Kayne Anderson Rudnick
Investment Management

Market Review

Third Quarter 2017

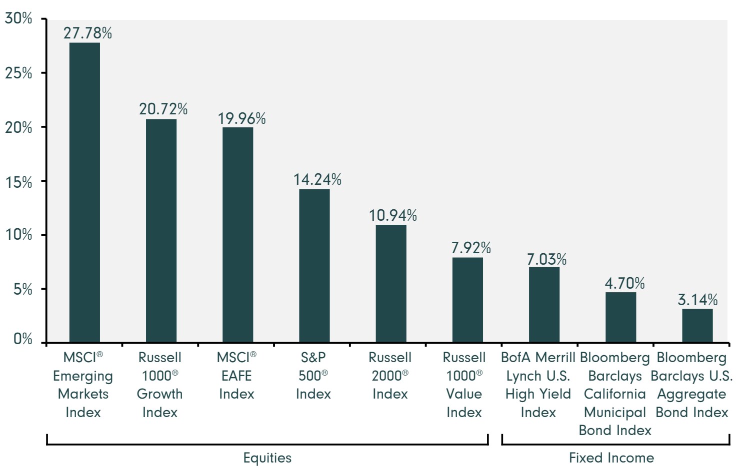
Is "Trump Trade" Back?

Stocks continued to march higher in the third quarter driven by low inflation, benign interest rates and improving global earnings. The S&P 500 Index advanced 4.48% for the quarter, bringing the year-to-date return to 14.24%. Small stocks, as measured by the Russell 2000 Index, did slightly better in the quarter relative to large-cap stocks advancing 5.67%, but are still trailing for the year-to-date, with a return of 10.94%. Despite some improvement in September, value stocks continued to lag growth stocks for the year-to-date with the Russell 1000 Growth Index up 20.72% versus the Russell 1000 Value Index advancing only 7.92%. International stocks performed even better than the S&P 500 with the MSCI EAFE Index advancing 19.96% year-to-date. Emerging market stocks have been the real standout thus far in the year, appreciating 27.78%.

Bonds continued to advance modestly in the third quarter with the Bloomberg Barclays U.S. Aggregate Bond Index up 0.85%, bringing the year-to-date return to 3.14%. California municipal bonds advanced 1.03%, bringing the year-to-date return to 4.70%. Credit, as evidenced by high yield returns of 2.02% for the quarter and 7.03% for the year-to-date, has continued to perform well. There was virtually no change in the 10-year U.S. Treasury yield during the quarter (2.30% as of June 30 versus 2.33% as of September 30).

Index Performance

Year-to-Date Ending September 30, 2017



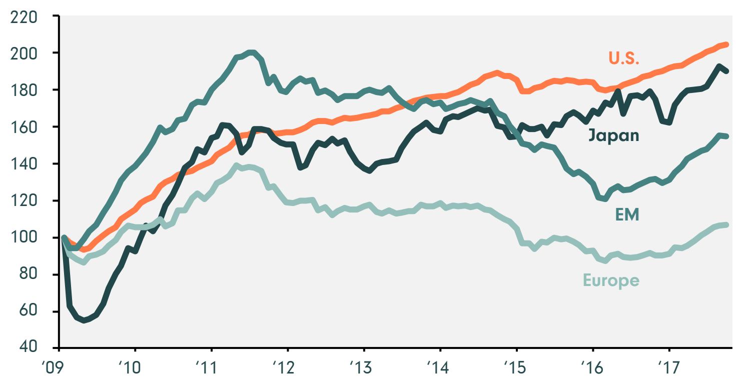
Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

Global Recovery Progressing

The last 12 months represent the first time since the global financial crisis of 2008 that global earnings growth has been in a synchronized recovery. Europe, Japan and many emerging market countries were not showing a broader-based recovery until the last year (See chart: *Global Earnings*).

Global Earnings

EPS, U.S. Dollar, NTMA, January 2009 = 100

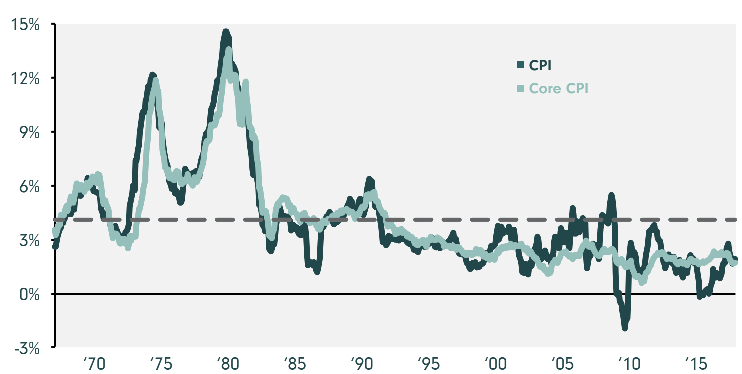


Data is obtained from FactSet Research Systems, MSCI, Thomas Reuters, Standard & Poor's and J.P. Morgan Asset Management and is assumed to be reliable. Past performance is no guarantee of future results.

Normally with this type of earnings growth, especially late in the business cycle, we would expect significant upward pressure on interest rates globally. However, many central banks (including in the U.S.) are still operating below targeted inflation rates. This has allowed the central banks more time to ponder or put off future interest rate increases. Inflation seems well-controlled overall due to lower energy production costs (particularly shale oil) and intense global competition from disruptive technologies in a variety of industries (See chart: *CPI and Core CPI*). In an environment of improving global earnings and tame interest rates, it would be unusual for equities to not do well.

