VAUGHAN NELSON

second quarter 2017

INVESTMENT *perspective*

During the second quarter of 2017, U.S. equity markets continued to move higher with large cap equities outperforming small cap equities. The S&P 500 and Russell 2000 Value appreciated 3.1% and 0.7%, respectively, during the quarter. Capital markets remain well supported by improving economic data, low interest rates, and liquidity injections by foreign central banks. However, we must acknowledge that margins and valuations for equities are at or near all time highs and the business and credit cycles are quite mature.

The Federal Reserve would like to continue to raise interest rates in order to normalize monetary policy. Although the prior interest rate increases have negatively impacted aggregate loan demand, a leading indicator of future economic growth, the recent material weakness in the U.S. dollar has provided a reflationary lift that has offset the Federal Reserve's interest rate increases. Economic growth should continue at a modest pace and support the current market environment provided the Fed continues to raise rates in a manner that does not tighten liquidity conditions or dampen economic activity in key sectors such as autos or residential and non-residential construction **(Charts 1 & 2)**.

CHART 1
Stronger Demand for Consumer Loans*

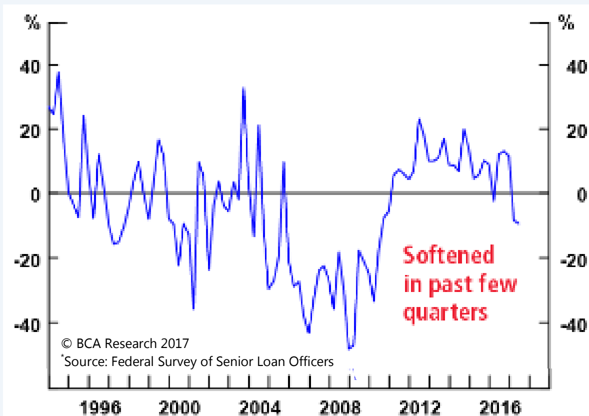
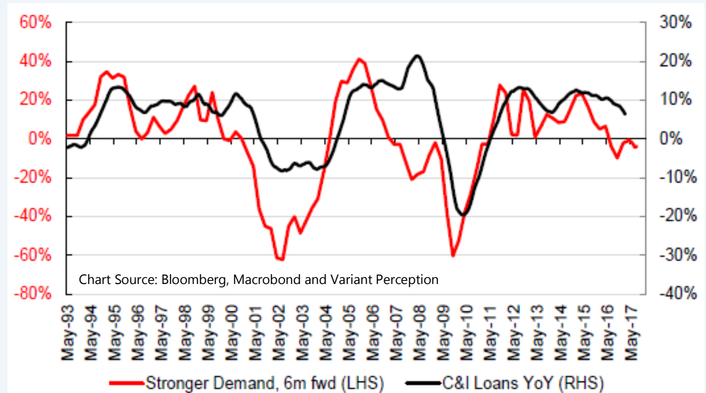


CHART 2
% Banks Reporting Stronger Demand (Advanced 6 Months) vs C&I Loans YoY



As we continue to transition from monetary to fiscal stimulus, we would expect market volatility to increase from the current exceptionally low levels. As the nature of the market continues to change there are still individual stocks that will perform well over the medium term. Our outlook remains balanced, stock-specific, and not reflective of opportunities in specific industries, regions of the world, or broader market indices.

Over for conclusion.

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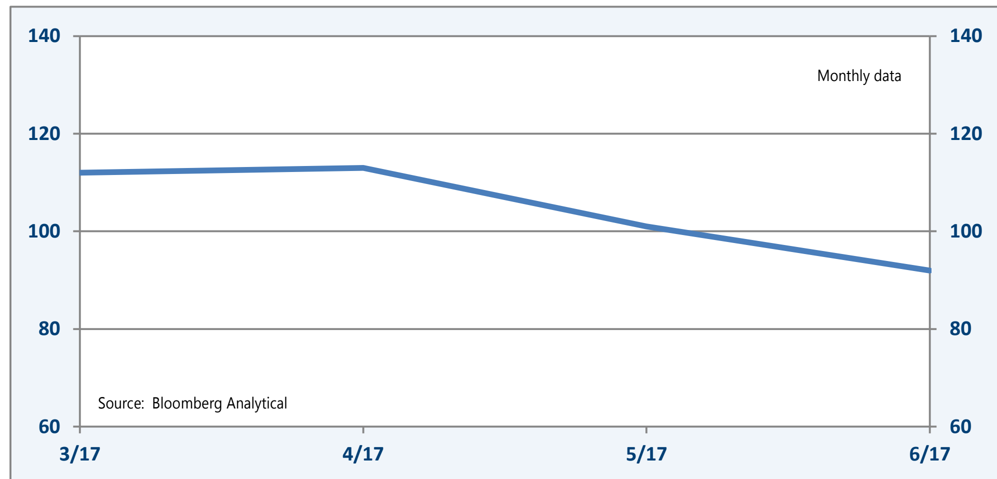
The 10-year Treasury note yield moved lower during the quarter but ended the period at 2.31%, only eight basis points lower than at the beginning of the quarter. The 2-Year to 10-Year Treasury yield curve continued to flatten during the second quarter ending at 92 basis points as yields were driven higher in the shorter end of the curve by another Fed interest rate increase on June 14th while longer dated Treasury yields declined **(Chart 3)**.

CHART 3
2-10 Year U.S. Treasury Yield Curve (basis point spread)



Both U.S. GDP growth and inflation have been below expectations during the first half of the year, which in turn has led to a breather in the "Trump trade" as doubts about stimulative fiscal policies have grown. Investment grade corporate risk premiums continued to decline in the quarter and now stand at 118 basis points above U.S. Treasury yields. We expect this trend to continue during the balance of the year, as corporate earnings remain strong and credit metrics are improving. Intermediate high quality municipal bonds outperformed both Treasury and corporate bonds on an after-tax basis and should remain the best fixed income option for taxable investors.