AUREUS
ASSET MANAGEMENT

January 2017

2017 Global Asset Allocation Review

Introduction

The Aureus annual global asset allocation reviews the risks and opportunities available in global financial markets and their potential impact on the investment portfolios of our clients. Our views constitute a Tactical Asset Allocation Policy expressing our position on investment opportunities for the coming year and may be adjusted as market conditions change.

In practice, Aureus develops customized investment policies for clients based on specific goals and objectives. This allows us to accommodate client-specific factors, including: income requirements, return objectives, risk tolerance, tax sensitivities and liquidity needs.

Summary

The Aureus 2017 global asset allocation review combines critical interpretations of global market factors with a particular focus on the following:

2017 Analysis			
Market Factors	▪ US Economy ▪ Global Economy ▪ Corporate Profitability ▪ Interest Rates & Inflation ▪ Geopolitics	Asset Classes	▪ Cash ▪ Fixed Income ▪ US Equities ▪ International Equities ▪ Alternative Assets

Valuations and economic fundamentals combine to result in a 'base case' asset allocation. The 'base case' has four principal asset categories: cash, fixed income, global equities and alternatives. In turn, equities are subdivided into US and International, while fixed income is subdivided by quality. Alternatives consist of two subcategories.

2017 Tactical Asset Allocation

Asset Class	Risk Level	2017 Allocation	Δ vs. 2016	2016 Allocation	2015 Allocation
Cash	Low	**5%**	↑	**4%**	**4%**
Fixed Income		**13%**	↓	**14%**	**12%**
High Quality Bonds	Moderate	10%	↓	11%	12%
High Yield Bonds	High	3%	=	3%	0%
Global Equities		**64%**	↑	**60%**	**58%**
US Equities	High	46%	↑	42%	42%
International Equities	High	18%	=	18%	16%
Alternatives		**18%**	↓	**22%**	**26%**
Directional Strategies	High	8%	↓	12%	12%
Absolute Return	Lower	10%	=	10%	14%
Total		**100%**		**100%**	**100%**

2017 Asset Class Commentary

This year's asset allocation reflects the following adjustments compared to 2016.

Cash: Returns on money market funds and Treasury bills approaching 0.5% still provide a negative real rate of return. However, cash provides important protection against market downturns as well as a source of liquid reserves for taking advantage of better price opportunities. We expect further increases in short-term rates driven by the Fed. We are increasing our cash allocation by 1% for 2017.

Fixed Income: After an initial rate hike in December 2015, the Fed waited 12 months for the second 0.25% increase. US 10-year interest rates spent most of 2016 below 2% and set a new cyclical low of 1.36% in July before closing the year at 2.44%, only slightly higher than the 2.30% rate at 2015 year end. In 2017, we expect the Fed will closely monitor the fiscal stimulus plans of the new administration and deliver two to three rate hikes during the year. We would concur with consensus expectations for 2-3% GDP growth in the US, increasing federal deficits and slightly higher inflation. We believe rates have seen their lows for this very long cycle and will move gradually higher in 2017. We expect core fixed income returns will be flat, with modestly higher coupons offset by gradually rising interest rates and inflation. We have slightly reduced the fixed income allocation for 2017 but believe it remains valuable for dampening volatility associated with the equity allocation. The high-yield bond market was very strong in 2016 as the economy was stable. An improving economy should keep spreads at, or about, current levels and provide a slightly better return opportunity than investment grade credit. We are maintaining our allocation to high yield for 2017.

Global Equities: The S&P 500 surprised many investors with a return of 12% for 2016. The index has produced an annualized return of 6.5% and 8.9% over the past two and three years, respectively. In the US, valuations are at the high end of historical averages but are supported by improving growth and high profit margins. We continue to believe that equity returns in the mid to high single-digit range are reasonable. The strength of the dollar remains a concern for multinational firms. Tax policy may provide relief for corporations and tax repatriation could be a positive for capital spending and additional share repurchase. We are increasing our allocation to US equities in 2017, a result of: rising GDP expectations, resumed earnings growth, and a potential reduction in corporate tax rates.

