

PRUDENT MAN ADVISORS MARKET OUTLOOK

WINTER 2017

Highlights

Prudent Man Advisor's 2017 market outlook called for improved returns for short-term investors and limited returns in the fixed income market with higher prospective returns for U.S. equities (see Figure 1). While the trend and direction of our estimate has thus far proved correct, an improving global economy, stronger corporate earnings and the halo of prospective tax reforms pushed equity and credit markets above their respective targeted returns. More importantly, while our 2018 projected market returns anticipate stronger relative performance for the equity market, Prudent Man Advisor's intermediate term outlook has somewhat dimmed as we remain skeptical of the sustainability of the U.S. economic expansion and risk valuations are relatively full. As prudent investors, we also remain wary of the market's ability to sustain the pace of the equity rally we have evidenced the past several years and the economy's ability to withstand the interest rate increases projected by the Federal Reserve. Market corrections can come later than anyone expects, but once they arrive, they escalate faster than most could imagine.

2018 Expected Returns	2018 Base Case	2018 Upside	2018 Downside	2017 YTD
Cash Returns*	1.50%	2.00%	1.00%	0.95%
US Treasury Returns	2.00%	3.00%	-2.00%	2.08%
IG Corporate Returns	2.50%	4.00%	-2.00%	5.57%
US Equity Returns	7.50%	15.00%	-10.00%	18.25%

Sources: Cash: PMA Cash Composite YTD, UST: G0Q0 Index, IGC: C0A0 Index, US Equity: SPX. 11/30/17

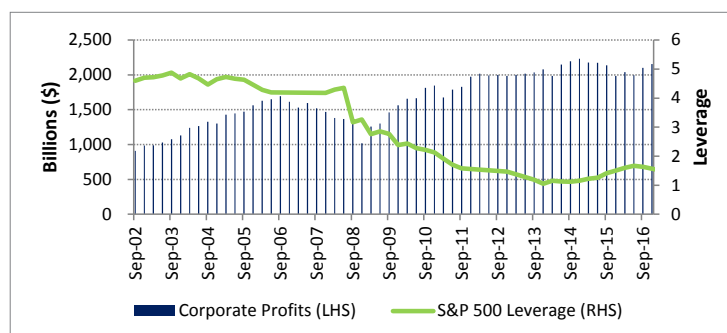
Figure 1.

Consistent with our 2017 market outlook, non-Treasury sectors of the fixed income market outperformed during the year as risk premiums rallied significantly due to both stronger fundamental and technical factors. Corporate bonds performed particularly well during the year following an already strong showing in 2016. While operating performance, financial risk and credit fundamentals have improved materially since the financial crisis, financial leverage is moving higher and animal spirits are alive and well in corporate board rooms (see Figure 2). Increased M&A activity, increasing share buybacks and the prospective use of overseas cash repatriation proceeds for shareholder enhancement activity are potential trouble spots for credit investors. With adjusted net leverage increasing, especially for non-financial companies, and risk compensation at cyclical lows, we anticipate credit spreads to move marginally higher as we move further into 2018, providing investment grade corporate bonds with

modest excess returns versus similar maturity Treasuries for the full year. We are in the mature bull market stage of the credit cycle and will continue to emphasize higher quality companies within our client portfolios and investment strategies.

While short-term interest rates have moved materially higher over the past year, long-term interest rates have actually declined. The yield curve has flattened considerably as tighter monetary policy is bumping up against the market's low inflation expectations, along with the fact that U.S. Treasury yields are attractive versus

U.S. CORPORATE PROFITS AND LEVERAGE



Sources: Bloomberg

Figure 2.

other global sovereign rates. Year to date total returns of 2% for U.S. Treasuries have been marginally positive overall with longer maturing Treasuries outperforming short- and intermediate-term Treasuries. The growing impact of cyclical factors such as a tighter labor markets, broader global economic growth and higher commodity prices could push inflation above our 2018 estimates, and with it, longer term interest rates. However, a steeper curve and materially higher rates is not our base case estimate for Treasuries next year. As you can see in figure 3, Prudent Man Advisor's estimates are higher than current yields, although largely in line with forward rates that have already been

