HAVERFORD

2017 SUMMER OUTLOOK

Slow and Steady Wins the Race

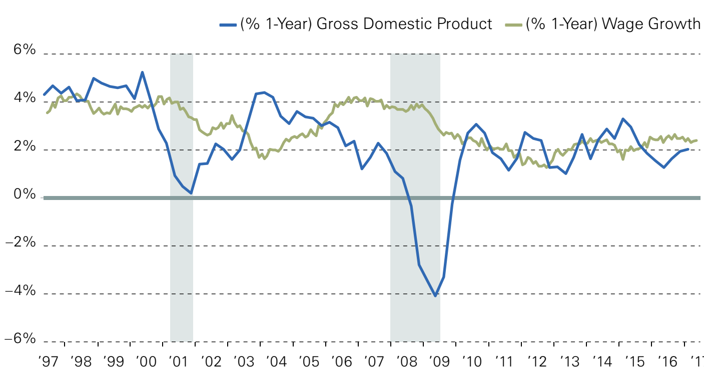
This summer the U.S. economic expansion enters its ninth year. It is now the second longest expansion post WWII, but also the weakest. Annualized gross domestic product (GDP) growth has averaged slightly under 2% over the past eight years. The expansion's below-average growth rate actually has a lot to do with its longevity. Expansions usually end because of excesses, created by too much growth. Inflation, tight labor markets, accelerating wage growth, high inventories, misallocation of capital, and credit excesses are often the seeds of the next recession. With only 2% growth, it is difficult for the economy to create any excesses.

Economic expansion now in ninth year with no sign of overheating

At the start of the new year, investors anticipated that the Trump administration and Republican Congress could enact pro-growth fiscal policies. Improving confidence surveys and other soft data drove the so-called "Trump trade." From Election Day to year-end 2016, sectors deemed as beneficiaries of Trump's policy agenda outperformed the broad averages. Financials rose almost 17%, thanks to rising interest rates and expectations of an easing of financial industry regulations. The Industrial, Materials, and Energy sectors outperformed on the prospects of significant infrastructure spending.

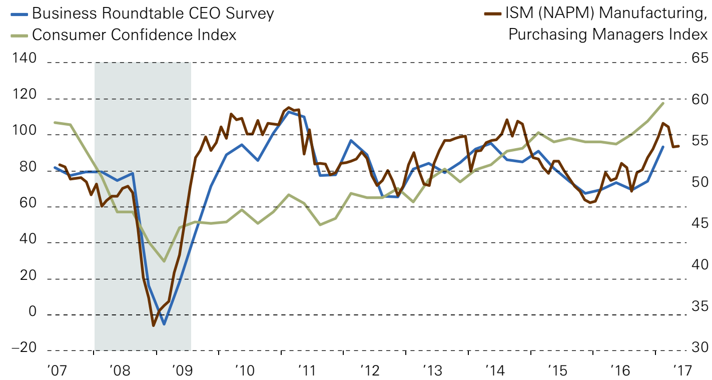
With the anticipation of faster GDP growth, investors rotated out of defensive sectors. Healthcare, Utilities, and Consumer Staples all underperformed with the latter two posting negative returns. Curiously, sectors like Consumer Discretionary and Technology, which would be the beneficiaries of faster GDP growth also underperformed the Index.. Fears of Trump's trade rhetoric, immigration policies, and the introduction of a new border-adjustment tax weighed on these two sectors.

