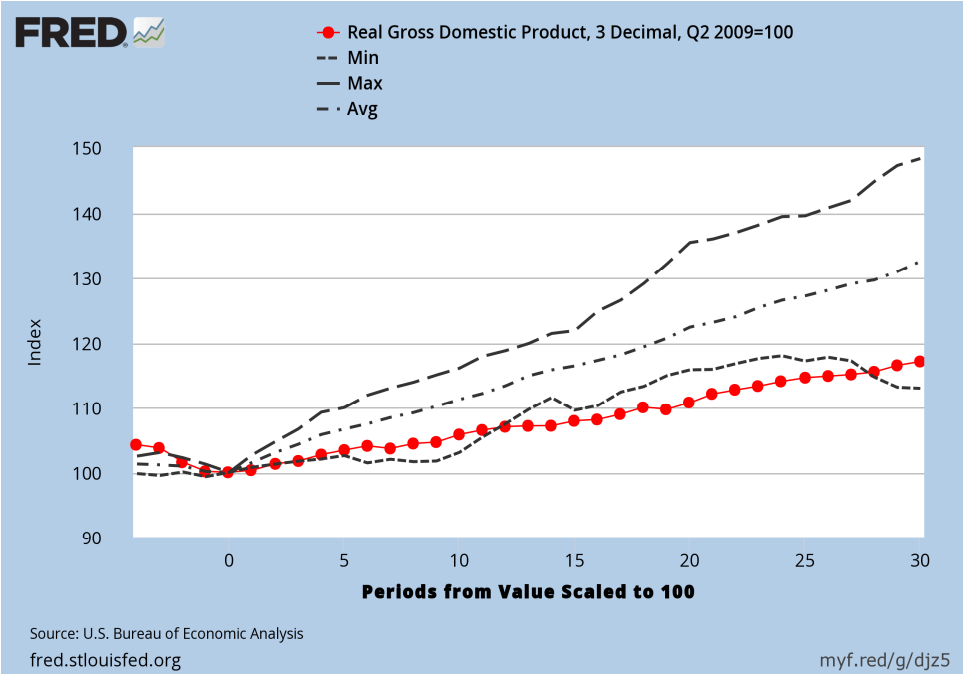
First Quarter Review

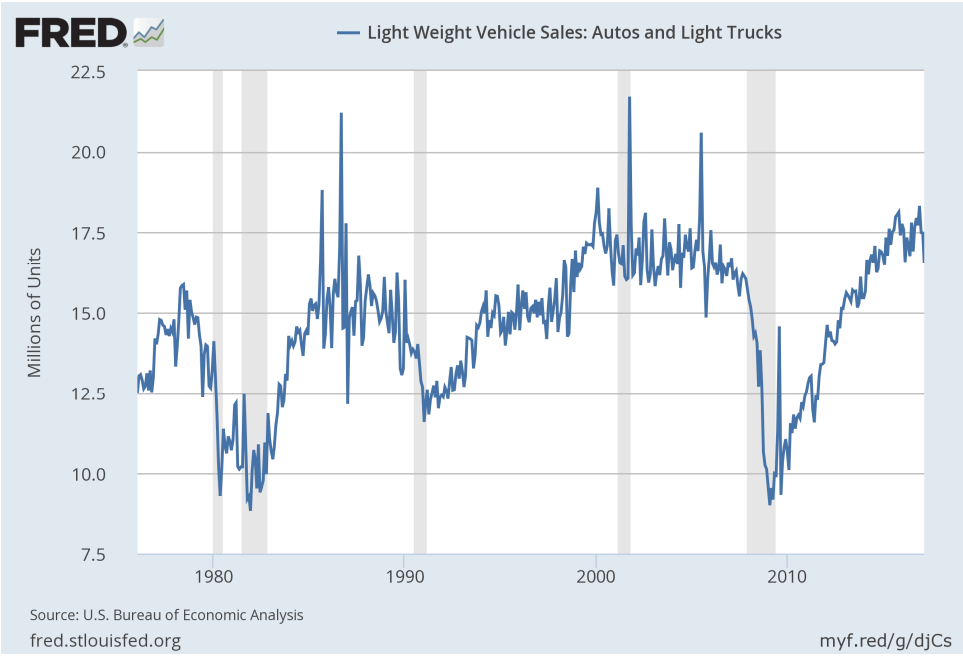
	Close 3/31/17	Total Return First Quarter
Standard & Poor's 500 Index	**2362**	**+6.07%**
Dow Jones Industrial Average	**20663**	**+4.56%**
NASDAQ Composite Index	**5911**	**+10.13%**
Dow Jones Global (ex U.S.)	**229**	**+7.30%**
Barclays Aggregate Bond Index	**1892**	**+0.82%**

The stock rally that started after November's elections continued through the first quarter. We cannot point to anything other than pixie dust to account for the strength of the market. Most of the typical factors that influence the market have been uninspiring. The Federal Reserve raised interest rates in March and appears on track to hike rates several more times this year. Corporate earnings reports were positive but management guidance somewhat guarded. On the political front, the only good news was in the Netherlands election, not in official Washington. Economic growth in the first quarter looks to be a disappointing one percent.

