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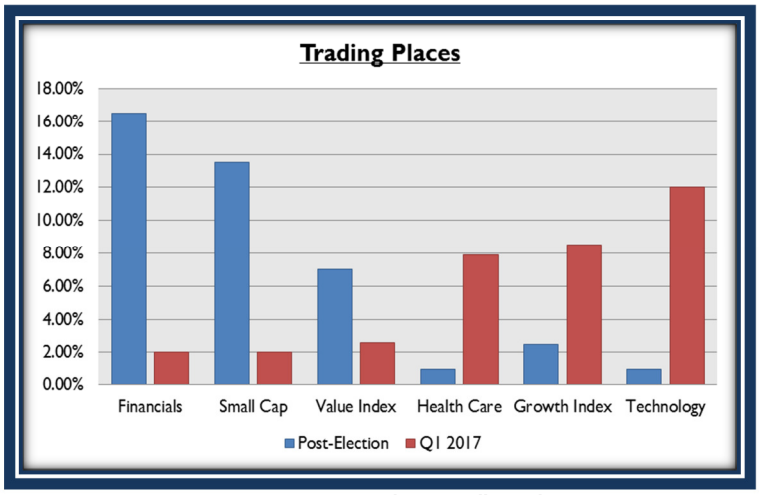
First Quarter 2017 Market Commentary

Index Performance

The first quarter of 2017 saw markets drift higher in the wake of last year's Trump Rally. While the tumultuous first days of the Trump administration roiled Washington, Wall Street was able to ignore the petty political squabbling and await the substantive economic policy that had been promised. Markets were therefore mostly calm as the new occupant of the White House settled into taking the country in a new direction. The S&P 500 gained 5.5% and the Dow rose 4.5% through the end of March. Technology and growth stocks did well this first quarter after their lagging performance last year. The NASDAQ returned 9.8% and the growth-oriented Investor's Business Daily Mutual Fund Index rose 7.8%. Bonds continued to underwhelm: the Barclays U.S. Aggregate Bond Index was up only .8% for the quarter.

Volatility was absent in 2017's first three months as the major indexes experienced only two days of moves greater than one percent. In contrast to last January's worst opening week ever and fears of a recession, 2017 has been relatively stable. Investors appear to be evaluating the post-election rally, reallocating where appropriate, maintaining confidence, and not letting every Trump-related news flare-up dictate their buying and selling. Buyers of the election's hottest sectors (including financial companies, small and undervalued companies) held firm and bought the sectors that had been decidedly out of favor last year (technology and healthcare companies and large growing companies).



Source: S&P Dow Jones Indices, Russell US Indexes

Note in this chart that none of the market segments has lost money: instead of selling investors are diversifying and seeking participation in a broader swath of the market. We take this to be a healthy sign for a bull market that entered its eighth year in March.

Although eight years seems long for a bull market to be sustained, and corrections have been few and far between (there have been four total) our current market environment can best be described as a "secular bull market." A secular bull market is measured not from a market bottom but from the index's achievement of a new high. From its previous high reached in 2007, the S&P 500 did not reach a new high until 2013. From this perspective, then, our secular bull market is only entering its fourth year. The bull may have further to charge.

The acclaimed 20th century investor Sir John Templeton famously declared that bull markets are born on pessimism; grow on skepticism, mature on optimism, and die on euphoria. Investor emotion these past three years has been anything but euphoric or optimistic. Both professional and retail investors have been frustrated by lac0kluster growth, and their skeptical forays into the stock market seem always to be accompanied by the fear of an inevitable, overdue bear market. We appreciate this apprehension but we approach the market with a realistic optimism: growth and other hard economic data still are mediocre, to be sure, but the trend has been improvement. And, politics aside, business thrives on tax cuts and deregulation.

Normalizing Markets Focus Attention on Washington

Following the breakneck pace of gains we experienced late last year the markets have returned to their previous muted normality. What is leading the markets thus far, and will continue through the rest of the year, is President Trump's legislative agenda. Meanwhile the Federal Reserve is ratcheting up interest rates as their outlook on the economy improves, and oil prices balance as OPEC attempts to reassert some semblance of control over crude supply.

