Outlook 2018

IT AIN'T OVER 'TIL IT'S OVER

Macro Strategy and Domestic Equities

by George W. Hosfield, CFA
Principal and Chief Investment Officer

Stocks not only ascended to record highs in 2017, but given the volatile political/media environment, they did so with surprisingly little volatility as U.S. blue-chip stocks rose each month last year for the first time ever. The U.S. economy enters its 10th consecutive year of growth amid a deregulatory push that has boosted business confidence. Furthermore, this "later-innings" push domestically has been joined by an increasingly synchronized expansion abroad, where investors have benefited from faster economic growth in Europe and healthy expansion in a growing number of emerging market countries.

Continued U.S. job growth has resulted in a full employment economy, but a "shadow" labor market and the positive forces of globalization and internet commerce have helped to contain wage growth and inflation. As noted MIT Economist Rudi Dornbusch once observed, "None of the post-war expansions died of natural causes, rather, they were 'murdered' by the Fed while attempting to fight inflation."

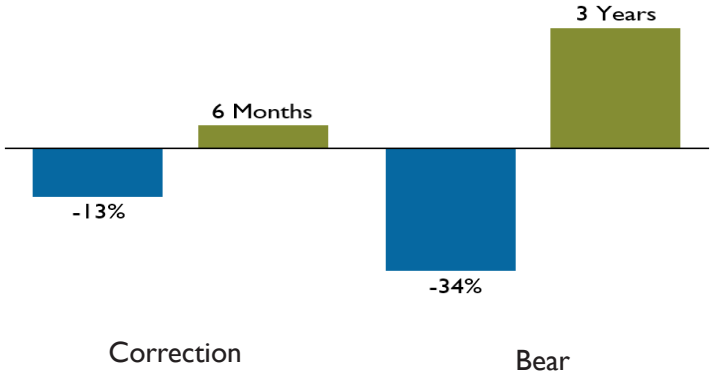
While we remain vigilant about the potential for faster inflation, with the Fed's preferred gauge of prices notably below its 2 percent objective, the U.S. central bank currently has no motive for murder. Accordingly, we expect the Fed to maintain a measured pace of interest rate hikes designed to remove extraordinary stimulus.

For bond investors, we see 2018 delivering a coupon-minus return environment envisioned a year ago. Stimulus from tax cuts is likely to provide the economy a boost that could sustain or improve upon recent quarters' 3-percent-plus growth. In a potentially higher growth environment, benchmark 10-year Treasuries could start to price in higher projected inflation.

With interest rates trending higher, next year more than ever equity returns will be dependent on earnings growth. Although valuations are elevated, equity investors stand to benefit from further economic expansion and lower corporate tax rates that together could result in another year of double-digit-earnings growth. We have never experienced a "bear market" in a year in which corporate earnings have increased. As the accompanying chart portrays, there is a huge difference in severity and recovery time between a correction and a bear market. Though we are certainly overdue for a market correction, given the favorable economic and earnings backdrop, we do not believe a bear market is in store for 2018. As alluded to by the title of this piece, we still foresee making money in stocks this year, particularly in our overweighted sectors of energy, financials and industrials.

Hold the Correction, Sell the Bear

Average Decline and Time to Recover Losses



Source: FactSet

Our "neutral" investment stance remains across asset classes, but we recognize the international equity game is still in early innings and thus one to potentially add to at some point in 2018. Finally, we are allocating to alternative investments in "real" assets, such as timber and agricultural land, which both provide attractive cashflow while possessing a muted correlation to stocks and bonds.

OUR 2018 INVESTMENT OUTLOOK PRESENTATIONS

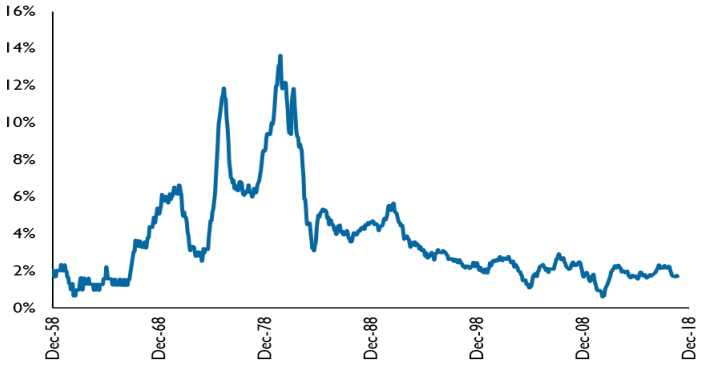
01/30 Boise, Idaho
01/31 Twin Falls, Idaho
02/06 Portland, Oregon (West Bearing)
02/07 Spokane, Washington
02/13 Vancouver, Washington
02/15 Portland, Oregon (Ferguson Wellman)
02/21 Seattle, Washington
02/27 Eugene, Oregon
02/28 Corvallis, Oregon
03/01 San Francisco, California
03/06 Palm Springs, California
03/08 Medford, Oregon
03/13 Bend, Oregon
03/15 Salem, Oregon

