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2016 SPRING OUTLOOK

The Fundamental Backdrop for the Equity Market Remains Positive

Happy anniversary, bull market! On March 9th the bull market in stocks reached its seven-year anniversary. But has it been happy? No. This has been one of the most hated bull markets throughout its seven-year advance. The Wall Street adage "bull markets climb a wall of worry" certainly applies to this bull run. Fear has fueled the bull market. Some of those fears included another banking crisis, housing market collapse, massive municipal bond defaults, U.S. government shutdowns, fiscal cliffs, and a breakup of the Eurozone. Today's fears center on a hard landing in China, zero interest rate policies, European bank stresses, and the negative implications — deflation/global recession — of the collapse in oil prices.

From a sentiment standpoint, bull markets usually end with euphoria. Just think back ten years ago to the housing bubble and before that the dot-com craze as examples of too much exuberance and greed. Investors rushed en masse to buy assets they thought could only go up in price. It did not end well. What are investors doing today? The same thing they have done throughout this seven-year bull market. They have been net sellers of equity funds. From the start of the bull market, domestic equity funds have seen net outflows of over $600 billion, whereas nearly $1 trillion net has flowed into fixed income funds. This January alone saw more than $15 billion withdrawn from stock funds! These tangible actions are not a reflection of greed or euphoria but rather fear and anxiety.

The valuation of the S&P 500 at 17x next year's earnings is neither cheap nor expensive, particularly given the low interest and inflation rate environment. The fundamental driver of stock price appreciation — earnings growth — has been stymied by the decline in energy prices and the rise of the dollar. The earnings contribution to the overall market derived from energy and energy-related services grew well

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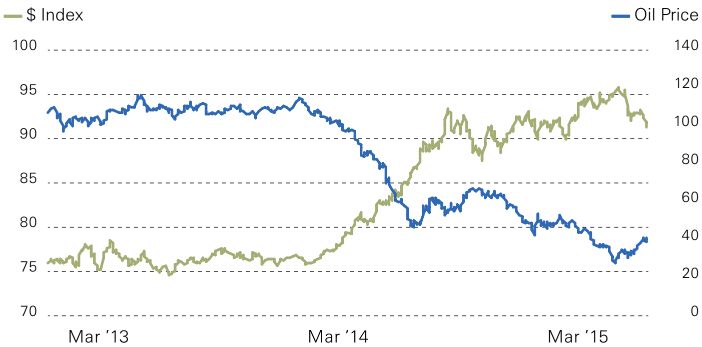
Declining Oil and Strengthening Dollar Combine to Create a Major Headwind to Earnings Growth



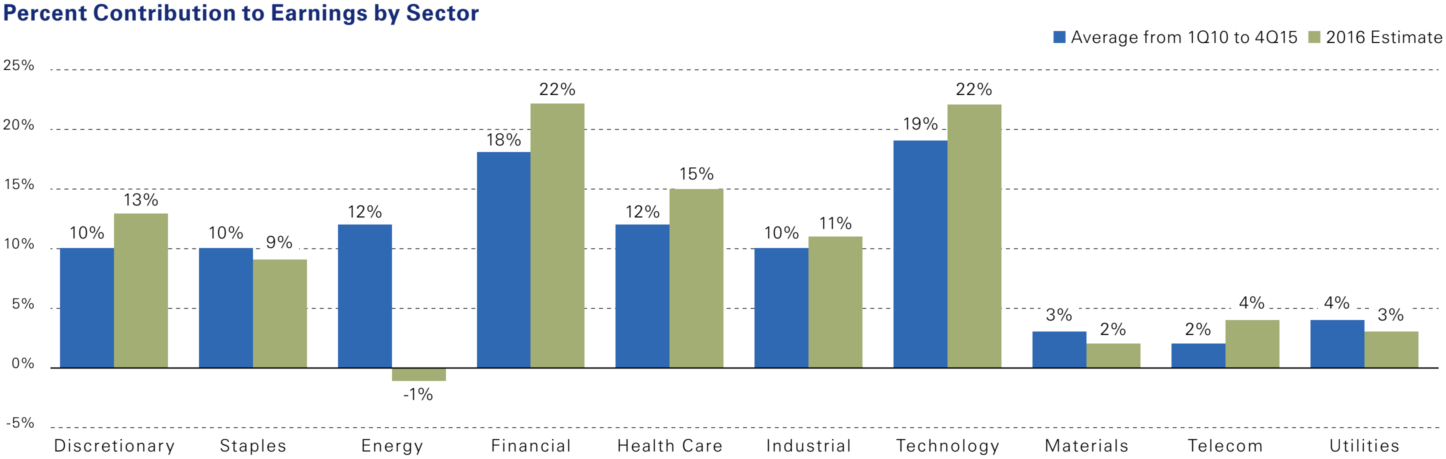
Source: Strategas Research Partners

in excess of 10% of total earnings in 2013 before falling to virtually zero by year-end 2015. In addition, over that same time period the trade-weighted dollar index appreciated by 27%. In aggregate, the S&P 500 derives approximately 40% of its revenues overseas. Those revenues have faced a tremendous headwind of being marked down by foreign currency devaluation. It is no wonder that top-line revenue growth has been so difficult to achieve for multinational corporations.

