very aware of the geopolitical risks that could alter the current trajectory. We are also reviewing our underperforming managers in these spaces. In such a strong rally, some underperformance for active managers is not completely surprising but calls for review, nonetheless.

- **Emerging market bonds:** We've recently recommended a long-term strategic allocation to emerging market bonds based on relatively attractive yields and improving creditworthiness.

- **Hedge Funds:** Early in 2017, we decided to lower our allocations to hedge funds and fixed income in favor of global equities. Prior to that, we had already replaced 100% of our liquid hedge fund holdings. We've been very pleased with the performance of our new managers and will likely increase allocations to this asset class as we begin to reduce exposure to equity market risk.

- **Real Estate Investment Trusts (REITs):** In third quarter 2017, we sold out of our relatively small allocation to REITs. REITs have performed very well over the past three years, although our allocations underperformed. REITS tend to perform well when interest rates are rising and GDP is expanding. However, we believe the artificially low interest rates during the past several years will alter how REITs perform going forward, even as GDP expands.

- **Infrastructure Equities:** We are actively researching a new asset class for LNWM – investments in infrastructure, through various vehicles (mutual funds and private equity funds). Infrastructure companies – transportation, communications, water, power, etc. – can provide diversification and a hedge against inflationary pressures, which we think could be on the rise in the US. Further, after decades of inadequate US government spending on infrastructure, the trend is toward more spending and investment in this space driven by private capital.

GLOBAL FIXED INCOME

Fed Rate Monitor

"If interest rates went up, it would be a disaster."

- May 2016

"It's a tremendous problem for the country and we are talking about rates that are practically at zero."

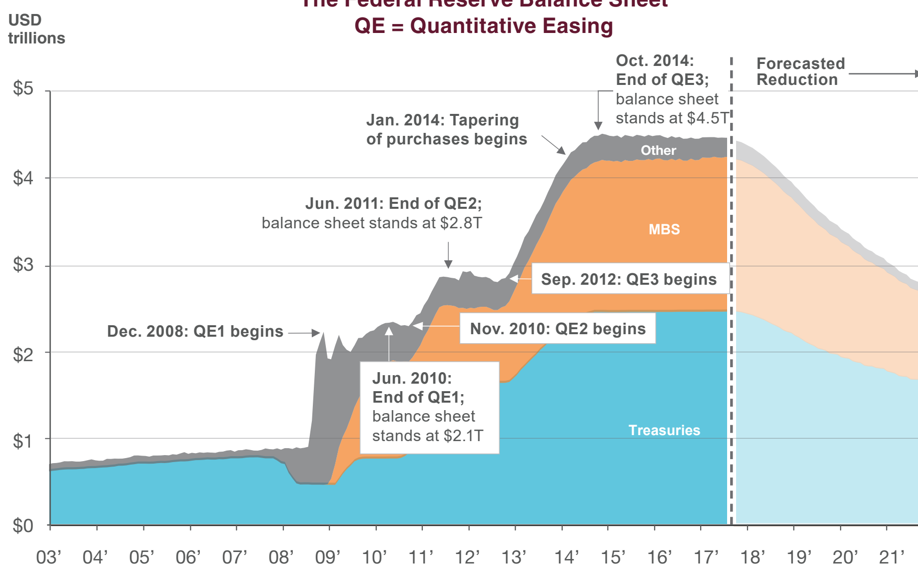
- September 2016

Janet Yellen

SOURCE OF DATA: Deutsche Bank Asset Management.

Janet Yellen's term as Fed Chair expires in February 2018. Along with the Fed Chair, President Trump also has two Fed Governor vacancies to fill. We believe his appointments will more likely be "dovish" or biased toward keeping interest rates relatively low, given some of his comments regarding the benefits of a weaker dollar. However, Trump cabinet appointments thus far have been less than predictable.