FIXED INCOME

by Marc Fovinci, CFA, Principal
Fixed Income Strategy and Portfolio Management

In the kitchen ... by Jerome Powell ... with the knife! While no "murder" has yet been committed, we already know the perpetrator and the weapon. Historically, economic expansions have not died of old age. Rather, they have been 'murdered' by a Federal Reserve raising interest rates while attempting to contain inflation. At present, core consumer price index inflation is mired below the 2-percent target desired by the Federal Reserve. As such, there is no reason to use the "knife" of several successive rate hikes to inadvertently kill the economy while attempting to restrain inflation. Though the Fed hiked rates three times in 2017, the current Fed funds rate of 1.5 percent is not enough to choke off the economy. It would take many more repeated "hits" to materially slow the economy. In February, Jerome Powell is expected to succeed Janet Yellen as chair of the Board of Governor of the Federal Reserve. Having already served five years on the Board of Governors, little change is expected from Powell in the direction of Fed policies.

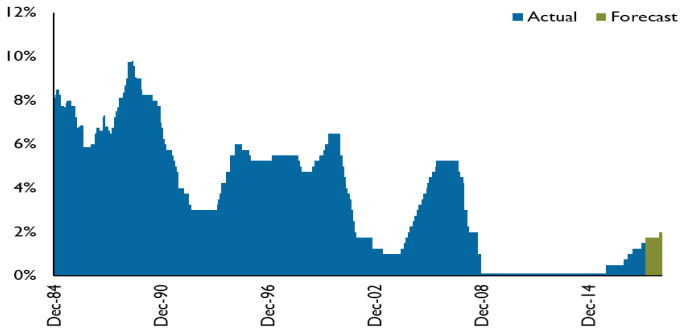
Struggling Toward Two Percent
Core CPI Inflation Year-Over-Year



Source: Bloomberg

Long-term interest rates were range-bound in 2017, with the bellwether 10-year U.S. Treasury bond ranging from a high of 2.6 percent in March to a low of 2.1 percent in September. A slow-and-steady economy and nonaccelerating inflation have provided little reason for rates to go up. The Fed funds hikes in 2017 have been due to the Federal Reserve's desire to "normalize" monetary policy and not an effort to contain inflation. As such, most Fed watchers would agree that the Fed is still "easy" and not "tight" in their interest-rate target.

The Weapon
Federal Reserve's Target Fed Funds Rate



Source: Bloomberg,

So far, the slow-and-steady economy has done well in creating jobs without fueling inflation; but as we move forward, inflation is key to watch. At some point, the growing demand for goods and labor will make inflation move faster, moving long-term interest rates higher and giving the Fed motive to raise the Fed funds rate at a faster pace. We do not see this yet; however, the passing of the tax package by Congress will make that point arrive a bit more quickly as the policy changes should add about 0.5-to-0.8 percent to 2018's economic growth.

Given the current economic momentum, both domestically and internationally, we see no recession on the horizon. As we get occasional upticks in inflation, interest rates should nudge modestly higher as the year progresses, with long-term interest rates up perhaps only 0.3 percent or 0.4 percent by year-end 2018. Our expectation of a very slow grind upward in interest rates leads us to keep portfolio average maturities and average durations lower, but still tight to benchmarks. With economic growth intact, if not a bit faster due to stimulus, the underpinnings to the corporate bond market are strong and we continue to maintain an overweight to corporate bonds.

While we remain vigilant in watching for signs that Fed Chair Powell is reaching for the "knife," we suspect that it might be some time in coming.

MUNICIPAL BONDS

by Deidra Krys-Rusoff, Senior Vice President
Tax-Exempt Trading and Portfolio Management

In a similar fashion to Treasuries, the municipal bond curve flattened throughout 2017, with one-year bond yields climbing 25 basis points from 01.00 percent to 1.25 percent and 30-year yields dropping from 3.08 percent to 2.70 percent. As the Federal Reserve continues to raise rates and economic activity gains momentum, we anticipate a parallel shift in rates in the year ahead.

Last year, we wrote about how the change in leadership in Washington, D.C., might impact the municipal market. Tax reform remains key among the probable shifts in the municipal market, containing repeals that create sweeping changes in the way state and local governments finance capital projects.

