WEALTH MANAGEMENT GROUP

FIRST AMERICAN BANK

INVESTMENT PERSPECTIVES

THIRD QUARTER 2017

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3rd Quarter 2017

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Equity Markets

3rd Quarter 2017 Recap

Equity markets continued to march higher around the globe as virtually every major economy is growing simultaneously. Even rising geopolitical conflict failed to dent market enthusiasm. U.S. stocks went along for the ride in the third quarter with the three major indices all reaching multiple record-high closes and participation in the rally broadening a little. A very strong 2Q17 earnings season and expectations for continued earnings growth over the remainder of this year have served to buoy stock prices. Political machinations in Washington did little to aid the equity markets during the first half of 2017 as reality consistently crushed positive expectations. That reversed somewhat in the third quarter. First, President Trump joined with opposition Democrats to reach a deal to kick the debt ceiling debate down the road into early 2018, thereby temporarily removing a potential default as a significant point of concern. Later in the quarter, Trump and Republicans finally focused their attention on tax reform and managed to renew optimism that a tax cut that will at least modestly boost corporate profits will happen by early 2018.

A very strong 2Q17 earnings season and expectations for continued earnings growth over the remainder of this year have served to buoy stock prices.

Most major international markets also surged higher in the third quarter. The MSCI Emerging Markets Index came close to doubling the return on the S&P 500, continuing its pace in the first half of the year. The MSCI EAFE Index (developed markets) also maintained its outperformance relative to domestic equities in the quarter.

While large-cap stocks maintained their year-to-date edge over both mid-cap and small-cap shares, small-caps staged a significant rally in the third quarter and managed to outperform large-caps as enthusiasm for corporate tax cuts grew. Mid-caps, though up in the quarter, trailed both small and large-caps in the quarter and year-to-date. Growth continues to outperform value so far for the year, but value managed a win among both mid-caps and small-caps in the third quarter.

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The information technology sector led the market higher in the third quarter, rising nearly 9%. The tech sector also leads the way year-to-date with a gain of more than 27%. Other big gainers in the third quarter were energy, materials and financials. Laggards for the quarter were consumer staples (the only sector with a negative 3Q17 return), consumer discretionary and real estate. Healthcare, the second biggest gainer year-to-date, returned just under 4% for the third quarter, which was good for only middle-of-the-pack performance. Tech, materials and energy, not coincidently three of the top four performing sectors for 3Q17, are also the top three sectors as measured by foreign revenue and earnings exposure. The 2% decline in the U.S. Dollar Spot Index provided a nice boost here.

Global Equity Index Returns (as of 9/30/17)

	3Q 2017	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500	4.48%	14.24%	18.60%	10.79%	14.18%	7.42%
S&P 500 (Equal Weight)	3.60%	11.94%	16.22%	10.04%	14.99%	8.74%
Dow Jones Industrial Average	5.58%	15.45%	25.45%	12.33%	13.54%	7.70%
NASDAQ Composite	6.07%	21.73%	23.79%	14.52%	17.36%	10.46%
S&P 400 Mid Cap	3.22%	9.40%	17.51%	11.16%	14.38%	8.96%
Russell 2000 Small Cap	5.67%	10.93%	20.70%	12.15%	13.76%	7.81%
MSCI EAFE (Non-U.S. Developed Markets)	5.47%	20.47%	17.79%	5.61%	8.96%	1.91%
MSCI EM (Non-U.S. Emerging Markets)	8.01%	28.08%	22.87%	5.25%	4.32%	1.63%

Equity Markets

4th Quarter 2017 Outlook

We were a little off in our projection at the end of the second quarter that earnings growth would drive further equity market appreciation in 2017 much more so than valuation expansion. While earnings growth has been impressive, valuations continue to advance as well with the forward P/E on the S&P 500 advancing approximately 70 basis points, or 3%, over the course of the third quarter. Even so, we're doubling down on our expectation that further equity price advances will come more from earnings growth than valuation expansion. The S&P 500 forward P/E stood around 17.7x at the end of the third quarter, well ahead of the five and ten-year averages and each of the rolling five-year averages over the past 30 years except for one (when you exclude the internet bubble period in 1998 and 1999). Fortunately, consensus earnings expectations for the S&P 500 call for 2% EPS growth in 3Q17 and 11% growth in both 4Q17 and calendar year 2018. Achievement of the 2018 earnings growth goals will require that revenue growth stays near 2017's mid-single-digit levels along with record high margins.

