The Monthly Letter

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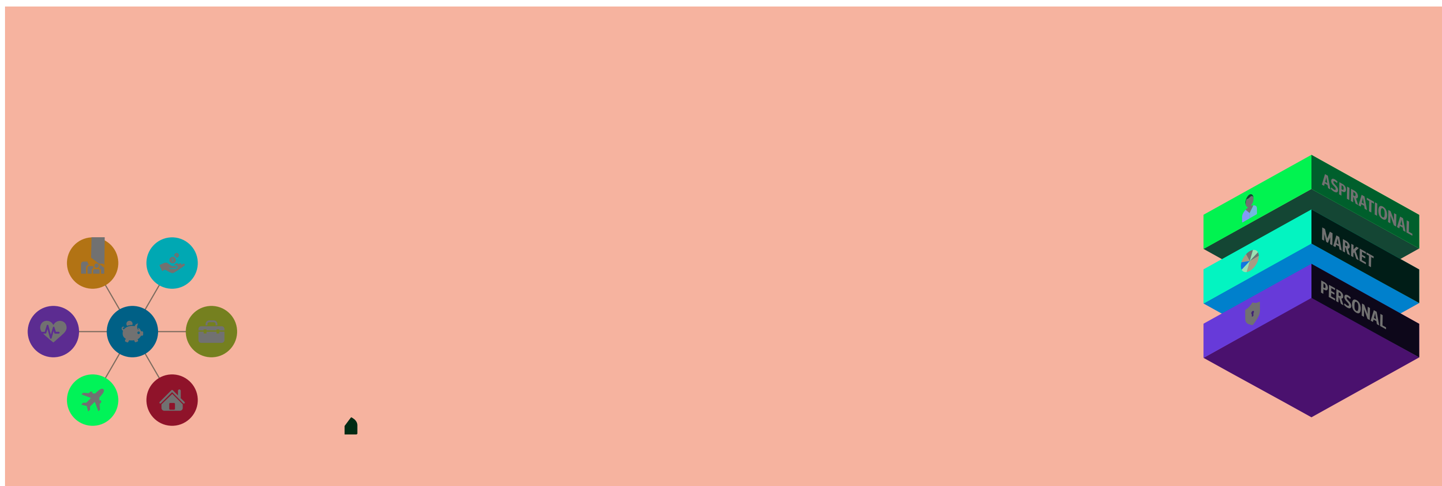

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Since the credit crisis ended in early 2009, people have used various adjectives to describe this environment, mainly because of the multiple cross-currents that have been interacting with each other around the world. The U.S. and the U.K. climbed out of the credit crisis first after a major reset. Europe followed, but utilized different tools to eventually stabilize the economy and financial system, with help from the growth of its global economic partners. Japan established a three-arrow framework targeting a combination of monetary and fiscal adjustments, which are finally beginning to show some positive results. As a group the emerging markets (EM), with their vibrant and growing middle-class, struggled over the past half-decade as commodity prices dropped significantly, the dollar strengthened and China's growth curve shifted lower. But EMs are now growing again and since the beginning of this year have exited their bear markets and recessions.

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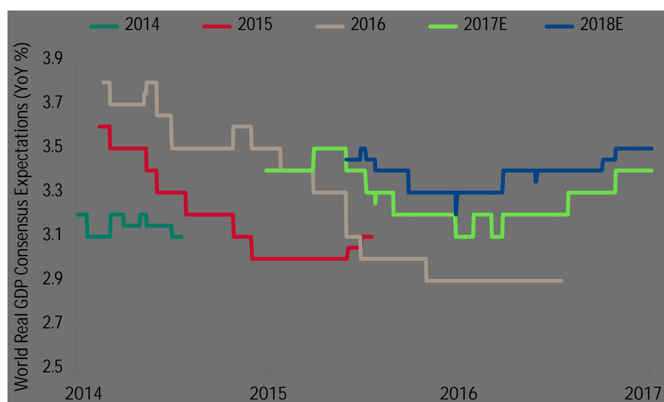
The global economy continues to chug along. All 46 countries monitored by the Organisation for Economic Co-operation and Development are on pace to grow for the full year, the first time this has happened since 2007. Historically, economists have tended to be overly optimistic about growth prospects, but this has not been the case over the past 12 to 18 months. Consensus expectations for global growth in 2017 and 2018 have marched upward during this time, driven by improving prospects for the Euro area, Japan and EMs (see Exhibit 2).

