Sit Investment Associates

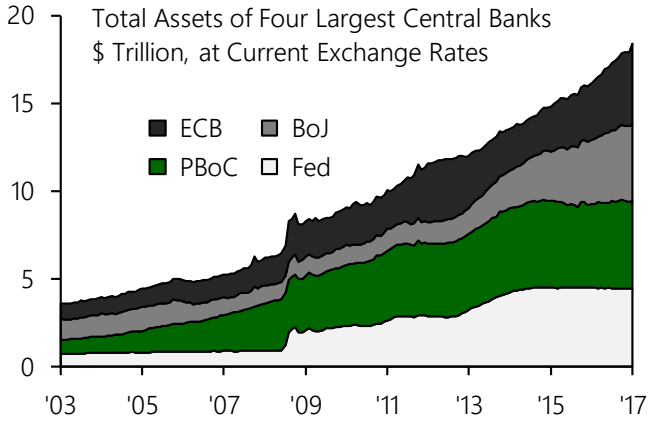
July 2017

Global Investment Outlook and Strategy

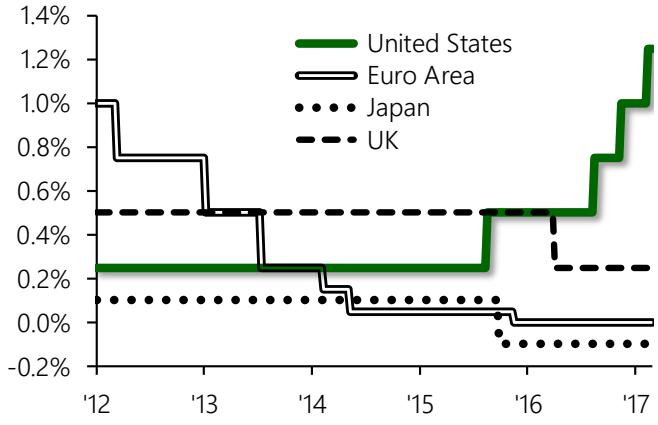
- **Special Topic: All Is Calm. . . Should Investors Be Worried?**
- **U.S. Economic Expansion Poised to Become Longest on Record**
- **Europe Economic Surprises Endure, but GDP Growth Plateauing**
- **China GDP Growth Will Slow as Deleveraging Process Persists**
- **Yield Curve Will Be Naturally Flatter as Fed Policy "Normalizes"**

Quantitative Easing Has Led to Low Volatility Across Asset Classes and Geographies

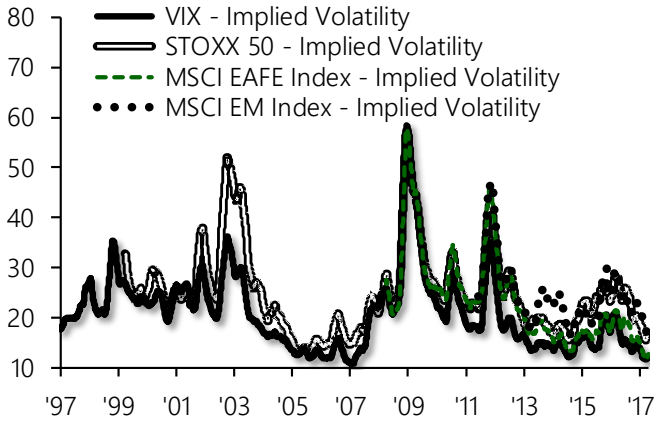
Global Central Bank Balance Sheets



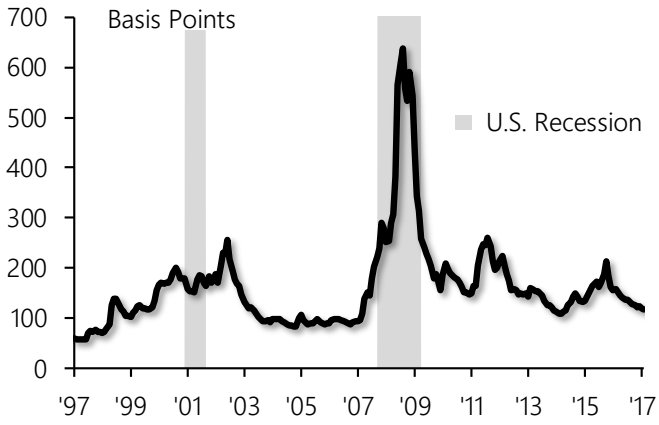
Global Central Bank Policy Rates



Implied Volatility of Global Equities



U.S. Investment Grade Corporate Yield Spread



Source: Bernstein Research, Factset, Sit Investment Associates, 6/30/17

All Is Calm…Should Investors Be Worried?

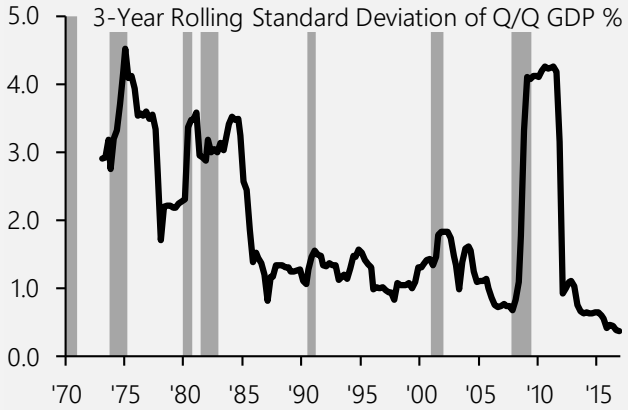
There has been much attention given to the remarkably low levels of financial market volatility that have persisted in recent years, with some measures hitting cycle lows in recent months. This has been viewed, perhaps legitimately, as a sign of market complacency against a backdrop of major uncertainties that lie ahead. While the "VIX" tends to be the focus of investors, it should be noted that the "low vol" phenomenon is observable across asset classes and geographies (see front page). In addition, credit spreads have recently approached cycle lows, indicating that investors are showing little fear that the long (albeit slow) economic expansion will not remain in place for some time.

In order to assess how long recent trends will continue, we first must try to understand the drivers of low volatility and the prospects for change. Although some argue that there is a structural element to the decline in volatility, we disagree. Without question, the latest leg down in volatility has reflected some improvement in global economic conditions (and hopes for pro-growth U.S. policies) following the growth/deflation scare that weighed on markets in mid-2016. From a statistical standpoint, growth in the global GDP has been remarkably stable in recent years (see exhibit below), albeit at low levels. Another significant factor to consider is the role of global central banks. Since the global financial crisis, central banks have been viewed as providing a "put option" on markets based on their willingness to step in during periods of market stress. To this point, despite steady growth in the global economy, interest rates remain at remarkably low levels.

While it is always difficult to predict the specific "event" that changes a market environment that has persisted for so long, there are emerging issues worth considering. First, while rates remain exceptionally low, the tide may be turning as some central banks have recently used more hawkish tones regarding future policy. The People's Bank of China has also started to tighten monetary conditions in an effort to reduce real estate speculation and financial sector leverage. Second, from a fiscal policy standpoint, there are clearly uncertainties regarding the pro-growth Trump agenda, as political realities and self-inflicted wounds are impeding progress. Third, given the important role of China in the global economy, we are increasingly concerned that the limits of the country's debt-fueled growth are being reached. China slowdown fears have rattled markets before, and we are closely monitoring economic indicators in the country. Finally, we have seen markets gyrate between "risk-on" and "risk-off" many times throughout this market cycle, often in response to perceptions on growth trends in the global economy. Given increased valuations on the heels of strong performance of global financial markets, the risk of data disappointments could have significant implications.

The key point is that the very factors that have led to this low volatility environment can change very quickly given the mean-reverting nature of financial markets. The investment implication, in our view, is quite clear: a continued focus on quality and fundamentals is critical at this point in the cycle. The unprecedented actions of global central banks in recent years have created a "lift all boats" environment, with all stocks (regardless of quality) benefiting from a liquidity-driven bull market. Furthermore, ultra-low interest rates and easy access to credit can often provide cover for fundamental weakness in a business. We strongly believe that quality wins out at this stage of the market cycle, and investors will be rewarded for identifying companies and sectors that can deliver sustained earnings and dividend growth in excess of market averages. Moreover, an increase in volatility often provides active investors with an opportunity to "upgrade" portfolios during inevitable times of market dislocation.

Global GDP Growth Volatility



Source: JP Morgan, Sit Investment Associates, 6/30/17

GLOBAL MACRO DEVELOPMENTS

The United States

The modest pace of economic expansion is contributing to its longevity, with a notable absence of excesses that have traditionally led to a recession. A slow and predictable normalization of Fed policy is unlikely to derail GDP growth in the intermediate-term.

