The Advisor

4Q 2017

EXECUTIVE SUMMARY

- The economy seemed undeterred by the effects of the fall hurricanes, as third quarter 2017 GDP accelerated to a 3.2% annualized growth rate. The growth reflected consumer spending gains, increased business investment and higher exports.
- Passage of tax reform will add additional stimulus to the U.S. economy, which already benefits from a strengthening global economy.
- Fourth quarter global and U.S. manufacturing and services PMI data remained comfortably in expansionary territory.
- Core inflation readings in the U.S. remain benign while EU inflation has found some footing.
- Both business and consumer confidence readings reflect heightened levels of optimism.
- A patient, data-dependent Federal Reserve should allow inflation to gradually foment, fostering a goldilocks environment for financial assets in 2018.
- Another year of economic growth will put the U.S. on course for its longest expansion on record.
- The yield curve will be a key determinant for fixed income returns in 2018.
- With more than 45% of S&P 500 companies' revenues and earnings generated by foreign sources, U.S. dollar weakness has helped the rejuvenation of the earnings cycle.

ECONOMIC REVIEW

The Republican-led Congress and Administration achieved its first major victory by passing the $1.5 trillion Tax Cut and Jobs Act — the largest overhaul of the U.S. tax system since 1986. Many of the tax changes will take effect in January. The tax bill is friendly to corporations by lowering the rate from 35% to 21% and for individuals, it broadens the standard deduction, marginally cuts rates, and slightly reduces itemized deductions.

Consumer and business optimism remain high, as consumers continue to benefit from job growth and corporate profits attain record levels. However, wage gains remain elusive for the consumer and, while capital expenditures have begun to strengthen, commercial and industrial lending has remained subdued.

The Federal Reserve ("Fed") met twice during the quarter and, in a widely anticipated move, raised the federal funds rate, taking it to 1.25% - 1.50% at the December meeting. Fed Chair Janet Yellen submitted her resignation in late November after President Trump nominated Jerome Powell for the position. The Fed is experiencing unusually large turnover and, while there are not expected to be any major changes in the current program trend, there is a heightened risk of policy error in a future economic crisis by a largely untested Fed.

Manufacturing remains strong across the world, with the Global PMI index at its highest level since March 2011, reflecting strength in both the advanced and emerging market economies. Yet inflation has remained tame, repressed by the disruptive impact of technological changes, buttressed by a fiercely competitive environment in most sectors and reflective of some continued labor market slack. Low inflation has given central banks the luxury of keeping interest rates low, which has supported asset prices.

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MACRO SUMMARY

GDP

- The 3.2% third quarter Real GDP growth reflected an increase in personal consumption, business spending on investment & inventories, and higher exports, despite disruptions from storms.
- Fourth quarter GDP growth rates are expected to remain above 3.0%, helped by rebuilding and renovations for 3Q storm damage.
- Strong growth is likely to carry into 1Q of 2018 as the U.S. economy continues to benefit from tax reform, reduced regulation, and improved global growth.
- Economic growth may back off slightly in the latter part of 2018 to a range of 2.5-3.5%.

Employment

- November's low 4.1% unemployment rate is approaching levels of full employment.
- Small business hiring plans have markedly improved, suggesting that the labor markets will continue to tighten.
- Although wage increases remain stubbornly flat at about 2.5% annual growth, wage acceleration has begun to materialize in many metro areas.
- Businesses cite that finding qualified workers has been a persistent problem all year.

Housing

- Existing home sales surged 5.6% and median home prices increased 5.8% year-over-year through November.
- A very tight 3.4 month supply is driving prices higher, outstripping income growth and potentially adversely affecting first time buyers.
- Tax reform shouldn't significantly impact housing; it's estimated that only 6% of mortgages exceed $750,000 and only 5% of homeowners pay more than $10,000 in property taxes.

Consumer

- Consumer spending is healthy and continues to benefit from jobs growth, but wage growth remains elusive.
- November's 2.9% savings rate is a post financial crisis low and has supported consumption, but further spending gains will require income increases.
- Healthy consumer confidence contributed to strong holiday retail sales.