Exhibit 2: Growth expectations more stable than in past years



Source: Bloomberg and Chief Investment Office. Data as of September 20, 2017
Past performance is no guarantee of future results.

Against this backdrop, we've examined key factors contributing to the ongoing expansion in order to assess their ability to continue driving growth.

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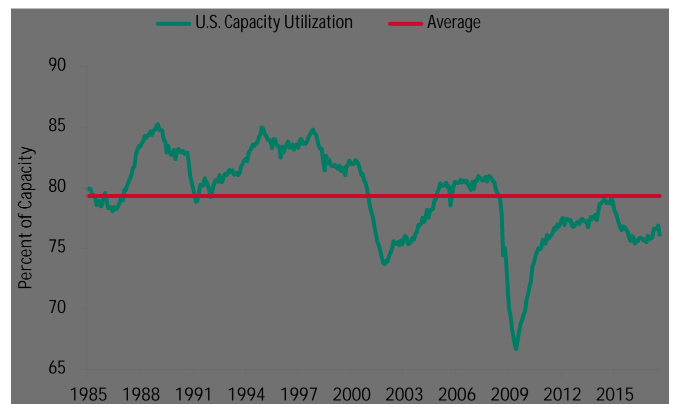
After rebounding sharply post-recession, manufacturing capacity utilization leveled off at around 76%, roughly four percentage points below levels typically associated with an "average" level of slack (see Exhibit 3). In recent months however, utilization rates have started rising again. We expect them to recover gradually as economic growth and earnings accelerate. However, we believe there is some degree of excess cyclical slack that remains in U.S. manufacturing, most likely reflecting some lingering spare capacity following the contractions in the energy sector and capital expenditures (capex) in 2015 and 2016. To the extent that demand continues to rise at an above-trend pace, we expect a further drawdown in slack, potentially stoking inflation.

Exhibit 3: Capacity Utilization not a constraint at this stage



Source: Bloomberg and Chief Investment Office. Data as of August 31, 2017

H[illegible]

The housing recovery has been slow as scars from 2008 ran deep, with banks reluctant to lend and supply far outstripping demand. While some indicators such as housing starts have doubled from the 2008 lows, they are far off past peaks, with plenty of room to expand further. Residential investment's contribution to gross domestic product has fallen from the level we saw in 2016, a headwind for the economic expansion. In our view, as long as job growth remains healthy and incomes pick up—and credit conditions do not tighten

drastically—2018 should bring more balance between supply and demand in the housing market and we should see faster growth in residential fixed investment.

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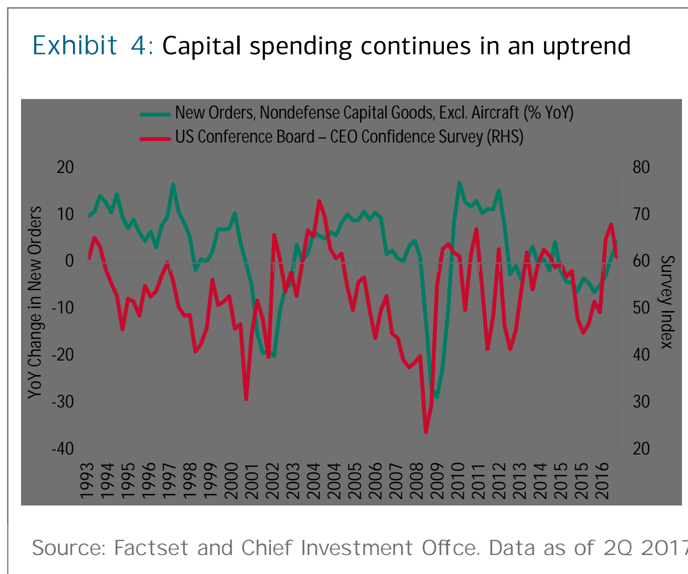
Elevated readings on capex in the first half of the year should persist into the second half. The key supports for sustained corporate spending remained in place despite a soft report on July factory orders and lackluster growth in commercial and industrial loans. Historically, sustainable capital spending cycles get underway only when businesses see evidence that consumer demand is on the upswing. Consumer expenditures averaged an above-trend 2.7% in the first half of the year. In our view, we believe that household spending will likely continue to improve in the second half. Furthermore, recent readings on core durable goods orders and shipments show that the uptrend that began in mid-2016 persists, despite recent volatility in the data (see Exhibit 4).

