Quarterly Newsletter – January 2018

2017 was a good year for investors. Foreign and emerging market stocks provided the best returns for the year, with U.S. stocks not far behind. Bonds and other asset classes delivered positive but more modest returns. Investors holding too much cash experienced significant opportunity cost, as cash returns were negative after accounting for inflation.

Strong global stock market returns have been driven by a solid earnings outlook (chart below), and to a lesser extent, price increases relative to earnings. A weaker U.S. dollar has also played a part, boosting the U.S. dollar returns of foreign and emerging market stocks for the year.

Global Stock Market Gains Have Been Supported by a Steady Rise in the Earnings Outlook

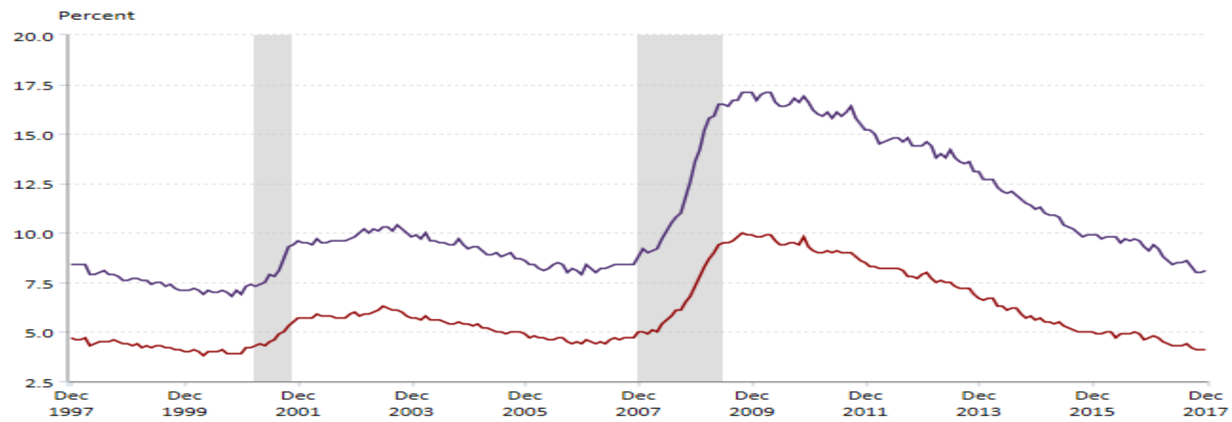
Source: Schwab Institutional, Factset; data as of December 2017.

Analysts currently expect earnings for U.S. companies to grow by 10% in 2017 and 13% in 2018, with revenues expected to increase by close to 6% in both years. These types of numbers should be a positive driver of stock market returns over the next year. What's behind the solid earnings picture? Among the key factors in the U.S. are a strong jobs market and accelerating global growth.

The U.S. labor force continues to tighten, with the official U3 unemployment rate ending the year at 4.1%. This compares to a high of 10% in 2009 and the 50-year average of 6.2%. Although not clearly defined, most economists consider the current level to be at or near "full employment[1]," with absolute low levels likely to fall in the mid 3% range.

The broader U6 measure of total unemployment has also improved significantly during the current expansion, falling to 8.1% in December versus a high of 17.1% in 2009. The result is a generally confident U.S. consumer that has repaired their balance sheet and is increasingly willing to spend their wages. Strong jobs data has been a key driver of consumer spending, GDP and earnings growth, and the Federal Reserve's decision to raise interest rates.

U.S. Unemployment Rate (U3 in Red, U6 in Blue)



Source: U.S. Bureau of Labor Statistics January 2018; gray bars represent economic recessions.

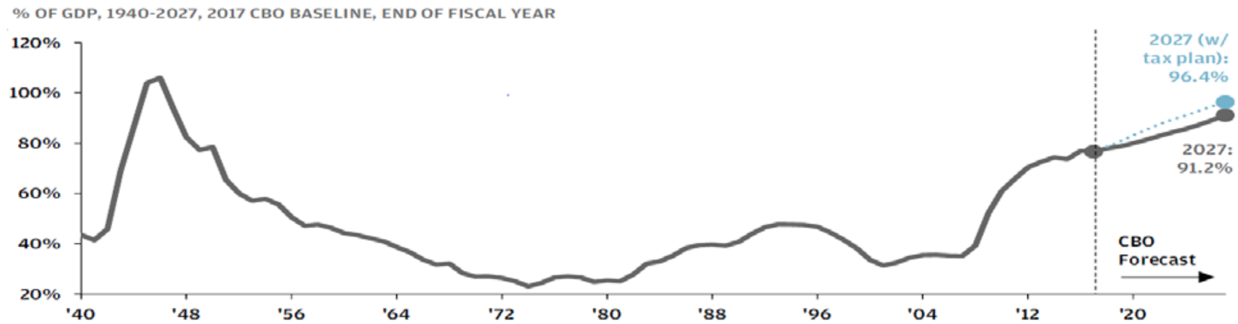
Economies outside the U.S. are also experiencing positive economic momentum. Global manufacturing data, highly correlated to GDP growth, improved throughout 2017 and signaled strong expansion in the Euro Zone as well as in many emerging market countries. Foreign economic strength benefits the earnings of U.S. companies that enjoy a significant presence abroad. Likewise, foreign economic strength drives positive trends for international company earnings and stock returns. Notably, foreign stocks still appear to have room to run. Despite this year's strong performance, valuations for foreign and emerging market companies are average compared to history, and earnings and prices are still well below previous highs. This is not the case for U.S. stocks. In the U.S., valuations are now above average and moving higher, and earnings and prices are at all-time highs. As a result, we plan to take some profit from the U.S. side of the ledger and add to our weight in international equities in the first quarter.

