THE NEXT GENERATION WEALTH PERSPECTIVE

It is Earnings, not Washington D.C. that Matters

	Q1 RETURN	YTD RETURN
Standard & Poor's 500	6.07%	6.07%
Balanced Portfolio - 60 / 40	3.59%	3.59%
Dow Jones Industrial Average	4.56%	4.56%
MSCI EAFE	7.39%	7.39%
Barclays Aggregate Bond	0.82%	0.82%
Barclays Municipal Bond	1.58%	1.58%

Arguably the most polarizing Presidential election in the United States of recent history has continued to leave Wall Street divided in the past three months: bulls emboldened by the prospects of lower corporate tax rates, infrastructure spending and regulatory relief, while the bears are concerned about policy uncertainty, protectionism, social unrest and valuation. Since the likely market outcome usually lies somewhere between these extreme bullish and bearish viewpoints, our thoughts in the 1st quarter commentary of ***The Next Generation Wealth Perspective*** focuses on the Federal Reserve, the US economy, and the global financial markets.

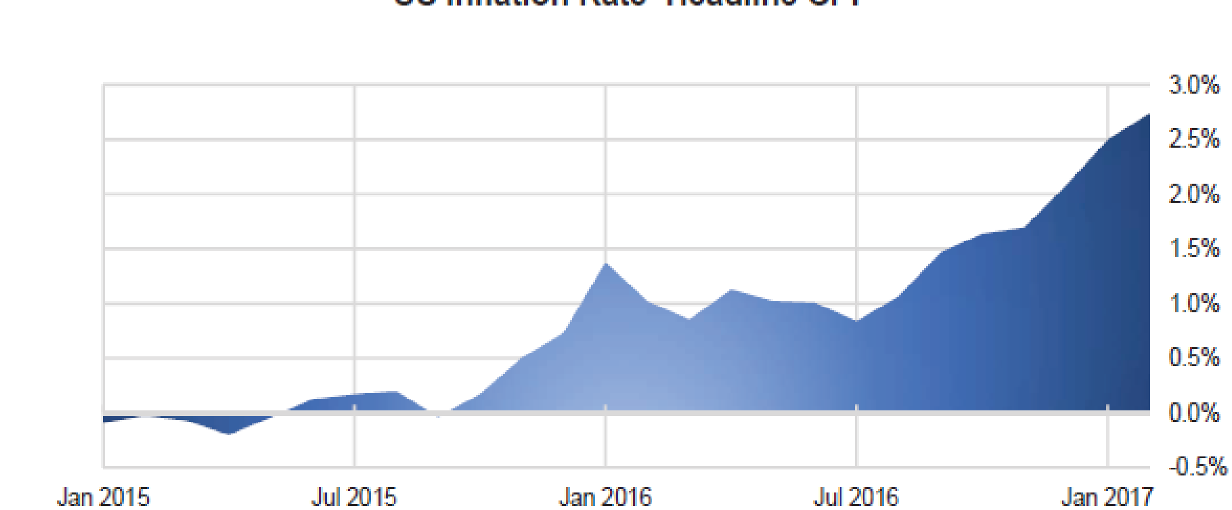
Trading in the US market has been uncharacteristically stable since November, as stock prices have climbed slowly and steadily, almost devoid of volatility and with only one day down as much as 1 percent. By historic measures current market volatility is low, but it is extraordinary when considering we are facing the first Federal Reserve tightening cycle since 2006, uncertainty surrounding critical tax legislation, unresolved healthcare reform and equity valuations that are simply reasonably priced (in relative terms).

While some market observers point to this low level of volatility as troubling evidence of market complacency, we caution that it is not a reliable indicator for reducing equity exposure. Market volatility, as measured by the Volatility Index (VIX), has remained low for protracted periods and has not been a useful predictor of bear markets or even mere corrections.

Conversely, spikes in volatility can serve as a useful indicator of market bottoms. Investors witnessed large spikes in volatility in 1998, 2002, and 2008-09, which generally mark periods of excessive fear, but instead resulted in investment opportunities now that we have the benefit of hindsight.

The Federal Reserve

The Federal Reserve took another step toward more normal monetary policy by raising interest rates another quarter of a percent at their March meeting. Since December of 2015, Chairperson Yellen has now increased rates three times for a cumulative increase of three quarters of one percent. The upper limit target for Fed Funds is now 1 percent. Supporting the Federal Reserve's decision is the recent uptick in inflation, as seen in the chart below showing headline Consumer Price Index (CPI). As of this writing, it looks like we likely will see another two or three rate hikes before the end of the year.



