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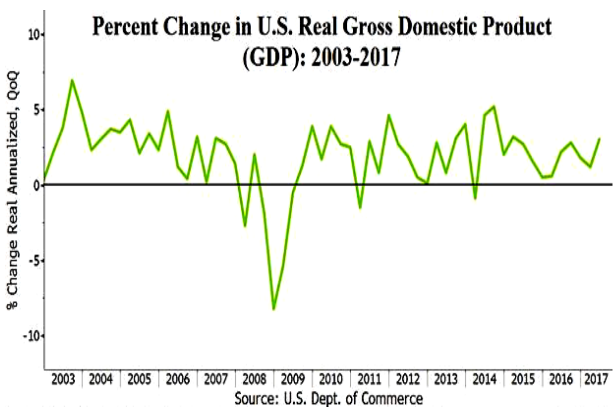
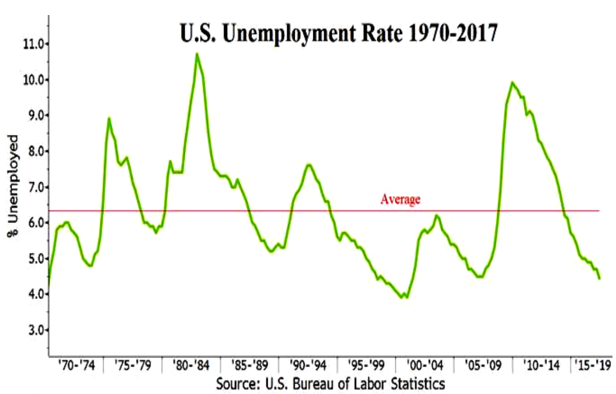
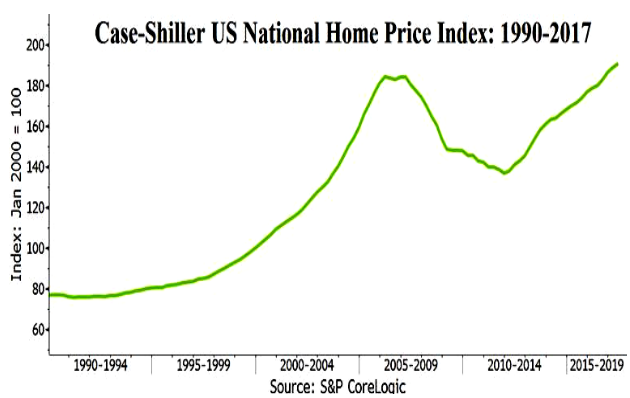
CLIENT BULLETIN: 4th QUARTER 2017

<u>Economic Overview:</u> Growth Continues.

Second quarter real GDP improved nicely to 3.1%, a pickup from the first quarter when GDP was a sluggish 1.2%. For the third quarter, most economists are forecasting growth of around 2.0%-2.5%. A similar GDP growth rate for the fourth quarter is also expected. Growth is being led by consumer spending as household wealth and incomes are rising, jobs are plentiful and the use of credit is increasing. Business spending has improved, with a strong jump in computer purchases. Business spending on inventory was flat in the second quarter, indicating room for growth in the second half of the year. Home building continues to improve as there is a shortage of homes for sale, leading to higher prices. The S&P/Case-Shiller U.S. National Home Price Index is at all-time highs. Government spending is likely to be flat except for defense, and thus contribute little to GDP growth. The civilian unemployment rate is down to 4.4%. Rarely does the rate drop below 4%, so we are nearing peak employment.



