Sit Investment Associates

April 2017

GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Is the "Trump Trade" Over?**
- **U.S. "Animal Spirits" Stirring, but 1Q17 Growth May be Muted**
- **Elevated Political Risk Remains a Headwind for Europe**
- **China's Economic Growth Will Moderate as Stimulus Wanes**

TRUMP ADMINISTRATION POLICY PROGRESS REPORT

Policy Subject	Progress
Infrastructure ■ Administration plans to unveil a $1 trillion, ten year infrastructure plan during 2017.	=
Trade ■ Withdrew from TPP negotiations, will not support T-TIP. ■ Signaled a desire to renegotiate NAFTA and take action on Chinese trade practices.	+
Taxes ■ Maintained plan to reduce corporate taxes and provide middle class tax relief; have yet to offer a concrete, legislative proposal on tax reform.	−
Regulation ■ Rolled back the vast majority of the Obama administration's regulatory initiatives. ■ Instituted a rule that for every new federal regulation, two must be removed.	+
Immigration ■ Increased enforcement of U.S. immigration law, including stepping up deportations. ■ While proposed, has yet to roll back President Obama's executive orders on immigration.	=
Healthcare ■ Proposed bill repealing and replacing the Affordable Care Act; the American Health Care Act failed to make it to a vote in the House.	−
Defense ■ Trump's proposed budget would end sequestration and increase defense spending by $54 billion. ■ Put pressure on NATO members to increase spending to the 2% of GDP threshold.	+
Energy ■ Lifted restrictions on mining coal and drilling for O&G; removed blocks on large energy projects.	+

+ Most Progress = Intermediate Progress − Least Progress

Source: Sit Investment Associates, 3/31/17

Is the "Trump Trade" Over?

The failure to "repeal and replace" the Affordable Care Act (ACA) has caused investors to reconsider the "Trump trade" that has fueled the stock market rally since November. While the absence of healthcare legislation has resulted in a loss of confidence and a perception of waning momentum as the administration tackles other pro-growth initiatives, we think investors may be missing the big picture: the post-election market rally was never about the ACA. Rather, optimism has been based on the potential for a variety of pro-growth policies to accelerate U.S. economic growth from the +2 percent pace that has prevailed for most of this expansion. The key elements of President Trump's policy agenda include tax cuts, repatriation of foreign earnings, regulatory reform, and increased spending on infrastructure and defense.

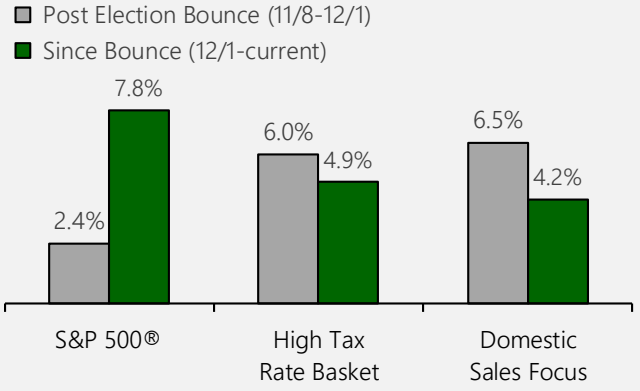
To be sure, the challenges (recently referred to as "growing pains" by House Speaker Ryan) could very well result in delays and some watering down of policies based on political realities, special interests, and fiscal constraints. However, we see progress on several fronts. As noted in the table on the front page, progress has been most significant on deregulation in key sectors (particularly finance and energy) of the economy. As we noted in our January publication, regulations have been particularly impactful on small businesses, with surveys indicating they are the number one challenge. Second, President Trump proposed a $54 billion increase in defense spending within the 2018 budget plan that aims to provide necessary funding for both improved troop readiness and equipment modernization. Third, we believe the Trump administration (and House and Senate Republicans) now has a great sense of urgency to push tax reform through. Over the next several months, we expect debates to be resolved in key elements of reform, including border-adjustment tariffs and interest rate deductibility.

It is true that there is intense debate on the longer run consequences (i.e., environmental, fiscal, inflation) of Trump administration policies. We believe, however, that the combined potential of the directional changes could have "multiplier" effects that catalyze consumer and business spending. This, in turn, would send corporate earnings materially higher, further boosting stock prices. While improved "animal spirits" may be enough to sustain economic and equity market momentum for a while longer, we believe tangible progress on tax reform (including repatriation) could be one of the most impactful market catalysts in the months ahead.

As we highlighted in our January publication, we have implemented a "barbell" strategy in equity portfolios, which entails holding both non-cyclical and pro-cyclical companies that stand to benefit the most from policy change. We believe this strategy provides favorable risk/reward potential for portfolios. Investors have recently begun to question the momentum around policy change and markets have turned choppier, but we believe this can create opportunities. For example, as detailed in the chart below, domestically-oriented companies with high tax rates have given back virtually all of their excess performance immediately following the election. We believe this underperformance is likely to reverse over the next few months as tax reform progress is made. Therefore, we will continue to add opportunistically to positions in policy beneficiaries in several industry groups, including finance, transports, defense, capital goods, and health services.

We conclude that, while markets may be volatile in the near term, we do not believe the "Trump trade" is over. Our investment team continues to focus on policy beneficiaries as we optimize risk/return potential within equity portfolios.

Performance of Trump-Policy Exposed Stocks



Source: RBC Capital Markets, Sit Investment Associates, 3/31/17

GLOBAL MACRO DEVELOPMENTS

The United States

Current fundamentals support +2.0 percent to +2.5 percent real GDP growth in the U.S. over the next couple of years. Stronger growth of +3.5 percent to +4.0 percent may be achievable if the right governmental actions and execution occur.

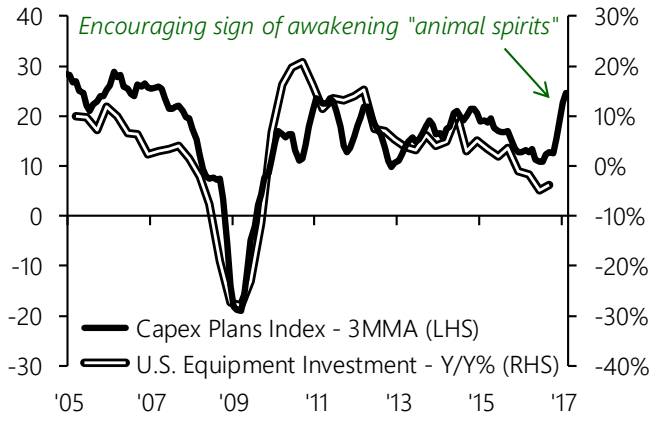
Modest GDP Growth Expected in 2017, But Signs "Animal Spirits" Awakening

Supported by an uptick in global growth, recovery in manufacturing/energy activity, lean inventories, and resilient consumer spending, we currently forecast U.S. real GDP growth of +2.5 percent in 2017 versus +1.6 percent in 2016, with potential upside based on the timing and magnitude of policy changes. If well implemented, President Trump's initiatives could provide a considerable boost to economic growth, notably in 2018 and 2019. Yet, some derivative impacts of these policy shifts – a stronger U.S. dollar, higher interest rates, and increased uncertainty – could also weigh negatively on GDP nearer-term. Nonetheless, it appears that larger U.S. corporations are preparing to ramp up domestic investment and that so-called "animal spirits" are beginning to emerge. As illustrated in Exhibit 1, the Morgan Stanley Composite Capex Plans Index suggests that investment in capital equipment may reaccelerate meaningfully in coming quarters. The extent to which capex plans translate to actual spending will likely be contingent on progress in Washington regarding tax cuts, deregulation, and fiscal spending initiatives.

"Soft" and "Hard" Data Diverge; Expect Subdued 1Q GDP Followed by Better 2Q

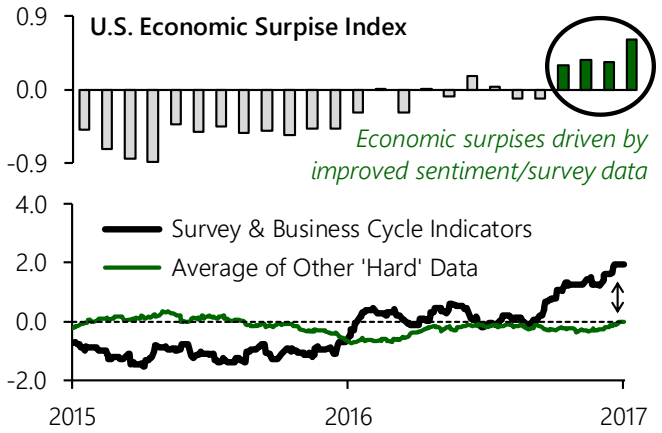
Business leaders have exhibited more optimism subsequent to the U.S. election, with the Conference Board's Measure of CEO Confidence and the NFIB Small Business Optimism Index leaping to levels not achieved since 2011 and 2004, respectively. Driven by better-than-expected business and consumer surveys (i.e., "soft" or qualitative data), the Bloomberg Economic Surprise Index has turned decidedly positive since November 2016 (see Exhibit 2). However, this optimism has not yet translated into an equivalent outperformance in quantitative (or "hard") data in the first quarter of 2017. We believe that this phenomenon is largely a function of the leading nature of survey data, but also evident of a "wait and see" mindset (particularly among small business owners) given continued policy uncertainty. Notably, the Federal Reserve Bank of

Exhibit 1: Morgan Stanley Capex Plans Index



Source: Morgan Stanley, Sit Investment Associates, 3/29/17

Exhibit 2: Bloomberg Economic Surprise Index



Source: Bloomberg, Morgan Stanley, Sit Investment Associates, 3/31/17

Atlanta's GDPNow model currently forecasts first quarter 2017 U.S. real GDP growth of just +1.2 percent versus its February projection of about +2.5 percent and consensus of +2.1 percent. Indicators currently imply that potential weakness in first quarter GDP will be followed by a better second quarter, in line with a common trend in recent years.