Exhibit 4: Capital spending continues in an uptrend



Source: Factset and Chief Investment Office. Data as of 2Q 2017.

CEO confidence, still a primary support for capex, recently soared to a 13-year high in the first quarter, but retreated modestly in the following one. The last reading came in mid-July, and the dip in sentiment reflected the lack of legislative progress in Washington. It stands in sharp contrast to the easing of concerns around monetary policy reflected in the Federal Reserve's Beige Book.

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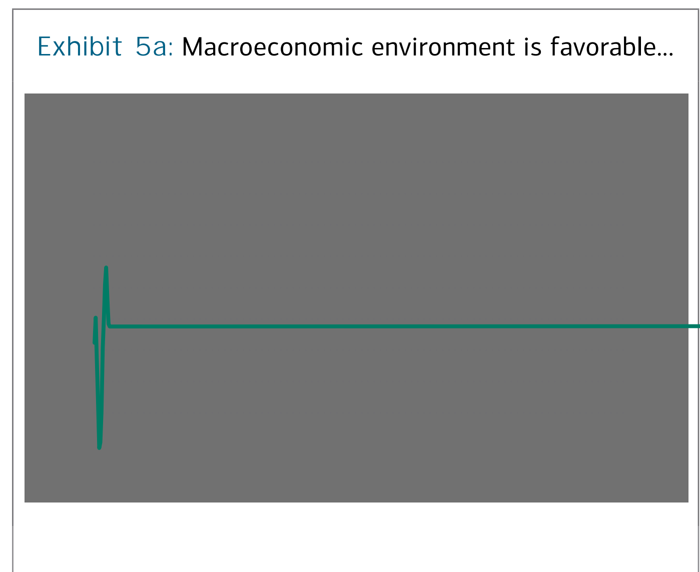
Earnings and sales growth in the second quarter ran ahead of expectations, supported by resiliency in profit margins. In our view, this is an important cornerstone supporting the economic expansion. Second-quarter earnings growth of +10% year-over-year decelerated from the first quarter's +15%, but was still stronger than any other quarter over the last five years

U.S. corporate profit growth was robust in the second quarter, with results surpassing consensus expectations across all sectors but one—Energy. While profits have broadly increased, growth has been more concentrated higher up in the capitalization spectrum, with profit growth for large-cap companies double the rate for small caps. Multinational companies were also a significant source of growth, benefiting from the weaker dollar and bolstered by greater exposure to international growth markets. Importantly, second-quarter results also resulted in top-line revenue growth of around 5% year-over-year, which is key given historically elevated profit margins and valuations. With a very strong first half behind us, a high-water mark may have been set.