Further gains in international markets may prove easier to come by over the next 12 to 18 months. Both the MSCI developed and emerging markets indices carry substantially lower valuations than the S&P 500 as well as higher expected earnings growth rates.

Equity Market Valuation

	12-Month Forward 9/30/17	12-Month Forward 9/30/16
S&P 500 P/E	17.3	16.3
S&P 500 Dividend Yield	1.97%	2.15%
S&P 400 Mid Cap P/E	18.4	18.3
Russell 2000 Small Cap P/E	24.6	22.2
NASDAQ Composite P/E	20.6	19.3
MXEA EAFE P/E	14.6	14.1
MXEF Emerging Markets P/E	11.7	11.9

Economics

3rd Quarter 2017 Recap

As with this year's second quarter, survey data called accelerating GDP growth as we entered the third quarter. Consistent with the second quarter as well was the deterioration of the expectations as the quarter advanced. Back in early August, the Atlanta Fed GDP Now model called for 4.0% real GDP growth for 3Q17 while the Blue Chip Consensus called for a range of 2.1% to 3.2% growth. By the end of September, those forecasts had fallen, respectively, to 2.3% and a range of 1.8% to 2.9%. Personal consumption spending, as well as business investment in equipment and intellectual property, are expected to be the primary drivers of GDP growth for the third quarter while investment in both residential and non-residential structures are expected to detract from growth. Continued employment growth should support personal consumption and wage growth would help too. Consumers remain key to economic growth in the U.S. as consumer spending accounts for 70% of GDP.

GDP growth in the second quarter provides an encouraging sign of third quarter potential. From the initial official estimate of 2Q17 real GDP growth to the final revision, the growth rate picked up by 50 basis points to 3.1%. This was the first quarterly real GDP advancement of greater than 3% since the first quarter of 2015 and only the seventh such quarterly report since the recession bottomed out in 4Q08.

Inflation also posted something of a comeback in the third quarter after the year-on-year Consumer Price Index (CPI) comparison worrisomely dropped by 110 basis points between February and its June bottom of 1.6%. The Federal Reserve wants to see inflation around 2% as an indicator that the economy has settled into consistent growth and policy interest rates can continue to rise. The July, August and September CPI reports all ticked higher with September reaching 2.2%.

Economics

4th Quarter 2017 Outlook

We expect both the domestic and broad global economies to continue expanding through the end of 2017. Absent shocks from outside the economy, we also believe that 2018 is setting up well for further growth globally. The Bloomberg Consensus real GDP growth rate for the U.S. is 2.2% for 2017 and 2.4% for 2018. Both of those numbers sound reasonable to us. Key questions in the U.S. will be the reaction to the Fed's balance sheet unwind and potential further Fed rate increases. Both of those factors will likely be influenced by whether or not inflation stabilizes around the 2% level, and that will further depend on whether continued strong job gains finally begin to drive wage inflation.

The consensus growth rate for the G8 (large developed western economies plus Russia) is forecast at 2.0% and 1.9% for 2017 and

2018, respectively. China is expected to grow real GDP by 6.7% in 2017 and 6.4% in 2018. Global real GDP growth is pegged at 3.5% and 3.6%, respectively, for 2017 and 2018. The synchronous global economic growth we're now seeing is a relatively rare occurrence. The rest of the world, except for China, is still catching up to the U.S., which accelerated out of the global financial crisis more rapidly than most other economies. A key question will be whether the already quite long-in-the-tooth expansion in the U.S. begins to sputter just as the rest of the world hits its stride. Nothing currently showing up in broadly followed economic statistics, nor in the fixed income market, suggests that a recession is imminent.

Further questions center on the relatively large number of potential developments that lack precedent. The world has never before undergone the unwinding of quantitative easing in three of the four largest global economies. Nor has it seen a still-developing economy nearly the size of China's try to transition from a debt and investment-driven economy to a more consumer-oriented one – never mind one that is nominally capitalistic but very much state-controlled in actuality. The seas appear calm for now, but wise investors will keep a lookout for potential storms.

Fixed Income

3rd Quarter 2017 Recap

The U.S. fixed income market ended the second quarter not far from where it began, but there was plenty of movement in between. The yield on the 10-year U.S. Treasury climbed all of two points over the quarter to 2.33% but flirted with both the 2.0% and 2.4% levels in between as market perceptions of economic growth and Fed movements varied materially. The yield curve, as signified by the spread between the 2-year and 10-year U.S. Treasury notes, was even less volatile, varying all of nine basis points over the quarter before falling to a 10-year low early in the fourth quarter. While the 2/10 spread has narrowed considerably in the past few years (just over 100 basis points since 2011), it remains significantly above levels that have previously signaled a coming recession.