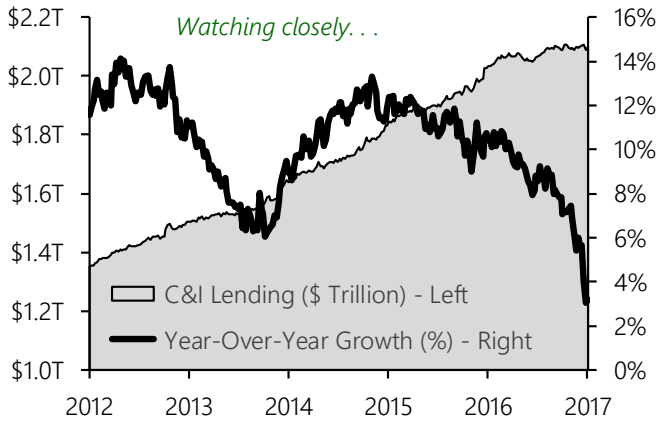
Despite Business Optimism, C&I Loan Growth Continues to Slow

Commercial and industrial (C&I) loan growth has also not yet caught up with the recent surge in business optimism, with lending growth continuing to slow. Whereas, C&I loans expanded at an annualized pace of +9.8% between 2011 and mid-2016, year-over-year growth has slowed to the low single digit range in recent weeks (see Exhibit 3). Conversely, the Senior Loan Officer Opinion Survey indicates that the net percentage of respondents tightening lending standards for C&I loans has generally declined. We believe the current disconnect in business optimism/capex plans and C&I loan growth can be explained by the lagged effect of business caution ahead of the U.S. elections, and, to a lesser degree, corporations funding growth initiatives through internal free cash flow and/or capital markets. In fact, to the extent that Washington is successful in tax reform, a higher portion of corporate capital needs going forward may be funded internally through lower tax payments and repatriated foreign earnings. However, we anticipate that C&I loan growth will reaccelerate as policy-related uncertainty eases.

Wage Growth (and Consumer Spending) Buttressed by Tight Labor Market

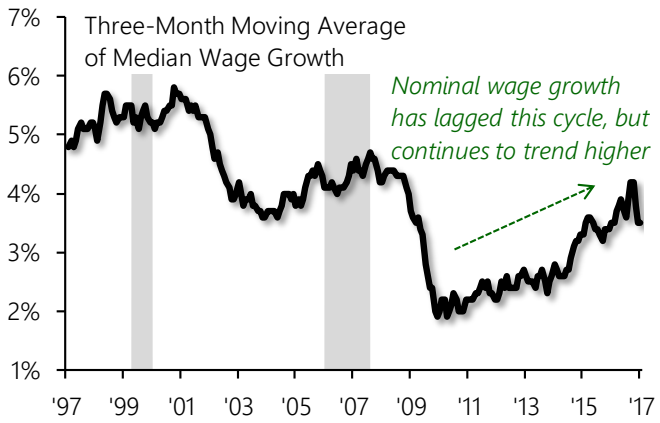
Representing roughly 70 percent of GDP, consumer spending has remained the linchpin of growth throughout the current economic expansion, which is now in its 93rd month. The U.S. consumer overall remains resilient as debt service ratios are at historically low levels, confidence is high, unemployment is low, and wage growth is accelerating (Exhibit 4). Although year-over-year growth in nominal personal income and spending growth has ticked up in recent months, higher energy prices and modest food inflation are affecting discretionary spending. We anticipate tight labor markets and investments in productivity-enhancing capital equipment to exert increased upward pressure on wage growth over the intermediate term, supporting ongoing strength in consumer spending. The tight labor markets, however, may have a dampening impact on expansion of small- and medium-sized businesses, which account for nearly 80 percent of private sector employment in the United States. According to the NFIB, nearly 50 percent of small businesses have indicated difficulty in finding qualified job applicants and 26 percent have raised compensation (highest reading since 2007).

Exhibit 3: Commercial Bank C&I Loan Growth



Source: U.S. Federal Reserve, Sit Investment Associates, 3/31/17

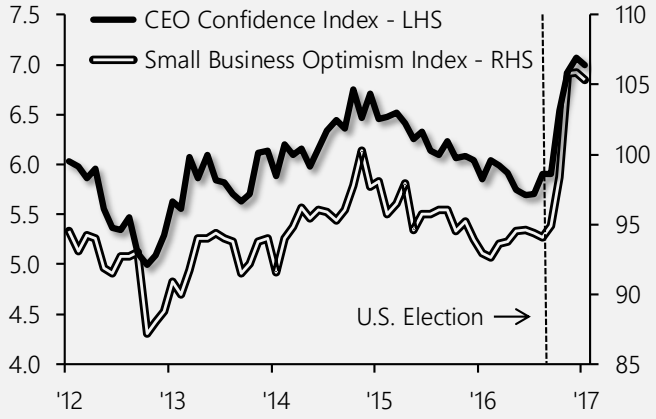
Exhibit 4: Atlanta Fed Hourly Wage Tracker



Source: Atlanta Federal Reserve, Sit Investment Associates, 3/31/17

United States: Notable Data Points

Business Confidence Remains Elevated

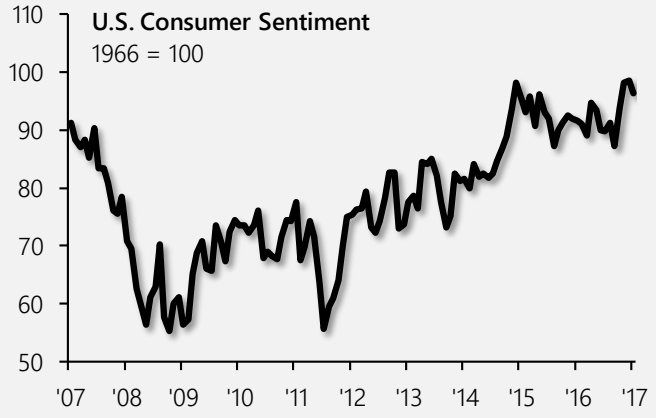


Source: CEO Magazine, NFIB, Sit Investment Associates, 3/31/17

Spike in New Order Activity Post Election

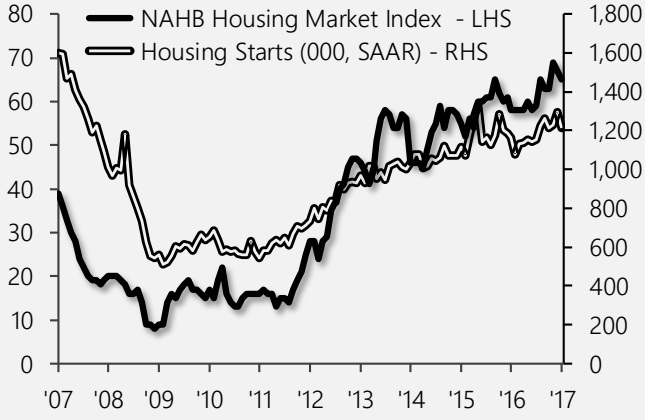
Source: Institute of Supply Mgmt., Sit Investment Associates, 4/3/17

Consumers Continue to Be Optimistic



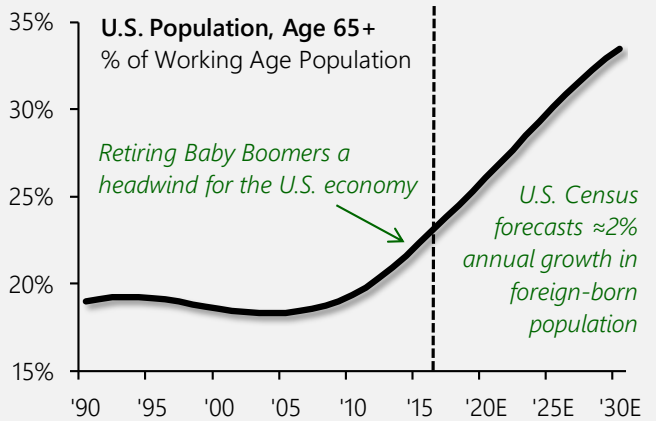
Source: University of Michigan, Sit Investment Associates, 3/31/17