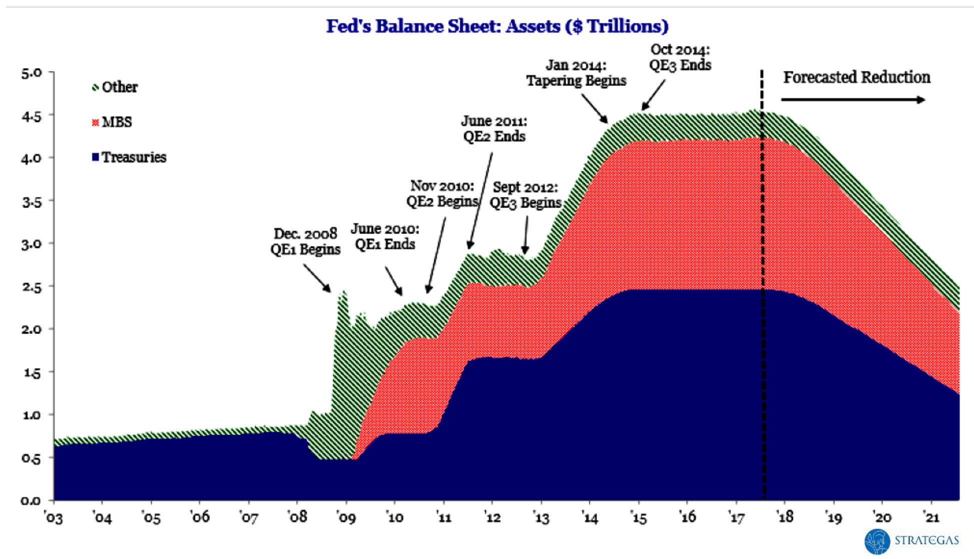




<u>Monetary Policy:</u> Still On Course.

The Federal Reserve is expected to hike interest rates this December and several times next year. The Fed will regard current GDP growth as strong enough to justify its plan to boost the short-term federal funds rate to 1.5% by the end of 2017. The plan is to move the rate to 3% by 2019-2020 (from 1.25% now), unless the economy slows sharply. The Fed will start reducing its $4.5 trillion balance sheet in October. It initially said it would do so only after the fed funds rate has normalized to 2%, but the FOMC members decided it would be better to normalize its balance sheet now. Of course, this plan may change if President Trump decides to replace Chair Yellen next year when her term expires (Feb. 2018). This uncertainty could cause some volatility in the markets as we move towards year-end.

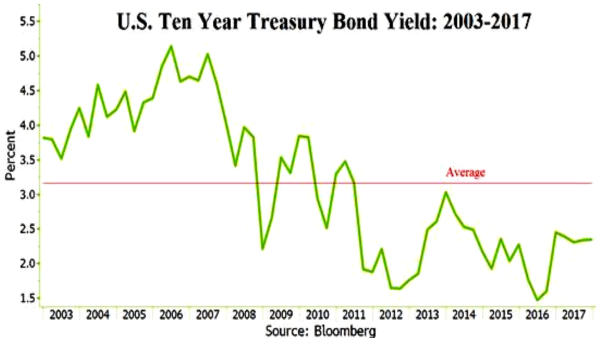
CENTRAL BANK POLICY SHIFTING BENEATH OUR FEET

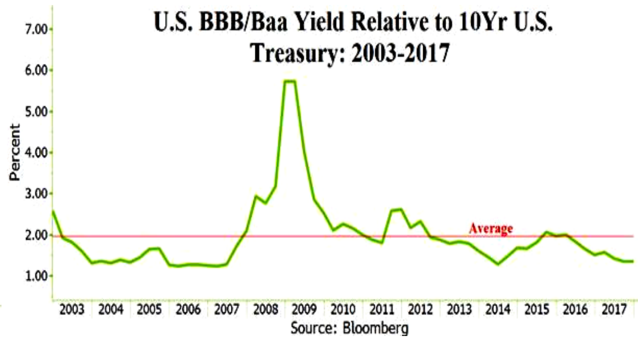


<u>Fiscal Policy:</u> Seeking Clarity.

