WINTHROP Capital Management

The foundation for our current investment position rests on the strength of the U.S. economy, which continues to expand at a healthy pace and seeds for an increase in the rate of inflation have been planted. As a result of the expansion, slack resources including labor and capacity are being put to work. Thus, after years of slow progress, we are starting to experience a higher level of scarcity in those resources. At this point, the fact that this expansion comes at a huge cost in the form of higher deficits and debt is not relevant. The key issue is the increase in interest rates as the scarcity of labor and resources continues to cause pressure on inflation. The move to higher interest rates effectively reprices the level of risk investors are willing to pay in the market.

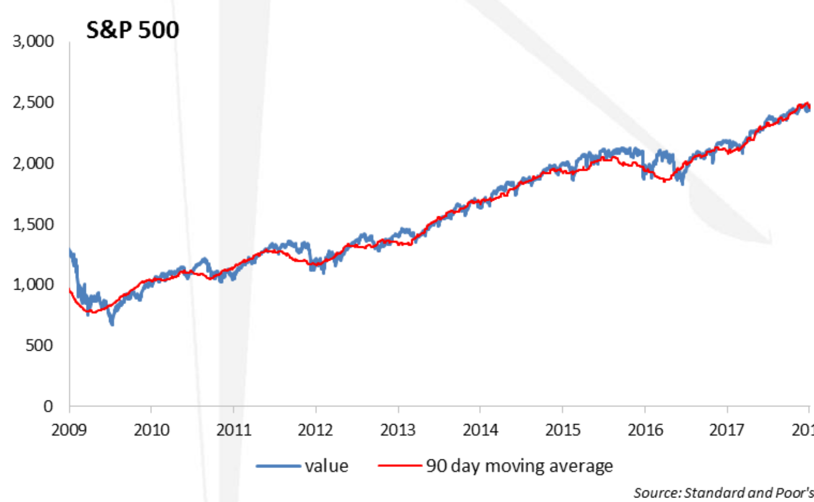
The question: "Where Do We Go From Here?"

Currently, we are experiencing solid economic growth, and we expect the Tax Bill will provide additional tail winds. The cut in the corporate tax rate to 21% and the repatriation of cash from overseas banks will result in an increase in capital investment which should persist through 2018.

Yet, we are in uncharted waters as the Federal Reserve continues to normalize monetary policy and reduce the size of its balance sheet. Consequently, U.S. Treasury and mortgage backed securities are being pushed back out into the market and off of the Federal Reserve's balance sheet – effectively reducing the subsidy the markets provided when the government purchased $4.5 trillion in bonds after the Financial Crisis. At the same time, issuance from the U.S. Treasury is increasing as the government increases its borrowing to fund the budget gap. When considering both the boost in Treasury supply coming to the market and higher expectations for inflation, an impending increase in interest rates is almost a certainty.

We continue to move through this journey with a healthy dose of caution. While the economy shows signs of strength, there are signs that indicate the next move may be toward slower growth. The flattening yield curve, the Federal Reserve's desire to normalize interest rates, slow loan growth in the banking sector, and the disruption around trade policy are each producing head winds for the economy.

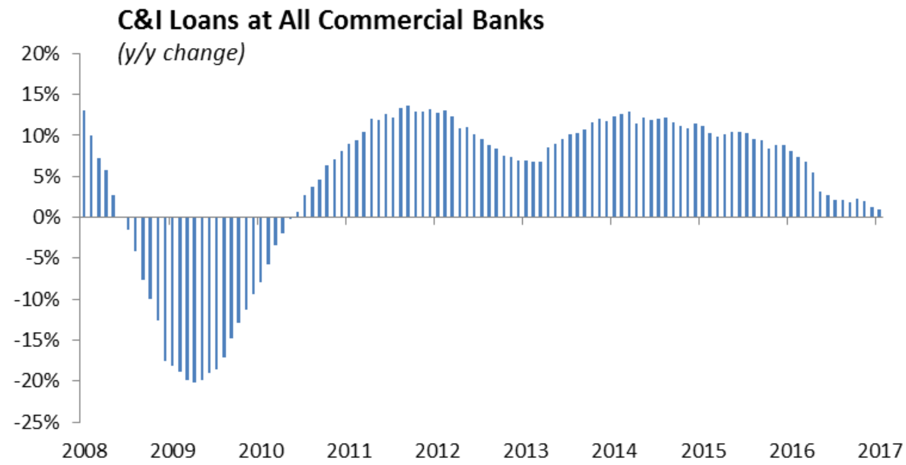
While we expect interest rates to push higher, at the same time, the equity market is showing higher volatility and valuations appear to be stretched. Investors should expect this heightened volatility to continue. Also, it is important to remember that this monetary policy normalization is a global issue. Most of the major developed countries led by Japan and Europe, are dealing with similar issues as they attempt to reduce the bond holdings held on the balance sheet of their central bank and normalize interest rate policy in coordination. Given the global interconnectedness of markets, the risk of disruption in our domestic capital market is compounded.