Favorable Housing Fundamentals Persist



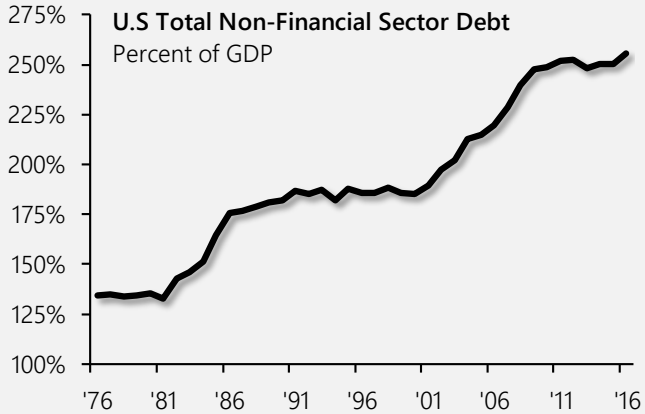
Source: NAHB, U.S. Census Bureau, Sit Investment Associates, 3/31/17

Policy Upside, but Demographic Headwinds



Source: U.S Census Bureau, Sit Investment Associates, 3/31/17

High Debt Poses a Structural Challenge



Source: BIS, Sit Investment Associates, 3/31/17

Europe

Growth in Europe remains at low levels despite positive economic surprises over the last couple of quarters. Elevated political risk, moderating currency tailwinds, and slow credit expansion will likely keep GDP growth potential somewhat muted.

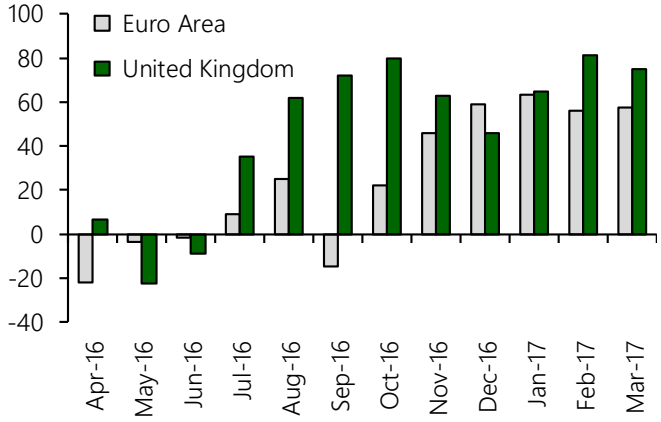
Even With Recent Positive Economic Surprises, Growth Stuck in Low Gear

As illustrated in Exhibit 5, macroeconomic data in both the Euro Area and United Kingdom continue to surprise to the upside. The combination of a weaker euro and uptick in global growth has contributed to strong exports and improving business activity across the Euro Area, with the Purchasing Managers Index (PMI) for both the manufacturing and services sectors rising to levels not observed since 2011. Although still indicative of economic expansion, PMI data (Exhibit 6) for the United Kingdom has moderated in recent months as waning consumer confidence, subdued real wage growth, and higher inflation have weighed on retail sales. Despite solid economic momentum year-to-date, tailwinds from favorable currency exchange rates, Chinese government stimulus, and easier year-over-year comparisons will likely fade in the second half of 2017. Consequently, we currently forecast that 2017 real GDP growth will remain relatively steady at +1.7 percent in the Euro Area and decline to +1.5 percent from +2.0 percent in 2016 in the United Kingdom as Brexit-related issues weigh on growth.

Monetary Policy Will Remain Accommodative, But Political Risk Elevated

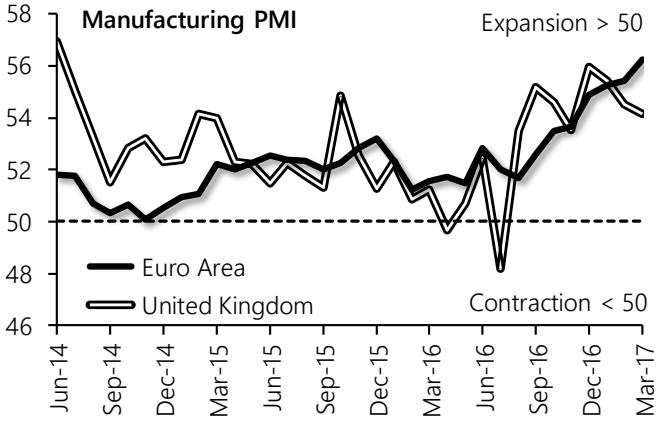
Deflationary pressures in the Euro Area have eased in recent months, with overall consumer prices projected to increase +1.6 percent in 2017 versus +0.2 percent in 2016 Yet, core consumer inflation is forecasted to remain relatively stable at roughly +1.0 percent. Despite the recent rise in overall inflation, we anticipate that the European Central Bank will continue its quantitative easing program through the end of 2017 and remain reluctant to raise interest rates until it becomes evident that the Euro Area is on a self-sustaining growth trajectory. Economic prospects remain somewhat constrained in the intermediate term by heightened political risk associated with upcoming elections in France, Germany, and Italy, as well as the United Kingdom's formal initiation of Article 50 (i.e., two-year process to exit the European Union) on March 29. However, we believe that a less-impactful political calendar heading into late 2017 and 2018 could set the stage for improved policy visibility and economic growth.

Exhibit 5: Citi Economic Surprise Index



Source: Citi, Sit Investment Associates, 4/3/17

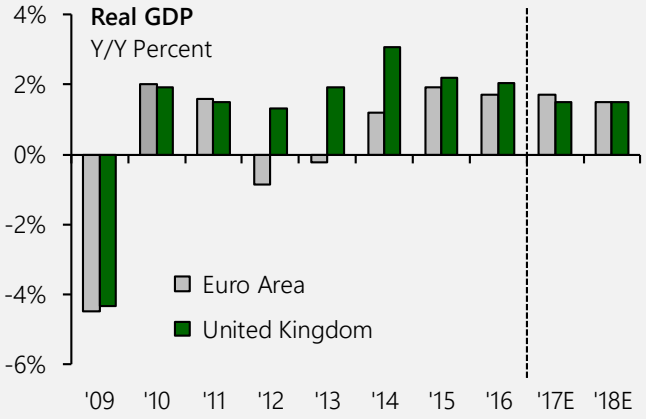
Exhibit 6: Markit Purchasing Managers' Index



Source: Markit, Sit Investment Associates, 4/3/17

Europe: Notable Data Points

Western Europe Stuck In Slow Growth Rut



Source: Eurostat, ONS, Sit Investment Associates, 3/31/17

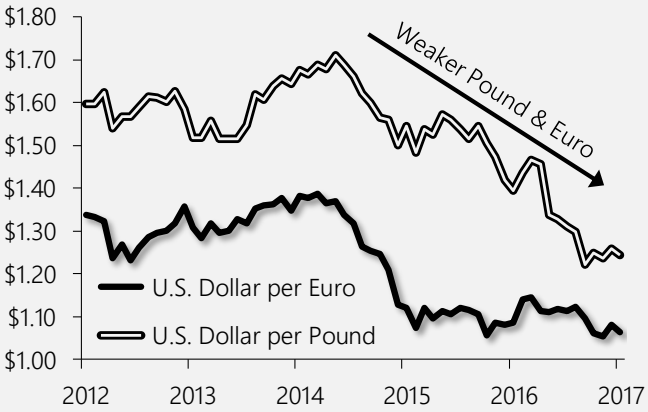
Euro Area Growth Remains Asymmetric

	Real GDP (Y/Y %)				
Country	**2014**	**2015**	**2016**	**2017E**	**2018E**
Germany	1.6	1.5	1.8	1.6	1.3
France	0.7	1.2	1.1	1.3	1.5
Italy	0.2	0.7	1.0	0.9	0.9
Spain	1.4	3.0	3.0	2.5	2.2

	Unemployment Rate (%)				
Country	**2014**	**2015**	**2016**	**2017E**	**2018E**
Germany	6.7	6.4	6.1	6.0	6.0
France	10.3	10.4	10.1	9.8	9.3
Italy	12.6	11.9	11.7	11.5	11.4
Spain	24.4	22.1	19.6	18.0	17.0

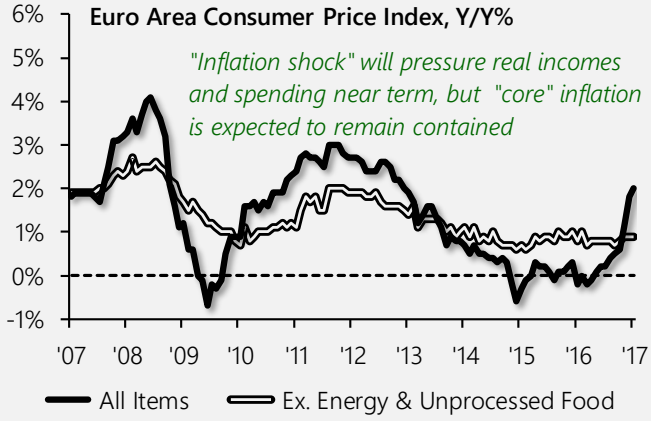
Source: FactSet, Sit Investment Associates, 3/31/17