Looking ahead, we expect companies to show stronger earnings growth because of easier comparisons. Oil may have bottomed in early February at $26 a barrel, and the dollar has stabilized over the past several quarters. Earnings growth that was negative for most of 2015, and most likely the 1st quarter of 2016, should again turn positive as these two headwinds dissipate. If you strip out the energy sector, S&P 500 earnings growth during 2015 was in the mid-single-digit range. We believe it will grow at that rate again in 2016.

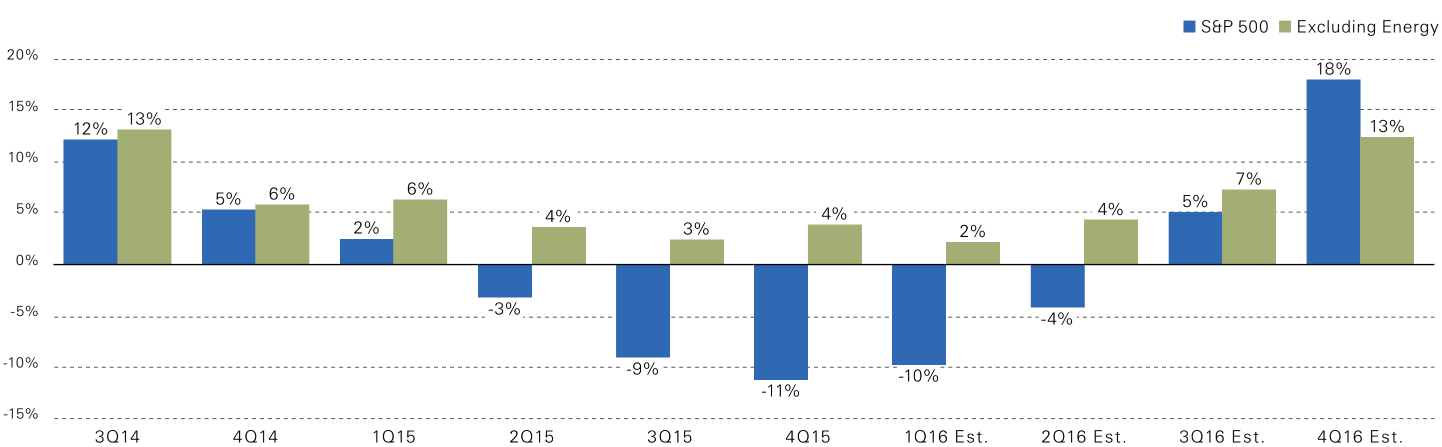
At 84 months, this bull market run is the third longest in history. If it continues through June it will move into second place, exceeded only by the 1990's rally. Despite headlines to the contrary, age does not kill bull markets. Recessions or the anticipation of a recession end bull markets. That was the fear at the start of 2016, after a soft 4th quarter that saw

Percent Contribution to Earnings by Sector



Source: Strategas Research Partners

EPS Growth: S&P 500 vs. S&P 500 Excluding Energy



Source: Strategas Research Partners

GDP grow 1%. The stock market's swift 12.5% correction into early February was forecasting an imminent recession. Fortunately the economic data does not support that narrative, and from the February lows the market has recouped most of its losses.

Excluding the energy sector and businesses that feed into it, the rest of the U.S. economy is in reasonably good shape. Employment is strong, wages are growing, and the consumer is in excellent shape. Household net worth is at record levels, up about 25% from the previous peak. Household debt service is at a record low. The housing sector is strong. Nationally, home prices have regained most of their losses from the 2008 crisis. Auto sales are at near records. Retail sales are about 10% above the previous recovery peak. Interest rates, inflation, and gas prices remain low. Consumer confidence is strong. This picture does not paint an economy that is in imminent risk of going into a recession.

The start of the year sell-off wasn't just about recession fears. After December's rate hike, Federal Reserve Vice Chairman Stanley Fisher expressed with confidence that the Fed would increase rates four times in 2016. This did not jibe with market expectations. After March's FMOC meeting, four rate hikes are now off the table. The Fed made it clear that it is going take a very gradual approach to raising interest rates. This increases the likelihood of only one or two more hikes this year, which is much more in-line with market expectations. Chairwoman Yellen also dismissed negative interest rates as a policy tool (NIRP) for the U.S. economy. The possibility of NIRP in the U.S. was creating much anxiety for several reasons: how would it work? Is it legal? Would it be at all effective? It is not clear if negative rates in Japan and much of Europe are working to stimulate their economies. In fact, there are worries that it might be counterproductive and markets do not like uncertainty and surprises. The Fed's recent statement helped remove these two concerns.

Yields around the World Continue to be Exceptionally Low

Based upon data from J.P. Morgan's Global Bond Indices, there were $6.6 trillion bonds valued at negative yields as of March 3, 2016. We continue to believe that low yields around the globe will moderate the pace of interest rate increases by the Federal Reserve.