Congress passed the Tax Cuts and Jobs Act, which repeals advance refundings of municipal bonds. Advance refunding of municipal bonds is a process similar to refinancing your mortgage: if a municipality can refinance an existing loan for a lower rate, it can issue new bonds for the same project and refund the old bonds with the new proceeds. Proposed caps to state and local tax exemptions may also impact the market by increasing demand for tax-exempt income, increasing the demand for municipal bonds in high-tax states. These repeals are proposed to help Congress pay for the corporate and individual tax relief.

The final tax package may decrease overall municipal bond issuance by 15-20 percent. This has motivated many municipalities to move planned bond sales forward from January and February, while these bonds are still federally tax-exempt. The large, unexpected additional supply has served to lower prices and increase yields. This will be followed by significantly decreased issuance in January and February, which should result in higher prices and lower yields.

The effects of the tax reform package lead us to believe that municipal bonds will remain well-bid, and that continued economic growth will serve to modestly cause municipal yields to rise across the curve.

REAL ESTATE INVESTMENTS

by Brad Houle, CFA, Executive Vice President
Fixed Income Research and Portfolio Management

With interest rates persistently low, commercial real estate is not an undiscovered asset. We are seeing this because many commercial real estate projects rely on debt financing and interest costs can be impactful on the profitability of such projects. Additionally, in a world that is starved of yield, commercial real estate is an income-producing asset that is sought-after in this current environment.

The fundamentals of most categories of commercial real estate remain healthy in the United States even though rent growth has recently slowed from its previous torrid pace. Two factors that heavily influence how commercial real estate performs is demand and new supply. While there are pockets of potential excess in certain markets, the supply of new commercial real estate is muted on a nationwide basis at this point in the economic cycle. This lack of new supply is exacerbated by lending conditions that have tightened compared to the previous economic cycle, which was caused by an increase in regulation following the financial crisis.

Demand is noticeably weak in the retail space with some secondary malls struggling as well as street-level retail in places like New York. Factors that are driving this dynamic are the shift of consumer preference to online shopping and the fact that rent growth for street-level retail space has grown much faster than the sales of the renting retailers. Conversely, industrial real estate properties, such as distribution centers for e-commerce, are in great demand with strong rent growth in many areas. Internet retailers, such as Amazon and Wal-Mart, need fulfillment centers to be able to deliver goods on the same day, or even next day, to consumers.

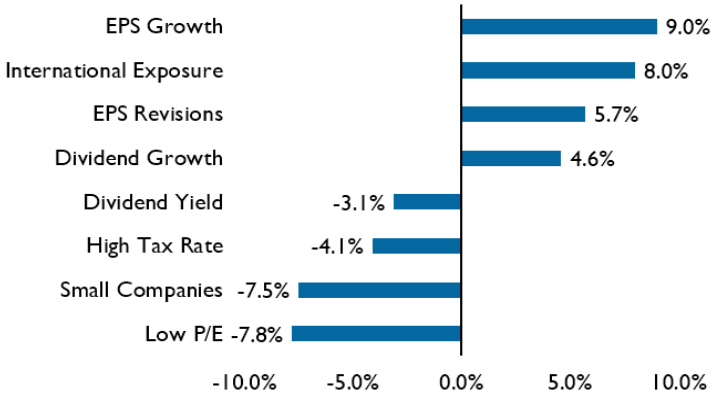
Versus Capital Real Estate Income Fund has been the primary vehicle we have employed to gain private real estate exposure for clients. This fund has been meeting our return and volatility expectations. Versus Capital is an innovator in their space in that it is one of the first mutual fund companies to offer exposure to private real estate in an investment vehicle that is accessible to many investors. Private real estate gives investors a coupon return that closely mirrors the risk and return characteristics of real estate as opposed to publicly-traded real estate investment trusts (REITs), which can be more volatile.

DIVIDEND VALUE

by Jason Norris, CFA, Executive Vice President
Equity Research and Portfolio Management

With the expectation of a pickup in global economic growth in 2018, we positioned our holdings for rising interest rates, as well as a tilt to those sectors that would benefit from global growth. Therefore, we reduced our exposure to those sectors with higher yields, namely staples, utilities and telecom, while focusing on those sectors that should benefit from rising rates and global growth. This would include financials, energy, industrials and technology.