Currency-Related Tailwinds Moderating



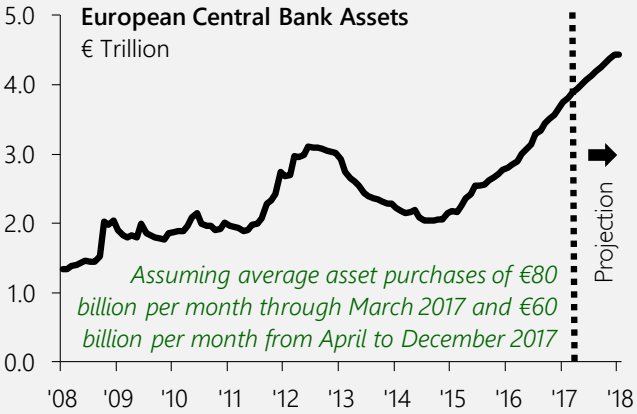
Source: FactSet, Sit Investment Associates, 3/31/17

Core Inflation Should Remain Contained



Source: Eurostat, Sit Investment Associates, 3/31/17

Monetary Policy will Remain Accommodative



Source: European Central Bank, Sit Investment Associates, 3/31/17

Political Risk Elevated, but Likely Plateauing

European Elections and Referendums

Mar 29	UK triggered Article 50; begin to exit EU
Apr 16	Turkish constitutional referendum
Apr 23	First round French presidential election
May 7	Second round French presidential election
Sep	Catalan independence referendum
by Oct 22	German Federal elections
TBD	Italian general election

Source: Sit Investment Associates, 3/31/17

Japan

The long run growth outlook for Japan remains downcast. While improved demand from overseas is buoying growth near-term, there remain few signs of broader transmission into domestic consumption as structural challenges, particularly the aging population, continue to overwhelm policy initiatives.

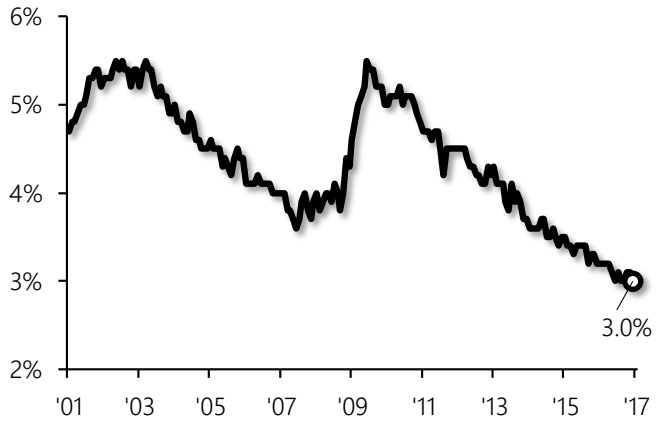
Exports Supporting Growth Near-Term; Structural Challenges Loom Beyond

Improved growth overseas has lifted Japan's economy in recent months. A pick-up in exports, particularly to China and the U.S., pushed growth to +1.2 percent in the December 2016 quarter and supported firming across a range of industrial metrics. Capital spending, too, has begun to stir. However, Japan's near-term growth remains tied to the prospects of its trading partners as internal growth sources remain held in check by severe structural challenges, particularly a rapidly aging work force. There has been limited feed-through of the industrial pick-up into the domestic economy as consumption figures remain sluggish and consumer confidence restrained. Consumer prices, despite the Bank of Japan's best efforts, continue to hover near zero. Prime Minister Abe's reform efforts have yet to clear a path toward sustained, domestic-driven growth. Until more effective measures are taken, fleeting stretches of export-driven growth may be the best the economy can muster. As such, we maintain a cautious stance on Japan's outlook, expecting limited growth of +0.5 percent both this year and next.

Negative Effects of Aging Population Becoming Increasingly Apparent

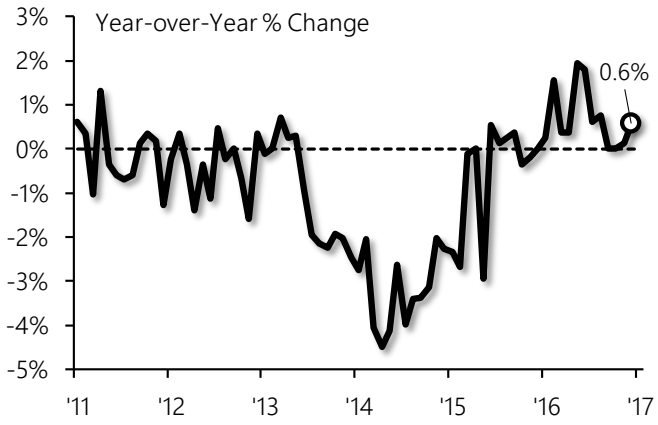
One of the main structural challenges faced by Japan is its aging population, which is creating labor shortages as the labor force dwindles. The unemployment rate has continued to fall in recent years, now well past previous cycle lows as shown in Exhibit 7, while businesses increasingly report difficulty in finding help. Government measures to improve labor force participation among women as well as the elderly have made progress, but labor supply shortfalls persist. While higher pay may be an expected favorable consequence, wages have remained stagnant as shown in Exhibit 8. Businesses are instead opting to cut store hours or capacity rather than add to fixed cost bases, a rational response in an environment of weak demand and limited pricing power. Without a more concerted policy effort to address Japan's aging demographic, labor shortages and stagnant wages may remain a fixture of its economy going forward.

Exhibit 7: Japan Unemployment Rate



Source: Japan MIAC, Sit Investment Associates, 3/31/17

Exhibit 8: Japan Real Wage Growth



Source: Japan MIAC, Sit Investment Associates, 3/31/17

Asia, Ex-Japan

- ***China has been in a temporary upcycle thanks to government stimulus and easy monetary conditions. However, we continue to see downward pressure on economic growth longer term as structural issues such as high debt levels remain challenging.***
- ***A new president's stimulus policies and strong export growth should bolster South Korean economic growth this year; Chinese economic retaliation remains a threat.***
- ***India's GDP growth should reaccelerate after last year's currency demonetization program materially dampened consumer spending.***

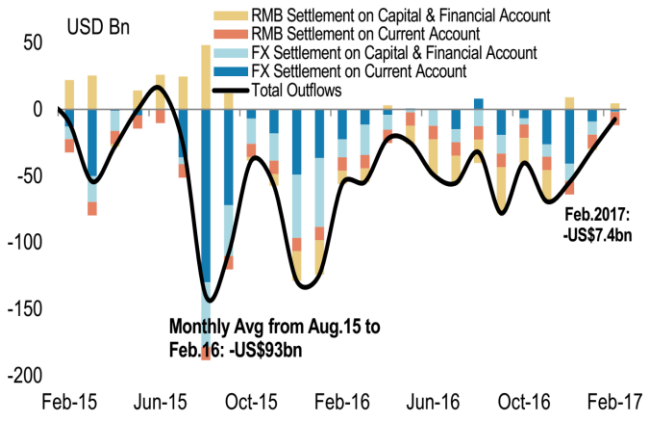
China's Economy Off to a Good Start in 2017, but Gradual Moderation Expected

Following a better than expected fourth quarter of 2016, China's economic growth has continued to surprise to the upside in early 2017. The current economic upcycle has lasted longer than expected thanks to government stimulus and easy monetary policy. However, with structural issues remaining and monetary policy already shifting toward neutral, we think there is a likelihood that China's growth is peaking in the near term. With that said, we expect only a gradual moderation in GDP growth rather than a sharp slowdown given favorable policy/growth dynamics leading up to the important power transition in November. We, therefore, believe the government's goal of +6.5 percent real GDP growth in 2017 is achievable. In addition, capital outflow has subsided due to tighter capital controls (Exhibit 9) and as the renminbi stabilized against the U.S. dollar. Given the benign inflation outlook, global uncertainty, and leadership transition, we do not expect China to tighten monetary policy sharply and that policy initiatives aimed at reining in high leverage (Exhibit 10) are unlikely to be a major drag on growth.

