Markets do not like uncertainty. The U.S. appears to be dealing with more uncertainty today than it was previously, yet the U.S. equity market appears unshaken. Areas of uncertainty include: the future of global trade, our overly complex and confusing healthcare system, tax reform, financial regulatory reform and growing geo-political risks. We have military ships heading to North Korea, bombs heading to Syria and icy relations with China and Russia. Oddly enough, the more things change, the more they remain the same. *The real question is are we compensated for the risks reflected in the capital markets that we are taking as investors?*

1. We are entrenched in a slow growth economy that is supported by a growing level of consumer and government debt and aggressive monetary stimulus. Yes, the economy is showing signs of improvement, but it continues to battle through weak business formation and a lack of private credit expansion. We are at the point where the Federal Reserve has indicated they are prepared to move away from the aggressive monetary stimulus they enacted following the Financial Crisis. *We expect that this will be a slow process given the fragile state of the economic recovery.*

2. *The valuation of publicly traded financial assets is elevated and is supported by a flood of liquidity and extremely low interest rates which were put in place as part of a shift in policy after the Financial Crisis.* Even though there has been some upward movement, interest rates are still bumping around near historic low levels.

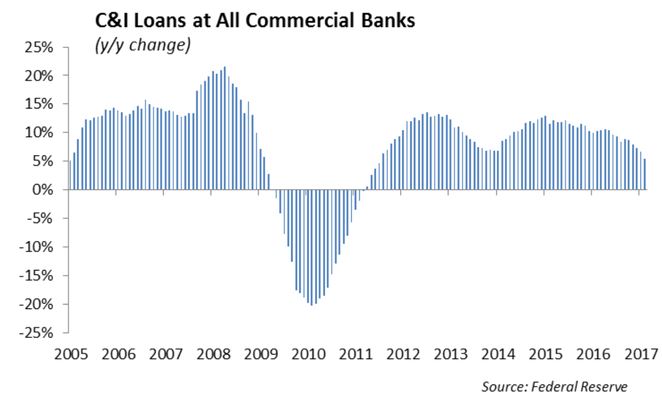
3. The end in the credit cycle signals the downward move in the business cycle. A credit cycle ends when both borrowers and lenders retrench. *The growing weakness in the quality of auto and credit card loan portfolios combined with a tightening in the commercial mortgage loan market, leads us to believe we are seeing the beginning of a downward shift in the credit cycle.* However, spreads in the corporate market remain tight based largely on suppressed volatility.

4. If we do not get meaningful tax and financial regulatory reform accomplished this year, we expect the U.S. economy will slow. We have relied on overly stimulative monetary policies and increased levels of debt to coax a nascent pace of economic growth. We are at the point where the marginal benefit from the Fed's monetary stimulus appears to have less impact on the economy. The consequence is born by savers who are showing up at the doorstep of retirement with insufficient savings in their retirement portfolios. We need simplified banking regulation that incentivizes more thoughtful risk taking and business lending.

5. The risks to Trump's economic agenda are not domestic, they are international. Although Trump reversed on his campaign promise and has decided not to label China a currency manipulator, there is still a high risk he will continue to put pressure on the traditional trade paradigm. Trump still vows to renegotiate or get rid of NAFTA, which introduces additional uncertainty. Paul Ryan's Border Adjustment Tax proposal has been met with a wide mix of reactions, from negative warnings by major importers to comments deriding its complexity from some of those in the administration. We do not see this as a realistic path forward and see trade as an issue that could continue to derail the administration on the goals of true corporate tax and regulatory reform.

