HighMark® CAPITAL MANAGEMENT

Economic and Market Perspectives

2Q 2017

Introduction

Political news (and occasional tweets) dominated global financial markets again in the first quarter with the inauguration of a new president followed by a frenzied pace of new policies and legislative activity. President Trump inherits a stable, albeit slow-growing, economy that continues to show improvement on many fronts. With the Republican Party controlling both houses of Congress, the political gridlock of the past six years is expected to abate.

To that end, anticipation of stimulative fiscal policies that may include tax reform and infrastructure spending has many consumer and business sentiment gauges running hot despite the Federal Reserve's signals that the days of record low short-term rates are over. Meanwhile, elevated future economic growth and corporate earnings expectations built on the promise of fiscal stimulus have been priced into domestic stock valuations, creating high stakes for legislative success.

Globally, economic data has been dominated by upside surprises and equity markets have continued to advance following a strong fourth quarter, while domestic bonds regained some lost ground as longer-term interest rates fell modestly. Historically low realized and forecast stock market volatility further underscores resilience in the face of growing uncertainty related to U.S. fiscal policy. Underlying the broad market moves, however, signs of a fading "Trump trade" have begun to emerge. Cyclical stocks, which performed well in the fourth quarter of 2016, trailed defensive and growth names in the first quarter—a clear sign of waning confidence that the new administration's agenda will come to full fruition. The U.S. dollar, viewed as a proxy for Trump policies, gave up ground against a basket of foreign currencies.

First Quarter Economic and Market Highlights

U.S. Growth: The domestic economy grew 2.1%[1] in the fourth quarter of 2016, bringing the full year growth rate to 1.6%[1]. Growth was held back by increased imports, decreased inventories and weak capital expenditures by businesses.

Inflation: Buoyed by a strong recovery in energy prices, year-over-year Headline CPI reached 2.7%[2] in February—its highest level since March 2012. Excluding food and energy (Core CPI), prices rose 2.2%[2].

Auto Sales: Despite aggressive incentives, auto sales have been declining from a peak of 18.5 million annualized sales in December 2016 to an annual rate of 16.6 million in March[3]. Rising interest rates and falling used car prices have been a growing headwind for the industry.

Housing: Higher interest rates have yet to impact the momentum of the housing market, as home sales and prices moved higher during the quarter. The National Association of Realtors Home Sales Index rose 5.5% in February. Meanwhile, home price growth as measured by the S&P/Case-Shiller U.S. National Home Price Index hit a 31-month high in January of 5.9% on a year-over-year basis.

Consumer: Sentiment among consumers remains strong according to the University of Michigan Sentiment Index, which hit 96.9 in March. Not surprisingly, survey data indicated that political party affiliation had a major impact on future expectations for finances.

Corporate Earnings: S&P 500 earnings grew 5.1% in Q4 2016 and are expected to grow by 9.1% in Q1 2017, according to Factset. For the full year 2016, S&P earnings grew just 0.5%, weighed down by weakness in the energy sector. A rebound in energy prices is expected to benefit earnings growth throughout 2017.

Market performance

	% Total Return				
As of 3/31/2017	Q1 2017	1-Year	3-Year	5-Year	10-Year
S&P 500 Index	6.1	17.2	10.4	13.3	7.5
MSCI EAFE Index (Net)	7.3	11.7	0.5	5.8	1.1
MSCI Emerging Markets Index (Net)	11.5	17.2	1.2	0.8	2.7
Barclays US Aggregate Bond Index	0.8	0.4	2.7	2.3	4.3
BofAML US Treasury Bills	0.1	0.4	0.2	0.2	0.8
Bloomberg Commodity Index	-2.3	8.7	-13.9	-9.5	-6.2

Source: Morningstar Direct
Periods greater than 1 year are annualized

1 U.S. Bureau of Economic Analysis
2 U.S. Bureau of Labor Statistics
3 Autodata

Under new management

America's seventh president (and first self-declared populist), Andrew Jackson, once said "I was born for a storm, and a calm does not suit me." If President Trump's first few months in office are any indication, he may have more in common with President Jackson than simply his populist leanings. President Trump hit the ground running and tackled lightning rod issues that ignited opposition both inside and outside of his own party. While controversy swirled in the media, optimism prevailed in equity markets. Investors still hope that tax and regulation reform will start a self-reinforcing cycle of economic activity not seen since the Reagan era.

