

PRUDENT MAN ADVISORS MARKET OUTLOOK

SUMMER 2017

Highlights

As we entered 2017, our outlook called for limited returns in the U.S. fixed income market with higher prospective returns for U.S. equities. Continued low interest rates, an improving global economy, stronger corporate earnings projections and the potential wildcard of President Trump's policy initiatives were supportive of our outlook. Thus far in 2017, market returns have surpassed our full year estimates despite weaker U.S. economic performance, large increases in short term interest rates and the lack of progress on policy initiatives due to a quagmire of investigations related to Russia's involvement in the 2016 election. As prudent investors, we remain wary of the markets ability to sustain the pace of the rally we've enjoyed so far this year. Credit and equity markets are increasingly stretched from a valuation perspective and low volatility measures indicate a historic level of complacency.

2017 Expected Returns	2017 Base Case	2017 Upside	2017 Downside	Actual Returns YTD	Forecasted Returns thru 1H18
Cash Returns	1.00%	1.50%	0.75%	0.70%	1.25%
US Treasury Returns	1.15%	3.00%	-2.00%	2.07%	1.00%
IG Corporate Returns	2.00%	4.00%	-3.00%	3.62%	1.50%
US Equity Returns	5.00%	12.00%	-10.00%	8.66%	3.5%

As of 5.31.17. Sources: Cash: PMA, UST: GOQ0 Index, IGC: COA0 Index, US Equity: S&P 500.

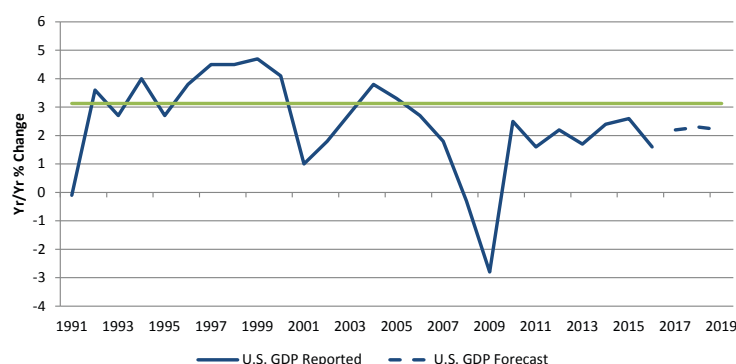
Despite these concerns, along with the prospect of further Fed tightening in the year ahead, high quality U.S. investment grade short term bonds are increasingly attractive on a relative and risk adjusted basis versus longer maturity and lower quality fixed income securities. The U.S. Yield Curve implies a higher probability for deflation and/or economic recession than our forecast predicts. One more increase in Fed policy, and the front end of the curve will be inverted if Treasury yields remain at current levels. Credit spreads are too tight, specifically in lower quality issuers if the yield curve is priced correctly. The bond market also risks miscalculating the fact that the largest buyer of bonds in the last decade is changing their behavior as the Fed begins to wind down their balance sheet later this fall. U.S. equities have some additional upside at this point in the credit cycle, but their return potential is offset by the risk of a large correction in the year ahead. Corrections come a lot slower than anyone expects, but once they happen, they escalate faster than most could imagine. We wouldn't be surprised to see these

markets experience a healthy correction in the year ahead and forecast low single digit returns for U.S. bonds with slightly higher returns for U.S. equities.

Economic Purgatory

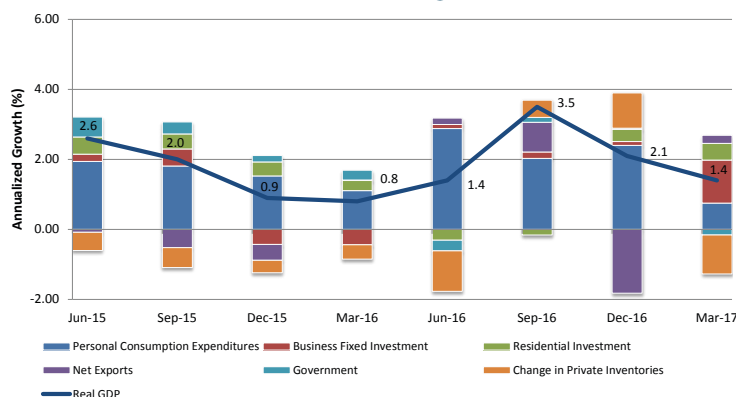
While we are in the middle of the 9th year of the current economic expansion, one of the longest in the past century, the slow growth expansion feels like we are stuck in economic purgatory. Economic activity continues to grow at a slow but steady pace, averaging 2.1 percent since the 2008 global financial crisis. We have long worried