	Current UST Yield	2018 PMA Estimate
Cash	1.16	1.75
1 Year	1.64	1.99
2 Year	1.81	2.15
3 Year	1.93	2.26
4 Year	2.06	2.36
5 Year	2.16	2.45
6 Year	2.24	2.51
7 Year	2.30	2.57
8 Year	2.34	2.62
9 Year	2.39	2.67
10 Year	2.40	2.67
20 Year	2.69	2.86
30 Year	2.79	3.05

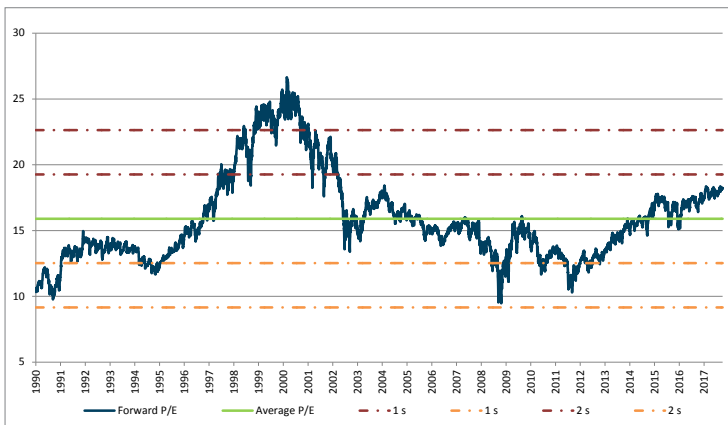
Figure 3.

▶ PRUDENT MAN ADVISORS MARKET OUTLOOK WINTER 2017

priced into the market. Overall, we expect Treasuries to return approximately 2% next year, slightly higher than our forecasted cash returns of 1.5% which will directly benefit from further Fed tightening.

The U.S. stock market has now entered the second longest bull market since 1926 as measured by the S&P 500 Index. While the current equity market somewhat reminds us of the irrationally exuberant bull market of the 1990's, equity valuations are not extremely overvalued based on corporate profitability, future earnings expectations and the lack of compelling investment alternatives. Forward P/E multiples, while rich to historical averages, aren't close to levels we have seen at previous market tops (see Figure 4). While this is not to suggest that a large market correction won't occur sometime during 2018, conservative earnings estimates still provide the foundation for continued strong equity performance next year. Prudent Man Advisor's base case expectation for domestic equity returns in 2018 is 7.5%, albeit with a wide range of potential returns given the possibility for increased volatility in the year ahead.

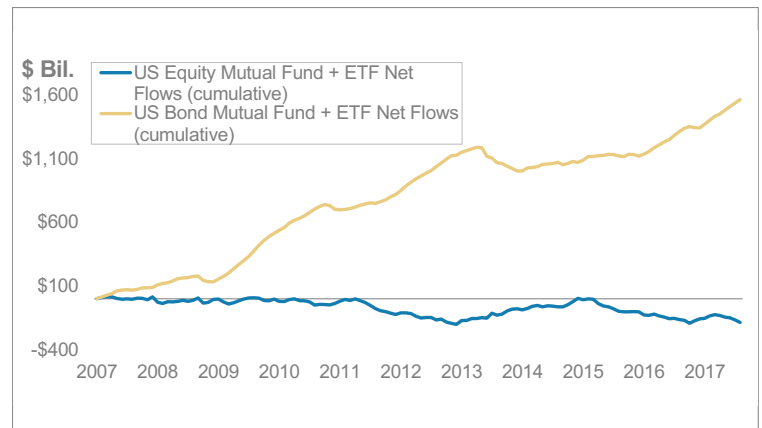
FORWARD S&P PRICE TO EARNINGS RATIO



Sources: Bloomberg

Figure 4.

As prudent investors, markets often become too complacent of potential risks at this point in the credit cycle. Importantly, while there is considerable uncertainty regarding the potential fiscal impact and consequences of the proposed changes in the tax code, we believe most of the market impact has already largely been priced into the market, pulling forward returns into 2017. Our return target is also informed by market technicals and our generally supportive economic outlook as discussed below. Historically, market tops have been marked by large and material investment flows from bonds into stocks, which we have not yet evidenced thus far during the bull market. In fact, according to research by Morgan Stanley, cumulative net outflows from U.S. equity ETFs and Mutual Funds approach \$150 billion since 2008 while U.S. fixed income ETFs and Mutual Funds have seen \$1.3T in net inflows (see Figure 5).