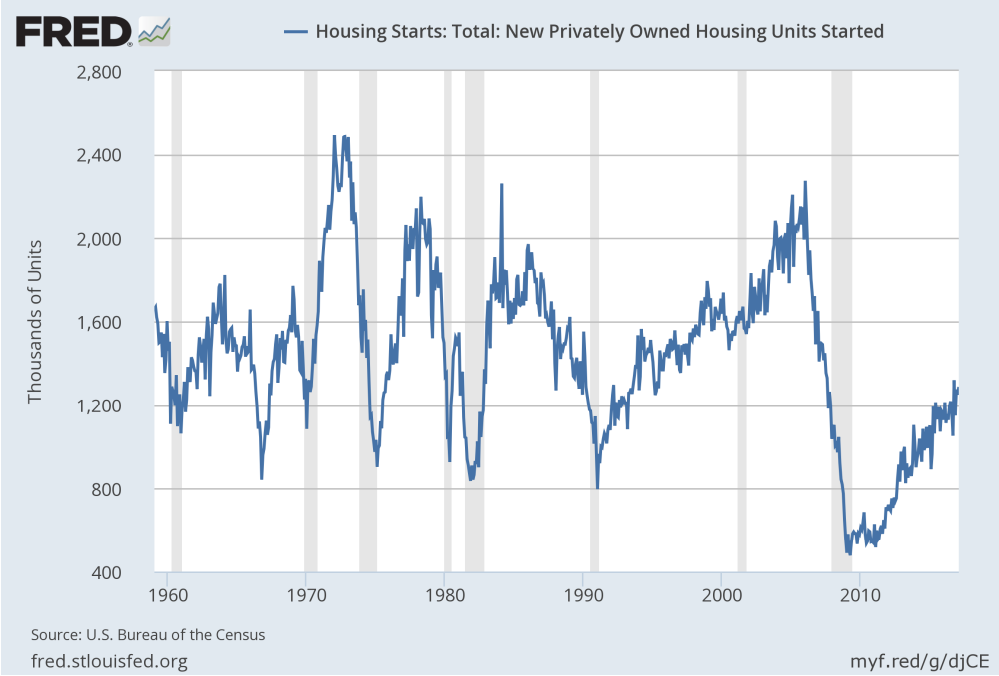
One of the reasons for the subpar economic growth during this recovery is the weak cyclical recovery in housing. The following graph shows the U.S. economic recovery (red dotted line) since the recession bottomed in 2009. The black lines show the minimum, average, and strongest recoveries from the past 10 recessions since 1945. Obviously, the current economic recovery as indicated by the red line is rock bottom.



Two important economic segments that typically spur our domestic economy are automobile sales and housing construction. As the graph below shows, automobile sales have recovered to some 17.5 million annualized units in this recovery. They have carried their normal recovery weight but have plateaued.



In contrast to automobile sales, housing starts (graph below) are nowhere near the peaks of prior recoveries. This is a major reason for the subdued domestic recovery.

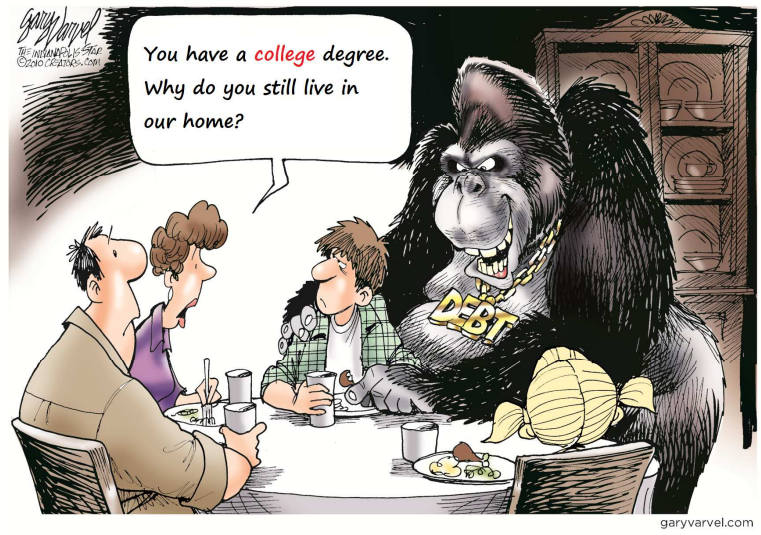


There are several explanations for the tepid housing recovery.