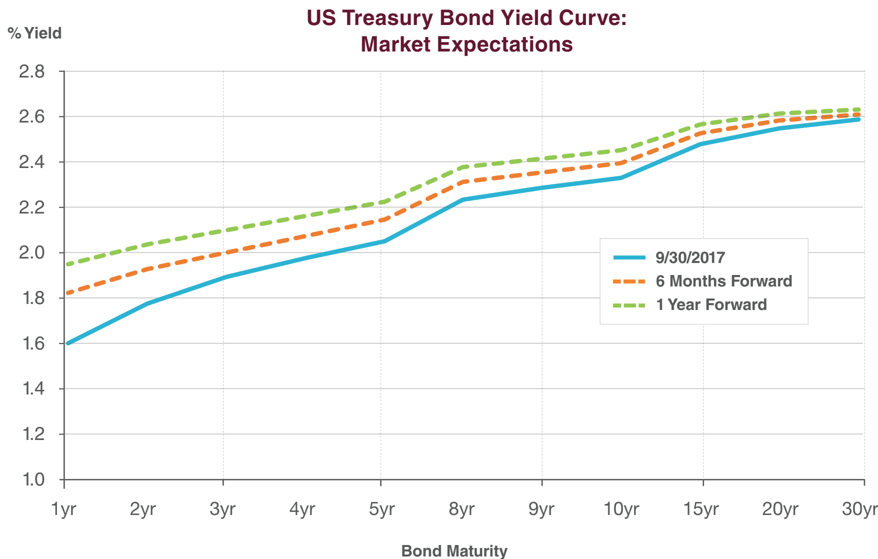
The Federal Reserve Balance Sheet
QE = Quantitative Easing



SOURCE OF DATA: J.P. Morgan.

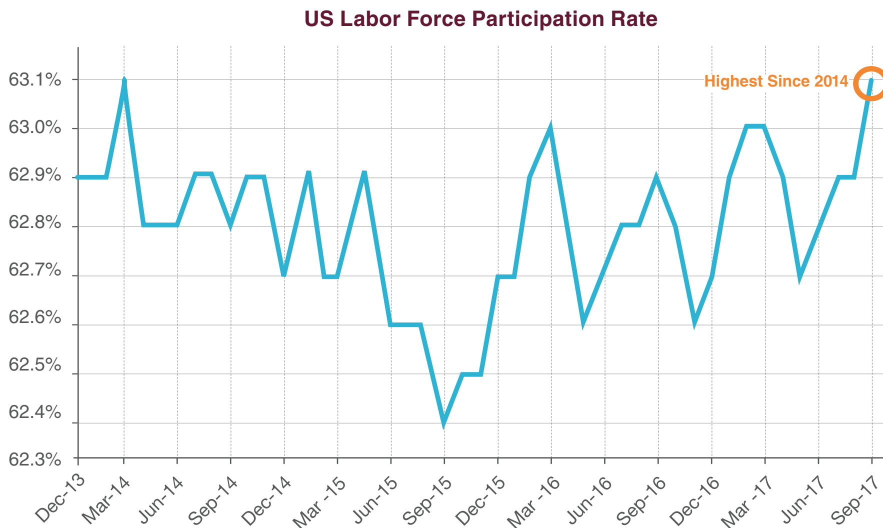
The Federal Reserve announced that it will begin reducing its balance sheet by not reinvesting a portion of the maturing fixed-income securities and interest payments received. The program calls for initially allowing $10 billion in bonds to mature monthly, a cap that would rise by $10 billion every three months until $50 billion per month is reached and thereafter continues for the foreseeable future. We believe the program is likely to lead to both higher bond yields and higher volatility.

GLOBAL FIXED INCOME



SOURCE OF DATA: Bloomberg.

We expect US interest rates to move higher given the Federal Reserve's plans to increase its target interest rate and changes to its bond-buying program. Given continued low inflation expectations, markets are pricing in larger moves in the front end of the yield curve (shorter maturities), which will lead to a flatter yield curve. Further, demand from foreigners and an aging US population should help keep longer-term rates from rising dramatically in the coming months.



SOURCE OF DATA: Bloomberg, Labor Department.

The US labor market continues to strengthen, as evidenced by the labor force participation rate (percent of work-eligible Americans ages 18 to 65 who are actually working). This rate has reached its highest level since 2014. Coupled with a 4.2% unemployment rate, which indicates nearly "full employment," we believe we will soon see signs of accelerating inflation, including higher wage increases. This will give the Fed additional comfort in raising rates.