Business

- Productivity rose 3.0% in 3Q, boosted by a 4.1% increase in output, while labor costs remained subdued.
- The December ISM Manufacturing Index's 59.7 reading exceeded expectations.
- December's 55.9 ISM Non-Manufacturing Index reading was disappointing, but still well in expansionary territory.
- Duke University's September CFO Survey showed an all-time high in optimism due to tax reform.
- The National Federation of Independent Business ("NFIB") says optimism remained near a 44-year high in November, as small business owners plan to increase capital expenditures over the next six months.

The Fed

- The Fed held rates steady at its October meeting, but raised its key rate in December by 0.25%.
- Fed officials indicated that there could be three more rate hikes in 2018 and did not appear to be convinced that tax reform will produce significant growth.
- The Fed expects real GDP growth to accelerate to 2.5% in 2018, but subsequently drop to 2.1% in 2019 and 2.0% in 2020.
- The newly reconstituted Fed may lean harder into expected fiscal stimulus if inflation rises with greater balance sheet normalization and financial markets begin to price in a fourth hike.
- There is an increased risk of a policy mistake given the new untested leadership.

Inflation

- The Personal Consumption Expenditure ("PCE") deflator remained at a relatively flat 1.8% increase in November, falling short of the Fed's 2.0% objective, with Core PCE's growth rate also lagging at 1.5%.
- November's Core CPI, at 1.7%, also trails the Fed's target, but many sources of deflation appear to be moderating.
- The Atlanta Fed Core Sticky CPI remained at a 2.1% annual rate of increase in November.
- Structural factors of globalization, technological advances and intense competition are serving to stifle pricing power for businesses and keep inflation low.

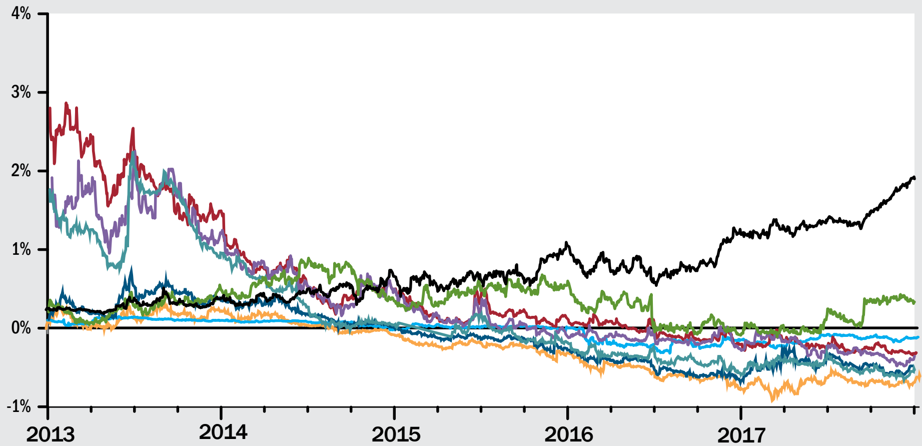
Commodities

- The dollar index of major currencies fell by 1.0% in the fourth quarter, as many global economies showed improving economic conditions. The lower dollar has been a positive factor for U.S. companies with high exports.
- The price of West Texas Intermediate oil rose 16.9% over the quarter to finish at $60.42 per barrel.
- Prices of key industrial metals strengthened in 4Q, with Iron Ore up 3.0% and Copper up 8.1% — a sign of positive economic momentum.

