HAVERFORD

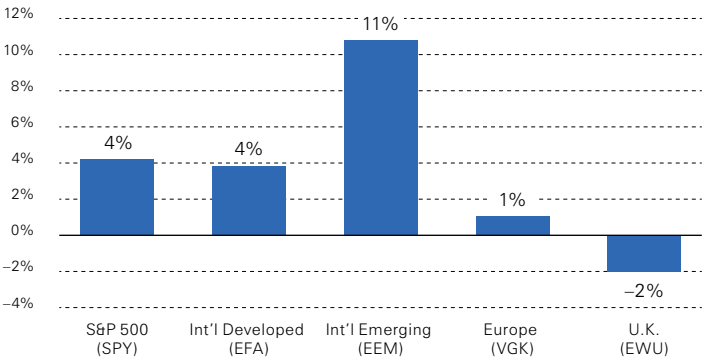
2016 FALL OUTLOOK

Investments in securities are not FDIC insured ▪ Not bank guaranteed ▪ May lose value

No Recession in Sight

Autumn is a beautiful season, and with it comes stunning changes to our corner of the country. The onset of fall brings a renewed focus on the markets, the economic outlook, politics, and, of course, your favorite football team. The season also comes with a pick-up in volatility and tends to be a tumultuous time for investors; over the past 100 years, September is the only month of the year during which the markets have a negative average return. Looking back on the summer, financial markets have exhibited remarkably low volatility—even by summer standards—following the June 23 UK vote on EU membership (Brexit). Not only has the S&P 500 climbed higher following Brexit, but virtually every global equity market, led by emerging markets, saw positive returns this summer. Why, in the face of such unprecedented economic uncertainty in the sixth largest world economy and the hub of European banking, have markets reacted so benignly? Dire predictions for Britain and Europe have not materialized, U.S. economic data has improved relative to the first half of the year, and the outlook for corporate profits is improving.

Performance by Region Since Day Before Brexit Vote (6/22/16)



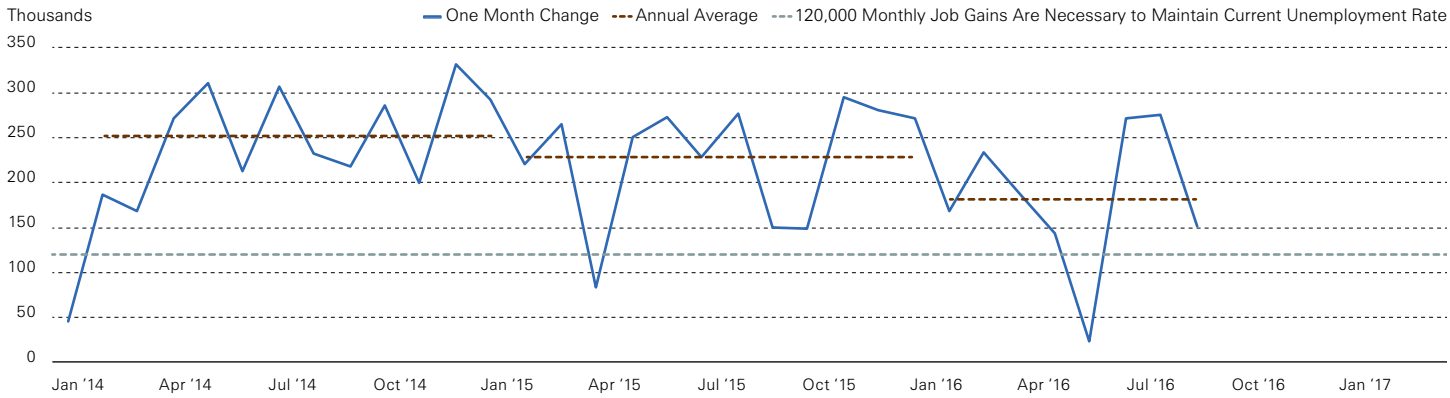
Source: FactSet Research Systems

Several easily identifiable market catalysts loom on the horizon: a Fed rate hike, the elections, negotiations between the UK and European Union, and the anticipation of stronger corporate profits in the second half of the year. Any one of these events could send jitters through the market. During the 8th year of a bull market we would very much expect the market to look for reasons to correct and retrench. If history is a guide, the stock market corrects (falls by 10%) on average once per year and it lasts less than six months. Corrections turn into bear markets (20% declines) as economies fall into recession. We view the probability of a recession within the next 12 months as very low; the employment numbers are too strong.