RELATIVE PERFORMANCE TO THE S&P 500



Source: Credit Suisse

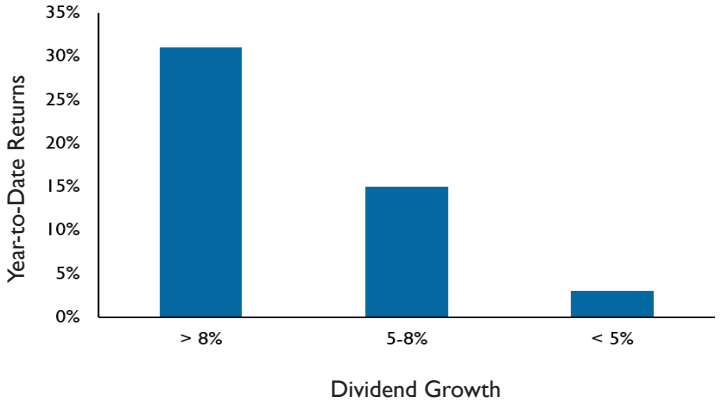
What surprised us in 2017 was the strength in growth stocks, where value names continued to lag. The chart above highlights this phenomenon.

Equities with attributes that tilted to growth did meaningfully better than the S&P 500. Earnings growth, earnings revisions and dividend growth factors all led to outperformance. Stocks with higher dividend yields and low price-to-earnings ratios were a headwind for investors.

Fortunately, we positioned the portfolio to focus more on dividend growth and less on yield. For instance, at the beginning of 2017, the dividend yield on the strategy was roughly 3.5 percent. At the end of November, it was 3.1 percent. What we've given up in absolute income, we hope to make up for in dividend growth. The estimated dividend growth rate for the strategy at the beginning of the year was 5-to-7 percent. As of the end of November, the estimated growth rate for 2018 is just under 10 percent. All but two positions in the strategy are raising their dividends in 2018. The chart below highlights the performance of stocks that have raised their dividends. Equities with growth above 8 percent delivered 30-percent returns while stocks that increased dividends less than 5 percent were up ... less than 5 percent.

One of the main catalysts in boosting the dividend growth rate is the rollback of capital restrictions in the banking sector. We are starting to see meaningful dividend increases in the sector as banks are able to use their excess capital they've accumulated since the financial crisis and deploy that to buybacks and dividend increases. The absolute yield of many of these names is still relatively low; however, with double-digit growth rates, income to investors will continue to increase.

DIVIDEND VALUE STOCKS: YEAR-TO-DATE RETURNS



Source: FactSet

With the Federal Reserve likely raising rates through 2018, as well as economic growth pushing longer-term interest rates higher, strategies focused on high-dividend yield may lag as interest rates rise. Our focus on yield and growth should result in continued long-term value appreciation and income growth that our clients are seeking.

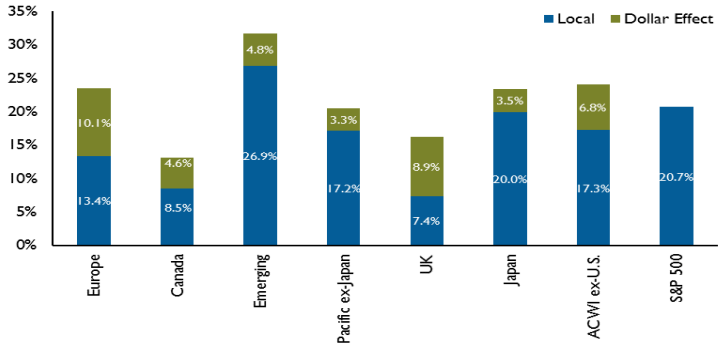
INTERNATIONAL EQUITY

by Ralph Cole, CFA, Executive Vice President
Equity Strategy and Portfolio Management

The synchronized global expansion kicked into high gear in 2017. The Organization for Economic Cooperation and Development (OECD) tracks 45 different countries, which all grew in 2017, and 33 of these countries grew faster than the previous year. This was the largest number of countries with accelerating growth since 2010, which we found somewhat surprising nine years into an economic expansion.

Accelerating growth around the world led to improved earnings and strong stock markets globally. International returns were led by small-cap international stocks, up 30 percent, and emerging markets. While U.S. growth continued at a steady pace, the economic improvement overseas led to stronger currencies abroad and a weaker dollar. One of the benefits of international investing is diversification away from dollar-based assets as depicted in the chart below.

GLOBAL EQUITY RETURNS



Source: FactSet

We believe that international equities have room to grow, even after such a strong 2017. Because stock prices grew with earnings last year, valuations outside of the U.S. remain compelling.