South Korean GDP Growth Expected to Remain Modest in 2017

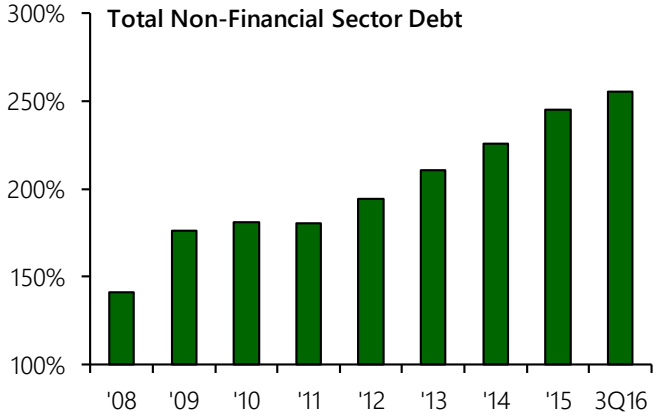
South Korea's GDP is projected to grow about +2.5 percent in 2017 versus +2.7 percent in 2016. While ongoing political uncertainty has weighed on consumption, we expect continued modest economic growth led by the stronger exports, a recovery in consumer spending, and a new president's fiscal policies. The Constitutional Court of Korea ruled to affirm the impeachment of President Park Geun-hye on March 10, with special elections on May 9. The new president will face the challenges of a slowing economy, growing threat from North Korea, and Chinese economic retaliation over deployment of the Terminal High Altitude Area Defense (THAAD) missile-defense

Exhibit 9: China Cross-Border Outflows



Source: Morgan Stanley, 3/16/17

Exhibit 10: China Debt-to-GDP Ratio



Source: BIS, Sit Investment Associates, 3/31/17

system. The leading presidential candidate, Moon Jae-In (Democratic Party of Korea), has pledged to raise disposable incomes. However, Moon Jae-In has also called for improved relations with North Korea and for the government to review the decision to deploy the United States' THAAD missile shield. The last time the liberals were in power (2008), they advocated for the Sunshine Policy of promoting aid and exchange with North Korea, hoping to build trust and guide it towards openness and nuclear disarmament. However, these policy initiatives were ultimately deemed a failure.

India's Economic Growth Expected to Reaccelerate Post Demonetization

India's strong economic growth should continue into fiscal 2018, driven by Prime Minister Narendra Modi's key reforms and strength in consumer spending. We expect GDP growth to accelerate to +7.4 percent in fiscal 2018 from +6.8 percent in fiscal 2017 (March). In November 2016, Prime Minister Modi cancelled existing 500 and 1000 rupee notes (86 percent of currency in circulation) in an effort fight corruption and tax evasion. Unfortunately, the government was slow to replace the currency with new notes, which had considerable negative impact on consumer spending (India is a cash transaction-driven economy). More recently, India's economy is showing signs of strength post the currency replacement. Urban consumption is recovering quickly and rural demand is normalizing. Passenger vehicle sales, a proxy for urban consumption, showed sales growing at robust levels in February. Likewise, motorcycle sales, a proxy for rural demand, improved after three months of contraction.

Latin America

Mexico's economic growth outlook is still unclear as NAFTA renegotiation has not been completed. Brazil's President, Michel Temer, is working to grow the economy after a severe recession, but political infighting may hamper passing measures to control the fiscal deficit and economic stimulus policies.

NAFTA Renegotiation Remains an Overhang for Mexico's Economy

Mexico's economic growth remains uncertain because of the United States' decision to renegotiate the North American Free Trade Agreement (NAFTA). U.S. Commerce Secretary Wilbur L. Ross said the talks would be later in the year after a mandatory 90-day consultation period with Congress. The effect has resulted in a slowdown in foreign investment into Mexico, which fell -6 percent last year. It remains to be seen how much the Mexican economy will be affected by the renegotiated trade agreement. We are currently forecasting that Mexico GDP growth will decelerate to +1.5 percent in 2017 from +2.3 percent in 2016, but the range of potential outcomes remains wide – the Mexican central bank's forecast is +1.3 to +2.3 percent.

Brazil President Working to Grow Economy Out of Recession

In Brazil, President Michel Temer is trying to get the economy out of a recession. Brazil GDP declined -2.5 percent year-over-year on the fourth quarter of 2016 on weak private consumption and investment and is forecast to grow +0.5 percent in 2017. The economic recovery should be helped by the Brazil central bank's lowering of interest rates. It cut rates -150 basis points to 12.25 percent year-to-date, and inflation has fallen to 4.8 percent in February, below the mid-point target, providing room for further interest rate cuts. However, there is risk in Brazil's politics. First, the government must approve social security reform to help contain the fiscal deficit, and second, there is an ongoing political scandal of illegal donations, which could delay Congressional action on economic growth measures.

Taxable Bonds

Increasing Interest Rates and Balance Sheet Reduction

The Federal Reserve responded to the recent acceleration in growth and inflation expectations by increasing the target Fed Funds rate in March by 25 basis points to a new range of 75-100 basis points. The yield curve flattened during the first quarter of 2017, as yields rose in shorter maturities (1-3 years) and fell in longer maturities (10-30 years). The market is currently anticipating 2 to 3 more rate hikes in 2017. In what we view as a major change, discussions at the Fed are now focusing on reducing its very large balance sheet. Just as the asset purchase program commonly referred to as Quantitative Easing (QE) was an experiment in monetary policy never employed previously, its reversal will be likewise volatile. While the goal of increasing the balance sheet was to reduce interest rates, the intent of reducing the balance sheet is to remove monetary stimulus and, in essence raise interest rates.

Portfolio Positioning for Changing Policies

As the new administration's policies are eventually implemented, we expect Treasury yields to continue to move higher over time but to do so in a range-bound fashion as positive developments on an economic front are partially counteracted by contentious social and/or political headlines. We have maintained an overall defensive posture against rising rates, as the aggregate result of regulatory and tax reform should help maintain high levels of consumer and investor confidence. We are maintaining an emphasis on quality and sectors we believe to have attractive valuations and the greatest potential to benefit from expected upcoming legislative activity.

Municipal Bonds

The Tax-Exempt Yield Curve Steepens Due to Yield Declines on Short End

The AAA tax-exempt municipal bond yield curve steepened slightly during the quarter due to modest yield declines at the short end of the curve and relatively small net yield movements 15 years out and longer. The difference between the 2-year and 30-year yields was 20 basis points larger at the end of March versus the start of the year. The yield on the Bond Buyer 40-Bond Index remained within 10 basis points of the 4.25 percent level where it began the year. The index yield was at its lowest point in mid-January, falling to 4.16 percent. Yields then rose steadily until peaking at 4.35 percent in early March, before declining once again to a yield of 4.25 percent at the end of March.

Belly of the Curve and Lower Rated Investment Grade Bonds Perform Better

All duration indices have had positive returns for the year, with performance relying modestly on positioning along the curve. The 5-year and 7-year indices performed best to start the year (see Exhibit 11). Nearly all of the positive return on bonds inside of 7 years took place in January and February, while longer duration bonds caught up in March. All investment grade municipal bond index returns were positive to start the year as well. Lower credit quality outperformed, with the Municipal High Yield Index returning 4.06 percent in the first quarter. Outperformance of the High Yield Index was bolstered by exceptionally strong tobacco bond performance and despite a fairly large sell-off of Puerto Rico debt in March. General obligation and revenue bonds have both performed nearly identically in aggregate. The housing sector, where we tend to have heavier weightings, has been the strongest performing investment grade municipal sector thus far in 2017. We continue to find that housing bonds offer strong relative and

defensive value in what is still broadly viewed as a rising interest rate environment for the near- to intermediate-term.

Decreased Municipal Debt Issuance and Choppy Fund Flows to Start 2017

Issuance for the first three months of the year was as low as it has been since 2012 and total 2017 first quarter issuance could be the second lowest of the past decade. It is down 12 percent from 2016. The number of refundings fell off, although recent yield declines may once again put some refundings back into the money. We continue to anticipate that a far lesser number of refundings will be economically feasible the further we move into 2017. We also expect supply for the current year to stay well off the record pace of 2016. Municipal bonds have posted weeks of both inflows and outflows, with little net aggregate change so far in 2017. Although the four week moving average of flows is positive, there is a likelihood of withdrawals for income tax payments in April.

Tax-Exempt Fixed Income Strategy and Near-Term Outlook

Despite the Fed Funds rate increase, yields fell across most of the municipal curve as investors in tax-exempt debt favored intermediate bonds in January and February, and longer bonds in March. Some of the movement in March could have been due to the heightened level of political uncertainty. The failure of the Republican AHCA bill has called into question the ability to pass other policy proposals that could prospectively impact the tax-exempt market, namely infrastructure spending and tax reform. The success or failure of tax reform is likely to impact performance in 2017, while an infrastructure bill is not likely to impact debt markets until 2018. Despite the political noise and trading volatility, we continue to have strong confidence in the fundamental credit quality that most municipal bonds provide. Our tax-exempt investment strategy will continue to place a heavy emphasis on bonds that provide strong current income, which we believe is the primary driver of total return over the full market cycle. We expect to shorten durations modestly going forward by placing an ongoing focus on investing in bonds with higher credit quality ratings and short call features with limited extension risk. As always, we view diversification as a key tenet in managing portfolio credit risk.