Sources: Morgan Stanley

Figure 5.

Ultimately, economic and business fundamentals drive asset values and market performance. However, liquidity, or the lack thereof, can create its own market outcomes, regardless of fundamental considerations. This is true in all markets but is particularly true in the over the counter bond market. In our opinion, the financial crisis was as much caused by a liquidity crisis as it was a credit crisis. We believe the potential for another liquidity crisis despite the massive amounts of new regulations and capital requirements put in place and over the past decade hasn't been solved. Think of market liquidity as a door to a room. That room (the market) is filled with investors of all sizes and shapes. The problem with the liquidity door is that it can shut very easily and very quickly. If a fire breaks out in the room, panic can ensue if the intensity increases. Adding further complexity to an investor's escape path, the size of the liquidity door shrinks in direct relation to both the number of investors who want to exit the room and their relative size. Once shut, the door does not open easily at all. As experienced investors, we must remain especially vigilant about the potential liquidity risks in the markets at this stage of the credit cycle. Liquidity is a critical consideration when managing all of our client portfolios.

Importantly, strategic diversification across allowable asset classes enhances portfolio returns, reduces portfolio risk and enhances portfolio liquidity. We would not be surprised to see the equity markets experience a healthy correction in the year ahead should interest rates move higher than our forecast. Such a scenario could unfold if the Fed follows through with their 2018-2019 policy estimates, which risks inverting the yield curve and causing the market to price in a higher probability of a recession. Conversely, we also would not be surprised to see another strong year of returns for risk assets despite full valuations. Prudent investors must remain cognizant that the future unfolds in a persistently inconsistent manner. A conservative portfolio mix of asset classes typically doesn't provide the highest or lowest returns, but creates long-term positive outcomes for that prudent investor (see Figure 6).

2010	2011	2012	2013	2014	2015	2016	2017
S&P 500 Stocks 15.06%	Taxable Municipal Bonds 20.91%	International Stocks 17.60%	S&P 500 Stocks 32.39%	Taxable Municipal Bonds 16.29%	S&P 500 Stocks 1.38%	High Yield Bonds BB 13.2%	International Stocks 24.40%
High Yield Bonds BB 14.93%	US Treasury Bonds 9.79%	S&P 500 Stocks 16.00%	International Stocks 15.59%	S&P 500 Stocks 13.69%	Taxable Municipal Bonds 0.93%	S&P 500 Stocks 11.96%	S&P 500 Stocks 20.49%
International Stocks 12.98%	Inv Grade Corp Bonds 7.51%	High Yield Bonds BB 14.36%	Portfolio Mix 13.53%	Portfolio Mix 9.51%	US Treasury Bonds 0.83%	Portfolio Mix 8.02%	Portfolio Mix 13.34%
Portfolio Mix 11.77%	High Yield Bonds BB 6.12%	Portfolio Mix 12.80%	High Yield Bonds BB 5.19%	Inv Grade Corp Bonds 7.51%	Portfolio Mix 0.09%	Inv Grade Corp Bonds 5.96%	Taxable Municipal Bonds 7.49%
Inv Grade Corp Bonds 9.52%	Portfolio Mix 4.67%	Taxable Municipal Bonds 11.08%	Inv Grade Corp Bonds (1.46%)	US Treasury Bonds 6.02%	Inv Grade Corp Bonds (0.63%)	Taxable Municipal Bonds 4.97%	High Yield Bonds BB 7.09%
Taxable Municipal Bonds 7.31%	S&P 500 Stocks 2.11%	Inv Grade Corp Bonds 10.37%	US Treasury Bonds (3.35%)	High Yield Bonds BB 5.34%	High Yield Bonds BB (1.04%)	International Stocks 4.72%	Inv Grade Corp Bonds 5.58%
US Treasury Bonds 5.88%	International Stocks (14.25%)	US Treasury Bonds 2.16%	Taxable Municipal Bonds (5.42%)	International Stocks (3.39%)	International Stocks (4.29%)	US Treasury Bonds 1.14%	US Treasury Bonds 2.08%