MACRO SUMMARY

2-Year Sovereign Yields

As of 12/31/2017
Source: Bloomberg

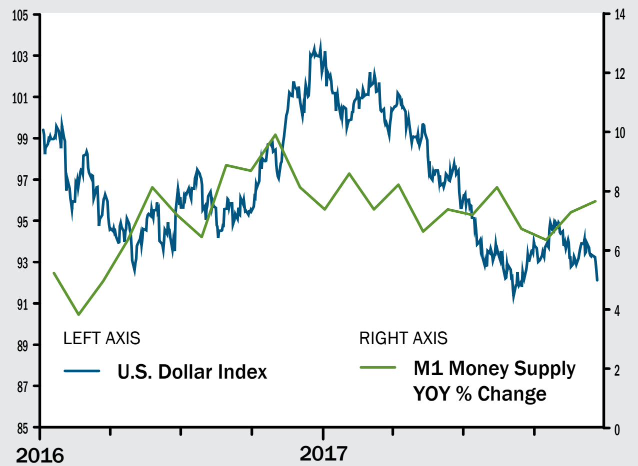


Treasury Yield Spread

As of 12/31/2017 Source: Bloomberg

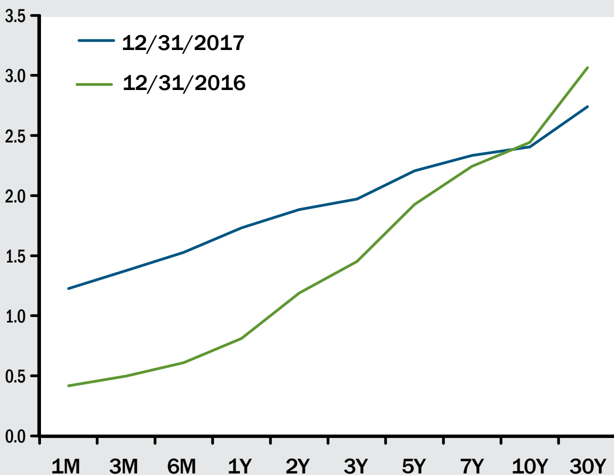
Money Supply vs U.S. Dollar

As of 12/31/2017 Source: Bloomberg



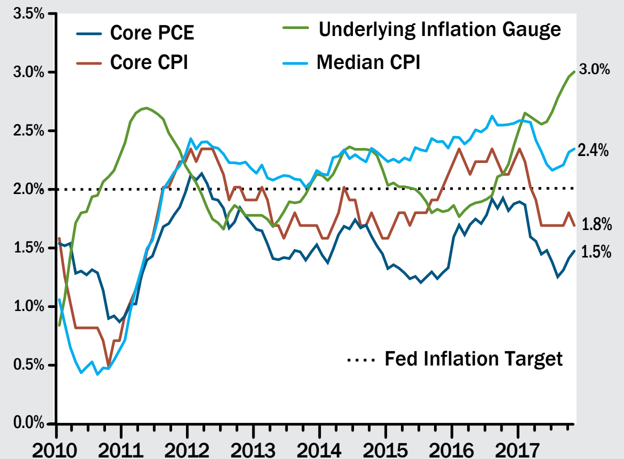
Yield Curve

As of 12/31/2017 Source: Bloomberg



Inflation Data (YOY percent change)

As of 12/31/2017 Source: Bloomberg



FIXED INCOME MARKET REVIEW

Will the Federal Reserve ("Fed") prematurely end the current expansion or allow the full potential of President Trump's Tax Cut and Jobs Act to be felt? An economy marked by slow but steady growth with the lowest inflation levels since 2009 has many speculating that we could be in the midst of the longest expansion on record. 2017 only served to embolden those with that view, ourselves included. After back-to-back quarters of above 3% growth in Q2 and Q3, the Atlanta Fed's GDPNow Forecast is predicting growth above 3% once again in Q4. The appointment and confirmation of the next Fed chair, Jerome Powell — seen as less concerned about runaway inflation than his predecessor and more open to further banking deregulation — was welcomed by markets. A truly data-dependent Fed that allows inflation to gradually foment will foster a continued goldilocks environment.

U.S. tax reform, repatriation, deregulation, infrastructure spending, and an ebullient jobs market in tandem with a continued synchronized global expansion will serve to steepen the U.S. Treasury yield curve, as growth and inflation expectations finally get priced into the market. The U.S. Dollar sank close to 10% over the course of 2017, a boon to multinational corporate profits as well as emerging market credit (+10.46%), as the end to unprecedented monetary stimulus became a reality (U.S.) and near reality (EU, Japan). With WTI oil up over 6% for the year, the entire commodity complex, especially copper continuing its ascent higher, and the labor market increasingly showing signs of wage pressures, the days of deflation fears are well in the rear view mirror. Burgeoning productivity gains and capital investment in Q4 put 2018 on solid footing.