- Household formations are key stimulants for house purchases. Household formations are running at a rate of 1 million per year down from over 2 million in 2005.
    - The deep recession of 2008-2009 had a big negative impact on individuals heading their own households. Homes were foreclosed at record rates and equity was wiped out for many homeowners.
    - Share of adults (18-34) living with parents increased from 26% in 1989 to 31% in 2016.
    - Less than 30% of millennials were married in 2014 compared to 48% of baby boomers (their parents) who were married at the same age.
- Housing debt is not the problem -- it is $1 trillion below the previous peak in 2008. However, student debt is a big problem -- up $700 billion from 2008. The millennial generation is strapped with student debt hobbling them from playing the historical role of buying starter homes.
- Home ownership rates have declined from 35% in 2010 to 25% in 2016 for young adults between the ages of 25 and 34.

High levels of student debt are holding millennials back from entering the housing market.

- Student debt totaled $1.3 trillion in 2016, up 170% from 2006. More students are attending college and more students are taking loans and borrowing more. The repayment rates are also slowing -- probably because of low wages.



- Delinquency rates are down on all borrowing (credit cards, autos, mortgages, home equity) since 2010 except student loans. Loan defaults, however, peaked in 2011-12. Defaults are highest on smallest loan amounts (e.g. $5,000-10,000) but defaults are increasing on those with higher debt levels. Repayment rates are also the slowest in the highest debt amounts.
- College grads with the higher student debt balance have the lowest home ownership rates.

Low inventories of starter homes have resulted in higher prices for entry level housing.

The National Association of Realtors reported in December that the number of homes for sale nationally had fallen to its lowest level since they began tracking inventory in 1999. The year-over-year number of homes for sale has dropped for twenty consecutive months. Low supply, especially at lower end starter homes, has resulted in bidding wars. Many builders folded up shop during the 2008 recession. Now builders are challenged to build better quality starter homes in the face of rising costs. House prices are going up (on average 5-7% nationally) just about everywhere with particular strength in Seattle, Denver and Portland as well as Cleveland, Nashville, Tampa, Louisville and Minneapolis. It is a challenge for many millennials to save enough money for a down payment on a starter home.

There are nonfinancial reasons as well that have caused millennials to delay home purchases:

- As can be seen by the strength in many West Coast cities, young adults are showing a preference for urban living. The same appears true in several East Coast cities.
- Young adults have invested and borrowed heavily in their educations. They want to dedicate and establish themselves in their careers before committing to marriage and the possibility of children.
- Banks continue to enforce tight lending standards for housing.
    - Underwriting has been tighter on mortgages (higher FICO score at origination) since 2008 than auto loans.

Despite the challenges facing millennials to enter the housing market, we expect that to improve over the next several years.

The most recent employment data shows that the percentage of 25-to-34 year-olds in the labor force is the largest in eight years. This group has also recently begun to see wage increases. The latest data for millennials shows that incomes increased seven percent. Several surveys of millennials indicate that they view their financial situations as much improved from prior years.

More millennials are finally starting families. The census projects that household formation will average about 1.5 million per year through 2020, up from the 900,000 annual average in the past five years. Higher rents of the last several years have tilted the scales in favor of home ownership. Despite the uptick in mortgage rates and starter home prices, homes are still in an affordable range. Although considerably weaker than prior recoveries, housing starts are moving up and homebuilder confidence is high and improving. An increase in the supply of existing homes could provide some relief to bidding wars. More homes could come onto the market this spring since fewer mortgages are underwater (mortgage greater than the value of home). Finally, the baby boom generation is starting to put their homes on the market in order to downsize and relocate to warmer geographies.

Summing Up

Although this economic recovery is one of the weakest on record, it is also one of the longest. Barring a significant increase in mortgage rates, we think the housing market has more room to improve over the next few years, which should add to domestic economic growth. Most of the other cyclical depressed sectors of the economy, such as autos and employment, have recovered and are reaching plateaus.

Overseas, European markets are betting/hoping that Marine Le Pen loses the upcoming election in France. That would be a relief for investors as would a win by Angela Merkel later this year in Germany. Once Europeans get past these elections they will focus on the Brexit issue and work out a deal that sustains their economic rebound.

The stock market recovery has also been one of the longest on record, albeit off a massive decline in 2008. At this point, investors are betting that this slow recovery has a few more years left in it. A stronger pickup in housing would certainly help. It is clear that the Federal Reserve is determined to "normalize" policy, which translates into higher interest rates. To what extent higher rates affect the housing market remains to be seen. Since the broad stock market is richly valued, a lot is now riding on hopes for corporate tax cuts later in the year. If rates are cut as we expect that would brighten the earnings outlook into 2018. The stock market has been remarkably calm in light of the continuing geopolitical tensions. Either investors are closing their eyes to the risks or concluding that cooler heads will prevail.

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