For 2017 we are holding the allocation steady to International equities. Developed market economies have trailed the US both in terms of effective central bank policies and potential fiscal stimulus. While valuations are favorable compared to the US, GDP growth rates, political uncertainty, and the negative impact of currency translation with a strong dollar, make the fundamental case less attractive. Emerging markets benefited from the rally in commodity prices in 2016. While an increase in global economic growth is positive for these countries, the magnitude of this growth may not be enough to significantly increase demand for commodities.

Alternative Assets: Overall allocation to alternatives decreases for 2017. Higher risk directional strategies have been a continued source of performance disappointment to investors, specifically long/short equities and event-driven strategies. In a single-digit return environment, these strategies will find it difficult to outpace the fee burden. We maintain the weighting to lower-risk or absolute return strategies as we believe these strategies can serve as fixed income substitutes for certain clients. Absolute return can offer a consistent source of return, dampen volatility and provide a reasonable alternative to fixed income. We remain positive regarding specialized credit, emphasizing distressed debt in both the US and Europe.

Review of 2016

US Equities again proved to be the best performing major asset class with a return of 12% in 2016. During the year we experienced rapid sector rotations with large swings in performance from quarter to quarter. Energy was the best performing sector, following a dismal few years, and traditionally defensive sectors such as Telecom and Utilities also posted good relative results for the first three quarters of 2016. The fourth quarter was dominated by the performance of the financial sector responding to rising inflation expectations and the potential for decreased regulation from the new administration. On a trailing five-year basis, US Equities have been the clear market leader with large caps and small caps performing comparably.

On the International equity side: Emerging Markets benefited from their commodity exposure and delivered an 11% return for the year, while Developed Markets returned only 1%. Developed Markets have outperformed Emerging Markets over the last 5 years, although over the last 10 years both are lagging most other asset classes.

Intermediate Treasury bonds returned 2.0%, while longer bonds returned 1.3%, hurt by rising interest rates in the second half of 2016. High yield bonds delivered particularly strong results as spreads narrowed considerably and credit quality concerns abated. High yield improved 17.5% in 2016.

The alternative asset class returns were unimpressive for 2016 with the exception of commodities which, led by energy, returned 11.4%. Most equity hedge funds were below the S&P 500 and as a group have not outperformed the market since 2008.

Investment Return Summary

Asset Class/Index	Asset	Returns 2016	2015	2014	2013	2012	*5 Year**	*10 Year**
Cash								
BofA Merrill Lynch U.S. Treasury Bills	Treasury Bills	0.4	0.1	0.1	0.1	0.1	*0.1*	*0.9*
Fixed Income								
Barclays US Aggregate	US Fixed Income	2.7	0.6	6.0	-2.0	4.2	*2.2*	*4.3*
Barclays US Treasuries - Intermediate	US Fixed Income	2.0	1.2	2.6	-1.3	1.7	*2.0*	*4.0*
Barclays US Treasuries - Long	US Fixed Income	1.3	-1.2	25.1	-12.6	3.6	*2.5*	*6.7*
BofA Merrill Lynch High Yield	US High Yield Bonds	17.5	-4.6	2.5	7.4	15.6	*7.4*	*7.3*
Global Equities								
S&P 500	US Large Cap	12.0	1.4	13.7	32.4	16.0	*14.7*	*7.0*
Russell 2000	US Small Cap	21.3	-4.4	4.9	38.8	16.4	*14.5*	*7.1*
MSCI EAFE	Developed International	1.0	-0.4	-4.5	23.3	17.9	*6.5*	*0.8*
MSCI EMF	Emerging International	11.2	-14.6	-1.8	-2.3	18.6	*1.3*	*1.8*
Alternatives								
HFRI Equity Hedge	Equity Hedge Funds	5.5	-2.3	2.3	14.3	7.4	*5.5*	*2.9*
HFRI Fund of Funds Composite	Hedge Funds	0.5	0.2	3.2	9.0	4.8	*3.4*	*1.3*
S&P GSCI	Commodities	11.4	-32.9	-33.1	-1.2	0.1	*-13.1*	*-8.1*
S&P GSCI Gold	Gold	7.8	-10.9	-1.8	-28.7	6.1	*-6.5*	*5.3*
Inflation								
CPI-U All Items Less Food And Energy	Inflation		2.1	1.8	1.7	1.9		

* *Annualized Return*

Best performing   Worst performing

Asset Class	2016 Investment Returns	
	Positive (Relative)	Negative (Relative)
Fixed Income	▪ High Yield Bonds	▪ Long Treasury Bonds
Global Equities	▪ US Large Cap ▪ US Small Cap ▪ Emerging Markets	▪ Developed Markets ▪ China
Alternatives	▪ Commodities	▪ Most hedge funds

2017 Model Factors

Model Factor 1 - Fundamentals

Key considerations include prospects for growth, chances of inflation or deflation, and potential for further earnings gains.