Market Movers: Brexit + Jobs + Profits

The economic catastrophe predicted in the aftermath of the Brexit vote has failed to materialize. Recent UK economic data has been better than expected, which seems to suggest that the British economy may skirt the recession that so many had predicted. Next year, the United Kingdom should begin negotiations on its withdrawal from the EU in a legal process known as Article 50. We expect that the city of London will retain the financial "passporting" rights it currently enjoys, while the British government will be able to exert more control over its borders and the flow of workers and immigrants. Meanwhile, the immediate adjustment to the pound sterling, down nearly 15% in the days following the vote, demonstrates one of the key benefits of an independent currency not tied to the eurozone. The depreciation is already boosting British manufacturing and exports, which will help to offset weaker personal consumption in the British Isles. Our optimism that the worst will not come to pass does not preclude us from believing that there will be immense implications to Brexit; we just view the issue as more chronic and less acute.

Monthly Change in U.S. Employment



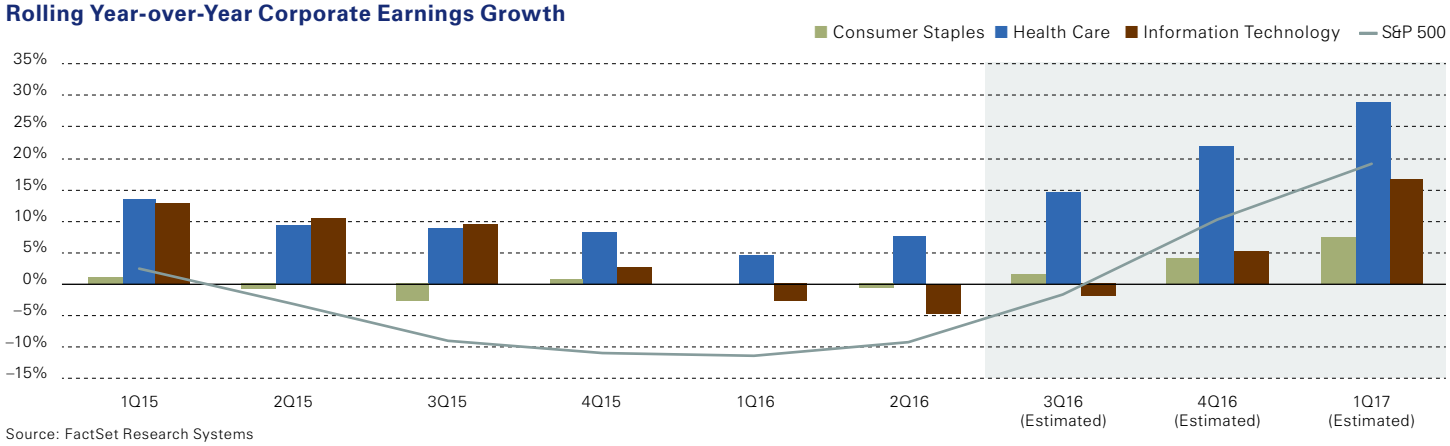
Source: FactSet Research Systems

Despite an exceptionally slow first half in the U.S., the stream of economic data continues to augur well for a stronger second half and a continuation of the economic expansion through 2017. Domestically, the most important drivers of economic prosperity are job and wage growth. Monthly job growth has moderated this year to just about 180,000 on average. Not bad in the eighth year of an expansion, when it takes monthly average job gains of only 120,000 to maintain unemployment at current levels[1]. More importantly, weekly initial jobless claims (a leading indicator of labor) are trending at a 46-year low. Wage growth this year continues to gradually accelerate with minimal impact on profit margins and inflation. The consumer is healthy and spending. Retail sales continue to grow, and consumer confidence is evident in the purchase of big ticket items such as homes, furnishings, and automobiles. One constant weakness throughout this expansion has been business spending. Corporations are reluctant to spend on plants and equipment, preferring instead to buy-back stock and increase dividends. While this has been good for stock prices in the short run, it does not help the economy in the long run. Improved business confidence is definitely an issue on which our next president and Congress can improve. Optimistically, business investment is a potential economic growth lever for the next phase of the economy.

