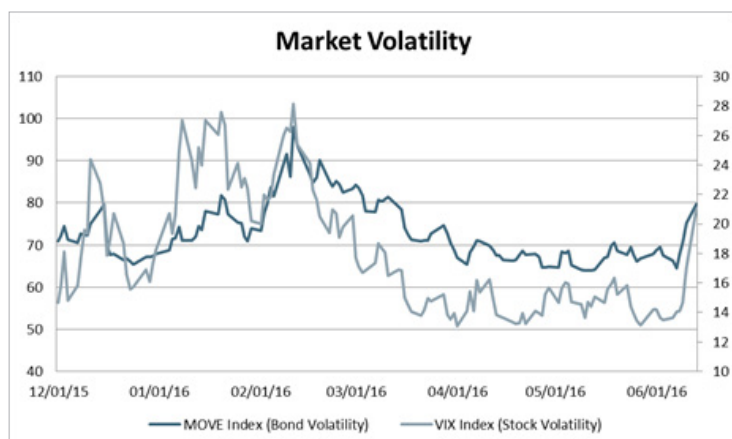


Highlights

As we entered 2016, our outlook called for higher volatility and a wider range of potential market returns. That expectation has played itself out fairly well as the U.S. bond and equity markets have weathered significant volatility to post solid year-to-date returns. U.S. equities started the year down over 10% in mid-February as energy and commodity prices plummeted to new lows. Risk off behavior and attractive relative global yields pushed Treasury prices higher as many market participants believed the U.S. economy was heading toward a recession. So as investors rushed for the exit door, commodity prices found a bottom, and equities and credit spreads rebounded sharply.



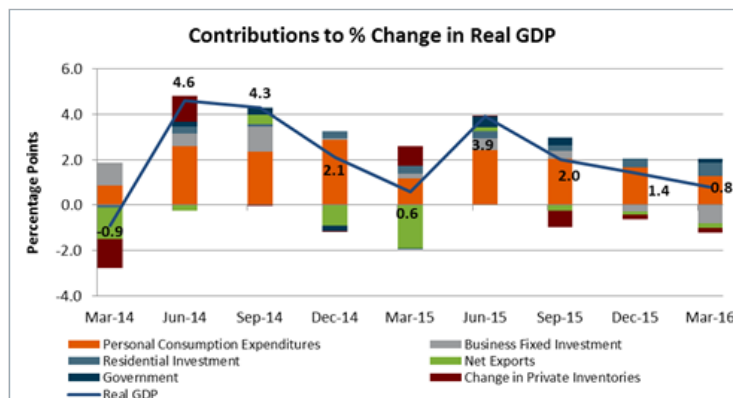
Source: Bloomberg

While equity prices acted like a yo-yo, U.S. Treasuries have acted more like a balloon as prices continue to move higher despite the rebound in risk markets and the promise of higher rates from the Federal Reserve. While we don't expect the balloon to burst, it's not going to take a significant change in inflation expectations to prick the balloon and watch prices leak lower. That said, our outlook continues to call for higher volatility and a wider range of potential returns in the year ahead. Modest economic growth, tighter monetary policy and an election year will make it difficult for the markets to generate outsized returns. While we do not believe the Brexit vote is a Lehman-like event, the aftershocks from Britain's decision to leave the European Union only will increase market volatility most assuredly. In our opinion, the U.S. short-term investment grade bond market is attractive on a relative value and risk adjusted basis versus longer fixed income and equity alternatives. We wouldn't be surprised to see those markets experience a significant correction at some point in the near future and we forecast low single digit returns in the year ahead.

