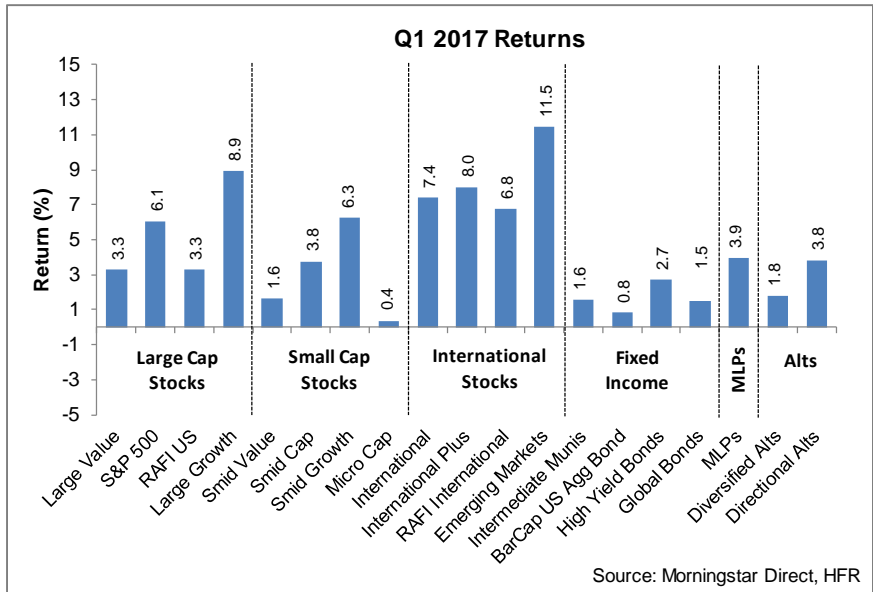


## First Quarter 2017 Investment Review & Outlook

To Our Clients and Friends,

Financial markets posted robust gains in the first quarter of 2017, buoyed by renewed optimism about the economy under now-President Donald Trump. In January and February, the U.S. stock market was particularly strong, rising just under 6% in the two-month period. Although the quarter's early momentum faded in March, it was enough to put the S&P 500 on track for its best year since 2013.

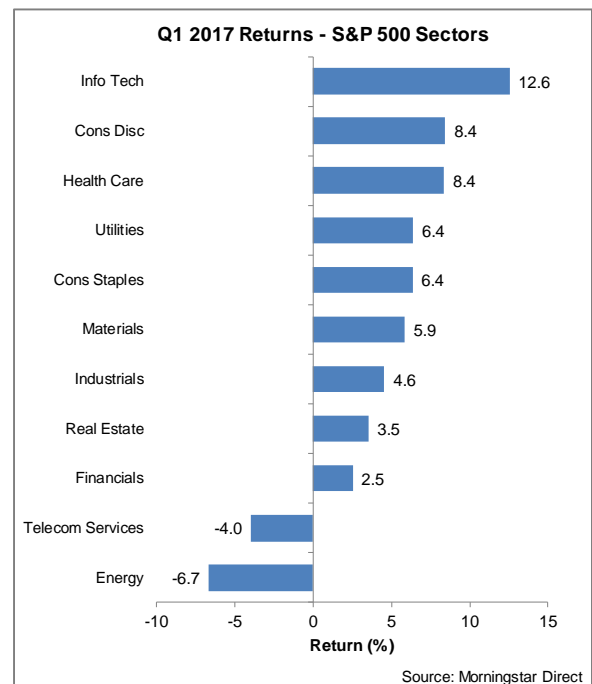


International markets were even stronger, with the primary developed market index (MSCI EAFE) climbing 7.4% and emerging markets finishing up 11.5%.

Despite initial concerns that a Trump regime may be a headwind for non-U.S. companies, investors have largely ignored this narrative amid improving economic data, stabilizing currencies, and better valuations than in the U.S.

At a sector level, the dramatic leadership reversals from 2016 continued in the first quarter. Energy sharply underperformed despite relative stability in oil prices, falling nearly 7% and trailing the S&P 500 index by 13%. Financials also lagged, rising just 2.5% despite positive sentiment following Trump's victory. Indeed, the so-called Trump Trade – consisting of more domestically-oriented and economically-sensitive sectors such as financials, industrials, and small cap stocks – largely did not play out in the first three months of the year. This may simply reflect strong gains that were front-loaded in the weeks following the election, or perhaps something more telling about the potential for Trump's agenda to succeed.

