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Stock Market Development

The economic cycle is in its ninth year and is not yet displaying late-cycle characteristics, such as wage pressures, higher inflation or higher interest rates. Domestic sectors, primarily consumption, continue to spur growth sufficiently in the absence of Trumponomics, which could have materially improved growth prospects over the medium term.

GDP grew at an impressive 3% in the last 2 quarters, mainly inflated by storm related inventory accumulation and weaker imports; we are, therefore, cautious in our view that this trend will continue. Global growth is likely to provide some tailwind to the US economy which hinges on the consumer. Income creation and access to credit are, therefore, essential to fueling consumer spending. We expect that fiscal stimulus will less likely at this point which would leave business investment and housing as secondary drivers for the economy. The stock market continues to respond favorably to the moderate and predictable pace of the economy. The S&P 500 TRA Index ended the last four months up 2.3% and YTD up 15.35%. We expect this trend to continue as Q3 corporate earnings continue to surprise on the upside.

Fixed Income Market Development

Corporate credit spreads in the investment-grade market tightened by 98 bps to new post crisis lows. In the high-yield market, credit spreads have not yet hit new post-credit-crisis lows, but are within 13 bps of reaching their lows in June 2014. The market is pricing in a 100% probability of a rate hike in December. With the expectation that short-term rates will be nudged higher, the yields on U.S. Treasury bonds continued their recent trend upward as interest rates increased slightly across the yield curve. The long end of the curve rose the most, as 10-year Treasury bonds rose to 2.35% and 30-year Treasury bonds rose to 2.84%. Equity markets reached an all-time high, commodity prices generally trended upward, and compensation for underwriting corporate credit risk has tightened to its lowest level since the 2008-09 credit crisis.

Economy

Healthy job growth is a critical aspect of the current economic cycle, allowing the U.S. economy to sustain growth via domestic consumption. Robust job gains amid limited wage pressures and stable labor-force participation provide the Federal Reserve policymakers the luxury of proceeding slowly and deliberately. Even if Washington aims to revive the manufacturing sector by lowering the corporate tax code, that sector is far less labor-intensive than in previous decades due to technological advancements. Therefore, the medium-term outlook on the labor market continues to depend on domestically oriented private services. Fiscal austerity has taken a significant toll on the pace of economic expansion in this cycle. We expect that improving domestic performance should support further tax revenue increases, and, in turn, loosen spending restrictions in the public sector.

Federal Reserve Policy

President Trump nominated Jerome Powell, a highly respected, well-informed and experienced professional to succeed Janet Yellen next February. He is known to have supported Yellen's Fed policy, and he will be welcomed by the markets. One more rate hike is expected in December followed by two next year, only if inflation pressures recover materially. The Fed has to carefully pace itself. Excessive or premature tightening would be a threat to the economy, while too slow of a pace will prevent a neutral policy stance from being achieved for at least a few more years. In order to accommodate the unwinding of the Fed's balance sheet which started this October, they are likely to flatten the fed funds trajectory.

Corporate Earnings

The marked slowing in headline Q3 EPS growth of a blended 6.6% from 15% in Q1 and 13% in Q2 based on the reporting of 260 out of 500 companies in the S&P 500 reflects the impact of hurricanes and outliers, while median growth is running at a solid 8%. -4.5% can be contributed to hurricanes and outliers (-3% from the insur-

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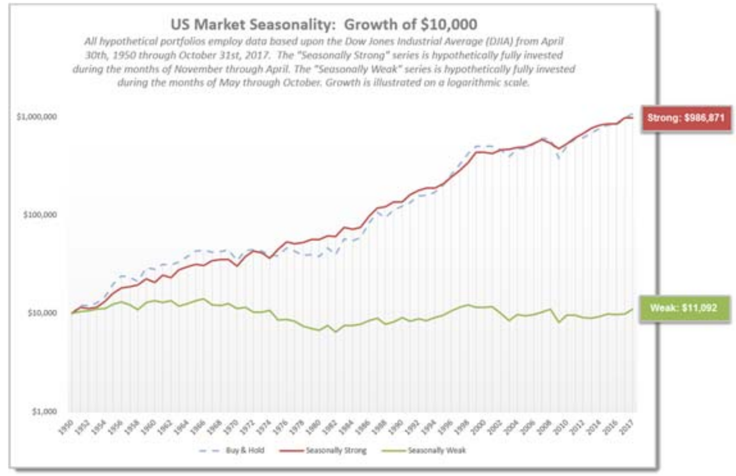
ance sector alone). Particularly notable is that analyst estimates for Q4 have remained steady this time despite a high watermark of a 12% average earnings increase estimates for Q4, and the number of companies providing positive guidance over negative guidance exceeded for a second quarter in a row. Lastly, there has also been a notable uptick in dividend payout commitments, which is another sign of increasing management confidence in their outlooks.

TN-Outlook

We are now entering what is typically considered the "strong six months" of the year according to The Stock Trader's Almanac published by Yale Hirsch, a fantastic source of information on the stock market. Their "Market Seasonality" study says essentially that the market has historically performed far better during the November through April time period than it has from May through October. In the graph below Dorsey, Wright Associates, LLC, reproduced the Six-Month Switching Strategy, first published by Stock Trader's Almanac, beginning in 1950, based upon the Dow Jones Industrial Average. The green line reflects the April 30th through October 31st period, while the red line shows October 31st through April 30th. You will note that, on a compounded basis, a theoretical $10,000 initial investment in 1950 is barely on the positive side during the April 30th - October 31st period using data through October 31st, 2017. On the other hand, in looking at the seasonally strong period between October 31st and April 30th each year, an identical $10,000 initial investment grew to $986,871 with an average rate of return of 7.56% in each of those six-month periods through April 28th, 2017.



It is our investment approach as active managers to equally weight our holdings to avoid an overconcentration in capitalization weighted holdings. "Equal-weighted" portfolios [of the largest 1,000 stocks] have outperformed the market by 2% a year over the past 50 years. Some of the advantages are risk-diversification and an increase in the value factor, as periodic rebalancing automatically incurs trimming some of the best-performing stocks and add to positions in the more underweight stocks to maintain the equal weight.

We continue to expect the best risk/reward in favor of higher short term interest rates in Financials. Technology remains attractive, but valuations are rich and we continue to take partial profits. Industrials will continue to benefit from global growth, Health Care remains undervalued and we continue to focus on specialty mid-cap healthcare.

We remain defensive in the fixed income markets and prefer short term maturities and/or corporate bonds with a short remaining time to maturity. Selected undervalued corporate names in large cap Industrials, Big Pharma, Energy and Financials are interesting sectors.

We will continue to watch carefully over your investments, and wish you all a "happy fall season".

Your Terra Nova Team!

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