First up on the new President's economic agenda was repealing and replacing the Affordable Care Act (ACA), also known as Obamacare. The new administration quickly experienced classic Washington gridlock and the proposed Obamacare replacement withered on the vine as divisions between fiscal hawks and doves in the Republican Party prevented its demise. A swift ratification of the GOP proposal to replace Obamacare was expected to signal the ease with which the GOP majority could implement a broader tax reform agenda, but unfortunately for the governing party, politics got in the way.

President Trump quickly dismissed the bill's failure, claiming he was "moving on." This was not the news investors wanted to hear, but was also not enough to send stocks into a deep retreat. However, investors are not likely to offer additional mulligans when it comes to broader tax reform. Looking forward, Republicans may take another shot at health care reform, despite President Trump's initial reaction, in hopes of gaining more traction on tax reform legislation. But a 'Hail Mary' effort to defang Obamacare once and for all may also fail and we expect a tough road ahead for much of the Trump agenda.

We believe investors should prepare for spikes in volatility as Trump-induced 'storms' are in the forecast. Paradoxical choices are synonymous with tax reform and in a highly-polarized political landscape, little should be taken for granted. The potential for standoffs looms over even the most basic issues, including passing a budget resolution and raising the debt ceiling to keep the federal government running. For now, about all the bull case can count on is deregulation which will not alone justify current equity market valuations.

Don't forget the Fed

The stock market adage "Don't fight the Fed" may need to be modified to "Don't forget the Fed" as fiscal policy expectations appear to surpass monetary policy to become the main market driver in the eyes of investors. For the past eight years, the U.S. central bank's extraordinary monetary stimulus measures have encouraged risk-taking despite wounds from the Great Recession. During the Obama administration, fiscal policy initiatives were generally out of the picture due to insurmountable partisanship between Democrats and Republicans.

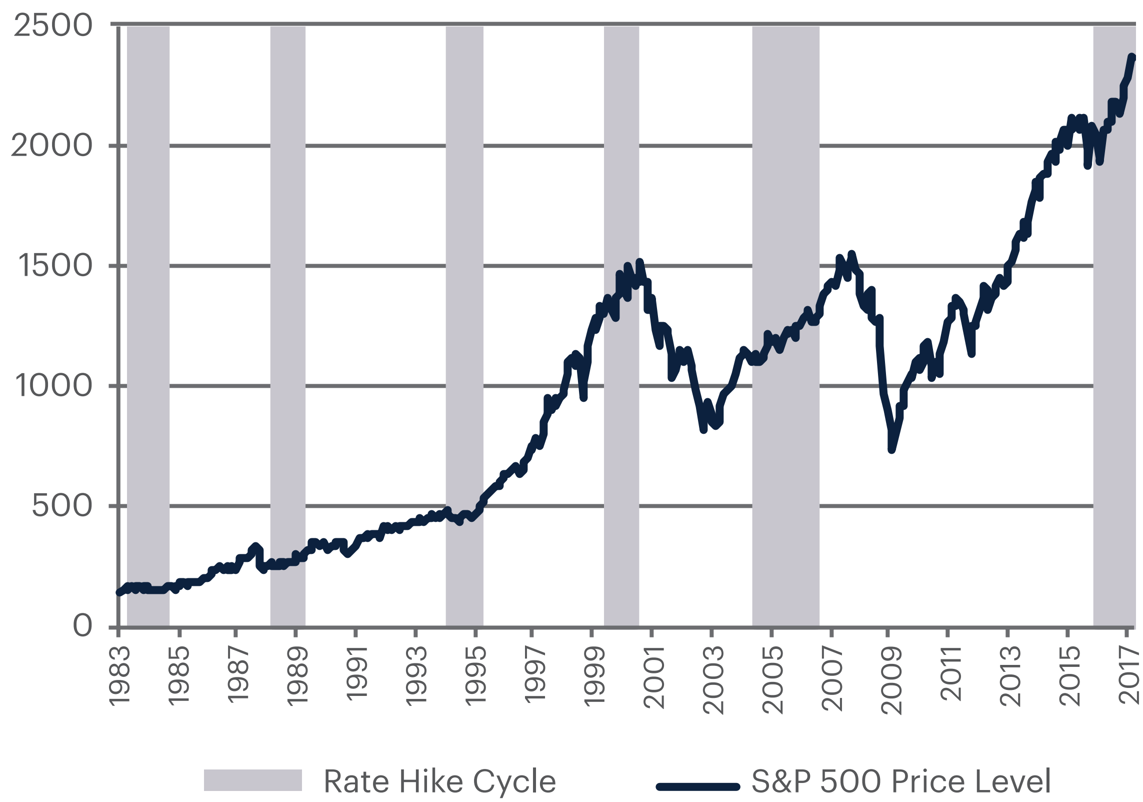
At its March meeting, the Fed raised short-term interest rates for the second time in three months. It also indicated that two additional hikes are likely in 2017. Meanwhile, on the long end of the yield curve, interest rates have risen considerably off the lows of July 2016, when the 10-year Treasury bond yielded just 1.36%[4]. At of the end of the first quarter, the yield had climbed over 100 basis points from its low to 2.38%[4]. In addition to rate hikes, the Fed has also indicated plans to unwind its $4.5 trillion balance sheet through the suspension of reinvestment later this year if the economy stays on track.