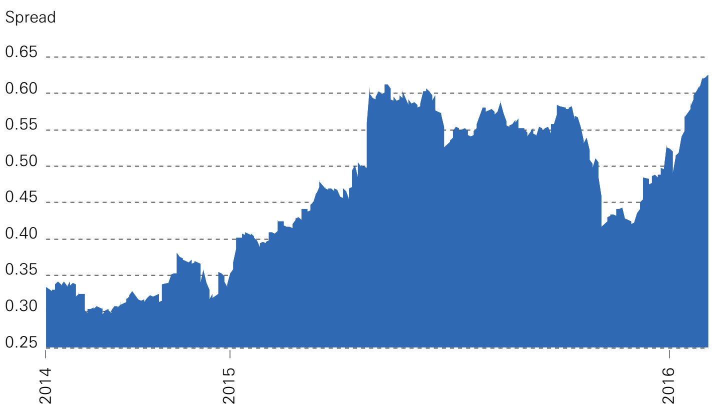
The pattern of moves in U.S. Treasury yields so far in 2016 has been eerily similar to the early months of 2015 despite the lack of horrible winter weather to blame. Concerns about the economy due to the weather and other factors resulted in a sharp drop in yields in January 2015. The 10-year Treasury yield dropped from 2.17% to 1.64%. By early March, yields had rebounded to year-end levels. This year, concerns about the global economy and commodity prices resulted in yields falling from year-end until February 11th, causing a drop in the 10-year yield from 2.27% to 1.66%. To date, yields have recovered approximately half of that decline. The pattern seems very familiar, with slight variations in timing and magnitude. The pattern of worry about the economy also echoes worries that have affected the equity markets during their seven-year bull market.

The Federal budget for the 2017 fiscal year contained interesting information regarding FNMA and FHLMC, the Government Sponsored Enterprises (GSEs) which the government placed into conservatorship in September 2008. The Treasury injected $187.5 billion into GSEs as part of the rescue and has since withdrawn $241.3 billion. The budget's long-term projections are for the Treasury to withdraw an additional $151 billion over the next decade. The continued withdrawal of profits from the GSEs does not permit them to rebuild sufficient capital to return to the private sector. If they remain metaphorical wards of the state for the entire period, it will have been eighteen years since the takeover. The lack of any resolution for such an extended period of time creates further uncertainty.

Despite the lack of an end game for the conservatorship, the bond market continues to price GSE debt with very minimal returns compared to benchmark U.S. Treasury yields. The intermediate maturity Agency component of Barclays indices yields only 2 basis points (0.02%) more than the intermediate U.S. Treasury component. This compares to a 67 basis points yield advantage as of December 31, 2007, before the financial crisis. We have found insured certificates of deposit to be reasonable alternatives for GSE debt in the current market. Investors can receive 20-30 basis points additional yield from CDs relative to GSE debt while maintaining the quality of FDIC insurance. At these valuations, clients can expect GSE bonds to mature and not be reinvested in the sector while CDs will be included in appropriate portfolios.

At this writing, the Commonwealth of Pennsylvania finally has a budget for the fiscal year ending June 30, 2016. To illustrate the impact a lack of budget has had, the accompany-ing graph depicts the pressure placed on Pennsylvania general

10-Year Pennsylvania GO Spread vs. Benchmark Yields



Source: Bloomberg

obligation bond yields relative to benchmark municipal bond yields. The points at which the budget impasse pushed yields higher are clearly visible. We would expect some relief now that there is a budget.

Despite the budget problems of the Commonwealth, individual credits continued to thrive. As an example, on February 26, 2016 Penn State University was upgraded by Moody's to Aa1, only one notch below the highest rating. Moody's commentary included bondholder support from Penn State's "exceptional liquidity enabling it to ably bridge the lack of Commonwealth of Pennsylvania appropriations due to the failure to enact its FY 2016 budget."

Illinois is the other state that has yet to pass a 2016 budget. Moody's was not so kind to its university system. The University of Illinois rating now has a negative outlook. Various others were hit much harder. Northern Illinois University and Northeastern Illinois University saw their ratings lowered to Baa2 and Baa3 respectively, just above speculative or "junk bond" status. Eastern Illinois University was downgraded below investment grade to Ba3.

The disparate credit impact from the lack of a budget on two states' university systems serves as a clear reminder of why we place so much importance on bondholder protections in the municipal bond market. Those credits with strong protections for bondholders and a substantial margin of safety are those whose bonds best meet our objective of protecting clients' assets even in volatile times.

One Final Note…

We feel obligated to make some comments on the presidential elections given the media space it occupies. We would stress that all of the rhetoric that is being bandied about is just that, talk. And talk is cheap! We are concerned, though, with the growing sentiment in both parties toward protectionism. Free trade is good for both the U.S. and global economy. Inhibiting free trade, as we saw in the 1930s, is not good for economic growth. The great depression was caused in large part by significant policy mistakes: allowing banks to fail, severe trade protection, and raising interest rates too soon. Let's hope today's politicians don't repeat those errors.

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