The Economy

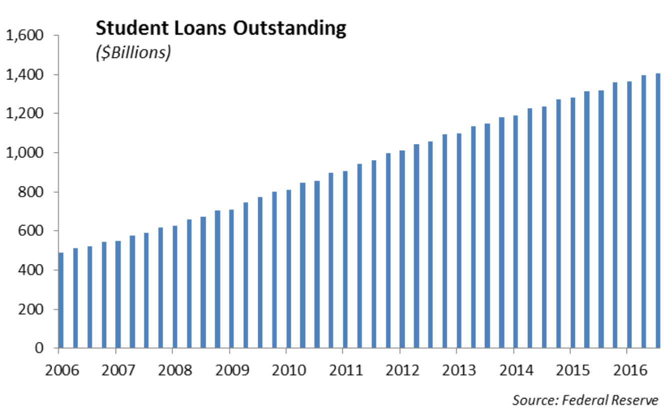
The U.S. economic expansion is now the third longest on record, however, it is one of the weakest recoveries on record as well. The U.S. economy, measured by Gross Domestic Product, grew at an estimated pace of 1.6% over the first quarter. In the context of economic recoveries and eight years after the Financial Crisis, this ranks as a fairly weak recovery. We expect the economy will continue to grow at a steady 2.0% pace until we see movement from Congress on financial regulatory reform and tax reform. Both are important to the economy since financial regulatory reform could mean a lighter regulatory touch in banking which could translate into an increase in loan growth. *Private credit expansion is the lubricant for the gears in the economy and bank lending is a primary source of credit especially with small business. New data from the Federal Reserve shows a consistent decline in loan growth to its slowest pace since 2014.*



The health of the consumer sector is critical to a sustained economic recovery. That health rests on two main issues: employment and wage growth. If the economy is creating jobs and people are experiencing wage growth, that translates into improved consumer confidence and spending.

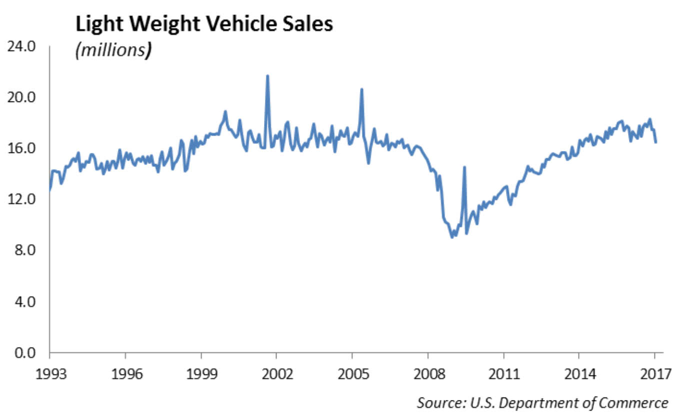
Unemployment dipped to 4.5% in the first quarter, hitting its lowest level in over a decade and shows growing tightness in the labor market. However, the structure of the job market is troubling as much of the growth is in part-time workers that have lower wages and do not receive employee benefits.

At this point, the consumer sector is stable but not accelerating. The rally in the domestic stock prices pushed U.S. household net worth to a record $92.8 trillion, which is positive for consumer spending. At the same time, household balance sheets are showing increased leverage, evidenced by growth in credit card, auto loans and student loan debt which has reached record levels. However, consumer debt relative to disposable income has declined. The recent annual increase in average hourly earnings of 2.7% underscores the growing tightness in the labor market and is positive for consumer spending.