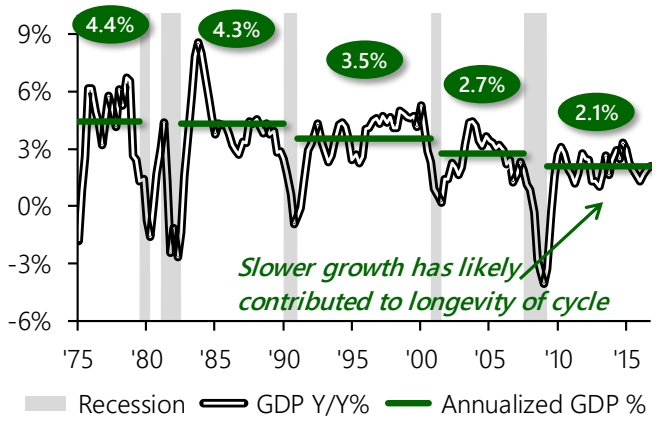
Economic Expansion Poised to Become Longest on U.S. Record

We forecast that U.S. real GDP growth accelerated to +2.5 percent in the second quarter of 2017 from +1.4 percent in the first quarter, driven by normalization of the seasonal adjustment, better consumer spending, buoyant private fixed investment, and a reduced drag from inventories. Underpinned by low unemployment, improving real income, and healthy household balance sheets, consumer spending continues to be resilient. Likewise, business confidence remains elevated and measures of business activity indicate modest growth in both the services and manufacturing sectors. As such, we believe current fundamentals support sustained real GDP growth of +2.0 percent to +2.5 percent in 2017 and 2018, with potential upside from pro-growth policy shifts. Although the pace of GDP growth continues to lag that of previous business cycles, the current expansion could prove to be the longest on U.S. record given the absence of meaningful excesses or overheating that have historically precipitated a recession (Exhibits 1 and 2).

The Expansion May Not Die of Old Age, but It Will Become Trickier to Navigate

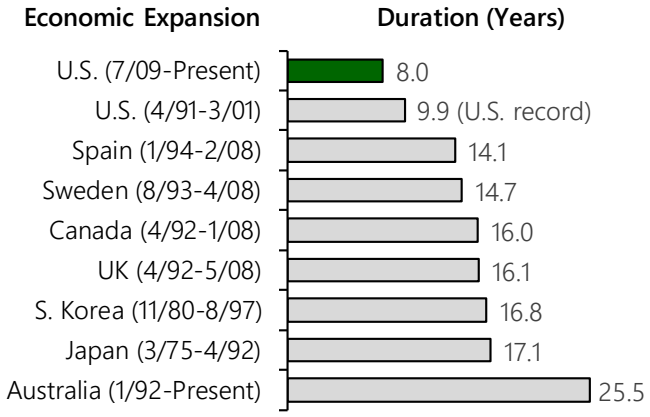
In and of itself, the maturity of the current U.S. economic expansion does not make it more susceptible to a recessionary shock: Australia's current 25-year-long expansion being a good case in point of the potential longevity of a business cycle. In fact, various economic models suggest that the probability of a U.S. recession within the next twelve months remains low. With that said, we anticipate that global economic conditions will become increasingly subject to potential policy missteps as major central banks eventually begin to moderate highly accommodative monetary policy and it becomes ever more difficult for China to balance structural reform with economic/social stability. Despite challenges such as shifting demographics, subdued productivity, tighter labor conditions, and high corporate debt, we believe that the U.S. economic outlook remains favorable. Yet, instead of a rising tide lifts all boats scenario, we expect that company-specific fundamentals will dictate investment performance as the cycle proceeds.

Exhibit 1: U.S. Real GDP Growth



Source: BEA, Sit Investment Associates, 6/30/17

Exhibit 2: U.S. Expansion in Comparison



Source: ECRI, Sit Investment Associates, 6/30/17

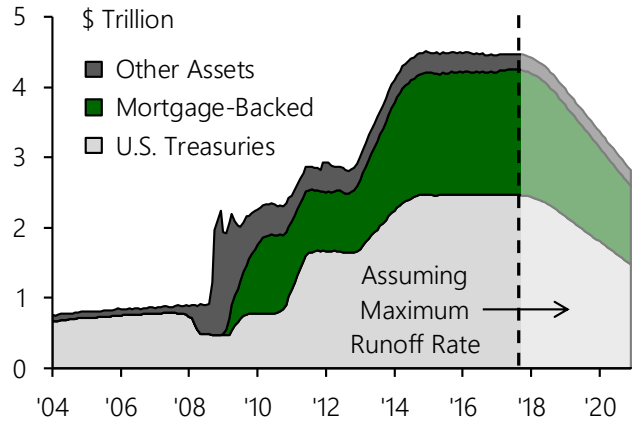
Monetary Policy Expected to "Normalize" at a Slow and Predictable Pace

Given relatively benign inflation, we anticipate that the Federal Reserve (Fed) will remain data dependent/market sensitive as it seeks to "normalize" the fed funds rate and its balance sheet concurrently. The Fed recently increased the fed funds rate by 25 basis points to a range of 100-125 basis points (its fourth such increase since 2015) and outlined a plan to reduce gradually the size of its balance sheet, which has swelled over 400 percent to nearly $4.5 trillion since mid-2007. To mitigate the potential negative impact to the economy and financial markets, the Fed will cap asset runoff at $10 billion per month for the first three months and slowly ramp to a maximum runoff rate of $50 billion per month thereafter. Rather than outright asset sales, the Fed will progressively decrease the reinvestment of the principal payments it receives from maturing securities. Even if lower reinvestment rates begin late this year and continue at the maximum runoff amount, the balance sheet would only decline to $2.8 trillion by late 2020 (Exhibit 3). All else being equal, we believe that a protracted moderation of such unprecedented easy monetary policy is unlikely to derail economic activity in the intermediate term.

High Congressional Polarization an Obstacle, but Tax Reform Is on the Come

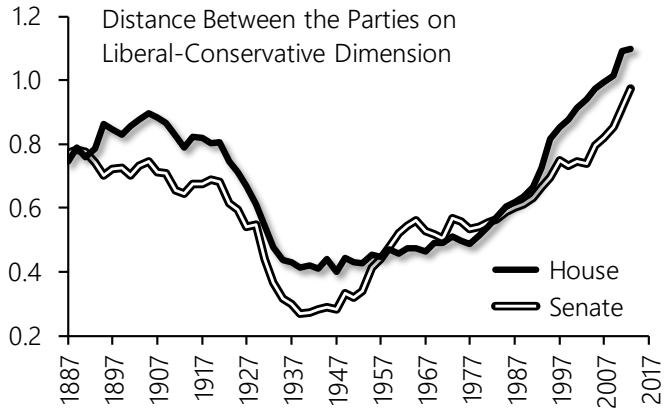
Measures of economic policy uncertainty and partisan conflict have eased somewhat in the last couple of months. Still, historically high polarization within Congress, perpetual "distractions," and the probe into possible Russian interference in the U.S. election have diminished investor confidence that the Trump administration's pro-growth policies will be implemented (Exhibit 4). As we highlighted in our April publication, we do not believe that the "Trump Trade" is necessarily over and that the market has become overly bearish on the prospect for pro-growth policy shifts. While efforts to reform the Affordable Care Act have been undeniably tenuous, it is likely that the final healthcare legislation that emerges will involve evolutionary changes that could allow Congress to then move on to more pressing priorities (i.e., tax reform and infrastructure spending). With 2018 primary elections on the horizon, we believe tax reform will remain an utmost priority for Congressional Republicans who will need to deliver on their growth agenda. Although a reduction in the corporate tax rate to the President's target of 15 percent is highly doubtful, Congress will almost certainly deliver at least a modest tax cut. It is yet to be determined, however, if tax cuts will be revenue-neutral or sunset at some point – both could diminish the stimulative impact of tax reform on the overall economy.

Exhibit 3: Federal Reserve Assets



Source: U.S. Federal Reserve, Sit Investment Associates, 6/30/17

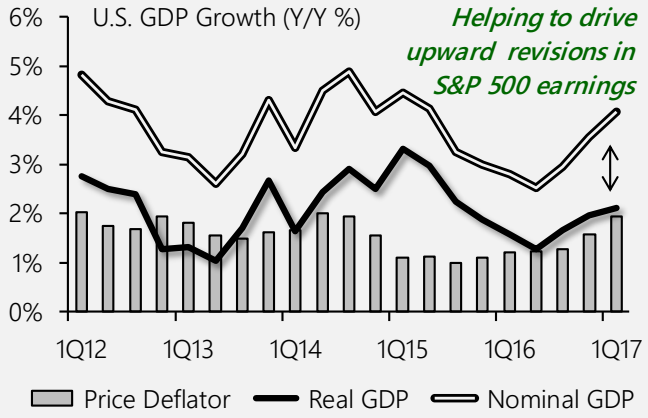
Exhibit 4: U.S. Congress Polarization



Source: Voteview, Sit Investment Associates, 6/30/17

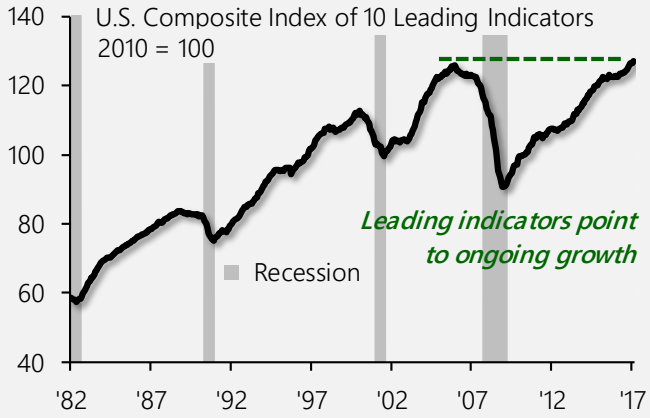
United States: Notable Data Points

Nominal GDP Growth Accelerating



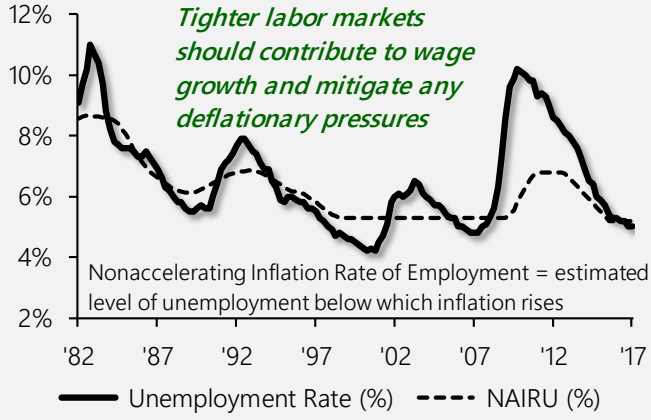
Source: BEA, Sit Investment Associates, 6/30/17