Economic Outlook

We continue to believe that the U.S. economy is stuck in a period of secular stagnation. Euro-area growth will likely be hit by uncertainty in the UK and lower confidence levels due to the recent Brexit vote. Following a tepid start to 2016, we estimate the domestic economy will grow around 2% over the next twelve months as consumer spending and private investment remain constrained. We do not believe the Brexit situation will have a material impact on U.S. economic growth over the forecast period. While the real estate and housing market should remain a source of strength, the thrust and resilience of domestic demand is a source of concern for our research team. While consumer confidence and business sentiment has stabilized

in recent years, we have yet to see increases that can propel the economy to higher rates of GDP growth. And while credit standards have been easing, the consumer continues to hold back spending for savings as memories of the credit crisis remain firmly entrenched.



Source: Bloomberg

Similarly, business fixed investment has not returned to pre-crisis levels given the economic, regulatory and political uncertainties facing most corporations. While we will get more policy specifics from Trump and Clinton in the months ahead, neither candidate's platform is particularly attractive for executives or prudent investors to make the difficult decision to take risk. Social discontent, while difficult to objectively measure, appears to be growing both domestically and abroad. The rise of nationalism, Britain's future in Europe and growing anti-establishment populism are all good examples. We do not see these polarizing forces receding in the foreseeable future.

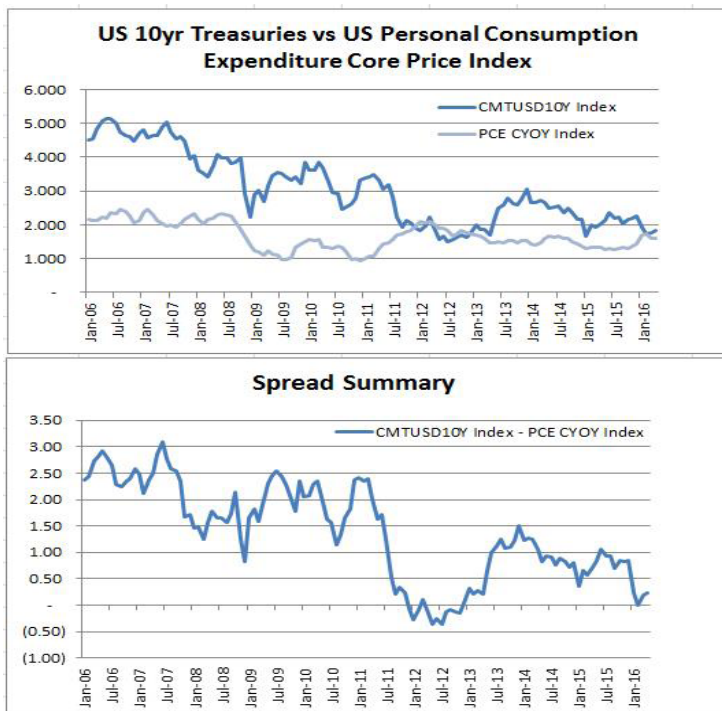
Another measure we are watching closely, and possibly one which ties into this era of social discontent is the weakening trend in U.S. productivity. As a reminder, productivity measures the increases in amount of output produced per hour of work. While we know that higher productivity levels increase economic growth, economists are not exactly sure why productivity might rise or fall. So while there are many factors impacting



Source: St. Louis Federal Reserve, The World Wealth and Income Database

productivity, we know this measure has been on a steady decline over the past fifteen years. During this same period, we have seen a steady increase in measures of income inequality. Hostility toward the elite and the establishment power is in vogue. Frustration over incomes, living standards and changing cultural norms are prevalent. Banks have caught the brunt of this populist concern with the call to “Break up the Big Banks” and to “Reform Wall Street” caused by financial abuse. More recently, we are seeing calls to change anti-trust regulations that were loosened during the 1990’s. These changes would suggest restricting merger and acquisition (M&A) activity to make it harder for competitors to buy each other. One popular argument is that big companies might be more productive with their capital engaging in new business and capital investment versus financial gearing like merging with a competitor and simply cutting costs (i.e. worker’s livelihoods) to gain efficiencies. As staunch free market capitalists and prudent investors, we understand how that argument may not resonate with many. Isn’t this just the invisible hand of the market at work? Perhaps this is true. However, it is worth debating whether current shareholder enhancement activity, specifically share buybacks and M&A activity, promotes healthy long-term economic growth. We should not confuse the value of returning cash to shareholders versus the value of real improvements in productivity. In addition, healthy long-term economic growth requires a strong social contract between owners and renters in society. Buy-in matters. We would much rather see board rooms engage in a sustained increase in investment and innovation versus listening to activist equity investors championing for the latest new deal. Unfortunately, policy conditions and cheap borrowing rates make financial gearing more attractive than the risk associated with increasing capital investment, so this condition will persist as long as U.S. and global monetary policy remains extraordinarily accommodative. This is not likely to change given the recent vote in Britain.