Source: US Bureau of Labor Statistics

Predictably, short-term interest rates have moved higher since December as a result of the Fed's rate decisions. As the Federal Reserve continues to pull back from stimulative monetary policy, short-term borrowers - particularly people with credit card balances - will be the first to feel the effects.

Long-term rates, on the other hand, have not moved within reason. From the beginning of December to the end of March, the Fed Funds rate rose 0.50 percent but 10-year and 30-year treasury yields have actually fallen slightly, which is troublesome to Janet Yellen. An upwardly sloped yield curve (the longer the maturity, the higher the yield) is often a sign of a healthy economy, while an inverted yield curve (where short yields are higher than long yields) often signals recession risk. One potential strategy on the table for the Federal Reserve to potentially drive longer-maturity yields higher is to start selling some of the nearly $4.5 trillion worth of bonds from its balance sheet. These are the bonds the Fed accumulated during the three Quantitative Easing programs from 2008-14. We expect the Fed governors to offer more details over the coming months.

The US Economy

United States political issues have dominated the economic headlines for much of the quarter. The failure of the Republican-led House of Representatives to repeal and replace the Affordable Care Act (ACA) delays consideration of tax reform and infrastructure spending. Following this legislative battle, there is more uncertainty now about when and if Congress can deliver changes to fiscal policy this year.

For several months now (if not quarters) the consumer and business sentiment surveys have presented an upbeat assessment of the global economies while the actual 'hard' economic data has presented a less sanguine picture. That said we believe the recent step-back in consumer spending should be reversed throughout the year. In addition, an increase in real Gross Domestic Product (GDP) growth is anticipated for the second quarter after a slow performance in the first quarter. The economic data remains constructive for corporate profits across much of the globe.

Key Economic Indicators

	2016				2017				Q4 to Q4 change			Annual change		
	16:1a	16:2a	16:3a	16:4f	17:1f	17:2f	17:3f	17:4f	2015a	2016f	2017f	2015a	2016f	2017f
Real Gross Domestic Product (% change, SAAR)	0.8	1.4	3.5	2.1	1.0	2.5	2.1	2.2	1.9	2.0	2.0	2.6	1.6	2.0
Consumer Price Index (% change, annualized)	0.1	2.3	1.8	3.0	1.8	1.5	2.2	2.1	0.4	1.8	2.0	0.1	1.3	2.3
Civilian Unemployment Rate (%, average)	4.9	4.9	4.9	4.7	4.7	4.6	4.5	4.5				5.3*	4.8*	4.6*
Federal Funds rate (forecast: mid-point)	0.36	0.37	0.40	0.45	0.70	0.88	0.93	1.18				0.40*	0.40*	0.92*
2-yr. Treasury Note	0.84	0.77	0.73	1.01	1.24	1.60	1.69	1.92				0.69*	0.84*	1.61*
10-yr. Treasury Note	1.92	1.75	1.56	2.13	2.44	2.65	2.80	3.00				2.14*	1.84*	2.72*

a=actual
f=forecast
*=annual average

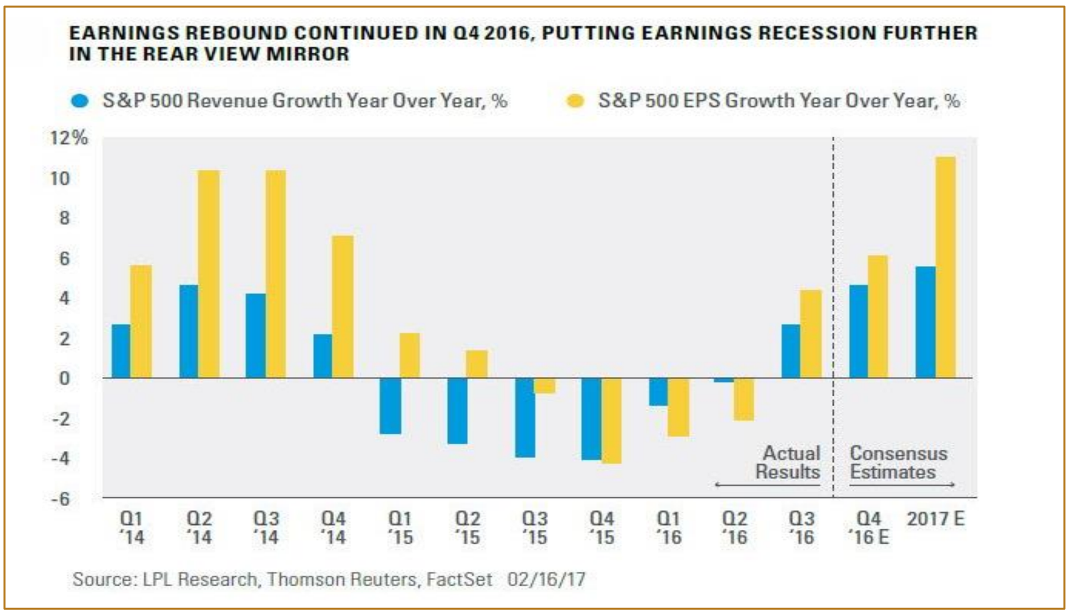
The United States economy is normally in a recession when Washington starts mixing policy concoctions of tax cuts, fiscal spending, and deregulation. That is clearly not the case today as our economy is quite healthy.