Exhibit 11: U.S. Fixed Income Index Total Returns

Percent, as of 3/31/17

				Annualized			
Bloomberg Barclays Indices	1 Month	YTD 2017	6 Months	1 Year	3 Years	5 Years	10 Years
Municipal	0.22 %	1.58 %	-2.10 %	0.15 %	3.55 %	3.24 %	4.33 %
1-Year Municipal	0.00	0.69	0.52	0.67	0.65	0.70	1.80
3-Year Municipal	-0.03	1.27	0.15	0.57	1.14	1.23	2.74
5-Year Municipal	0.03	1.90	-0.78	0.35	2.03	2.06	3.84
7-Year Municipal	0.17	1.95	-1.79	-0.06	2.89	2.72	4.47
10-Year Municipal	0.33	1.78	-2.58	-0.24	3.60	3.35	4.81
15-Year Municipal	0.31	1.52	-3.01	-0.27	4.30	4.02	5.00
20-Year Municipal	0.29	1.50	-3.09	0.04	4.58	4.12	4.93
Long (22+ years)	0.34	1.74	-3.29	0.39	5.36	4.51	4.67
High Yield	0.23	4.06	-2.02	4.31	5.46	5.64	4.29
Muni Aaa	0.18	1.43	-1.94	-0.25	2.67	2.46	3.72
Muni Aa	0.20	1.49	-2.00	-0.02	3.26	3.05	4.21
Muni A	0.23	1.71	-2.32	0.65	4.21	3.93	4.69
Muni Baa	0.43	2.18	-2.36	0.50	5.06	3.67	3.28

Source: FactSet, Sit Investment Associates, 3/31/17

GLOBAL EQUITIES: ENVIRONMENT & STRATEGY

The "Trump rally" in U.S. stocks continued in the first quarter of 2017, with the S&P 500 Index generating a total return of +6.1 percent year-to-date through March 31. Buoyed by a pro-growth presidential agenda, strong business optimism, and positive global economic momentum, the S&P 500® Index has produced a total return of +11.4 percent since the U.S. election on November 8. As illustrated in Exhibit 12, bottom-up earnings for the S&P 500 Index continue to recover as energy- and currency-related headwinds began to fade in the second half of 2016, with consensus currently projecting earnings growth of +10.2 percent in 2017 and +11.8 percent in 2018. Although consensus projections have consistently proven to be too optimistic early in the year (see Exhibit 13), we believe earnings do not yet fully reflect potential upside from President Trump's various policy initiatives.

Based on current estimates, the S&P 500 Index is trading at a forward price-to-earnings ratio of 18.2 times versus its long-term average of 15 times. Although not cheap relative to their own history, U.S. equities are attractive relative to other asset classes. For instance, the earnings yield of the S&P 500 Index of +5.5 percent compares favorably to the 10-year Treasury yield of +2.4 percent (see Exhibit 14). We believe earnings growth will be the primary driver of stock appreciation going forward and that we cannot expect multiples to expand further. Looking forward, we believe the U.S. stocks will be subject to a number of fits and starts in response to progress (or lack thereof) in Washington, pace of interest rate hikes, and global macroeconomic data. Given ongoing policy uncertainty and its impact on potential economic outcomes, we continue to implement a diversified, "barbell" strategy in which portfolios are overweight a combination of holdings that are pro-cyclical/policy beneficiaries such as banks and transports and those that are less cyclical/U.S.-focused such as HMOs and telecoms (see Exhibits 15 and 16).

The MSCI Europe Index generated a total return of +7.6 percent on a U.S. dollar basis in the first quarter of 2017, with a local currency return of +6.2 percent augmented by modest strength in the euro and British pound relative to the U.S. dollar. Notably, the performance of the MSCI Europe Index has generally tracked that of the S&P 500 Index over the last three quarters as macroeconomic indicators in both Europe and the United States have continued to surprise to the upside relative to subdued expectations.

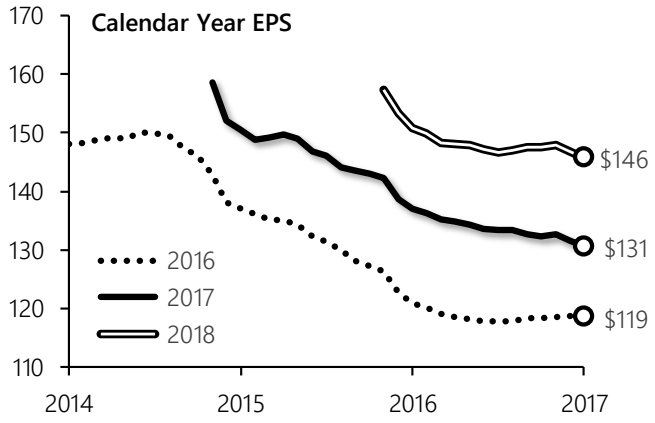
Exhibit 12: S&P 500 Bottom-Up EPS Forecast

Consensus, Y/Y % Growth

S&P Sector	'17E	'18E	S&P Sector	'17E	'18E
Energy	293%	45%	Staples	5%	8%
Financials	13%	12%	Health Care	5%	9%
Materials	12%	11%	Industrials	4%	13%
S&P 500	**10%**	**12%**	Real Estate	2%	7%
Info Tech	10%	11%	Telecom	1%	3%
Discretionary	6%	13%	Utilities	-1%	6%

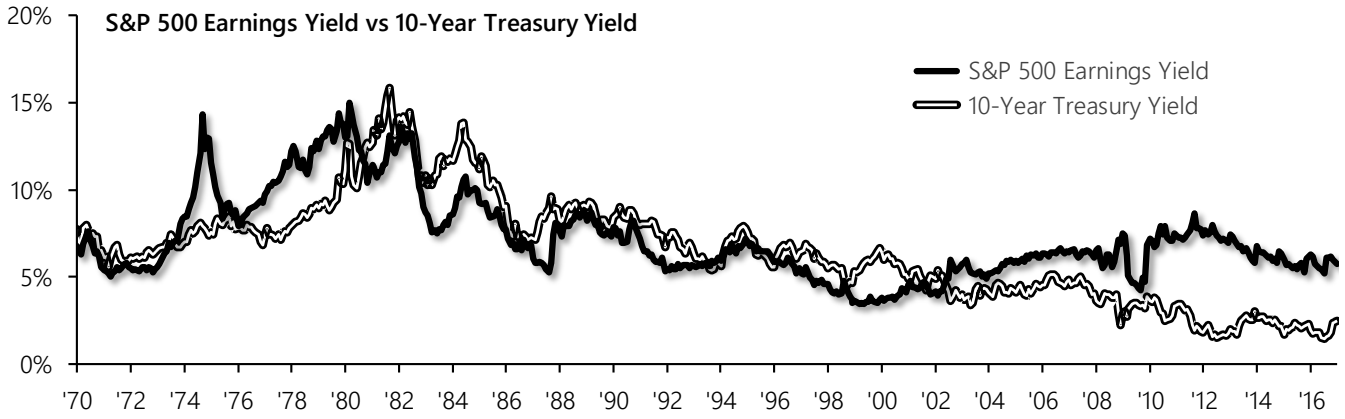
Source: FactSet, Sit Investment Associates, 3/31/17

Exhibit 13: S&P 500 Consensus EPS Estimates



Source: FactSet, Sit Investment Associates, 3/31/17

Exhibit 14: U.S. Equity Valuation versus Treasury Bonds



Source: FactSet, Sit Investment Associates, 3/31/17

Exhibit 15: Components of Sit Investment Associates' U.S. "Barbell'' Strategy

Overweight - Procyclical/Policy Beneficiaries		Overweight - Defensive/Domestically Focused	
Characteristics		**Characteristics**	
U.S. domestic exposure, high corp. taxes, pro-cyclical, high beta, strong balance sheets, limited impact from higher interest rates		*Non-cyclical, attractive valuations, limited currency risk, government policy beneficiaries, low beta, U.S. exposure*	
■ Banks/Investment	■ Parcel Carriers	■ Defense	■ HMOs
■ Life Insurance	■ Home Improvement	■ Oil & Gas Pipelines	■ Medical Distributors
■ Railroads	■ Trucking	■ Oil Refiners	■ Biotech
■ Airlines	■ Media Companies	■ Packaged Food	■ P&C Insurance
■ Semiconductors	■ Engineering & Construction	■ Waste Management	■ "Growthier" REITs/Utilities
■ Restaurants	■ Commercial Construction	■ Food Retail	■ Telecom

Underweight - Slower Growth/Limited Policy Upside	
Characteristics	
Significant international exposure, weak balance sheets, currency risk, reliance on imports, below average growth, low corporate tax	
■ Pharma	■ Insurance Brokers
■ IT Hardware	■ Department Stores
■ Integrated Oil	■ Non-Energy Minerals
■ Household Personal Care	■ Hospital/Nursing Management
■ Auto - Suppliers	■ Auto - OEMs
■ Beverage Companies	■ "No Growth" REITs/Utilities