And, our economic commentary wouldn’t be complete without briefly touching on the disinflation/inflation debate. While deflationary forces have been massive following the financial crisis, current interest rates reflect the market’s complete disregard of the risk that inflation will ever be problematic again. In the accompanying graphic, we spread the yield on U.S. 10-year Treasuries versus the U.S. Personal Consumption Expenditure (PCE) Core Price Index for the past ten years.



Source: Bloomberg

Those rates are virtually the same right now. The market must believe that core inflation is going to drop precipitously, otherwise the current market can be characterized by the highest level of inflation with the lowest level of long rates witnessed in a very long time. And to be sure, the FOMC watches inflation measures very closely, specifically forward inflation expectations. By this measure, inflationary pressures are less of a concern to the Fed than they have been since the depths of the crisis. Their preferred measure of inflation expectations is to review 5yr/5yr forward breakeven rates. (See graph below) This measures the yield on 5 year U.S. Treasuries versus U.S. inflation linked bonds (TIPS) on a forward basis. While inflation risk is not being priced into the current market, should it ever become problematic, this could end very badly for long-term investors. With that warning, we do expect headline inflation to move back toward the Fed’s 2% target as economic growth remains positive and the unemployment rate declines further. A tighter labor market, rising energy prices and higher housing costs should push inflation higher during the next year and with it, interest rates.



Source: Bloomberg

Interest Rate Outlook

We expect interest rates to modestly increase in the year ahead. We believe the Fed has effectively fulfilled their dual mandate of full employment and price stability, allowing policy to move towards 1%. While the risk of tighter policy increases the likelihood for higher market volatility in the year ahead, we don’t believe it will have as large of an impact in the real economy. The recent rally in interest rates over the past several months has been more of a technical reflection of relative global rates and capital flows versus a more fundamental concern on the U.S. economy. While the aftermath of Brexit will continue to push U.S. Treasury yields lower, our research indicates that bond valuations do not fully price in the risk of higher inflation. While the Fed’s statement following their June meeting was justifiably dovish, current yield levels don’t provide investors with a significant income cushion to offset lower bond prices if the Fed decides to act more aggressive in tightening policy. Global and domestic economic risks, along with the recent risk of Britain exiting the European Union, have largely been priced into the market. The risk of higher inflation is not currently priced into the market. Higher oil prices should move headline inflation back to the Fed target in the year ahead. While we expect the Federal Reserve to tighten one to two more times in the coming year, we don’t believe they can tighten policy significantly beyond those levels without presenting downside risks to the global economy and markets. The Brexit vote makes further tightening even more difficult for the Fed.

Expected Returns

U.S. RATES

As the U.S. economy continues to post modest economic growth and the Fed tightens policy, short-term rates should drift slowly higher. Forward rates largely approximate where we would expect the 1-3 year part of the curve should trade next year. As a prudent investor, this means you should stay invested and let the steep front end of the yield curve continue to work to your advantage. Predicting the direction of interest rates can be dangerous to your financial health. The uncertainty associated with the current economic and market environment is a good reminder to stay invested in line with your liabilities and spending needs. Further out the curve, specifically in the 10-30 year part of the curve, we anticipate there is more risk for U.S. Treasuries than what is currently priced into the market. Our experience informs us that the front end of the yield curve tends to trade off of economic expectations, while the long end of the curve tends to value itself based on inflation expectations. Our view is that while short-term rates will likely move somewhat higher in the year ahead, headline inflation will increase to Fed target levels and force longer rates to be repriced lower. As a result, we forecast Treasury returns to remain modestly positive in the year ahead with the risk that longer Treasury returns turn negative on a total return basis.