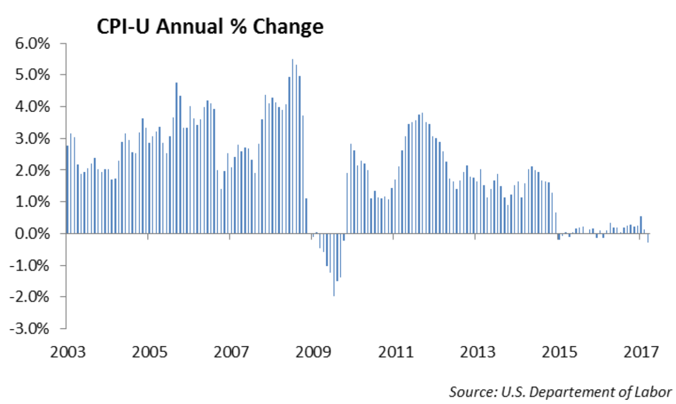
The student loan market remains a concern for our economy. An increase in the number of Americans choosing to attend college over the past decade has helped to double the amount of student loan debt over the same period. Student loan debt reached $1.3 trillion this past quarter according to the Federal Reserve Bank of New York. Today, the average student leaves college with $34,000 in debt which is an increase of nearly 70% over the past decade. The delinquency rate on student loans is much higher than credit card and auto loan debt with nearly 10% of borrowers 90 days past due on their payments. *The student loan debt is a structural problem in our economy and has turned into a subsidy for universities and a growing burden for the student who enters the job market with a high level of debt relative to their earnings.*

The two pillars we use to measure the health of the consumer are domestic auto sales and new home sales. This past quarter, domestic auto sales appear to have peaked and look to be slowing. After running at over 17.5 million units average sales in 2016, car and light truck sales declined to 16.5 million during March. Since the decline comes at a time of generous incentives from car companies and low gas prices, this suggests that car sales are past their peak. In addition, we see trouble looming in the subprime auto sector as banks, such as Capital One, bolstered reserves for loan losses in their sub-prime auto portfolios last quarter.



In contrast, the housing market is showing signs of continued strength. U.S. homebuilding jumped in February as unseasonably warm weather boosted the construction of single-family houses to near a 9-1/2-year high. In addition, according to the Commerce Department, housing starts increased 3.0 percent to a seasonally adjusted annualized rate of 1.29 million units earlier in the quarter. Homebuilding was up 6.2 percent compared to February 2016, suggesting housing would be a net contributor to economic growth this year. In addition, home prices rose in January at their fastest pace since mid-2014.

The manufacturing sector is showing stability. U.S. industrial production was flat in February, however, the underlying data suggests steady growth with a pickup in manufacturing and mining activity. Much of the flat growth near term appears to be weather related. Nonetheless, manufacturers are having to deal with rising commodity prices and in some cases rising inventories. *We expect the manufacturing sector to be a steady contributor to the economy this year, but we do not see a dramatic acceleration in manufacturing output.*



An increase in the level of inflation combined with growth in wages will help economic growth. With the 1.8% February increase in the Core PCE Index, it appears that the rate of inflation is now within the lower end of the Fed's 2% target range. In spite of a decline of -0.1% in consumer prices in March, modest pressure on both wages and prices have contributed to the overall pickup in inflation this past quarter. In December, the average hourly earnings for private sector workers reported by the Bureau of Labor Statistics increased at 2.9%, its largest increased during this recovery.

What is the Next Move Coming from the Federal Reserve?

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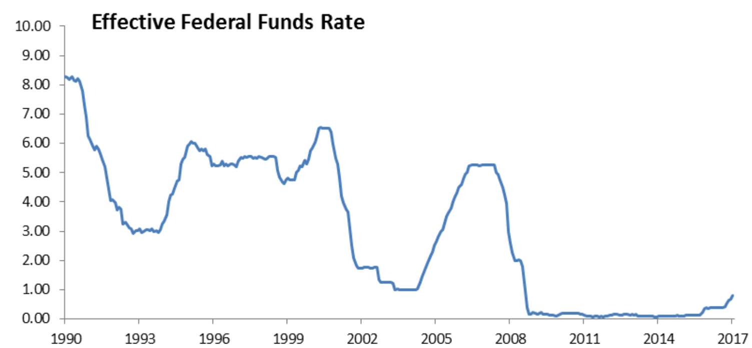
The recent improvement in the global economic recovery along with a much stronger capitalized global banking system is taking pressure off of global central banks to keep interest rates at low levels. The Federal Reserve is preparing the way to allow short term interest rates to increase albeit, in a slow and orderly pace. The Fed increased the target for the Fed Funds rate by 25 basis points in January and signaled that it would target an additional two moves in the Fed Funds rate throughout this year.