Leading Indicators Remain Constructive



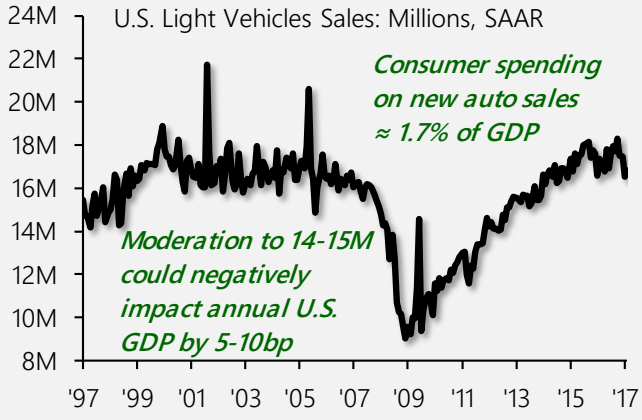
Source: The Conference Board, Sit Investment Associates, 6/30/17

Tight Labor Market Underpins Wage Growth



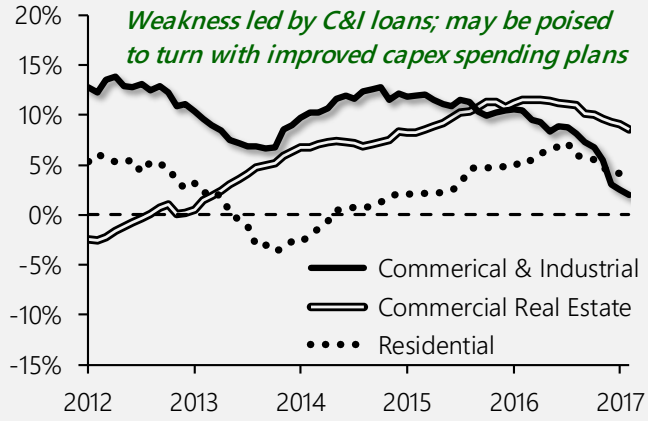
Source: DOL, Oxford Economics, Sit Investment Associates, 6/30/17

Peaking New Auto Sales; Impact Likely Muted



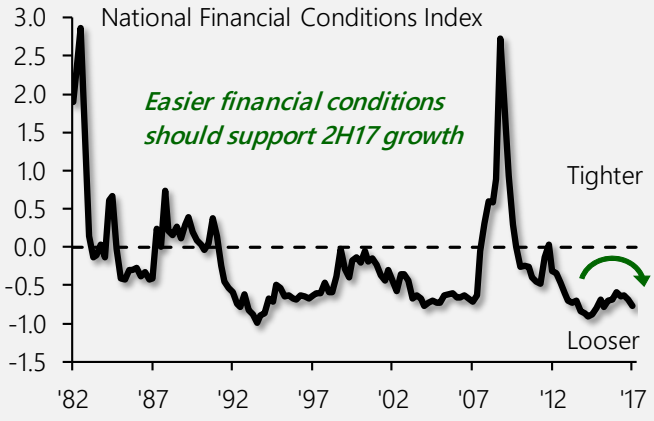
Source: Ward's Automotive, Sit Investment Associates, 6/30/17

Bank Loan Growth Has Moderated. . .



Source: U.S. Federal Reserve, Sit Investment Associates, 6/30/17

. . . But, Financial Conditions Support Growth



Source: Chicago Fed, Sit Investment Associates, 6/30/17

Europe

Positive economic surprises continue against tempered expectations, but GDP growth has likely plateaued. Brexit-related uncertainty, the Italian general election, and the eventual moderation of accommodative monetary policy remain key risks.

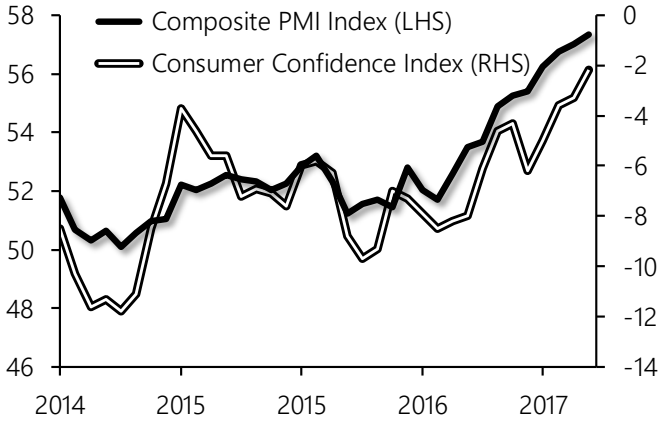
Positive Economic Surprises Continue, but Annual GDP Growth Has Plateaued

Euro Area economic data has consistently surprised to the upside in 2017, with measures of business activity and consumer confidence near historically high levels (Exhibit 5). Domestic demand remains the driver of incremental growth and employment conditions are improving. Yet, economic momentum is starting to show some signs of moderation as tailwinds from a weaker euro, Chinese stimulus measures, and easier comparisons fade in the second half of 2017. We forecast that Euro Area real GDP growth in calendar 2017 and 2018 will be relatively flat with the +1.7 percent year-over-year rate achieved in 2016, but remain well above the +0.8 percent annualized rate of the last five years. The UK economy has also performed much better than initially feared by many post the EU referendum in June 2016. However, ongoing Brexit-related uncertainty, diminished confidence, weak capital formation, and slowing household spending will likely cap UK GDP growth at +1.5 percent in 2017 versus its five-year annualized rate of +2.1 percent.

Political Risk will Remain Elevated into 2018; Monetary Policy Still Easy

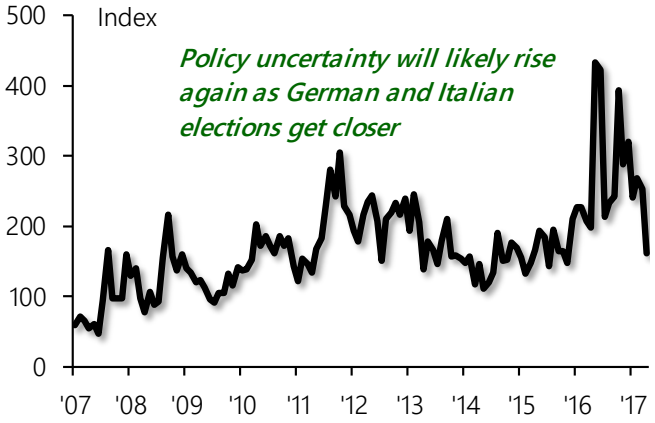
As illustrated in Exhibit 6, economic policy uncertainty plunged after the landslide win of the Emmanuel Macron (pro-reform, centrist) over rival Marine Le Pen (anti-EU, far-right) in the French presidential run-off election on May 7. The substantial majority win for Macron's political party in the subsequent legislative elections should pave the way for business-friendly reform and potentially better economic prospects. Conversely, the Conservative's recent loss of majority control in the UK House of Commons adds an element of policy risk and may complicate Brexit negotiations. While the German federal election this fall will likely prove less eventful, the 2018 Italian general election presents a rising risk given the popularity of the Five Star Movement political party (anti-EU, anti-establishment). In terms of monetary policy, we anticipate that the European Central Bank (ECB) will continue its asset purchase program through the end of 2017 at a pace of €60 billion per month, but announce plans this fall to taper gradually purchases in early 2018. We believe that the ECB is unlikely to reverse its accommodative stance until there is more evidence that the Euro Area is on a self-sustaining growth trajectory.