CPI and Core CPI

% Change Versus Prior Year, Seasonally Adjusted



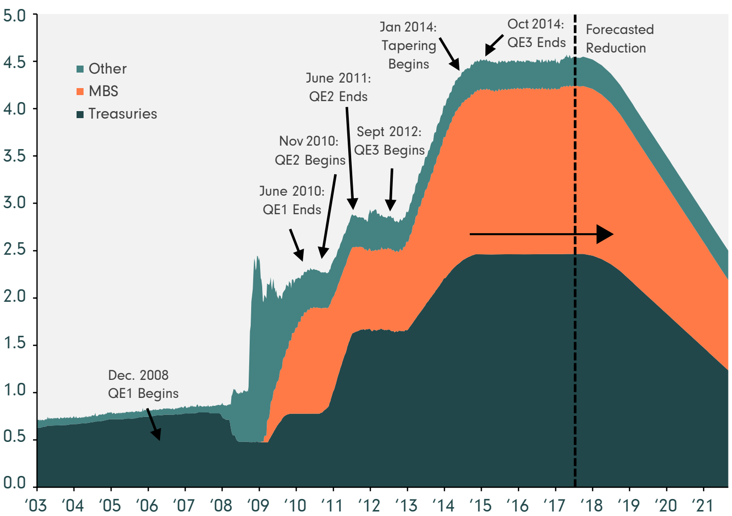
Data is obtained from FactSet Research Systems, BLS and J.P. Morgan Asset Management and is assumed to be reliable. CPI used is CPI-U and values shown are % change versus one year ago. Core CPI is defined as CPI excluding food and energy prices.

Continued on Page 2

The U.S. Federal Reserve has telegraphed its intention to start shrinking its balance sheet gradually and raise short term rates one more time in December (See chart: *Fed's Balance Sheet*). The Fed is simply attempting to move back to a more normal monetary policy stance and is not trying to engineer a major slowdown. Many so-called macro investors fear this slowdown in stimulus, but we believe the economy can absorb these events without any major difficulties.

Fed's Balance Sheet: Assets

(Trillions)



Data is obtained from Strategas and is assumed to be reliable. Past performance is no guarantee of future results.

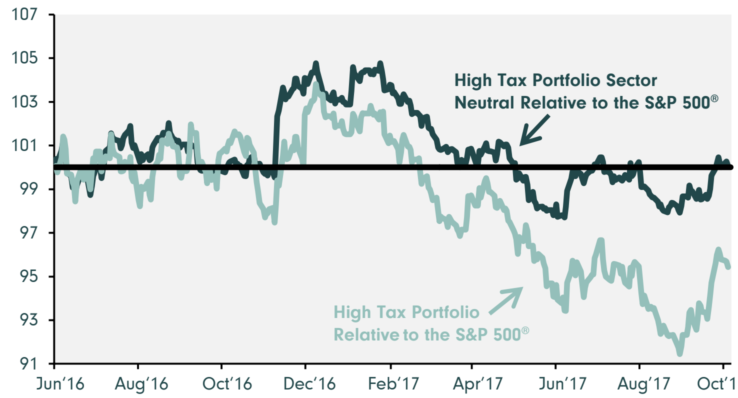
Trump Trade 2.0

The so-called "Trump Trade," which has been dead all year, started to come back over the last three weeks of September. Since the Obamacare repeal failed, the Trump administration and Congress have pivoted towards tax reform. This has created some budding optimism that tax reform could occur before year end or early next year. We are not so sure given both Trump and Congress's inability to get anything done. However, if meaningful reform is accomplished over the next year it should have a positive impact on many high tax-paying companies and many large multinationals with billions of cash currently trapped overseas (See chart: *High Tax Portfolios Relative to the S&P 500®*). Merger and acquisition activity has slowed this year, as many corporate boards await tax reform before undertaking any significant deals. This will surely accelerate if repatriation actually occurs. Early estimates show that the S&P 500 could benefit 5% to 15% in overall earnings growth if tax reform passes.

Market Outlook

On balance, the outlook for equities continues to be favorable. Any meaningful uptick in inflation caused by either higher energy prices or significant wage growth is the principal risk in the outlook for the stock market. We will continue to monitor inflationary trends closely over the next couple of years. Geopolitical events, such as hurricanes and tensions with North Korea, have taken a back seat to the improving global earnings outlook so far this year. With the stock market at all-time highs, we believe it is important for clients to focus more than ever on their longer-term goals and risk tolerance, as market corrections can and do occur frequently even in bull markets. With such unpredictability, we recommend that clients do not try to time the market, as most often investors fail severely in this endeavor and hurt their returns.

High Tax Portfolios Relative to the S&P 500®



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Douglas S. Foreman, CFA
Chief Investment Officer
Douglas S. Foreman, CFA is Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 31 years of investment experience.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Growth Index is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Value Index is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. The MSCI® Emerging Markets (EM) Index is a free-float adjusted market capitalization index tracking the equity performance of global emerging markets. The Bloomberg Barclays U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The Bloomberg Barclays California Municipal Bond Index is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more. The Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.