VAUGHAN NELSON
third quarter 2017

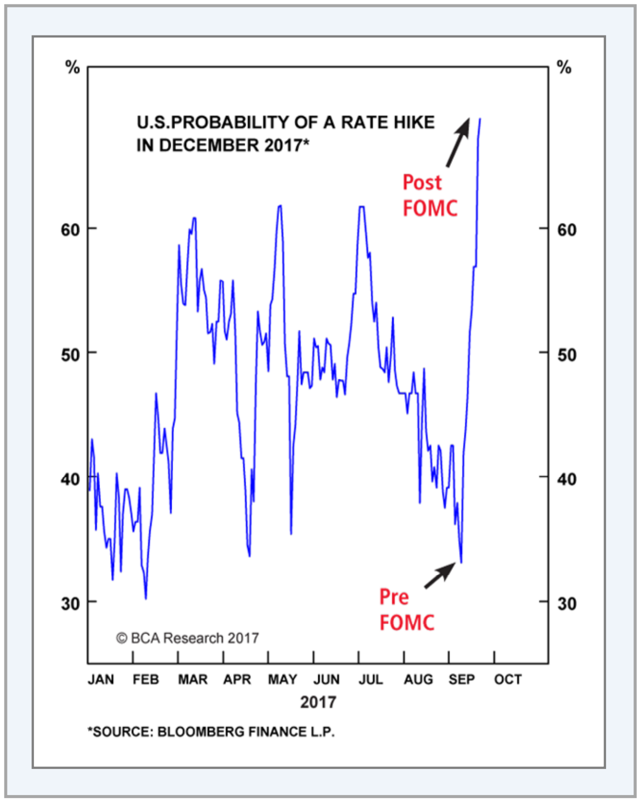
INVESTMENT *perspective*

During the third quarter of 2017, U.S. equity markets continued to move higher with large cap and small cap equities each appreciating approximately 5.0%. The S&P 500 and Russell 2000 Value have appreciated 14.24% and 5.68%, respectively on a year-to-date basis. Capital markets remain supported by improving economic data, low interests rates, liquidity injections by foreign central banks, and the hope of corporate tax reform.

The Federal Reserve is anticipating one additional rate hike in December of 2017, and will begin shrinking its balance sheet, "quantitative tightening," in October of 2017. Should the Federal Reserve continue to raise interest rates and shrink its balance sheet in a manner that does not dampen economic activity in key sectors such as autos or residential and non-residential construction then economic growth should be able to continue at a modest pace and support the current market environment. Equity market valuations are quite extended. Should future earnings be dampened by slower economic growth or acceleration in input costs, we would expect volatility to increase and equity markets to experience a correction **(Chart 1)**.

CHART 1

Market Expects A Hike in December



As we continue to transition from monetary to fiscal stimulus, we 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.

While the bellwether 10-year U.S. Treasury note ended the quarter basically unchanged at a 2.33% yield, the range was wide. In early September, yields approached 2.00% before a combination of another

Over for conclusion.

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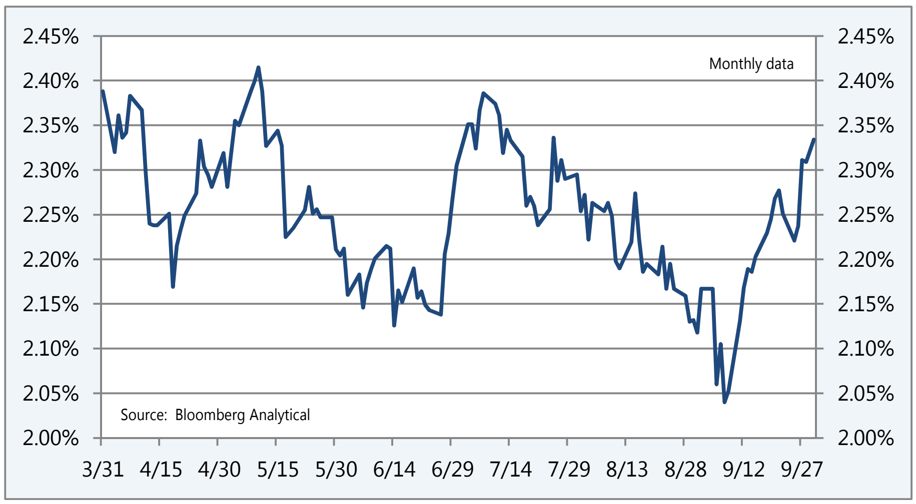
strong employment report and a repricing of another Federal Reserve rate increase in December caused the selloff in Treasury markets. Corporate bonds continued to perform well in the quarter as investor demand for higher yielding securities drove credit spreads to post-financial crisis lows at 106 basis points over comparable Treasury yields. While early in the tax reform debate process, current reforms being discussed of corporate tax rate reductions plus elimination of interest expense deductibility and repatriation of overseas cash are potentially very positive for continued credit outperformance **(Chart 2)**.

CHART 2
10-Year U.S. Treasury Yield
(3/31/17 - 9/30/17)



Demand for high quality municipal bonds remained strong in the quarter. With supply expected to remain below levels of the past few years, we continue to favor tax-exempt bonds over taxable bonds for investors in the top tax brackets. The impacts from hurricane Harvey along the Gulf Coast of Texas should have no negative affect on state and local governments' credit ratings, although unrated Municipal Utility Districts (MUDs) and special purpose bonds within the hardest hit areas will be negatively impacted. Vaughan Nelson does not invest in this small, less liquid sector of the market.