Fa abe e i e f ea i g a d a e

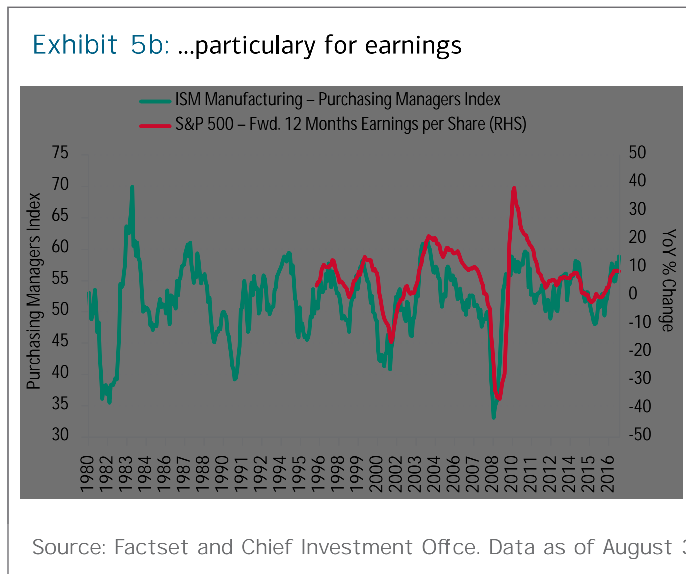
The August reading of the ISM manufacturing Index supports our case for accelerating profits in the second half of 2017 (see Exhibit 5a). Historically, industrial production has been a good proxy for sales of S&P 500 companies. Recent strong readings on the ISM index, which tracks it, suggest that it should accelerate in the next six months.

Exhibit 5a: Macroeconomic environment is favorable...



period of margin expansion and moderate top-line growth. The elevated level of the ISM index sets the stage for earnings growth to gather momentum in the second half of 2017 (see Exhibit 5b). Solid readings on the ISM index indicate that our bullish profit story for 2017 is still intact, supporting our overweight stance towards stocks versus bonds.

Exhibit 5b: ...particulary for earnings



Source: Factset and Chief Investment Office. Data as of August 31, 2017.

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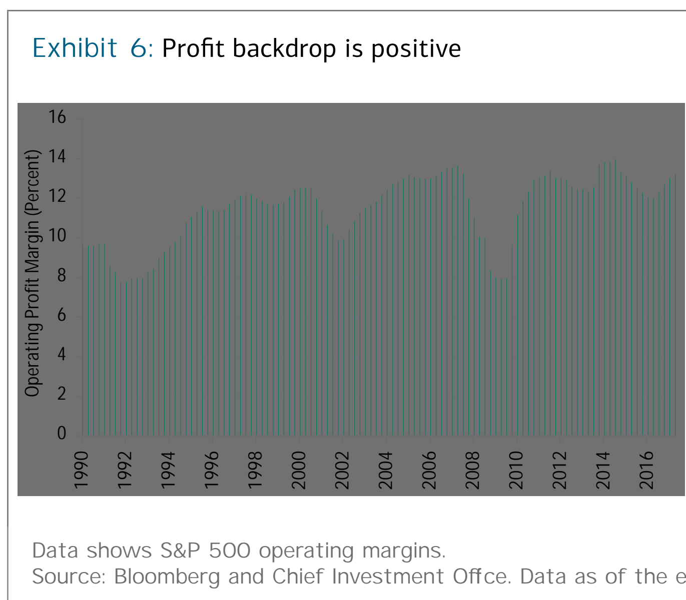
Just as many have questioned the durability of the economic expansion, others have expressed skepticism about the outlook for profit margins. After a full percentage point dip during the mid-cycle slowdown in 2014-2015, operating margins for the S&P 500 have rebounded to close to their prior highs (see Exhibit 6). Margins have nonetheless held steady in the range of 8.5% to 10.0% since the second-half of 2010.

Exhibit 6: Profit backdrop is positive



Data shows S&P 500 operating margins.
Source: Bloomberg and Chief Investment Office. Data as of the end of 2Q 2017.

We expect profitability to remain high on a structural basis given supports from wage growth that is still low but gradually rising, and increasing adoption of labor-saving technologies such as robotics and other automation. As economic growth continues to accelerate on a cyclical basis into 2018, key risks to watch include unexpected wage acceleration, interest rate increases that are faster than expected, higher commodity prices and capital expenditures being made into an aging expansion.