Exhibit 5: Euro Area PMI and Confidence



Source: Markit, Eurostat, Sit Investment Associates, 7/5/17

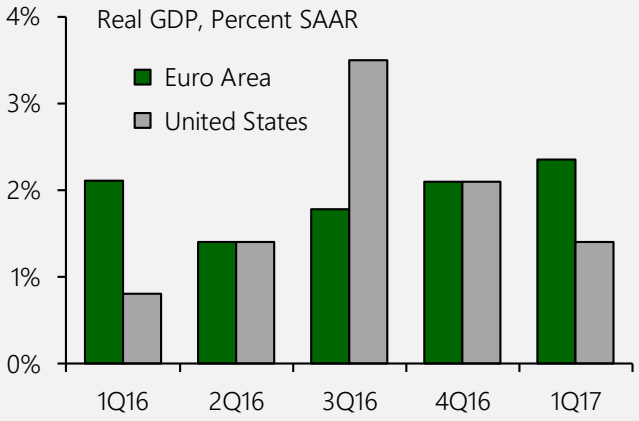
Exhibit 6: Europe Economic Policy Uncertainty



Source: PolicyUncertainty.com, Sit Investment Associates, 6/30/17

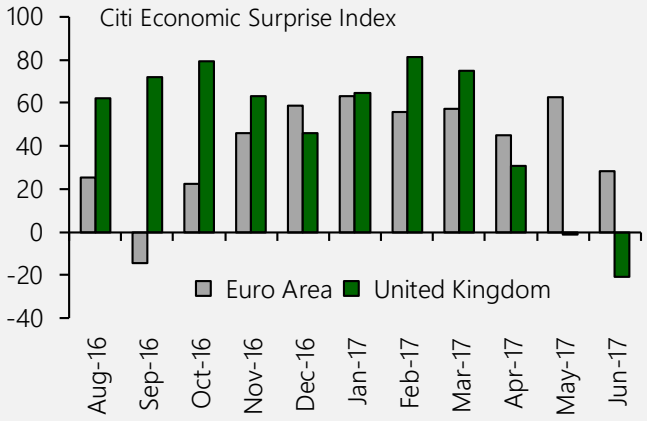
Europe: Notable Data Points

Euro Area Growth Has Gained Some Traction



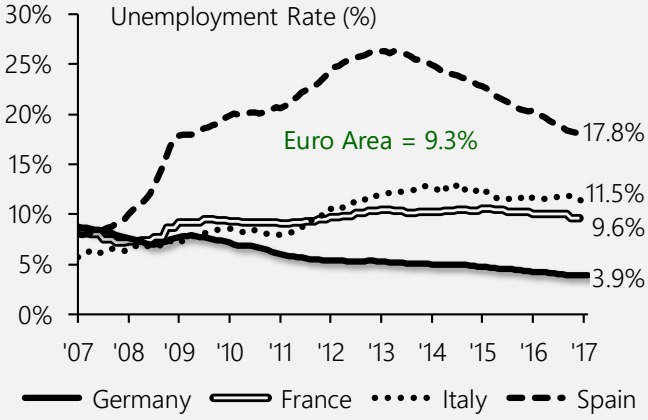
Source: Eurostat, Sit Investment Associates, 6/30/17

European Economic Surprises Moderating



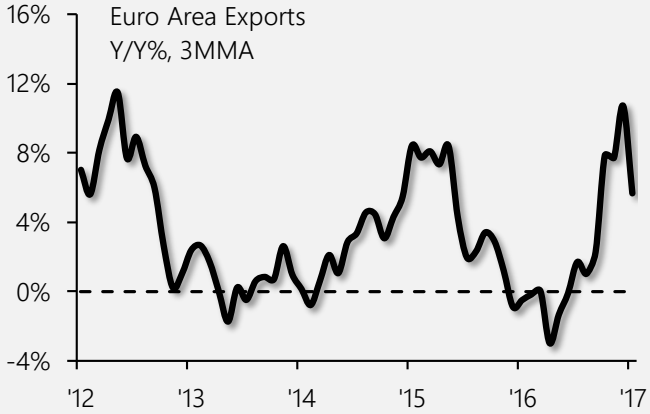
Source: Citi, Sit Investment Associates, 7/5/17

Euro Area Unemployment Remains Elevated



Source: FactSet, Sit Investment Associates, 6/30/17

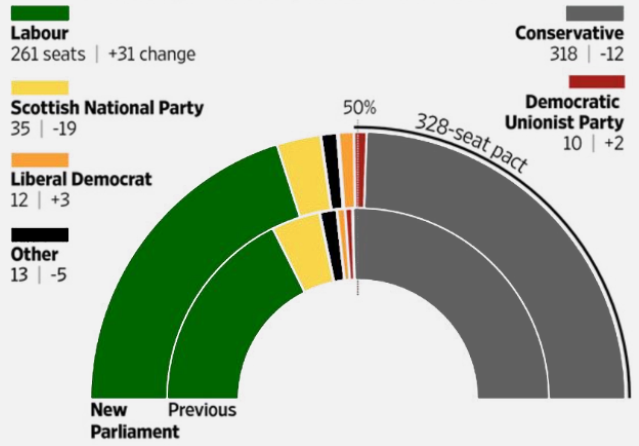
Euro Area Export Growth is Decelerating



Source: Eurostat, Sit Investment Associates, 6/30/17

UK Conservative's Seat Loss Adds Uncertainty

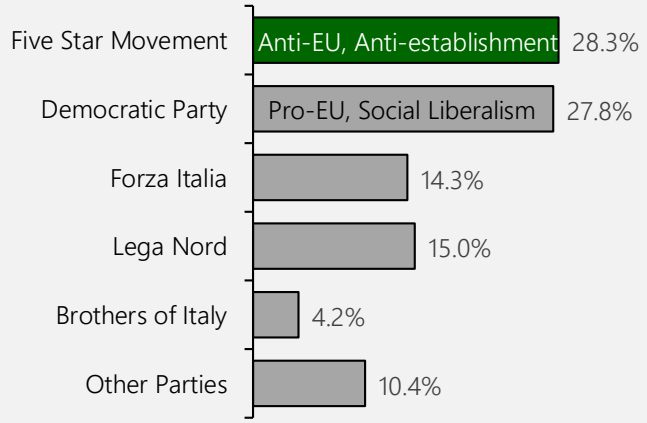
June 2017 General Election, House of Commons



Source: The Wall Street Journal, 6/9/17

Upcoming Italian General Election a Risk

2018 General Election Voter Intentions



Source: Ipsos, Sit Investment Associates, 6/28/17

Japan

Structural challenges continue to weigh on Japan's economic outlook. Despite recent speculation otherwise, we believe the Bank of Japan will stick with its easing stance.

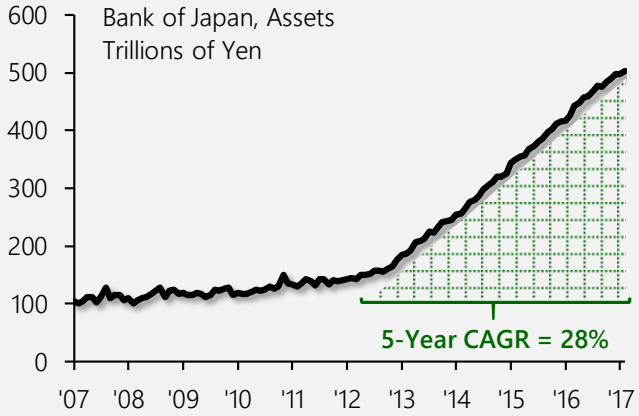
Japan remains stuck in an extended period of limited-to-no growth. Thus, recent speculation that the Bank of Japan (BoJ) may soon provide a strategy for exiting its easy policy stance is premature. Inflation remains far below the BoJ's targeted rate of +2 percent and anticipation of tighter financial conditions would undo the limited economic gains made thus far. Rather, we believe that the BoJ, equipped with a number of unconventional policy tools, has braced for a protracted effort to lift inflation. We anticipate this will sustain accommodative financial conditions and provide a weakening bias to the currency. However, the weight of structural challenges (i.e. aging population, etc.) should more than offset monetary policies and prolong the current low growth environment. These challenges will likely persist as Prime Minister Abe's Liberal Democratic Party is in a weakened position to lead reforms following significant losses in recent local Tokyo elections, a defeat partly reflecting growing impatience with the Party's limited progress. We expect GDP growth of only +0.5 percent this year and next.