Source: Sit Investment Associates, 3/31/17

Exhibit 16: Global Equity Strategy at a Glance

Regional Weightings

Region/Country	Sit Investment Sentiment	Themes Within Region/Sector
North America	+	US growth supported by consumer/wage growth, policy change, and uptick in capex
Euroland	+/=	Asymmetric recovery supported by accommodative monetary policy, but politcial risks
United Kingdom	=	Brexit-related weakness offset by weaker fx, monetary easing, and (potential) fiscal stimulus
Greater China	=	Economy stabilizing, launch of SZ-HK Stock Connect, money inflow from mainland
Japan	−	Faces headwinds from yen, a cautious corporate sector, and tepid consumer spending
Rest of Asia	+/=	Australia GDP growth slower; Asia xJapan economies performing well
Latin America	−	Brazil/Argentina/Venezuela in recession; modest growth in Mexico (closely tied to U.S)

Sector Weightings

Commodities/ Energy		
Non-Energy Minerals	−	Slowing China economic growth slows demand for metals
Energy Minerals/ Industrial Services	−/=	Supply/demand coming into balance, but higher oil prices largely reflected in valuations
Process Industries	=	Secular growth in agricultural technology, beneficiaries of cheap U.S. natural gas
Total	−/=	
Capital Spending/ Tech		
Producer Manufacturing	=	Improving capex in some end markets; overweight defense/aerospace
Electronic Technology	+	Ongoing productivity enhancement, wireless communications, widespread growth in semis
Technology Services	+	Outsourcing; delivery of software and services via the internet; information requirements
Total	+	
Early Cyclicals/ Consumer		
Transportation	+	Pricing power amid capacity discipline throughout sector, particularly rails and parcel
Consumer Durables	=	Autos appear near peak, upside in housing
Retail Trade	−	Structural margin pressure from online penetration/ competition.'
Consumer Services	=	Slow growth in most segments; favor media companies
Commercial Services	−	Limited secular growth in most areas
Total	=	
Staples/ Non-Cyclicals		
Health Technology	+	Favor companies with new products for unmet medical needs (biotech, pharma, medtech)
Health Services	=	Favor HMOs (less political risk, stable utilization trends) over PBMs/ Distributors
Consumer Non-Durables	−	Valuation unattractive, intense competition in mature biz, higher costs near-term
Communications	=	Dominant wireless and wireline service companies provide attractive dividend yields
Total	=	
Interest Rate Sensitive		
Utilities	=	Attractive yields and rate base growth, but vulnerable to higher interest rates
Finance	+	Emphasize strong balance sheets & capital return; overweight banks, underweight REITs
Total	=	

+ Overweight/Positive = Neutral − Underweight/Negative

Source:, Sit Investment Associates, 3/31/17

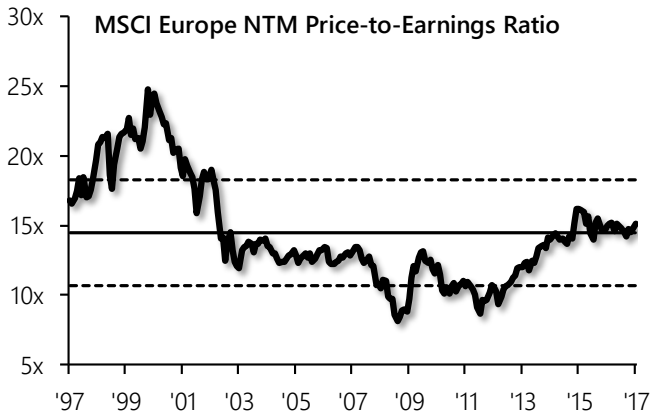
Heading into the second half of 2017, European equity performance should be underpinned by the prospect of diminished political risk in 2018, better corporate earnings helped by easy comparisons, and relatively attractive valuation. The MSCI Europe Index is currently trading at a forward price-to-earnings multiple of about 15.1 times (see Exhibit 17), which is a 17 percent discount to the S&P 500 Index.

We anticipate that European equity markets will be volatile ahead of key elections across the region and that investors will continue to climb the so-called "wall of worry" with regard to potential Brexit-related disruptions, ongoing global growth concerns, and moderating central bank intervention around the world. We remain selective with regard to sector, end market, and company-specific exposures. In particular, we prefer companies that are either plays on domestic secular growth, address markets where there is pent-up demand, benefit from modest inflation/rising global yields, and/or have meaningful positive exposure to policy shifts in the United States. Despite decent performance year-to-date, we continue to underweight stocks that have significant exposure to certain emerging markets given our concerns that a stronger U.S. dollar and tighter Chinese government stimulus will weigh on economic growth/commodity prices.

The MSCI Japan Index, measured in U.S. dollars, rose +4.6 percent on a total return basis during the first quarter of 2017, driven solely by a stronger yen as the local currency return was nearly flat at -0.2 percent. Japan equities lagged most other developed markets on a constant currency basis, adding to the country's modest underperformance since late October last year. Within Japan, leadership by the more pro-cyclical materials and industrial sectors to begin the year gave way to outperformance by more defensive areas as the quarter progressed and the yen strengthened. Japan continues to trade at a discount to other developed markets as the MSCI Japan Index, at a 13.8 times forward price-to-earnings multiple (see Exhibit 18), trades at a -9 percent and -24 percent discount, respectively, to the MSCI Europe and S&P 500 indices.

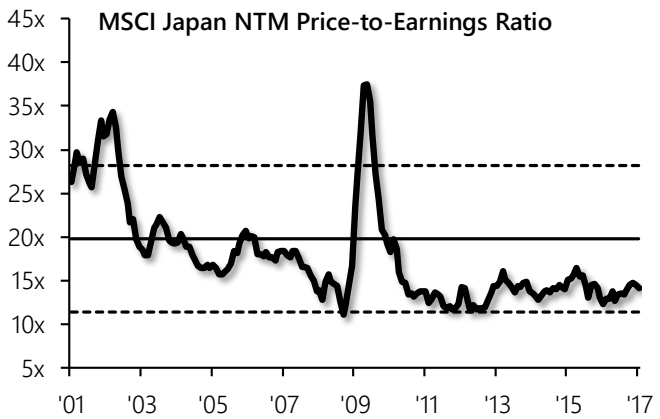
We remain cautious on Japanese equities and maintain underweight positions across our international strategies. Our caution stems from the country's uncertain long-run growth outlook and its number of structural issues – a rapidly aging population, ballooning public debt load, inefficient labor market – that have not yet been adequately addressed by Prime Minister Abe and his pro-growth reform agenda. Where we do hold Japanese

Exhibit 17: MSCI Europe Index Valuation



Source: FactSet, Sit Investment Associates, 3/31/17

Exhibit 18: MSCI Japan Index Valuation



Source: FactSet, Sit Investment Associates, 3/31/17

equities, we continue to employ a "barbell" approach that should perform well in an environment of continued economic and political uncertainty. On one end, we focus on defensive domestic consumption names, such as healthcare and consumer staples, that should perform well in a low growth environment. On the other, we look to hold overseas-exposed names that benefit from higher growth in select other regions of the globe and also gain from an export advantage due to the weakened yen.

As macro concerns faded amid better than expected data and trade tensions with the U.S. tracked better than feared, the MSCI China Index generated a total return of +12.9 percent in the first quarter of 2017 and outperformed both MSCI Emerging Market and MSCI World indices (see Exhibit 19). On a forward price-to-earnings basis, the MSCI China Index is currently trading in line with its long-term average of 12 times. Though we continue to see downward pressure on China's economy overall, we remain positive on the internet sector as we expect continued robust growth as the secular shift from offline to online expands. In South Korea, we expect an election market rally as the country selects a new president and expect a reasonable resolution to North Korea's missile program. Our South Korean holdings include global technology, utilities, and banks. In India, we like the outlook for the consumer and bank sectors.

We remain underweight Latin American markets. The economic outlook for Latin American countries, mainly Mexico and Brazil is unclear/volatile. Mexico's trade will be affected as the United States renegotiates NAFTA and Brazil's political paralysis may limit the country's economic recovery. The Mexican peso fell -11 percent since the U.S. presidential election to end-2016, but has appreciated +9.7 percent against the U.S. dollar year-to-date, reflecting a more conciliatory tone from President Trump on trade policy. The Mexican peso's strength has also been helped by the Mexican central banks' +75 basis point increase in rates this year, to help stem higher-than-expected inflation of +4.9 percent. We expect further volatility in the Mexican market and the peso until trade negotiations are completed. We are positive on the consumer sector (about two-thirds of GDP), as private consumption growth remained solid last year, at +2.8 percent. In Brazil, we are retaining a defensive strategy because of doubts over the economy's recovery from recession. We are also concerned over Brazil's fiscal situation, given its high public sector debt to GDP ratio of 70.0 percent (up from 51.3 percent in 2013).