Bond investors have been aware of what the Fed is up to, but stock investors have been less worried that the "punch bowl" is being taken away. For its part, the Fed has stressed it will take a gradual approach to raising rates and has no set path. In other words, it will remain "data dependent." This is good news for both U.S. bonds and equities, as an overly-aggressive Fed could trip up the economy and financial markets.

The track record of Fed tightening cycles during periods of economic expansion and contraction may provide some confidence that the current pace of U.S. economic improvements is unlikely to be derailed by future rate hikes. As shown in the chart below, instances of rate hikes by past Fed regimes did not spell doom for the U.S. equity market, at least in the early stages.

We expect the Fed to err on the side of caution, which is to say they do not feel the pressure to fight inflation at this time. During economic expansion periods, the Fed typically worries about inflation running too high. This dynamic has not been an issue this cycle, although there have been recent inflationary pressures coming from a rebound in commodity prices. While we do not expect these pressures to persist, we do believe the Fed wants to move away from accommodative monetary policy to the greatest extent possible in order to store up dry powder for the next recession. Barring a major setback in the economy, we expect the Fed to raise rates five to six more times through the end of 2018.

S&P 500 Price Level vs. Fed Rate Hike Cycles



Source: Bloomberg, Standard & Poor's, Federal Reserve

[4] Bloomberg

A divergent path

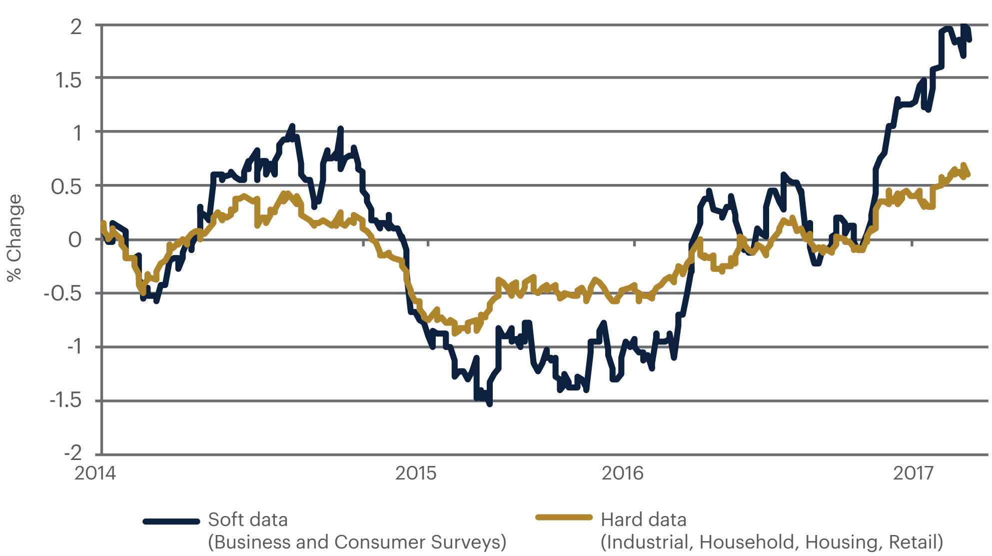
Last year's Presidential election ushered in a new paradigm for how investors view the domestic economy. With the House, Senate and Executive branch now controlled by the Republican Party, companies and consumers alike quickly pivoted to the notion that fiscal stimulus is the likely outcome. Promises of tax cuts, deregulation and infrastructure spending made on the campaign trail are expected by many to reinvigorate an economy that has averaged just 2% real growth since the end of the financial crisis.