Japan: Notable Data Points

Japan Remains Stuck in Low Growth

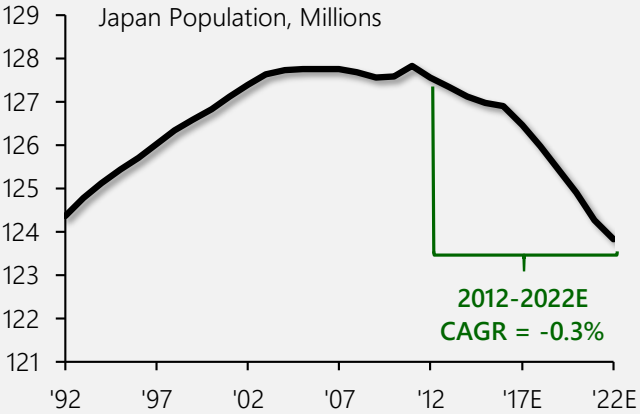
Source: Japanese Cabinet Office, Sit Investment Associates, 6/30/17

The BoJ Continues to Ease Aggressively



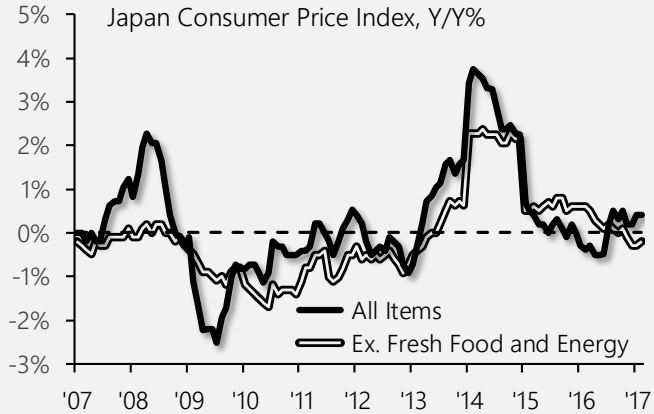
Source: Bank of Japan, Sit Investment Associates, 6/30/17

Shrinking Population a Structural Headwind



Source: Japanese Cabinet Office, Sit Investment Associates, 6/30/17

Limited Consumer Demand Weighing on Prices



Source: Japanese Cabinet Office, Sit Investment Associates, 6/30/17

Emerging Markets

- ***China's growth trajectory likely peaked in the first quarter and we expect a gradual moderation in 2H17 and 2018. Financial deleveraging will continue beyond 2017.***
- ***India's economy should grow strongly post the currency demonetization. The implementation of the Goods & Services Tax is also beneficial long-term.***
- ***South Korea plans to increase fiscal spending and to raise the minimum wage, but missile tests and possible renegotiation of U.S. trade agreement remain an overhang.***
- ***Mexico's economic growth remains uncertain given NAFTA renegotiation; Brazil's economy continues to struggle amidst political paralysis.***

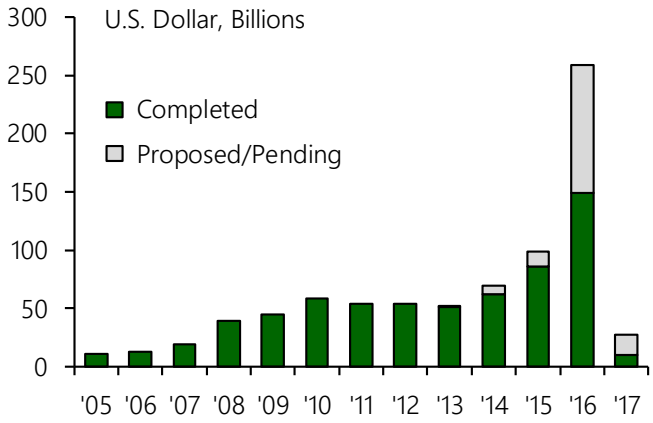
China's Quarterly Growth Trajectory Likely to Moderate

We believe China's real GDP growth rate peaked in the first quarter of 2017 and will moderate as the year proceeds. We expect real GDP growth to achieve the government's goal of +6.5% in 2017 and slow a tad to +6.3 percent in 2018. Overall fixed investment growth will moderate as the housing market cools down due to tightening measures, and consumption growth could see a mild slowdown as well. Auto sales will be a drag due to a partial rollback of last year's tax cuts, but stable household income from a better job market will remain supportive of overall consumption growth. Lastly, net exports will become a positive contributor to GDP growth in 2017 as external demand recovers.

Financial Deleveraging Process in China Will Prove Lengthy

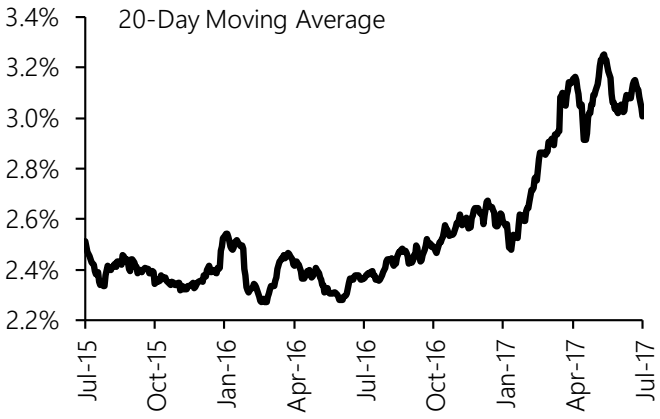
News outlet, Caixin, recently reported that China's banking regulator is examining the borrowings of top overseas dealmakers (Exhibit 7). We believe this is part of the overall financial deleveraging process in China. During the annual economic conference in 2016, policymakers put "containing financial risks" among their top priorities. Since then, we have seen a tightening in financial regulation aimed at reducing financial risk. So far, the deleveraging effort is mostly within the financial sector amid rising contagion risk among financial institutions. While measures such as tightening of the interbank market (Exhibit 8) and stricter MPA rules have led to some positive developments for shadow banking credit, we expect financial deleveraging to continue beyond 2017. We believe policymakers are aware of the risk of over-tightening and are trying to push for an orderly deleveraging. Though the process could bring near-term financial market uncertainties, it should be positive for the long-term health of China's financial system.

Exhibit 7: Global M&A by Chinese Firms



Source: Morgan Stanley, 6/28/17

Exhibit 8: China 7-Day Interbank Repo Rate



Source: Bloomberg, Sit Investment Associates, 6/30/17

India Economic Growth Poised to Recover

India's fourth quarter fiscal year 2017 growth of +6.1 percent was weaker than estimated due primarily to the continued effects of the currency demonetization in November 2016, which impacted the construction, financial and real estate services sectors the most. We expect stronger growth in fiscal year 2018 of +7.4 percent; up from fiscal year 2017's +7.1 percent as the currency demonetization headwind lessens. Economic indicators have begun to improve, as shown in improving car and motorcycle sales and aviation passenger traffic. India will benefit from lower oil prices (as they are an heavy importer) and expected better weather during monsoon season, given its high dependence on the agricultural sector for employment. India's inflation is below the target of +4.0 percent, as May's CPI increased only +2.2 percent year-over-year.

South Korea Fiscal Spending to Drive Economy

The newly-elected president, Moon Jae-in, plans to increase fiscal spending to stimulate the South Korean economy. He has set aside an 11 billion won ($9.8 billion/0.7 percent of GDP) supplementary budget to raise the minimum wage +16 percent over the next three years and to create new jobs. The South Korean economy has also benefited from strong export growth (e.g., mobile memory, phones) given it is an export-driven economy (45 percent of GDP). As a result, we expect 2017 GDP growth of +2.6 percent. South Korean inflation remains low, at +2.0 percent year-over-year in May. The key risks to the country's economic growth are the continued missile tests from North Korea and its trade relationship with the United States. North Korea has escalated the number of missile tests this year and the possibility of a heated conflict could affect consumer spending. Moreover, the South Korea/United States free trade agreement in 2012 may be renegotiated, as the U.S. trade deficit with South Korea has more than doubled, with 2016's U.S. trade deficit with South Korea at -$23.2 billion.

Mexico Economic Growth Uncertainty due to NAFTA

The United States' decision to renegotiate the North American Free Trade Agreement (NAFTA) remains an overhang for the Mexican economy. Trade talks are scheduled for late 2017 after a mandatory 90-day consultation period with Congress. However, the renegotiation could be delayed until 2019, as the Mexican presidential election in July 2018 and the U.S. mid-term elections in 2018 will likely prevent consensus on a trade agreement. We forecast GDP growth in the low +2.0 percent range this year, dependent upon NAFTA being renegotiated and strength in the U.S. economy.

Brazil Politics are Hindering Economic Recovery

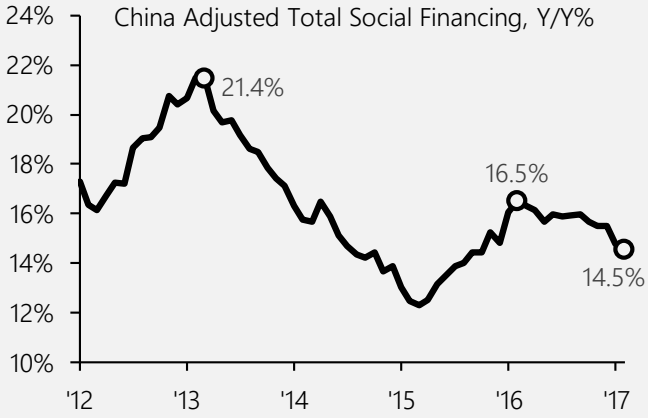
Brazil's President Michel Temer survived the "confidence vote" of not being impeached, but he now faces corruption charges from the Supreme Court. We see reforms (such as pension reform, social security reform) likely being delayed, thus resulting in a continued weak economy. Brazil's GDP fell -0.4 percent year-over-year in the first quarter of 2017, on falling private consumption and investments. We forecast 2017 GDP growth of +0.5 percent, up from 2016's -3.6 percent. On the positive front, inflation increased +3.6 percent year-over-year in May, below the central bank's target of 4.5 percent. As a result, Brazil's central bank has continued to lower interest rates, with total cuts in its key policy rate of -350 basis points to 10.25 percent so far in 2017.

Emerging Markets: Notable Data Points

China's Economy Holding Up . . .