The most volatile part of the fixed income market in the third quarter was expectations for the next rate hike by the Federal Reserve. Following the Fed's most recent hike in June, opinion was split over whether we would see another hike this year or whether a sputtering economy and concern over the impact of unwinding the Fed's balance sheet would push any further rate hikes into 2018. As the third quarter began, the futures market judged that there was a just better than even chance that the Fed would hike again in December. By the end of July, the futures guessed the next rate hike would come in March 2018, and by the end of August, the futures said no rate hike until June of 2018. By the end of the quarter, aided by a recovery in inflation statistics and ongoing strength in a broad number of economic indicators, the futures market had priced in a 70% chance of another hike this December.

Fixed Income Rates

	9/30/2017	9/30/2016	Change
U.S. Treasury 10-Year Note	2.32%	1.60%	+72 bps
U.S. Treasury 2-Year/10-Year Spread	40 bps	44 bps	-4 bps
U.S. High-Yield/U.S. Treasury 10-Year Spread	312 bps	458 bps	-146 bps
Federal Reserve Discount Rate	1.75%	1.00%	+75 bps

Fixed Income

4th Quarter Outlook

Bond market movement in the fourth quarter is likely to reflect the markets' expectations for economic growth in 2018 but could also be influenced by global geopolitical developments and the beginning of the Fed's balance sheet unwind. We expect U.S. rates to move modestly higher as the quarter progresses and global economic expansion continues. Upward movement in U.S. rates will probably continue to be muted by the fact that much of the rest of the developed world has much lower interest rates that are being held down by central bank intervention. Further flaring of conflict between the U.S. and North Korea could spur a flight to safety which would also tend to depress rates.

Perspectives

Will the party keep going even as the punch bowl is wheeled out?

Most global financial markets appear to be in a sweet spot currently. We're experiencing near-synchronous global economic growth for the first time since before the global financial crisis (GFC). Volatility is low not only for stocks but also for many bond, currency and commodity markets as well. Earnings growth in the U.S. has been strong for a few quarters now as companies that have adapted their cost bases for low top-line growth are benefitting from the strongest sustained revenue growth we've seen in a while. International developed economy equity markets are doing even better than the U.S. for the most part as those markets are now catching the up-wave that the U.S. found a few years ago. Emerging markets are also mostly thriving as commodity prices have recovered and demand growth has remained steady. This relatively rare concurrence of growth around the world has allowed markets to look through many risks that likely would have a caused market corrections not too long ago.

We expect this coordinated global growth to continue as we move into 2018, absent any shocks from unanticipated geopolitical events. We also expect stocks to continue rising but in a less coordinated manner than we've seen so far this year. The primary challenge in the U.S. is valuation. The only time during the last 30 years when the forward P/E on the S&P 500 meaningfully exceeded its current level of approximately 18x was during the blow-off phase of the tech bubble in 1998 and 1999. While we understand that the relatively low interest rates we now enjoy justify higher P/Es for stocks, we're also cognizant that if current interest rates stay where they are, that means that real GDP growth is unlikely to improve much from the 2.0% to 2.5% rate we've been stuck at for eight years now. If we can't expect much in the way of multiple expansion for domestic equities, then earnings growth will have to be the primary driver of stock market appreciation. Absent an unexpected pick-up in productivity, earnings growth looks set to moderate in 2018 and beyond. Granted, an effective tax reform bill out of D.C. could boost both after-tax corporate earnings and consumer spending in 2018 and perhaps into 2019. Our view on the chances of a successful and effective tax bill is cautious relative to apparent market expectations.

By way of perspective, consider the 10-year rolling return on the S&P 500. Measured from just before the prior bull market peak in 2007 to now, the 10-year return (price appreciation only) on the S&P 500 is approximately 5.1% annually. When compared to the long-term average 10-year return on the S&P 500 of around 7.3%, the return over the last ten years looks almost puny. It would at first appear obvious that we should have much further to run. A different perspective provides a more cautious outlook, though. If the S&P 500 simply maintains its current price level over the next two years (through September 30, 2019), the rolling 10-year return will be 9.3% annually. Should we achieve 5% price appreciation in each of the next two years on the S&P 500, the rolling 10-year annual return would be 10.4%. Certainly not unthinkable, but perhaps asking a bit much of a market faced with the lineup of long-term challenges the U.S. market must consider today (slow population growth, stagnant productivity, political gridlock and ever-rising debt levels).