Monetary Policy

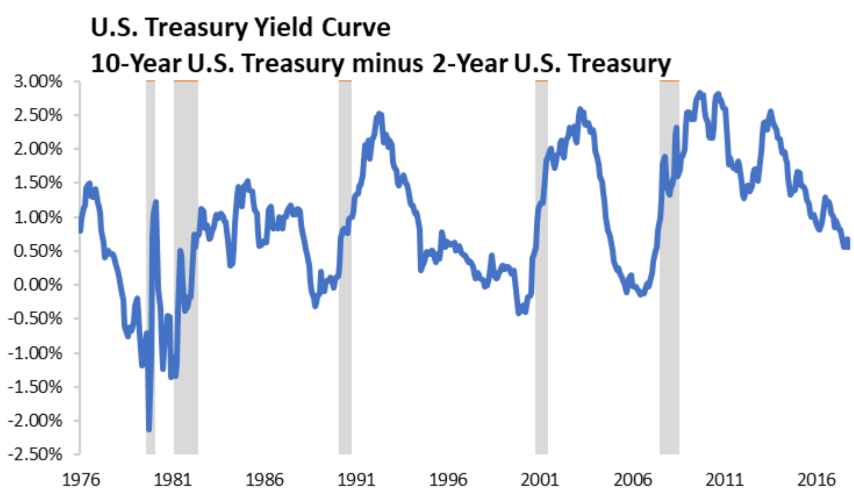
We are working through a huge global economic experiment. After the desolation of the Financial Crisis nearly ten years ago, the central banks of the major developed countries simultaneously poured money into the global capital markets in an attempt to jump start economic growth. This resulted in historically low interest rates and is the foundation of our new monetary policy.

Previously, we have written about our belief that we are in a new monetary regime - one in which the Fed uses its balance sheet to effect changes in interest rates across the yield curve. It is important to recognize this shift as we cannot continue to assume that the capital market machine functions the same way it did before to the Financial Crisis.



Source: Federal Reserve

Banks still serve the role as the leading source of lending in our economy. However, after the repeal of the Glass-Steagall Act in 1999, banks have expanded their operations into wealth management, capital market and other businesses that do not require as much capital. As a result, bank profits have increased consistently, and they are more efficient with their capital. Private credit expansion has been slow, and bank lending, measured by loan growth, is declining. At the same time, the banking sector is extremely healthy as loan portfolios perform well and capital levels are near their highest in recent history. Financial crises do not occur when the financial sector is performing well.

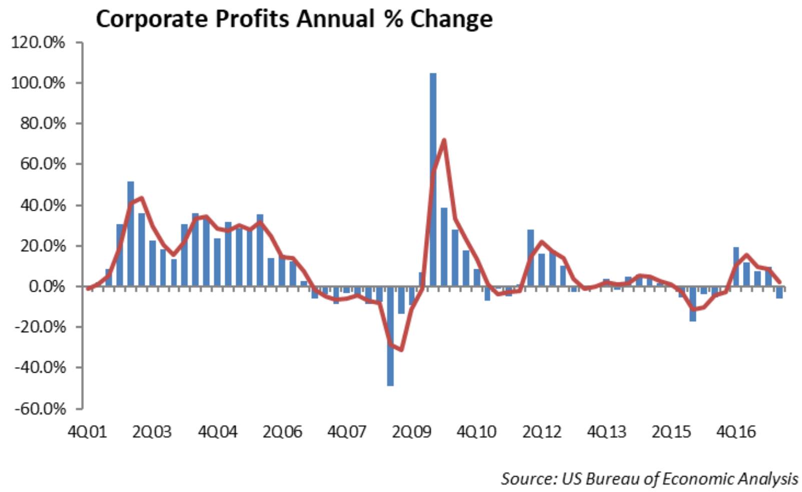


**Shaded area represents U.S. recessions* *Source: Bloomberg*

The concern for investors is the expectation that a rise in the rate of inflation will result in a correlated increase in the level of interest rates. While we expect pressure on rising short-term interest rates as the Fed continues to push rates higher, we do not expect an accelerated climb in yields in long-term rates.