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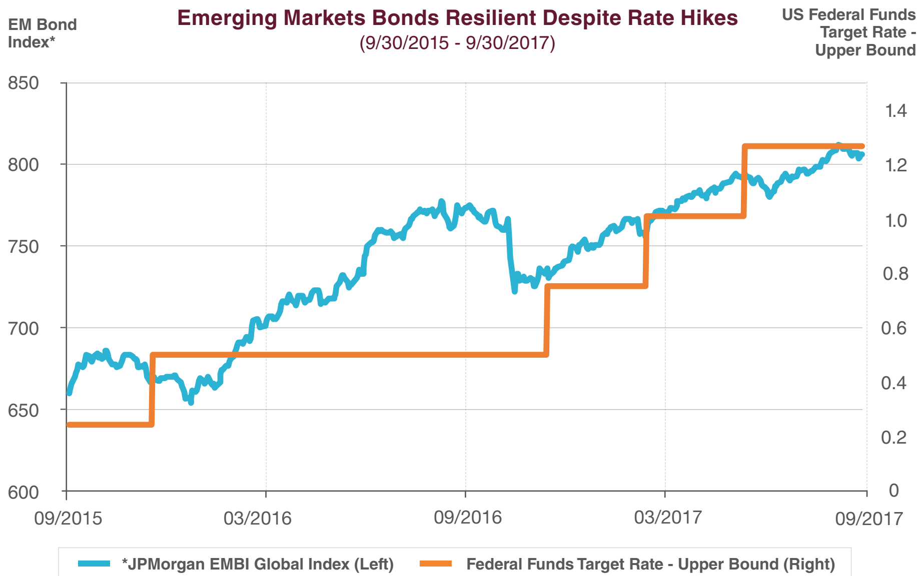
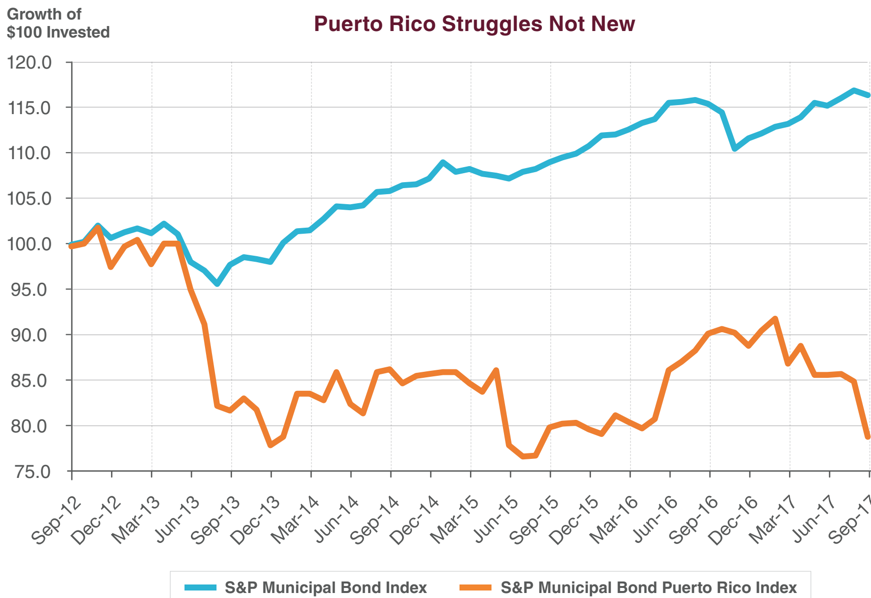
GLOBAL FIXED INCOME



SOURCE OF DATA: Bloomberg.

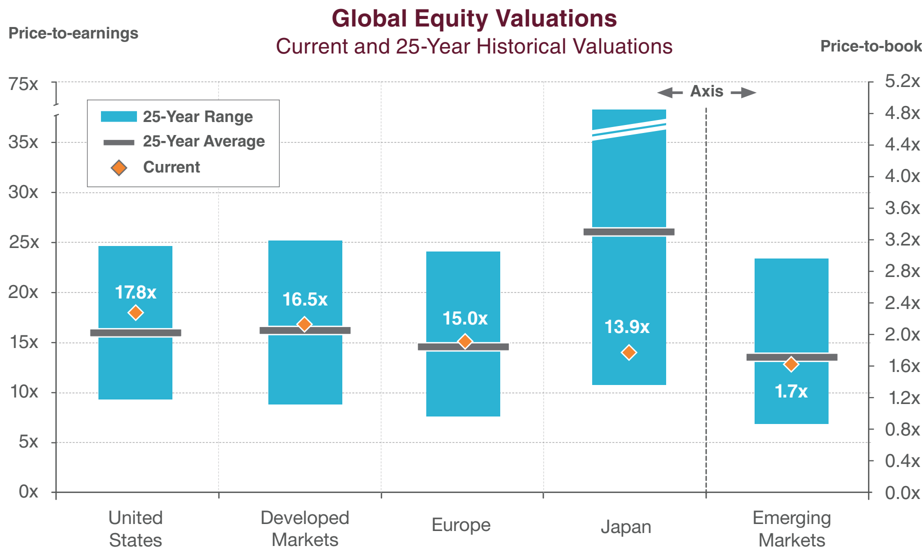
We've recently recommended a strategic (long-term) allocation to emerging markets debt in fixed-income portfolios, based on relatively attractive yields and the ongoing development in emerging markets economies. While a prolonged rise in US interest rates is a likely headwind for most areas of fixed income (emerging markets debt included), emerging markets debt has historically outperformed US Treasuries on a relative basis in such periods. For example, in the chart at left, US Dollar denominated EM sovereign debt has provided 22% cumulative return despite four Fed interest rate hikes in the last two years.