	CURRENT/ SPOT	12/31/15	FORWARD RATE 6/30/17	PMA FORECAST 6/30/17
Fed Funds	0.375	0.375		0.875
1YR UST	0.66	0.60	1.02	1.00
2YR UST	0.78	1.05	1.13	1.15
3YR UST	0.93	1.31	1.28	1.35
5YR UST	1.23	1.76	1.56	1.65
10YR UST	1.70	2.27	1.89	2.10
30 YR UST	2.51	3.02	2.62	3.00

Source: Prudent Man Advisors, Inc. and Bloomberg

PMA FORECAST	YIELD	ROLL DOWN	EXPECTED RETURNS
Cash	0.375	0.00	0.375
1 Year	0.66	0.00	0.66
2 Year	0.78	-0.33	0.45
3 Year	0.93	-0.54	0.39
5 Year	1.23	-0.84	0.39
10 Year	1.70	-2.71	-1.01

Source: Prudent Man Advisors, Inc. and Bloomberg

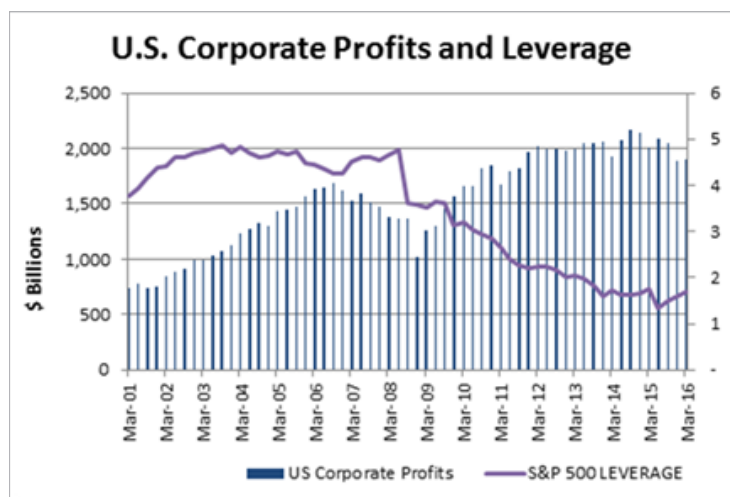
CREDIT

History reinforces our belief that managing credit risk and paying particular attention to market liquidity is of particular importance at this point in the credit cycle. Thus far in 2016, we have seen the credit markets perform quite well despite high levels of new issuance and increased shareholder enhancement activity. Extraordinarily accommodative monetary policies in place throughout the world continue to reward corporations for this behavior. While we believe we are in the mature bull stage of a credit market, we don't believe that the market is primed for a material correction at the present time. We do believe spreads will remain volatile but do not expect investment grade spreads to gap materially given our economic outlook.

Sector	OAS		Δ
	06/20/16	12/31/15	
Communication	189	200	(11)
Consumer Discretionary	151	157	(7)
Consumer Staples	120	123	(3)
Energy	242	305	(63)
Financial Sr	127	120	6
Financial Sub	243	203	40
Healthcare	135	135	0
Industrials	119	132	(13)
Materials	218	297	(79)
Technology	129	130	(1)
Utilities	152	158	(5)
All Sectors	157	168	(11)

Source: Prudent Man Advisors, Inc. and Bloomberg

High-quality investment grade spreads remain relatively attractive on an expected return basis versus similar maturity U.S. Treasuries. On a fundamental basis, while sales and earnings growth for U.S. corporations has been relatively weak over the past year, we would expect growth to improve over the next year. Short-term credit will likely outperform long-term credit. High-quality credit will outperform lower-quality credit. As was the case this year, sector considerations will be of particular importance in generating excess returns. The snap back in the Energy and Materials sector has been massive following the improvement in oil prices thus far in 2016. High-quality industrials, consumer staples and utilities are attractive. Financial spreads, despite the healthiest and safest balance sheets evidenced in the past several decades, should remain relatively wide due to ongoing new issue supply.