Federal Reserve

The Federal Reserve raised short term interest rates in March for just the third time in over ten years. The federal funds rate now hovers in a range between .75 and 1%. Investors welcomed the hike and especially welcomed the Fed's latest assessment of the economy. "We have confidence in the robustness of the economy and its resilience to shocks," Fed Chair Janet Yellen stated following the hike. Two more hikes are expected this year.

The Fed's new confident stance signals to wary investors that after eight years of accommodative monetary policy, the economy is nearly healthy enough to thrive on its own. Moreover, the Fed at their March meeting discussed shrinking their balance sheet toward the end of the year. Recall that the Fed has about $4.5 trillion of government and mortgage bonds on its balance sheet that it purchased during the recession to stimulate the economy with new money and lower yields (called "quantitative easing"). While the Fed will need to be gradual and deliberate as it winds down its outsized influence in bond markets, the fact that both stimulus strategies—zero-interest rates and quantitative easing—are fading is a return to normal and a good thing for the economy and securities markets.

Oil

Since its bottom in February last year, oil has risen over 100% to a comfortable range around $50 per barrel. The low prices spurred on by OPEC maintaining production levels in 2015 put many domestic shale drillers out of business. But it also made many of these companies more efficient and better able to make money at levels that previously resulted in net-losses. And so OPEC and Russia agreed in November to production cuts to raise the price of crude notwithstanding the imminent boon to American shale.

The result of this manipulation has been a sustained balanced price of oil. The price per barrel is widely expected to remain below $60 for the third year in a row. This year overly optimistic expectations of rising prices and a glut of oil here at home have combined to make energy stocks the worst-performing in the first quarter. Nevertheless shale is flourishing and American oil production is second in the world to, and fast encroaching, that of OPEC boss Saudi Arabia. With the OPEC cartel counterbalanced by American ingenuity and favorable production regulations, investors are comfortable with this new normal and are no longer beholden to oil's price fluctuations as they had been in 2014 and 2015.

All Eyes on Washington

What the market does the rest of the year depends in large part on what happens in Washington, D.C. Such is the extent to which investors have bet on the positive effects that President Trump's pro-growth policies may have on our moribund economy. The two days of real volatility we experienced in the first quarter can be attributed to the goings on of the federal government. Following the President's address to Congress Trump-traders were invigorated by his calls for deregulation, infrastructure spending, and tax reform and they pushed indexes up over one percent the next day. Three weeks later the reality of Beltway gridlock became apparent to those same traders as Republican infighting on healthcare reform brought down the President's first major legislative push. Indexes fell over one percent for the first time since last October on news of the fiasco and what the failure could portend. Investors and observers, including a fuming Wall Street Journal editorial board, deduced from this masochistic disaster a divided Republican party unwilling or unable to cohere in order to implement the President's agenda. Thus did markets limp through March suffering a slight loss on the new narrative of an ineffective Trump presidency.

In addition to these domestic policy disputes the President is also grappling with heightened risks around the world. However, stocks have shown an uncanny ability to shrug off foreign policy concerns, though such entanglements may distract the White House from putting on the aggressive drives necessary to get legislation through both chambers of Congress. In all events we will be looking to Washington to help us ascertain to what degree markets will rejoice or retreat depending on the success or failure of the President's agenda.

Key Economic Indicators

Gross Domestic Product

The economy grew at a mild 2.1% rate in the fourth quarter of 2016. This is an upward revision from earlier estimates but is still a disappointing number. The annual growth rate for 2016 was just 1.95%, right in line with our middling growth since the recession of 2008. The election of Donald Trump caused the sentiment underlying the economy to rise to new heights, as explained below. We will see whether this recent optimism can translate to real economic growth this year. Consumer spending, after all, remains the largest component of the GDP measurement.