Economic Overview

The US continued its slow growth pattern with a GDP estimate of +1.7% in 2016, although the rate improved in the back half. Developed International economies also experienced slow, but positive, growth led by the United Kingdom (2.0%), followed by Germany (1.7%), France (1.3%), Italy (0.9%) and Japan (0.9%). The headline among emerging economies remains the slowing growth of China, which is estimated at 6.7% for 2016. We see limited risk of recession in the US and most developed countries for 2017.

Globalization

Since the 1980s, the world's economies have embraced a theme of globalization. This term came to mean open trade throughout the world, with much lower tariffs and other trade barriers. Especially since the early 1990s, when China joined the World Trade Organization, open trade resulted in lower consumer prices for developed countries and higher exports for emerging markets.

During the past year, the costs of globalization moved to center stage. It became clear that manufacturing workers in Western countries were hurt by the movement of factories overseas, contributing to the rise of nationalist or populist movements in many countries. In the June Brexit vote, the UK voted to leave the European Union. Then, in November, Donald Trump won the US presidential election, attracting voters with his promise to "Make America Great Again".

The significance of these two votes should not be underestimated. Instead of open trade agreements between large geographical blocs, such as NAFTA, the US will probably withdraw or refuse to extend these agreements, forcing negotiations on a country-by-country basis. These changes could significantly alter our trade balance with other countries.

Tariffs and trade restrictions can meaningfully impact inflation, employment, GDP, and currency moves.

Shift from Monetary Policy to Fiscal Policy

Since the recession of 2008-9, the primary stimulus for recovery has been monetary policy. Interest rates in the US fell and remained extremely low for about eight years. Rates in both Europe and Japan went negative in an attempt to boost economic growth when fiscal policy (i.e., tax cuts or greater spending) proved too difficult to implement. Although monetary policy helped avoid another crisis and stabilized the economy, it was unsuccessful in reigniting growth to pre-recession levels.

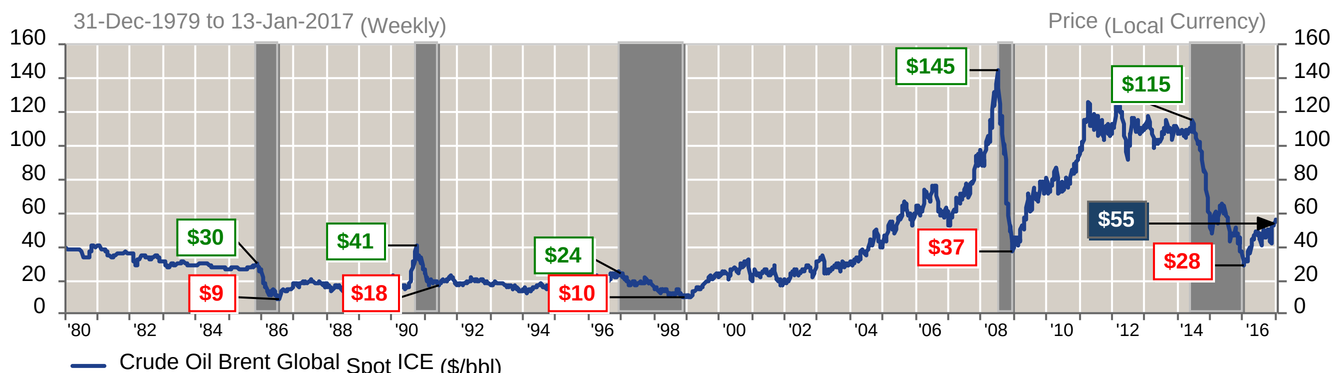
This extreme reliance on monetary policy is likely to change significantly. Once again, the US is leading the way. The Congress and the President have made it clear that higher domestic spending on infrastructure and defense are priorities, although it is unclear whether this added spending will be paid for by higher deficits or tax benefits. Fiscal stimulus may result in more employment, higher GDP, higher wages and inflation. It's probable that the Europeans and the Japanese will follow the US toward more fiscal spending, but their policy changes are slow to materialize.