Annual U.S. Real GDP Growth



that the economy won't have enough gas to achieve escape velocity from the current state, which would thereby encourage corporations to accelerate capital expenditures in anticipation of more growth and opportunity. At the same time, we are not of the belief that we are headed back to the pits of a recession in the next few years either.

Contributions to % Change in Real GDP



Perhaps the memories of the most recent crisis are still too vivid for economic behaviors to fundamentally change. It's undeniable that this recovery has been distinctly different than those of the past several decades. Typically, recessions follow periods of strong growth that cause the economy to overheat and prices to spike. The Fed tries to cool things down with tighter policy, increasing the cost of credit and putting a lid on inflation pressures. But current economic growth and inflationary measures haven't been strong enough to escape purgatory yet. Not surprisingly, our base case estimate calls for real growth and headline inflation around 2% in the year ahead. Good numbers, but nothing that suggests the Fed needs to raise rates to 3% by 2019.

We saw weaker growth during the first quarter of 2017 as lower consumption levels from a warm winter put a drag on the U.S. economy. On the brighter side during the first quarter, residential investment remained solid and we saw the strongest level of business fixed investment for the past several years. This is a critical component for the economy to return to longer term trend growth of 3%. A strengthening global economy should also help the U.S. economy. Euro area real GDP is improving at the fastest pace in six years as their manufacturing and service segment has led the

way. Manufacturing more broadly has shown solid increases in the U.S., Euro Area and China during the past twelve months as factories have been busier. Uncertainty about the true pace of growth is quite large for 2017. The Trump administration introduces a policy wildcard that could both positively and negatively impact the economy in the years ahead.

The labor market remains strong as the unemployment rate has reached a 10 year low of 4.3%. While payroll growth has moderated somewhat over the past three months, the economy has added jobs for 80 consecutive months. Consumer sentiment, as measured by the Conference Board Consumer Confidence index, rose to 118.9 in June after posting 125.6 in March; the highest level since December 2000.

The overall trend in consumer sentiment remains positive. However, many employee studies show a disturbing widespread lack of engagement for most U.S. workers at this point in the economic cycle. Incomes haven't kept pace with inflation during this recovery which impacts economic behaviors and consumer sentiment. Positive workplace engagement improves productivity which directly impacts economic growth. The unemployment rate fell to 4.3 percent in May, down from 4.8 percent in January and from a high of 10 percent in October 2009. It has been encouraging to see

The Wage Growth "Surprise"



17.7%

82.3%



Source: BLS, Piper Jaffray & Co.

other employment indicators show slack in the labor market being drawn down. At end of April, the number of job openings, a measure of labor demand rose to the highest on record, totaling 6.0 million jobs, while hires fell to 5.0 million, the lowest since April 2016. The employment-to-population ratio increased to 60.2 percent, the best showing in 2017 and the highest since February 2009. All the above indicators point to a tightening labor market and the prospect for higher wages. Wage inflation, while certainly higher over the past several years, has had less of an impact on headline inflation than we anticipated. Wage growth has been uneven for different workers, and we would expect wages to place upward pressure on inflation in the years ahead.