The initial estimate for first quarter 2017 GDP is due at the end of April. Where this number will end up is something of a mystery because the two Federal Reserve Bank forecasts (from the Atlanta and New York Feds) diverge significantly. The Atlanta Fed, as of this writing, predicts weak .6% growth while the New York Fed predicts a healthier 2.8%. The actual number may be somewhere in between the two forecasts, suggesting a continuation of stalled growth but with upward momentum fueled by the optimism of President Trump's first months in office.

Consumer Sentiment

American consumers are feeling optimistic and confident in the economy. Consumer sentiment remains at elevated levels and reached a new high in January thanks in part to the honeymoon period of Donald Trump's first months in office. The persistence of elevated consumer sentiment is somewhat surprising given the uninspiring hard economic data released so far this year. What's more, Trump's approval rating is the lowest of any incoming president since polls started being taken with Harry Truman. Nevertheless, sentiment is high and consumer confidence (the average consumer's assessment of current business and labor markets) recently reached its highest level since December of 2000.

What explains this disparity? Pollsters and pundits blame rank partisanship, or the tendency of voters to don rose-colored glasses when their party is in power. But this explanation fails to account for Trump's disapproval rating and the fact that different polls have arrived at the same conclusion: sentiment and optimism have not been this high in years. We think the American consumer is encouraged despite unremarkable hard economic data because President Trump, however crudely, offers an alternative to the repeated blunderings of our governing class. Whether this enthusiasm will turn out to have been justified we will find out these next four years. In the meantime, Americans remain hopeful, and hope is a good thing for the economy.

Employment Situation

The unemployment rate fell in March to 4.5%. The last time the number was this low was ten years ago, pre-recession. Job additions have averaged 177,000 per month this year and the broad unemployment rate measure, the U-6 rate, continues to trend down coming in at 8.9% in March.

Wage growth was up in March 2.7% from a year ago, still beating inflation and a good sign that employers may be increasing pay to attract the best employees in the new competitive jobs market. The labor force participation rate, the percentage of people working or seeking a job, stands at 63%, a disappointing low at which it's been stuck for four years. Retiring baby boomers and young folks now staying in the cocoon of higher education partially explain this new phenomenon, but it is undeniable that there are significant numbers of able-bodied workers simply not working and not seeking to work. All things considered the employment situation is decent and improving. There is more room for wage growth and increasing participation levels, though unemployment has fallen and "slack" in the market is being tightened.

Looking Forward

Confidence and sentiment are riding high as Americans have lofty expectations for what the president may accomplish his first year in office. The president proclaimed his goal of 3-3.5% GDP growth on the campaign trail to be ushered in by his business-friendly policies. Excited markets advanced, perhaps prematurely, though this first quarter saw a sobering up. Investors haven't retreated but are wisely taking a wait-and-see approach to what may come out of Washington. More so than in previous years, we in the investment community will be focused on the federal government and seeking possible opportunities created by legislation or by speculation surrounding the same.

The second quarter is usually more volatile than the first. The old wrong-headed adage to "sell in May and go away" is premised on negative market movement occasionally experienced at this point in the year. With this in mind and as we navigate our way further into 2017 we remain committed to our investment strategy which stresses the importance of risk-appropriate portfolios. Our investment technology can, with a proper selection of diverse mutual funds and ETFs, create such risk-appropriate portfolios—from the most conservative investor all the way to investors focused solely on aggressive growth. In addition, with our Target Volatility strategy investors desiring lower risk have the opportunity to engage with the markets without the fear of being jerked around and without the frustration of sitting on the sideline unable to participate in market gains. Finally, with our innovative tactical Walk Forward strategy investors with higher risk tolerances can seek to maximize growth as our technology analyzes and allocates to asset classes exhibiting the best potential for progress.

So while we may experience more volatility as expectations continue to conform to reality, we believe we have an investment strategy that can help us maneuver through this year of political and economic change and uncertainty.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk includes the uncertainty and volatility of potential returns for a portfolio or an individual investment over time. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk. A computer modeling program may not reflect actual risk and return parameters applicable to any particular portfolio or investor. Actual investment decisions made on the basis of a computer generated model or modeling program may be materially different from expected or intended results, and any computer modeling program is subject to errors in the program and system failures at any time.

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