Source: Bureau of Statistics , Sit Investment Associates, 6/30/17

. . . but Could Moderate on Recent Tightening

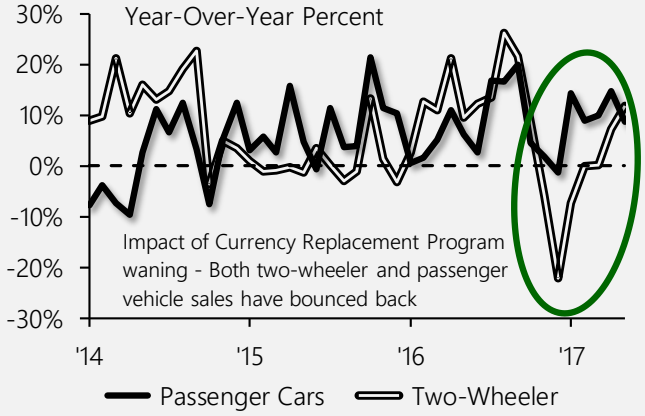


Source: Morgan Stanley, 6/4/17

Asia Ex-Japan Exports Have Been Strong

Source: Morgan Stanley, Sit Investment Associates, 6/30/17

India: Demand Improving Post Demonetization

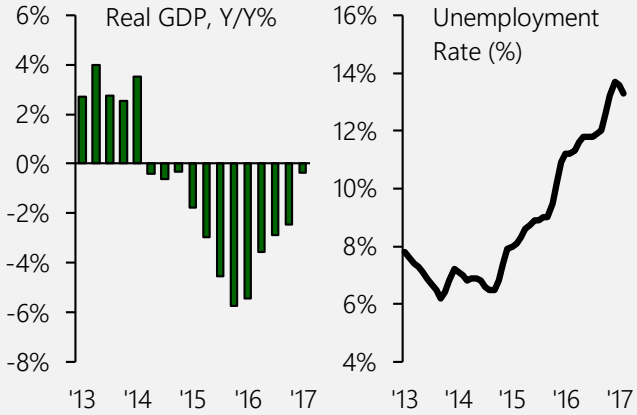


Source: Morgan Stanley, Sit Investment Associates, 6/30/17

U.S. Trade Deficit with S. Korea Has Widened

Source: U.S. Census, Sit Investment Associates, 6/30/17

Brazil GDP Weak; Unemployment High



Source: IBGE, Sit Investment Associates, 6/30/17

Taxable Bonds

Quantitative Un-Easing

The yield curve continued to flatten during the second quarter of 2017, as yields rose in shorter maturities (1-3 years) and fell in longer maturities (10-30 years). Increases in the target fed funds rate have continued to move short-term yields higher, while the modest reduction of stimulus has partially relieved fears of rising inflation, resulting in modestly lower longer-term yields (Exhibits 9 and 10). Our view is that the yield curve has flattened from a historically very steep position and we expect it to assume a naturally flatter shape as the Federal Reserve (Fed) continues to normalize monetary policy. We expect the Fed to continue raising the target fed funds rate at a pace of roughly 25 basis points every three months.

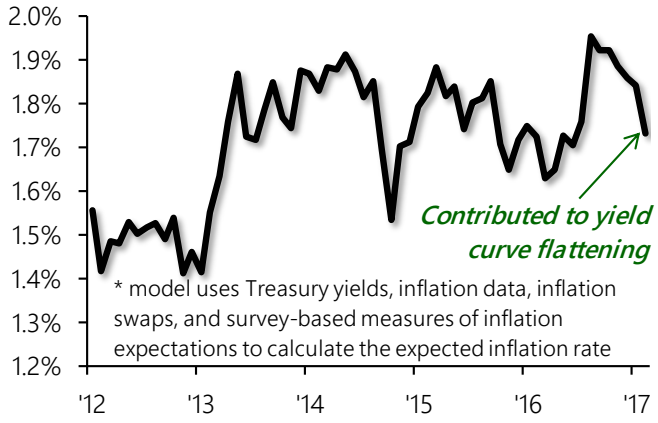
As previously noted, in conjunction with the rate increase in June, the Fed outlined plans to reduce its $4.5 trillion balance sheet, which we expect to begin in September. In an unprecedented effort to provide monetary stimulus beyond reducing short-term interest rates, the Fed began purchasing Treasuries and agency mortgage-backed securities during the financial crisis. It did this with the click of a button – essentially creating trillions of dollars out of thin air. Active purchases of both Treasuries and mortgages continued until late 2014, with assets currently comprised of roughly $2.5 trillion in Treasuries and $2 trillion in mortgages. Since 2014, the Fed has maintained its $4.5 trillion balance sheet by reinvesting proceeds received from maturing bonds. Currently, the Fed is purchasing $30-$50 billion of Treasury and mortgage securities each month.

To reduce its balance sheet, the Fed is simply going to reinvest less money each month. So, instead of buying up to $50 billion of securities every month, they will initially only purchase $40 billion and then incrementally reduce their purchases thereafter until it reaches zero. The maximum reduction will total $10 billion per month in the first three months, consisting of $6 billion in Treasuries and $4 billion in mortgages. These amounts will increase quarterly by $6 billion for Treasuries and $4 billion for mortgages until they reach a maximum monthly amount of $30 billion and $20 billion, respectively (Exhibits 11 and 12). Even at the maximum monthly runoff, we anticipate the balance sheet would only shrink to $2.8 trillion sometime in late 2020.

Exhibit 9: U.S. Treasury Spread

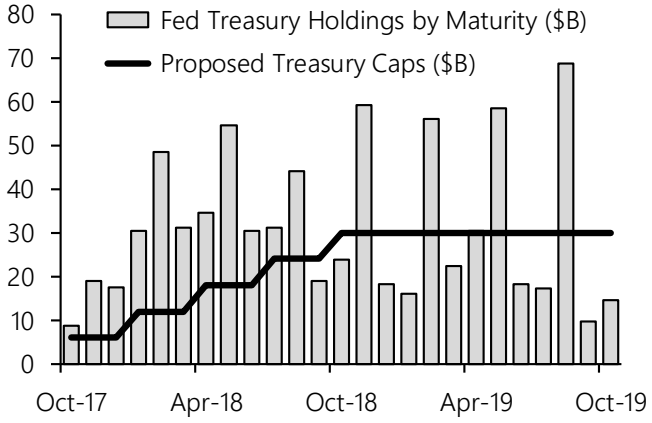
Source: FactSet, Sit Investment Associates, 6/30/17

Exhibit 10: U.S. 10 Year Expected CPI Inflation



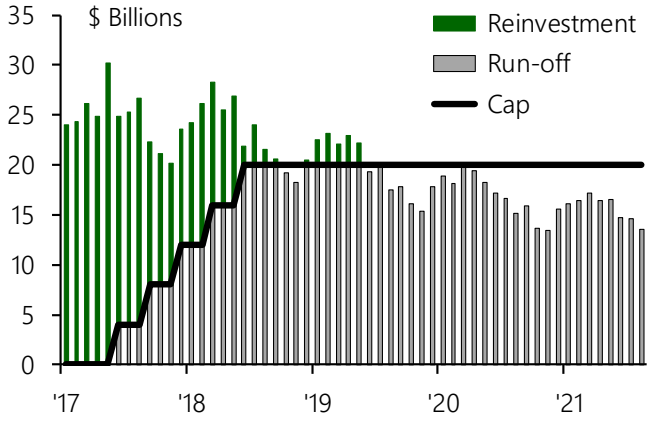
Source: Cleveland Fed, Sit Investment Associates, 6/30/17

Exhibit 11: Fed Treasury Holdings and Caps



Source: Bloomberg, 6/28/17

Exhibit 12: Fed MBS Holdings and Caps



Source: Citi, Sit Investment Associates, 6/30/17

Taxable Fixed Income Outlook and Strategy

We expect economic growth to continue at the current pace, allowing the Fed to continue its path of "normalization." We believe the Fed will gauge the market's reaction to the balance sheet program before implementing further interest rate movements, barring significant economic changes. The Fed will also keep a watchful eye on any impact to the housing market. We expect the implementation of balance sheet reduction will cause spreads to increase modestly on current coupon mortgages and, coupled with the anticipated rise in interest rates, could lead to meaningful increases in mortgage rates. This leads to a conundrum. A slowdown in the mortgage market will reduce prepayment activity which, in turn, limits the amount of run-off the Fed has available to reduce its balance sheet. It could compensate by selling mortgages, fill the void by not reinvesting a portion of the maturing Treasuries (if available), or simply not meet the maximum monthly caps for balance sheet reduction.

We maintain our positions in high-coupon, seasoned agency mortgages, as these securities benefit from a slowdown in prepayment activity and exhibit very little interest rate sensitivity. We also believe corporate bonds will have strong performance, benefitting from a strengthening economy. Overall, client portfolios are positioned defensively against a rising interest rate environment.

Municipal Bonds

Tax-Exempt Curve Flatter As Yields Decline on Intermediate and Long Maturities

The AAA tax-exempt municipal bond yield curve flattened during the second quarter, primarily due to sizeable yield declines across the middle and the long end of the curve. Meanwhile, yields rose slightly on maturities of two years and less. The difference between the 2-year and 30-year yields was 30 basis points less at the end of June than it was at the start of April. The yield on the Bond Buyer 40-Bond Index also trended lower from the end of March through early June, reaching its lowest point, 4.02 percent, the first week of June. The index yield rose modestly to 4.08 percent to end the month.

