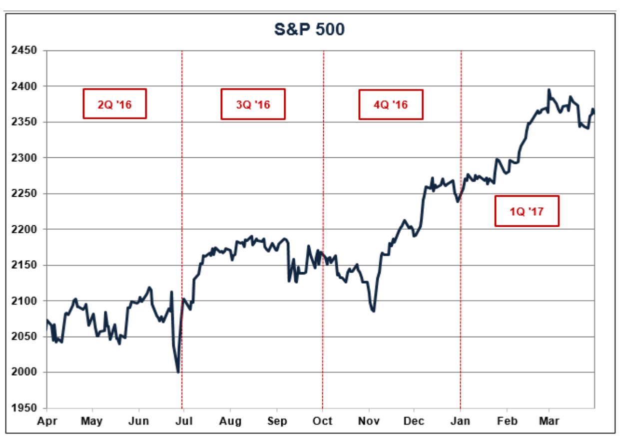
ECONOMIC & MARKET REVIEW

First Quarter 2017

The U.S. equity market (S&P 500) returned 6.07% for the first quarter of the year, impressive given the political/economic headwinds during the quarter. Bonds (Barclays Aggregate) managed a modest 0.82% return, equally impressive considering the Federal Reserve hiked rates again during the quarter. The best performance came from emerging markets, (MSCI Emerging Markets), up 11.49%.

First Quarter and Trailing 12 Months Performance

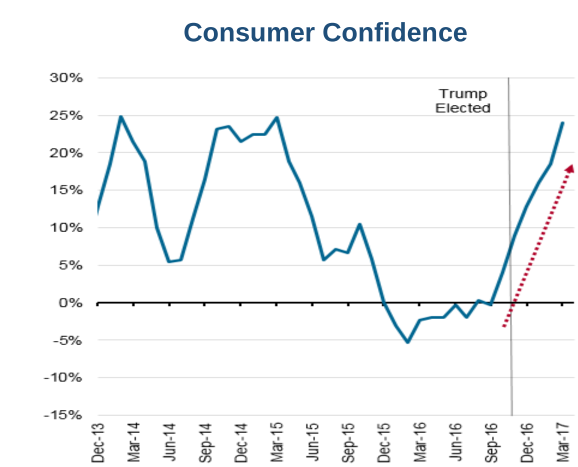
	1st Quarter	Last 12 Months
S&P 500	*6.07%*	*17.17%*
Russell 2000	*2.47%*	*26.22%*
Barclays Agg.	*0.82%*	*0.44%*
MSCI EAFE	*7.39%*	*12.25%*
MSCI EM	*11.49%*	*17.65%*



Source: FactSet, Cavanal Hill Investment Management. As of 3/312017.

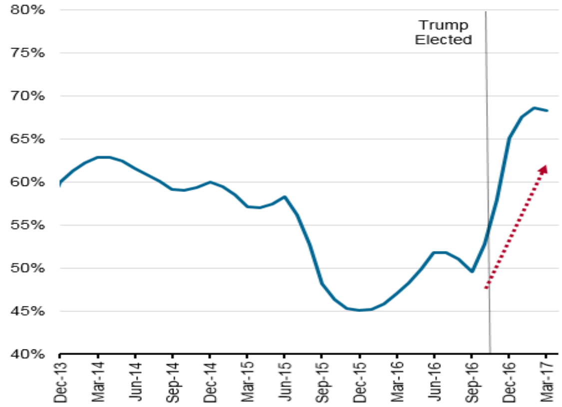
The quarter was chock full of information, political turns and economic surprises.

On March 15, 2017 the Federal Reserve announced a rate hike of 0.25%. This is the third rate hike of this cycle, following the first in December 2015 and the second in December 2016. Beginning 2017, the market fully expected the pace of rate hikes to pick up, but I don't think most expected it to happen before the end of the first quarter. However, as economic news was released during the quarter it was clear the economy was on solid footing, leaving the window open for a rate hike. By the time the first Fed meeting of the year took place in March, the market fully expected another tightening. Minutes from the March Fed meeting indicated the central bank would expect to raise rates three times per year from 2017-2019. If we are going to see that much tightening over the next few years, you would expect to see both short and long term rates begin to move higher. Indeed, rates have moved up some, however, the 10-year Treasury note dropped in yield by 24 basis points following the Fed's March rate hike announcement. Economic growth has been slow over the quarter. The first quarter has a history of being the slowest quarter of growth. What has changed since last November is a significant increase in consumer and business confidence.



Source: Conference Board, FactSet, Cavanal Hill Investment Management. As of 3/31/2017.

Business Confidence



Source: Conference Board, FactSet, Cavanal Hill Investment Management. As of 3/31/2017.

This is what is known as soft data. Confidence and sentiment surveys give a realistic look at how businesses and consumers feel about current conditions. Hard data would be economic statistics, which report actual collected results. So the question today is: will the impressive improvement in soft data lead to an improvement in economic activity? I think it will, as I would much rather have consumer and business confidence improving than declining. Economic realities though are that growth has been very slow, and engineering a better environment will require a combination of tax cuts, repatriation, reduced regulation and an infrastructure program. The Republican administration and Congress chose to attempt a repeal and replacement plan for the Affordable Care Act as their first goal. They failed. That failure has raised doubts about their ability to debate and enact all of the important and market friendly plans I just outlined. The run-up in equity prices post the Presidential election was based in part on addressing these issues. To the extent they are postponed or watered down, or simply don't get passed, the market will be disappointed.

Equity valuations are fully priced. I don't mean that as a warning of a serious setback that is about to occur, just an observation of reality. But overall equity valuations are a collection of, in the case of the S&P 500, 500 individual stocks. Some stocks are very highly priced relative to any kind of valuation metric, but many are not. This is the point at which stock picking brings value. So, making a broad judgment that the whole market is overvalued is too simple. Bond yields have moved up slowly, reflecting modestly higher inflation. I just don't think economic growth will be fast enough to generate significant inflation. So, gradual increases in interest rates, that reflect the modest growth in the overall economy seem likely to me.

Finally, the world is no longer a place where growth can only be found in the United States. We are in a synchronized global expansion. Little to no growth in Europe and Asia has led to U.S. interest rates being lower than they might have otherwise been. Growth in multiple areas of the world should lead to a more normal-looking recovery. The President has espoused what I think are pro-growth policies. Employment, which is the most fundamental of all economic statistics, is robust. So, I see the glass as half full, fully recognizing this will not be a smooth ride.

Jim Huntzinger
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April 1, 2017

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All data presented is as of 3/31/2017, unless otherwise noted.