Several attempts to repeal/replace Obamacare have failed, highlighting the difficulty to satisfy enough legislators to pass a highly complex bill into law. We fear the tax plan may suffer the same fate. The budget hawks will balk at the rising deficit as a result of tax cuts. Some think tanks estimate the US debt-to-GDP will rise from 80% to 100% over the next decade as a result of this plan. Additionally, the US is entering a period where its fixed obligations are continuing to rise (entitlements, interest, defense) making it more difficult to lower taxes. Regarding deductions: the elimination of the deductibility of state and local taxes is not sitting well in high tax states like NY and California. In the end, the current plan may not do much to boost GDP as the tax cuts to most individuals are modest. The real winners are the corporations as the corporate tax rate will be reduced to 20% from 35%, with domestically oriented companies reaping the biggest rewards.

<u>Fixed Income:</u> Tug-of-War Continues. For the last 18 months, the 10 year US Treasury has been mostly range bound between 2.0% and 2.6%, except for a brief period during the "Brexit" summer of 2016. When the markets receive a spat of softer economic data or geopolitical tensions flare, the Treasury yield heads towards 2.0%. When the tensions pass or better economic data is reported, the yield drifts higher. All year we have cautioned that fixed income returns would be subpar. Treasury yields are low, corporate credit spreads are tight, and some junk bonds do not compensate the investor for the risk being taken. Short-term Treasury purchases are a good place to "hide" until better investment opportunities arise as they guarantee return of principal.

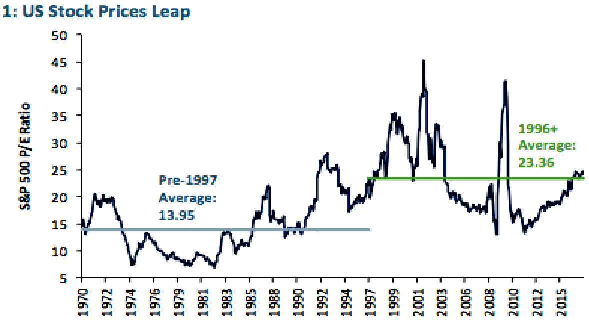




<u>Equity Markets:</u> Permanently High Valuations? The S&P 500 currently sits at about 20X this year's earnings estimates and 18X 2018 earnings estimates. Many investors believe the stock market is overvalued based on these ratios. Surely these levels are elevated compared to the long-run average of about 15X. However, if you delve deeper, you may conclude the S&P 500 is in a range of fair value. As the accompanying exhibit shows, the S&P 500 has traded on average at 23.4X since 1996.

In addition, it has traded above the pre - 1997 average of 14X for the better part of 28 years! Despite two market crashes (2000 and 2008), the stock market has traded below its pre-1997 average for a total of only six months during this period. If you were an investor waiting for stocks to become "cheap" you would have missed out on the greatest bull market in history.

Exhibit 1: US Stock Prices Leap



As of 3/31/17
Source: Compustat, GMO

<u>Financial Market Scoreboard</u>
<u>3rd Quarter 2017</u>

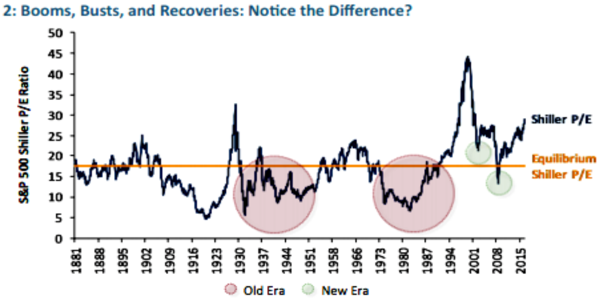
<u>Equity Indices</u>

S & P 500:	+4.5%
Dow Jones:	+5.6%
Nasdaq Composite:	+6.1%

<u>Fixed Income Indices</u>

Long Term Treasury ETF:	+0.3%
Barclay's Govt/Credit:	+0.8%

Exhibit 2: Booms, Busts, and Recoveries: Notice the Difference?