Source: Federal Reserve

However, interest rates will not begin to normalize to pre-crisis levels until the Federal Reserve begins the process of shrinking its balance sheet. During the Financial Crisis, the Fed used its balance sheet to buy over $4.5 trillion worth of US Treasury and mortgage backed securities (MBS). This allowed the banks to continue to originate residential mortgage loans and sell them into pools, which in turn were purchased by financial institutions, investors, mutual funds, and the Federal Reserve. This has had a powerful impact on helping to keep interest rates low.

With the improvement in economic growth, inflation and the job market, we are approaching a time when the Federal Reserve is willing to engage in a dialogue on what it looks like to begin to reduce its balance sheet.

The process of unwinding the Fed's balance sheet portfolio will be long and complex. We expect that in mid-2018 the Fed will announce that it will no longer re-invest coupon and pre-payments from its mortgage-backed security portfolio. This will amount to over $200 billion in MBS that will not be reinvested into the Fed's portfolio and will be allowed to be subsumed into the market. We would expect that once the Fed no longer reinvests in its MBS portfolio that may pressure spreads wider in the MBS market. Ultimately, as the Fed reduces its subsidy purchases in the MBS market, mortgage originations may slow and, in turn, mortgage rates will likely move higher as a result.

We do not expect the Federal Reserve to bring the size of its balance sheet down to pre-crisis levels over the near term. As a result, we expect interest rates will have a natural ceiling to how high they can rise given the slow pace of economic growth and low levels of inflation. Ultimately, we believe that the Federal Reserve will continue to use asset purchase programs as a policy tool in the future.

Expect the European Central Bank to Begin to Taper

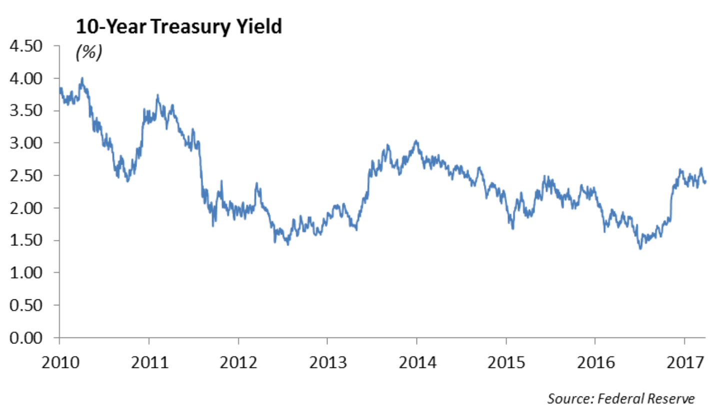
We expect the European Central Bank (ECB) will begin to taper its asset purchase program this year. When combined with several politically charged elections this summer, we expect this will result in elevated volatility in the European markets. The ECB began paring back its monthly purchases from €80 billion to €60 billion in April. *In contrast to the US Fed program, the ECB includes corporate bonds in its monthly purchases. As a result of paring back these monthly purchases, credit spreads will likely widen since the ECB is the dominant purchaser of non-financial corporate debt since last June racking up over €75 billion in euro-denominated corporate debt.*

British Prime Minister Theresa May gave official notice to the European Counsel that the United Kingdom was officially leaving the European Union. Brexit will take a long time to play out but will ultimately be stimulative to Europe. The noise around Brexit may also cause an increase to volatility. We expect that the populist movement in Europe will be a wild card to elections and the capital markets.