It was a year where curve positioning mattered immensely. Typically a bellwether, the 10-year U.S. Treasury showed itself a poor gauge of its overall sector returns in 2017. Virtually unchanged in yield from the beginning of year at 2.41%, its behavior stands in stark contrast to that of the 2-year, higher by 70 bps to end the year at 1.88% (+0.25% return) and that of the 30-year, lower in yield by 32 bps to end the year at 2.74% and returning over 9% for 2017. Yield curves flattened to 51 bps for the 2-year/10-year, from 125 bps at the beginning of the year, and the 2-year/30-year closed out the year at only 84 bps from a year earlier level of 182 bps.

Disappointing CPI readings throughout the back half of the year kept Treasury Inflation Protected Securities returns contained at 2.95% for 2017. 10-year inflation breakeven levels started and ended the year right around 2%, belying intra-year volatility that had them drop 50 bps during the summer. High yield credit put in another great year at 7.48%, besting loans at 4.25% but dramatically underperforming the S&P 500 at close to 22%. Investment Grade ("IG") credit returned 6.42% with 3.46% of excess returns and closed the year at the lowest spread level since the Financial Crisis at 93 bps. Lower credit quality, longer maturity, and cyclicality drove outperformance for both. Long IG credit returned 10.47% for the year. All in yields for investment grade and high yield credit are historically low, sitting at 3.25% and 5.77%, respectively. Although Mortgage-Backed Securities ("MBS") performed well in 2017, their performance lagged credit significantly. Aided by historically low volatility but tempered by the impending Fed balance sheet unwind, MBS returned 2.48% with 0.52% of excess returns.

EQUITY MARKET REVIEW

PERFORMANCE: 2017	Value	Core	Growth
Large Cap	15.35%	21.82%	27.43%
Mid Cap	12.30%	16.23%	19.91%
Small Cap	13.45%	13.15%	14.71%

Source: Bloomberg
* As of 12/31/2017. Returns calculated on Standard & Poor's equity market indices.

- 2017 was an exceptional year for U.S equities — the first time ever the S&P 500 Index showed positive total returns for each month.
- Large Cap Growth stocks outperformed Small Value significantly in 2017 — a complete reversal of 2016 results.
- For the year, companies displaying improving analyst estimates, strong capital efficiency, and higher price momentum outperformed stocks displaying more favorable valuation and higher volatility.

PERFORMANCE: 4Q 2017	Value	Core	Growth
Large Cap	6.32%	6.64%	6.79%
Mid Cap	5.34%	6.24%	7.08%
Small Cap	3.97%	3.90%	3.84%

Source: Bloomberg
* As of 12/31/2017. Returns calculated on Standard & Poor's equity market indices.

- Equity market returns climbed higher in the fourth quarter, spurred on by favorable third quarter earnings reports and the anticipated passage of U.S. tax reform.
- For the quarter, companies displaying strong capital efficiency, more favorable valuation and improving analyst estimates outperformed stocks displaying better historical growth and higher price momentum.
- S&P 500 Index operating earnings rose 9.2% year-over-year in the third quarter — a marked slowdown from the 20% average growth rate of the previous three quarter earnings.

FORWARD EARNINGS

Analysts' initial estimates of future earnings are frequently overly optimistic and tend to fall over the course of the year, but 2018 estimates remained remarkably high over 2017, as illustrated in the heat chart below showing EPS estimated changes by sector.

ANALYSTS' 2018 EPS ESTIMATES

Date of Estimate	2016	2017				Total Return
	12/31	3/31	6/30	9/30	12/29	2017
S&P 500	$146.45	$145.56	$145.11	$143.66	$145.36	21.8%
Consumer Discretionary	$40.63	$39.41	$38.97	$37.75	$37.34	23.0%
Consumer Staples	$29.78	$29.39	$29.35	$29.56	$29.61	13.5%
Energy	$24.11	$24.49	$22.59	$18.99	$20.98	-1.0%
Financials	$30.70	$31.11	$30.95	$30.83	$31.23	22.1%
Health Care	$60.96	$58.30	$58.24	$58.27	$57.75	22.1%
Industrials	$33.82	$34.04	$34.70	$33.99	$32.78	21.0%
Information Technology	$54.79	$55.66	$56.15	$57.20	$59.82	38.8%
Materials	$19.61	$19.79	$19.92	$20.25	$20.56	23.8%
Telecomm Services	$5.86	$5.46	$5.38	$5.15	$5.17	-1.3%
Utilities	$13.03	$12.64	$12.33	$12.32	$12.50	12.1%
Real Estate	$15.38	$15.39	$15.42	$15.35	$15.37	10.8%