Central banks are playing a key role in the continued growth in both Europe and Japan. While the Fed is slowly shrinking its balance sheet, the ECB plans to purchase $30 billion in assets-per-month, down from $60 billion, through September of 2018. Japan will also continue with its quantitative easing program into 2018, which should support economic growth in the developed world in the coming year.

While central banks have supported the recovery in developed economies during the expansion, both India and China have benefitted from strong leadership within their governments. Narendra Modi in India and Xi Jinping in China both solidified their power in 2017, which reduces the uncertainty for both economies in the coming years.

With Prime Minister Modi's leadership and favorable demographics, India is our favorite international market for the long term. Modi has implemented some of the most aggressive reforms of any leader in recent years. The digitization of India has a goal of formalizing and financializing the Indian economy. Much of the Indian economy took place in the "shadow" economy, meaning cash-only transactions that were not taxed nor properly tracked. In 2016, India took the initial step of demonetizing all 500- and 1,000-rupee notes. You could exchange the notes for new tender or they simply became worthless. Once this was accomplished, Modi implemented a value-added tax. This led to a two-pronged benefit for the government: an increase in transactions taking place in the regulated economy and the government collecting taxes more efficiently and fairly.

While we are not overly fond of Chinese-style capitalism, we appreciate what the country has been able to achieve over the past couple years. We believe growth will continue to slow in the coming years, but the drivers of growth will be dramatically different. Historically, state-owned enterprises (SOEs) were the leaders of China's economy. These SOEs focused in areas such as metals, energy and chemicals. Today, new leadership is emerging in China in the form of technology and alternative energy. China continues to open its markets to the rest of the world and we think there will be opportunities associated with this transition.

We maintain our positive view on international markets. Two reasons we like international markets are valuation and growth prospects in emerging markets. Also, international stocks have significantly underperformed the U.S. markets since the financial crisis, which could mean there is relative opportunity going forward.

ALTERNATIVE INVESTMENTS*

by Dean Dordevic, Principal
Alternative Assets and Portfolio Management

The "Asset Class of the Year Award" definitely goes to public equities. Both domestically and abroad, the public markets rallied providing a tailwind for hedge funds and private equity. Though returns this year showed improvement over past years, the success of liquid public markets kept our firm reserved in our allocation to alternative investments. We continue to search for and vet new partners in private debt and equity, hedge fund and real estate for inclusion in select client portfolios.

Below is a brief summary of the offerings that we have chosen to participate in as of December 2017.

PRIVATE EQUITY

The Partners Group is a globally diverse evergreen private equity fund-of-funds. The portfolio is diversified across transaction types, regions and vintage years. The evergreen nature of the fund allows select clients to be fully invested in private equity. The Partners Group is a core private equity solution.

Keystone National Private Equity Funds II, III, IV, V are primarily distressed, credit-oriented private equity funds. Funds III, IV, and V have returned all committed capital. All funds are out of their investment periods and are now returning cash at a steady rate.

Vista Ridge Diversified Fund is a traditional private equity fund-of-funds. The portfolio has been fully committed and self-funding since 2011. Vista Ridge has achieved extremely strong returns on invested capital and continues to return capital at a steady pace.

HEDGE FUNDS INVESTMENTS

Ironwood Multi-Strategy Fund is a multi-strategy fund of hedge funds believing that a portfolio of market-neutral and market-uncorrelated investment strategies offers great potential for long-term investment success. Ironwood focuses on managers with strong operations who invest in historically uncorrelated strategies, such as relative value, event-driven, market neutral and low-net equity, distressed and credit securities and various arbitrage-based approaches. The Ironwood Multi-Strategy Fund is a core hedge fund solution.

The Asius Fund is a fund focused on China, India, Korea and Southeast Asian (ASEAN) countries. This fund gives unique access to local managers in these respective markets. Nearly three-quarters of the fund are invested in China and India to benefit from the economic rebound in India. The Indus Fund is a fund focused on India specifically. It constitutes 35 percent of the Asius Fund and was a significant contributor to returns this year.

Millennium International Management is a market-neutral multi-strategy product structured around proprietary trading teams grouped into three main core strategies: relative value equity, statistical arbitrage and fixed income and a focus on liquid instruments. The firm employs uniquely restrictive portfolio and risk parameters. This fund is currently closed to new investors.

REAL ASSETS

Versus Capital Real Assets Funds are designed to serve as a core allocation to institutional-quality real asset holdings. The fund provides exposure to private infrastructure, farmland and timberland. A majority of the fund is invested in private institutional funds while the remainder employs liquid public investments.

**Alternative investments may not be appropriate for all investors. The appropriateness of an investment or strategy will depend on the investor's circumstances and objectives.*