Wage growth peaked above 4% before previous recessions



Source: FactSet Research Systems

Confidence indices and manufacturing surveys remain at healthy levels



Source: FactSet Research Systems

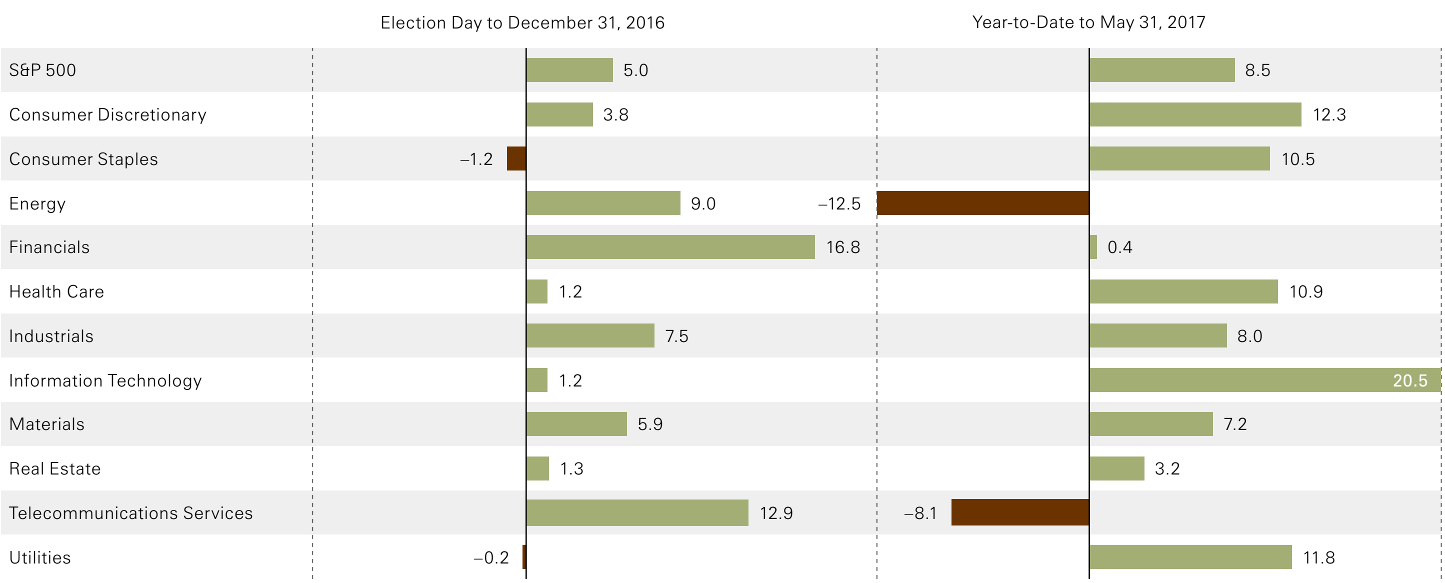
The Trump trade continued into 2017, but sector performance completely reversed. Those sectors that underperformed the S&P 500 index during the last two months of 2016 have outperformed through May 2017 and vice-versa. The sharp sell-off in bonds reversed as well. After the election, the 10-year Treasury yield "soared" to 2.65%. By mid-June, the 10-year yield had fallen to 2.11%. Investors have become increasingly doubtful that they will see any meaningful pro-growth policies enacted in 2017. Without fiscal stimulus, it is unlikely the economy can grow faster than 2% due to two powerful trends: changing demographics and the persistent weakness in productivity growth over the past ten plus years.

Even with just 2% growth, the Federal Reserve is confident enough to have increased the fed funds rate twice already this year. And why not? Employment trends still look reasonable despite being near or at full employment. Wages continue to grow at a moderate pace. Recent monthly job gains have softened somewhat, but weekly jobless claims (a leading indicator of employment) remain at a 40-year low. Yet inflation remains stable, below the 2% Fed target. Consumer spending is relatively strong, although consumers continue to prefer spending on experiences as opposed to material goods. Consumer and business confidence remains elevated. Manufacturing and service sector Purchasing Managers' Index (PMI) surveys are healthy. The housing market continues in a modest uptrend. Taken together, this economic backdrop should give the Fed confidence to move from extraordinary accommodation towards a neutral policy.

The S&P 500 may be up 14% since the election, but it is not the new administration that is driving performance. (The market has brushed off political setbacks and a lack of consensus on the major issues—even within the GOP—which have pushed much of the Trump agenda into 2018.) Rather, the market is reacting to a resurgence in corporate profit growth. S&P 500 profits grew 14% in the first quarter—the strongest quarterly growth in more than five years. Earnings were helped by a pickup in global GDP, a rebound in energy prices from a year ago, and a softer U.S. dollar that helped multi-nationals' profits. Of course, 14% growth is an unsustainable pace. In fact, the consensus for 2017 S&P 500 earnings growth is only 10%. This implies a slower pace of growth for the remainder of the year, but at a rate still well above the pace of the past three years. Ten percent earnings growth combined with low inflation and interest rates should support the market's current valuation of 18X 2017 earnings.

We remain confident in our view that an imminent recession is just as plausible as +3% GDP growth; both are very low-probability events. This is important for the bull market, which most likely will end in anticipation of a recession. This outlook continues to support the case for a broadly diversified

S&P 500 Sector Performance

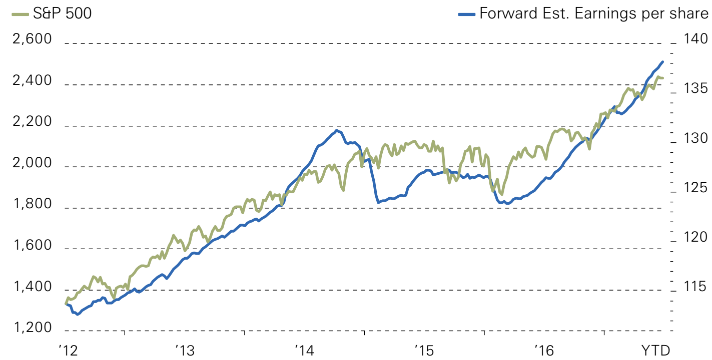


Source: FactSet Research Systems

portfolio, one that balances offensive (cyclical) and defensive sectors. Most of our defensive exposure is in the Consumer Staple and Healthcare sectors. When the eventual downturn comes, earnings from these two sectors should hold up relatively well, hence their defensive nature. Our cyclical exposure comes from holdings in the Consumer Discretionary, Industrial, Materials, Financials, and Technology sectors. If we start to see the significant risk of a recession increasing, we would shift to more defensive allocations.