*Estimates are CAPIQ bottom up analyst consensus estimates using operating earnings

- Analysts' 2018 estimates for the Information Technology sector were consistently revised higher throughout 2017 and contributed to the sector's strong relative performance for the year.
- 2018 earnings growth for the Financials sector was initially bumped up in early 2017, but fell over the middle portion of the year before being raised at year end. The sector's performance over the year followed similarly.
- Analysts lowered estimates for the Telecommunication and Energy sectors over the course of 2017, which was reflected in the poor annual performance of these sectors over the past year.

ECONOMIC OUTLOOK

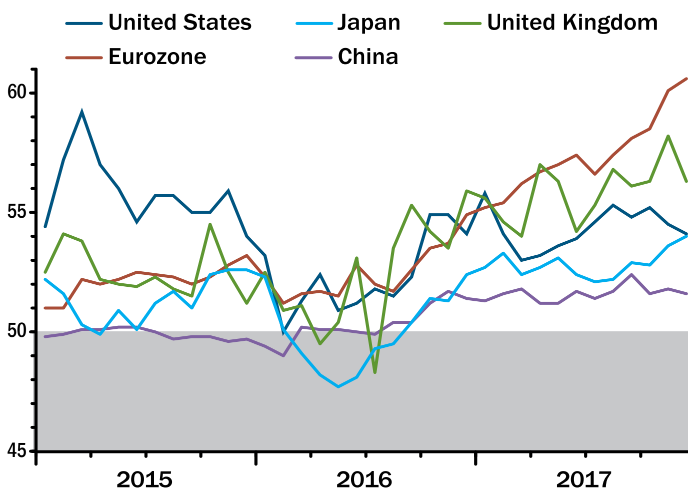
In the U.S., the passage of the new tax policy, buoyant consumer and business sentiment and the still relatively low level of long-term interest rates should support an economy with already considerable momentum going into 2018. Ideally, businesses could use the windfalls from tax reform to invest and expand, which could help sustain the economic expansion. Several large companies have announced plans to share part of that tax windfall with their employees, in what will hopefully become a growing trend.

Synchronized global economic growth continues to gain steam, supported by easy monetary policies across the globe; and 2018 should be another year of strong global growth, helped by a steady rise in employment and supportive policies. Taking a cue from the U.S., global fiscal stimulus in the form of tax cuts could be a stimulative follow up from quantitative easing and central bank balance sheet expansion as the engine of future world GDP growth.

In most advanced economies, core inflation will rise slowly toward policy targets as increased production narrows output gaps. More central banks are likely to begin the withdrawal of monetary policy stimulus as inflation materializes. Improving inflation in the Eurozone has slowed quantitative easing measures and created a potential for the European Central Bank ("ECB") to wind-up its securities purchases later this year.

The U.S. and global economic expansion remains healthy and, barring some exogenous shock from a geopolitical event or other unforeseen crisis, the odds of a recession in 2018 appear very low. However, as global economies strengthen, the risk heightens that unanticipated strong inflation forces an unexpected marked tightening of financial conditions by monetary authorities.

Global Purchasing Managers' Index (PMI)



As of 12/31/2017 Source: Bloomberg

FIXED INCOME MARKET OUTLOOK

Inflation, both domestic and global, and the Federal Reserve's ("Fed") interest rate policy will likely be the two most important determinants of asset performance for 2018. If both move gradually over time, as we anticipate, equities and credit will have another good year, albeit not as good as 2017. A surprise spike in inflation and/or aggressive Fed tightening will be unwelcomed. Earnings are key and tailwinds abound with the global growth impulse, weakening dollar, more balanced oil supply/demand outlook and tax reform with Washington's pro-business, pro-growth deregulation agenda.

