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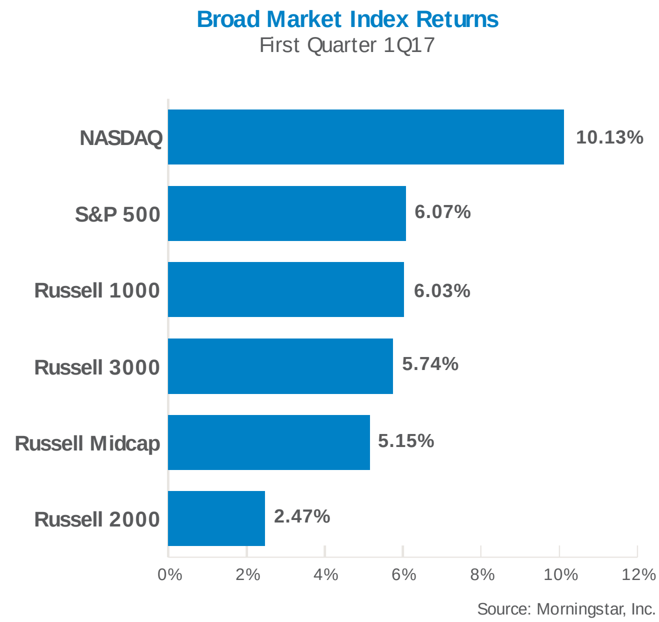
The strong equity market upswing we saw following last November's election continued through the first quarter of this year, with most areas of the equity market posting strong returns. After significantly trailing domestic equities in 2016, international equities also rebounded with the EAFE Index outpacing the S&P 500 Index. Finally, following a very challenging fourth quarter of 2016, it was nice to see bonds also rebound and in general post positive total returns this past quarter.

The Economy



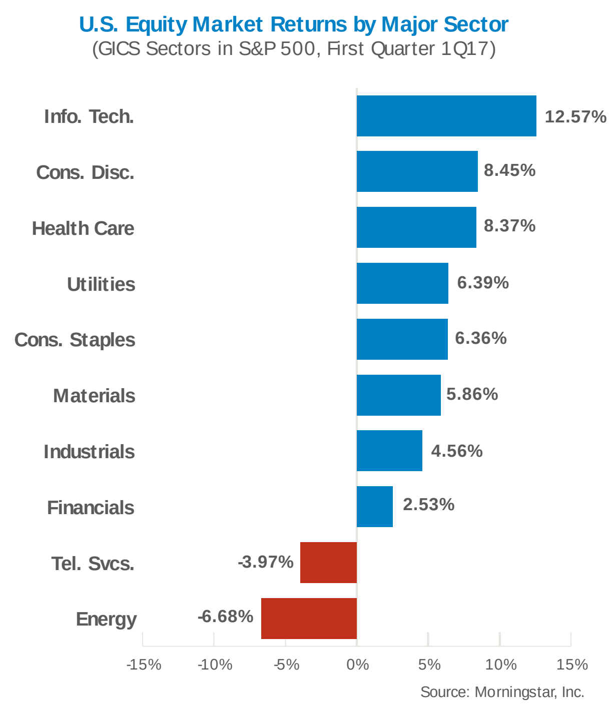
In recent quarters, the U.S. economy has proven to be a stable, steady grower, and according to most economists, few dark clouds are on the horizon. The economy continues to be supported by improving job growth and, more recently, a surge in consumer, business, and investor confidence. The first two months of the Trump administration have spawned a swell of enthusiasm, despite Congress' recent setback of failing to move ahead with overhauling healthcare. The Bureau of Economic Analysis reported its third estimate of fourth quarter 2016 gross domestic product (GDP) of +2.1%, up a notch from the prior estimate, but lower than the third quarter's +3.5% reading. The employment situation took a positive turn, with an average of nearly 209,000 jobs added each month, a further indication of an improving economy. The unemployment rate of 4.7% remained near cyclical lows. The better-than-expected jobs data was one data point the Federal Open Market Committee (FOMC) considered when it voted to raise short-term interest rates at its March meeting by 25 basis points to 0.75%–1.00%. Analysts anticipate two more rate hikes in 2017.

The global economic landscape is improving. Although the dollar's appreciation has suppressed U.S. growth, it has helped prospects for foreign economies exporting to the United States, particularly Europe, Japan, and China. In addition, improving domestic growth will certainly help the outlook for economies worldwide, as U.S. consumers demand more goods and services. The Eurozone's recovery is picking up steam, albeit modestly, on the back of rising export growth and the housing market's steady recovery.