SOURCE OF DATA: Morningstar Direct.

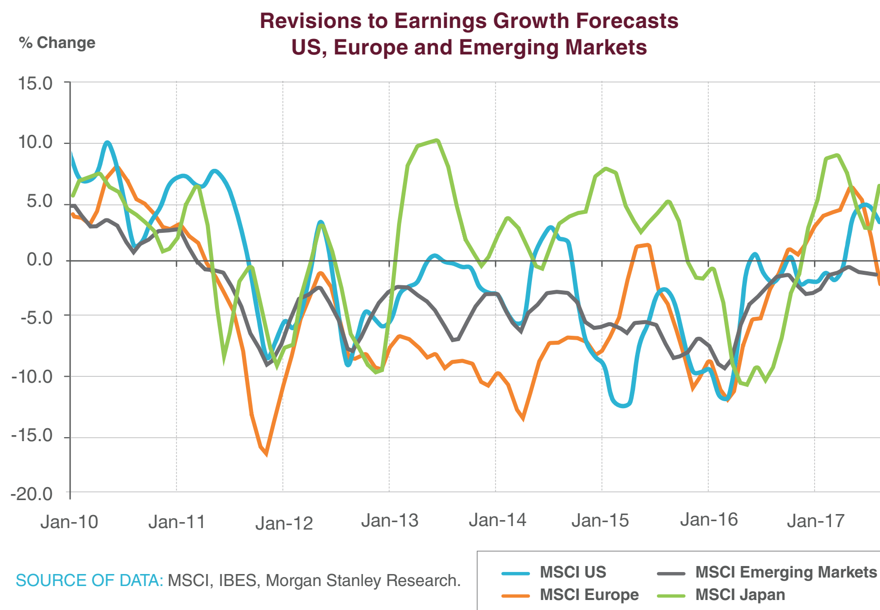
While the recent hurricanes have exacerbated Puerto Rico's financial woes, the debt crisis faced by the island is not new. Puerto Rico had been able to finance itself via the municipal bond market based on the attractive tax advantages of its bonds despite a now decade-long recession, unemployment and population decline, all of which began to be recognized by investors in 2013. As the chart shows, Puerto Rico bond returns have been much weaker than overall municipal bond market returns. Our portfolios have little if any exposure to Puerto Rico and we anticipate the crisis will not spill over into the rest of the much more resilient and stable municipal bond market.

GLOBAL EQUITIES



SOURCE OF DATA: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

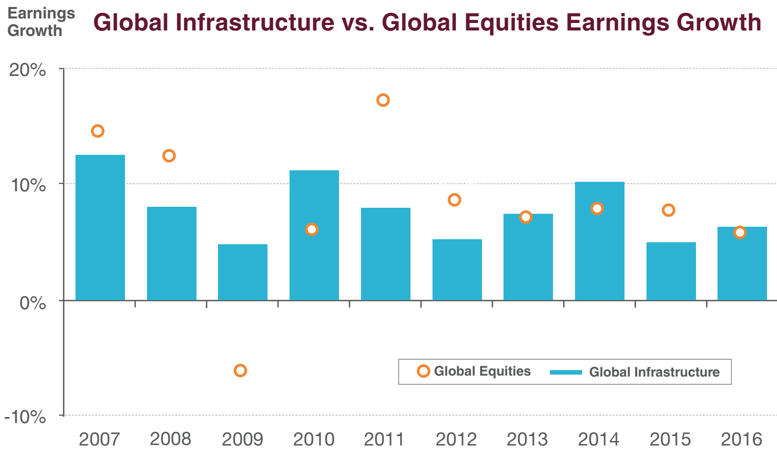
Excluding Japan, equity valuations across the globe continue to be near or above 25-year averages. Relative to the US equity market, Europe and emerging markets offer attractive opportunities. Japanese data continues to be skewed given long-term idiosyncratic issues, but currently displays the largest relative discount to long-run averages.



SOURCE OF DATA: MSCI, IBES, Morgan Stanley Research.