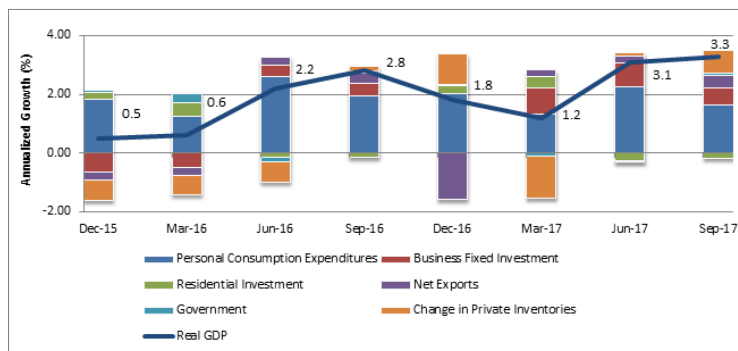
As of 11.30.17. Portfolio mix: 50% Equities / 50% Diversified Fixed Income

Figure 6.

Economic Outlook

The current U.S. economic expansion represents the third longest expansion since 1900. This year, economic activity is on pace to surpass the current expansion average growth of about 2.2% per year. Third quarter gross domestic product grew at a 3.2% annualized following a 3.1% gain during the second quarter. The strong number was a surprise to the markets following localized slowdowns caused by major storms in Texas and Florida. Underlying data showed positive contributions from consumer spending, inventory investment, business investment, state and local government spending, and exports (see Figure 7). Business spending has been a key driver of growth in the last two quarters; primarily supported by accommodative financial conditions and positive business sentiment. Growth detractors included housing investment and imports. Thus far, a combination of economic and market based indicators suggest that economic activity in the U.S. will likely be sustained around current levels in 2018. A few potential boosts to economic growth in the next few years could come from fiscal policy and a strengthening global economy. While the potential economic impact of tax reform is highly uncertain, a potential impact may include increased short-term economic growth albeit with higher budget deficits in the long run. Global economies continued to pick up steam throughout 2017. According to the World Economic Outlook report by the International Monetary Fund (IMF), global growth is projected to rise to 3.7% in 2018. This should support the U.S. economy and markets as well. We expect U.S. growth to maintain the current trend and anticipate U.S. GDP growth of around 2.50% for 2018 (see Figure 10).

CONTRIBUTIONS TO % CHANGE IN REAL GDP

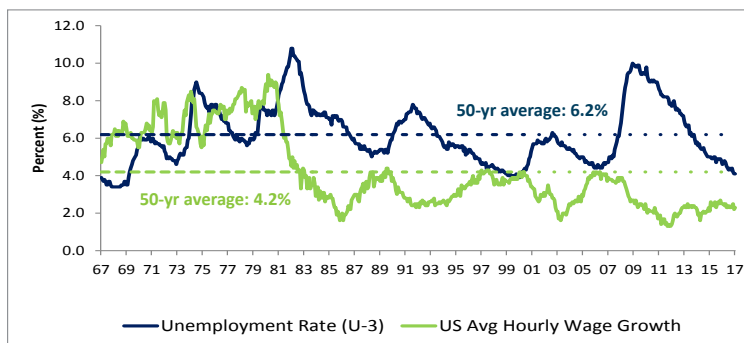


Sources: Bloomberg

Figure 7.

U.S. leading economic indicators continue to indicate stable domestic growth in the year ahead. Overall, improvements were associated with increased business and consumer confidence, a tightening labor market and a stronger manufacturing sector. Housing market indicators and consumer credit remain below trend but show positive momentum. The November jobs report showed the economy added 228,000 jobs, which remains above the three month average of 170,000. Sectors that contributed positively to the jobs report include professional and business services, manufacturing and health care. The unemployment rate remained at 4.1%, the lowest in 17 years and well below the long-term average (see Figure 8). The labor force participation rate of 62.7% remains steady and is in line with readings over the past three years. As long as job creation continues (>150,000 jobs per month) to exceed flow of new entrants to the labor market (80,000 to 100,000 jobs a month), the unemployment rate is likely to remain low. Our outlook for 2018 calls for a 4.3% unemployment rate by year-end.