Source: Bloomberg

While we are concerned with the growth in the size of corporate debt issuance and shareholder enhancement activity, balance sheets are not overly levered versus historic levels, at least not yet. Asset coverage, cash flow generation and liquidity remain relatively healthy versus historic levels.

MUNICIPALS

Municipal spreads have tightened along with the corporate market year-to-date. That said, high-quality taxable municipal bonds continue to trade slightly wide of comparable rated corporate debt in general. While credit fundamentals and the lack of supply should allow the market to outperform similar maturity U.S. Treasuries in the year ahead, we think the market is somewhat overvalued presently. We don't believe investors are being paid for the relative illiquidity of the sector at present. While we expect continued fundamental improvement in municipal credit quality overall, there is significant variance in credit risk across certain state and local governments who have large unfunded pension obligations and suffer from political dysfunction. As a result, we continue to emphasize larger deals and higher quality issuers when possible within our portfolios.

Funded Ratio, %								
State	Pension Legal Reform Flexibility Score	Pension Funded Ratio	State	Pension Legal Reform Flexibility Score	Pension Funded Ratio	State	Pension Legal Reform Flexibility Score	Pension Funded Ratio
NY	1	87%	LA	3	58%	KY	5	44%
AZ	1	73%	ID	4	85%	ME	6	80%
AK	1	55%	SC	4	65%	WY	6	79%
IL	1	39%	MD	4	65%	OH	7	80%
WA	2	93%	MS	4	58%	CT	7	49%
NE	2	89%	RI	4	58%	WI	8	100%
TN	2	88%	NJ	4	57%	MN	9	80%
GA	2	78%	SD	5	100%	NM	9	73%
CA	2	74%	NC	5	94%	TX	10	80%
NV	2	69%	OR	5	91%			
VT	2	67%	DE	5	88%			
AL	2	66%	FL	5	85%			
PA	2	63%	IA	5	79%			
MA	2	61%	UT	5	77%			
ND	2	61%	AR	5	77%			
WV	2	61%	MT	5	73%			
NH	2	57%	MO	5	71%			
KS	2	54%	OK	5	69%			
MI	3	61%	VA	5	64%			
HI	3	60%	CO	5	57%			

Source: Moodys, Center for Retirement Research at Boston College, "Public Pension Plan Reform: The Legal Framework" report published by Amy Monahan, J.P. Morgan

U.S. AGENCIES

Agency spreads have tightened over the past year as supply has decreased. The large agencies have preferred issuing callable debt to fund their portfolios versus issuing global bullet debentures further out the curve. Callable agencies generally trade rich versus comparable maturity bullet agency issues when one accounts for the value of the imbedded call option. As a result, we don't find much value in traditional callable agency paper versus high quality alternatives. Diminishing supply and the lack of high quality investment alternatives have combined to push bullet agency spreads tighter to similar maturity Treasury paper. While we don't see a lot of value on agency spreads at present, we prefer longer agency spreads as their curves appear too steep. Generic global benchmark agency bonds are most attractive during the new issue period as secondary spreads tend to tighten quickly to the curve following new issue. We are also seeing an interest for some of the agencies to issue floating

rate debt given their relatively low cost of financing versus LIBOR. We are neutral on agency mortgages as we remain concerned on potential supply and extension risk which could negatively impact returns.