Exhibit 19: Total Returns of MSCI Country/Regional Indices and S&P 500

Percent, as of 3/31/17				Annualized			
in U.S. Dollars	1 Month	YTD 2017	Since 11/8	1 Year	3 Years	5 Years	10 Years
MSCI China	2.1	**12.9**	6.8	19.9	6.6	5.9	5.5
MSCI EM Latin America	0.6	**12.1**	1.6	23.6	-3.7	-5.8	1.1
MSCI Emerging Markets	2.5	**11.5**	7.0	17.7	1.5	1.2	3.1
MSCI AC Asia Pacific	1.8	**9.5**	7.6	17.1	4.9	5.9	2.9
MSCI Europe	4.1	**7.6**	11.2	10.5	-0.9	6.3	1.3
MSCI EAFE	2.9	**7.4**	9.7	12.2	1.0	6.3	1.5
MSCI World Index	1.1	**6.5**	10.6	15.4	6.1	10.0	4.8
S&P 500	0.1	**6.1**	11.4	17.2	10.4	13.3	n/a
MSCI Japan	-0.2	**4.6**	5.1	14.8	6.4	7.1	0.8

Source: FactSet, Sit Investment Associates

Global Economic Assumptions

	GDP Growth				Inflation			
	2015A	2016E	2017E	2015-2019 (5 Yr CAGR)	2015A	2016E	2017E	2015-2019 (5 Yr AVG)
Global Economy	**2.7 %**	**2.5 %**	**2.8 %**	**2.8 %**	**1.9 %**	**3.0 %**	**3.1 %**	**2.8 %**
United States	2.6	1.6	2.5	2.3	0.1	1.4	2.8	2.1
Euro Area	1.9	1.7	1.7	1.6	0.0	0.2	1.5	1.5
United Kingdom	2.2	1.8	1.5	1.7	0.0	0.7	2.0	1.5
Japan	0.5	1.0	0.5	0.5	0.8	0.0	0.5	0.5
Asia Ex Japan	6.0	5.8	5.7	5.8	2.1	2.1	2.5	2.3
Latin America	-0.7	-1.5	1.3	0.6	14.0	8.0	10.0	17.6

	10-Year Bond Yields			
	2014	2015	2016	2017
	12/31A	12/31A	12/31A	12/31E
United States	2.2%	2.3%	2.5%	3.0%
Euro (Germany)	0.5	0.6	0.2	0.7
Japan	0.3	0.3	0.1	0.0
United Kingdom	1.8	2.0	1.2	1.7

	Exchange Rates			
	2014	2015	2016	2017
	12/31A	12/31A	12/31A	12/31E
Euro ($/€)	1.21	1.09	1.05	1.05
Japan (¥/$)	120	120	117	115
UK ($/£)	1.56	1.47	1.23	1.25

Source: FactSet, Sit Investment Associates, 3/31/17

Expected Range of Future U.S. Fixed Income Returns

		Time Horizon					
		6 Months		1 Year		3 Years (Ann. Return)	
Risk Level/Representative Issue	**Interest Rate Forecast**	**Terminal Yield**	**Total Return**	**Terminal Yield**	**Total Return**	**Terminal Yield**	**Total Return**
Low Risk							
2 yr. Constant Maturity Treasury	Pessimistic	2.00 %	-0.8 %	2.50 %	-1.1 %	4.00 %	-0.5 %
Present YTM 1.26%	Most Likely	1.75	-0.3	2.25	-0.7	3.00	0.2
	Optimistic	0.50	2.1	0.50	2.8	2.00	0.8
Intermediate Risk							
5 yr. Constant Maturity Treasury	Pessimistic	2.75 %	-2.8 %	3.50 %	-5.2 %	5.00 %	-2.6 %
Present YTM 1.93%	Most Likely	2.50	-1.7	2.75	-1.9	4.00	-1.1
	Optimistic	1.00	5.5	1.00	6.5	3.00	0.3
Medium Risk							
10 yr. Constant Maturity Treasury	Pessimistic	3.75 %	-10.1 %	4.00 %	-10.8 %	5.50 %	-5.8 %
Present YTM 2.39%	Most Likely	2.75	-1.9	3.25	-4.9	4.50	-3.3
	Optimistic	2.00	4.7	2.00	5.9	3.50	-0.6
High Risk							
30 yr. Constant Maturity Treasury	Pessimistic	4.50 %	-23.1 %	4.75 %	-24.8 %	6.00 %	-12.1 %
Present YTM 3.00%	Most Likely	3.50	-7.7	3.50	-6.2	5.00	-7.8
	Optimistic	2.25	17.8	2.25	19.3	4.00	-2.8

Source: Sit Investment Associates, 3/31/17

Global Equity Index Price Returns

Percent, as of 3/31/17

= Top Quartile Performance

Country Benchmarks (U.S. Dollar)	1 Month	YTD	Since 11/8	Annualized 1 Year	3 Years	5 Years	10 Years
Poland (WIG)	1.8	**17.9**	19.2	11.0	-5.5	2.0	-5.9
Mexico (IPC)	10.0	**16.3**	-1.3	-3.7	-6.0	-3.5	-0.3
India (SENSEX)	5.9	**16.3**	10.1	19.2	6.8	6.0	8.7
South Korea (KOSPI Composite)	4.4	**15.1**	9.4	10.7	1.2	1.7	4.6
Singapore (FTSE Strait Times)	2.6	**14.0**	11.9	7.7	-3.6	-1.0	1.8
Spain (IBEX 35)	10.2	**13.4**	13.4	12.6	-7.7	1.0	-10.5
Taiwan (TAIEX)	1.9	**12.6**	10.4	19.0	3.6	3.8	6.3
Brazil (Bovespa)	-4.5	**10.6**	1.9	44.9	-2.9	-10.4	-1.8
Turkey (BIST 100)	1.3	**10.0**	1.6	-17.4	-9.2	-6.9	-4.9
Austria (ATX)	3.7	**9.5**	11.5	16.9	-4.5	1.0	-13.3
Hong Kong (Heng Seng)	1.4	**9.3**	5.0	15.8	2.8	3.2	4.1
Australia (ASX All Ordinaries)	1.7	**8.8**	9.3	13.6	-3.5	-0.3	-1.4
Germany (DAX)	4.7	**8.7**	13.7	16.0	0.0	7.3	7.4
Portugal (PSI 20)	8.4	**8.5**	6.3	-6.4	-20.1	-6.3	-19.2
Netherlands (AEX)	5.0	**8.4**	11.1	10.2	-0.2	5.1	-4.1
Italy (FTSE MIB)	9.1	**8.0**	18.0	6.2	-9.8	0.6	-17.0
Czech Republic (PX-50)	3.5	**7.9**	5.8	2.4	-8.4	-5.7	-13.7
Euro Area (Euro STOXX 50)	6.2	**7.9**	12.1	9.3	-4.9	2.6	-7.6
Belgium (BEL-20)	7.2	**7.3**	5.9	6.2	-1.8	5.7	-7.3
Switzerland (SMI)	1.4	**7.0**	8.9	6.1	-3.3	4.6	3.3
France (CAC 40)	6.1	**6.8**	10.8	9.6	-3.3	3.7	-6.1
Sweden (OMX Stockholm 30)	2.0	**6.5**	11.3	5.6	-5.5	1.9	0.5
Thailand (SET)	2.6	**6.4**	6.1	14.6	2.6	3.4	19.0
Philippines (PSEi)	1.5	**5.9**	-3.1	-7.6	0.5	4.1	17.0
United States (S&P 500)	0.0	**5.5**	10.4	14.7	8.1	10.9	10.7
Denmark (OMXC 20)	1.0	**5.0**	8.3	-9.2	0.5	10.6	9.6
Greece (ATHEX Composite)	3.8	**4.9**	10.8	8.3	-27.1	-6.0	-35.1
New Zealand (NZX 50)	-3.0	**4.8**	-0.9	7.3	4.1	11.8	11.4
China (SSE Composite)	-0.9	**4.7**	0.7	0.7	12.7	5.4	2.6
Finland (OMX Helsinki 25)	2.6	**4.4**	7.9	11.9	1.1	6.6	-0.2
United Kingdom (FTSE 100)	1.3	**3.7**	7.9	3.2	-5.9	-0.1	-5.8
Ireland (ISEQ Overall)	2.4	**3.6**	5.9	-0.9	1.1	10.4	-10.6
Japan (Nikkei 225)	-0.7	**3.5**	3.6	13.8	5.6	6.7	3.0
Israel (TA-100)	-0.8	**3.5**	7.1	3.7	-2.1	4.4	7.6
Canada (S&P/TSX Composite)	0.3	**2.3**	6.1	11.7	-3.5	-1.2	0.4
Norway (OSE Benchmark)	-3.0	**0.8**	3.6	14.7	-5.2	1.4	1.2
Hungary (BUX)	-0.8	**0.2**	-0.2	14.2	11.7	5.4	-2.8
Russia (MICEX)	1.7	**-3.1**	14.8	26.6	-3.1	-7.2	-11.5

Source: FactSet, Sit Investment Associates, 3/31/17