Oil Prices

After major declines of 40% in 2014, another 35% in 2015, and touching a low of $28 early in 2016, oil appears to have "stabilized" near a $50 price per barrel.

As mentioned in this piece last year, the 2014-2015 price decline was driven by excess supply rather than a drop in global demand. OPEC countries have spent much of the past year discussing production limits with little definitive action. An increase in global economic growth should provide stability to demand and we are not assuming a major shock in oil prices in either direction this year.

1980-2016 Crude Oil Prices



Source: FactSet Prices

Interest Rates and Inflation

We believe that global inflation will rise gradually in 2017. Even with employment at close to a "full" level and modestly higher interest rates, we are not expecting high rates of inflation.

Corporate Earnings

Corporate profit margins in the US remain at record highs and balance sheets are relatively healthy. Companies are using excess cash to raise dividends, repurchase shares, or make acquisitions. Capital spending has trailed profit growth, but as demand continues to rise and unemployment declines, we anticipate a lift in capital expenditures. The strength of the US dollar is a renewed headwind for US multinationals. International corporations, with the exception of those in commodity and related industries, are in solid financial condition.

Economic Growth

United States:

We expect that US real growth will accelerate to a range around 2.5% in 2017. Unemployment should remain below 5%, with payrolls continuing to increase and wage growth moving above 3%. The consumer is in good financial shape, which combined with the positive employment/wage outlook, should increase consumer spending in 2017. If Congress lowers corporate tax rates, this will also help earnings growth.

Factors	Influence
▪ Strong consumer and corporate balance sheets	+
▪ US GDP growth continues to lead the developed world	+
▪ Accelerating wage growth, low unemployment	+
▪ Rising interest rates and inflation	–

Europe and Japan:

There will be key elections in both Germany and France this year. The June 2016 Brexit vote has put nationalism in the spotlight. There are many implications for immigration, labor movement across Europe, and trade policies. Because the EU and Japan have been slow to adopt any economic policies, we expect slow growth in both Europe and Japan this year.

Factors	Influence
▪ Continuation of easy monetary policy by central banks	+
▪ Equity markets valuations below average	+
▪ Risk of highly nationalistic policies through new elections	–
▪ Brexit uncertainty	–

Emerging Markets:

Trade tariff and import restrictions by the US will hurt emerging markets as will a stronger dollar. China, by far the most important emerging country, continues to shift from an emphasis on infrastructure to more reliance on the consumer and on social services. South America should gain from government change in Argentina and Brazil, and from a recovery in commodity prices. Mexico is under threat from a change in US policy towards NAFTA and other trade deals.

Factors	Influence
▪ Better commodity prices	+
▪ Reasonable equity valuations	+
▪ China economic transition	–
▪ US political reaction against imports	–

Model Factor 2 - Valuation

Key considerations are valuation and yields, viewed historically, in absolute and relative terms.

Equities

The rising US stock market combined with minimal earnings growth in 2016 has placed equity valuations toward the high end of the 10-year range. We anticipate earnings growth in 2017 will improve valuations, but expect potential equity returns to be limited to single digits for the year. With rising interest rates there is less competition from bonds near-term, but higher coupons could move some investors toward bonds later in the year.

Valuations in Europe, using price/earnings ratio, are above their 10-year average with Japan slightly below. Similar to the US, earnings growth will be the key driver of equity returns. Emerging markets are valued slightly above their longer-term averages, although this varies by country. As was the case in 2016, commodity prices and global GDP growth remain the key to positive equity performance from these countries.