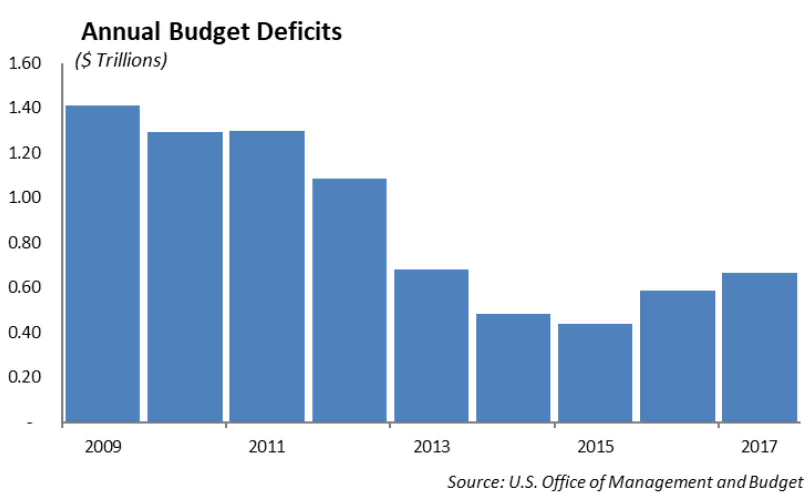
Furthermore, the U.S. capital markets continue to attract global investors helping to suppress the rise in the level of interest rates.

Fiscal Policy



While the domestic economy is hampered by uncertainty in foreign trade policy, a significant tail wind from the recent tax reform is contributing to economic growth. Corporate profits are coming off a year of solid growth, and we expect the tax reform to help sustain this profit wave through 2018. Capital investment will lag but still continue to contribute to economic growth. However, profit margins are near peak levels, and companies should feel pressure as commodity prices and labor costs increase, restricting further margin expansion.

Profit growth has been a contributing factor to the increase in equity prices. Quantitative easing has helped reduce interest rates which, in turn, helps corporations lower their borrowing costs and term out their debt maturities. However, these initiatives come at a large cost as government debt levels and the projected budget deficit increase. The debt to GDP ratio of the United States is approaching 100%, which is the highest level since World War II.



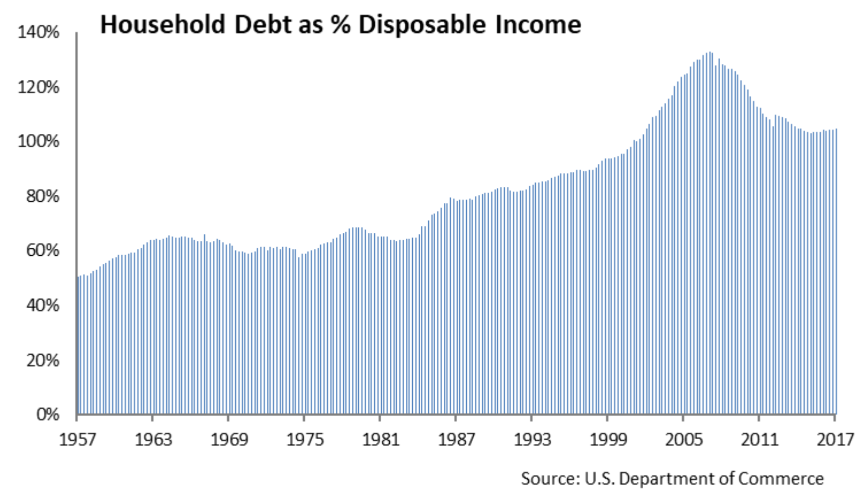
Following the Financial Crisis, the government consistently ran budget deficits from 2009 to 2012 which consistently exceeded $1 trillion in order to spur economic growth. The two year budget deal passed by Congress in February projects a budget deficit by 2019 that approached $1.2 trillion. We still expect the Administration to push for an infrastructure bill this year, which will further fuel economic growth.

The growing income disparity in our country threatens long term economic growth and will continue to challenge our democracy. In future elections, professional politicians will be challenged by candidates with "brands." The best way we can make sense of our current political environment is the belief that our form of democracy is *evolving.*

History affirms that, left unaddressed, the growing income disparity in the United States will eventually become a source of social unrest. Further, the evolution in our democracy and form of capitalism appears to be trending toward a "Universal Income" in which every qualifying household is provided money from the government to spend.

