VAUGHAN NELSON

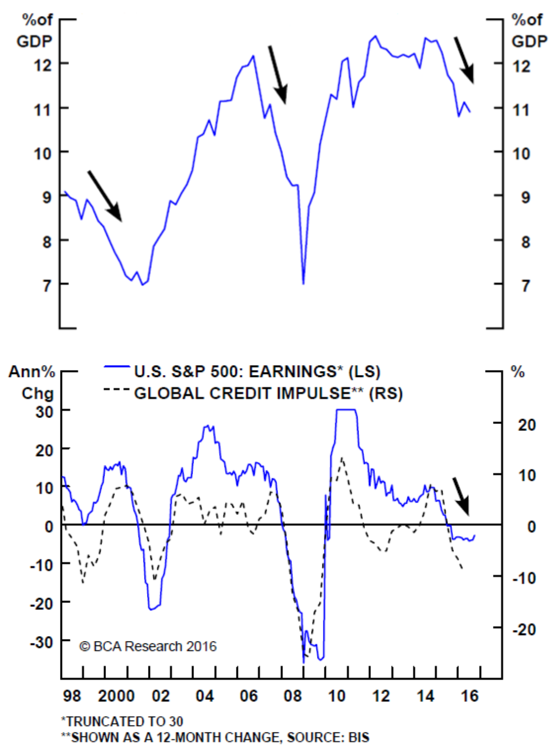
third quarter 2016

INVESTMENT *perspective*

During the third quarter, equity markets continued to appreciate as domestic and international economic activity showed modest improvements relative to the weak fundamentals during the first half of the year. The modest improvement in economic growth expectations combined with a further delay by the Federal Reserve to increase interest rates was sufficient to move the S&P 500 and the Russell 2000 higher by approximately 3.9% and 9.0%, respectively during the quarter. Corporate earnings expectations declined for the fourth quarter of 2016 and for full-year 2017, resulting in a further increase in valuation multiples as markets continued to rise. For the S&P 500, earnings are expected to grow approximately 13% in 2017, which seems unrealistic at this point in the business and corporate margin cycle **(Chart 1)**.

CHART 1

U.S. CORPORATE PROFITS AS A % OF GDP



Despite the attractive gains year to date, we can't help but believe equity markets might be in a state of unstable equilibrium given the significant structural changes that are occurring with central banks' monetary policy, U.S. government deficits, and the way oil is purchased globally. We have seen a significant rise in LIBOR, which the media relates to key money market reforms that go into effect on October 14, 2016. Certainly, the money market regulatory reforms are impacting LIBOR. However, the increase in LIBOR is also occurring at a time when government deficits are widening and foreign central banks are reducing their holdings of U.S. Treasuries at an alarming rate. We are hopeful that the rise in LIBOR will begin to reverse post the October 14th regulatory implementation. If LIBOR remains elevated or continues to rise after the implementation, this may be a symptom of U.S. government deficits crowding out private sector credit. If that is the case, a further increase in federal deficits or a further decline in purchasing of Treasuries by foreign central banks could force the Federal Reserve to raise rates and/or initiate a larger round of quantitative easing. Such a scenario is certainly not priced in to risk markets and would significantly increase market volatility.

One of the most important structural changes that is occurring is the reduction in use of the U.S. dollar for the global trading of crude oil. China, Russia, and others have begun trading oil in their respective domestic currencies without first exchanging their currencies for U.S. dollars. While this change may seem minor, it has a profound impact on the U.S. dollar's role in global trade, the United States' geopolitical leverage, and it impacts the ease at which the government can finance its deficit spending. When the U.S. dollar is used in global oil trade, both importers and exporters of oil would naturally hold large balances of U.S. dollars in the form of Treasury notes as foreign reserves. By no longer exclusively utilizing the U.S. dollar for the importing and exporting of crude oil, foreign central banks can materially reduce their U.S. dollar reserves. Should the dollars role in global trade continue to weaken, especially at a time when government deficits are beginning to widen, we would expect further volatility in currency markets that could ultimately spread to other risk assets.

As the nature of the market continues to change, there are still individual stocks that will perform well over the medium term despite the increasing market headwinds. Our outlook has become more balanced, stock-specific, and not reflective of opportunities in specific industries, regions of the world, or broader market indices.

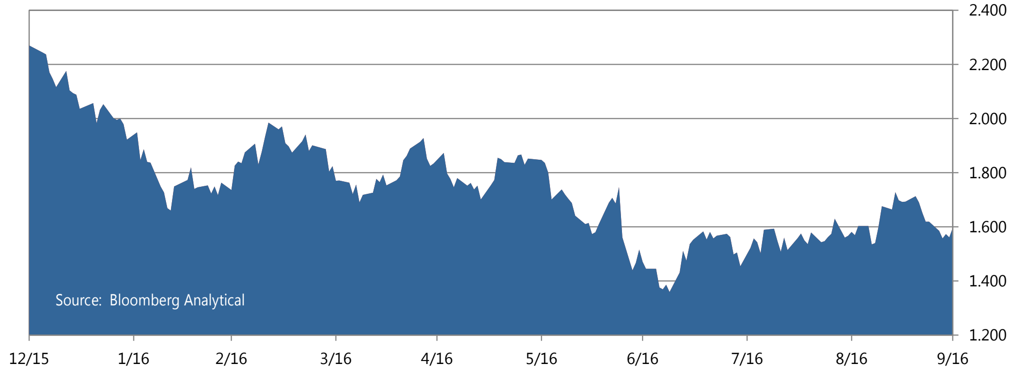
Over for conclusion.

The U.S. 10-year Treasury yield drifted higher during the quarter ending at 1.60%, up 13 basis points. At 1.60% the bellwether 10-year Treasury is still 67 basis points lower than at the beginning of the year. Investment grade credit spreads narrowed during the quarter by 20 basis points to +142. Both were impacted by reduced concerns about the negative implications from Britain's vote to leave the European Union ("Brexit") **(Chart 2)**.

CHART 2

U.S. 10-Year Treasury Yield

12/31/2015 - 9/30/2016



While we believe continued improvement in overall credit metrics is behind us, we expect the deterioration to be gradual. The search for higher investment yields/returns within the investment grade universe will continue to drive strong demand for corporate bonds.

Intermediate municipal yields remain attractive for taxable investors. Generic AA-rated 10-year bonds currently yield fifteen basis points more than the 10-year Treasury note, which on a taxable equivalent basis (35% tax rate) is a 2.7% yield to maturity.

Vaughan Nelson Investment Management

600 Travis, Suite 6300
Houston, Texas 77002-3071

713.224.2545
888.888.8676
713.228.4292 fax
www.vaughannelson.com

CEO and CIO

Chris Wallis, CFA, CPA

EQUITY INVESTMENTS

Dennis Alff, CFA
Benjamin Carrier
Stephen Davis, CFA
James Eisenman, CFA, CPA
Chad Fargason, PhD
Tyler Fry
Scott Weber, CFA
William Wojciechowski, PhD

FIXED INCOME INVESTMENTS

Charles Ellis
Blanca Garza-Bianco
Steven Henriksen

MARKETING/CLIENT SERVICE

Mark Farrell
Michael Hanna
George Holewyne
Daniel Hughes
Cynthia Lones