Optimism thus far has been clearly observed in measures of consumer and business sentiment, referred to as "soft data." Not surprisingly, measures of actual economic activity, or "hard data", have yet to materially benefit from the enthusiasm surrounding the expected end of the status quo in Washington. As seen in the chart below, soft data is more volatile than hard data and the two series are not perfectly correlated. This historical perspective reminds us that optimism alone cannot jump-start the virtuous cycle of economic activity.

Fulfillment of campaign promises will be required to move the needle on hard data and ultimately validate current valuations in the stock market. Major financial decisions by corporations or individuals related to changes in fiscal policy are only likely to occur after legislation has been passed and policy details are made clear. Policy implementation can take time to accomplish, as demonstrated by the ACA example.

The economic benefits of new policies are not likely to be instantaneous and will take time to move through the real economy. While we are hopeful that the hard data will catch up to the soft data over time, we must acknowledge that the potential for disappointment has increased given current market valuation levels.

Bloomberg U.S. Economic Surprise Indicators



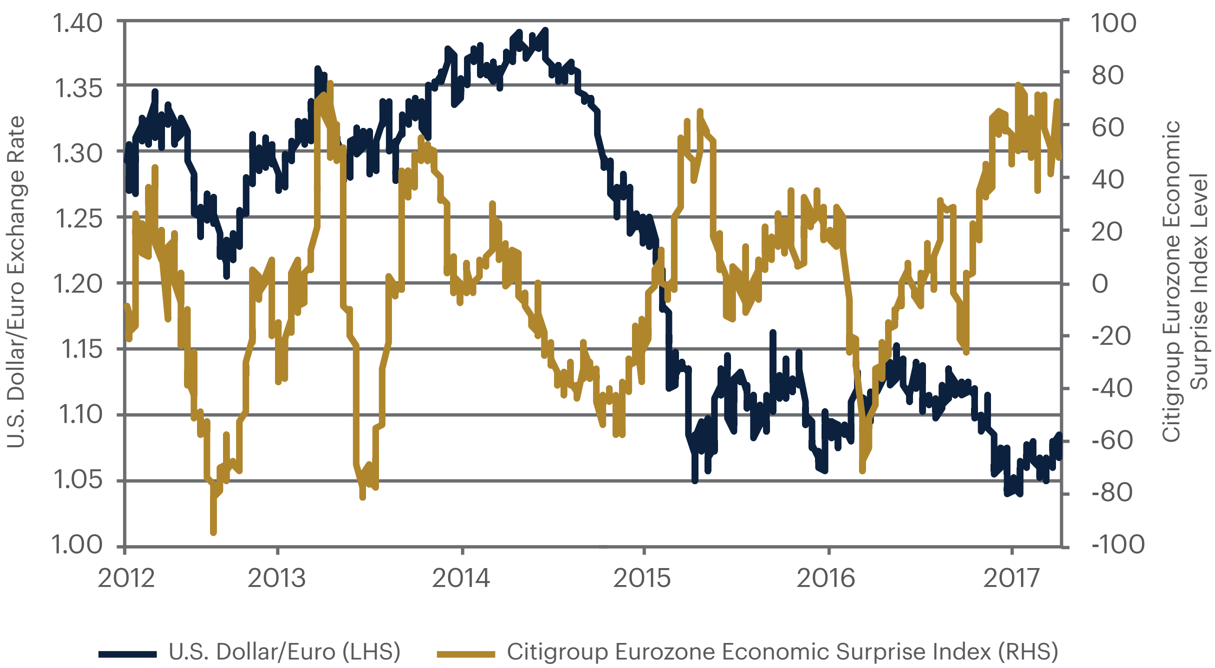
Source: Bloomberg. "Soft data" is represented by the Bloomberg ECO U.S. Surveys & Business Cycle Indicators Surprise Index. "Hard data" is represented by the Bloomberg ECO U.S. Surprise Index

