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Stock Market Development

Through January the markets continued to reach new highs in anticipation of fiscally expansive policies, decent GDP growth, moderate inflation, a solid labor market, tolerable interest rates and better corporate earnings. The major U.S. averages only suffered their first 1% drop in March '17 since November, a small giveback of the 10.4% advance in the Standard & Poor's 500 since Election Day. The market was up 6.3% in Q 1. Those gains had been predicated largely on expectations the Trump growth agenda would pass, which is in jeopardy now as efforts to repeal the Affordable Care Act, a.k.a. Obamacare—were withdrawn from a vote in the Republican controlled congress due to a lack of Republican votes. Furthermore, growth forecasts for 2017 remain unchanged as sustainability and clarity on Trump's policies are still missing. In our opinion the market has been pricing in too much optimism about the Trump administration's fiscal proposals and caution is warranted.

Fixed Income Market Development

The ongoing preference for higher risk assets has continued to drive the fixed-income market since February 2016 when oil prices had bottomed. The impetus for the movement has been the market's expectation the economy is entering a reflationary environment based on renewed economic activity, which will be spurred by fiscal stimulus and tax reductions. In addition, industrial commodities and oil prices had not only stabilized but were trending upward. Despite mixed 4 Q earnings reports and a lower than expected GDP growth in 4 Q investment-grade bonds continued to rally in Q1 of 2017 and are trading significantly higher than their long-term averages. U.S. Treasury bonds have been drifting lower at the same time and interest rates reached their highest levels since 2004. We expect inflation to rise to 2.4%-2.6% and real GDP to average 1.75%-2% by the end of the year. Based on this interest rates are likely to rise 1% further to 3.5%. We recommend caution as the upside is very limited at this point.

Economy

While the economic cycle has entered its eight year it does not display late cycle characteristics, such as significant wage pressures, accelerating inflation or elevated interest rates. The US economy's reliance on domestic demand is critical as global growth concerns remain elevated. This insulates the U.S. from international developments, although the large concentration on consumer spending leaves the economy highly dependent on the sustainability and pace of household income creation. Contributions from government and business investment, on the back of expected fiscal-stimulus, will take time to materialize given logistical issues, passing tax reform or budget measures through Congress. Any international trade skirmishes could prove economically disruptive by affecting supply chains and lifting import prices. The housing sector, which added only two tenths to GDP growth in 2016, and business investment, which has been subdued due to shrinking profits and sluggish demand, should provide modestly positive contributions to growth in 2017. Even if manufacturing is being revived, that sector is far less labor intensive today due to technological advancements. The job market therefore relies on domestically-oriented private services. Real GDP was revised higher to 2.1% compared to 1.9% mainly due to stronger-than-expected consumer spending. Growth at 2% yoy marks a substantial pickup from the troubling slowdown to 1.3% in the middle of last year.

Federal Reserve Bank Policy Outlook

With job gains of 219 K full employment was reached in February. March weak employment numbers of 98 K are likely to be a fluke due to the severe winter storm that impacted the Northeast during the survey as the unemployment rate fell at the same time from 4.7% in February to 4.5% which is contradictive. Full employment is a game changer because it will result in labor shortages extending beyond specific pockets of skilled workers. This will help alleviate wage stagnation. While wage inflation may moderately lag behind labor market performance, conditions are ripe for a sustained acceleration. The Fed

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therefore increased the Fed funds rate by another 0.25% on March 14. The Fed will continue to be data driven and will be wary not to over-tighten financial conditions by raising rates too quickly until a sustained acceleration is more evident. Furthermore, the Fed will be careful in unwinding their balance-sheet of $ 4.5 trillion by selling off assets rather than letting assets "roll-off" and/or refrain from interest rate increases during phases of high volume maturities to keep the market orderly. This is important as asset prices whether equities or high-yield bonds are higher than they would be if the Fed had not intervened in the market on such a large scale. We are expecting two more interest rates increases of 25-BP this year with the Fed funds rate reaching 1.25%-1.50% at the end of 2017. A third hike cannot be ruled out completely and would likely have a more meaningful impact on the U.S. dollar and interest rate market. While the U.S. 10-year yield has risen it remains just below its post-election high of 2.5967%, set on Dec. 15.

Corporate Earnings

4 Q corporate profits rose just 0.5% after 5.8% in 3 Q. In yoy terms the consecutive gains pushed profit growth to an impressive 9.3% from 2.1% prior. Given that profits had been contracting yoy from 2 Q 15 to 2 Q 16, the latest rebound indicates that corporate profit recession has ended. Faster economic growth, the recovery of activity in the energy sector and the fading impact of a rising dollar should bode well for profits. Stronger corporate profits will provide a significant tailwind to private-sector economic activity and therefore overall growth.

TN-Outlook

The stock market was in particular driven by the prospect of easing regulation and lower corporate taxes. Any meaningful cracks in Trump's fiscal agenda could cause a reversal in the recent market rally. Caution is therefore warranted. We expect to be in a rising interest rate environment for the next several years. Although the market has been resilient despite two interest rate increases, some form of correction can be expected. We recommend to reduce interest-rate risk by shortening duration and rather take on more credit-risk selectively in sectors like finance, utilities and industrials. Financials are interesting in particular as banks have to continue to strengthen their balance sheets and protect their investment-grade ratings, all in the bondholders' interest. The average Investment –grade corporate bond yield is down from 214 basis points on Feb. 2016 but still 115 basis points over comparable treasuries. The equity markets will continue to be driven by a strengthening domestic economy, improving corporate earnings, continuous share-buy-backs, and the expectations of a pro economy tax reform. We continue to be well positioned in sectors with the best corporate earnings growth potential in 2017. Financials are expected to grow 12%, materials 13.4%, technology 9.8%, consumer discretionary 5.9%, real estate 4.2%, healthcare 4.2% and industrials 3.2%. The energy sector is expected to be the winner with 306% earnings upside for the integrated oil and gas companies due to higher oil prices. Only utilities are expected to have a slight negative growth of -0.7% in 2017. The financial sector will be driven by higher interest rates and less regulation. Technology in particular the semiconductor industry stands out due to deal making, better pricing, and increasing demand for chips used to power everything from smart phone devices to clout computing to automobiles. Health Care, once an earnings power house, is battling the furor over drug pricing. In this sector one should concentrate on specialty healthcare companies.

We will keep a close watch over our investments and are ready to act when we detect signs of weakening.

Your Terra Nova Team!

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