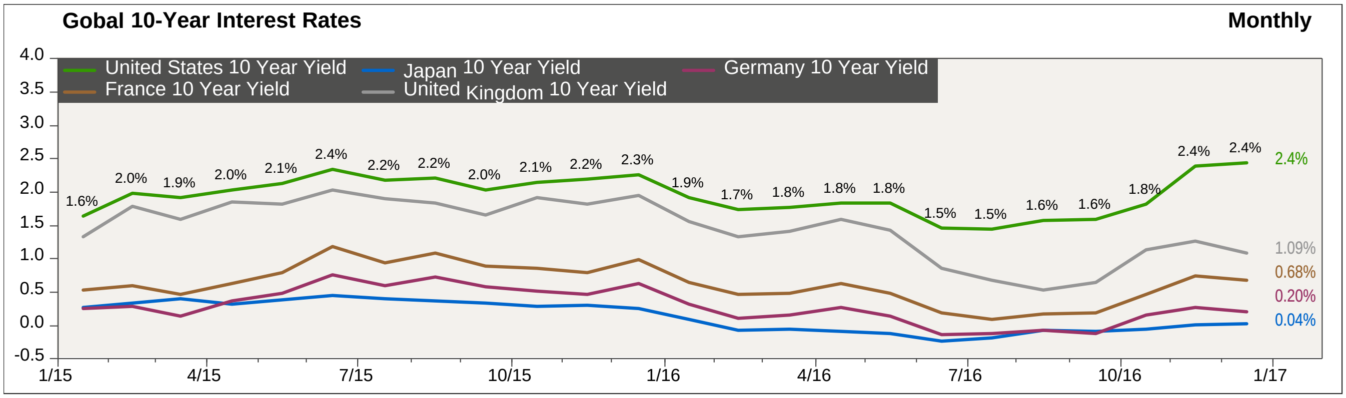
Global Equity Valuation Comparison

	10 Year P/E Ratio			Jan.	Jan.	10 Year Price/Book Ratio			Jan.	Jan.
Country/Region	High	Low	Avg.	2017	2016	High	Low	Avg.	2017	2016
US	18.4	8.9	14.9	17.8	16.8	2.7	1.3	2.2	2.6	2.5
Europe	16.3	6.6	12.3	14.4	14.9	2.3	0.9	1.5	1.6	1.6
Japan	36.4	9.3	15.6	15.1	14.7	1.9	0.8	1.2	1.3	1.3
Emerging Markets	18.8	5.8	12.9	14.6	15.6	2.9	1.0	1.8	1.7	1.8

Source: Factset, January 18, 2017. Forward P/E and P/B ratios.

Bonds

Global interest rates appear to have bottomed. In the US, the Fed has indicated a policy of gradual short-term rate increases and rates are higher across the yield curve since mid-2016. We expect the 10-year US Treasury to trade in a range of 2.5% to 3.5% during 2017. High yield bond spreads have narrowed considerably from a year ago, however, economic strength should keep valuations acceptable in the coming year. Bonds outside the US do not appear to offer sufficiently attractive valuations, especially in relation to those countries’ equity markets.



Model Factor 3 - Geopolitical

Key considerations are government and political conditions in specific geographies that may impact economies and investment markets.

United States

Our new President will change past policies in unpredictable ways. Under scrutiny are tax reform, regulation reductions, more nationalistic foreign and economic policies, and increased government spending especially on infrastructure and defense. But what shape new policies will take and what will actually get passed remains unclear. Increased volatility in financial markets may be the inevitable result.

Europe

The significance of Brexit is hard to overstate. For the first time, a major nation is withdrawing from the European Union. How and when that withdrawal happens will be subjects for intense discussion. On top of that, there are major elections in Germany and France in 2017. As in the US, unpredictability seems a likely result.

Japan

In contrast to Europe, Japan has no important elections this year. Stability of policy should be maintained by the present government. Policy prescriptions so far have addressed the most important reforms, which could restart economic growth.

Emerging Markets

Since the early 1980s, emerging economies have greatly benefited from globalization policies adopted by the developed world. These seem very likely to change. Both the US and Europe are now aware that globalization brings with it certain costs, such as competition from unrestricted immigration and reduction in jobs for those with less than a high level of education. Emerging countries are going to have to focus more on their own internal demand, rather than base their livelihood on exports.