With the price of oil and the value of the U.S. dollar having stabilized, they are no longer a source of constant consternation for business leaders. According to several recent business surveys, capital expenditures, which have slumped substantially during the past year due in part to plunging energy prices, have begun to show signs of a recovery. Corporate research & development spending is also rising. These factors should improve aggregate earnings for corporate America in the coming quarters. Not only will the Energy sector see a boost, but so too

1 Atlanta Fed Jobs Calculator

Rolling Year-over-Year Corporate Earnings Growth



Source: FactSet Research Systems

will the many areas of the economy that sell goods and services into the Energy sector. Additionally, with more than 40% of the revenues of multi-national companies generated overseas, a more stable currency environment should help corporate profitability. Analysts expect these trends to drive modest earnings rebounds in sectors such as Consumer Staples, Health Care, and Information Technology.

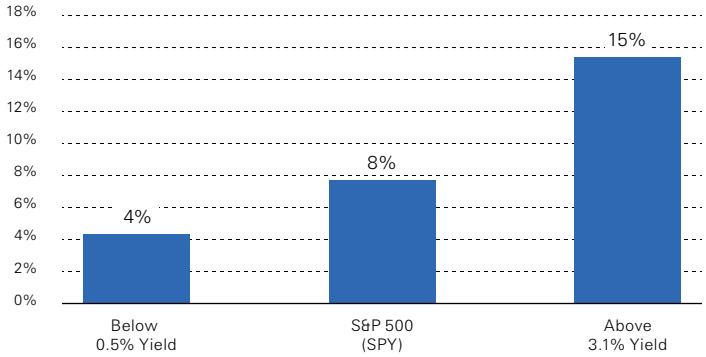
We believe a resumption in corporate profit growth is necessary if the market is to hold its recent gains. It has been six quarters since S&P 500 profits have shown a year-over-year increase. The only other time in modern history when profit growth stalled for this long without an accompanying recession was 1985. Coincidentally, 1985 also saw drastic declines in the price of oil. Larry Fink, the CEO of BlackRock, made headlines earlier this summer on his bearish call for stocks. He didn't think there was "enough evidence to justify these levels in the equity market at this moment." He is probably correct—current levels of corporate growth do not justify a rising market—but the market is an anticipatory animal, and it is currently anticipating a return to growth in the coming quarters.

Shrugging Off Rate Rhetoric

The markets have also come to grips with the prospects of rising U.S. interest rates. We believe the trajectory of rising rates will be extremely shallow and in no way severe enough to derail either the economy or the markets. While various members of the Federal Reserve have waffled on the pace and timing of rate hikes, they have been consistent regarding the factors necessary to raise rates. Labor markets continue to tighten, with the U.S. unemployment rate now at just 4.9% and wage growth accelerating. On the other hand, inflation remains subdued, below the Fed's 2% target, and global events continue to surprise central bankers with new complications. Members of the Federal Open Market Committee (FOMC) feel obliged to opine monthly on the latest data—whether it be May's utterly disappointing jobs number or June's blowout—but we believe Fed Chair Janet Yellen remains focused on the big picture. Rates will remain lower for longer, the normalization of rates will occur at a very conservative pace, and the normal level of interest rates is lower today than it was 10 years ago. Our diligent compliance team often asks us to quantify "lower for longer." It is not an easily quantifiable statement. Instead, we would offer that, based on previous expansions, this current economic environment will see lower rates and more gradual hikes.

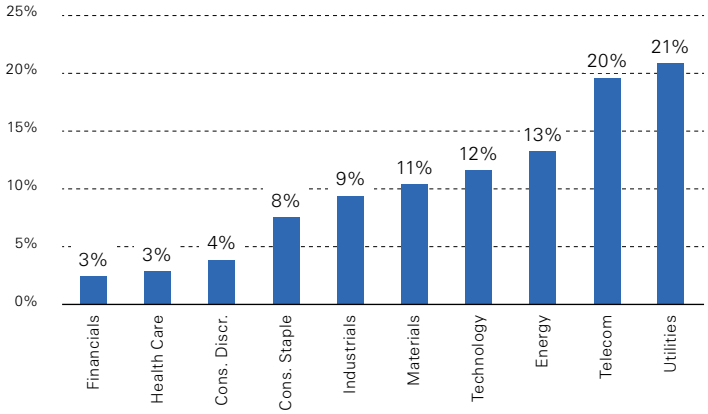
Low interest rates and a lack of income-producing alternatives have certainly helped to fuel financial assets, particularly equities with attractive dividend yields. Year-to-date, high-yielding stocks have outperformed the S&P 500 by almost 8%