U.S. EQUITIES

We would expect to see continued volatility and some large price swings in the equity markets in the year ahead. Equity returns, similar to Federal Reserve policy, will largely be data dependent. Overall, we believe stock returns will remain modestly positive given our economic outlook and the lack of compelling investment alternatives for most long-term investors. While market valuations have moved higher and debt issuance has increased, the equity markets do not appear overly extended versus the fixed income market. The market is trading at 16x 2017 forward earnings estimates and dividend yields are attractive versus bond yields. Britain's decision to exit the European Union will be a headwind for global equities on a relative basis. U.S. equities should perform well on a relative basis.

S&P 500	2009	2011	2013	2015	CURRENT	TREND
Gross Margin	31.93	32.46	32.3	33.47	33.31	Flat
EBITDA	16.56	18.19	18.82	17.23	17.23	Flat
Price/Earnings	19.14	13.44	17.44	18.66	19.61	Higher
Price/EBITDA	7.84	6.78	8.95	10.47	10.95	Higher
Price/Book Value	2.15	2.05	2.58	2.77	2.83	Higher
EV/EBITDA	10.11	8.78	10.66	12.25	12.82	Higher
Dividend Yield	2.12	2.12	1.89	2.15	2.15	Higher
Total Debt	0.52	0.46	0.34	0.35	0.36	Lower
Total Debt to Total Equity	139.98	116.54	101.37	108.96	111.73	Lower
Net Debt to EBITDA	3.15	2.19	1.59	1.61	1.68	Lower

Source: Prudent Man Advisors, Inc. and Bloomberg

Contact Information



JOHN H. HUBER, CFA

Senior Vice President, Chief Investment Officer
Prudent Man Advisors, Inc.

Tel: 630.657.6510

Email: jhuber@pmanetwork.com

John Huber, CFA, leads Prudent Man Advisor's asset management business and investment process. He is responsible for portfolio management and directs the advisor's research and trading efforts. Mr. Huber is a proven investment leader with over 20 years of experience managing institutional portfolios. He received his Bachelor of Arts from the University of Iowa and earned an MBA in Finance from the Carlson School of Management at the University of Minnesota. He is a Chartered Financial Analyst (CFA) charter holder and a member of the CFA Society of Minnesota.



This document was prepared by Prudent Man Advisors, Inc. for clients of the firm and its affiliated PMA entities, as defined below. It is being provided for informational and/or educational purposes only without regard to any particular user's investment objectives, financial situation or means. The content of this document is not to be construed as a recommendation, solicitation or offer to buy or sell any security, financial product or instrument, or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation, or trading strategy would be illegal. Nor does it constitute any legal, tax, accounting or investment advice of services regarding the suitability or profitability of any security or investment. Although the information contained in this document has been obtained from third-party sources believed to be reliable, PMA cannot guarantee the accuracy or completeness of such information. It is understood that PMA is not responsible for any errors or omissions in the content in this document and the information is being provided to you on an "as is" basis without warranties or representations of any kind. Securities, public finance services and institutional brokerage services are offered through PMA Securities, Inc. PMA Securities, Inc. is a broker-dealer and municipal advisor registered with the SEC and MSRB, and is a member of FINRA and SIPC. Prudent Man Advisors, Inc., an SEC registered investment adviser, provides investment advisory services to local government investment pools and separate accounts. All other products and services are provided by PMA Financial Network, Inc. PMA Financial Network, Inc., PMA Securities, Inc. and Prudent Man Advisors (collectively "PMA") are under common ownership. Securities and public finance services offered through PMA Securities, Inc. are available in CA, CO, FL, GA, IL, IN, IA, KS, MI, MN, MO, NE, OH, OK, PA, SD, TX and WI. This document is not an offer of services available in any state other than those listed above, has been prepared for informational and educational purposes and does not constitute a solicitation to purchase or sell securities, which may be done only after client suitability is reviewed and determined. All investments mentioned herein may have varying levels of risk, and may not be suitable for every investor. PMA and its employees do not offer tax or legal advice. Individuals and organizations should consult with their own tax and/or legal advisors before making any tax or legal related investment decisions. Additional information is available upon request.

©2016 Prudent Man Advisors, Inc.

Integrity. Commitment. Performance.™