Because policy makers are starting with a healthy economy, a stimulus concoction does not have to be very strong to get the economy booming. The risk at this point in the cycle could be that the mix is too strong and our economy overheats.

The US Markets

The market continued to drift higher throughout the 1st quarter but it was the low levels of volatility making headlines as investors waited for signed legislation regarding tax reform, trade policy, Obamacare, regulation, and infrastructure spending.

With all the political punditry, it was easy for investors to lose sight of what matters - earnings. We are in the early stages of a strong earnings recovery, as can be seen in the chart of S&P 500 quarterly earnings estimates below.



Unlike the last three years, these estimates have *not* been revised significantly lower in the first quarter. But high expectations are an antecedent to disappointment, so we are paying close attention to earnings in the second quarter. The backdrop for the markets right now is a mirror image of this time last year. Pessimism has morphed to optimism, volatility into complacency, and earnings weakness into strength.

As I referenced on page 1, there is an abundance of valuation metrics indicating that the broad US equity market is overvalued. The Schiller Price Earnings Ratio (PE) is north of

30 times earnings. The trailing Generally Accepted Accounting Principles (GAAP) are elevated given the severity of energy related earnings write-downs in 2016. On the other hand, risk premia is much more reasonable when viewed in the context of the earnings yield-interest rate differential. The trailing twelve-month earnings yield for the S&P 500 is 4.6 percent. And while that seems precariously low, relative to the US 10-year Treasury note at 2.4 percent, the differential is approximately one standard deviation above its 60-year average. From this perspective, equities remain attractive on a relative basis as seen in the chart below.

S&P Forward Inflation Valuation

	1958-2016			
	Inflation	Average P/E	Highest P/E	Lowest P/E
	0 – 1%	16.3	20.9	11.7
	1 – 2 %	17.0	20.6	13.1
We are here	2 – 3%	17.6	26.7	10.8
	3 – 4%	16.0	20.7	10.1
	4 – 5%	14.0	21.0	9.5
	5 – 6%	14.9	20.2	8.2
	6 – 7%	11.6	17.9	7.2
	>7%	8.4	11.5	6.6

Source: Bureau of Labor Statistics, FactSet, as of December 31, 2016. Inflation is y/y % change based on core CPI. P/Es based on forward 12-month earnings.

Concluding Thoughts

Since the nationalist tone struck in his inauguration speech, Wall Street has been trying to decipher what would be the likely policies of President Trump versus the rhetoric of candidate Trump. We are only a couple of months into his administration and it is still too soon to know with much confidence the eventual scope of trade, healthcare and tax legislation reform.

However, the early signs indicate that 1) protectionism will not be as onerous as feared, 2) deregulation will be a priority, 3) healthcare reform remains uncertain at best and perhaps unlikely, and 4) tax cuts may likely happen, but the magnitude may disappoint.

While we acknowledge significant changes are likely coming, we can't know the details, the timing or the impact, especially in the short-term. The financial markets have never been very good with uncertainty or patience, so we are prepared for bouts of volatility up and down in the months ahead. In the interim, we are always evaluating client accounts and remaining true to our disciplined approach.

As always, we will communicate our views accordingly should the economic, financial or geopolitical backdrop change materially over the course of the coming year.

Respectfully yours,

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