While commodity prices have recovered nicely from the lows of early 2016, producing benefits for countries in South America and parts of Asia, continuing slow global growth has restricted improvement in exports to the developed world.

US policies towards Russia and China will go through a process of change, but in ways that cannot be forecast with any accuracy at the present time.

Terrorism remains a threat, although unquantifiable.

Model Factors – Summary Table:

Region	Economic Fundamentals	Valuation & Risk	Geopolitical
US	▪ Modestly higher GDP growth than in 2016. ▪ Federal Reserve committed to several increases in short-term rates. ▪ Fiscal policy moves to the front of economic stimulus, replacing monetary policy. ▪ Corporate and consumer balance sheets remain relatively strong. ▪ Dollar impact continues to weigh on corporate earnings.	▪ Equity valuations at higher end of historic ranges. ▪ Earnings growth is key to equity performance as limited potential for multiple expansion. ▪ Cash yields rising slightly. High yield spreads narrowed in 2016. ▪ Equity market volatility experienced in 2016 likely to continue.	▪ Negative sentiment associated with election year has carried over to new administration. ▪ Nationalism replaces globalism in the political arena. ▪ Trade agreements expected to increase uncertainty for global economic landscape. ▪ Global terrorism has the potential to impact consumer and political behavior. ▪ Oil prices, while improved, increasingly dependent on global supply factors.
Developed Markets	▪ Improving growth prospects, led by the US. ▪ European central banks will gradually reduce monetary ease. ▪ Dollar should remain strong against euro and yen. ▪ Many corporations have strong balance sheets and remain highly profitable.	▪ Equity valuations slightly above historical averages, but reasonable. ▪ Interest rates appear to have reached an important long-term bottom. Bonds are less attractive.	▪ Increased uncertainty given new leadership in US and UK. ▪ Globalization under pressure given resurgence of nationalism. ▪ Revised trade agreements and potential tariffs may change economic relationships over time. ▪ Terrorism and refugee crisis poses challenges for European countries.
Emerging Markets	▪ China continues to slow, but its government will control the rate and pace. ▪ Rise in commodity prices benefits much of South America and parts of Asia and Africa. ▪ New governments in South America have the potential to reduce inflation and improve growth prospects.	▪ Equity valuations generally reasonable in many countries. ▪ Pressure on dollar denominated debt persists. ▪ Currency weakness likely continues. ▪ Expect less flow of funds from developed world.	▪ Relations between US and China, Russia and Europe hard to predict. Expect rhetoric to increase with new administration. ▪ Less opportunity for emerging nations to export cheap goods to developed world. New tariffs a possibility. ▪ Middle East remains a potential source of conflict.

Expected Returns

2017 Asset Allocation: Expected Returns

Asset Class	Expected Nominal Return	2017 Tactical Allocation	Expected Nominal Return Attribution
Cash	0.5% – 1.0%	5%	0.0% – 0.0%
Fixed Income	1.0% – 3.0%	13%	0.1% – 0.4%
US Equities	5.0% – 9.0%	46%	2.3% – 4.1%
International Equities	5.0% – 10.0%	18%	0.9% – 1.8%
Directional Alternatives	4.0% – 8.0%	8%	0.3% – 0.6%
Absolute Return Alternatives	3.5% – 6.5%	10%	0.4% – 0.7%
Total Portfolio Nominal Return		100%	**4.0% – 7.7%**
Less Expected Inflation			(2.0%)
Total Portfolio Real Return			**2.0% – 5.7%**

Calculating expected returns is mainly a quantitative exercise to establish a range of returns for both asset classes and an overall "average" portfolio. History has shown that rarely will these asset classes deliver these expected returns during any one calendar year given the cyclicality and volatility of individual asset classes. However, using these expected returns allows us to express our assumptions and their application to a client's portfolio.

For 2017, we expect better returns to come from US equities and International equities. When applied to a diversified portfolio, the expected returns are in the 4.0% to 7.7% range with the overweight to US equities providing the bulk of the return contribution.

As always, we remain diligent in our approach to the financial markets and the management of our clients' investment portfolios. As new information becomes available we update our models and, when market conditions warrant, will make adjustments to our tactical allocations.

We appreciate the opportunity to share our views and welcome your questions and comments.