Overseas, positive economic data indicates an increasingly healthy global economy. In Japan, exports have surged, benefitting from the weaker yen, as well as an increase in Asian demand. Unemployment fell to 2.8%, the lowest in more than 20 years, helping to support domestic consumption. In Europe, a string of contentious elections has passed, with the populist anti-EU parties failing to make much headway. With political risks easing, investors have begun to take notice of the surprising strength in the European economy. Eurozone manufacturing PMIs rose to a six-year high, boosted by strong demand for exports, while factories are increasing headcount at the fastest pace in 20 years.

The market's strong performance post U.S. election has been accompanied by rising earnings expectations.



Source: FactSet Research Systems

Consumer and business confidence has also surged to multi-year highs. With corporate earnings growth starting to accelerate, European equity markets have posted strong gains after a long period of relative underperformance. Improving prospects across Europe and Japan bodes well for U.S. equities too, given the market's large exposure to multi-national companies.

Fixed Income

The Federal Reserve has announced the framework for reducing its balance sheet, which has grown to more than $4 trillion due to "Quantitative Easing" asset purchases over the past several years. That unwinding will begin slowly and likely take as much time as the purchases. We believe that the bond market can absorb the reduction in the Fed's balance sheet without undue disruption. As of June 16, 2017, the benchmark 10-year U.S. Treasury note is trading at a yield of 2.15% while the 30-year trades at 2.78%. Both bonds are yielding close to the lowest levels since the U.S. election. Clearly, the bond market believes that the Fed can reduce its balance sheet slowly enough to avoid roiling the market.

Municipal Bonds

In our annual *2017 Outlook*, we projected that the municipal bond market would recover from what we believed was an over-reaction following the U.S. election. After six consecutive months of strong performance, tax-exempt municipal bonds have fully recovered from their post-election sell-off. Fears concerning changes to tax-exemption of municipal bonds have certainly abated. Investor expectations have swung to the opposite extreme, now questioning if there will be any tax changes for individuals in 2017.

Another factor contributing to the performance of municipal bonds has been a reduction in supply. Total new issue supply through May has been 8.5% below the amount for the comparable period in 2016. However, the supply story varies tremendously by state, as is often the case in the municipal market. Locally, Pennsylvania issuance is up 28%, while Florida, typically a large issuer, leads those with reduced supply with a drop of 60% from 2016's issuance. Modestly higher interest rates, which have reduced issuers' ability to refinance existing debt, is the primary reason for the reduction in supply. The sharp differences in supply have resulted in a wider than usual dispersion of relative bond performance between various states. We recommend that investors consider their state's tax rate and available supply when evaluating shorter-term performance.

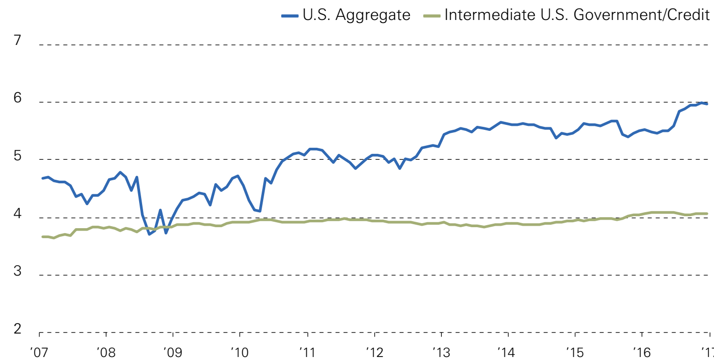
We continue to favor tax-exempt municipal bonds for tax-paying U.S. investors, but the relative rebound has reduced the margin of error for surprises.

Taxable Bonds

Investors are concerned about risks to bond portfolios as the Fed raises rates for the third time in the past six months. Bond investors may be more vulnerable to future rate hikes due to the higher duration of the broad market. We believe Haverford portfolios will not exhibit this vulnerability due to our focus on intermediate maturity bonds.

In recent years, the duration of bonds (i.e., the Bloomberg Barclays U.S. Aggregate Bond Index) has increased significantly, while the Intermediate index's duration is almost unchanged. As a result, the broad bond market is now much more sensitive to changes in interest rates than in previous cycles. There are three primary reasons for this shift. Consumers have refinanced their mortgage debt just as aggressively as other borrowers have. The effect of replacing higher coupon mortgages with lower coupons has reduced the risk of early repayment and has lengthened the duration of mortgage-backed securities from 2.9 as of year-end 2011 to 4.5 at the end of May 2017. Mortgage-backed securities carry the potential to extend duration in rising interest rate environments. We are underweight mortgage-backed securities to avoid this additional risk.

The duration of the Intermediate Index has not increased with the broader market



Source: Bloomberg Barclays Indices

All data as of June 16, 2017, unless otherwise noted.

With the right people, the right solutions, and the right client experience, let us show you the difference Haverford *Quality Investing®* can make. Please contact your Haverford Relationship Manager or, if you have yet to meet with us, call our offices to arrange a time that is right for you. Either way, we're looking forward to getting to know you.

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