TRILLIUM | Economic and Market Outlook

June 30, 2016 (2nd Quarter)

The U.S. economic outlook is stronger than current market sentiment and bond yields indicate. U.S. economic growth continues to be solid, even if slow. Job creation is slowing, as would be expected as the economy nears full employment; the current unemployment rate of 4.9% is the lowest since 2007. We are slightly less positive about anticipated equity returns than in prior quarters, due to the higher level of uncertainty resulting from the Brexit vote, and our concerns about the persistent low inflation, low interest rate, and low growth environment. However, we still regard the U.S. stock market as attractive relative to bonds, cash, real estate, or other developed stock markets. The current expected earnings yield on the S&P 500 is 5.1%, while the yield on the 10 year Treasury Inflation-Protected Securities, or TIPS, is -0.1%, indicating an approximately 5.2% greater expected return for large capitalization U.S. stocks than for bonds. Despite the market turmoil following the United Kingdom vote to exit the European Union, U.S. markets reflect less concern about recession now than was witnessed in January and February, and U.S. markets do not show signs of severe financial stress.

A PERSISTENT STRUCTURAL PROBLEM OF SLOW GROWTH AND GROWING INEQUALITY

The past three months brought a rising tide of ugliness and rising hostility directed at those perceived as "other," including Donald Trump's calls for racism, nativism and the construction of The Wall; Omar Mateen's murder of 49 people at the Pulse nightclub in Orlando; police shootings of black men Philando Castile and Alton Sterling; or the Dallas sniper who killed five police officers in a coordinated shooting.

> Due to the heightened level of political risk in the wake of the Brexit vote, we do believe that we will see lower long-term interest rates for a longer period than we had previously expected.

Both Donald Trump and the British Leave campaign have exploited concerns and resentment about perceived unfairness — that good, deserving, ordinary "folks like us" are being left behind and that others are somehow reaping undeserved benefits. These appeals to resentment are effective because they tap into a reality of persistent and rising income and wealth inequality. In a classic use of demagoguery, the resentment is turned against others competing for the same small slice of the pie, rather than against the beneficiaries of rising inequality. Longer term, continued uneven distribution of income and wealth will restrain economic growth and stock market returns as stagnant family incomes do not support robust consumption.

On June 23, English voters exploded conventional political expectations, by voting to exit the European Union, and catalyzed an investor flight to perceived safe assets. The campaign to Leave wasn't so much about Europe as it was about austerity and inequality, nationalism, immigration, and nativism. The vote exposed sharp regional and generational differences, with Scotland, Northern Ireland, and younger citizens voting to remain, while England and older citizens strongly favored exiting. The immediate tangible effects on British employment and GDP growth will come through the 11% drop in the value of the British pound, which will make imports more expensive, and through multinational firms' decisions on where to locate offices and production facilities, which will be increasingly moved away from Britain. Post-vote consumer and business confidence surveys are already showing big declines. Longer term, negotiations between the U.K. and the European Union will determine the impact on exports; 44% of U.K. exports go to the European Union and will be affected by changes in the tariff regime.

Worldwide, investors' instant reaction was strongly negative. Investors immediately bought up perceived safe assets such as U.S. Treasuries, Japanese yen, the U.S. dollar, and gold, and sold the British pound and stocks worldwide. Over the next two weeks, U.S. stock prices largely recovered, but the drops in interest rates, European stock markets, and the British pound persisted, as did the increases in the value of gold, the dollar, and the yen.

Ultimately, the vote to Leave will not improve regional disparities in growth, whether within or between nations,

nor will it improve the personal wealth and security of those who feel they have been left behind. More likely, the vote will increase economic stagnation and heighten social and economic instability. Both the Brexit voters and growing responses to populist rhetoric both in the United States and in Europe highlight the pressing need to address this growing income gap. We need to find a way to do this that unites rather than divides.

STRONG SIGNALS

The flight to "safe haven" assets since the Brexit vote indicates widespread fear and anxiety. Record low interest rates for sovereign debt send a strong signal of expected slow growth and deflation ahead, while the 25% increase in the price of gold year-to-date signals either inflation or fear of worldwide financial collapse. We expect neither imminent financial market collapse nor rampant inflation, but due to the heightened level of political risk in the wake of the Brexit vote, we do believe that we will see lower long-term interest rates for a longer period than we had previously expected. Central banks, including the European Central Bank, the Bank of England, and the Bank of Japan have all indicated a willingness to provide monetary easing to avoid financial panic and collapse. We expect that the uncertainty about the stability of the European Union generated by the Brexit vote will slightly decrease world economic growth, and may push the United Kingdom into a recession. Segments of the British economy that are strongly tied to the European Economic Union, such as the financial services sector and London real estate, will see even more profound effects.

SECOND QUARTER 2016 RETURNS

Small and Mid-Cap stocks outpaced larger stocks for the quarter. The Russell 2000 Index total return was 3.79% for the quarter, while the S&P 500 returned 2.46% and the S&P 1500 returned 2.59%. European markets fared less well, with the return for the MSCI Europe, Asia, and Far East (EAFE) index returning -1.23%. The MSCI All-Country World Index (MSCI ACWI) returns, for dollar-based investors, were +1.17% before foreign dividend taxes, and +0.99% net of these foreign taxes. The price of a barrel of West Texas Intermediate Oil recovered to $48, up 26% in the quarter. Our decision to position our equity strategies to reflect our economic outlook detracted from relative investment performance for the quarter, as investors sought safety, defensive positioning, and value, with returns for defensive sectors such as Energy, Utilities, and Telecommunications, returning 11.6%, 6.8%, and 7.1% respectively, far outpacing those of the more cyclically exposed sectors such as Information Technology and Consumer Discretionary, at –2.8% and -0.9%. Once again, the expected increase in short term interest rates did not materialize, and financial services stocks returned just 2.1% in the quarter.

VALUATION

Current valuations for U.S. stocks are neither excessive nor extremely attractive for the existing economic conditions. The Price/Earnings ratio for the next twelve months expected earnings is at 16.6x, slightly above the 25 year average of 15.9x. Looking at the Cyclically Adjusted P/E ratio (CAPE) proposed by Yale Economics Professor Robert Shiller, valuation is at 26x the average of the past 10 years earnings, right at the 25 year average of 25.8x. Interest rates are lower than they have ever been in the U.S.

POSITIONING

We continue to position our portfolios in companies we believe are high quality companies that are reasonably valued, with strong cash flows that offer the potential for dividend increases and for attractive risk-adjusted returns. Given our revised expectation that interest rates globally will be lower for longer, we are looking for opportunities to improve the dividend yield on our equity portfolios. Companies with strong balance sheets, strategic leadership in their products and markets, and strong environmental, social, and governance policies will have the financial flexibility and leadership wisdom to navigate choppy and volatile economic conditions. At the same time, we continue to address the structural issues facing the global economy with our corporate engagement and policy work on important issues such as corporate responses to climate change, the gender pay gap, and the need to pay a living wage. Overall, we believe that the global financial system will prove to be resilient and that the continuing economic recovery in the U.S. provides the time to address these structural social and economic issues.