2016 Year-to-Date Performance by Yield



Source: FactSet Research Systems

2016 Year-to-Date Performance by Sector



Source: FactSet Research Systems

and have outperformed low-yielding stocks by more than 12%. Dividend growth has taken a backseat to absolute dividend payments. REITs, Utilities, Telecom, and Staples with strong yields have generated returns double that of the broader market, and valuations on these sectors have expanded accordingly. Some of the most expensive areas of the market are least likely to provide strong future dividend growth, are highly leveraged, or are already paying out substantial portions of their earnings in dividends. We believe investors have become too complacent as they assess the risk of these investments, owning securities just for the yield they provide. These companies often come with less recognizable risks, and is perhaps the reason they are generating high yields in the first place.

In this environment, our approach to portfolio construction has been to take profits in those stocks that have outperformed due to their high yields and have reached stretched valuations. We have rotated these profits into securities we believe have better total return prospects through a combination of dividends and growth, with a kicker from multiple expansion as investor sentiment improves. Gilead, Apple, and Wells Fargo are three examples of stocks that fit this description.

The current low interest rate environment has not benefited all sectors of the economy. In fact, persistently low rates could eventually hamper economic activity, as a less vibrant financial industry may not be willing or able to allocate capital to achieve desired profits. Like most indulgences, too much of a good thing can turn bad. The Bank of Japan and European Central Bank can attest to the unintended consequence of extremely low (negative) interest rates. Following a brief flirtation with negative rates early in 2016, the Fed and, more importantly, the markets believe that a negative interest rate policy in the United States is unlikely. With interest rates likely to increase, we anticipate that banks' margins will improve, which will benefit us as long-term investors in both J.P. Morgan and Wells Fargo. A 100 basis point parallel move in the yield curve could result in increased profits of 3–9% for each of the two banks.

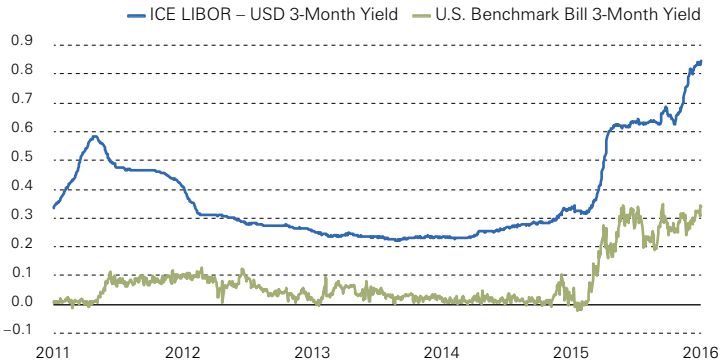
Money Market Reform Creates Complications

Unsurprisingly to the politically astute, there are still many provisions of the seminal Dodd-Frank legislation that have yet to be enacted. On October 14, 2016, Money Market Fund (MMF) Reform will go live. The primary change that impacts investors is that certain classes of MMFs will have Net Asset Values (NAV) that float rather than remain stable at $1.00 per share. The regulators will no longer allow "institutional" funds invested in corporate-backed securities (i.e., non-government securities) to retain a stable net asset value of $1.00. Essentially, MMFs desiring to maintain a stable NAV are being forced to invest in Treasuries, while those willing to let the price of their fund float out to 1/100 of a penny will be allowed to invest in higher-yielding corporate securities. Not surprisingly, in anticipation of this change, investors have moved as much as $300 billion from Prime MMFs that will be subject to floating NAVs into stable NAV funds that are invested primarily in U.S. Government Securities.

The move in MMFs is one of the primary contributors to the very atypical moves recently witnessed in the London Interbank Offered Rate (LIBOR)[2]. In sharp contrast to Treasury Bills, LIBOR has noticeably defied "lower for longer" with increased volatility. This divergence would often be viewed as a warning signal of financial stress, but we believe that several technical factors, including MMF reform, are the primary causes of the move. And, of course, the uncertainty regarding Brexit put additional pressure on LIBOR. There are numerous overlapping and contradictory banking rules and regulations within the EU that will need to be reconciled as part of the negotiations between Britain and the European Union.