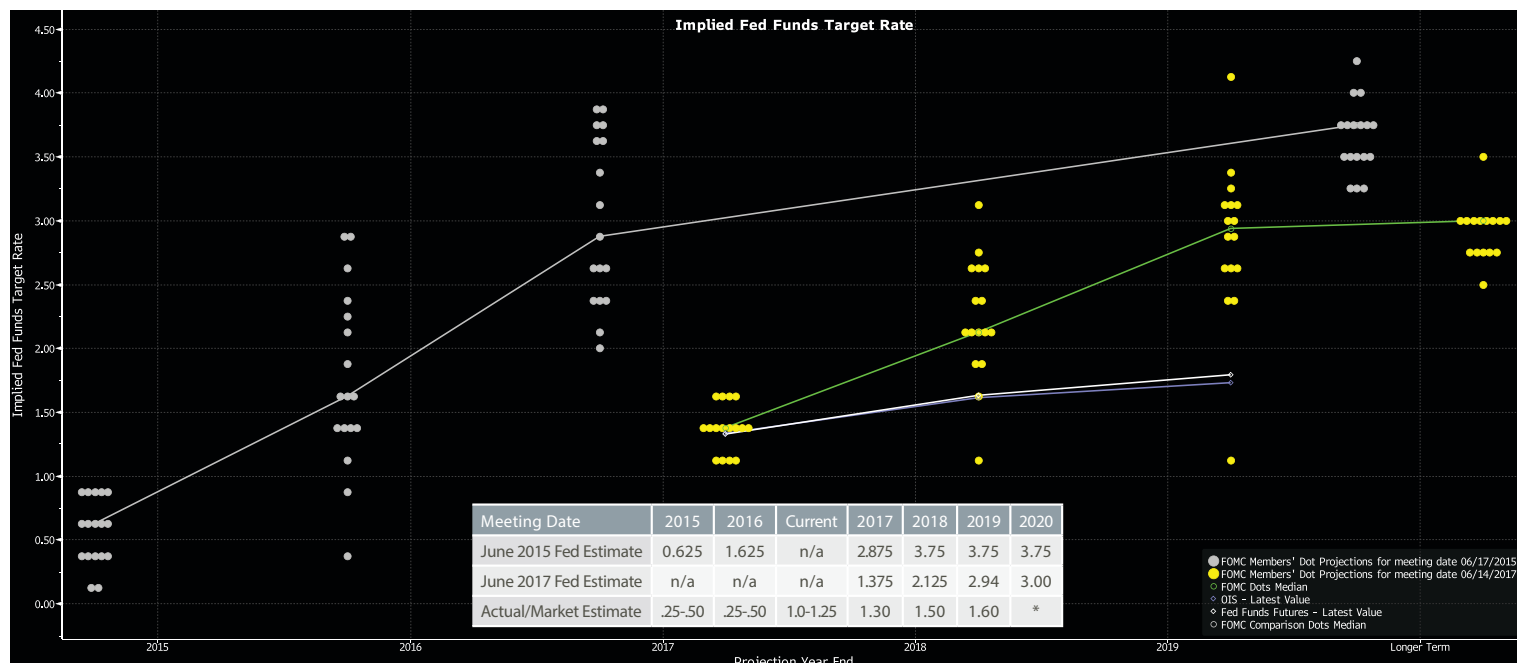
Inflation pressure remains moderate as deflationary forces continue to impact the economy. The core personal consumption expenditure (PCE) price index, Fed's preferred price gauge rose at a 1.5 percent annual pace in April, down from a 1.8 percent increase in January. The Fed's long term projection is a range between 1.7 percent and 2.0 percent. Underlying data indicates that prices have remained stable and inflation is currently contained. With an economy operating at or near full employment, going forward, we expect to see inflationary pressures firming as the economic recovery ages. All the above factors point to improved economic and financial conditions. As such, we expect the Federal Reserve to continue normalizing monetary policy.

Looking ahead to the second half of 2017, we expect to see hard data better reflect the survey based evidence. If it does, we expect to see GDP growth of around 2% percent for 2017. While the post-crisis road out of economic purgatory has been long, we believe the

U.S economy will remain in a sustained period of slow but steady growth with moderate inflation. In the short-run, a combination of monetary policy and fiscal stimulus will support growth. In the long-run, economic growth will be weighed down by an aging population and weaker productivity growth.

The Fed and the Future

We are entering into a critical phase for Fed policy and the potential impact it will have on the economy and markets. On June 14th, the Federal Open Market Committee (FOMC) increased the target federal funds rate to a range of 1.00 – 1.25%. Thus far, Fed officials have raised interest rates three times in the last six months, which reflects the Fed's confidence that the economy will move toward its goal of attaining full employment and stable prices. The FOMC's most recent June projections for the target rate clearly indicate higher short term interest rates should be expected in the years ahead. The FOMC projects one additional move in 2017 followed by three moves in 2018 and an additional three moves in 2019. Longer term estimates beyond 2020 average out to a 3% target rate. While the Fed got the trend and direction right, the actual Fed projections have typically overshoot ultimate Fed policy by a large amount. Currently, the divergence between the market and Fed expectations have become even more acute as the current yields imply the Fed has only one or two (at the most) hikes left in them before the economy is forced back into recession. The rubber should meet the road in the next twelve months, and that eventuality should awaken the markets from their current slumber.