Although China is expected to see further easing in GDP growth, as the country continues its transition to a more consumer-oriented economy, analysts nevertheless expect its economy to grow at close to 6% in 2017. Additionally, domestic demand in China is increasing, as a result of a significant rise in consumer credit.

Highlights

GROSS DOMESTIC PRODUCT (GDP)



The Bureau of Economic Analysis released the third estimate of the fourth-quarter 2016 real GDP, a seasonally adjusted annualized rate of 2.1%, down from the third quarter's +3.5% annualized growth, but up slightly from the 1.9% prior estimate. Although the fourth-quarter results were lower than those of the prior quarter, they were still above the +1.7% average of the previous four quarters. Consumer spending was the primary growth driver during the quarter, whereas both government spending and trade proved to be key detractors. Analysts point out that the rising dollar is hindering U.S. competitiveness, serving as a drag on growth. Although wage pressures have begun to pick up slightly, inflation remained stable in the quarter, with the personal consumption expenditures (PCE) index of prices rising +1.9%, following a +1.5% advance in the prior quarter. The consensus among economists is for little risk of recession over the next several quarters, as few imbalances exist in the economy, such as the housing bubble prior to the Great Recession.

HOUSING

The housing segment has steadily improved. Existing home sales for February (the latest monthly data available) grew at an annualized rate of 5.5 million units, a decrease of about -3.7% from the 5.7 million-unit-rate reached in January, yet up +5.4% from February 2016. The inventory of existing homes was slightly less than four months of supply, modestly lower than year-ago levels. Existing home prices in

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February were up a slight +0.4% from January, but have gained nearly +7.6% from February 2016, the fastest growth rate since early 2015. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 71, its highest reading in the past 12 months. Homebuilders and analysts expect the headline number to remain steady or pull back slightly in the quarters ahead, as higher interest and mortgage rates may dampen new homebuilding activity.

EMPLOYMENT

The employment situation experienced resurgence in the most-recent monthly report. Employers added 235,000 jobs during February, far exceeding the consensus expectations of 190,000 new jobs, and in line with the prior month's gain. The three-month moving average also rose, coming in at 209,000, its highest level since September. The unemployment rate in February was 4.7%, just off its cyclical low of 4.6% reached in November. Average hourly earnings increased by a modest +0.2% in February, and have risen +2.8% in the past 12 months. Most economists agree that job growth should average somewhat below 200,000 per month for the remainder of the year. As the job market continues to improve, employers may face increasing difficulty in filling positions.

FED POLICY

As analysts' consensus had expected, the FOMC ended its recent March meeting by raising the target range for the federal (fed) funds rate by 25 basis points to 0.75%–1.00%. In its statement accompanying the rate decision, the Committee said the risks to the economy remain balanced, and signaled there will be additional rate hikes over the course of 2017. The interest rate futures market is currently implying two additional increases before 2018. The Committee indicated that an improving economy, rebounding employment, and inflation nearing its target level of 2% made this an opportune time to initiate another increase. An encouraging addition to the FOMC's statement this time was the implication that it would not necessarily consider 2% inflation as a ceiling before it accelerated rate increases. Many economists believe the FOMC should allow the economy to "run hot" for a bit, or let the inflation rate rise above 2% before pulling in the reins again.