We believe investors can benefit from LIBOR's dislocation. We have taken advantage of the rise in LIBOR by increasing our exposure to floating rate notes benchmarked to LIBOR. In many cases, the yield is actually higher than available in fixed-rate bonds with the same maturity. The floating rate can also continue to rise, creating a benefit if the Federal Reserve chooses to increase rates. Additionally, we have elected to ensure that our clients' MMF assets are in stable NAV funds as these new regulations take effect. We believe that a stable NAV is most consistent with Haverford's emphasis on preservation of capital. We do not see any rationale in choosing the floating NAV funds until we can see both the risks (actual degree of fluctuation in NAV) and rewards (extra yield) for doing so.

Rising LIBOR / Rates



Source: FactSet Research Systems

Update on Pennsylvania

Municipal bond investors are relieved that the Commonwealth of Pennsylvania enacted a budget for its June 2017 fiscal year well ahead of last year's pace. One of the ongoing issues with the budget process has been funding for Pennsylvania's school districts. One factor overlooked in all of the rhetoric regarding school funding has been the reserves that school districts have accumulated. State Department of Education data shows total reserves of approximately $4.6 billion. That is a sharp increase from $1.7 billion a decade ago. The lingering impact of the 2008–2009 financial crisis has clearly motivated the districts to have increased capacity to handle volatile economic cycles. Not surprisingly, there is a great deal of disparity in the

2 LIBOR is the average of interest rates estimated by each of the leading banks in London that it would be charged were it to borrow from other banks.

amount of reserves. The Pennsylvania School Boards Association (PSBA) reports that 16 districts have negative balances and 24 have thin reserves less than 5% of annual expenses. At the other end of spectrum, 320 districts have more than 15% reserves. Note that the PSBA's suggested policy is to have reserves between 5–10%. As our team evaluates the creditworthiness of the districts, we analyze the general credit quality, the strength of bondholder protections, and the adequacy of reserves. For the healthy majority of districts, the Commonwealth's funding mechanism affords strong protections for bondholders, and reserves offer additional capacity to meet obligations, including both bonds and pensions. For those with thinner margins of protection, the current market does not offer sufficient yield to compensate for the additional risks.

Not the Most Important Election of Our Lifetime

Once every four years, investors have to grapple with the presidential election. Electing a president takes on a grand aura of importance. Every four years, one hears this refrain: "This is the most important election of our lifetime." We are fortunate that our Founding Fathers created a brilliant system of checks and balances to mitigate the impact of poor election decisions (presidential or congressional). We could recite plenty of historical trends: Wins by an opposing party are usually followed by market declines; markets tend to advance during the months of August, September, and October in years when the incumbent party wins; markets tend to perform better in the 12 months following a Democratic win, etc. Historical data is fun to look at, but it's not the political party but the policies that will have the greatest effect on the market.

Policies against free trade and sensible immigration combined with the public's shift toward protectionism and isolationism is worrisome. Free trade becomes a very difficult policy to defend during a period of sub-par economic growth. The benefits of global markets are diffuse, bringing small and incremental benefits to entire populations, but the negative effects are often acutely felt by a small minority. The point we would like to conclude with is, regardless of the election outcome, the new president, with Congress, has the opportunity to pull several fiscal levers (i.e., tax reform, regulatory reform, increased spending) to help accelerate GDP growth and take some of the burden off monetary policy.

In Conclusion

As we head into the autumn season, many things will begin to change. Fall colors will emerge, the nights will turn chilly, and pumpkin-flavored everything will appear on the shelves. We may have a slightly higher Fed Funds rate and the country will elect a new president—events which could lead to elevated volatility for the equity markets. However, beyond the volatility, we expect a slightly stronger economy as compared to the first half of this year. Monetary policy is likely to remain accommodative well into 2017 and perhaps even longer. We can expect consumer spending to be resilient, on the back of a strong labor market and modest rises in wages. Corporate profits look set to rebound in the second half, albeit moderately. Tentative signs of improving business confidence could drive the beginning of an investment cycle, helped along by a renewed focus on fiscal policy after the election. Despite some of the challenges faced this autumn, current economic conditions, with no signs of recession in sight, should be supportive of equity markets.

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* Including assets under management or consultation for The Haverford Trust Company as of 8/31/16.

All performance data as of September 23, 2016, unless otherwise noted.

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