Fixed income markets generated modest gains amid a slight decline in longer-dated interest rates and a further tightening of credit spreads. High quality municipal bonds gained approximately 1.5%, high quality taxable fixed income added 0.8%, and non-investment grade corporate bonds gained approximately 2.7%. Floating



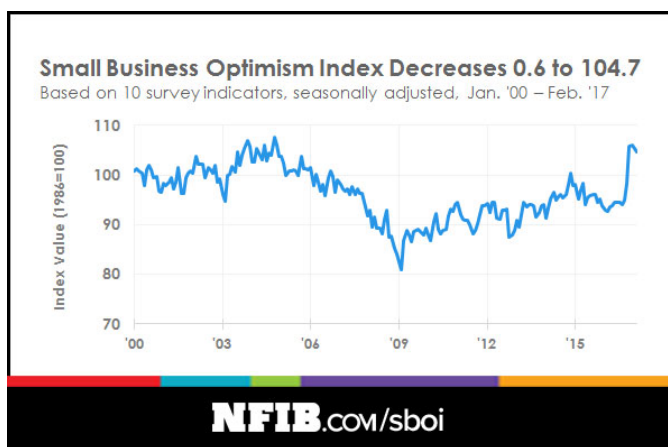
rate bank loans, an area we have favored given the potential for higher interest rates, added 1.5% in the quarter. Both bank loans and high yield credit appear mostly to be coupon-clipping investments at this juncture, as they have fully recovered from their selloff in 2015/early 2016.

While Trump's inauguration and chaotic first 70 days in office dominated headlines, actions by the Federal Reserve arguably deserved more attention in the first quarter. Most economists initially didn't expect an additional rate increase so soon after December's hike; however, the Fed moved forward in March by raising the Federal Funds rate for the third time since the financial crisis. Citing improved economic conditions and burgeoning inflation, the group has stated its intentions to raise rates two more times this year and to start winding down its \$4 trillion balance sheet near year-end. The latter announcement has garnered limited press but we consider it as important as rate hikes. At present, the Fed continues to reinvest tens of billions of dollars of maturing principal every month back into Treasuries and mortgage-backed securities. That practice will presumably stop and may contribute to increased volatility and reduced liquidity moving forward.

Indeed, some could say the training wheels are finally coming off for the U.S. markets. After many years of stimulus and reactionary policy by the Fed – propping up the markets at every turn – economic and corporate fundamentals should hold greater sway over market outcomes in the future. While a change from the status quo, this is a much healthier environment than the perverse “bad news is good news” regime we've become accustomed to. We ultimately want our investments to rise because they are actually good investments (growing earnings, improving margins, etc.), not because of an artificial source of demand in the marketplace. Fed stimulus has had a diminishing marginal effect and, in the long run, cannot sustain markets alone.

To that end, there is much to be encouraged by: many economic indicators are improving, unemployment is substantially lower, and corporate earnings have returned to positive territory after several quarters of contraction (a so-called earnings recession). GDP could certainly be higher, but it remains positive (+2.0% in the fourth quarter) and traditional recession indicators remain noticeably absent. Fiscal policy also promises to be accommodative; although the scope and timing of said policy remains unknown at this juncture, it has translated to significantly increased economic confidence. Small business optimism, for example, has exploded to multi-year highs in the wake of the election. That in and of itself can have a fundamental impact on economic growth to the extent it encourages further spending and investment by the corporate sector.

We weigh these developments against the same risk factors we discussed last quarter: elevated valuations, the potential for unexpected Trump action, and the possibility that Trump's agenda items do not materialize as expected. Indeed, all three were in focus during the quarter amid increased P/E multiples (S&P 500 now at 17.5x forward earnings, above the 25-year average of 15.9x), sudden geopolitical tensions with North Korea and Russia, and early legislative stumbles from the new administration. Volatility has been exceptionally low of late, but that is likely to change as Trump's honeymoon period ends and reality is separated from campaign rhetoric.



On balance, the combination of an improving fundamental backdrop with higher risk potential leads us to a slightly more cautious, but still constructive outlook for equity markets. Markets can and have risen in the face of geopolitical risks, so we must avoid being shaken out of our long-term asset allocation targets based on these issues alone. Otherwise, one would perpetually sit in cash. We believe portfolios are well prepared for the risk of equity market and interest rate volatility given current positioning and asset class diversification. There are a number of reasons to believe significant upside can still occur in equity markets – most notably, if fundamental earnings growth comes through as anticipated – but we do want to be thoughtful about taking new or additional risk in this market environment.

As always, please call us or visit our offices should you have questions. If you would like to review your current asset allocation or risk profile, we encourage you to speak with us at your convenience.

Kindest regards,  
Your Investment Team  
4/19/2017

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