Longer Duration Bonds Performed Better Across the Entire Curve

All duration indices posted a second consecutive quarter of positive returns, with performance during the period being consistently better for longer maturities (Exhibit 13). The positive return occurred over a strong April and May period, while June had a

modestly negative return. All investment-grade municipal bond index returns continue to be positive on the year. Bonds with A and/or BBB ratings have generally outperformed more highly rated bonds. Performance of the High Yield Index continues to be bolstered by exceptionally strong tobacco and IDR/PCR performance, even as Puerto Rico lags significantly. Revenue bonds have outperformed general obligation bonds by 39 basis points since March. Within the Revenue bond index, the hospital sector has performed best, while housing lagged modestly during the quarter. However, housing leads all revenue sectors year to date, and we continue to believe that housing bonds offer strong relative and defensive value as rates are expected to rise modestly in the near-term.

Positive Fund Flows with Average Supply is Supporting Tax-Exempt Bond Prices

Issuance in 2017 has picked up since April, but still lags the previous two years' totals through June. We expect supply for the current year to stay well off the record pace of 2016, but in line with longer-term averages. Refundings have comprised about 40 percent of all 2017 issuance, compared to 50 percent of 2016 issuance; refunding volume could drop off further over the remainder of the year as well. Municipal bond fund flows have been mostly positive since March, as a year-to-date cumulative of $5.3 billion has flowed into muni funds through June in 2017. The steady inflows have gone predominantly to long funds, resulting in strong price support; although we are not forecasting a change in sentiment, shifts can and often do happen quickly.

Tax-Exempt Fixed Income Outlook and Strategy

The fed funds rate was raised once again in June and it may be increased further in 2017. Despite this, yields fell across most of the tax-exempt curve as investors in tax-exempt debt favored both intermediate and long maturities. It is also noteworthy that despite the Senate not passing a health care bill, the hospital sector has nevertheless outperformed. It still remains to be seen if the other policy proposals most likely to impact the tax-exempt market, namely infrastructure spending and tax reform, will be passed into law. We ultimately believe that some tax reforms will be enacted and they are likely to impact tax-exempt bond performance in 2017, while an infrastructure bill is not likely to be implemented until 2018. The budget crisis in Illinois is moving more into the forefront of concern for municipal investors and ratings agencies. Indeed, Illinois may find its ratings downgraded below investment grade in the third quarter. Should this occur, the disruptions to the municipal markets could be meaningful. The focus on Illinois has caused many market participants to put more emphasis on pension obligations for issuers of all stripes. Despite the political rancor in Washington DC and the State level issues in Illinois, we continue to have high confidence in the strong fundamental credit quality that most municipal bonds provide. Our tax-exempt investment strategy will continue to place a heavy emphasis on investing in bonds that have premium coupons and provide meaningful current income, which we believe is the primary driver of total return over the full market cycle. We expect to maintain most portfolio durations near their current levels while also continuing to 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 13: U.S. Fixed Income Index Total Returns

Percent, as of 6/30/17

Bloomberg Barclays Indices	1 Month	3 Months	YTD 2017	Annualized 1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
Aggregate	-0.10 %	1.45 %	2.27 %	-0.31 %	2.48 %	2.21 %	4.48 %
Treasury	-0.16	1.19	1.87	-2.32	2.01	1.28	4.06
Corporate	0.31	2.54	3.79	2.30	3.60	3.96	5.76
CMBS	-0.34	1.31	2.18	-0.33	2.57	3.13	5.24
Asset-Backed	-0.07	0.60	1.14	0.63	1.66	1.49	2.98
Mortgage Pass-Through	-0.40	0.88	1.35	-0.06	2.18	2.00	4.36
US Aggregate (AAA)	-0.25	1.06	1.67	-1.26	2.08	1.61	4.01
US Aggregate (AA)	0.12	1.64	2.61	-0.15	2.93	2.56	4.56
US Aggregate (A)	0.30	2.43	3.48	1.12	3.64	3.76	5.43
US Aggregate (BAA)	0.32	2.68	4.44	3.54	3.47	4.32	6.58
US Aggregate Govt. - Intermediate	-0.26	0.66	1.20	-1.25	1.47	1.07	3.39
US 1-3 Year Government	-0.08	0.20	0.48	-0.07	0.71	0.65	2.01
US Aggregate Govt. & Credit (1-3 Y)	-0.04	0.31	0.72	0.35	0.95	0.95	2.30

Bloomberg Barclays Indices	1 Month	3 Months	YTD 2017	Annualized 1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
Municipal	-0.36 %	1.96 %	3.57 %	-0.49 %	3.33 %	3.26 %	4.60 %
1-Year Municipal	-0.08	0.26	0.96	0.60	0.66	0.72	1.76
3-Year Municipal	-0.30	0.54	1.81	0.43	1.08	1.24	2.76
5-Year Municipal	-0.43	1.25	3.17	0.44	2.02	2.06	4.00
7-Year Municipal	-0.45	1.93	3.92	0.17	2.81	2.80	4.74
10-Year Municipal	-0.40	2.35	4.18	-0.41	3.56	3.40	5.13
15-Year Municipal	-0.50	2.44	3.99	-1.08	4.10	4.04	5.35
20-Year Municipal	-0.39	2.49	4.02	-1.02	4.24	4.15	5.29
Long (22+ years)	-0.25	2.75	4.54	-1.30	4.90	4.53	5.10
Revenue	-0.32	2.19	3.85	-0.49	3.72	3.59	n/a
General Obligation	-0.50	1.80	3.46	-0.71	2.89	2.88	4.55
High Yield	-0.22	1.99	6.13	1.22	5.62	5.22	4.46
Muni Aaa	-0.45	1.73	3.19	-0.70	2.59	2.52	3.97
Muni Aa	-0.36	1.89	3.41	-0.52	3.09	3.07	4.49
Muni A	-0.30	2.19	3.94	-0.28	3.96	3.96	4.99
Muni Baa	-0.37	2.09	4.32	-0.59	4.41	3.60	3.52

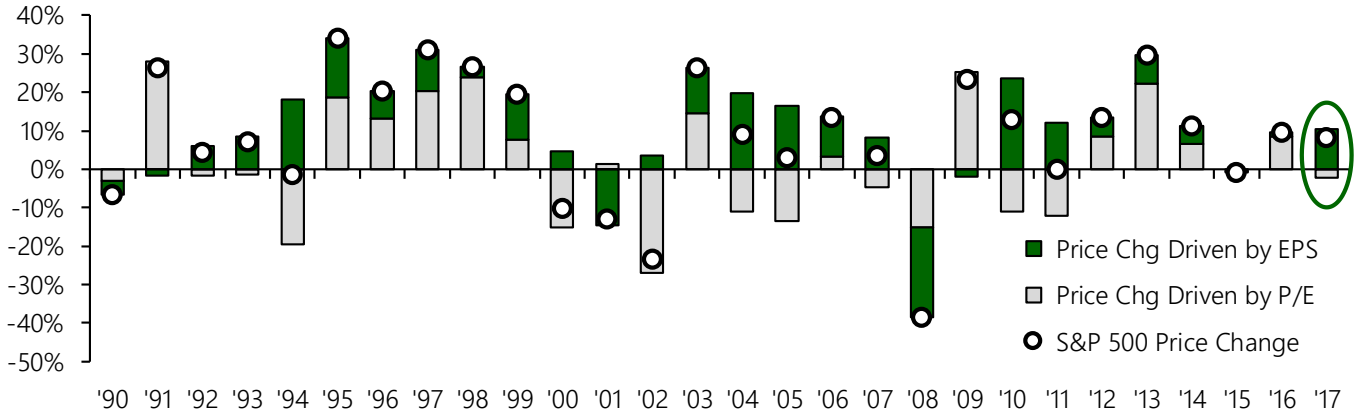
Source: FactSet, Sit Investment Associates, 6/30/17

Synchronized global growth, improving corporate earnings, benign inflation, and positive economic surprises have contributed to the solid performance of U.S. equities this year, with the S&P 500® Index generating a total return of +3.1 percent in the second calendar quarter and +9.3 percent year-to-date. Earnings growth, as opposed to the PE multiple expansion of recent years, has been the driver of stock appreciation in 2017 (Exhibit 14). Earnings revisions for a number of sectors have turned positive over the last two quarters and current bottom-up estimates for the S&P 500 Index suggest earnings growth of +10.4 percent in 2017 and +11.6 percent in 2018 versus +1.1 percent in 2016. Although U.S. stocks are generally trading towards the higher end of historical price-to-earnings ranges, equities remain attractive both when adjusted for low inflation and compared to other asset classes. The earnings yield of the S&P 500 Index of +5.3 percent compares very favorably to the 10-year Treasury yield of +2.3 percent.