U.S. UNEMPLOYMENT AND WAGE GROWTH



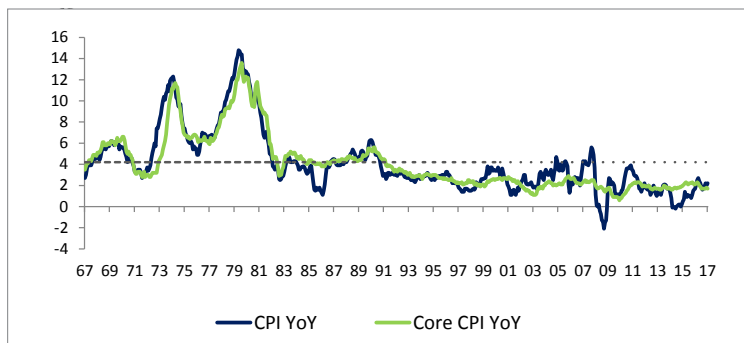
Sources: Bloomberg

Figure 8.

Although U.S. payroll data continues to exhibit solid job gains, wage growth remains persistently sluggish. Historically, periods of labor market tightness have resulted in rising unit labor costs. Thus far, wage pressures have remained subdued. During the month of November, hourly earnings grew 2.3% on a year-over-year basis, in line with current headline inflation levels but below the long-term average of 4.2% (see Figure 8).

Inflation remained well contained once again in 2017. While deflationary forces have remained persistent since the financial crisis, we do see inflation pressures building somewhat in the year ahead. In November, the year-over-year headline Consumer Price Index (CPI) grew by 2.2%, spurred by higher energy costs, used vehicle prices and shelter costs. Headline CPI for the same period in 2016 was 1.8%. Core CPI (excluding food and energy) fell slightly to 1.7% in November while the Personal Consumption Expenditure Core (PCE) index, the Fed's preferred gauge of inflation, came in at 1.5%, well below the Fed's 2% target (see Figure 9). In the near term, we expect to see a slight pick-up in wage and price inflation, supported by tighter labor markets and overall global growth. We expect 2018 headline inflation in the U.S. to increase slightly to 2.25%, somewhat above the Fed's 2.0% inflation target.

CPI AND CORE CPI



Sources: Bloomberg

Figure 9.

Despite mixed inflation data, the Federal Open Market Committee (FOMC) raised the target range for the Fed Funds rate by 0.25% to a range of 1.25% to 1.50% on Dec. 13. In their meeting statement, they cited solid economic growth, driven by job gains and a continued drop in the unemployment rate despite hurricane related disruptions. The Fed currently forecasts three hikes in 2018, a more rapid pace than what the bond market currently anticipates. Prudent Man Advisor's forecasts two more rate hikes in 2018. While economic fundamentals will ultimately determine the pace of tightening, moving the Fed Funds target range above 2% could prove problematic for the economy and the markets.

The future path of interest rates will also be affected by the actions of global central banks. Following the global financial crisis, central banks around the world engaged in accommodative monetary policies which led to unprecedented central bank balance sheet growth. In an effort to normalize interest rates, central banks have started to shrink their balance sheets gradually. This process will take time and could lead to higher interest rates in the future. So far, the Fed has been reducing the volume of bonds held at a rate of \$10 billion per month with a plan to accelerate to \$50 billion per month by the end of 2018. The impact of the unwinding thus far has been benign although, as prudent investors, we recognize market technical's are changing, which can impact valuations.

Overall, we expect the U.S economy to continue experiencing modest economic growth with full employment and slightly higher inflation in 2018. Primary risks to our outlook include geopolitical concerns, policy uncertainty and market cycle considerations.

Economic Projections	2018
US Real GDP	2.50%
US Headline CPI	2.25%
US Unemployment Rate	4.30%

Sources: Prudent Man Advisors

Figure 10.

Contact



JOHN H. HUBER, CFA
Senior Vice President, Chief Investment Officer
Prudent Man Advisors, Inc.

Tel: 630.657.6510
Email: jhuber@pmanetwork.com

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