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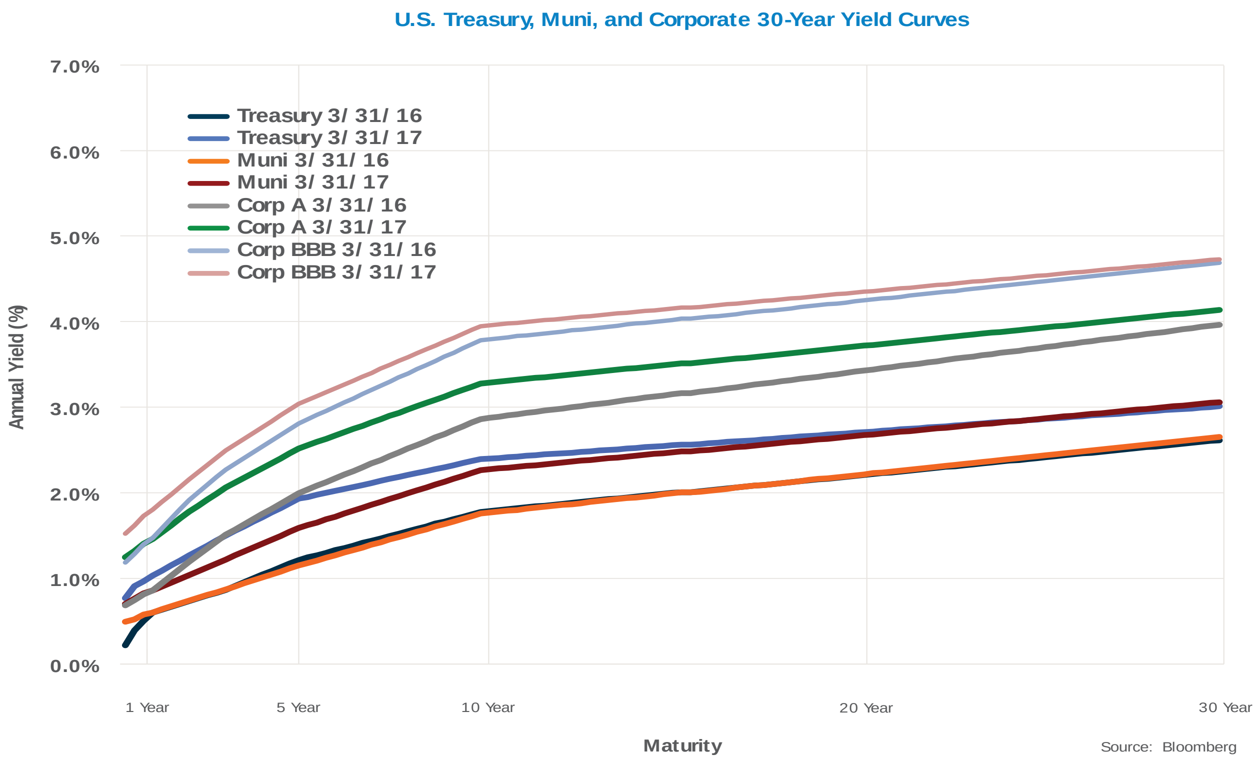
Interest Rates

As was the case over the prior two quarters, the primary drivers of fixed-income securities' prices during the past three months were anticipation of (and ultimately the FOMC's decision to move ahead with) a hike in the fed funds rate, an improving economic outlook (especially the employment situation), and record-high stock prices. With the economic backdrop supporting a rate hike, there was little suspense as to whether the FOMC would move to increase rates, especially after members of the Committee, in the days leading up to their meeting, signaled such an outcome was likely. The fixed-income markets also digested the inauguration of Donald Trump and the heightened activity surrounding his first weeks in office.



In contrast to the prior quarter, the yield curve flattened slightly, as yields on short-term securities rose more than those in the intermediate- to long-term end of the spectrum. The flattening was largely due to the FOMC's rate increase, which is expected to have little impact on longer-dated issues. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note was little changed, ending the quarter at 2.39%, compared to 2.45% on December 31.

As happened in the fourth quarter of 2016, yield changes along the maturity spectrum were largely a result of several primary factors: the FOMC's decision to raise the fed funds rate, a rebound in employment and other

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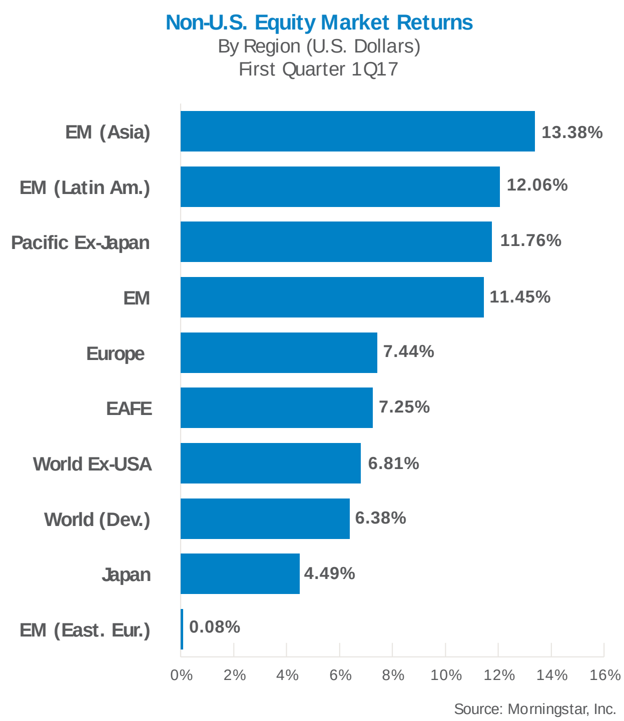
economic data, and the perception that the Trump administration will espouse pro-growth economic policies. Yields at the shortest end of the yield curve (up to one year) rose in line with the 0.25% fed funds rate increase, but maturities of two years and longer experienced little change in yields. Inflation expectations crept higher, with the Fed's gauge of five-year forward inflation expectations closing at 1.93% on March 31, the same level as December 31.