The Trump administration's policies have the potential to provide a boost to economic growth if effectively implemented. However, the range of potential economic outcomes continues to be wide as Washington remains bogged down by partisan conflict and the Federal Reserve begins to unwind its bloated balance sheet. As a result, we believe a diversified, barbell strategy provides the most favorable risk/reward profile for our client portfolios at this stage (Exhibits 15 and 16). We are overweight a mix of holdings that are pro-cyclical, policy beneficiaries to include banks, select technology industries, and transports as well as holdings that are noncyclical/defensive such as select healthcare, telecom, and P&C insurance. We prefer technology companies favorably exposed to secular change or significant product cycles that will continue to outgrow the economy. We also believe bank stocks will outperform going forward based on rising rates, better growth, regulatory relief, tax relief, and an M&A cycle. Within the healthcare sector, we are investing in companies that possess an attractive mix of innovation and cost savings, both of which are currently providing attractive growth at reasonable valuations.

On a U.S. dollar basis, the MSCI Europe Index generated a total return of +7.7 percent in the second quarter of 2017 and +15.9 percent year-to-date. U.S. dollar weakness enhanced the local currency returns of +2.1 percent and +8.4 percent, respectively. We generally remain constructive on European equities heading into the second half of 2017, as a less-impactful political calendar should set the stage for improved political visibility

Exhibit 14: Contribution to S&P 500® Price Returns from EPS and PE



Source: Cornerstone Macro, Sit Investment Associates, 6/30/17

Exhibit 15: Sit Investment Associates Global Equity Strategy

Regional Weightings

Region/Country	Sit Investment Sentiment	Themes Within Region/Sector
North America	✚	U.S. 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 uncertainty offset by weaker fx 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 ex-Japan economies performing well
Latin America	▬	Brazil/Argentina/Venezuela in recession; modest growth in Mexico (closely tied to U.S.)

✚ Overweight/Positive 〓 Neutral ▬ Underweight/Negative

Source: Sit Investment Associates, 6/30/17

Exhibit 16: Components of Sit Investment Associates' U.S. "Barbell Strategy"

Overweight - Procyclical/Policy Beneficiaries

Characteristics

U.S. domestic exposure, high tax rates, pro-cyclical, high beta, strong balance sheets, limited impact from higher interest rates

- Banks/Investment
- Life Insurance
- Railroads
- Airlines
- Semiconductors
- Restaurants
- Parcel Carriers
- Home Improvement
- Trucking
- Media Companies
- Engineering & Construction
- Commercial Construction

Overweight - Defensive/Domestically Focused

Characteristics

Non-cyclical, attractive valuations, limited currency risk, government policy beneficiaries, low beta, U.S. exposure

- Defense
- Oil & Gas Pipelines
- Oil Refiners
- Waste Management
- HMOs
- Medical Distributors
- Biotech
- Insurance Brokers
- P&C Insurance
- "Growthier" REITs/Utilities
- 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
- IT Hardware
- Integrated Oil
- Household Personal Care
- Auto - Suppliers
- Beverage Companies
- Packaged Food/Food Retail
- Department Stores
- Non-Energy Minerals
- Hospital/Nursing Management
- Auto - OEMs
- "No Growth" REITs/Utilities

Source: Sit Investment Associates, 6/30/17

and growth. Yet, ongoing global growth concerns, elevated equity market valuation, and central bank policies shifts will likely cause some volatility. We place an emphasis on companies that will benefit from a weak euro/pound, Trump policy beneficiaries, and companies with exposure to the U.S. market. In terms of sector-specific exposure, we are maintaining a barbell strategy, focusing on a combination of cyclical companies that could benefit from pro-growth U.S. policies and less-cyclical companies in telecom, defense, technology, consumer non-durables, and healthcare. We are also limiting exposure to certain emerging markets given the potential negative impact of a stronger U.S. dollar and tighter Chinese policy.

We continue to meaningfully underweight Japanese equities across our global strategies. Our concern continues to lie in the country's subdued economic outlook and, by extension, the limited potential for earnings growth and equity price appreciation. While Japanese equities have returned a respectable +10.1 percent this year as measured by the MSCI Japan Index on a U.S. dollar basis, they have generally lagged developed market peers. While the MSCI Japan Index trades at a discount to other developed markets, valuation appears less attractive in the context of the limited growth potential. Where we do have exposure to Japan, we maintain a mix of defensive consumption-focused holdings that should perform well in a weak demand environment and names with exposure to select faster growing overseas markets that may also benefit from a cost advantage due to the weak yen. Across all holdings, we continue to emphasize quality names with strong positioning in their respective markets and solid balance sheets.

The MSCI China Index is up +25.0 percent in U.S. dollar terms year-to-date, outperforming the MSCI EM Index (+18.6 percent) and the MSCI World Index (+11.0 percent). Better than expected macro data, easing capital outflow concerns, improving earnings, and positive fund flows are driving the strong performance. The MSCI China Index is trading at roughly 13 times forward price-to-earnings, slightly above its historical levels, but still inexpensive in our view. We remain selective in our China exposure and are positive on the Internet sector. While we could see short-term trading uncertainty after strong outperformance year-to-date, we believe the outlook for our holdings remains solid.

We are positive on the India and South Korean markets. India's GDP growth should recover post the currency demonetization last November, with strength led by the consumer. India will also implement the Goods & Services Tax, which should increase economic growth as it simplifies the tax structure and removes tax cheating. We are positive on India's economic-driven growth stories (i.e., financials, technology, and consumer stocks). In South Korea, we prefer global technology, utilities, and banks.

The MSCI EM Latin America Index has risen +10.3 percent year-to-date on a U.S. dollar basis, but weakened -1.6 percent during the second quarter of 2017 (Exhibit 17). The Index's correction in the second quarter of 2017 was mainly due to Brazil's sell-off, as MSCI Mexico Index increased +7.3 percent and MSCI Brazil fell -6.6 percent. We continue to be underweight the Latin American markets given economic uncertainty from the NAFTA renegotiation impact on Mexico and political paralysis in Brazil. In addition, Mexico's dependence upon the U.S. economy (about 80 percent of exports) may result in slower economic growth. Mexico's inflation has been higher than expected, with first half of June CPI up +6.3 percent year-over-year, above the target's +3 percent. This has underpinned Banco de Mexico's interest rate hikes of +125 basis

points to 7.0 percent year-to-date. We remain underweight Brazil, as President Michel Temer tries to fix the problems of a weak economy, in the midst of facing corruption charges. He is likely to see reforms delayed, especially with regard to pension reform and social security reform. Furthermore, the Brazil economy is still weak, as consumer confidence nose dived -4.4 percent year-over-year and the unemployment rate remained elevated at 13.6 percent in April. These conditions point to a prolonged economic recovery. Our investment strategy in Mexico is focused on consumer stocks, as retail sales remain relatively strong (+1.2 percent month-over-month seasonally adjusted in April). In Brazil, we are maintaining a defensive strategy, owning consumer staples and exporters.

Exhibit 17: Global Equity Index Total Returns

Percent, as of 6/30/17

= Top Quartile Performance within Group

U.S. Dollars	3 Months	YTD 2017	Since 11/8	Annualized 1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
MSCI China	10.7	25.0	10.7	32.3	8.3	9.2	4.2
MSCI Mexico	7.3	24.5	7.3	12.3	-4.5	0.0	0.7
MSCI Emerging Markets	6.4	18.6	6.4	24.2	1.4	4.3	2.2
MSCI Europe	7.7	15.9	7.7	21.8	0.3	9.4	1.2
MSCI AC Asia Pacific	5.9	15.9	5.9	23.0	4.8	8.6	2.8
MSCI EAFE	6.4	14.2	6.4	20.8	1.6	9.2	1.5
MSCI World Index	4.2	11.0	4.2	18.9	5.8	12.0	4.6
MSCI EM Latin America	-1.6	10.3	-1.6	15.4	-6.3	-3.5	-0.9
MSCI Japan	5.2	10.1	5.2	19.6	5.9	9.9	1.4
S&P 500®	3.1	9.3	3.1	17.9	9.6	14.6	7.2
MSCI Brazil	-6.6	3.1	-6.6	17.4	-7.6	-4.4	-1.6

Local Currency	3 Months	YTD 2017	Since 11/8	Annualized 1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
MSCI China	11.0	25.6	11.0	33.0	8.5	9.3	4.2
MSCI Emerging Markets	6.7	15.0	6.7	22.2	6.5	8.0	4.7
MSCI AC Asia Pacific	6.4	12.0	6.4	26.7	8.1	12.8	2.5
MSCI Mexico	3.1	9.4	3.1	10.1	6.7	6.1	6.0
S&P 500®	3.1	9.3	3.1	17.9	9.6	14.6	7.2
MSCI World Index	2.9	8.6	2.9	19.5	8.4	13.8	4.9
MSCI Europe	2.1	8.4	2.1	20.9	7.2	12.2	3.3
MSCI EAFE	2.9	7.9	2.9	22.7	7.5	13.0	2.5
MSCI EM Latin America	-0.3	7.4	-0.3	17.1	5.6	4.9	4.0
MSCI Japan	6.1	6.1	6.1	31.0	9.6	17.6	0.5
MSCI Brazil	-2.5	5.0	-2.5	21.4	5.8	5.5	3.9

Source: FactSet, Sit Investment Associates, 6/30/17