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Globally, the Earnings Revision Ratio, which compares analysts' upgrades and downgrades to projections of corporate earnings, and usually has a strong relationship to stock price performance, has been improving month after month. It has been rising for most regions and is especially strong for cyclical sectors like Financials, Industrials and Information Technology. The trend is weaker for defensive sectors including Telecom, Utilities and Consumer Staples. In our opinion, this indicates further gains in global stocks are likely.

R i f G ide a i : While many point to the length of the current economic cycle and look to that as evidence that it is close to over, we do not share that view. In our view, the economic expansion has momentum to continue now that we are seeing global synchronized growth. A key support of the cycle continues to be growth in corporate profits. As long as profits continue to grow, we believe this expansion has legs to continue.

While we do expect the economic expansion to continue, growth is likely to be slower than it has been in the recent past. Slow and steady growth continues to support our view of equities over fixed income, however, especially as equity valuations look attractive relative to those of bonds. We maintain our overweight across all regions but have a preference for international developed markets, specifically Europe and Japan, along with some emerging markets exposure and large-cap U.S. stocks. In balancing our allocations to growth and value, we prefer a cyclical approach to sector positioning. We believe healthcare and financial stocks are attractive on a valuation basis, while favoring technology and healthcare as secular opportunities for long-term capital.

However, as noted in the most recent edition of our Investment Strategy Committee Viewpoint, The Garden of Realists, one risk that could disrupt the expansion would be "policy error," particularly a misstep in monetary policy. Historically, raising rates sharply and too much at a time when growth is slowing and leverage is high has been the mixture that has turned the cycle the other way, causing recessions. Even though we see the macro environment as constructive for the market, and expect further expansion, we should not be complacent regarding this risk given the influence monetary policy has had across the globe since the credit crisis.

When assessing your portfolio in light of our current guidance, consider the tactical positioning around asset allocation in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate, given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your financial advisor can help you customize your portfolio in light of your specific circumstances.