Fixed-income securities generally produced positive total returns in most market segments. Emerging-markets bonds also fared well after a dismal fourth quarter, as the JPM EMBI Global Index rallied +3.9%.

Equity Markets

Equity markets continued their recent trend of strong performance in the first quarter, rallying again to record highs in the midst of robust employment data, clarity on the interest rate front, and a flurry of initiatives in the Trump administration's first weeks in office. Stock prices gained ground right from the start of January, and didn't encounter much in the way of headwinds until the middle of March, when Congress shelved legislation to overhaul healthcare due to its lack of support. Nevertheless, the March reading of consumer confidence checked in at its highest level since 2000, indicating that the rise in stock prices is supported by a great deal of optimism. Against this backdrop, the S&P 500 Index finished the quarter with a gain of +6.1%.



The ten primary economic sectors delivered solid performance during the quarter, with only a couple of notable exceptions. Performance disparity between the extremes was wide, making sector allocations important. As with the prior two quarters, the performance disparity between the best- and worst-performing sectors was significant, amounting to more than 20% for the three months.

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Information technology, healthcare, and consumer discretionary were the strongest performers, producing gains of +12.6%, +8.4%, and +8.5%, respectively. The energy, telecommunication services, and financials sectors were the poorest relative performers, posting returns of -6.7%, -4.0%, and +2.5%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +6.0% total return, bringing its one-year advance to +17.4%. Within the large-cap segment, growth stocks outperformed value stocks. Small-cap stocks, as represented by the Russell 2000 Index, underperformed large caps for the first time in several quarters, and finished with a total return of +2.5%. Small-cap growth outperformed small-cap value by more than 5%. The Nasdaq Composite, dominated by information technology stocks, finished with a gain of +10.1%, and is now up +22.9% over the past year. The Dow Jones Industrial Average of 30 large industrial companies gained +5.2%.

Real Estate Investment Trusts (REITs) declined again during the quarter, with the DJ US Select REIT Index posting a loss of -0.3%. Commodities also generated losses, with the Bloomberg Commodity Index sliding -2.3%.

International stocks produced a much more robust performance than U.S. equities overall, reversing, at least temporarily, a prominent trend that has been in place for several years. Global investor confidence seems to be on the rise following the 2016 U.S. election, European economic growth has stabilized, and many economists believe 2017 will bring more of the same. Within this context, international stock indices were mostly higher. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the United States, gained +7.9%. The MSCI EAFE Index of developed-markets stocks rose by +7.3%, and is now up +11.7% over the past 12 months. Regional performance was, on balance, positive. The Asia region was the strongest performer on a relative basis, with the MSCI Emerging Markets (EM) Asia Index posting a return of +13.4%. Eastern Europe and Japan were the poorest relative performers, with gains of +0.1% and +4.5%, respectively. Emerging-markets performance was robust, as the MSCI Emerging Markets Index surged +11.5%, and is now up +17.2% on a year-over-year basis.

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Looking Forward

Whatever one's political leanings and views on President Trump and his administration, there is little doubt that his election has generated a great deal of optimism about the economic outlook. The stock market rally that has occurred since Election Day has been driven, at least in part, by expectations for accelerated economic growth and improving employment. General optimism is reflected in the most-recent consumer, business, and investor confidence surveys, which in some cases show the highest levels of confidence since 2000; however, as has been evident in recent weeks, failing to meet these expectations can have serious consequences: stock investors experienced a sharp drawdown as a result of Congress' tabling of healthcare legislation in March. Somewhat chastened, investors will now be watching carefully as Congress moves on to tackle tax reform and other elements of President Trump's economic agenda. If the outcome appears as though it will disappoint, stocks could face further vulnerability, due to extended valuations relative to historical norms. Reasons exist to be optimistic about the economic outlook going forward, but the ride may not be smooth, and stock prices may face bouts of volatility that have not been experienced in more than a year.

From an investment standpoint, 2017 has started out well; however, it is always important to remember that market volatility can return at any time and often will do so very quickly. Subsequently, it is important to be prepared for the return of market volatility. If you feel your portfolio allocation is no longer appropriate for your situation or you have anticipated cash needs from your portfolio that we are not aware of, please let us know so any necessary changes can be addressed.