Frexit

Nine months after the UK voted to leave the European Union (E.U.), Prime Minister Theresa May signed a letter evoking Article 50 of the Treaty of Lisbon—effectively the charter of the E.U.—that formally began the withdrawal process. The UK will now begin a two-year period of negotiating the terms of separation. The so-called "Brexit" vote was the first major victory for Europe's populist movement. Despite uncertainty created by Brexit and the growing threat of domestic populism, the European economy as a whole is beginning to show signs of life.

Citigroup's Eurozone Economic Surprise Index, which measures a broad range of economic data against forecasts, has registered positive readings since last quarter. Improving economic growth in the Euro area has been aided in large part by a currency that has weakened against the U.S. dollar by over 20% over the last three years as shown in the chart below.

Turning the Corner



Source: Bloomberg

Despite the geopolitical challenges of populist politics and upcoming elections in the region, we are optimistic on European equities due to improving economic hard data and attractive valuations relative to U.S. stocks.

Forecasted earnings growth of European firms is starting to outpace that of U.S. companies, but investors remain wary of European stocks for good reason. Further progress by European nationalist movements has the potential to threaten the very foundations of the E.U.

The French Presidential elections in April and May are the key known events in the second quarter and many consider the event a Brexit redux, a referendum on economic and social integration and the lure of isolationism. Marine Le Pen, the National Front Party candidate, is a nationalist and a populist who holds anti-immigration views and has called for a referendum on France's membership in the E.U.—nicknamed "Frexit". Although she recently backed off her anti-E.U. rhetoric, her strength in the polls is a major source of concern for investors. At present, Le Pen is not expected to win, but similar predictions about dark-horse candidates have been made before.

Lombard Street Research, a macroeconomic research firm, framed it well in a recent note, saying:

"As the second-largest economy in the euro area, and given extensive trade and financial sector linkages with other member states, the course of events in France has the potential for cross-border spillovers, both positive and negative... A victory for Le Pen would raise uncertainty, market volatility and risk premia, given the implications for French policy and the European project more broadly."

With these implications in mind, we remain cautiously optimistic on the outcome of the election. Le Pen's likely opponent on the expected run-off ballot will be former finance minister and investment banker Emmanuel Marcon of the newly self-created En Marche Party. Marcon has proposed a long-needed reform agenda that is far less disruptive to the Euro area than Le Pen's. We believe that when the election is over, if Le Pen is unsuccessful, investors will begin to gravitate to the attractive valuations and earnings growth outlook in Europe relative to the U.S.

Conclusion

Even calm and rising markets require a healthy assessment of potential risks that might change the status quo. Synchronized global growth appears to be finally emerging, but pockets of trouble are lurking. For the positive momentum to continue, these areas of concern must not grow.

In the U.S., the Trump administration must find its stride. Republicans need to find a path to solidarity before optimism fades leading to a negative self-reinforcing economic cycle. Across the pond, the trajectory of the European economy finally appears headed in the right direction, yet remains clouded by the potential for political upheaval. Elsewhere, in the Middle East (Syria) and in Asia (North Korea), geopolitical tensions are rising.

We remain cautiously optimistic that the risks mentioned above will remain in check, but remind ourselves to remain agile, as expected outcomes (and the reactions to those outcomes) are far from certain.

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