ASSET CLASS	CHIEF INVESTMENT OFFICE VIEW: Negative		Neutral		Positive	COMMENTS
Global Equities	•	•	•	●	•	Maintaining our overweight to global equities versus fxed income based on expectations and improving corporate profts.
U.S. Large Cap	•	•	•	●	•	Positive based on higher growth, improving sales and earnings growth for S&P 500 comp extended valuations. Favor cyclical sectors such as consumer discretionary, fnancials, sele and factors like dividend growth, high quality. Slight preference for Value over Growth ba improving earnings.
U.S. Mid & Small Cap	•	•	•	●	•	Slight overweight due to rising fscal policy uncertainty, especially concerning tax reform a complacency. Valuations are stretched on an absolute basis but not relative to large caps
International Developed	•	•	•	●	•	Positive on Japan on fscal and monetary stimulus, weaker yen and potential for improving Increasingly positive on Europe on improving growth outlook, earnings growth and recedi
Emerging Markets	•	•	•	●	•	Moderately positive given attractive valuations, improving economic activity, rising profts. reform-oriented countries and consumer spending exposures are preferred.
Global Fixed Income	•	●	•	•	•	Bonds provide portfolio diversifcation, income and stability, but low rates skew down-side to slightly short duration is warranted, balancing expectations of higher short-term rates overwhelming demand for fxed income and extremely low rates globally.
U.S. Treasuries	•	●	•	•	•	Current valuations stretched. Rate risk is more balanced, but still tilted toward the upsid small allocation for liquidity and safety is advised. Fed will continue to raise short rates a be impacted by impending fscal stimulus and balance sheet reductions.
U.S. Municipals	•	•	•	●	•	Muni valuations have softened some, but are still relatively rich to Treasurys on a historic technical environment is likely to persist in the near-term, based on heavy seasonal reder volume, and solid demand. Certain states, such as Illinois, New Jersey, and Connecticut fa due to budgets, pensions, and health care reform.
U.S. Investment Grade	•	•	•	●	•	Favorable view predicated on a gradually improving economic backdrop, modest carry rela and agencies, and continued technical tailwinds, particularly from institutional investors. A global central bank monetary policies beginning to tighten is a risk. Overweight positionin towards U.S. banks.
U.S. High Yield	•	●	•	•	•	Valuations are rich. Expect a high degree of volatility. Prefer actively-managed solutions t credit quality. Fundamentals remain soft. Allocation to foating rate, secured bank loan str
U.S. Collateralized	•	●	•	•	•	Mortgage-backed security (MBS) spreads expected to widen further, as the market antic balance sheet unwind. Carry continues to be the main theme in Commercial MBS and ass (ABS) space as spreads remain on the tighter side of the range. We are cautious on cert segments. Select opportunities exist in properly structured CMBS and ABS.
Non-U.S. Corporates	●	•	•	•	•	Yields continue to be low. Despite valuations, we see spreads grinding tighter for the nex to favorable tailwinds.
Non-U.S. Sovereigns	●	•	•	•	•	Compressed yields and risk premiums around the globe compared to the U.S., combined w higher volatility in non-U.S. markets, present unfavorable risk/reward conditions for non-U justifying an underweight position.
Emerging Market Debt	•	•	●	•	•	A more stable global backdrop and supportive monetary policies are positives, but growth c Prefer dollar denominated debt.
Alternatives*	•	•	●	•	•	Select alternatives help broaden the investment toolkit to diversify traditional stock and
Hedged Strategies	•	•	●	•	•	We see the environment for active management, and hence hedge funds, improving throu continue to recommend a diversifed approach when investing in this heterogeneous asse maintain our moderately positive view on equity long/short.
Private Equity	•	•	●	•	•	We view private equity strategies as potential portfolio return enhancers with unique acc deals unavailable to most investors. When committing capital to private equity, we favor year commitment strategy that builds portfolio diversity among diferent managers, styles importantly, vintages. Currently, we see opportunities in special situations and private cre
Real Estate	•	•	●	•	•	The U.S. real estate markets are mostly healthy with supply and demand in balance for m Notwithstanding what we consider to be full valuations and a mature real estate cycle, b demand-side fundamentals for rentable space across the major property sectors and in n generally in good shape and will likely remain that way through 2017.
Commodities	•	•	●	•	•	Medium-/long-term potential upside on stabilizing oil prices; near-term opportunities in er equities /credits.
U.S. Dollar	•	•	●	•	•	In our view, the dollar is mildly overvalued on a trade-weighted basis, but interest rate dif favorable and we think the dollar will remain broadly stable with slight upside risks agains
Cash	•	•	●	•	•	We have a small cash position awaiting deployment when opportunities arise.

* Many products that pursue Alternative Investment strategies, specifcally Private Equity and Hedge Funds, are available only to pre-qualifed clients.

Appendix

Index Definitions

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg Barclays U.S. Municipal Index covers the U.S. dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

The EURO STOXX 50 Index, Europe's leading blue-chip index for the eurozone, provides a blue-chip representation of supersector leaders in the eurozone. The index covers 50 stocks from 12 eurozone countries.

The Euro TWI is represented by the Goldman Sachs Euro Trade Weighted Index.

The MSCI Europe Index captures large and mid cap representation across 15 Developed Market (DM) countries in Europe. With 441 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European DM equity universe.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 318 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the U.S. market. With 636 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

The Nikkei 225 is comprised of 225 stocks selected from domestic common stocks in the first section of the Tokyo Stock Exchange, excluding ETFs, REITs, preferred equity contribution securities, tracking stocks (on subsidiary dividend), etc., other than common stocks.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Yen TWI is represented by the Goldman Sachs Yen Trade Weighted Index.

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Asset allocation and diversifcation do not ensure a proft or protect against loss in declining markets.

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Investments have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fuctuate in response to events specifc to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, infation and credit risks. Investments in high-yield bonds may be subject to greater market fuctuations and risk of loss of income and principal than securities in higher rated categories. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT). Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnifed for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversifcation and sector concentration. Investments in real estate securities can be subject to fuctuations in the value of the underlying properties, the efect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fuctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or fnancial factors.

No investment program is risk-free, and a systematic investing plan does not ensure a proft or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your fnancial ability to continue purchases.

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