Investment Strategy

For much of the first quarter of 2017, the capital markets discounted an economic stimulus push coming from Trump's signals. This includes financial regulatory reform, reduced regulation across industry, healthcare reform, tax reform and an infrastructure spending initiative. Interest rates rose through much of the quarter, with the 10 year US Treasury peaking at 2.6% a few weeks ago before declining to a yield of 2.35%. At the same time, spreads in the risk sectors tightened which reduces the risk premium for investors. *The failure of the Trump Administration to get the votes necessary to repeal Obamacare has resulted in a decline in interest rates at the end of the quarter and appears to reflect an adjustment to more realistic assumptions of what the Trump Administration and Congress will actually accomplish over the near term.*

While performance across the credit sector was solid in the quarter, with spreads approaching recent tight levels, performance in the credit sector will be challenged over the near term. *We expect the 10 year US Treasury to trade in a range of 2.35% to 2.70% over the near term given our current economic outlook. Key drivers to interest rates will be tax and financial regulatory reform, as well as what the Fed decides to do to reduce its balance sheet this year. Solid movement in any of these areas will ultimately allow rates to move above our expected 2.70% threshold level.*



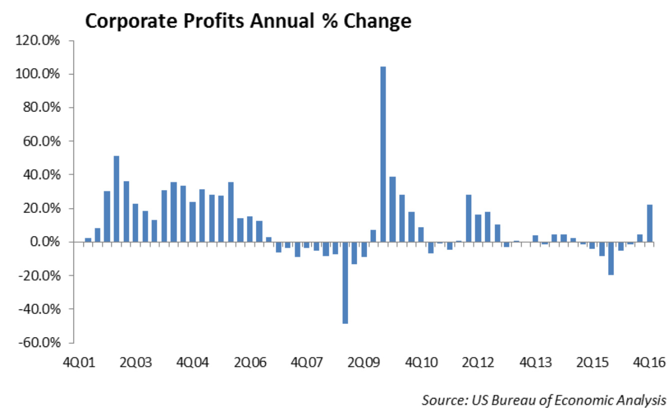
The low risk sectors, which include banks and utilities, offer the best relative value in our view. We see general deterioration in the credit quality of Real Estate Investment Trusts (REITs), particularly as it relates to retail, shopping malls and senior living. We see good relative value in the energy sector including the pipelines.

From insurance companies to public pension funds to private equity funds, there appears to be a substantial amount of money chasing the commercial mortgage loan market. A study by CrediFi indicates that in New York City alone, debt loan funds increased by 60% between 2014 and 2016. *While there are a number of reasons for this trend, it raises concerns for us given that cap rates in general have not adjusted higher with the recent move in interest rates.*

Equities

The S&P 500 posted its biggest quarterly gain since the end of 2015 with an increase of 6.07%. The move higher in stocks has extended post-election gains and pushed indices to record levels and valuations to stretched levels. The tech sector, which now represents over 22% of the total market cap of the S&P 500, lead the market with a 12.57% increase in the first quarter. During the quarter both the REIT and retail sectors underperformed. Retail has been under significant pressure as several companies including HH Gregg filed for bankruptcy, Macy's closing over 100 stores, and Sears received a going concern warning from its auditors. This has pushed vacancy rates in shopping malls to elevated levels and forced more restaurants into what has traditionally been retail space in malls.

This earnings season should be solid with marginal improvement in corporate profits. According to the Commerce Department report, after-tax corporate profits increased by 22.3% in the fourth quarter of last year compared to a year earlier. This is the strongest year-over-year gain in five years. We expect profit growth will continue given the comparisons to weaker energy related quarters last year.



With oil trading around $50 per barrel and structural improvement in the balance sheets of many energy companies, we believe there are still investment opportunities in the Master Limited Partnership (MLP) space. Oil prices are a wild card for our economic outlook this year. While oil prices have been stable around $50 per barrel, oil supply is at near record levels and Saudi Arabia announced an increase of 263,000 barrels a month in production in February.

We still like the bank stocks; however, valuations are approaching their higher levels. However, we are concerned about credit deterioration in the loan portfolios.