The Economy

Despite the modest growth in first quarter economic activity measured by Gross Domestic Product (GDP) to 2.4%, we believe economic growth will be closer to 2.7% for the rest of 2018. Although noise around trade in the near term causes some concern, we expect most sectors to contribute to economic growth this year.



While the consumer sector slowed in the first quarter, it still appears healthy. Despite gains in household income, consumer spending rose at a slower pace during the past quarter as the saving rate increased. With lower unemployment, more people are earning income and wage pressure is resulting in bigger pay checks. More income inevitably leads to higher consumption. As a result, household debt as a percentage of disposable income is trending lower.

The manufacturing sector continues to exhibit strength; however, there are heightened signs of stress. The auto sector is experiencing decreases in production, and dealer inventories are declining. In addition, the global supply chain is under pressure, which is limiting production. The increase in oil prices to $70 per barrel has helped increase production in the United States. For example, operations in the major drilling regions such as the Permian Basin, which is experiencing a shortage of workers and resources, have increased. A shortage of truck drivers, trucking capacity, and rail capacity adds pressure to manufacturing production and the supply chain. The Institute for Supply Management's Index, which measures backlogs of orders in manufacturing, reached its highest level since 2004 this past quarter. Seeds for an increase in the rate of inflation have taken root.

In our view, structural problems still persist in the economy following the Financial Crisis. In contrast to the strength in manufacturing, the pace of overall business formation remains slow. We believe this is due to two major issues: limited access to capital and a perceived heightened risk to starting a business. Since small businesses have historically driven job creation, this will likely have a long term impact on employment growth. However, since the Financial Crisis, large companies have created more jobs than small companies in the United States, mitigating the impact of the slowing business formation pace.

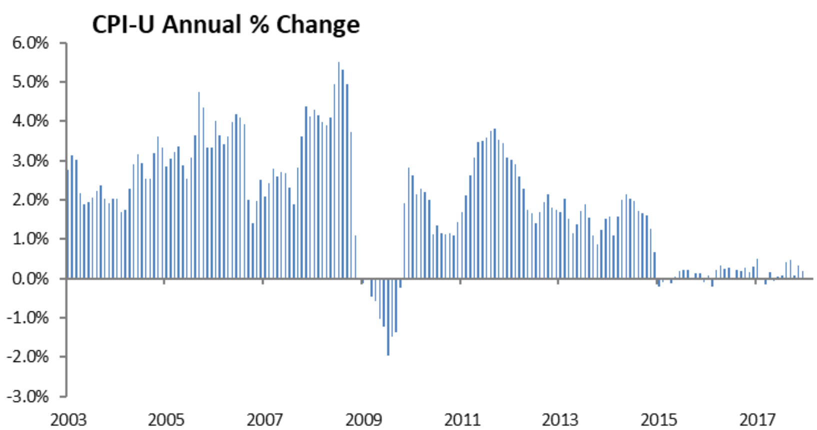
We are seeing evidence that the credit cycle is turning. There is an increase in the number of loans in workout with the banks and increased activity with bankruptcy lawyers. The American Bankruptcy Institute reported a sharp increase in companies filing for bankruptcy protection in March. As interest rates rise, business models predicated on low borrowing costs will be challenged to operate effectively.

Source: Federal Reserve

Investment Strategy

During the first quarter, investors were forced to navigate through higher volatility as a result of interest rate normalization. We expect this to be the theme for the remainder of 2018, which will lead to several repercussions.

First, U.S. stock prices, which have seemingly risen in a straight line since 2009, will likely feel more resistance. Corporate profits will remain strong, but margin pressure from increased labor and raw materials costs will impact profits. Stocks in the technology sector appear overvalued; however, equities in the oil and gas sector have more attractive valuations for investors.



Source: U.S. Departement of Labor

Second, this increase in volatility is normal. Markets do not move in straight lines over long periods of time, but investors have become complacent after several years of quarterly statements that display consistent increases in market values. *Markets are simply a means to price risk. As investors reassess the level of risk, the price of risk changes. Higher volatility is a reflection of the change in the price of risk.*

Third, interest rates are moving higher. With the improving trend in GDP growth and the reduction in monetary stimulus, we expect the yield on the ten year U.S. Treasury to normalize at a level below 3.5% before the Federal Reserve slows its tightening push. There is a higher probability of a rising rate of inflation today, rather than deflation. After four years of stagnant inflation, the markets are reacting to rising inflation expectations with higher interest rates. The simplistic argument is that *the Fed desires a higher short term interest rate largely so it has room to lower rates during the next decline in economic activity.*