Analysts continue to revise their corporate earnings estimates for the coming year upward for US and Japanese equities, as these countries benefit from weaker currencies and improving global growth. European earnings revisions have recently turned negative on concerns about a stronger euro and the European Central Bank potentially reducing monetary stimulus. We view the downturn in European earnings growth estimates as transitory and continue to view the region positively based on regulatory reforms and better growth prospects. We further are reviewing our Japanese allocation as we see positive momentum in the country and believe it could benefit from a weaker yen and moderate global growth.

GLOBAL EQUITIES



Essential Assets:
Transportation, energy & communication

Monopolistic:
Inelastic demand profile

Long Term:
Visible, stable, and contractual cash flows

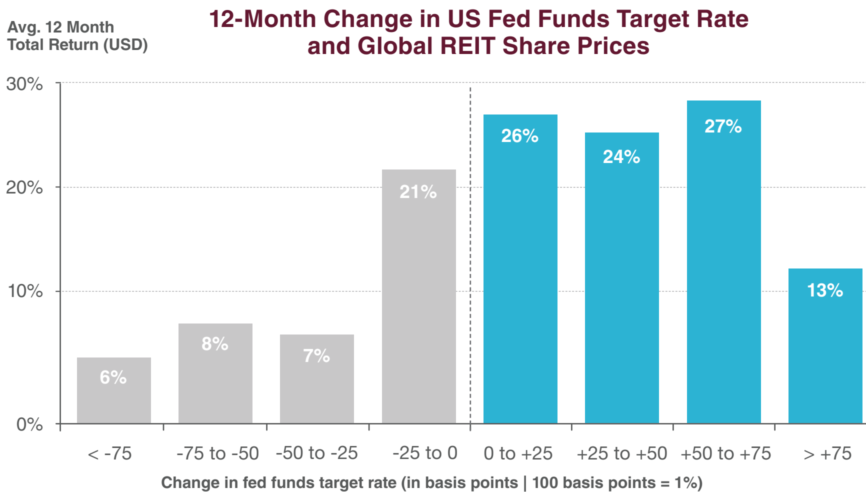
Inflation Protection:
Pass rising costs on to end users

Infrastructure Dividend Yield:
3.9%

Equities Dividend Yield:
2.5%

SOURCE OF DATA: Deutsche Bank Asset Management.

We have begun to consider specific infrastructure equity funds, which includes transportation, communications, water and energy. Infrastructure stocks have posted higher earnings growth historically versus global equities. Infrastructure also boasts a higher dividend, lower price volatility, stable cash flow, and consists of essential assets demand for which is not dependent on economic cycles.



SOURCE OF DATA: Bloomberg, CBRE Clarion.

Historically, Real Estate Investment Trusts (REITs) have done well during periods such as the current one – an ongoing economic expansion, coinciding with a rise in interest rates. However, we think REITs could be challenged in the near term, as low interest rates have elevated real estate values. Looking ahead, we anticipate that a rising rate environment could hurt valuations, particularly given that 20% of REITs are in the retail sector, which has been especially challenged.

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.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

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The Moderate Model Portfolio is not an actual portfolio and it is not possible to invest in the Model directly. Neither is it possible to invest directly in any index used in the comparative asset allocation blends shown. The Model investment performance does not represent the actual performance experienced by any client or group of client accounts. Actual performance results in client accounts will have varied substantially from the performance shown as a result of the inception of the investment, the timing and expenses of trades in the portfolio, the addition or withdrawal of cash, funds or securities, the imposition of taxes, expenses of custody and other variables not accounted for in the Model Portfolio.

Fees charged by Laird Norton Wealth Management will reduce the net performance of your investment portfolio. For example, a $3,000,000 investment for the 10-year period ending December 31, 2016, allocated in line with a Moderate Portfolio Model, would have a value of approximately $4,863,109 at the end of the period. A 1% annual fee, collected monthly in arrears, would reduce the ending balance to approximately $4,403,809. The Laird Norton Tyee Asset Strategies, LLC standard schedule of fees is set forth in our Form ADV Part 2A and is available upon request. Fees for accounts managed by Laird Norton Trust Company are based on the trust company's standard fee schedule and may include fiduciary fees and related expenses in addition to investment management fees.

The 60/40 Equity & Fixed-Income Blend Portfolio: Annually rebalanced blend of the Barclays Capital U.S. Aggregate Bond Index and the MSCI All-Country World Index (ACWI). The blend is intended to reflect a typical moderate asset allocation without active management or manager fees for comparison.