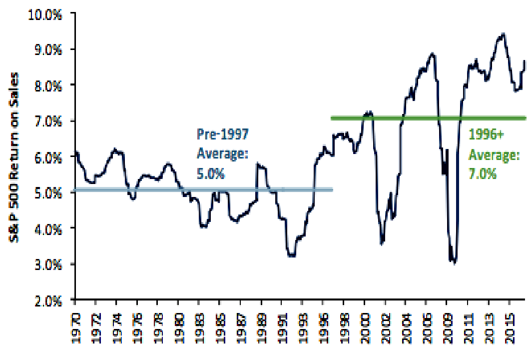


Note: The Shiller P/E Ratio uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle.

As of 3/31/17
Source: Robert Shiller, GMO

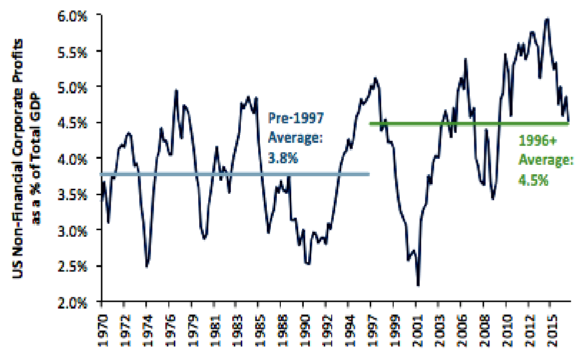
Equity Markets: Permanently High Valuations? Cont'd. So what gives? A number of factors have combined to raise P/E ratios to current levels. First, interest rates have come down significantly from the low teens of the early 1980s to 2% today. Also, global trade has allowed resources to flow to the countries with a "comparative advantage" vis-à-vis other countries, lowering costs for all. Finally, a rollback in regulation and new technologies has allowed companies to become more monopolistic (Google, Facebook, Amazon, Microsoft, and others), thus raising profit margins. This monopolistic power has given companies a larger influence on what happens in Washington, D.C., cementing these companies at the top of their respective industries. As a result of these factors, returns on sales for US Corporations rose to 7% from 5% in 1997 and corporate profit margins as a percentage of GDP rose to 4.5% from 3.8%. Higher profitability equals higher P/E ratios.

Exhibit 3: US Profits Jump



As of 3/31/17
Source: Compustat, GMO

Exhibit 4: US Profits Jump



As of 12/31/16
Source: NIPA (BEA), GMO

The factors that have caused valuations to rise remain in place. Until something changes, we believe markets will stay elevated for the foreseeable future.

Investment Outlook: A Very Good Year So Far. The S&P 500 is up over 12% year-to-date, already a good year by most standards. Every sector in the S&P 500 is up year-to-date, except for Energy (-9%). Other than the oil majors (Exxon, Chevron, Occidental), we have stayed away from the oil patch since the summer of 2015 and that has been a good decision thus far. Our focus in the aerospace and defense areas (Boeing, Raytheon, General Dynamics) has worked out well. Boeing has gained over 60% through 9/30/17, while Raytheon has gained almost 30% and General Dynamics almost 20%. We see further gains for these stocks.

We continue to remain constructive on the US financial markets. We expect the economy to continue growing at a moderate pace and interest rates to remain around current levels. If so, we don't expect many changes to the portfolio for the remainder of the year. We have confidence in the competitive positioning of the companies in our portfolio and believe they will continue to grow earnings and dividends into the future.

Administrative: As required by Cypress Capital Policy, we are providing our updated Corporate Proxy Voting Policy for 2017.

Disclaimer: Any projections, outlooks, or assumptions should not be construed to be indicative of the actual events which will occur. Discussions, market conditions, objectives, and strategies set forth herein are specifically subject to change if market conditions change, or if the Adviser believes in its discretion, changes and/or modifications are warranted accordingly.

October 2017