We remain 90% benchmark duration with a large underweight to shorter maturity US Treasuries and neutral positioning to longer dated securities. We do not believe the flattening of the U.S. Treasury yield curve portends recession. Twin forces of the Fed's QE portfolio and its future preferred front end issuance combined with foreign purchases, given relative attractiveness to European sovereign yields, appear to be having an outsized impact on treasury pricing. Flows reflecting hedging of equity gains with the long bond further exacerbated by the flattening. A positive signal, the U.S. 2-year Treasury continues to out yield the target Fed Funds rate by 50bps to 75bps. Treasury Inflation Protected Securities are attractive and warrant investment as part of an overall underweight U.S. Treasury allocation. Ultimately, wage pressures will emerge in 2018, pressuring U.S. Treasury yields higher. The Fed will be patient and raise its benchmark Fed Funds rate 2 to 3 times in 2018. We will closely watch developments in China and the stability of the Yuan as volatility management measures pursued have the potential to impact U.S. Treasury yields.

Given paltry and negative yields in local markets, Europeans have been significant buyers of U.S. fixed income assets. By removing a large price insensitive buyer, the end to the European Central Bank's asset purchase program will cause European sovereign and corporate yields to rise, and more than likely crowd out demand in U.S. markets. However, uber-dove Mario Draghi may cause this process to drag on for quite a while. We will closely monitor this development as a signal to tactically reduce our overweight to U.S. Corporates (pro-cyclical and lower quality bias). We remain favorable on high yield bonds, assuming equity earnings hold up, and floating rate loans.

Gradually rising Treasury yields will help both investment grade and high yield credit demand as all-in yields sit historically low. Our neutral/underweight positioning in Mortgage-Backed Securities is supported by our interest rate view, belief that volatility will increase from ultra-low levels, and the acceleration of the Fed's balance sheet normalization over the course of 2018.

EQUITY MARKET OUTLOOK

- ZCM's 2017 S&P 500 EPS estimate of $122.00 to $125.00 represents about 16% year-over-year growth.
- Tax reform could boost S&P 500 operating earnings by around 10%, while faster nominal growth and share repurchase could escalate 2018 EPS growth to about 15-20%, which would produce an EPS of $141.00 to $148.00.
- Companies with primarily U.S.-based operations and customers that are leveraged to capital spending and have high effective tax rates will likely benefit most from the new bill.
- Companies with lower effective tax rates and high levels of debt servicing will not likely benefit from the new tax bill.
- Multinational large cap growth stocks have benefited from faster foreign growth and U.S. dollar weakness over 2017, but further significant dollar depreciation is less likely in 2018 if U.S. interest rates move higher.
- Valuation becomes an increasingly attractive driver of performance, on a factor basis, in an environment of improved economic growth.
- High P/Es have been supported in large part by lower interest rates. A move into a higher rate environment would require strong earnings growth to support current market levels.
- At year-end, the S&P 500 Index traded at 18.2x one-year forward consensus operating earnings estimates, well above its 25-year average of 16x.
- Market volatility gauges are at historically low levels, reflecting an unsettling degree of complacency toward risk.

Ziegler CAPITAL MANAGEMENT, LLC

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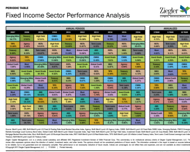
Ziegler Capital Management is a premier asset management firm comprised of investment teams employing repeatable processes providing tailored investment solutions across the fixed income and equity markets.

We are based in Chicago, Illinois with additional offices in New York, New York; San Francisco, California; St. Louis, Missouri; and Milwaukee, Wisconsin. Our clients include corporations, mutual fund sub-advisory, municipalities, pension plans, foundations, endowments, senior living and healthcare organizations, and high net worth individuals. Ziegler Capital Management has grown significantly in recent years through strategic business combinations with experienced investment teams nationwide. Through these combinations, we have expanded our investment strategy offerings and broadened our portfolio management teams to best serve our expanding client base.

Other Market Insights



Periodic Table: Fixed Income Sector Performance

The chart provides a detailed look at Fixed Income performance over the past decade, broken down by 13 sectors.

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History Lesson?

Those who do not remember the past are condemned to repeat it.

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