Source: Bloomberg

We continue to observe divergence in the stock and bond markets as well. The stock market continues to move higher, primarily driven by consumer and business optimism that President Trump's pro-growth policies will eventually stimulate economic growth. The bond market appears to be sending the opposite message and reflects significantly less optimism about economic growth. Since February, the yield on the 10-year Treasury note has dropped by 30 basis points following the release of weak economic data including the first quarter GDP number which showed tepid growth. The shape of the yield curve continues to flatten. Short rates increased following FOMC policy actions, while rates on the long end remained range bound as inflation expectations fell across the maturity spectrum. All in all, the stock market points a rosy picture of economic expectations while the bond market is predicting weaker economic growth. As prudent investors, we listen closely to the Fed and specifically the Fed Chair. However, we listen more closely to what the market is telling us more fundamentally in how the market is pricing assets. Ultimately, economic and business

fundamentals should drive asset values and market performance. While economic growth remains soft and earnings continue to outperform expectations, current levels can likely hold in here for the short term. But given the decline in volatility within both the equity and bond markets more generally, we wouldn't be surprised to see volatility return once again creating better buying opportunities for us in the year ahead. We would expect modestly higher interest rates as Fed moves forward with two more increases in the Fed Funds rate and begins to normalize its balance sheet. We prefer higher quality, liquid, shorter duration assets within the fixed income market. Credit spreads and dealer liquidity need to be watched very closely. Meanwhile, equities should continue to perform reasonably well other asset classes as they exhibit higher expected returns. Importantly, risk management, skilled trading execution and portfolio diversification will be critical elements in generating outperformance in the year ahead.

2010	2011	2012	2013	2014	2015	2016	2017
S&P 500 Stocks 15.06%	Taxable Municipal Bonds 20.91%	S&P 500 Stocks 16.00%	S&P 500 Stocks 32.39%	Taxable Municipal Bonds 16.29%	S&P 500 Stocks 1.38%	High Yield Bonds BB 13.2%	S&P 500 Stocks 8.66%
High Yield Bonds BB 14.93%	Portfolio Mix 10.96%	High Yield Bonds BB 14.36%	Portfolio Mix 5.52%	S&P 500 Stocks 13.69%	Taxable Municipal Bonds 0.93%	S&P 500 Stocks 11.96%	Portfolio Mix 4.84%
Portfolio Mix 9.95%	US Treasury Bonds 9.79%	Portfolio Mix 11.62%	High Yield Bonds BB 5.19%	Portfolio Mix 12.06%	US Treasury Bonds 0.83%	Portfolio Mix 6.87%	High Yield Bonds BB 4.25%
Inv Grade Corp Bonds 9.52%	Inv Grade Corp Bonds 7.51%	Taxable Municipal Bonds 11.08%	Inv Grade Corp Bonds (1.46%)	Inv Grade Corp Bonds 7.51%	Portfolio Mix 0.49%	Inv Grade Corp Bonds 5.96%	Taxable Municipal Bonds 3.71%
Taxable Municipal Bonds 7.31%	High Yield Bonds BB 6.12%	Inv Grade Corp Bonds 10.37%	US Treasury Bonds (3.35%)	US Treasury Bonds 6.02%	Inv Grade Corp Bonds (0.63%)	Taxable Municipal Bonds 4.97%	Inv Grade Corp Bonds 5.96%
US Treasury Bonds 5.88%	S&P 500 Stocks 2.11%	US Treasury Bonds 2.16%	Taxable Municipal Bonds (5.42%)	High Yield Bonds BB 5.34%	High Yield Bonds BB (1.04%)	US Treasury Bonds 1.14%	US Treasury Bonds 1.14%

As of 5.31.17. Portfolio mix: 25% Equities / 75% Diversified Fixed Income

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