That brings us to the punch bowl. The Federal Reserve will soon begin to reduce its balance sheet, which has increased from approximately $1 trillion before the GFC to nearly $4.5 trillion now. The reduction has been well telegraphed and will be very gradual. Most observers believe that given the growth and changes in the economy over the past decade, the Fed will stop reducing when it reaches $2 trillion or even $3 trillion. Even so, it's hard to deny that all that liquidity (our punch bowl) has buoyed asset prices and perhaps distorted risk perceptions over the past decade.

While we're somewhat cautious about domestic equities, we believe that international equity markets appear to have more room to run. Many international economies are where the U.S. was two or three years ago– picking up speed but with some questions about sustainability. We think the outlook is favorable for most international markets. In addition to being lower on the growth curve, valuations are more modest both relative to the U.S. and history. In fact, rolling ten-year returns for both the MXEA (international developed markets) and MXEF (international emerging markets) indices are currently between -1% and -2% annually. Additionally, their punch bowls, in the form of balance sheet expansion at the European and Japanese central banks and debt accumulation in the Chinese banking system, appear set to remain in place for a while longer. With all of this in mind, we are positioning our First American Bank strategies toward moderately larger international allocations at the expense of domestic allocations.

Your advisors in First American Bank's Wealth Management Group will continue to monitor market developments and adjust asset allocation and portfolio positions as market conditions warrant.

Asset Class Return

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	3Q2017	10-YR Annualized
MSCI EM 39.4%	Barclay's Agg. Bond 5.2%	MSCI EM 78.5%	REITs 28%	REITs 8.3%	REITs 19.7%	Russell 2000 38.8%	REITs 28.0%	REITs 2.8%	Russell 2000 21.3%	DJ UBS Commodity 10.5%	S&P 400 8.6%
DJ UBS Commodity 16.2%	Russell 2000 -33.8%	S&P 400 37.4%	Russell 2000 26.9%	Barclay's Agg. Bond 7.8%	MSCI EM 18.2%	S&P 400 33.5%	S&P 500 13.7%	S&P 400 - 2.2%	S&P 400 20.7%	MSCI EM 8.0%	S&P 500 7.3%
MSCI EAFE 11.2%	DJ UBS Commodity -35.6%	MSCI EAFE 31.8%	S&P 400 26.6%	S&P 500 2.1%	S&P 400 17.9%	S&P 500 32.4%	S&P 400 9.8%	S&P 500 1.4%	S&P 500 11.9%	MSCI EAFE 5.5%	Russell 2000 7.2%.
S&P 400 8%	S&P 400 -36.2%	REITs 28%	MSCI EM 18.9%	S&P 400 -1.7%	MSCI EAFE 17.3%	MSCI EAFE 22.8%	Barclay's Agg. Bond 6.0%	Barclay's Agg. Bond 0.6%	DJ UBS Commodity 11.8%	Russell 2000 5.3%	REITs 5.4%
Barclay's Agg. Bond 7%	S&P 500 -37%	Russell 2000 27.2%	DJ UBS Commodity 16.8%	Russell 2000 -4.2%	Russell 2000 16.4%	REITs 2.9%	Russell 2000 4.9%	MSCI EAFE -0.8%	MSCI EM 11.2%	S&P 500 4.5%	Barclay's Agg. Bond 4.3%
S&P 500 5.5%	REITs -37.7%	S&P 500 26.5%	S&P 500 15.1%	MSCI EAFE -12.1%	S&P 500 16%	Barclay's Agg. Bond -2.0%	MSCI EM -2.2%	Russell 2000 -4.4%	REITs 6.7%	REITs 3.6%	MSCI EM 1.7%
Russell 2000 -1.6%	MSCI EAFE -43.4%	DJ UBS Commodity 18.9%	MSCI EAFE 7.8%	DJ UBS Commodity -13.3%	Barclay's Agg. Bond 4.2%	MSCI EM -2.6%	MSCI EAFE -4.9%	MSCI EM -14.9%	Barclay's Agg. Bond 2.7%	S&P 400 3.2%	MSCI EAFE 1.7%
REITs -15.7%	MSCI EM -53.3%	Barclay's Agg. Bond 5.9%	Barclay's Agg. Bond 6.5%	MSCI EM -18.4%	DJ UBS Commodity -1.1%	DJ UBS Commodity -9.5%	DJ UBS Commodity -17.0%	DJ UBS Commodity -24.7%	MSCI EAFE 1.6%	Barclay's Agg. Bond 0.9%	DJ UBS Commodity -6.8%

Wealth Management Group

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