Turning to Washington, positive sentiment and pending earnings revisions related to tax reform helped the market move higher in the 4th quarter. The tax bill[2] was finally passed in mid-December and includes several changes to the current law. Key provisions include lower individual rates across the board, a reduction in corporate rates from 35% to 21%, and a doubling in the estate tax exemption.

The overall impact of the changes is expected to be stimulative, at least in the near term. Higher after-tax income for individuals may lead to higher consumer spending. Similarly, higher after-tax income for corporations, along with 100% expensing of capital investments, could lead to higher business spending and the potential for an uptick in productivity. And a significantly higher estate tax exemption should simplify planning and allow for greater generational transfer of wealth.

Most economists currently expect the tax bill to boost U.S. growth to above 3% in 2018. The impact beyond that is uncertain, given already tight labor markets and demographic constraints on the U.S. labor supply. Importantly, the bill is estimated to cost $1.45 trillion in reduced tax revenue over the next 10 years. Even with an increase in near term growth helping to offset some of the cost, the changes are expected to increase the federal debt from its current level of 77% of GDP to an estimated level of 96% of GDP in 2027. Without the tax bill, 2027 levels were expected to reach 91% (chart below). All else being equal, federal debt at 90% of GDP or greater is not good for the equity market. High debt increases interest expense and limits output, both negatives for stocks longer term.

Net Debt Held by the Public, % of GDP



Source: Congressional Budget Office, Joint Committee on Taxation, J.P. Morgan Asset Management. Projection does not include the impact of dynamic scoring or interest costs. Data are as of December 20, 2017.

Returning to the present, we continue to favor an overweight to stocks over bonds given positive global economic momentum, low interest rates, and gradually tightening monetary policy. We acknowledge that current valuations should lead to more modest returns going forward, especially for U.S. stocks nearing the 9th anniversary of the current bull market. Risks to this outlook include higher than expected inflation, a misstep by the new Fed chairman, geopolitical turmoil, an inverted yield curve, the increase in federal debt, and further valuation expansion. These are all factors that we will be watching closely.

[1]*Full employment is an economic situation in which all available labor resources are being used in the most efficient way possible. Full employment embodies the highest amount of skilled and unskilled labor that can be employed within an economy at any given time. Any remaining unemployment is considered to be frictional, structural or voluntary.*

[2]*Tax bill-- Tax Cuts and Jobs Act of 2017, H.R-1, 115th Cong. (2017).* https://www.congress.gov/bill/115th-congress/house-bill/1

Disclosures: Investment Products: Not FDIC Insured – No Bank Guarantee – May Lose Value - Not insured by any federal government agency
Private Capital Management, LLC (PCM) is a wholly owned subsidiary of Guaranty Bank and Trust. Opinions and information presented have been obtained or derived from sources we believe to be reliable, but we cannot guarantee their completeness or accuracy. Opinions represent PCM's judgment as of the date of the report and are subject to change without notice. This material is for general information only and is not suitable for all investors. It is not soliciting any action from any particular investor. This presentation is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this presentation may be unsuitable for some investors depending on their specific financial position and investment objectives. Private Capital Management and/or its personnel may trade for their own accounts, be on the opposite side of customer orders, and have positions in securities related to issues mentioned in this presentation. Investing in foreign securities presents certain risk that may not be present in domestic securities. Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses. PCM does not provide tax or legal advice. Please consult appropriate tax or legal advisors to determine how this information may apply to your own situation. The indices and benchmarks mentioned for comparison purposes are unmanaged. You cannot purchase an index. Index

returns do not reflect any fees an investor may incur to purchase the securities underlying the index or an index fund. The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI), and is comprised of stocks from both developed and emerging markets.